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## RCM Global Investment Outlook with Andreas Utermann

**Roger Miners:** A very warm welcome to this our third RCM Global Investment Outlook call of the year. Today we'll be sharing views from RCM's Global Policy Committee last week, and Andreas will be outlining our latest outlook, the recent global economic and market developments, and Barbara Evans will be looking at implications for long-term investors arising from the Gulf of Mexico oil spill.



**Andreas Utermann, Global Chief Investment Officer:** Thank you very much, Roger and hello everyone. Let me kick off with what's going on in the markets, where there is a renewed fear of a double dip recession and associated potential deflation. The policy makers are obviously concerned and the market has cottoned on to this so we have a self-fulfilling prophecy; a marked decline in risk appetite and renewed stresses in the money markets.



This is not something that we find terribly surprising. We had predicted that the second half of 2010 will be quite difficult in terms of the macroeconomic news. Expectations in 2009 and the early part of 2010 had run ahead of themselves both in terms of earnings as well as growth expectations. More importantly, after four quarters of very easy comparables starting with the second quarter of 2010, the comparables going forward will be much more difficult in terms of the macroeconomic data and earnings given that the strong recovery from the very tough macroeconomic environment of 2008 and early 2009 is now wearing off. So we now really have to get back to a more normal growth path.

There is considerable uncertainty as to what the growth path will look like, whether it is going to be a more traditional recovery or whether it is going to be an anaemic recovery in the West and continued strong recovery in the emerging markets. The fear now gripping the market seems to be whether we will see a double dip led by the United States and potentially also in Europe given the various significant fiscal retrenchment that's going on there and the expected necessity of fiscal retrenchment in the United States.

However we believe that in a month or two risk appetite will rise again given the very meagre returns that are available on risk-free assets. And therefore the market will recover, risk appetite will increase until such a time as asset prices have risen sufficiently for the market to start getting concerned about inflation.

What are the other significant developments that we need to talk about? First of all sovereign debt risk, those concerns will continue particularly in Europe and will continue to rattle markets. It is our view that an outright default of Greece or any other Southern European country is very unlikely - but possible. I would say it is even probable that we will see some form of debt restructuring in Greece once it is clear

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that the deficit reduction measures that they have put in place are more or less working. At that point in time credibility will be almost restored and that will provide an opportunity for some debt restructuring but as I said we don't think this will be a default and therefore will not lead to a break-up of the European Monetary Union.

The second important aspect to look at particularly as it pertains to equities: we think that earnings growth in the second half of the year all over the world will probably disappoint slightly on the down side, obviously feeding concerns about a double dip recession. This in our view will provide a buying opportunity.

Finally, the last event I want to comment on is the very welcome announcement by the Chinese authorities to let the renminbi appreciate gradually over time and to reduce the reliance on the dollar currency peg. We had predicted that this move would take place and that the renminbi - indeed as other emerging market currencies - would appreciate against the dollar and euro.

In terms of actual investment strategy at the moment we prefer emerging market currencies over the dollar and over the euro. We think that the yen will weaken substantially from its current level. Emerging market bonds: we think that the premium paid for many emerging market bonds over Western bond markets is probably still too high and might over the next decade even reverse. Clearly we think that staying at the short end of the bond market currently is the right strategy given that we are in a period of risk aversion which has obviously led to bond yields falling substantially over the last few weeks. As that reverses that will obviously hit the longer maturities and hence we will stay short.

In terms of equities we would prefer for the medium and longer-term emerging market equities and buy them on weakness. Other than that the two big themes that we continue to favour are yield stocks, which in many cases exceed equivalent corporate bond yields with pretty much a free option on capital appreciation, as well as high quality growth stocks, as we explained right at the offset that the economic environment for the next 12 months will continue to be very difficult. Quality franchises that have growth potential particularly with exposure to emerging market consumption growth will do well.

I will leave it at that and I look forward to the questions at the end. Thank you.

**Roger Miners:** Thanks Andreas. With that I would like to move on to Barbara Evans and specifically the lessons to be learned for investors as regards the Gulf of Mexico oil spill.



**Barbara Evans:** Thanks Roger. Yes, so to move specifically to the Spill. In short, we would argue that if anything positive is to come out of the current environmental crisis in the Gulf of Mexico it should be further support for the integration of environmental, social and governance risks in fundamental company analysis.

We believe that the spill has served to highlight the need for better management of all corporate responsibilities. There are three key reasons. Firstly, it has become evident that there are increased inherent risks in some sectors, be they operational, reputational, environmental, social or political, and specifically this spill has refocused attention on the ever more difficult and complex nature of extracting what have become known as 'unconventional' sources of oil and gas.

We would argue that accessing the natural resources on which we are dependent is becoming increasingly challenging from a technical, environmental and political standpoint. It is not enough to simply understand the economics of a big resource discovery. If you are thinking about how a stock will perform or making an investment decision, then an extraction project of the kind we saw at Macondo well will not be successful unless all the companies involved have properly understood and prepared for all the environmental, social, political and regulatory risks that could be involved. Particularly in the case of BP, we believe that preparing for these risks means incentivising management in the right way: reward should not just be based on delivery at any cost, because that cost could be extremely high as we are currently seeing.

Secondly, we think it is really important to focus on how stakeholders interact. These stakeholders come from a variety of places and include: suppliers, contractors, regulators, employees and local communities. BP and all its partners in Macondo will have a lot to learn from this incident in terms of how they conduct their relationships with each other going forward.

Then finally, we believe an ability to demonstrate good environmental, social and governance risk management can be critical in maintaining a good reputation. You could argue that BP is learning the hard way that reputation is an increasingly important part of maintaining a company's license to operate. Following the financial crisis and this current environmental catastrophe, politicians have an even greater mandate to take decisive action against companies that they believe, rightly or wrongly, are acting irresponsibly. So far this year, we've seen examples with action taken against Goldman Sachs by the US government, and now with BP. Both have felt the impact on their share price, in BP's case very significantly. We strongly believe that other companies with a prominent place in the public eye need to take note: the media and consumers now have an international focus and the pressure they bring to bear can be very powerful.

To wrap up and in summary we would argue that for asset managers to be best equipped to avoid the financial effect of disasters such as the one in the Gulf of Mexico, they must work harder to understand how company management is responding to these issues. And as a sustainability research team here at RCM our focus is on making sure that information is available to all investment professionals and that we are as best informed as we can be when we are making investment decisions on our client's behalf. Thank you, Roger.

**Roger Miners:** Thanks, Barbara. We would like to move on then to questions. The first question to Andreas: with the G20 failing to reach a consensus in Toronto on a global banking levy, can the financial services industry breathe a collective sigh of relief?

**Andreas Utermann:** I would say, no, they can't breathe a collective sigh of relief although there are certainly parts of the industry that could have been worst effected by some of the legislation that is being proposed or even passed in various countries. Firstly, it is clear that every major country could pass banking legislation which could reduce the scope for leverage, increase the cost of capital and in some way change the existing business models. And the question is just how bad the impact is going to be. And hence if you start off for example in the US with the spectre of the potential reintroduction of a Glass-Steagall type act which would essentially prevent the banks from running combined investment banking and retailing banking models then clearly what is now being passed - or proposed - is not as draconian and therefore better for the US investment banks. That having been said clearly life would not be the same after the new legislation is passed.

Secondly, we believe that particularly in Europe the banking crisis is not yet over. And many, many banks have problem assets on their balance sheets which they may have temporarily refinanced by selling them on to the ECB but nevertheless the underlying problem still being there. That will only surface over the next few quarters or years and will therefore prevent the European banking industry from fulfilling its customary role to really finance investment and private consumption. This is a big problem, European policy makers will have to address this and until it's done the European banks will suffer considerably. And this is without any new legislation necessarily effecting their profitability and that has been worked out particularly in Germany, France and the UK. And we believe that this will be relatively negative for the European banks.

Overall, while the global agreement has failed, regional and local agreements will definitely be put in place in our view and they will be tough and therefore we remain cautious on most of the global or regional banks.

**Roger Miners:** Thank you. The second question: the policy dilemma facing central banks is framed in terms of a choice between deflation and inflation; in fact we have talked about that on previous calls. What do you see as the likely outcome and has your view changed?

**Andreas Utermann:** Our view is that we will have neither scenario and that the central banks - ultimately more easily in the OECD than perhaps in the emerging markets because the latter are on a slightly more inflationary path which is entirely appropriate - will steer a path between deflation and inflation and hopefully manage to get growth with a modest amount of inflation back on track.

The most likely scenario that we see is one of initially anaemic growth with a modicum of inflation, but deflation being avoided and inflation not a problem for the short to medium-term.

**Roger Miners:** Thank you. Our third and final question is, do you see the forthcoming stewardship code as a positive move for the industry, or do we face the prospect of investor activism getting out of control?

**Andreas Utermann:** I think this a very important question and a very important debate which is currently happening. We at RCM are doing a lot of work on this topic both with industry bodies as well as internally and there will be more on that in the coming weeks.

Clearly it has been mooted that shareholders may not have done enough in the past to try and rein in some of the excesses that were seen particularly in the banking sector but perhaps also in the automotive sector, where non-sustainable business models were in place without really effective checks and balances, and shareholders exercising their role.

In our view there is a big danger that 'principals' and 'agents' are being confused. We must not get into a situation - which is a clear risk - that the asset management industry who act as agents for the principals, namely the shareholders, are compelled to behave as if they were indeed the principals. That's an extreme difficulty, would significantly increase the cost base even if it was possible to vote on all matters, and would probably land up in an enormous amount of conflicted interests with various client interests colliding within a firm. It would be very, very difficult.

We believe that the actions need to be more about trying to encourage the actual shareholder to instruct us, rather than to get the agents of the shareholders to try to take the aggressive lead here. It's a tricky topic. What we are committed to at RCM is to be very transparent and clear about which topics we care about, how we are going to vote on certain matters that are being proposed to AGMs, and also transparent about the way we have voted.

We think that gives clients a good indication as to where we stand. They can engage with us if they don't agree how we propose to vote, and they will always be able to check that we have actually done what we can in terms of voting and how we have voted. We think that is industry best practice and if a code went in that direction we would fully support it.

**Roger Miners:** Thank you Andreas and thank you to all of you for joining us for the call. If you do have questions that comes to mind after the call, please do either contact us or your relationship managers. We look forward to speaking with you again in the next quarter.

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