



This weekly Briefing Note aims to pick out some of the key financial and economic issues touched on in the press over recent days and from time to time includes the views of some of our independent fund managers.

A Quantum of Solace

Whilst financial relations became frosty following Iceland's decision to block a deal to repay Britain and the Netherlands some €3.9bn lost by savers in the country's failed banks, stock markets carried on from where they left off before Christmas, continuing their rally into territory not seen since Spring 2008. But analysts are keeping an open mind it seems, with **The Financial Times** quoting one as saying "It's way too early to characterise the tone of the market other than saying that for now at least, market participants are looking for a second leg to last year's run-up in stocks and commodities as the economic recovery shows further signs of stability". By mid-week a little caution had crept in as investors pondered on official US jobs data due later in the week and the Federal Reserve's committee minutes from last month were mulled over. In the eurozone, policymakers were trumpeting a ten-year recovery plan and here in the UK investors were left with mixed messages about the pace of economic recovery.

The snap of cold weather coincided with higher commodity and oil prices - with the cost of US crude rising above \$80 per barrel. Overall though the mood remained quietly confident, with the Vix volatility index - often called Wall Street's *fear gauge* - falling to a 16-month low of around 18. By the end of the week, most of the major indices had registered useful gains - in London the FTSE100 index rose 121.36 points on the week - leaving them at 16-month highs. The most notable exception was in China, where the Shanghai Composite index fell back slightly as investors remained on the sidelines.

Wanted: A Job

One of the painful features of the global economic recovery to have manifested itself is the lack of jobs and indeed, whilst admittedly a lagging indicator, the jobless figures on both sides of the Atlantic have remained stubbornly high. In the US, news that the economy shed another 85,000 jobs in December dashed hopes that a quickening labour market turnaround could add momentum to the economic rebound. Revised November figures showing a gain of 4,000 jobs opposed to a loss of 11,000 did little to offset the disappointment. In the eurozone, official data showed that unemployment had hit 10% in November - the first time the jobless rate has hit double digits, matching the rate in the US. The data triggered concerns among some economists about the prospects for continued recovery in the eurozone, coming hard on the heels of news that industrial orders fell in the region during October, ending a six-month period of uninterrupted growth. Within the region the unemployment story is mixed, with the worst hit being Spain where some 4m or 20% of the workforce is out of a job.

The main reason for Spain's deeply entrenched problems has been the collapse of the property market and construction industry upon which the economy had become over reliant. The importance of the housing market to consumer-dependent Western economies was highlighted this week with the release of the US Federal Reserve's minutes of its December meeting. The Fed's policymakers expressed worries that the winding down of the central bank's massive purchases of mortgage securities could help "undercut" a fragile housing market recovery. The minutes said "some participants noted the risk that improvements in the housing sector might be undercut next [2010] year as the Federal Reserve's purchases wind down, the homebuyer tax credits expire and foreclosures and distress sales continue". The Fed has effectively, via its purchase of some \$1,425 billion of securities issued by Fannie Mae and Freddie Mac, provided around 85% of the mortgage funding for the US housing market during the financial crisis. The planned withdrawal of this support in March could therefore have a significant impact.

Plenty of Fizz?

News that some of the UK's major retailers enjoyed a bumper Christmas gave investors and economists a boost last week, with John Lewis emerging as a clear winner, trumping its arch rival Marks & Spencer. But the question that remains is whether consumers can sustain their spending splurge - both John Lewis and Next have warned that the outlook for this year looks challenging. **The Times** commented that the prospect of the VAT increase must have brought forward some purchases and, according to the Nationwide Building Society, consumer confidence had a wobble in December. With higher taxes ahead and the possibility of higher interest rates, the paper said that, whilst the headwinds are challenging, it is possible that the resilience of the great British consumer will out.

Data on the health of the UK economy was plentiful last week if not mixed. According to figures issued by the Chartered Institute of Purchasing and Supply (CIPS), the service sector index - the largest part of the economy - ticked up to 56.8 last month, with any figure over 50 indicating growth. Vicky Redwood of Capital Economics said that the data provided "further evidence that the economy moved decisively out of recession in the fourth quarter" and may even have grown by 0.6% in the

last three months of 2009. Conversely though, the construction purchasing managers' index for December came in at 47.1, registering a fall in activity for the 22nd month in a row, as a surge in housing was offset by a sharp decline in commercial building. "December was another disappointing month for the UK construction sector. Unlike other parts of the economy, it seems unable to escape the shackles of the recession" said David Noble, CEO of CIPS.

Staying with housing, the Halifax reported prices rising by 1% last month, bringing the total rise for the year to 1.1%, aided by a surge in buying interest in the second half of the year and defying the economic downturn. Halifax said that the cuts in interest rates last year had significantly reduced the cost of servicing a mortgage for many households. "The significant cut in interest rates . . . has markedly reduced the burden of servicing a mortgage and this has helped stimulate demand, albeit from a low base" commented Halifax's economist Martin Ellis. But despite the buoyancy, the bank gave a cautious outlook for the year ahead, warning that it expected house prices to remain flat for the year overall. One potential problem for the economy could be higher inflation – official statistics from the ONS showed that factory gate inflation hit 3.5% last month, up from 2.9% in the year to November. The increase reflected price rises in transport equipment, food and electrical products – higher fuel costs impacted on input price inflation, which is a measure of manufacturers' costs. Overall though, most economists played down the impact, saying the Bank of England would not be concerned.

Star Manager Optimistic

One of the UK's best known fund managers, Neil Woodford of Invesco Perpetual, caused a stir on Friday when he said during an interview that there was a "high probability" of Britain losing its coveted AAA credit rating because of the country's unprecedented levels of public debt. However, many leading City firms were sceptical, saying it was highly unlikely, as rating agencies had said they would defer any decision on Britain's status until after the election. Away from this, the main thrust of Neil Woodford's views centred on explaining why his fund had under-performed last year after an excellent 2008 and where he saw opportunities ahead.

"In terms of relative performance, last year was obviously disappointing. The events of last year meant that whilst I focused on the macro situation, which was very poor, the market bought into the 'V-shaped' recovery story and that was then reflected in the huge re-rating of stocks that had performed very poorly during the crisis. Cyclical sectors such as financials and basic metals and mining performed extremely well. It is not unusual for share prices to diverge from the fundamentals and this is what happened last year – my portfolio was positioned to reflect the reality of what is happening economically by owning those companies that I believe can still perform well, pay dividends and increase their earnings. The market on the other hand chose to ignore this.

I always have a 3-5 year time horizon and am not influenced by short-term events. That doesn't mean I am not open to change – I am and over the years the portfolio has changed significantly, but right now I remain focused on the long-term. Where we are now is that financial stability has been achieved by policymakers, but the ingredients for a recovery are still a long way off. There are always times where there is a disconnect between reality and market behaviour, but ultimately the markets will adjust to reflect what is happening. 2009 was a year where, for whatever reason, the markets detached themselves from reality, but this year I believe we will see the fundamentals reassert themselves and have a bigger impact. This means that we may witness some market wobbles – whilst things are better, there is a long period of resolution ahead before we can safely leave the banking crisis behind us, despite the recent fund-raising exercise by the banks: more de-leveraging is inevitable, meaning credit will remain tight.

If the market does suffer a setback, I think it will manifest itself by investors rotating out of cyclicals into more defensive sectors, and the portfolio is pre-positioned for such an event. The outlook is tough and you need to own businesses that are best placed to deal with the challenges, so I own utilities, telecoms, tobacco stocks and pharmaceutical companies. The companies I own have strong dividend flows and good prospects to increase their earnings and profits – many yield more than their own corporate bonds, which is extraordinary. The yield on the portfolio is 4.2% - some 20% higher than the broad stock market and I am very confident about the prospects of those dividends rising. The highest yielding stocks rarely offer the greatest opportunity for growth but today that is the case – unusual as it may be.

Short-term local politics may impact on the UK market but ultimately economics override – we face a difficult fiscal challenge and the markets will impose a timetable for reform. So looking ahead, I see stability but a drawn out, weak recovery in the developed economies. Deflation is the greatest challenge so I don't see interest rates rising significantly over the next few years. Big picture, the market trades on a forward p/e of 13.5 which does seem expensive but this assumes a 30% rise in corporate earnings -leaving huge scope for disappointment. Consequently I see stock rotation out of cyclicals into defensive sectors which is why I remain very optimistic about the outlook for my funds during the coming year and ahead".

Neil Woodford also manages funds for St. James's Place.