GlobeTrot
— FROM DELMORE ASSET MANAGEMENT —

Global Commentary **16th February 2010**

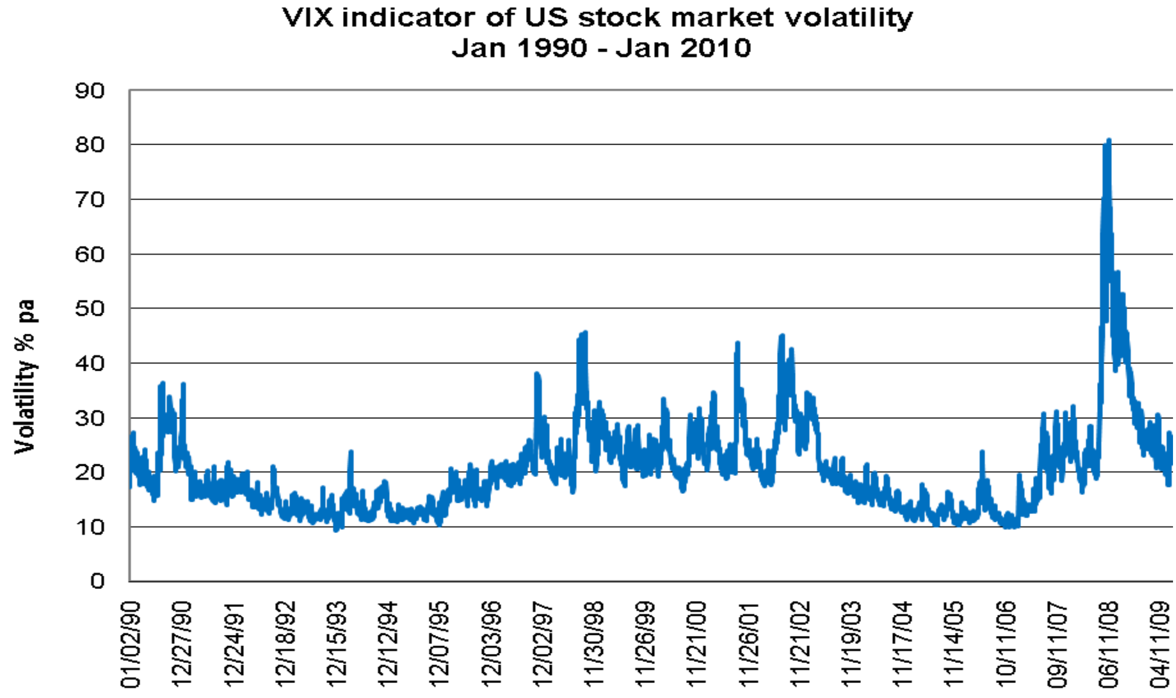
Nothing is certain except debt and taxes

(with apologies to Benjamin Franklin)

The performance of equity markets in 2009 was dramatic. The total return on the FTSE World Index was 34% in US dollars (but only 17% in sterling) during the year - and a massive 73% from its nadir in March. We do not expect a repeat roller coaster ride this year, but as January closed we have been reminded that progress during 2010 will continue to be uneven.

The dominant theme last year was strong recovery in the indices for global emerging economies, the Asia/ Pacific region (ex Japan), and global smaller companies, which posted capital returns of 81%, 70% and 45% respectively. Such a result is typical of a period in which investors' appetite for risk returns. The clearest indication of this return to more normal conditions is the performance of the Chicago Board of Exchange Volatility Index, more commonly called the VIX.

During periods of great uncertainty funds sell down their equity exposure and buy the VIX as insurance against a severe fall in the stock market - hence the other name for the VIX: the fear index! As confidence plummeted during the last quarter of 2008, the VIX rose to a high of 80. In normal times a rise to a level of 30 denotes considerable caution; at a level of 80 we entered a panic level.



Source: www.cboe.com

© Delmore Asset Management Ltd · 111 Baker Street · London · W1U 6SG
Tel: 020 7224 2889 Fax: 020 7224 3631 Email: howard@delmore.co.uk Web site: www.delmore.co.uk
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The graph shows the initial panic has passed but that confidence remains fragile. As recently as 11 January 2010 the VIX fell to a level of 17.3, but within 10 days it regained the 27 level. This suggests investors are now less risk averse – but not yet fully risk tolerant.

Nevertheless, equity markets are closer today to fair value than the extremely cheap valuations seen at the bottom last March. Global interest rate cuts and massive fiscal stimulus ($10 trillion, about 16% of global GDP) reinjected considerable confidence into the global economy and financial markets.

Consensus estimates for 2010 show a general return to growth after what is being called The Great Recession. A sharp 5.7% increase in US growth in the final quarter of 2009 confounded the markets. We believe there is scope for US growth to continue to surprise on the upside during this year.This will feed through into sales and impact net profits.

There is no gain without pain; faster than expected growth risks higher inflation, particularly if wages and salaries increase by a quarterly rate of 2.2% as in Q4 . Federal Reserve Vice Chairman Kohn alluded to this risk when he spoke about the cessation of quantitatitive easing and possible increases in interest rates.

Meanwhile, the final figure for the University of Michigan's index of consumer sentiment reached a two-year high of 74.4 in January, which also suggests the recovery is broadening and becoming more solid.

Consumer confidence and business confidence indicators rose in early 2009 - in several cases before the stock markets - and continued to climb throughout 2009. Business confidence broke above its pre-Lehman level by late summer 2009 in the US and by November in the UK.

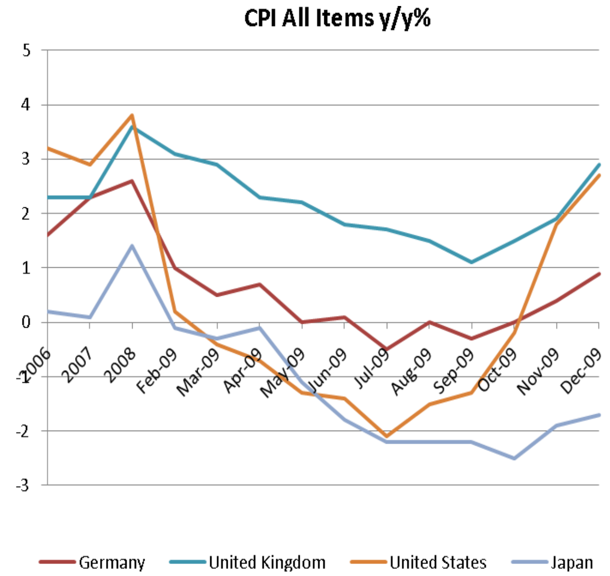
Consumer confidence has generally been quicker to recover. In the OECD survey, the UK was one of the first countries to reach pre-Lehman levels, in March of 2009. Its continued rise through the year produced better than expected Christmas sales. A British Retail Consortium survey showed like-for-like sales up by 4.2% in December.

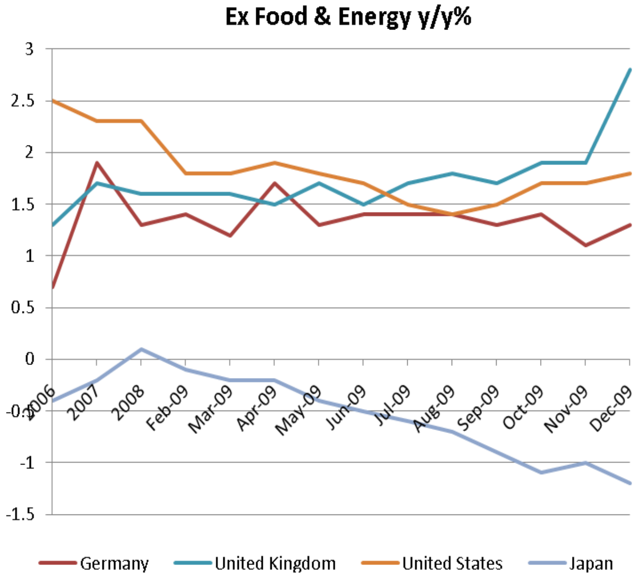
Inflation has also picked up, particularly in the UK. The UK CPI hit 2.9% in December (RPI 2.4%), well above the MPC's 2% target. The CPI (ALL Items) in the USA also surged to 2.7%in December. In the heart of Europe, the harmonised rates have all turned positive.

Much of this current increase reflects a surge in energy, with some notable increases in food prices. Brent crude spiked at $145 in the summer of 2008 and then fell sharply to around $40 during the first quarter of last year. Its contribution to overall inflation was sharply negative for most of 2009 but since October, the y/y comparison has turned positive – particularly in the last few weeks. In fact, the recent price of $78 is 73% higher than January 2009.

Metal prices have also recovered sharply with large increases in Chinese purchases;partly for their massive infrastructure programmes and also due to their decision to diversify their dollar holdings by purchasing raw materials at the depressed prices ruling during the early months of last year.

The rise in inflation also reflects the onset of fiscal tightening which marks the end of the stimulus programmes. The UK reversed its 2.5% VAT cut at the start of this year and, although some retailers will absorb part of this cost in the coming weeks, this will be fully reflected in consumer prices by mid-year.

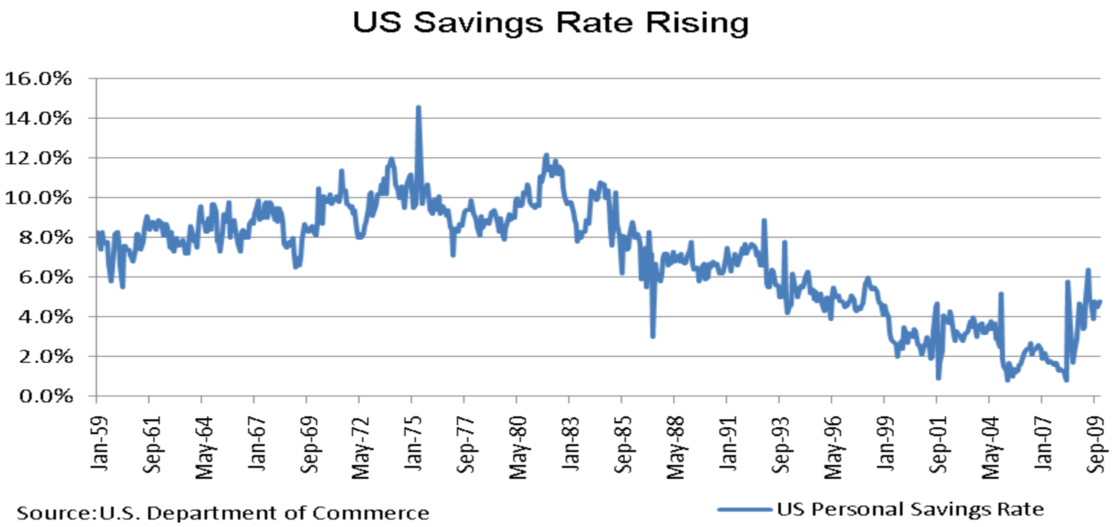




The Bank of England's latest Inflation Forecast (November 2009) predicts further rises during the first half of 2010. After that, it expects inflation to start falling again – and rather sharply to around 1% - by the end of the year. The forecast anticipates low wage increases due to a steady rise in unemployment as the year progresses. Clearly we are not alone in our cautious outlook for the UK economy during 2010.

A primary reason for this caution is the likelihood of savage cuts in public spending - whichever party wins the UK General Election. UK plc is over-borrowed both in the public sector and among consumers. The Government is bound to try to raise tax revenue and cut the total cost of public sector employment. The burden of future de-leveraging will be borne by households, other private sector entities and by national and local government

Consumption is the biggest single component of modern Western economies. McKinsey estimated personal consumption has represented 77% of real US GDP growth and about a third of the growth in private consumption across the planet since 1990. Consumption has been increasingly fuelled by debt, but we are now saving more. Between 1990 and early 2008, the amount saved by the average US household dropped from 7% of disposable income to less than 1%. Between 2000 and 2007 US household debt doubled to $13.8trillion. Economic uncertainty and rising unemployment have driven the household savings rate to 4.7% in the USA (Nov 2009), up from record lows of 0.8% in April 08. Each 1% increase is estimated to take about $100bn out of the tills (McKinsey).



The picture is similar in the UK. Between Q1 of 2008 and Q3 of 2009 the savings rate has risen from negative 0.7% to positive 8.6%. But this is still a long way short of the 10% typical of the late 70s/ early 80s and early 90s. The US and the UK savings rates are in sharp contrast to the 16.5% rate in the eurozone and the much higher rates seen in many developing markets, particularly in Asia, some parts of Latin America and Australia.

In China, the rate is close to 30%. But this is a special case since they have precious little by way of state-funded social security. With no universal pension provision and very expensive health care costs, the vast majority of Chinese must save heavily. The Party is now introducing basic welfare entitlements as a high priority and these programmes willl be a drag on economic growth in the future, but will help foster much greater consumption.

Consumers now face higher tax bills

Although we do not expect an abrupt withdrawal of the fiscal stimulus packages, the first moves have been made. The US “cash for clunkers” is history and the $8,000 tax-credit for first time homebuyers is due to end on April 30th. Each will test the durability of the recovery in their respective sectors.

In the UK, a 2.5% VAT cut has been removed which is an estimated £12bn claw-back to the Treasury. Given the scale of the debt mountain, there is more to come. The Bank of England will keep interest rates artificially low, provided clear progress is made towards cutting the deficit. A further 2.5% hike in the UK rate to 20% would serve to bring the UK rate in line with the European average and take another £12bn from the tills

The USA remains one of the few developed countries without a federal VAT but we estimate that a temporary 7% rate, the same as in the other NAFTA members (Canada and Mexico), could eliminate the US deficit/GDP ratio by the time of the next election. Meanwhile in the Eurozone the suffering will range from the extreme in Greece, Portugal, Eire and Spain to moderate in France.

The emerging consumer: China and Brazil to overtake UK

Brazil, Russia, India and China (the BRICs) have increased their share of global consumption - particularly since 2004 - from under 10% in aggregate to 13.3% in 2008. Among the major developed economies, only the Eurozone consumer has increased market share - by almost 2% to 29.7%. The UK (6.5% in 2008), Japan (12%) and the USA (38.5%) have seen market share eroded by 0.6%, 0.8% and 3.8% respectively.

At recent growth rates we estimate China could overtake the UK's contribution to global consumption by the end of this year and that of the Eurozone by 2017. Similarly we estimate that the BRIC countries could almost double their share of global consumption in the next eight years.

Two multipliers for exposure to Chinese consumption

China's growth of almost 10% in 2009 is expected to have propelled her economy to second position in the world, displacing Japan. Yet per capita GDP is still only $6,000 ranking her 133rd in the world alongside Albania! We expect that figure to rise rapidly, as the migration of more than 400million people from rural to urban areas continues apace. It is the biggest human migration in history

As per capita GDP rises so there is a tendency for consumption as a share of GDP also to rise. In China that ratio was less than 40% in 2008; in major developed economies it ranged from 56% in the Eurozone to 70% in the USA. Even among the BRICs the rate in China is low. We also expect the Chinese to revalue their currency this year as a further measure to encourage imports and consumption.

Thus exposure to the Chinese consumer appears to offer two multipliers: the growth in per capita GDP and the consequent growth in consumption as a proportion of GDP.

Asset values in China rose sharply in 2009. Equities rose by over 80% and for the time being, we would prefer to get our exposure via larger, more liquid western companies exporting into China.

Investment Implications for 2010

A modest recovery is underway. Weak top-line growth for western companies is likely to spur consolidation-driven M&A.

Bonds and longer-dated gilts are likely to be the underperformers and oil would be expected to outperform gold.

After hitting recent lows the US-dollar could continue to see some return to strength.

No further stimulus is expected and the ending of special programmes will test the durability of the recovery in the housing and auto sectors plus the global economy.

The cessation (but not yet reversal) of QE programmes is likely to lift the lid on bond yields, especially with inflation on the rise again. We do not expect managed rates to rise materially this year, if at all, in major developed economies.

As the private sector, governments and western consumers "de-leverage", risks remain. These risks will be exacerbated by continued contraction in bank lending. We are adopting a strategy of "defensive growth" with a continued focus on high yielding defensive equities and international "mega caps".

China and Brazil could overtake the UK in their contribution to global consumption this year and in 2013 respectively. After their strong out-performances in 2009 we prefer to get our exposure via larger, more liquid western companies exporting into China particularly.

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