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VIEWPOINT

Newsflash

A new month and the 60th issue of Viewpoint from PPi.

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As was the case in August, investors were buffeted by September's prevailing downdraft. By the end of the month 8.6% had been wiped from the value of global developed equities in US Dollar terms, with shares in emerging markets falling by 14.6% over the period. The third week of September witnessed the largest share price falls since the height of the financial crisis, with the global aggregate declining by 6.9% in US Dollar terms.

Government bonds offered a safe harbour for investors, albeit a crowded one, with valuations remaining high by historical standards. The JP Morgan Global Government Bond index fell by 1.4% in US Dollar terms, despite posting gains in the majority of local markets. US Treasuries gained 1.6% during September, whilst UK Gilts rose by 3.6%; Japanese government bonds also added 0.3%. This apparent inconsistency between positive local returns and the negative performance of the global aggregate was down to the base currency effect, with the Dollar posting gains against the majority of other major global currencies. Bonds benefitted from fears over the outlook for global growth, prompting investors to discount the opportunity cost of committing funds for long terms at fixed rates of return.

Property securities underperformed the broad equity market, whilst commodities declined by 14.0%. Even gold, a metal often touted as a safe haven by investors, lost a touch of its lustre, falling by 10.7% during September. Investment grade corporate bonds benefitted from the fall in government benchmark rates, whilst spreads increased, resulting in a rise of 0.3% for US

corporate debt. High yield bonds fell by 3.3% in the US, and by 4.2% in Europe in local currency terms.

In currency markets, the Swiss National Bank announced its willingness to intervene in the foreign exchange market to weaken the Swiss Franc, as the EURCHF currency pair fell below the Bank's minimum 1.2 Francs per euro threshold. The Bank pledged "unlimited" resources in support of its action, prompting a 7.8% swing versus the euro during the first week of the month.

Emerging market equities continue to underperform global developed markets. Emerging market equities have lagged their developed peers in 2011 by 9.7%, despite the relative strength of both their public and private sector balance sheets. This is attributed in large part to their starting base, with emerging market valuations having become stretched by the end of 2010. The growth in trade between emerging economies has so far failed to allay investor fears of the negative implications of a slowdown in developed markets for growth in these regions. Ultimately this trade needs to be internally generated and self-propagating, rather than solely a function of developed market demand; only then can global emerging markets be considered truly 'decoupled'. Emerging market currencies fell by an average 7.3% during September versus the US Dollar, with the Brazilian Real underperforming peer currencies, depreciating by 15.4%.

The banking sector was notably weak during September, with the MSCI World Financials sub index falling by 23.0%. The current environment is difficult for lenders, as tepid growth weighs on the value of receivables. Whenever aggregate growth in the economy falls significantly below aggregate lending rates, it is clear that there will be a portion of borrowing that is unlikely to be repaid in full. Bank shares continue to attract scrutiny from investors, as a steady flow of negative news emerges from the sector. The Federal Housing Finance Agency announced at the start of the month plans to sue 17 major domestic and foreign banks in relation to asset-backed securities sold to Fannie Mae and Freddie Mac. Two weeks later, UBS marked the third anniversary of Lehman Brothers' collapse by issuing a short statement to the market declaring that it had become aware of a serious case of fraudulent trading at its offices in London. Whilst losses were small relative to the bank's equity base, the admission raised fresh concerns over UBS' internal controls. The European TED spread – the difference between the rate banks pay to borrow money from each other and the risk free rate – rose steadily during the month, to reach levels last seen in early to mid 2008, albeit still some way short of the peak that followed the collapse of Lehman Brothers. The European Central Bank (ECB) announced it would be working in concert with authorities in the US, UK, Japan and Switzerland to provide dollar liquidity facilities for the banks in the form of swap lines, to ameliorate funding pressures related to investors seeking to move capital out of the Eurozone.

Economic data generally disappointed forecasts in September. The IMF's latest World Economic Outlook report lowered growth expectations for almost all countries for the current year, as well as 2012. US 2011 growth was cut by 1.0% to 1.5%, with German growth downgraded by 1.6% for the current year. The Fund lowered its forecast for 2011 global growth to 4.0% from 4.3% in June, with growth rates expected to remain materially different between developed and developing economies. A dislocation appeared during the month between expectations and actual data releases. Whilst the University of Michigan consumer confidence survey approached the lows that followed Lehman's collapse, the latest data on US core retail sales exhibited growth, whilst September's industrial production beat expectations as output rose by 0.2% month-on-month. September's ISM manufacturing reading exceeded market expectations at 51.6, up from 50.6 previously, although the new orders component of the report remained at 49.6, indicating modest contraction. The US ADP Employment report surprised on the upside, recording 91 thousand new jobs. Employment in the service sector, however, contracted for the first time in 13 months according to the ISM report.

Policymakers remain committed to promoting growth and

Source: Momentum Global Investment Management September 2011

ensuring the orderly functioning of markets. The aforementioned swap lines are indicative of the closer attention being paid to the banking sector. For a new crisis to mirror the last would suggest policymakers have failed to learn from events in 2008/09, whilst critically undermining the presumed efficacy of government fiscal and monetary tools. In a joint session of Congress, US President Obama announced plans to create new jobs by injecting USD 447 billion into the US economy through a combination of tax cuts and increases to spending. The American Jobs Act proposed the halving of payroll taxes on the first USD 5 million of companies' payrolls, alongside a full payroll holiday for added workers or increased wages. The Federal Reserve Open Market Committee added its own shot of stimulus, unveiling plans to purchase USD 400 billion of longer-dated US Treasuries between now and June 2012. The Federal Reserve will sell shorter dated securities in order to purchase bonds with maturities of between six and 30 years, in a move aimed at reducing longer term borrowing costs in the US. The yield on the US 30 year Treasury duly fell to below 3% for the first time since the end of 2008. Principal repayments from the central bank's agency mortgage-backed securities book will be reinvested to support the mortgage market.

The Group of Twenty (G20) broke from their annual World Bank-IMF meetings in Washington to issue reassurance to the market that they would do what is necessary to resolve Europe's debt crisis and to restore confidence. European Finance Ministers pledged to address the capital needs of the region's banks and to boost the size of the current bailout fund to as much as EUR 3 trillion. Nonetheless, key officials remain divided over the share of pain to be borne by creditors versus debtors. Whilst borrowers have no doubt been profligate with their spending, creditors also shoulder a portion of responsibility for lax lending standards.

Tensions remain elevated in Europe, with Jürgen Stark, the ECB's chief economist, resigning at the start of the month. Mr Stark's decision has been linked to the Bank's purchases of Italian and Spanish government debt, and follows the resignation of Bundesbank President Alex Weber in February. The emergence of political tensions is of key concern, given the political capital invested in the project. Greece continues to fall behind the terms of its loans programme, with government inflows falling faster than its expenditures. Greece's finance minister admitted that GDP would shrink by more than previously forecast, with the size of the decline in output now expected to exceed 5%. Supranational lenders involved in Greece's bailout have postponed a decision over the disbursement of additional financial aid to the country. A planned meeting on 13 October was cancelled, with officials now set to reconvene in Greece in the second half of the month.

Despite the pressures, five more countries successfully ratified July's proposals to increase the paid-in value of the bailout fund. Only Malta, the Netherlands and Slovakia are still to vote on changes to the European Financial Stability Fund (EFSF). Whilst signs of greater coordination amongst European officials were welcomed by market participants, the extent to which this latest rhetoric translates into decisive action remains to be seen. Slovakia's Freedom and Solidarity Party remains opposed to the proposed changes to the EFSF, and holds sufficient votes to block the passage of the bill.

Source: Momentum Global Investment Management September 2011

Asset Class Performances

Asset Class/Region	Index	Currency	Month	Year to date
		To 30 September 2011		
Equities				
United States	S&P 500 NR	**USD**	-7.1	-9.1
United Kingdom	FTSE All Share TR	**GBP**	-5.0	-10.9
Continental Europe	MSCI Europe ex UK NR	**EUR**	-5.7	-18.1
Japan	Topix TR	**JPY**	-0.3	-13.4
Asia Pacific (ex Japan)	MSCI AC Asia Pacific (ex Japan) TR	**USD**	-14.1	-18.2
Global	MSCI World NR	**USD**	-8.6	-12.2
Global emerging markets	MSCI World Emerging Markets TR	**USD**	-14.6	-21.9
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	**USD**	1.6	9.0
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	**USD**	-0.2	10.9
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	**USD**	0.3	6.1
US High yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	**USD**	-3.3	-1.4
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	**GBP**	3.6	10.7
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	**GBP**	0.2	4.6
Euro Government Bonds	Citigroup EMU GBI TR	**EUR**	0.8	3.9
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	**EUR**	-1.2	0.1
Euro High yield	Merrill Lynch Euro High Yield 3% constrained TR	**EUR**	-4.2	-6.5
Japanese Government	JP Morgan Japan Government Bond Index TR	**JPY**	0.5	1.8
Australian Government	JP Morgan Australia GBI TR	**AUD**	1.0	10.5
Global Government bonds	JP Morgan Global GBI	**USD**	-1.4	7.1
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	**USD**	-2.0	5.7
Global Convertible bonds	UBS Global Convertible Bond	**USD**	-6.5	-8.8
Emerging Market bonds	JP Morgan EMBI +	**USD**	-4.1	3.8

Source: Momentum Global Investment Management / Bloomberg / Lipper Hindsight. September 2011.

Asset Class/Region	Index	Currency	Month	Year to date
		To 30 September 2011		
Property				
US Property securities	MSCI US REIT TR	**USD**	-11.1	-6.5
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	**GBP**	-8.4	-7.6
Europe ex UK Property securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	**EUR**	-9.1	-11.2
Asia Property securities	FTSE EPRA/NAREIT Developed Asia TR	**USD**	-14.2	-22.8
Australian property securities	FTSE EPRA/NAREIT Australia TR	**AUD**	-13.4	-10.2
Global Property securities	FTSE EPRA/NAREIT Developed CR	**USD**	-12.4	-12.3
Currencies				
Euro		**USD**	-6.8	0.0
Sterling		**USD**	-4.3	-0.5
Yen		**USD**	-0.8	5.2
Australian Dollar		**USD**	-9.3	-5.2
Rand		**USD**	-12.9	-17.7
Commodities				
Commodities	RICI TR	**USD**	-14.0	-11.1
Agricultural Commodities	RICI Agriculture TR	**USD**	-15.0	-14.3
Oil	Brent Crude Index (ICE) CR	**USD**	-7.2	12.1
Gold	Gold index	**USD**	-10.7	14.8
Commodities			**Current rate**	**Change at meeting**
United States	21 September 2011	**USD**	0.25%	-
United Kingdom	6 October 2011	**GBP**	0.50%	-
Eurozone	6 October 2011	**EUR**	1.50%	-
Japan	7 October 2011	**JPY**	0.10%	-
Australia	4 October 2011	**AUD**	4.75%	-
South Afrika	23 September 2011	**ZAR**	5.50%	-

Source: Momentum Global Investment Management / Bloomberg / Lipper Hindsight. September 2011.

Focus: Think Tank 2011

Think Tank, Momentum's international investment conference was held in London on September 28 and 29 2011. Now in its twelfth year, Think Tank has consistently impressed in terms of the calibre of delegates and speakers, and this year's event was no exception. This month's Focus brings together key themes from the event, with the aim of shedding light on the current investment landscape and the many disparate views adhered to by investment professionals. The following summary represents Momentum GIM's own interpretation of the main talking points, but credit is due to our guest speakers, from whose excellent presentations this material is prepared.

The macroeconomic environment

Many speakers addressed the issue of global imbalances, which, it was argued, have reached levels never before seen in history. The US has used its huge productive capacity to underwrite its consumption of the surplus from developing countries. Developed countries in aggregate are laden with extraordinary levels of public and private debt, which has, in some cases, come to exceed the capacity of the underlying economies to readily service it. For example, over the next five years, the proportion of US government spending required to meet interest payments will rise from the fifth highest spending cohort for the government today, to exceed spending on welfare, with a similar picture repeated across much of the developed world.

The post war years have witnessed a unique debt supercycle, with government debt levels initially cut in the decades following the conflict, before growing rapidly thereafter. As a result, significant deleveraging is necessary to start to unwind the vast volumes of public and private sector debt that have been accumulated. Generalised deleveraging has implications for the reliability of economic forecasting, with traditional models premised on credit expansion, rising house prices and personal finance. More importantly, a simultaneous reduction in both public and private consumption may ultimately prompt a new recession, which therefore leaves policymakers with little margin for error. A stark example of this type of demand side shock may be found in recent history: in 1937 President Roosevelt tried to balance the US budget by means of fiscal contraction, only succeeding in pushing the economy into a long period of stagnation.

Current asset prices, and in particular the divergent world views apparent in bond and equity markets, imply a shift in the current economic paradigm. The so-called 'Great Moderation' produced three of the longest expansions in history, during the last 30 years. Whilst the mean expansionary period since 1854 has been around 40 months, a combination of factors allowed these latest expansions to grow to as much as 10 years. As such, making assumptions based on the last 20 to 30 years of market data, without allowing for the unique characteristics of this period, is potentially risky. In the decades leading up to 1998, central banks had an unusual degree of flexibility due to a one off decline in inflation created by globalisation. This afforded policymakers room to cut interest rates regularly in order to cure economic ills, whilst at the same time unwittingly fostering today's imbalances.

In spite of extraordinary levels of government stimulus, the recovery since economic growth bottomed in June 2009 has been the weakest in US history, based on growth in nominal output. As a result of this anaemic growth, market participants have duly questioned whether the West is in for a 'lost decade' of the type experienced by Japan. There is some resonance between today's challenges and those faced by Japan in the late 1990s. Both Japan and the West were rocked by the bursting of an asset bubble, triggering a banking crisis and a balance sheet recession. In Japan, the resultant unwinding of debt and large output gaps then exerted deflationary pressures which are still being felt today. Differences are apparent, however, between the two region's experiences: equity valuations were extremely stretched in Japan going into the start of its crisis, whereas they were less extended in 2008. It subsequently took the Bank of Japan nine years to move to zero interest rates, unlike the US Federal Reserve et al which reacted within 18 months. A series of political impasses in Japan also meant that fiscal

Source: Momentum Global Investment Management September 2011

policy failed to feed through to the real economy, whilst the strength of the yen further undermined policymakers' efforts to reinvigorate production in an export centric economy.

Reducing the debt

Today's public debt levels are not necessarily insurmountable. The US reduced its public debt from over 100% of GDP to below 40% in the decades following the Second World War, at the same time avoiding an economic crisis of note (albeit, private sector debt was far more contained at the time, and a further headwind came from favourable demographics). The period between the 1940s and the 1980s saw fixed income investors take a de facto haircut virtue of inflation, and a 40 year bear market in bonds was assuaged through regulations such as capital controls and the requirement for savers to buy bonds in their pensions. This underlines the attractiveness of reasonable levels of positive inflation to governments, especially where the alternative is generally considered to be deflation: a phenomenon that would increase the real value of outstanding debt.

With governments firmly committing to supporting asset prices through monetary easing, inflation is seen by many commentators as being an inevitable outcome. Despite the destruction of a portion of demand, generating inflation would seem to be easier now than at any time in history. Prior to the abolition of the gold standard in 1971, instances of countries suspending the convertibility of their currency were always temporary. The period post 1971 has witnessed a unique real world experiment into the relative merits of a system of pure fiat currencies. In the past, if a government wanted to debase its currency it had to perform a physical act on it, such as shaving a fraction off or diluting its content with other metals, whereas now all that is required is the press of a button. With governments in charge of the printing presses, there is an opportunity to create inflation.

The question of Europe

Turning to issues in Europe, delegates were reminded that there is fundamental disagreement over the relative share of pain to be borne by debtors and creditors. Whilst the former were no doubt profligate with their spending, the latter are also culpable for loose lending standards. During the course of Think Tank, it was submitted that there is no silver bullet for the Eurozone, not even recently mooted Eurozone bonds or leveraging the bailout fund, as the problems are structural in nature. The periphery needs to improve its competitiveness through wage restraint, although the necessary policies to achieve this aim carry high levels of political risk. Ireland is leading the way in this regard, with large wage cuts across most sectors of the economy. Fiscal consolidation, by way of cuts to entitlement payments and higher taxes, is also probably necessary, but equally challenging to deliver.

The outlook for asset prices

Even as European policymakers moved to reassure the markets that they were committed to supporting the region's peripheral economies on 22 July, stock markets slumped, entering a period of weakness that lasted through August and into September. Investors subsequently removed risk from their portfolios and sought government debt 'safe havens', in spite of the unattractive yields available. Indeed, it was observed by a number of speakers that bond yields are currently at 220 year lows and only offer meaningful upside in the event of deflation. As Think Tank moved into its second day, it became clear that whilst the investment outlook is highly uncertain, opportunities are nonetheless available:

- Equity markets

Gloomy news, such as that regarding the state of Europe's peripheral finances, is no secret and can therefore be expected to be largely reflected in asset prices. Of late, weak sentiment has weighed on equity prices in an indiscriminate manner, leading to areas of unwarranted cheapness. Many market leading companies remain in Europe, and can be expected to profit even during difficult periods for their respective governments and economies. In aggregate, European corporates boast strong balance sheets, with many private sector companies sitting on large volumes of cash.

It was submitted that Japanese equities are now in line with the rest of the developed world for the first time in a decade,

Source: Momentum Global Investment Management September 2011

based on various valuation measures. The years since 1998 have witnessed a secular bear market for Japan, and a relatively steady increase in the value of Japanese government debt. The equity market has behaved rather differently over this period, with a number of cyclical rallies within this structural bear market. In addition to the global economic headwinds, Japan has suffered its own idiosyncratic problems of late in the form of the Great East Japan Earthquake. The Japanese economy has displayed noteworthy resilience in recovering from a deep trough post the disaster, with industrial production back to 90% of its pre-earthquake level. Were the yen to weaken, this should provide an immediate boost to corporate profitability.

Whilst assessments of equity market valuations vary based on different measures, speakers were able to identify subsets of value. These subsets include large capitalisation, high quality companies that generate large volumes of free cash flow. Such companies can be expected to compound earnings even during times of crisis, and may therefore provide something of a midpoint between fixed income and the broader equity markets. There is a tendency for analysts to ignore large companies with 'boring' levels of organic growth, despite the benefits that accrue from steadily compounding earnings. The high quality approach to investing need not simply provide exposure to the 'old' economies, but, by buying blue chip companies, an investor can gain exposure to a large proportion of earnings in emerging markets.

- The Emerging Markets

Secular macroeconomic themes were regularly addressed by speakers, including the general consensus over the middle class growth story driving emerging economies. Demographics (outside of China) are extremely positive, and governments are generally uninhibited by debt. Together, this points to sustainably faster growth for these economies. Conversely, relative GDP performance has historically proven a poor indicator of stock market returns, and much will depend on the valuation investors are able to 'lock in' upon entry. Despite their size, the BRIC nations may not prove to be the main engine of this growth over the next thirty years, with opportunities likely to arise in less popular markets.

Rather than simply following the West, there is evidence to suggest that the Emerging Markets are becoming leaders in their own right. Speakers pointed to their growing influence both domestically and internationally, in areas including fashion, alcohol sales, manufacturing and mobile phone usage. There are, however, downsides to prosperity, as evidenced by burgeoning obesity issues in the developed world. Should emerging economies come to emulate their developed peers in terms of food consumption, there will be an increase in non communicable diseases such as diabetes and obesity, which will need to be addressed medically and socially. Indentifying those companies best placed to benefit from these various trends is the key aim for investors.

- Commodities

The multi-decade growth phase in emerging markets should be adequate to offset the woes of the OECD, according to speakers. In many ways it represents a return to form for the likes of India and China, which, thanks to their population heft, have dominated global production for centuries. Urbanisation and industrialisation will be immensely commodity intensive trends, augmenting the demand for raw materials for the foreseeable future. The supply of commodities will continue to be constrained by geological issues, with companies forced to exploit increasingly remote areas. Offsetting this positive driver is the threat of populist nationalist policies in response to the global economic slowdown. Investors need to be selective in their approach to the asset class, with ambitious plans by some commodity suppliers set to come on stream in the next few years.

- Property securities

Inflationary pressures may prompt investors to seek income streams that contain a degree of inflation protection. Real estate investment trusts (REITs) enjoy contractual income streams for several years into the future, and are generally either directly linked to inflation or by virtue of upward-only

Source: Momentum Global Investment Management September 2011

revisions. The fundamentals for property appear healthy: very little new supply is coming online and there is scant financing available for development. Even with currently muted levels of demand, supply is sufficiently tight to support positive price action.

- Corporate credit

In the face of lower growth prospects, one speaker highlighted the opportunities available lower down the capital structure in corporate credit. At current levels, yields appear to provide a decent margin of safety against future defaults, whilst generating healthy income for investors in the meantime. This assessment extends to high yield, where prices are consistent with an extended slowdown, although it is not impossible for spread levels to widen further on poor sentiment.

In summary

By way of conclusion, it was submitted that much of this year's price revisions to equities can be traced back to the exuberance which greeted the start of 2011. At the time, analysts' forecasts for GDP growth and corporate performance were excessively high, prompting consistent downward reappraisals over the course of the year. Whilst the outlook for global economies remains uncertain, equity market valuations are undemanding, especially when compared to the high quality debt markets. Traditionally equities have offered lower yields because of the inherent inflation proofing in dividends, alongside the potential for growth; at the moment, even quality equity is coming at a discount to government paper as far as yields are concerned. Nonetheless, high tail risks exist for global economies, whilst capital preservation remains of utmost importance. Investors should be guided, as always, by a strict valuation discipline. Genuine diversification remains the key to efficient portfolios, and investors should rely on dynamic asset allocation to take advantage of valuation opportunities when they are inevitably thrown up by volatile conditions.

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