Premier Discretionary Team

Asset Allocation - For Professional Adviser Use

8th November 2010

Minutes

Present: F Fulcher, D Pendlebury, M Jennings, R Hallen, N Kelsall, K Cushway, P Smith, A Ross.

Overview

Since the last meeting, equities have taken off and in many cases breached their April 2010 highs. The tone for a stabilisation in equities since the summer doldrums has been due to a levelling off in macro economic data worldwide, with the expectation and subsequent announcement of Quantitive Easing, QE2, providing the catalyst for the strong markets.

Q3 Chinese GDP came in at 9.5% annualised, down from 10.3% in Q2. Chinese retail sales continue to run at 18.8% per annum and industrial production at 13.3%, although the authorities did raise the lending rate by 25 basis points, taking deposit rates to 2.5% and lending rates to 5.56%.

In the US, consumer confidence came in ahead of expectations and suggests modest growth rather than a collapse. Employment is always important for the Federal Reserve (Fed) and therefore watched closely by the market. Despite a sharp correction in June, we have seen a subsequent recovery but the unemployment rate remains stubbornly high at 9.6% in the US, with the Fed highly unlikely to embark on any monetary tightening until a material improvement in this number has been registered and it is perceived to be sustainable.

Regarding Quantitative Easing, the Fed and Bank of England hinted at this in August, and it was this prospect that set equity and bond markets on a renewed surge. $600 billion has been earmarked to be spent by the Fed, but there is also an open ended commitment to target; getting US inflation back into the 1.5%-2.0% target range, versus 1.1% now. CSFB believe that this could mean a further $500-750bn, and requires US GDP growth of 4%pa[1].

By buying up bonds across the curve, the Fed is ensuring low long term interest rates (as well as short). Although consumers may not be able to borrow at these levels, corporate debt is priced off sovereign yields and so the cut is at least partially passed through. Coca Cola issued $4.5 billion bonds on the day that QE2 was announced, with one 3 year tranche paying a coupon of 0.75%, a record low for a corporate.

As one commentator eloquently put it recently "QE raises the price of bonds but reduces their value" - this sounds like the definition of a bubble. From an economic perspective, QE is designed to spur activity e.g. Coke borrowing cheaply to add capacity and generate inflation thus reducing the "value" of bonds.

It also has the useful effect of cutting the cost of budget deficits thereby helping those highly indebted countries miraculously improve their finances. From a market perspective, it is likely to cause currency weakness, i.e.: lower yields equals weaker currency, and all assets to rise (risk free rates down, greater supply of money etc). As the dollar is the world's reserve currency, this has multiple ramifications elsewhere:-

1. Weak dollar means that other Emerging Market currencies need to rise.
2. Dollar weakness tends to go hand in hand with strong commodity prices, especially gold.
3. Many emerging currencies are pegged to the dollar and US monetary policy. They therefore have a weak currency, negative real interest rates and a strong economy, again this is fuel for a bubble.

During 2010, the bears have been worrying about a double dip and that expected earnings growth would not materialise. Whilst the effect of fiscal tightening still has to take its toll, economic evidence currently gives little fuel to the thesis of a double dip. Fears of deflation would also seem to have been allayed by the Fed and QE2.

Regarding earnings, the Q3 US results season has produced a 29.6% annualised gain as at 5th November. Not only is this clearly a strong number, but it is comfortably better than the 23.4% gain expected on 1st October. Indeed over the month of October alone, the US saw 199 companies raise their profit projections, versus 130 that cut, a very bullish ratio. The rise in the equity markets has, of course, impacted valuation although partially mitigated by strong earnings.

For 2011, the US is now trading on 12.7x, Europe 9.6x, and the UK 10.4x. These remain well below the 17x global 40 year average. Dividend yields remain well above cash and bond yields in Europe, with UK equities, for example, yielding 3.8% in 2011, versus 10 year Gilts at 2.99% and 3 month cash at 0.74%.

Modest economic growth, low inflation, plentiful liquidity, and valuations cheap versus history and very cheap versus other asset classes; this is a highly attractive cocktail for equities and this is where we are at now.

However, short term indicators show assets to be overbought, bull-bear ratios are extended, the VIX has collapsed and the CRB commodity index is at an all time high. Therefore, it could be logical to expect a consolidation in equities over the near term, but we feel the underlying direction is still up despite there still being plenty of equity sceptics around, which is very healthy.

The “Mega Bull” case Scenario:-

Whilst this is not our core view there are numerous reasons why a “mega bull” run could come about over the next year or so. The first is simply valuation. Taking the UK for example, a 10.4x PE gives an earnings yield of 9.6%, so the equity index should produce a return of 3.2 times greater than a 10 year Gilt, and 19.2 times the base rate. The maths for equities is overwhelmingly attractive relative to cash and bonds. If equities are re-rated to give an earnings yield of 6%, then the PE would need to rise to 16.6x and this would give a 59% gain in UK equities, equating to 9,324 on the FTSE 100.

The other “Mega Bull” case is a function of QE. Negative real interest rates and a weak dollar with strong economies is a formula for a bubble which prevails in many emerging markets. With economic growth rates and national finances generally far superior from emerging economies than in the developed world, growth investors are being increasingly tempted as emerging markets trade at 11.5x[2] forward earnings, a 4% discount to their historical average. It is entirely conceivable that investors could become willing to pay a substantial premium to developed markets. QE is designed to force up asset prices and force down the return from risk free assets, this plays into the hands of all assets but most particularly the riskiest – i.e. equities and especially emerging markets.

Premier’s Pan European Property Share Fund Manager, Alex Ross, joined the meeting to provide an update on the property market. There is a slight risk that UK commercial property prices could get “frothy” given that gilt yields are trading at such low levels and could force institutions to ‘pay up’ for property. This is not deemed a likely outcome given the visibility of supply, mainly from banks who have recently been more aggressive sellers and prepared to write off losses.

Alex believes there is a large overhang of supply which will match buying demand. This scenario of supply meeting demand suggests limited scope for further yield compression (capital growth) with average total returns from mainstream property driven almost entirely from income (averaging c.6%).

Bricks and mortar funds, which have no gearing and suffer rental income tax, are likely to see these income returns diluted further by fund charges and rental income taxes. Alex feels more confident that REITS will produce better returns than bricks and mortar funds over the next 12 months, due to the benefits of gearing in a flat market.

It was agreed for the Conservative, Balanced and Growth strategies to marginally reduce exposure to property, Europe and UK in favour of emerging markets.

All data sourced to Bloomberg unless otherwise stated

[1] Source: Credit Suisse, 03.11.2010

[2] Source: Citigroup, Global Equity Strategist, 17.11.2010

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