



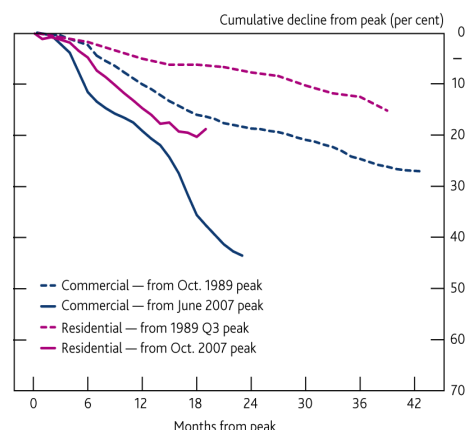
Searching for my compass

Markets have had a brilliant summer as sentiment has improved and participants have become more convinced about the durability of the recovery. This rally has continued in spite of the fact that the news continues to be mixed. Markets have reacted positively to good news and seemingly want to ignore most bad news. As we scan the papers, the term 'turning point' is featuring more regularly. This Globetrot attempts to explain which stage we have reached in the cycle and our forecasts for the next six months.

During August government bond prices rose substantially whilst stock markets and commodity prices also continued to increase. Investors are now prepared to tolerate more risk and this is confirmed by lower cash holdings. The fall in government bond yields across most markets indicates a residual caution and that quantitative easing was not the only factor at work. Government bonds prices and equities rarely move in the same direction for long periods and we expect bonds to buckle first.

Here in the UK, prime commercial property prices have risen and some of the housing price indices have improved. The downturn appears to have been shorter and sharper than last time. The flood of cheap money seems to be stabilising commercial property prices, but the current consumer caution will mean a gradual housing recovery.

Chart 1: UK Property Values



It is also clear that the massive fall in US residential property prices is abating, undoubtedly helped by the \$8,000 Federal Tax Credit for first time buyers as well as buy-to-let buyers taking advantage of the abundance of foreclosed homes. As a result the Case Shiller Index has now started climbing. The supply of mortgage finance has become less restricted and the strong recovery in volumes signifies that some buyers now consider that prices are close to the bottom. These higher sales have cut back the stock overhang, even though the number of loan holders who are more than a month in arrears with their mortgage payments has risen above 9%.

In spite of these payment difficulties and the big rise in credit card delinquencies, consumer confidence measures continue to improve, although in the US this has not yet translated into a consistent rise in the overall level of retail sales. The US consumer appears to be willing to spend a relatively fixed amount of their income on consumption. Consequently the sharp rise in vehicle sales as a result of the "cash for clunkers" programme meant that consumer spending in other areas was cut back.

Table 1: UK Housing market indicators

	Averages since 2000	2009			
		Apr.	May	June	July
Activity					
Mortgage approvals (000s) ^(b)	97	44	44	48	n.a.
RICS sales to stocks ratio ^(c)	0.39	0.15	0.20	0.22	n.a.
RICS new buyer enquiries ^(d)	-4	45	50	67	n.a.
HBF net reservations ^{(e)(f)}	-8	11	23	21	n.a.
HBF site visits ^{(e)(f)}	-15	4	4	1	n.a.
Prices					
Halifax ^(g)	1.8	-3.3	-3.1	-2.3	0.8
Nationwide ^(g)	2.0	-2.9	-0.3	1.0	2.6
Average of lenders' indices ^(g)	1.9	-3.1	-1.7	-0.6	1.7

Sources: Bank of England, Halifax, Home Builders Federation (HBF), Nationwide and Royal Institution of Chartered Surveyors (RICS) and Bank calculations.

Overall, most forecasters expect that unemployment will continue to rise in both the US and the UK. We expect that the official rate in the US will exceed 10% by early next year, since it has already reached 9.7%. Many more people have fallen off the list either because they have exhausted their benefits or are working part time as they cannot find a full-time job. Unofficial estimates suggest the level of people looking for full-time work is nearer to 16% than 10%.

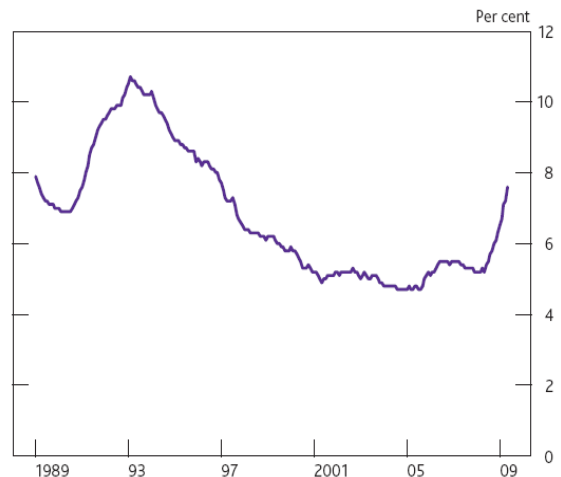
At the present time, average earnings are increasing by around 2-2.5% in the UK and US. In the UK this implies a nil real increase, but it equates to over 4% in real terms in the US given the recent deflation in the CPI. Certainly the bounce back in output following the deep fall seen in the two quarters to the end of March 2009 has been produced through higher productivity; not by an increase in man hours and with a minimal increase in employment.

US productivity in the second quarter was 6.6% ahead of the previous quarter, the largest increase since 2003, and unit labour costs were down by 3.9% over the same period. These statistics help to explain the reason that corporate earnings improved in the second quarter as increased turnover impacted profits directly.

Once the fall in the CPI reverses, real wages could fall and it is this factor which will stop the Fed increasing short interest rates until well into next year. Getting the unemployed back to work will of course be a key factor in driving any sustained global economic recovery.

Here in the UK, the second quarter recorded the fastest drop in capital investment since 1966. [Perhaps this bodes well for England's chances in the 2010 World Cup.] In the US, capital goods demand has improved on a superficial level, however a more detailed analysis of the constituents shows that the transport component has had a particularly strong influence. In both countries, construction activity remains subdued. Whilst the US building industry is seeing a modest upturn in volumes in the residential sector, both the UK and the US continue to see a rapid fall off in building activity in the commercial sector.

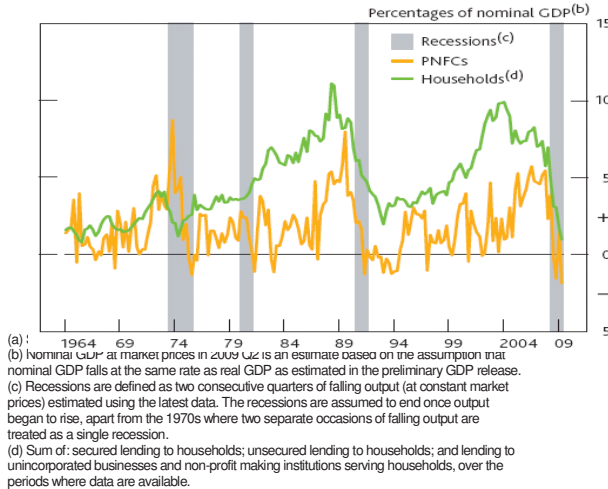
Chart 2: UK Unemployment Rate



Source: Labour Force Survey.

(a) Percentage of the economically active population. Rolling three-month measure.

**Chart 3: UK Net bank lending to PNFCs and households
 (Private Non-Financial Corporations)**



The chart implies that both the demand and supply of credit has contracted substantially

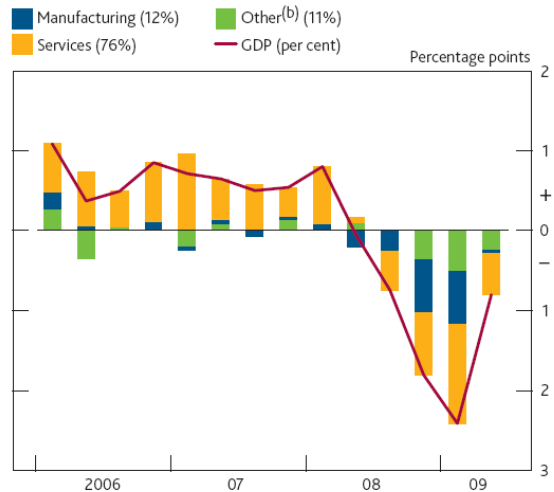
The Big Question; What next?

Following the severe falls in output and GDP for the six months to 31 March, the world economy has gradually thawed out and a more normal scenario seems to be emerging. In light of the sharp rise in the markets and given that the recovery is still clearly quite patchy, we are entitled to ask where markets go from here.

We need to try and understand the basis for the substantial change in sentiment. Markets are now less risk averse. They are looking across the valley of trough earnings and see that profits are already benefiting from the fact that labour rates are severely constrained. There will be a big bounce across the world from inventory replenishment during the second half of this year.

Cash for clunkers has spurred demand across the broad economy in the US and Europe. It is estimated that the auto industry is still responsible for a considerable slice of US GDP, whilst foreign manufacturers across the world have all benefited. China also continues to grow strongly and lending there has been storming ahead to the extent that the authorities are attempting to reduce loan volumes.

Chart 4: UK; Contributions to quarterly GDP growth



(a) Chained-volume measures. The GDP series is at market prices. Services and manufacturing are at basic prices. 'Other' is calculated as a residual. The figures in parentheses show shares in the level of nominal value added in 2007. Shares may not sum to 100 due to rounding. The chart shows data consistent with the Q2 preliminary GDP release. Production data were subsequently revised.

(a) Includes agriculture, mining and quarrying, electricity, gas and water supply and construction.

Nevertheless the effects of the recent plunge in activity will be with us for quite some time. In addition the massive policy response of both fiscal and monetary measures will need to be reversed at some stage. Fiscal adjustment will need to be quicker and more effective. Monetary reversal will be more gradual but could still have the effect of depressing activity.

All over the world the consumer stands in the centre of these opposing forces. If activity continues to move ahead then the central banks will raise interest rates next year. If this does happen, government revenues will benefit substantially from a sustained pickup in activity because the tax take will rise and the level of welfare payments will fall as the rise in unemployment starts to reverse.

Today it is not so clear cut that consumer spending will return to the levels seen in the last thirty years. Both the UK and US consumer will need to rebuild their savings for the next few years. In addition, the rate of increase in unemployment has moderated but these people are not being quickly re-absorbed back into the workforce. This fact is not lost on those who remain employed and serves to add to their caution.

Here in the UK, the 2.5% reduction in VAT will be reversed (or possibly increased to 20%) from 1st January 2010 and this will add to inflation. It is possible that we will see good Christmas sales as customers rush to buy goods ahead of the 2.5% re-instatement or a possible net increase. This will only bring forward possible 2010 demand to the final quarter 2009 and may hit retail sales quite hard in Q1 2010. The rise in fuel and food prices will hit the inflation numbers as the year draws to a close.

In the OECD capital is still triumphant and the workers are taking much lower compensation due to the downturn. Costs have been cut savagely across the world and most management teams elected to cut back on labour costs as soon as the outlook deteriorated. This has been a major factor in protecting or improving margins. Now that the various stimulation programmes are having a clear effect, many firms are seeking to expand output whilst refusing to increase numbers employed.

This more sombre outlook for employment - which will impede the pace of recovery - and the continued open market operations by the Central Banks have helped depress government bond yields in spite of the massive rise in issuance. Lately stock and bond prices have risen in tandem but we think bond prices will crack first. Once medium and long bond yields start to rise substantially the recovery will be confirmed.

What needs to change?

- Access to credit has stalled at helping the big players; overall it continues to decline. It must permeate to small and medium sized enterprises and consumers. These groups have suffered the most.
- Consumers need the “feel good factor”. At present they are still vigilant, only buying when larger goods and services are available at fire sale prices.
- Job creation needs to accelerate. Corporations still seem more willing to consider cutting than hiring and soon local and national governments will be joining in.
- Revenue growth needs to take over from cost cutting in driving the corporate earnings recovery.

The effects of the recent plunge in economic activity will be with all of us for quite some time. Governments have spent huge amounts to bale out corporations, keep workers in employment and boost their spending intentions.

2010 will be a hugely challenging year for the consumer whose spending accounts for up to two thirds of developed nations GDP. The rise in world trade suggests that life is beginning to return to normal, although the increase in protectionism in the US and in China is a worrying development.

As always investors are faced with difficult choices. We expect the following broad outline to occur which will prompt a number of investment decisions.

- 1) Quantitative easing/fiscal stimulus will continue for some time. This will bolster capital markets.
- 2) Commodity prices will continue to increase but with more volatility.
- 3) The housing market in the US will improve ahead of the UK.
- 4) Production will rise across the world.
- 5) Fewer jobs will be created than expected as companies cut costs further.
- 6) The SME sector and the consumer will suffer from the lack of credit.
- 7) The rebound in Chinese activity will continue.
- 8) Headline inflation will slowly increase as real capacity utilisation tightens.
- 9) Real wages will be squeezed as high unemployment reduces wage settlements.

These markets are riding a wave of optimism supported in part by extra liquidity supplied by the central banks. Currently they are pretty complacent and content to react to good news and ignore much of the bad news.

The biggest danger is to ignore the possible downside risks as many cyclical are valued on very optimistic assumptions; sometimes two years ahead. If the recovery falters; the stocks on optimistic valuations will be the first to be cut down like infantry at the Battle of the Somme. On the other hand experience has shown that one needs to be very clever to successfully bet against the power of the market.

Short term interest rates will remain low to encourage a durable recovery. Over time this will elevate the valuation of dependable income flows. If cash is not much use then the price of medium and high yield assets will rise as investors seek secure income flow. This confirms the renaissance in commercial property and real estate stocks.

Portfolio stance

Equities

- Stay long of equities but prepare for a bumpy 2010 when rate increases get much closer.
- We still see value high yielding defensive equities for 2010.
- Maintain a bias towards international mega caps.
- Increase the weighting in financials.

Bonds

- Despite the recent rise we continue to buy high yielding corporate bonds
- Lower government bond exposure into strength ahead of inflation scare.



Property

- Buy property (or property stocks) as the yields are still very attractive.

Cash

- Prepare to raise some cash towards the end of 2009.

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