

## Professionals' View – January 2011.

### Met Office Gives Up Forecasting:

The bad weather that we experienced in December was apparently, forecast by the Met Office this time around. Unfortunately, they failed to let anyone know for fear of being ridiculed after their previous “Barbeque Summer” and “Mild Winter” efforts of the previous year. Now, call me old fashioned, but isn't the job of a weather forecaster to forecast the weather? Even if it's just a jolly good guess I feel more comfortable with having something to go by when I step out of the door in the morning rather than receiving a report later in the day about why I'm thawing out in front of the fire having been caught in a T-shirt in that afternoon's blizzard.

In our world you can replace “Met Office” with “Economists”. Economists are experts in telling us *why* something has happened. They don't appear awfully good or willing at telling us what is *about* to happen. This is why there are now countless books about the collapse of Lehman Brothers and the consequent fall-out across the globe and precious few about what lay in store in 2011 and beyond. Which is not very helpful really, as anyone with investments needs to know where to position them *before* the various markets move for or against them. Our job is to position portfolios in readiness for what is coming, and we can't possibly do this without having a view on what the next few months holds in store, all things being equal. This proviso is important, as we cannot possibly foresee a “9/11 style” event, one of which could torpedo the best-laid plans, especially in the short term.

Ah, the short term, a time-span much maligned by writers in the investment industry. How often do we hear about the merits of taking the long-term view with investments? This is all well and good, but much money and opportunity is lost in taking a long-term view and waiting for the market to agree with one's own prognosis. The long term is made up of several shorter term periods, the successful negotiation of which having a significant effect on overall returns. As we emerge from the first decade of this century, those stubbornly holding on to the long term view that they took in 1999 by holding a fund 100% invested in US equities are still down on their original investment to a

man [*MoneyWeek* December 24th 2010]. In that same period, BlackRock Gold & General is up 710% and Threadneedle Latin American up 387%. Shorter time horizons must surely be taken in the modern world to take advantage of the changes that we are witnessing in the world order today.

### So What Are Our Forecasts for 2011?

Apart from a Barbeque Summer, what are we expecting this year? One thing is for certain – every month that passes without the Bank of England raising interest rates is a month closer to raising them again. This is going to be a major call as the year progresses. Many commentators at the beginning of 2010 were forecasting that they would have risen by now. The consensus view now is that they will start increasing towards the end of this year. Investors do not want to be anywhere near gilts as a rate rise increases in probability. TwentyFour Asset Management remind us of September 1994 when interest rates were raised by 0.5% on the back of a build up of inflationary pressure. 10 year gilts began that year yielding 6% and ended it yielding 9%. That 3% jump in yield equated to a 20% loss of capital for the gilt holders. For a “low risk” asset class, a similar loss would be intolerable for risk-averse investors.

Today is not 1994 but there are similarities. Not least we need to keep an eye on inflation as VAT increases, energy and heating costs, fuel bills and food prices all seem to be rising quite sharply. It is a nasty inflation particularly for those in retirement and on fixed incomes because none of these are really discretionary. On the other hand, there is precious little wage pressure or signs of manufacturers looking to raise prices other than to deal with their own increased transport and commodity costs. So we are a long way from inflation running out of control, but like a nagging toothache it's there in the background. So our views can be summarised thus (and our portfolio construction will reflect these in the short term):

**Bonds:** We are happy to avoid gilts wherever possible and have, as yet, not gone for index-linked gilts as we will look for funds that can short government debt as a

proxy. We are also avoiding the government debt of the US and European regions. Corporate bonds however remain relatively attractive, particularly at the high-yielding end of the spectrum as we feel that cash will continue to seek a source of income against a background of improving corporate results and this reduces the risk of default. Rising interest rates in China and other emerging markets probably means that emerging market debt has seen its best for now. Without doubt the easy money has been made in bond markets and the asset class will revert to its dull and dreary norm with an increased risk to capital.

**Equities:** A ridiculous phrase as, of course, it depends upon which ones we are talking about. Many advisers were recommending the high-yielding mega-caps at this time last year. After the collapse of the bank shares in 2008 and the demise of BP and its dividend in 2010, let us hope that the message is getting through that there is no such thing as a stock being too big to fail and size, after all, doesn't matter. Diversification is key.

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. It is fast becoming insulting to refer to the BRIC economies as "emerging". Perhaps a more accurate description would be to refer to the US, UK and Europe as the Submerging Markets. We will still be allocating towards the developing world with an eye on the increasing range of Frontier Market funds coming to market (the best performing markets in 2010 were Mongolia, Sri Lanka, Peru and Estonia in that order) but our main plays at the beginning of the year will be towards Germany and Japan. Any investments that we make in the US will be through sector funds such as energy or healthcare, while UK investments will tend to be focused on the smaller company end of the market.

**Commodities:** We've done well so far in taking an early stance in favour of the commodity boom being driven by the seemingly insatiable demand from China et al and it would be a surprise to see this trend reverse significantly. **But.....**expectations could be dented if China decides to slow its growth aggressively

this year and the multi-year returns enjoyed by resources funds could be vulnerable to a sharp and damaging retreat at some point. The number of adverts on TV and in shopping malls and bus stops up and down the country offering to buy our gold jewellery should also be acting as a warning that prices for precious metals are topy. Max King of Investec makes the point that "the final stages are often the steeper stages" for prices of assets in a strong bull market and we agree with him that gold is still a good place to be, but with an eye keenly scanning for clues as to when to make for the exit before the rush begins.

**Property :** We're getting closer to going back to the property sector, but not just yet. It remains pretty dull and we see a very real threat in the event that interest rates rise. Domestically there could be carnage if rates rise and the buy-to-let army beat a retreat caused by the public sector cuts and if mortgages fail to be covered by rental income. Commercially there seems to be no good reason why values should rise or for rents to be increased, so the sector remains unattractive for now.

**Absolute Return Funds:** These have been disappointing on the whole, failing to protect on the downside while simultaneously missing out on the upside. There are one or two exceptions but we tend to favour a well- managed multi-asset fund rather than absolute returns in this climate and can not foresee a reason to change that stance this year. As for cash, until we see a rise in rates, it remains a risky asset when considered in relation to inflation. In real terms, cash investors are mostly losing money and alternatives have to be more attractive.

As always, if you would like a review of your current asset allocation, or you have any questions on our views, we would love to hear from you. **All the very best wishes for 2011.**

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