

- Most Western economies are likely to need a period of austerity to address high and increasing debt levels. Recent evidence of the slowing pace of the economic recovery from the last recession will make it more difficult to avoid another recession or at least a period of economic stagnation as this austerity bites. Policy makers have few tools left with interest rates already very low, and having tried fiscal and monetary stimuli. Furthermore political risks are high with little agreement on the best way to tackle the major issues such as the Eurozone crisis or the US budget deficit.
- Emerging markets, in particular China, have provided a hugely important source of growth for the world economy since the global financial crisis, but even here there are issues. Rising food and energy prices and increasing inflation have led many developing countries to tighten monetary policy significantly. Higher interest rates and strong currencies are now leading to slower growth rates. China also has specific problems related to its overheated property market and the wider economy's dependence on fixed asset investment spending.
- Despite the difficult economic background, the corporate sector is surprisingly healthy. Many companies have cut costs aggressively since the recession and have rebuilt their balance sheets as profits have recovered. Labour costs have been under tight control and profit margins are high. In addition multinational companies, which make up a large part of the UK market, have been able to exploit growth opportunities in developing countries in contrast to the relatively tough home environment.
- Aggregate stock market valuations look attractive on a long term basis, especially compared to government bonds and discount many risks. We would caution that certain cyclical sectors, including mining and industrials, are making high or record profit margins that could be vulnerable in the event of a significant economic slowdown. Bottom-up analyst forecasts imply strong earnings growth and margin expansion across most sectors next year, which we consider unlikely to happen. We can, however, find many attractive companies in which to invest, where low valuations offer genuine support to the long term investor.

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Source: RCM as at 30 September 2011

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