

Vestra Wealth Conference Call

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“Goldilocks and the Three Bears”

MARK HOLDEN

Good afternoon, everyone, and welcome to our eleventh monthly conference call. I'm a partner and head of Investment Strategy here at Vestra Wealth and I'm joined by James Follows, who's a senior investment strategist with me today. We're going to follow the format that we normally do. I'm going to do a quick review of what's been happening in the markets over the past month and then we're going to go on to our main subject, and I'm calling that today “Goldilocks and the Three Bears”, and I guess the big question is: is it a story that's too scary to tell your children at the moment? We all know how the children's story ends - and it's not particularly happy - and let's hope our world and the context I put this story into today ends a bit better. I also want to touch on BP at the end, which I know a lot of people are interested in, giving it's making news headlines every day, particularly if you're based anywhere near America. And then we'll open up to questions and answers, as we normally do at the end of the session.

So what has been going on in the markets over the last month? Well, there has been very, very clear risk aversion; the sovereign debt crisis, as it has become known, has moved up a gear in the sense that Spain, Hungary and Belgium have now been targeted in addition to the other PIGS which, of course, are Portugal, Ireland, Italy, Greece and Spain. Hungary put their hands up and suggested that they may be about to turn into the next Greek crisis, and then the ministers quickly backpedalled, trying to ease what was a big selloff of their government bonds. And Belgium some people are beginning to call “the Greece of the north” -- well, we have a couple of Belgium employees here who didn't take very kindly to that comment going around. But they have an election this weekend, on Sunday, and there's a fear that the new government or coalition will not be able to implement the austerity packages and the debt reduction programmes that they so badly need and, therefore, their Belgium bonds moved out quite heavily as well.

But the big issue, really, was Spain where their government bonds moved up to higher yields than were prevailing at the time that Greece government bonds moved up to 13½% yields. Spain moved up to about 4.6% this week. They're a bit more stable this week at about 4½% but, still, that's about 70 basis points higher than you would get from a UK gilt of the same duration.

At the same time the global economic data has been steady but, for the first time really, we've seen a bit of a wobble in the US data that has come out, and that was on the employment data last week. The private sector only created 41,000 new jobs last month when the number had been expected to be nearer 200,000, so that sent markets into a bit of a tailspin. It may be a one-off number but it may also be that companies in America are bracing themselves for maybe another downturn on the back of austerity packages, drawdowns and repayments that have to take place. And all that caused the euro to hit a five year low and then, of course in the background, we've had BP which until very recently was one of the biggest companies in the FTSE 100.

So in terms of how that actually worked its way into markets, in the world of

equities the German DAX was the best performer over the past month. It fell 1%, and that was the best performer. The worst market was actually Japan, the NIKKEI 225 fell 9.4% and the FTSE 100, which obviously is close to home for most of us, fell 6.4%, just to put it in perspective.

Just to talk about what has been going on in the PIGS: Portugal was actually the best performing market of the PIGS. The equity market there fell 4.8%. Greece fell 17.8% - was the worst - and Spain a whopping 15.4%. So it shows you that, actually, if you do get a wobble in government bond markets, it does have a marked impact on your equity markets too.

In the world of bonds, the German 30 year government bond rose 8%. That's a huge move up in what is a government bond and shows you the degree of risk aversion, particularly within Europe. The German 30 year government bonds are up 8.1%. That was the best performing major bond market we look at. Spain was the worst. It fell 5%. Their bonds fell 5%. And in the UK ten year gilts, which is the equivalent to the Spanish ten year which fell 5%, we actually rose 3½%; people giving the benefit of the doubt to the UK Coalition Government.

In the world of currencies, the US dollar remained very strong and the strongest currency, up 4.1%, another sign of risk aversion. The euro, as I mentioned, hit a five year low and was down 2% and the pound against the dollar, we rose about 2%, so again, another tick in the box for the new coalition.

In commodities, oil actually had a rebound having dipped below \$70. It's up 11% since then, and is trading about \$74. That is the best performing currency recently.

Sugar was again weak and gold has pushed up to a new high recently, and is up about 4% or so on the month as a whole - like I say, up against -- towards its new high in virtually any currency you want to talk about. More on that later.

So I want to talk today about Goldilocks and the Three Bears, and I guess the big question is: does this have a happy ending? Goldilocks I'm going to talk about in a moment, but it's basically the background for investing in equities, the short term earnings momentum we're seeing, global recovery, low inflation and low interest rates, which ordinarily would be very good for equities. But in the background you've got the bears, which Daddy Bear would be the sovereign debt crisis, the possible breakup of the euro. Mummy Bear would be, you know, the need for credible debt and deficit reduction plans, and the austerity package have got to be implemented to do that. Is there going to be a tax grab? Will that cause deflation? And then the Baby Bear really is the growing government unpopularity around the developed world. We've got a UK coalition here. Will that hold? And undoubtedly, there is more political interference in all three markets than I can remember in my entire career. So we know how the children's story ends, and it's not a happy ending there. I suspect by the end of you hearing me talk about this you'll also realise that we don't think it's a happy ending either.

So to the Goldilocks economy: if you sort of arrive from planet Zog and you'd never sort of read any papers or realised what had happened around the credit crunch, I guess you'd be looking at the backdrop for investing in equities with fairly rose tinted glasses. You'd be very bullish really. We know that the stimulus has worked and the worst of the credit crunch has passed or had passed. Emerging markets have recovered quickly; employment had stabilised - is

stabilised around the world - and global growth is now back on trend or even above trend in many parts of the world, particularly in the developing world. At the same time inflation and interest rates look to remain very low for the foreseeable future. At the same time balance sheets, companies have been restructured, they're very well funded; profits are consistently beating expectations and - in the main - full costs for companies' earnings are still rising.

At the same time as well we've got increasing merger and acquisition activity. So everything, as Goldilocks would say, "Is just right". It's almost the perfect backdrop for investing in equities. However, as I say, there are a number of bear factors and the biggest one is Daddy Bear. So in the developed world, let's just step back a bit. Now, if you remember, private sector debt from the banks, the automotive industries in America, etc, were transferred from the private sector and put onto the government balance sheets, and that's causing huge strain now, along with the governments printing money to restart the economies. This debt bubble has swelled to a level as high as it has ever been. At the same time, something that's not really talked about very much, but there are some capital requirements potentially being put in place, regulatory capital requirements potentially coming, called BAL III(?), which may take place in 18 months' time for banks, and something called Solvency II for insurers, and these could make matters much worse. It means that the amount of money any bank has to put against, for example, a mortgage loan that they have, could increase quite markedly.

To put it in perspective, Royal Bank of Scotland where, of course remember, we the taxpayers own 87% or so of the company, if BAL III comes into effect - as it is meant to be in 18 months' time - that company will need to raise another £90 billion, and of course the taxpayer would have to find the bulk of that, given the shares that we own. For Lloyds it would be a staggering £60 billion and for Barclays £30 billion. Now, given that the Conservative/Liberal pact has just talked about the first £60 billion of cuts, you can see that that could dissipate quite quickly and look like a drop in the ocean, and that's without trying to take the £170 billion deficit down, which is their intention.

At the same time, governments that are suffering from a selloff in their bond markets their ability to actually pay the interest on that is now becoming dangerous, it's becoming quite difficult, particularly if we get a slowdown and the tax take falls as well. Credit ratings agencies have actually downgraded a few of the European countries, most latterly Spain, and they've put the UK on watch. So everything in the UK, really, will depend on what happens in the Budget on 22 June, I suspect. So watch that date very closely. It's not far away now.

And, as I say, despite the lowest ever interest rates that I can certainly remember, government borrowing costs in the main have been rising in countries where they're perceived to have a problem. In the UK, Germany and the US, that has actually been the opposite. They've been staying stable or falling, which is a good thing for us personally but it doesn't help what's going on in Europe. It's a global problem. It's not just confined to the PIGS. As we see, Hungary and Belgium have been brought into the equation in the past month.

So Mummy Bear now that I talk about, clearly in order to attack that debt pile governments need to implement severe austerity packages. Government plans have to be credible in the eyes of the market otherwise their bonds will sell off

anyway. And those plans are bound to involve public sector salary cuts and job cuts, pension cuts and an extension to the retirement age, self taxes, such as rises in VAT. I wouldn't be at all surprised to see corporate taxation rising as well. And of course, already in Australia - something that scared the market a few weeks ago - we've had a super tax put on the Australian resources companies. If that were to be spun out or put into other sectors, such as oil, which wouldn't be very hard to do, given what's going on in the Gulf of Mexico, but if it went into pharmaceuticals, utilities - the list goes on - you could suddenly take the majority of these, for example, even the FTSE 100 index and maybe implement a one-off tax there, which would be very unpopular for investors but, obviously, maybe not so unpopular for governments and for most people in the street.

And of course in the background we've got growing civil unrest. We saw that in Greece a month or so back, and clearly that's something that I'm sure every government is worried about. The big question is: can this be anything other than deflationary? Our view - my view - is certainly it's going to be deflationary and certainly not inflationary.

Don't forget Baby Bear. We know that there are desperate measures being implemented to counter the speculators. In the recent past we've seen the Germans stand up and put a ban on short selling of certain financial instruments. A point I would bring to the fore here is that when the Americans - and when we and the Europeans - put on a short selling ban after Lehmans went bust in September 2008, the stock markets then fell another 40% in the next six months. So it didn't really work. I'm afraid, you know, capitalism works in mysterious ways and governments try to interfere at their peril. There is obviously - as I say - politically the most interference I've ever seen in free markets. We know that from time-to-time the ECB are intervening to try and support the euro, there's quantitative easing, as I say, and the likes of the Germans are putting short selling bans in place.

Governments everywhere are going to be very, very unpopular as they put these austerity packages to work, and they're likely to remain so for the foreseeable future. The danger of that is of course you get the rise of extremists and, God forbid we get anything like that. But also the final thing I'd put into Baby Bear, if you like, is that in the UK we've had the first coalition government since the Second World War. If you go down the bookies I think they're betting it will only last until October but so far - to be fair to them - I think they've done a reasonably good job. They've held it together and actually the market seems to be giving them the benefit of the doubt and the gilts have actually moved up in price and sterling has remained fairly stable, and those are the two areas you would see a lack of confidence flowing through first. And just remember that these are some of the things we worry about least as investors at the moment.

So how does the story end? I mean there's just so many questions and so little time. The question that everyone was asking last year, of course, was: will all this extremely loose monetary policy cause inflation? I think you can put a line through that now. The next question is: will all the austerity in the developed world cause deflation? We certainly think so. Will one of the PIGS default or restructure? And will - as I call here - Swine Flu spread to other countries? Well, in the past month unfortunately it does seem to be spreading, as we saw in Hungary and Belgium. A default would be -- or a restructuring of those PIGS' debts would be very bad and that would certainly put off investors funding new government

spending anywhere that it does not have severe austerity. The big question is: can developed countries efficiently fund their spending and will their sovereign debt piles ever be paid back? It's a very interesting question at the moment, and I have to say the jury is very much out on that one.

Some people will say that China and the other BRICs - so Brazil, Russia, India and China - can they come to the rescue of the rest of the developed world? Well, I always think about rape and pillage when something like this is said to me because if they were to come and start helping out the developed world they certainly won't do it for nothing, and we could find a huge amount of assets and wealth transferred over to those countries which would be to the detriment, obviously, of the likes of America, Europe and the UK.

I mentioned earlier the Australian resource super taxes. Will they be spread elsewhere? Very possibly. It's politically acceptable to do so I guess. We talked about the UK coalition, civil unrest, and then just to throw in the last thing of course we've seen -- in the last month we also saw a marked increase in the tension between North and South Korea and even in the last few days we see that Iran are beginning to come to a standoff again about their nuclear developments. The million dollar question, though, at the end of the day is: will the euro break? That's where lots of investors are focused at the moment. That's the only place, really, to focus.

So, what to do about it? From a portfolio perspective we -- and we're very cautious on the outlook for the euro. If you believe like us there's deflation coming, austerity across, particularly Europe, then it can only be bad for the euro. If one of the countries defaults then it will be very bad for the euro. We believe in deflation not inflation, therefore index linked bonds look very expensive to us at the moment. We'd be selling those. Sovereign debt and poorly financed nations, even Spain - the likes of Spain - it's something to avoid. Consumer exposure in all of the developed countries is an area to avoid as well, given if the public sector are going to have to take the bulk of the cuts in the next sort of few years, then there's a huge amount of spending going to be pulled out of the real economy and you don't want to be near any of the consumer type areas at the moment. Financials: we continue to have no banks and life assurance companies in our portfolios. And the reason is very clear: if some of these bonds default then it will hurt their balance sheets. But more importantly, if BAL III, Insolvency II are put in place then there are very, very big rights issues and equity fund raisings to come in the next 18 months or so.

All that feeds through into a negative view on property and we do believe very simply now is not the time to be taking big risks. However, there are some things we do like. We continue to like the US and the Canadian dollars. Funnily enough, I think I'd probably put sterling in that camp as well - just for the time being. We have to see - I stress - what happens on 22 June at the time of the next Budget, but if that delivers in terms of a credible debt reduction plan then maybe sterling will start to strengthen.

We want to buy -- we're quite happy to buy debt in some of the financially stable nations, such as the US and the UK; potentially again, 22 June is important. Emerging markets: we instinctively want to buy, given the much better finance and then they've got demographics that work very much in their favour with very strongly growing populations. But we still think now is not the time. There will be a time but it's not quite yet.

Economically and sensitive growth companies we like; these things like funeral operators, etc, shouldn't be affected by what's going on in the wider economy, and large overseas earners. But again, that largely depends on sterling really drifting lower. If it starts to strengthen then that will work a little bit against some of the large overseas earners. So we've got to be careful there.

At the moment, this very moment in time, the US looks the best of a bad bunch, but then again you're overlaying some currency risk there. We instinctively want to own absolute return funds that can short assets, but if these short selling bans the Germans have put in place spread to other countries then it may jeopardise their ability to do things.

We still like gold. Oil is more difficult to call. Given what's going on in the Gulf of Mexico there's a chance that supply gets quite cut back in the next 18 months, but industrial demand may fall away if we're going to double dip in the global economy. And of course cash, cash is always king at moments like this. So it looks very dull the things we like but we still believe capital preservation is the order of the day.

So just to reiterate, our biggest positive asset allocation is still to gold and in the last few months we've actually upped that. Yes, it's a traditional inflation hedge. Well, we don't believe we've got inflation but it is a store of value during deflationary times but, most importantly - and this is what everyone is beginning to work out - in a world of competitive devaluations, and we've said this consistently, and given a level interest rate playing field which it now has with near zero interest rates around the world, gold is a currency of choice and, of course, we don't have creative accounting or central bankers with printing presses who can make more of this asset, and we think it's really coming into its own. It's right up near its all time high and we think it will push on through that and higher still.

Now I know there's -- anyone who reads the business press for the past six weeks would have been staggered almost by the amount of press coverage BP have had, and the big question is whether you should be buying it as the shares have now fallen 30% or whether it's going bust. Frankly, the jury is still out. The big unknowns are: how much it's going to cost to clear up this mess. And there are huge ranges on these numbers. What the ultimate litigation will be. And you add those two numbers up and you can get up to numbers that are quite staggering, maybe as high as \$60 billion or \$70 billion, some of the numbers we've seen bandied around. And that, interestingly, is about the same amount that the market capital of BP has fallen by. At the same time, though, you've got issues such as credit ratings have been cut by Moody's and Fitch, which makes their ability to raise money cost effectively in the credit markets more difficult. The biggest issue, though, is probably what happens next. Will they be curtailed from getting new licence application for new drilling? They may be forced under US law to sell some of their best assets to their competitors. And this is the big issue: politics are very deeply ingrained now in BP, given Mr Obama is making a personal crusade -- taking a personal crusade against them. We don't know how this is going not play out. Unfortunately, as investors, once politicians get involved your ability to properly value an asset becomes very difficult, and BP is no exception to that rule. So on the face of it fundamentally it could look very cheap. However, one of the reasons for the big fall overnight was there are people in America talking quite openly about forcing the company into Chapter 11 or near bankruptcy, which of course would have terrible effects on the share prices and the bonds, and that obviously would be most unpalatable. What we think they'll do, well

they will probably have to cancel part of the dividend. I mean this is \$10 billion of dividend that goes into the UK market. I think it's about 12% of the total FTSE 100 dividend payouts, so it's a huge number but it might be politically correct to cut or pass that until the backlash against them has subsided. They spend about \$20 billion a year on capital expenditure, new drilling programmes, etc. That will have to be looked at very carefully and probably cut back dramatically which will undoubtedly impact on their longer term growth potential. And, as I say, the cost of their debt is becoming very prohibitive. So they're going to have to start saving money wherever they can. The problem is the more the equity price falls the harder it will be for them to actually raise more money through an equity issue, if that's what is needed. If, for example, some of the debt facilities get pulled back or reined back by the banks, and of course the other question is: what will happen to the management? Will they be forced to resign? Will they go to jail? All terrible sort of issues for them personally. But these are issues that, as investors, we need to be aware of.

So they fall into £3.50 this morning. They rebounded a little bit to sort of £3.70. A lot of people I'm sure are saying, "Now is the time to buy it". At £3.50 - to give you a clue - if they actually halved their dividend at £3.50 they would yield 5%. Now the question is: given the backdrop, is that enough of a yield to compensate for all the risk that is still going to hang around for several months yet or is that a very attractive buying opportunity? Also, at around £3.50 the price per barrel of oil that BP has falls to a very, very low level - about half of what the rest of the industry would pay for a barrel of oil. So fundamentally, it could look cheap there on that basis. The yield, I would argue, is probably not enough. But the big issue, really, is what we call "the death spiral". The more the share price goes down the harder it is for them to raise money through equities. The more the bond holders get worried they sell it, the price of their bonds fall. So their ability to raise money through the bond markets also falls, and therefore they have to put in cuts that damage long-term growth prospects and you get into the spiral, and it's a very bad spiral that can ultimately lead to liquidation or bankruptcy. Now, we're not saying that's going to happen but for those of you that follow the changes we've put in - follow our most preferred list - only last week we took BP out of the model at about £4.30 and we put it into Rockhopper, which has successfully found oil in the northern Falklands basin at £2.40. So, whilst we're not necessarily telling people to sell the stock, we certainly feel that it's not right to be buying it yet. I will always go and pay -- I'd pay a much higher price, even £1 higher than where we are today, if I had certainty that the big issues were behind us. Right now, I think uncertainty is growing not subsiding, so I think at the very least it's a strong avoid.

Well, that sort of finishes my formal presentation. I'm happy to take any questions on any of those subjects or anything else you want to. So over to you.

OPERATOR:

Thank you. We will now begin our question and answer session. If you have any questions or comments please press 01 on your keypad to enter the queue. After you're announced please ask your question. If you wish to cancel your question at any time, you can press 02.

Once again, ladies and gentlemen, if you have any questions or comments please press 01 on your telephone keypad now.

Okay, there are no questions in the queue. Back over to you, Mark, for any closing comments.

MARK HOLDEN: Thank you very much. Well, thank you everyone for phoning in. If you've missed any of today's call then a transcript of it will be placed on the web site as soon as possible, and the next call will take place at 12 noon on Thursday, 8 July. Thank you very much everyone.

OPERATOR: This now concludes our conference call. Thank you all very much for attending.