

Professionals' View February 2011

Arab Berlin Wall?

The trouble that has spread from Tunisia to Egypt and Jordan in recent days has been likened to the Arab region's own version of the Berlin Wall coming down. While this appears to be a rather tenuous comparison, there is no doubt that the rest of the world is watching developments unfold with more than just a passing interest as the extent of the contagion is, as yet, unclear. Once again oil has been seen to be a good investment to hold within a diversified portfolio as the regular eruptions of unrest within the Middle East always send the price of oil upwards. Of more immediate relevance to UK investors is the effect that this may have on a) other emerging markets and b) inflation.

A Reminder to Emerging Market Investors:

Only last month we said, *"Emerging markets had become the recipient of the largest recorded inflows in the unit trust world by October last year, a warning if ever there was one of an impending slowdown in that sector. Ironically, increased liquidity in the Developed world has led to a surge in this liquidity heading to countries that don't really want it."* Lo and behold, emerging market funds have seen a reversal of fortunes due to the political unrest in the Middle East but also because of worries over Chinese overheating. What should also be very much borne in mind is the question of whether you can get your money back as quickly as you parted with it, in the event that something happens that gives you the jitters about an investment that you have made. In other words, the liquidity of the investment is important.

The Egyptian stock market has been closed for a few days (at the time of writing) and it is unclear for exactly how long this may remain. One can recall clearly that the Russian market was closed regularly during the immediate aftermath of the Lehman crisis. With the recent increase in fund launches focusing upon the fledgling emerging markets (more commonly referred to as Frontier Markets) it would pay to reflect upon the ease with which you could cash in your investment if conditions turned choppy. There are few things more disconcerting than being

told that your money is locked up without any indication as to how much of it, if any, you will be getting back, or when.

This is not to say that we have turned sour on the potential of emerging markets to outperform over the medium to longer term – we have not. There appears to be a momentum to their development that seems unstoppable, but recent weeks have shown that it is not a one-way ride. Money can begin to flow out as fast as it flowed in, and you are best to be at the front of the queue if it does.

Economics And Benchmarks Are Not Always Helpful:

As always appears to happen, the biggest wave of money arrives at the end of the party. This may be partially explained by the use of benchmarks, which, as Andrew McMenigall (Senior Investment Manager at Aberdeen Asset Management) explains "are backward looking" and do little to identify the forthcoming prospects of their underlying components. He says that a benchmark approach would have had an allocation "of 56.9% to the US in 2001" and typically only around 2% to emerging markets. According to Morningstar statistics used in *Investment Week*, the average 5-year return from an emerging market fund has been 77.7% whilst the average return from a North American fund over the same timescale has been 15.9% [to 24th January 2011]. It will be very interesting indeed to see how returns compare over the next five years as allocation rates to emerging markets have risen while those to the US have fallen.

Investors often make the mistake of equating current economics with expectation of investment return. They do not always move in tandem.

Warren Buffett observed that "even if you knew what was going to happen in the economy, you still wouldn't necessarily know what was going to happen in the stock market" [*Investment Adviser* 31.01.11]. Markets are driven by sentiment and *anticipation* of events. Most private investors react only *after* they have heard about a trend. This is why so many end up disappointed.

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This Inflation Is Deflationary:

What a curious statement, but one that bears scrutiny. It was made by Bill Mott, manager of the PSigma Income Fund who is all-round "investment sage". January's RPI figure came in at 4.7% and the Government's preferred measure, CPI, was 3.7%. Incredibly, in Zimbabwe, it is 3.2% [*MoneyWeek* 21.01.11]. This has led to the common assumption that interest rates are likely to rise sooner rather than later, as raising interest rates is the tried and tested tool whereby to squash inflationary pressures. BUT..... the unexpected contraction of 0.5% in the UK economy last quarter has thrown a spanner in the works. An interest rate hike against this backdrop would be "GDP suicide" according to M&G's Jim Leaviss.

According to the Bank of England, once food, mortgage payments, tax rises and VAT and commodities are stripped away, the real rate of inflation is only 1%. This is tremendous news for that part of the population who lives mortgage-free, buys nothing and does not eat. For the rest of us, and particularly those who rely on their savings to get by, it is becoming more and more painful. The one thing that is missing, and it stands out like a beacon, is the lack of wage pressure, and it is this factor that is arguably the most important when it comes to future inflation expectations. Basically, the increase in the cost of living is coming from factors that the Bank of England can do nothing about. The public cowers in the face of well-publicised cuts, in services and inevitably in jobs.

The last thing that any sane person would do would be to go out and splash the cash if they didn't know whether they were going to have a job the next month. And they can't splash it in anything like the manner they were just a couple of years ago because the credit card companies are not giving it to them to splash.

A rise in interest rates now would make the dreaded double-dip recession a near certainty, and it is hard to see how that could be to anyone's benefit. As Merryn Somerset Webb argues in *MoneyWeek*, a recovery

needs "low interest rates, relatively low corporate taxes, a competitive currency, low inflation, cash-rich customers and, finally, a commitment to slash a bit of red tape." Raising interest rates would send the pound higher and reduce the cash available for the public to spend, so it would come as a big surprise to see the status quo upset in the near term.

Which suggests that, if rates stay low in the Developed world, but inflationary pressure is growing ever larger in the Developing world, we could soon witness a rotation of demand for stocks and bonds in the US, Europe, UK and Japan in preference to those in Asia, Latin America and other such "emerging" regions. It will not happen overnight, but perhaps those invested in emerging markets should be making their excuses, collecting their coats, and prepare to head back home a little earlier than the latecomers to the party.

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