

Investment Manager Commentary – Q2, 2008

Equity investors in most of the developed markets have suffered a wretched six months. In the UK, the FTSE 100 index fell by 14.4%, the worst first half in 14 years, and is now down by nearly 20% from the peak last October. It has been a similar story elsewhere with Europe down 21% and America by nearly 20%. The price of oil has risen by 44%, which has been beneficial to the markets of Brazil, plus 22%, and Russia, plus 10%. The MSCI World Equity Index is down just over 12%, which is the worst performance since 1982.

Shocking as these figures are, they serve to hide some truly dreadful falls in individual shares, and indeed sectors. The hardest hit have been banks, housebuilders and retailers. Whilst RBS managed to get its rights issue completed, those of HBOS, Barclays and Bradford and Bingley are currently underwater, albeit that they are thought to be underwritten. Attempts by Taylor Wimpey, a housebuilder, to raise funds had to be abandoned.

In the midst of this chaotic scene, it is worth remembering that markets enjoyed a significant bounce following the rescue of Bear Stearns in mid March, which in the UK amounted to nearly 1000 points, truly a trap for the unwary.

Steep rises in energy and food prices are pushing up inflation, damaging profit margins, and constraining economic growth. This is the worst possible combination of factors for equities, and a very difficult position for central bankers. The choice is between reducing rates and risking inflation or increasing rates and thereby the likelihood of recession. The Americans have opted for the former course of action, the Europeans the later.

Meanwhile the UK has gone for the third way of basically doing nothing, paralysed by a tail end political administration, and a severe deterioration in the public finances.

Much of the economic and political background was well known, and the consequences, if not the magnitude, foreseeable. Hence the very cautious stance we have adopted for the last eighteen months. Often this has seemed a very lonely course to have been pursuing, but what seems to have changed in the second quarter is that the consumer finally got the message, and has started to react accordingly.

House prices have continued to fall dramatically in America, and are starting to do so in the UK and parts of Europe. This readjustment has further to go since there is a very strong correlation between mortgage advances and house prices. In May, just 42000 loans were approved, less than half the figure twelve months ago. Morgan Stanley reckon that a 20% decline in house prices will push 2 million in to negative equity, but the reality for the vast majority is that they will simply sit it out. Transactions will follow the same trend as the advances, and much lower economic activity in this sector will lead to increasing unemployment.

Spending habits are changing; in a week when Marks and Spencer shares fell 25% on fading sales, Matalan, (a discount clothing retailer), reported annual profits had doubled. Whilst car retailers, estate agents and builders are caught in the eye of the storm, sales of caravans, log burning stoves and energy efficient boilers have risen strongly. Consumers love to consume, they will just find different ways of doing so. In the face of relentless media gloom, this is worth remembering.

Outlook

Most investors have now moved in to our cautious camp, and being uncomfortable with consensus, this leads us to think that the time may be approaching when we redeploy some of the liquidity. Heading in to the Autumn, the prospects for 2009 should become clearer; a drop in the oil price could change sentiment dramatically.

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