



**Nigel Cuming**  
Chief Investment Officer

## Global Investment Review and Outlook 2009

In our last market review we suggested that whilst equity market conditions would remain volatile for the foreseeable future, we felt that the unprecedented governmental support that has been given to the global economies combined with attractive valuations would eventually win the day and that an equity market rally of some significance was likely. Our view remains unchanged. The increasing weakness of economic data over the quarter has prompted the global authorities to take increasingly decisive action. Global interest rates have been slashed, major stimulus packages have been announced and the Fed has embarked upon a policy of quantitative easing, flooding the markets with liquidity. Whilst deflationary fears will continue to mount in the immediate short term, these unprecedented policy measures will eventually kick start the global economies with a vengeance.

“Q4 2008 started in much the same way as Q3 ended...”

Q4 2008 started in much the same vein as the previous quarter had finished with mounting fears concerning the stability of the global banking system. Whilst the co-ordinated worldwide interest rate cut on October 8th was helpful, it was not until the UK government announced plans to inject up to £37 billion into banks, effectively part nationalising those that participated, that some semblance of normality returned. The ECB, whilst taking a more hawkish stance on interest rates, followed the UK's lead in guaranteeing interbank lending. In the US the \$700 billion rescue plan for the banks was eventually passed and equity markets rallied strongly for a short while.

“...perpetuating fears of systemic banking failure and economic decline”

November was also a bad month for equities where fears concerning the banking system were replaced by worries concerning the length and duration of the global recession. Interest rates were slashed as policy makers started to fear a savage slowdown and possible deflation. Indices of market volatility such as the VIX (see chart below) rose sharply, peaking towards the end of month. The chart encapsulates the extraordinary volatility that we have suffered from this year, peaking at around 90 in late October having been as low as 15. Another demonstration of this volatility is the fact that so far in 2008 the S&P 500 has made 44 daily moves of 5% or more, compared to a mere 34 times between 1950 and 2006.

“Bailouts and rescue packages may have calmed these fears, but equity markets have been ravaged by volatility”

**Figure 1: US Equity Market implied volatility**



“We continue to believe that conditions remain in place for an equity market rally this year...”

That said, the month ended with a strong global equity rally as the markets were bombarded with further fiscal and monetary initiatives. The US Treasury again proved imaginative with a plan to buy US\$ 700 billion of asset and mortgage backed securities and also announcing plans to guarantee US\$ 300 billion of Citigroup debt. In the UK a substantial package of public spending and tax cuts, worth about £20 billion, was announced. As this is being written there is a developing mood that markets are starting to form the base from which the long awaited rally can occur (see chart below).

Figure 2: US S&P forming a base in late 2008



Source: Bloomberg as at 15/12/2008

“...and we maintain our pro-equity stance as a result, adding to both our US and European positions”

On asset allocation we have maintained our pro equity stance and in fact increased exposure slightly after the bail out of the banking system in mid October. We took advantage of the slump in gold share prices and repurchased a fund we had previously owned at substantially lower levels than we sold it at. In November we addressed our underweight to European equities which had worked well for us and exposure was increased at the expense of Japan where the strength of the currency was a partial offset to the weakness of the market.

“That said, our underweight in government bonds has been a mistake, but threats of future issuance, the longer-term inflation outlook, and low yields mean that government bonds remain unattractive to us”

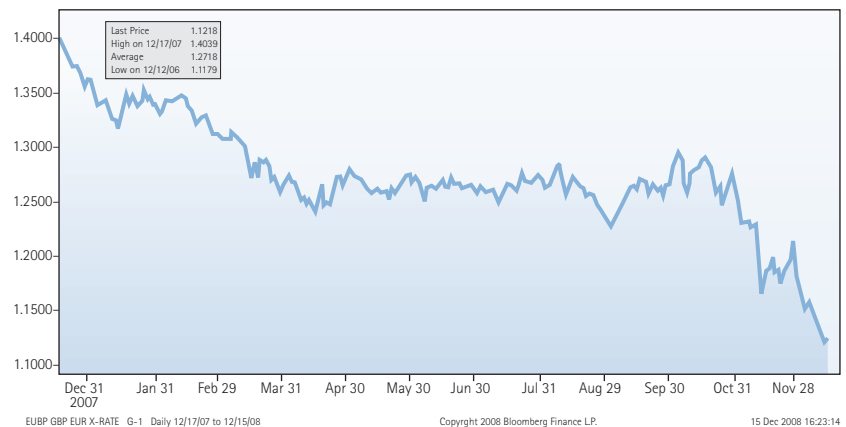
Our underweight to government bonds has clearly been a mistake and has adversely impacted our benchmark relative performance. We have clearly underestimated the momentum behind government bond markets and the low level to which yields would be driven by investors nervous of deflation. Although government bond yields are likely to fall further in the immediate short term, we are disinclined to buy at present levels for two main reasons. Firstly, this could only be funded by reducing our exposure to either equities or corporate bonds, both of which offer extreme value at present. Secondly, although in the short term sentiment will be underpinned by next year's highly favourable inflation outlook on the back of collapsing oil prices, the likely level of future issuance is a worry.

Over the medium term there is a distinct possibility that present deflation fears will eventually be replaced by inflation concerns as the stimuli kick in. It is for this reason that we have some exposure to index linked bonds.

“Dollar strength in 2008 will likely give way to renewed weakness in 2009”

On the outlook for currencies, renewed US dollar weakness is likely once markets stabilise. The outlook for sterling however remains worse as it is not a currency that foreign governments need to own, unlike the US dollar. Whilst historically high UK interest rates have compensated for poor domestic fundamentals this is no longer the case and the present level of emergency government spending and the future tax hikes which will be necessary to help fund it, is not a pleasing backdrop for overseas investors. Sterling has already fallen by nearly 20% against the Euro this year, and notwithstanding the odd bounce seems destined to reach parity.

Figure 3: Euro Sterling exchange rate – heading for parity



“Sterling weakness will also be a feature with likely parity against the Euro”

“Indeed, recovering markets will also herald stronger emerging markets and commodities”

“The biggest mistake we could make is to capitulate in the wake of deteriorating economic data”

One of our investment themes over the last few years has been our desire to participate in the re-rating and appreciation of emerging market bonds and currencies. As risk aversion has increased this year both have been marked down savagely as investors grew nervous of prospects for global trade. That sell-off now appears overdone and many areas offer outstanding longer term value. We have a similar view towards commodities and will be looking for opportunities to increase exposure in the next quarter.

#### Conclusion

We remain of the view, as we suggested last quarter that equity markets began a volatile bottoming process in October. After the traumas of this year it may be necessary for a retest of the previous lows before a sustainable advance is able to get underway but we deem this unlikely. We feel that the biggest mistake we could make is to capitulate in the face of the present wave of deteriorating economic data and a still near frozen credit market. Whatever the short term downside risk, we do not want to run the risk of missing a sizeable equity market rally. Such rallies start when least expected and are difficult to participate in once they have started. To wait for firm evidence that economies are stabilising is risky because markets typically bottom at least 4-6 months before an economic recovery begins. Whilst there may be grounds for expecting this downturn to be deeper and longer than usual, since 1900, recessions have become shorter and less frequent.

On the face of it, macroeconomic policy management has helped smooth the business cycle, preventing the worst fall-out from excess and prolonging periods of expansion. Lessons have been learned from crises past. The average length of a recession since 1900 has been 14 months and just 10 months after 1950 (Figure 1). Since 1900 the average S&P adjustment to a recession has been -30% (measured market peak to trough). Post-1950 adjustments have tended to be in the order of -27%. In the context of what we've seen already in terms of a peak to trough adjustment to the S&P (-52%), the current recession adjustment already seems mature in both duration and market adjustment.

Figure 4: Equity adjustments to US recessions since 1900

Average indicator adjustments	Since 1900	Excluding 1929	1929 depression	Since 1950	Worst Year since 1950	Current*
Duration of recession (months)	14	13	43	10	16	11
Stock market correction**	-30%	-25%	-86%	-27%	-49%	-52%
Trough in market – growth (months)	4	3	9	2	-11	n.a.

\* based on recession starting in November 2007 (the end of the first negative quarter of growth)  
\*\* peak to trough in stock markets rather than growth, and excluding those recessions where the stock market made positive gains

Source: Bloomberg, NBER, DataStream, Collins Stewart Research

“We continue to believe that a volatile bottoming process for equity markets began in October”

Unless one is a forced seller of equities there seems no point in leaving the market now, a year into the recession and after a 52% correction. Whilst there may be further forced liquidations from hedge funds, the deleveraging that has caused so much panic selling is estimated to be at least two thirds complete and in equities it may be nearly finished. With virtually no return from cash, negative yielding Treasury bills and government bonds at historically low yields, investors will follow the example of Warren Buffet and Anthony Bolton and return to equities in 2009. Equity market valuations are at an extreme both in absolute and relative terms and multiples are at multi decade lows. The 4% dividend yield on the S&P 500 is comfortably in excess of 10 year and 30 year US government bond yields for the first time in years and in many markets, next year's PEs are comfortably into single figures. For all their faults, PE multiples and the like are trading at a discount to fair value and the market implied equity risk premium is as high as we've ever seen it. The market discount function is hard at work, and broadly speaking the equity adjustment already suggests the credit crunch is as bad, or worse, than anything we've seen over the past 100 years or more apart from the Great Depression. In that context at least, it seems clear to us that selling risks are rising.

Markets are hugely oversold with virtually every measure of market sentiment at a level of extreme bearishness. As we have seen the US correction is in excess of 50%, Europe is off 55% with emerging markets averaging 65%.

It appears to us that the bears are underestimating the potential positive effects of the unprecedented stimulus that has so far been announced. It is much too early for the benefits to have kicked in. Lessons have been learnt from Japan's lost decade and rescue packages have been coming thick and fast. The latest Obama fiscal stimulus announcement is further indication that the authorities are prepared to accept the longer term adverse implications over severe downside risk to growth. It took the Japanese authorities nearly eight years to appreciate the seriousness of their problems in the nineties; this time, concerted and, moreover, coordinated global action occurred within a year.

This is not the end of the world; the US recession, in all probability, will be over within a matter of months. Although we are nervous of the longer term costs of the stimulus, especially for the US and the UK, we are confident that a significant global equity market rally is imminent.