UK – applying the brakes

We have noted on several occasions during 2005 that economic growth in the UK is slowing and this was highlighted very clearly by the Chancellor in his pre-Budget report, revising his economic growth forecast down to 1.75%. To date there has been a big dislocation between economic growth and stockmarket returns, with the latter indicating a very robust backdrop at the corporate level, which is certainly true. Companies are still in good shape, having become more disciplined in the management of their balance sheets, building up large cash reserves in the process. This bodes well for further shareholder-friendly initiatives such as share buy-backs and increased dividends, as well as greater merger and acquisition activity, all of which should provide good support to current market levels in the year ahead.

There was a further sharp rally in UK smaller company shares in the final quarter of 2005. We have been advocating a shift away from smaller capitalised shares in recent times on grounds of overvaluation. This argument has strengthened in recent weeks, with smaller companies looking vulnerable to profit-taking and now significantly overvalued relative to larger companies.

"Companies are still in good shape, having become more disciplined in the management of their balance sheets."

USA, heading for phase two?

The minutes from the last meeting on interest rate policy indicate that the US Federal Reserve is now near the end of its tightening phase, having raised interest rates in small steps thirteen times to 4.25% since the low of 1% in June 2004. Our view is that the Fed will stop at or just below 5%, although there is some pressure from regional presidents of the Bank to make no further increases.

"…the overall conditions for the US economy seem quite reasonable and could surprise us this year…"

At the end of this month the interest rate baton is passed from Alan Greenspan to Ben Bernanke, who will no doubt want to demonstrate his authority. Inflation, which is expected to pick up in the first half of the year as a result of higher energy prices, may provide the trigger to increase rates a little further, but after that Bernanke will be on his own and will need to find a highly convincing explanation for any rate increase above current forecasts. The overall conditions for the US economy seem quite reasonable and could surprise us this year: the economy is expected to grow by around 3.4%, higher than most developed economies, and the stockmarket valuation is now much more acceptable after a period of strong earnings growth. However, a lot still hinges on what the Fed does and how this impacts consumer sentiment. In short, Americans need to keep spending.

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investment update

1st quarter 2006

Inside

BERRY

A year which coped well with events

2005 turned out to be a surprisingly good year for stockmarkets, with total returns in most major markets exceeding 20%. Only the US market fell short of this heady return, although US stockmarket returns for European investors were boosted by the strong dollar. We say that the year was surprisingly good because there were several events during the year that could easily have checked the pace of stockmarket growth more than they did. In no particular order of importance, we have seen a series of interest rate rises across the globe, sharp increases in energy prices, corporate failures which have unsettled high yield bonds and hedge funds, more terrorist attacks, hurricanes, and a general slowing of economic growth in most parts of the world.

Without wishing to be the party pooper, we need to keep our feet firmly on the ground, however, and not forget the risks that tend to build up when things appear to be going so well. The strong gains made from global stockmarkets since March 2003 have not particularly helped our strongly held belief in diversification into alternative asset classes, which by comparison have seemed rather pedestrian. Tempting as it may be, however, loading up with more equity market exposure at this juncture will probably be the wrong call. All market setbacks are unwelcome, but sometimes we need a gentle reminder that stockmarkets do not go up in straight lines and that returns of 20% or more in twelve months are abnormal, probably unrepeatable in the year that follows, and are earned only through the acceptance of quite a high level of risk.

"It is important to enjoy the party whilst it is in full swing, but also to be well prepared for the time when the music changes to a slow waltz or stops completely."

Ultimately, investment returns revert to the mean, which in the case of stockmarkets has been around 5% higher than the return earned from cash deposits over the very long-term. In the current climate, this means that we should expect shares in most developed economies to deliver returns of less than 10% (including dividend income) in the year ahead. If we can get fairly close to the long-term expected return with less risky and somewhat uncorrelated investments (which we can often do without venturing near shares), then this must be worthy of serious consideration. It is important to enjoy the party whilst it is in full swing, but also to be well prepared for the time when the music changes to a slow waltz or stops completely, which is inevitable at some point.

The fact that markets have coped so well with various events in the past twelve months suggests that either investors are becoming more tolerant of riskier assets or there is still a wall of long-term money circulating the system that needs to find a home. The answer probably lies in a combination of the two. As markets have risen, the fear of missing out has driven markets higher still through momentum and inertia. We are also being told that we need to save more to fund an acceptable standard of retirement living, which, by all accounts, could be as long a period as our time in employment. The oldest 'baby boomer', born after WW2, has now turned 60, with more attaining this age at a rapid rate. In the US, for example, one third of the population is now a 'boomer', which should provide a firm backdrop for the savings market and consumer spending in the years to come. Companies may need to adjust to accommodate the needs of an ageing population and their changing consumer habits, but one thing for certain is that there will be plenty of capital moving around in the system for companies to get their hands on, and which should provide very good long-term support for share prices, even if we do pause for breath in the meantime.

January 2006

Energy – a heated debate

The direction of energy prices, and their impact on inflation and consumer spending, has probably been the subject of most debate during 2005 and caused the greatest influence on the direction of stockmarkets. As we begin 2006, similar energy-related stories are impacting financial markets.

The latest is a gas dispute between Russia and the Ukraine, which has forced gas prices to high levels. Thankfully, a resolution appears to have been reached quite quickly, with Russia's attempt to reassert its authority over the former Soviet republic seemingly having backfired. However, this recent episode highlights how reliant European economies are on imported energy and also how vulnerable they are. Around a quarter of Europe's gas supplies come from Russia, virtually all of which pass through Ukrainian pipelines.

The EU estimates that 75% of its gas requirements (and around two thirds of its total energy needs) will be imported by 2020, much of which will be supplied by Russia. Hopefully recent events will galvanise EU officials into accelerating plans to diversify its energy sources. Russia knows that it is in a strong position, but by flexing its muscles too hard, as it has done with the Ukraine situation, it runs the risk of alienating itself at the top table of the G8 nations, something, in the long run, it can ill afford to do.

"The EU estimates that 75% of its gas requirements will be imported by 2020.