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Speaker: Mark Holden  
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OPERATOR: Hello and welcome to today's January Investor Call for 2010. Today I am pleased to present Mark Holden.

For this call all participants will be in listen-only mode and afterwards there will be a question and answer session. I will now hand you over to Mark.

MARK HOLDEN: Good afternoon everyone, and welcome to the sixth Vestra conference call. As you know we do this monthly. My name is Mark Holden. I'm Head of Investment Strategy here at Investor Wealth and a partner of the firm. What I plan to do today is just give us a quick overview of what has happened in the last month in the major asset classes, and then go on to talk a little bit about what happened last year and, really, our outlook for this year, 2010.

With no more ado then, over the past month quite an interesting turnaround from the last quarter of 2009, in that the Nikkei Index in Japan was actually the best performing equity index around the world, somewhat surprisingly. It was up nearly 7½% in the past month. And actually, the worst performing market was - somewhat perversely again - against the trend of last year, particularly with the Shanghai Composite Index which was down 2.6% and the Hang Seng was not far behind it, down 1½%; more of that later.

But if you want to know what the UK did. Really the FTSE100 - buoyed up by a lot of mining and resource companies - was up 3.8%, very respectable so far in the past month, and the Mid 250 Index up 6.4%. A lot of that gain came right at the end of last year as the markets did their usual yearend rally to make everyone feel good at the end of the year and give you a nice Christmas present. As we roll into 2010, there are some more issues facing us - but I'll talk about that a little bit later - not least the fact that the Chinese authorities have decided to start to put the brakes on their economy and that's led to the selloff in the Shanghai and the Hang Seng

indexes in the past week or so.

In the bond markets, well it was a pretty torrid end to the year to be honest with you; people worrying about more issuance; worrying that there's inflation coming back and the economic growth out there is going to be strong enough to generate that.

That is still not our view. Again, I'll talk about that a little bit later. But the worst performing part of the sovereign bond market was the US 30-year Treasury - so long dated US government bonds - and that fell about 3½%. The best performing part of the global government bond market was Germany. Their two year bonds were little changed. They were down about just 0.2%. In the UK the area we invested in most for our clients, 10-year gilts were down about 1.2%.

In the currency world there was some reversal of the trends we'd seen in the fourth quarter of last year. Right towards the end of the year the US dollar, which had been under the cosh all of last year, staged something of a rally where everyone had been putting their money before with the Japanese yen, and so you saw a lot of reversal of that. In fact, you saw a near 4% reversal in the dollar/Japanese yen value. Sterling was a game of two halves really. Towards the end of last year it was coming off quite heavily as opinion polls in the UK were looking at the potential for a hung parliament, or certainly a smaller than previously anticipated potential Conservative majority at the next election, and when there was a challenge to Gordon Brown - a week or so ago - people decided that that was a sign of Labour weakness and the Conservatives would certainly benefit from that and hence sterling also started to rally.

Now clearly, there is a big issue coming up - between now and probably May and the election - and sterling will no doubt move up and down with sentiment regarding who's going to get power at the next election. If Labour are considered potential winners then I suspect sterling goes easier. If there is potential for a hung parliament, again sterling goes easier and perhaps more so. There's nothing worse than uncertainty of hung parliaments. But if the Conservatives look like they're

going to win comfortably then I think you'll see sterling rally quite strongly.

In the commodity world there was a very, very strong run in oil towards the end of the year. I think the main influence there perhaps was the return for the first time in - it may be a year or so - of geopolitical risk, as Iran have failed to meet their commitments on the nuclear programme de-commissioning and it's got people a bit more worried about potential tensions in the Middle East. So the oil price pushed up over \$80. It slipped a little bit back in the last week or so, but it was up a significant 15% or so over the past month. The worst performing commodity was wheat, which had been recovering but had been weak all of last year; one of the weaker commodities. There has been a huge crop across the world and that continued to weigh on the underlying commodity price, and that was down nearly 3% last month. Sugar on the other hand was another very strong performer, up a little bit more than oil actually, on the other side. This is being helped by the fact the Europeans have taken a huge amount of capacity out of the growing of sugar beet across the European Union, and that has led to a supply shortage and the sugar price is up 17½%. It was one of the best performing agricultural commodities last year.

That is a bit of background about where we've been over the past month, in terms of assets and market moves and I think really last year was quite amazing, really, in that coming into 2009 we'd seen the steepest ever decline in GDP around the world and an unprecedented collapse in banking. There was no country, whatsoever, that managed to avoid that, of being impacted. Those with high cash balances, in Asia and certain parts of Northern Europe, suffered as much in the downturn as anyone else, and particularly those countries - like ourselves and the US - which are heavily indebted. So no one was unscathed and everyone really this time last year, if you remember, was just worrying about how many of the banks or which major industry was about to go into bankruptcy or to become part of the government assets or

state control. So, that was a pretty torrid start to the year. This time last year we were all very pessimistic and I certainly was.

Then in mid-March we had quite an interesting change. It started, really, with a small amount of re-stocking through the manufacturing cycle, where manufacturers and industrialists had run down stocks for some six months or so and eventually that came to an end and a few people had to start re-stocking. That manifested itself in the new orders part of industrial surveys that we see, through purchasing managers, etc. And it led a few people to think, really, that perhaps the world hadn't ended and that slowly but surely gathered pace. There was no doubt that the first couple of numbers surprised on the upside, although they were off really low bases but that saw a return to confidence and gave people belief that the government stimulus - that we were seeing put in place around the world - was beginning to work, and that had started in the fourth quarter but hadn't really showed signs of working until about mid-March. So the commodity world took hold of that first and took heart from it, that people were going to start re-ordering steel and iron ore and coal, and commodities really led the rally upwards, quickly followed by emerging markets, and then the broader equity markets around the world, in the developed world such as the UK and the US. Emerging markets certainly were the strongest and that then led into a few weeks' later - sort of by mid-April - a recovery in corporate bonds which typically lag what happens in the equity markets by about six weeks or so.

What is quite amazing really is towards the end of the year what had been very weak, property markets in certain of the city centres around the world, began to recover very strongly and I know from some of the anecdotal evidence that, for example, in London now some houses are actually trading and selling at higher prices than they were before the credit crunch began, which is very hard to believe. In America residential prices are down 40% or so, although of course in places like New York it's a lot less than that, they're still down nevertheless. But in London a

staggering 30% fall in sterling towards the end of 2008 has clearly pulled international investors into London property and so that's taken prices to higher levels now than they were before the credit crunch, which I find quite staggering really, and I think throws up a lot of risks which we'll maybe talk about a little bit as we go forward.

So in the end, I think it was a very profitable year for most asset classes actually. The only assets that declined a bit were government bonds, on the worry that the government and the authorities were going to keep interest rates too low for too long, this would then generate potentially dangerous inflation and at the same time they'd be issuing huge amounts of new government debt to fund the stimulus packages that they were putting in place, some of this no doubt is quantitative easing, of course.

So the big question we have is: do people really realise that 2008 happened at all? It certainly doesn't feel like it. Equity markets all finished materially higher on last year, up 20% or so in the developed world. The interesting thing is, from our point of view, all of them now look as if there has been some sort of return to normality.

There are very few areas that are saying there are still problems. The one area is bonds, which is an area we particularly like and that really goes back to our core belief here. What do we think about the world, going forward? All of last year - and still now - we have been of the belief that, given the huge amount of deleveraging from both the consumer, the corporates and governments, that a deflation or disinflation - certainly price stability - is much more likely than inflation, going forward. We are now in a very small minority who believe that. The majority of investors and pundits out there think that we're going to get a bout of inflation, hence you've had a recovery in equities, and commodities particularly, and that's also helped our favourite commodity, gold. But where it has damaged sentiment is in the bond market and the bond market is now at its steepest; the yield curve is at its steepest level. In other words, if you wanted to invest in government bonds just

a year out you'd be lucky to get 1% return on that; if you went out 10 years, however, you'd get over a 4% return now. So you'd be able to buy a lot of those government bonds at subpar, which - at a 4% return when interest rates are 0.5% - is really quite attractive in our view. But it does need you to believe that if there is any inflation it will be controlled by government and that the markets can absorb the huge amount of issuance that is undoubtedly coming. But these are all things we know about and that's the point. What a lot of people forget is that the way investors make money, really - in a most simplistic form - is by working out what people are expecting and if people are expecting too much and the end result is disappointing then share prices and values of those assets tend to fall quite substantially, and vice versa. So, at the moment, I would argue that there is a huge amount of high expectations being built into equity markets; being built in some respects into the commodity world, and certainly in the property market in central London property, and that is now very dangerous. On the other hand, the bond investors are very pessimistic. They believe that there is going to be a huge amount of inflation, the issuance will carry on for a lot longer than people think and they're taking the opposite side. And instinctively, that makes us want to go and invest in bonds and take money out of equities and commodities.

We do recognise, however, that there is likely to be continuation of this optimism for some time yet until we start to see some disappointments, in either the economic data or from companies. I'll talk a little bit more about that later. But if you do start to get those disappointments we could see a very sharp reversal of the current trends. In other words, equities would come off very sharply and bonds could rally very strongly, particularly longer dated government bonds. The problem with short dated government bonds is everyone is of the opinion that interest rates are going to stay very low now for the next year or so still and so yields are very low there. If authorities do get worried about inflation, ironically, there will be talk of higher interest rates and that will hurt government bonds that have less than two years left

to maturity and actually will help the longer dated bonds because investors will take heart, bond investors will take heart that the governments are actually trying to do something to counter inflation potentially building through the system. Like I say, we believe that there is a huge amount of excess capacity still in the world of manufacturing, and out there, which means that any inflation or demand pool that we start to see will be easily absorbed by industry, and that means that prices still won't be able to go up. I mean, if you think that global GDP is still about 10% below where we were 18 months' ago, that's a huge shortfall that's got to be made up and it's our opinion that that will take a lot longer to absorb than people think and if anything that will be disinflationary.

I think the other side of the equation is: how much saving is taking place and how much debt repayment? The big issue here is about paying back government debt and consumer debt and company debt over the next few years, and that will act as a real drain on the real economy as cash comes out to do that. Now, if you look at companies a lot of them issued corporate bonds last year and equities and we've obviously participated in a few of those issues and made good money in many respects because the discounts were very large. But nevertheless, companies, it is fair to say, I think have been very good at rebuilding their balance sheets, getting themselves cash rich again so that they're in a position to see out any potential fallback in the economy or a double dip, as some people might be expecting.

So they've deleveraged, if you like, companies have. Have the consumers done so? Well we don't think so at the moment. So far, savings ratio has gone up but compared to history, if you strip out the last ten years, it's still very low, about half the level it was back in the 1970s and the early 1980s, and so more needs to be done there. Interestingly, consumers seem to have shrugged off the threat of unemployment and have spent like crazy over Christmas. I mean, John Lewis saw like-for-like sales up over 20% in December. Clearly, consumers are not worried about their jobs, going forward. They believe that the recovery is well under way

and that their jobs will be safe, going forward, because otherwise why would you go and spend. As I say, with savings rates where they are people are either taking money out of their house where they can or, worse still, putting extra spending on their credit cards which we know is just building up ultimately a worse problem later on.

So we're satisfied that corporates have rebuilt their balance sheets; we're less convinced that the consumer has and I think that as you go into an election or when governments start to think about paying back some of this debt, that will perhaps weigh a little bit more on consumers than it is doing so at the moment.

That brings us on to, really, government debt. In the UK alone, in order for us to keep our credit ratings we need to really start paying down our debt very significantly. Some of the plans that have been put in place in the pre Budget report expect to pay back about £50 billion year for the next sort of five years plus.

Expectation in the bond market is that needs to be at least twice that level. With an election though coming up in the UK no politicians are really prepared to go out on a limb and say how aggressive they want to be on that front, particularly Labour, and so the bond market has taken a wobble from that, worrying that governments will be imprudent and fiscally they'll remain very stretched. However, as I said earlier on, if the Conservatives do come in then there will be an expectation that they'll be more prudent and more fiscally constrained and that will be good for bond markets, but the next few months are going to see a lot of ebb and flow backwards and forwards as the Labour Party's and the Conservative Party's fortunes in the polls move back and forth.

One of the issues we have, as well, is that in Europe there is new legislation coming through called Bal2, which requires banks to tighten their capital ratios. This means that the amount of lending they can do will be curtailed, despite government efforts to get them to do more and the assets that they hold will have to be of higher quality. Now interestingly, this could work very much in favour of the government

bond market because the highest quality capital that a bank can hold is government bonds and not mortgaged securities or other leveraged vehicles and things that they use at the moment, and they got into a lot of trouble last year. There is no doubt that economic growth is returning around the world and the pickup has been quite marked, particularly in Asia, to the point where actually the Chinese have now decided they're going to start putting the brakes on. We've had some very, very strong economic numbers out of them in the past month or so. In Australia we've now had three interest rate rises in a row. They're re-employing people. Asia and the developing world is certainly very strong. The developed world is now picking up. In the UK obviously we had a very good Christmas for the retailers. We'll have finally come out of recession when we see the next GDP data out of the UK, and the US is also picking up. However, it's all a little bit illusory because we're coming off a very low basis. We're against very easy comparatives from this time last year and it all needs to be sustained and built up. The momentum needs to keep building if equity markets are going to make any more progress from here. We believe that - as I said right at the beginning - that equity investors are now over optimistic, compared to reality and it will be very interesting to see how they react to the next reporting season, which interestingly starts tonight in America after the US close Intel report and JP Morgan report tomorrow. So we'll get the first feel, really, for how companies have performed in the last quarter and how they've performed against investors' expectations. Share price reaction will be very important. I suspect a lot of companies will be up to expectations or even beat them, but I'll be watching very closely how share prices react to that. So I think there is no doubt that there is a huge amount of more confidence around and people are certainly feeling that we're through the worst of it. The danger here now, though, is that people - like I say - have got themselves too optimistic and any cracks in the recovery or any thawing of confidence could be very, very dangerous and see a very sharp fall, particularly in equities from here.

So I guess, to summarise, we're really still quite cautious about equities, going forward. We're getting more and more positive about government bonds, particularly longer dated ten years because we think the market has got itself too bearish about inflation which we still believe is not a threat and, therefore, in the coming months you'll probably see us begin to reduce equity positions in favour more of upping government bonds, but particularly UK gilts of about a ten year maturity.

That's really what I've got to say. We're looking forward to hopefully another profitable year all round because out of even chaos comes opportunity and, hopefully, we'll be well positioned to take advantage of any big market moves either way. With that, I'd like to hand over to you and take any questions you may have.

OPERATOR:

Thank you very much, Mark. If you would like to ask a question, please press 01 on your telephone keypads now. You will enter a queue and after you are announced you may ask your question. If you find your question has been answered before it is your turn to speak, you may press 02 on your telephone keypads to cancel. So that's 01 to ask a question or 02 to cancel. Are there any questions?

A reminder again, participants can ask a question by pressing 01 on their telephone keypads now. And it seems we have no questions, Mark.

MARK HOLDEN:

Okay. Well, thank you very much everyone for calling in. Our next conference call will be on the second Thursday of February, and I look very much to having you join me again then. Thanks very much.

OPERATOR:

This concludes our call. Thank you for attending.