Reflections on Markets in 2009

Although 2009 has seen investor sentiment swing from the depths of despair to the euphoria of the recent rally. Nothing much has changed in our portfolios but we reflect below on a number of aspects of what has occurred.

Cyclicals

Markets may be approximately the same level as they were at the end of last year but within them much is different. In particular, a number of cyclical manufacturing and mining companies have risen in price substantially – for example, RTZ is up 91%, Ford 148%, Nippon Steel 20% and Toyota 37%. What can we deduce from this?

First, it is a behavioral norm for rallies such as the current one to be led by those companies that went down the most in the bear market, which in turn tends to be the companies that led the preceding bull market. RTZ, an emblem of the last bull market, went up 7x from 2002-2008 and then fell 85% in the remainder of 2008 before rallying in 2009 by 3x from the bottom (in November). The same happened to the shares that led the technology boom that ended in 2000. Market rallies after the peak in 2000 were led by the leading shares from the previous bull market, notwithstanding the fact that as the bear market matured each rally was less influenced by those former leaders. Over time (and it was two years after the technology bull market peaked) a new bull market emerged that was driven by a new cohort of companies. Then, the leading shares of old withered on the vine and de-rated to valuations well below the norm. Take Oracle or Microsoft for example, principal performers in the tech boom. Between 2002-2008 they barely kept pace with the market and, having traded on earnings yields well below long-term bonds, now trade on yields well above. So even though RTZ and its cyclical cousins may be performing today, investors should be cautious. The likelihood is that the bull market in these shares is over, condemning them much lower valuations in the future.

Next, the influence of China on world stock prices is everywhere to see. Not only are Chinese shares themselves up 50% from the lows in November but companies that have benefited in the past from strong growth in industrial demand in China, such as Xstrata and Nippon Steel, have risen as well. Large dollops of public money and plentiful lending by Chinese publically controlled banks have helped to sustain infrastructure projects in Central and Western China, for now. But the largest part of China's economy is its export sector, whose destiny is in the hands of western consumers who today - and for some time hence - are likely to place a priority on saving over spending. Without a recovery in western demand all that this new infrastructure investment will do is to further increase supply and intensify the deflation that has returned in China following the collapse in commodity and product prices and the loosening of the labour market. New deflation is being exported to the West, exacerbating the deflationary forces already prevalent from the collapse in domestic demand. China may have more capacity to boost its economy compared to most developed countries but we doubt that by these means alone it can offset the negative effect of declining trade.

Finally, Ford and Toyota's performance is indicative of the leading performance of automobile stocks in both Japan and the USA. In both countries automobiles have been the best performing sector so far this year. This is despite an overhang of productive capacity. The recent trend of financing car purchases with loans, either provided by the automobile companies themselves or by third parties, had the effect of bringing forward tomorrow's sales to today which in turn flattered overall demand. But now, with the cost of financing punitive and the availability restricted by a funding drought, car sales are reliant on demand from only those consumers that have no need to resort to borrowing. As a result, it is likely that owners will hang on to their cars for much longer in the future before buying a replacement. It is instructive to note that when the recession hit in Japan, following the bubble in the late 1980's, car sales fell from an annualized rate of approximately 6m units in 1990 to 2.5m currently, a fall of 60%. And then financing was not as prevalent as it is now. So watch out for a dearth in demand for many years in Western countries. Already such fears have hit the weaker companies, GM and Chrysler. Survivors such as Ford and Toyota see the chance of reduced competition and higher market shares, which may account for recent share price strength. But for these companies to benefit from the demise of others hard decisions need to be taken and production capacity needs to be cut, not just transferred, as is planned today. At least Toyota and other Japanese automobile companies had the outlet of higher demand through exports after the Japanese domestic market collapsed. Then, annualised exports rose from 3.5m units in 1996 to 7m in 2008 helping to alleviate the domestic production adjustments for Japanese companies. But now exports are falling. So Japan will after almost 20 years be forced to address excess capacity at home just as US companies are doing the same. Vehicle sales in the US in 2008 have already collapsed from approximately 16m units per month to below 10m units, down 40%, with probably more pain to come. Without substantial reductions in capacity in both countries, losses will mount to undermine the recent recovery in share prices.

Banks

UK and US banks are up significantly from their lows in March (80% from the bottom in the US) and have outperformed the market nicely so far this year. What's changed? The infusion of capital from governments has stabilised balance sheets for now and the central banks' zero interest rate policies have helped to materially boost the net interest income of these institutions. Take Lloyds as an example: pre-provision profits are now running at £13bn per annum. Provisions will arise from the next £15bn of losses incurred from the assets placed in the government's Asset Protection Scheme ('APS') (the company has already provided for the first £10bn) and then 10% of any subsequent losses, to a maximum of

£23.5bn. Also, the company will have to depreciate the £15.6bn APS insurance premium itself over seven years. Then the company has to contend with regular "real economy" related loan provisions against the backdrop of a recession and rising unemployment. The great attraction of Lloyds is its dominant book of UK mortgage lending (currently £277bn outside the APS) which in past cycles has exhibited a rock solid credit history. However, this recession could be different. Nominal property prices (UK all dwellings house prices), which are down approximately 15% from their peak, are already off the scale compared to past experience. The only down years since 1956 were in 1982 and 1992 when prices fell by just 2%. Of course, in the past, bouts of inflation ensured the real value of mortgage debt fell materially allowing nominal prices to continue to edge ahead even in recession but nascent deflation today ensures the real value of mortgage debt is actually increasing while property prices are falling – a unprecedented and potentially catastrophic combination. As a result, the gathering view that Lloyds has drawn a line under the extent of its potential losses may yet prove too optimistic. At least 2-3 years of bumper pre-provision profits will be needed to match ongoing provisions and protect the company from a diminution of its net worth. The only consolation is that whilst Lloyds, with its focus on retail banking and mortgages, remains under pressure other UK banks such as Barclays now have a bigger balance sheet (£2,000bn versus £840bn for Lloyds) and much higher exposures in riskier areas such as international capital markets and corporate lending that risk unraveling if economy-wide problems persist. Thus, there remains the chance that only a proportion of the banks' bad assets have been addressed so far and that continued economic weakness and higher unemployment will gnaw away at the asset quality in the future forcing more recapitalizations in even more hostile circumstances than in the past, with nationalization remaining the possible outcome and ultimate solution.

Fixed Interest

Long-term bonds in both the UK and US have fared badly in 2009. We know as we own the UK irredeemable and a US Treasury with a 21 year maturity. The former are down 14% and the latter 13.5%. The prospect of quantitative easing proved great for bond prices in 2008 but the reality a drag on prices as investors focused on the long-term inflationary consequences of such a policy. The general view is that rising inflation is almost a certainty given the combination of excessive monetary easing and the political necessity to inflate away a proportion of the excessive government debt that in the space of a year has doubled debt as a percentage of GDP in the UK and US. But while such concerns are contributing to falling bond prices now we believe the reality of falling consumer prices, with the direct implication of a rising real return from bonds, plus the persistence of disappointing economic growth could rekindle a material rally in long-term debt, especially the undated gilts. We believe that prices could rise as much as 50% from here, assuming long-term bond yields fall to 3%, as we think they might. Unfortunately, we see no such benign environment for corporate bonds whose premium over government issues, already high by historical standards, may widen as excessive government spending crowds out the private sector and risk aversion heightens as corporate cash flows continue to decline.

Durable businesses

Consumer franchises held up well in the rout in 2008 but have done poorly so far this year, especially lately as the recent rally in prices has accelerated. Yet for most of these businesses, dividends at a minimum are secure and some are growing. While the yield on competing financial assets remains so uncompetitive (yields on bonds are now lower than dividend yields on many of these companies and cash has no yield at all) these dependable assets have an allure that in our view justifies a significant premium to competing assets. In fact these stocks trade at lower than average valuations while investors ignore these attributes and instead anticipate a sharp recovery in profits led by cyclicals and other less stable businesses. As we implied above in our comments on cyclicals we think that such an outcome is unlikely and once this is more widely recognized that investors will not only reconsider the attractions of stable and steady returns but especially will rerate them to. In particular we are encouraged by the prospects from businesses exposed to the growth in living standards in emerging markets, such as Unilever and Heineken, and the growth in revenues from businesses that own valuable media content, such as Nintendo and Reed Elsevier. These businesses have the prospects to double or more.

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