

# Investment Outlook – December 2007

Twelve months ago, very few people had heard of sub prime mortgages, and of those who had, the reckoning was that, at \$100 billion, the problem was containable. We have consistently argued that the effects would be more profound, although no one predicted the extent of the chaos which has ensued. The unfolding credit crisis will be felt most keenly in America and the UK, the two most indebted nations on earth. House prices are deteriorating rapidly in America, and are beginning to do so in the UK; consumer spending is the largest component of GDP in both countries, supported by property equity.

Credit will become more difficult to obtain, and more expensive, as lenders tighten criteria, and increase margins. The standard response has been to cut interest rates, a process already under way, and which has further to go. However, this will only work if confidence returns to credit markets, and this has yet to happen on any scale. Recession, with all its negative implications, is a real possibility.

And yet; there are reasons to believe that there will be a happier outcome, although it will be a close run thing.

The flip side of the coin is that there are beneficiaries of this, albeit unexpected. Corporate balance sheets are strong in most markets; just looking at the UK, profits have risen by more than share prices since the low point of the market. Shares have been de rated and arguably the price/earnings ratio is the lowest it has been in 30 years. Earnings will come under pressure, but no major commentators are forecasting them going into decline.

Other parts of the World continue apace; emerging markets have been amongst the strongest performers this year, and maybe it is time they lost this pejorative tag. According to an IMF Survey in August 2007, the countries with the largest Foreign Exchange Reserves were China, Japan, Russia, and then India in Sixth, and Brazil in ninth. The growth rates in these economies are staggering, ranging between 8 and 10% for next year. To put this in context, it is just 10 years since the Sovereign State of Russia defaulted on its debt.

This is not to say that any of these markets offer value; the Chinese stockmarket fell some 20% in November, but is still thought to be on a p/e of 55 times next year's earnings. It is undeniable that the strength exhibited by these economies is starting to replace the American engine of World growth; the trend is becoming more established. Less and less will the World be dependant on the US consumer, but the timescale for that changeover of economic leadership remains uncertain.

Our Central View is that a combination of the above factors will enable the Global economy to grow next year, albeit at a slower pace. The interest rate cycle has clearly peaked, and historically this has proved positive for equities. We also feel that there is value in fixed interest, at long last, but in both of these asset classes, selectivity will remain the key.

Each economic cycle produces its own twists, but a long memory remains essential. A "run on the bank" is nothing new, and property has always been an illiquid asset, as will become increasingly apparent in 2008. But each cycle also produces opportunities, and we look forward to capturing those for our clients next year.

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