

- Two vast economic forces dominated the macroeconomic story of 2009. On the one hand, forced deleveraging and inventory liquidation led to a huge contraction in demand. On the other hand, the largest monetary and fiscal intervention ever was put in place in order to offset these forces. Thus far, the latter effect has succeeded in offsetting the extreme negative effects of the former, and markets naturally responded accordingly.
- As we move into 2010 and beyond, the monetary and fiscal stimulus will have to be gradually reduced. For equity markets to continue posting strong gains, the global economy will need to show that it can stand on its own two feet, without relying on government aid. There are three key issues that will determine whether or not this proves to be the case.
- First, credit growth in the major economies needs to show some sign of improvement. Historically credit growth has been a necessary condition for sustained economic growth. Unfortunately, despite all the monetary stimulus over the past eighteen months, actual growth in credit has been anaemic. Central banks have generated a huge increase in the money supply, but very little of this has found its way back into the real economy. The banking system remains firmly in deleveraging mode. Whether or not this reverses in 2010 will be a key determining factor to the shape of the recovery.
- Secondly, the position of governments themselves could de-rail the recovery. The combined effects of the recession (lower tax receipts, higher social security costs) and the banking bailouts have caused levels of government debt to rise to previously unheard of levels. Current forecasts suggest that the UK economy will be running a budget deficit of greater than 10% of GDP for the next three years. On these forecasts the level of government debt to GDP could easily rise above 90%. This is clearly unsustainable. Spending will have to be cut and taxes likely rise. Indeed, recent academic research has shown 90% debt/GDP ratio to be a key threshold, above which economic growth tends to be more muted. The situation in the UK is made more uncertain by fact that a significant chunk of the deficit is being funded by the Bank of England's quantitative easing programme, thus keeping market interest rates below where they would otherwise be. At some point the Bank of England will have to wind down its quantitative easing programme. The effect that this has on long term interest rates will be key in determining both the government's funding position and future pattern of consumer spending.
- Finally, the resilience of emerging markets, and particularly China, will be a crucial factor in determining the shape of the next economic cycle. At the beginning of 2009, expectations for emerging markets were very downbeat. Some investors even expected China to experience a recession. The actual outcome has been much more positive, with key emerging markets such as Brazil, Indonesia and China all showing positive economic growth, the latter underpinned by a huge fiscal stimulus. The sustainability of this situation is crucial for the UK and other developed economies, as it will be a key driver of investment demand going forward. The main risk is that domestic consumer demand within emerging markets will not be strong enough to offset a structural decline in demand in the US and UK driven by ongoing consumer deleveraging.
- Notwithstanding these risks, equity markets have continued to move upwards, as the short term economic data has continued to surprise on the upside and many companies have continued to see earnings upgrades. The market does have some valuation support at present levels, although certain cyclical areas are now discounting relatively robust economic growth. If the recovery proves very strong then there could be further upgrades to come. However, on balance, as markets continue to move upwards, we are becoming more concerned about these specific cyclical areas. The defensive growth companies, however, typically trade at or below market multiples while also offering high and sustainable free cash flow yields. These types of companies are where much of our new capital allocation is targeted.

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