

Professionals' View March 2011

Big Calls To Be Made:

2011 is shaping up to be a key year when it comes to making the correct calls for a number of asset allocation decisions. There are two or three major themes emerging, each interwoven with the other to some extent, around which money is either going to be maintained, won or lost. These include the unrest in the Middle East and the effect that it is having on the oil price; inflation at home and abroad; the timing and extent of any interest rate rises; and the sudden switch from inflows to outflows of capital from emerging markets.

Domestic Inflation and Interest Rate Decisions:

There has been much speculation recently about when interest rates in the UK move. Most commentators are focusing upon the rate of inflation being 4%, double the Bank of England target, and the assumption that in times of rising inflation interest rates go up. Is this necessarily going to be the case this time though? Mervyn King has said that "hiking rates as a signalling gesture to the public would be self-defeating" and it is by no means certain that a rise in interest rates is as close as markets are pricing in. The problem is that the causes of the current inflationary spike – surging oil prices, rising food prices, one-off VAT increase – are all outside the Bank of England's control. The soaring commodity prices that make our manufacturing costs, distribution costs, supermarkets bills, energy and heating costs, and the cost of a tank of petrol, topics for coffee break discussions are nothing to do with domestic policy and everything to do with events and trends overseas. At home, the public sector cuts make everyone aware of how nice it is to have a job at all, so the risk of wage pressure adding to inflationary concerns appears remote at present.

Add to this the sluggish GDP figures released in the last couple of months by the Office for National Statistics and it makes the value of a rate rise questionable. Gone are the days of rampant spending on their credit cards by the general public. Higher

rates will surely lead to a fall in the property market and a danger of further contraction in GDP, whilst the current increase in the CPI Index (inflationary measure) will only continue in similar fashion if we believe that food and energy commodities will continue to gain by 30% or more every quarter. This is highly unlikely. So those funds and portfolios that have already been positioned in anticipation of interest rate hikes may have moved too early, while if rates remain lower for longer it should be beneficial for equities and high yield bonds. This is call number 1.

Overseas Inflation and Interest Rates:

One of the problems being witnessed in the emerging markets at the moment is that they are having to deal with inflation and rising interest rates. Coupled with the unrest in the Middle East this has reminded us all that geopolitical risk is never far away in some of those countries where money has been expectantly heading in recent months. There has been a recent aggressive outflow of money from the developed world that has resulted in some uncomfortable losses for investors who had become used to reading about double-digit returns being made. As Bart Turtelboom of GLG Partners reminds us- "the door or the way out tends to be narrow and the exit could be ugly". (*Source: Investment Adviser 28.2.11.*)

In the week ending 2nd February 2011, investors pulled more than \$7 billion out of emerging markets equity funds. In comparison, developed market portfolios took in \$6.6 billion during the same week. (*Source: Fund Strategy 21.2.20*).

This leads to call number 2. Is the rotation out of emerging markets towards developed countries a short-term correction or a longer-term trend? If the former, we should be adding to our positions as a buying opportunity. If, as we suspect, it is the latter, then the reminder of the exit being narrow and dangerous is a timely one.

The longer term trend of emerging markets' development is surely still intact but then the apparent

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recovery being seen from the developed markets seems a better opportunity at the moment based on the inflated valuations of the emerging markets compared to the more reasonable valuations to be found in the likes of the US, Europe, Japan and the UK.

The Trend Is Your Friend

Some funds are run along the lines of simply following the latest trends, and, despite the many claims for contrarianism from successful fund managers, we are reminded of the words of Hugh Hendry when he says "you only need to be contrarian 20% of the time".

The trend followers adhere to the following "don't fight the Market direction, forget your personal opinion about where markets should be going and focus on going with the trend".

So if this exit from emerging markets for whatever reason is a trend for this year, there's no point in standing "Canute like" in the face of it.

Are we seeing a similar trend in the oil price? Are the problems in the Middle East going to go away in the short-term? If not, some exposure to oil and energy stocks would appear sensible. It is also worth bearing in mind that the Russian market was very closely correlated to the oil price on the way down so perhaps this is one developing country in which to retain an interest.

It will be interesting to see what is this year's best-selling ISA fund, because history has shown that people tend to follow a trend and go into the wrong sector at the wrong time, buying a story too late. Previous years have seen such things as technology at the top of the list just prior to the dot-com bubble bursting, and property being all the rage in 2006. Some investors who jumped on that last particular bandwagon through the Aberdeen Property Shares Fund, are still 40% down on their money. Following the Market turmoil of 2008, Absolute Return and Cautious Funds became hugely popular just as the

Stock Market bull-run took off in 2009. It is no surprise therefore to see the emerging markets giving up some of their gains now, having been the best-selling sector of all in 2010.

So this is call number 3 and it is particularly pertinent around ISA time. If you or your clients are putting in new money now, are you confident of where it should go? And, as importantly, bearing in mind the old adage of if you wouldn't put new money in existing funds, should you still be in them, is it time for a re-assessment of current portfolio strategies?

We would be delighted to help if this strikes a chord.

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