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# Global Investment Report Living in Fear

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## Q3

- ▶ A continuation of Q2 with volatility in all risk assets at extreme levels. Investors moved from fear to blind panic, buying only the most defensive of assets namely core government bonds and shifting into cash.
- ▶ Equities saw a significant de-rating across the board and the more emerging and cyclical/financial you were the more you suffered.
- ▶ Fixed income also struggled with high yield and corporate bond spreads shooting out even as nominal yields collapsed in line with the decline in sovereign government yields.
- ▶ Commodities fared no better with silver and gold particularly taking harsh hits from investors keen to liquidate all assets.

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## Our thoughts on Q4

- ▶ There is little change to a central view on the major asset classes for the year as a whole. We still believe that equities are the asset class of choice but believe that volatility will dominate sentiment, much as in 2010, given the wide range of issues facing investors i.e. government debt, rising inflation, rising bond yields, Europe sovereign debt etc.
- ▶ Starting valuations still suggest that equities are best placed to deliver this year and this is driven by positive earnings growth and still extremely accommodative monetary policy.
- ▶ The recent de-rating could in fact reflect the reality of a double-dip recession and indeed if you were to believe government bond yields we are actually flirting with a depression. This outcome is of course a possibility but cannot be the central case.

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## Q4 Outlook

- ▶ Investors are now taking fright and pricing in a fairly severe recession. High yield spreads now imply a 13% default rate for companies – to give you an idea of what this is saying, the peak default rate in the early 1930s depression was 9%.
- ▶ We are seeing liquidation across the board with both credit and equities coming under stress and investors still hiding in cash. Valuation can never be a catalyst but it is clear that at under 9 times earnings the FTSE All Share is generationally cheap and certain sectors have dividend yields not seen in most investors' life times.
- ▶ Barring a complete absence of thought from politicians in Europe in relation to the debt crisis we are likely to see a strong rally from deeply oversold levels in equities.
- ▶ Within fixed income a similar stance should apply with high yield and investment grade credit offering good value in all but the most extreme outcomes for the global economy.

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## Government Bonds

- ▶ The yields on government bonds now imply an extreme outcome for global growth and it is hard to conceive that they reflect anything other than total fear on the part of investors.
- ▶ There are clearly shades of the financial illiquidity that was evident in 2008 but corporate balance sheets are in better shape, banks in aggregate are less geared and the major outstanding issue namely the European debt crisis when resolved should alleviate the worst fears.
- ▶ It is extremely hard to justify government bonds as an investment opportunity. It remains the deflation/fear trade only at these levels.
- ▶ Operation twist in the US ensures that we are about to or have witnessed the lows for US Treasuries.

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## Credit

- ▶ Credit markets have moved to price in a fairly significant recession and now offer some scope for capital gains once again.
- ▶ High yield had been priced extremely aggressively with limited scope for capital gain. The recent rout has pushed valuations back to compelling levels on a spread basis, again in all but the worst of economic circumstances.
- ▶ We highlighted, a quarter ago, the issue of “yield tourists” in the high yield asset class and cautioned investors to be wary of strategic bond funds which are heavily exposed to this area. The recent performance of these funds reinforces this caution.

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## Property

- ▶ UK direct commercial property yields are relatively attractive compared to cash.
- ▶ Capital growth is limited to prime properties however with secondary yields still likely to trend upwards.
- ▶ Central London offices and high quality shopping centres remain the key areas for investment.
- ▶ Overall total returns, assuming no capital growth, would be around 6%.

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## Equities

- ▶ The largest debate amongst commentators is whether we are witnessing the mid or end of the economic cycle. We continue to side with the mid-cycle outcome.
- ▶ To deny problems exist is futile, to argue that the bulk of them are priced in to equities is not. On a total return basis and from current valuations, equities should provide decent returns for investors.
- ▶ Just as in 2010 we suspect investors will need to be “in it to win it”. There will be a series of road bumps along the way and corrective phases in equities will be commonplace. Once again investors will be forced to climb the proverbial “wall of worry” to generate returns well above inflation.

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## Equities

- ▶ Recent price moves again reflect liquidation by investors with no obvious reason to believe that a double-dip is guaranteed. This recovery was never going to be typical and investors continue to lose sight of the fact that the big leveraged party of the last 20 years in the developed world is actually over. A two speed world will develop.
- ▶ Emerging markets will have typical economic cycles namely boom or bust while the developed world will stay in a relatively subdued state. This is not necessarily bad news for investors as people will be forced to save rather than spend and income will become a priority in a low growth world.
- ▶ Corporates are one of the few entities that can actually play a growing income in the form of dividends.
- ▶ The medium term view is that equities have de-rated adequately for a new bull market to emerge but that the cost of capital is still wrong at zero interest rates and that investors need to prepare for further periods of range trading and volatility in equities until this issue is addressed. Longer term investors will be served well by investing in equities at these points of maximum stress.

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## Thank You! Questions?

- ▶ Questions?
- ▶ If you would like a copy of the slides or would like to submit a question offline, please contact [enquiries@obsr.co.uk](mailto:enquiries@obsr.co.uk)
- ▶ Thank you for listening.

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