

Conference call highlights

Global equity update

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One year on

Twelve months after the collapse of Lehman Brothers market volatility is now back to pre-crisis levels, which means that investors can sensibly deploy risk capital. This has driven significant inflows to risk assets, with equities and corporate bonds notable beneficiaries. But whilst credit spreads are now back at the levels seen a year ago, equities are still between ten and 20% down on the year (depending on market) despite their recent rallies. There are still significant sums of cash on the sidelines awaiting investment. This suggests that any setback in risk assets could be met with renewed buying.

Sluggish economic recovery expected

It is becoming increasingly clear that we are past the worst in the global economy. However, while markets seem to be discounting a rapid recovery, we continue to be cautious on the outlook for economic growth. Consumer balance sheets need to be repaired and the resulting deleveraging will dampen consumption in western economies for several years. At the same time, governments need to repay their burgeoning debts, which suggests lower public sector spending and higher taxes.

Rates to stay low

The good news on the economic front is that inflation is well contained, and this means that central banks will be able to keep interest rates at low levels for a prolonged period. This creates good conditions for capital markets. It also influences sector strategy – for example, low short-term interest rates benefit banks as they help to support healthy lending margins. The recent gains in equity markets have also removed concerns about solvency in the insurance sector. With these factors in mind, we have substantially added to financials in recent months and are now significantly overweight.

Companies looking to the future

We are seeing a reversal of the dysfunctional vicious circle in capital markets. Having conserved capital in order to survive the past year, companies are now beginning to take a more constructive view. Capital expenditure plans are being reinstated, inventories are being rebuilt and recent weeks have seen a return of M&A activity. We expect M&A to be an increasing feature of the coming months as companies seek to increase efficiencies, boost growth and lower levels of competition. Meanwhile, the return of capex bodes well for companies in areas such as engineering, technology and oil services.

Operational gearing

Most commentators have been surprised at the strength of corporate earnings over the past two quarters. This recovery has been driven largely by cost cutting. Once demand recovers and revenues start to rise, reduced cost bases will create strong operational gearing for many firms, resulting in an accelerated profits recovery. It also appears that cost cutting is allowing returns on capital to bottom at higher levels than in previous cycles.

Stock selection a key driver

The early phase of the equity market recovery has been led by lower quality, highly cyclical areas – especially stocks that had previously been priced for failure. However, performance is now broadening out and we are seeing increased rotation within rather than between sectors. As a result, we expect sector strategy to be a diminishing influence on performance in the months to come, and for stock selection within sectors to become increasingly key.

Change in portfolio emphasis

We have made intensive efforts over the past few months to unearth new stock ideas to ensure that the portfolio remains optimally positioned for changing conditions. New positions have been established in a range of sectors, including industrials (Lockheed Martin, whose involvement in the F35 programme is under-appreciated), IT hardware (Dell, which we see as a good example of cost cutting providing attractive operational gearing into an economic recovery) and financials (under-researched stock Fortis is mis-valued in our opinion). We have also added to our emerging market exposure via new holdings in Visanet (a Brazilian credit card processor and beneficiary of growing emerging market consumption), mobile telecom provider Millicom (another consumption theme beneficiary) and Bank Rakyat, an Indonesian micro-lender with strong growth potential and high barriers to entry.

Current positioning

The fund is overweight in financials, technology, telecoms and healthcare and underweight in consumer discretionary, consumer staples, energy, industrials, utilities and materials. Geographically the portfolio is above benchmark in emerging markets, Europe and the UK, neutral in the US and underweight in Japan and developed Asia.

Outlook

Recent data suggests that the global economy is on the road to recovery, but we expect this road to be long and difficult. Nevertheless, equity markets are forward-looking entities and investors have reacted very positively to the prospect of a recovery in growth and earnings. In the short term, markets have got somewhat ahead of levels justified by the fundamentals and, as such, a period of consolidation would not come as a surprise. Over the medium term, however, we are positive on the outlook for global equities and current conditions are providing many opportunities to add value through stock selection.