PREMIER ASSET MANAGEMENT

An update on world events

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The world's capital markets have entered panic mode of late. Equities have fallen sharply, sovereign bond yields are at multi year lows and the Swiss franc, along with Gold have spiked – these are all classic responses to fear, with the flight to those assets perceived as being safe.

As Chief Investment Officer, I thought that it might be useful and pro-active to discuss with you, what has happened, why it has happened and where I think we go from here?

The MSCI world index fell 13.3% in the second quarter and is down 10.9% in the first six months of 2010, a steady drop when compared to an 8% gain over the year from the end of June. Two year US Treasuries stocks fell to the lowest levels since records began in 1976 and the VIX, the index of volatility, often referred to as the fear gauge, has doubled since March and April, suggesting a significantly more volatile market. This speed of risk aversion has not been seen since the second quarter of 2008, when the Lehman's crisis hit the headlines.

So why the panic and is it justified? The problem goes back to Iceland, Ireland and Greece's over indebtedness. These are all old news and none is big enough to matter from a global perspective. All these economies are small, relatively domestically orientated and geographically peripheral. The issue, however, is whether they are only the start of a domino effect. After all, many economies, such as the UK, are substantially over indebted, so will we suffer the same fate or can we head it off with a combination of economic growth and fiscal prudence?

Credit rating agency, Moody's, has just placed Spain on credit watch, threatening to downgrade them from Aaa by two notches. Unlike Greece, Ireland and Iceland; Spain and Italy, for example, are far more important economies, which would have serious ramifications should they collapse under a mountain of debt. For example, Spain's Gross Domestic Product, or GDP, is approximately six times that of Greece whilst Italy is nearly seven times.

Controlling excess debt, as we are beginning to experience first hand here in the UK, means constraining growth. Investors have therefore become acute economic data watchers, looking out for any signs that the developing recovery will be clobbered by spending cuts and tougher conditions in which to refinance debt. If the global economy can continue to recover whilst paying down its debt, then all is fine. If, however, the European consumer retrenches, then a vicious circle could ensue whereby US and Asian export markets suffer, leading to higher unemployment and lower growth, in other words the fabled double dip back into recession.

This unpleasant scenario is entirely feasible, and should not be dismissed lightly. However, economists are still expecting 3.2% real GDP growth for 2010 in the US, and 10.1% in China according to consensus numbers, so they are a long way from predicting collapse even though these numbers have drifted down slightly. Nonetheless, markets are running scared. Anecdotally, a number of companies have recently guided analysts forecasts moderately lower and their share prices have been thumped by 10 or 15% as a result. This ferocious reaction is a function of widespread panic.

Unfortunately when sentiment dominates, I can't tell you whether it will turn today, next week or next month. What I would suggest in such times is to revert to fundamentals. Sentiment tends to drive short term performance, but fundamentals should drive the long term. Companies have been impressively pro-active during this recession at aggressively cutting costs. That means that profit margins have held up well and that companies are well placed to convert modest sales growth into far superior profits growth.

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The second quarter results season begins on July 12th, with most US companies reporting in the third week of July, and European companies following up in late July/early August. In the US, earnings growth expectations are for an annualised 33.7% gain in profit in the second quarter with a total of 33.6% in calendar year 2010. Valuations are substantially cheaper than their historic averages, with the dividend yield on the UK and many European markets exceeding bond yields. This is highly unusual and suggests to me that fear has been grossly overdone.

In the last decade, growth was boosted by a borrowing binge. In the next decade, growth will be more modest as we repay that debt. As you will be painfully aware, the strong economic growth of the last decade was met with 10 years of poor equity performance. Similarly, the weak growth ahead does not necessarily imply that equity market performance needs to also be poor.

Equity valuations suggest one of two conclusions. Either analyst and company forecasts are wildly optimistic and we are on the brink of massive cuts in expectations, or equity markets have become extremely cheap on a medium term view and are overdue a rally. Growth jitters are real, so I sympathise with the downgrade arguments, however, in my opinion, falls have been overdone, and many stocks offer incredible value today.

Finally, a word on the Premier Funds. We have a broad selection of income and growth funds with differing risk profiles and geographic biases. The income selection being generally more defensive in nature, have done best. For the more defensive, our Premier UK Money Market fund remains first quartile against peers over the year and our UK Equity Income funds, although down in absolute terms, have comfortably beaten UK equity indices this year so far. Our broad range of equity growth funds have battled against the tide in 2010, but for investors looking for a rebound in markets, our Premier UK Thematic, Premier Global DSR, and Premier China Enterprise funds would all expect to benefit strongly on equity market appreciation.

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MSCI Index – Returns 30.06.09 – 30.06.10, bid to bid, USD, Financial Express Analytics on 7.7.10 and Bloomberg on 2.07.10. US earnings growth, Gross yield 22.06.10 source Bloomberg on 02.07.10.

VIX Index – 02.07.2009 – 01.07.2009 USD Source Bloomberg 02.07.10. MMF – Total Return, GBP Bid to Bid as at 30.06.10 Source Financial Express Analytics. Other Equity Income Funds – Source: Financial Express Analytics and Bloomberg taken on 07.07.10

All data sourced to Premier Fund Managers Limited unless otherwise stated.

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