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RCM Global Investment Outlook with Andreas Utermann and Bibi Tabisim



Bibi Tabisim: Good morning. My name is Bibi Tabisim and I am joined this morning by Andreas Utermann, RCM's Global Chief Investment Officer. A very warm welcome and a happy New Year to all of you for this first call in 2010. Following an interesting 2009, today we will be taking a look at what lies ahead for global markets. Andreas will provide his views on the recovery so far and will present an outlook for inflation, interest rates and equities. There will be an opportunity to ask Andreas questions towards the end of the call, and with that I would like to hand over to Andreas.



Andreas Utermann, Global Chief Investment Officer: Bibi, thank you very much and may I also add my warm welcome to everybody on the call. When we looked at the state of the markets in October, which was the time of our last call, we focussed very much on market dynamics and the scenario for earnings surprises being positive in the fourth quarter and that being the major force to driving markets higher. That indeed turned out to be the case.

There was overall a fairly rosy picture that we predicted for the fourth quarter not only, as I said, driven by surprise on the upside from corporate earnings, but also the wall of money with interest rates continuing to be very low and therefore people looking for riskier assets. The market has continued to move up in the fourth quarter and what I propose to do in today's call is really primarily focus on the major themes for 2010 and focus slightly less on the market dynamics, although I will pick up on that.

We believe the major themes for 2010 will be inflation, the question of budget deficits, potential future bubble formation and the interest rate policies of the major central banks, currencies and also development of emerging markets. Let me take each of those in turn.

First of all inflation. Some of the emerging markets are experiencing slightly higher and rising inflation rates. They will start to tackle that in terms of slightly more restrictive monetary policies. Particularly China has already started putting the brakes on its credit expansion, we then have the major OECD economies led by the Euro Zone and the United State of America. What we expect there is a temporary flaring up of inflation followed by, for the rest of 2010, a fairly benign inflation picture. Within the US inflation is probably closer to 2% and Euro Zone inflation being below the target rate of 2%, probably more in the region of 0.5% to 1%. And finally Japan which is continuing to struggle with deflation.

All of that means that for the majority of 2010 inflation will not be a major topic for markets in the sense that we expect central banks to continue to be accommodative, and keep the yield curve steep. It is

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possible that the Fed will start raising interest rates in the fourth quarter, we think though that is an outside possibility, more likely to happen in the first half of 2011. For the ECB we are almost certain that interest rates at the short end will continue to be at the current level and will only be raised at the earliest in the first or second quarter of 2011. With yield curves continuing to be steep monetary policy will continue to be accommodative for the major OECD economies and therefore that will be a positive backdrop for risk assets in equity markets in general terms.

That does not mean however that central banks won't start to roll back some of the extraordinary measures and quantitative easing. The ECB has already started on that task and we are fairly certain that the Fed and the Bank of England will also follow suit in due course. That means that liquidity will not be as abundant, as it was in the year 2009, for the year 2010. And as we move through the year obviously that liquidity will increasingly become less abundant and therefore be less supportive overall for risk assets. But conventional monetary policy, as I said, will continue to be accommodative providing an overall relatively positive background for risk assets.

If we then move on to **budget deficits** which is going to be a major topic for discussion throughout 2010 and we predict the years thereafter as governments try to consolidate their fiscal position that had become compromised through the fiscal support in which most of the major economies of the world had to engage in 2009. Budget deficits will continue to be high in 2010, the funding needs of governments will increase and debt to GDP ratios will edge towards 100% or above for all the major economies including the UK, the United States and Germany.

This obviously causes a number of structural problems that we will need to address and look at very carefully as investors. It means that tax rates will have to go up on the margin, including corporate tax rates. It would probably mean ultimately cuts in state spending which will obviously take away some of the stimulative measures that have been put into place in 2009 and 2010.

Overall these rising budget deficits, increasing tax rates will provide a significant drag in coming years on growth. And therefore after the initial growth that we are currently seeing following the deep recession, we predict a below par economic performance for the major OECD economies for the next two or three years.

Obviously these rising budget deficits will also put pressure ultimately on long-term interest rates. As I said earlier the funding needs of governments will increase and therefore will put up pressure on interest rates, further steepening the yield curve.

If you add to that possible resurgence of some inflation concerns in 2011, it is fairly obvious that barring a major catastrophe such as a renewed global recession - which we don't anticipate - that interest rates at the long end will have to continue to edge up as they have already over the past few months. At some point therefore in 2011 the yield curve will have to shift altogether and central banks will be pressured into raising interest rates. But that's a concern for 2011.

Let me address **the question of bubble formation** which commentators have started discussing more urgently and perhaps than in the previous quarters as we were more concerned about deflation and global depression. The current rise in equity markets and associated relatively good performance of risk assets was obviously fuelled, as I mentioned earlier, by the abundance of liquidity. And some people are saying this could prepare us for a new bubble.

I personally think that central banks are wise to this, particularly the ECB, and we have heard numerous discussions, seen numerous discussion papers suggesting that central banks will start to try to lean against the wind if asset prices get out of whack again, particularly if that happens on a global basis. My starting proposition and my central scenario is that we will not see in the near future, that is to say the next 2 or 3 years, a renewed global bubble which once deflated would put us back to where we were 18 months ago with a very major risk of a global deflation as that bubble deflator. That doesn't mean that we can't have localised bubbles or bubbles in particular asset classes. But I don't think they will be of the nature

that we have seen two years ago which basically was the ability to pull the global economy into a major depression and endangered the global financial system the way did it did in this current crisis.

Let's examine the **role of emerging markets** in all this. Emerging markets have in many cases either avoided recession altogether or really only seen very moderate fall in growth maybe in one quarter. Certainly China, India and Brazil have continued to grow albeit at slightly lower rates and have helped to avoid a more serious global recession and depression. We expect the emerging market economies to continue to grow; the fiscal positions of the major economies that we are talking about are relatively healthy, there is further pent up demand for consumption; the fly in the ointment is the undervalued exchange rate particularly in the case of China. Also the lessened ability of some of the western economies to buy the exports from India, China, Brazil and so on, which means that growth in the emerging markets while it will continue to be strong will probably be slightly less strong than it has been in the years leading up to the current crisis.

The equity markets of many of these economies have bounced back more strongly than the western equity markets as you would expect given that they fell very sharply in the aftermath at the beginning of the crisis. We expect that the equity market of these economies probably will be very volatile in 2009 and probably not rise by much further in the course of the year. More on that in a moment when I talk about the prospects for the equity markets more generally and the various regions.

Let me finally touch upon currencies. I think **currencies will be a very important feature in 2010**. The dollar could come under renewed pressure in the latter half of the year as it becomes more apparent that the western economies will grow below par for the next two years or so, as it becomes more apparent that risk assets have probably run quite far and the pressure on the Chinese to start to appreciate their currency will intensify. How it all pans out will be very interesting for us to look at and we will update you in the course of 2010. Generally the trend for the dollar should be slightly down, emerging markets' currencies slightly up, and the euro on a trade-weighted basis will probably tread water.

Let me now just briefly talk about the major asset classes and their prospects before taking your questions. Let's start with **bonds**. My earlier comments about the steepness of the yield curve and potentially the yield curve becoming even steeper in the course of 2010, means that in our view the long end of the government bond market is probably overvalued and will continue to provide poor returns. The higher quality corporates are probably a much better bet particularly around average duration or slightly below. We predict though that having seen the rally in risk assets given that the recovery will be somewhat anaemic and turn out to be so in the second half of the year, some of the more 'junk' or lower quality corporate spreads will start to widen again.

In equity terms we think that at the end of the year we will probably be at higher levels than currently. But it will be a fairly rocky road, and we could see a set back sometime in the first quarter as earnings expectations catch up with reality. The **earnings picture** therefore will be no longer as supportive as it was in 2009 and with increasing focus of market participants on possible tightening of interest rate policy and reduction of availability of liquidity, markets will find it much tougher to make progress from here. Earnings will really have to drive markets higher rather than just expectations of future earnings.

However, that doesn't mean that there won't be significant opportunities. The market rally in 2009 was driven very much by return to risk appetite and particularly the highly geared companies, the smaller company stocks and those companies with a very cyclical exposure performed very well. We think that there will be much more differentiation just like in the bond markets. Within equity markets, stock picking will really be at a premium which we think plays into our hands, with RCM being a research-focused house. We expect stock picking will provide very significant alpha in 2010.

Within equity markets and regions we think that on a currency adjusted basis European equity markets should do relatively well, so will the US equity market. Japan will probably likely to continue to struggle and the emerging markets will be very volatile, maybe higher at the year-end but we will likely see some setbacks in the course of the next two or three quarters.

I think I have touched upon all the major topics I wanted to raise and really looking forward to any questions you may have.

Bibi Tabisim: Andreas, if I may just ask a few questions. We have had a number of clients who have emailed us questions ahead of this call, so if I may while we gather questions from the listeners start with the first of those. The first question that has really come through is, **which asset class in your opinion do you think will benefit from institutional flows** over the next 12 months?

Andreas Utermann: Given the very low returns on offer on money market funds and the likely relatively sub-par performance of government bonds, particularly longer maturities, the fact that property in most economies is not a very attractive proposition currently and also private equity given the lack of willingness to provide significant risk capital to private equity firms, it does not leave much choice than equities. I think institutional investors in the course of 2010 will continue to rebalance their portfolios and reallocate towards equities.

The other area that I think flows will go into is currencies. We have seen renewed client interest in currency management. Currencies have been very volatile and good currency managers have proven that there is alpha that can be generated in that space, so I think currencies will be another major area of focus.

Finally, we are also seeing a return of interest in balanced management. Some clients are looking again at balance strategies of the traditional sorts, 60:40 or 70:30. Those balance strategies even throughout the crisis have shown that they can significantly reduce volatility while still producing over a 3, 5 and 10 year horizon relatively decent asset returns. These are the three areas I think that people will be focussing on in 2010.

Bibi Tabisim: Thank you. If we focus more specifically on the UK, **when do you think the UK will begin to increase interest rates?** Do you think there is a danger if the UK does not raise rates soon enough? What are your views on that?

Andreas Utermann: It's a very good question. I think the UK economy is in a very difficult position. The fiscal position of the UK is deteriorating rapidly, and the unemployment rate is continuing to go up. We may well have seen somewhat of a false recovery in the property market, I am not sure that the crisis in the property market, particularly residential property, is over. Hence tax rates will go up, we have already seen that. Fiscal expansion will have to be turned back and that may well weigh on sterling for some time to come. That presents a very difficult picture because if we have significant further weakening of sterling that could obviously lead to some imported inflation.

The output gap in the UK economy is so significant that the core inflation rate is very low. And in the absence of a very major rally in the oil price which we don't predict given the relatively below-par economic performance globally, I do not think that interest rates in the UK at the short end will go up in a hurry. We think many of the other OECD economies long rates will continue to edge up putting further pressure on public finances and on investments and activities. I think it is going to be a very, very tricky path for the UK economy for at least two or three years.

Bibi Tabisim: Andreas, thank you. We have a question from Mauro Fresia: **what is your view on commodities?**

Andreas Utermann: I think we have to distinguish between the secular view and the more tactical view. First we would talk about the secular view. I think that commodities play role in portfolio diversification, not for everybody but for those who have sufficient assets for that diversification to make sense. We think that the commodities super cycle that started four or five years ago, some argue six, seven years ago is here to stay. We think that the energy intensive nature of the growth of the major emerging markets means that there was an underlying demand that is very positive for many years to come. Secularly it is a good place to be.

The other argument which secularly make sense to me is that at some point I am fairly confident that we will see the resurgence of some inflation, I am not predicting double digit inflation for the OECD economies but certainly higher than 1% or 2% may be in the region of 3% or 4%. And in that scenario obviously bonds will sell off more at the long end and commodities can provide some measure of inflation protection. Secularly again if you are thinking a 3 to 5 year view that might make a lot of sense from the portfolio diversification perspective.

Tactically, I think it is a slightly different picture because where commodity prices rise too rapidly like they did in 2008, that would fairly immediately raise significant concerns in the market about the negative impact on global growth. It would probably mean that global growth expectations would fall, which would then again depress commodity prices, would take it back to the point I made earlier.

I do not think we would see the development of major bubbles in this scenario because as soon as one of these bubbles - such as a commodity bubble – started to develop that would have such a depressing effect on the global economy that it would basically immediately fall back on itself.

Bibi Tabisim: Thank you. We have a question from Beatrix Anton-Groenemeyer: Taking the picture you gave about the fixed income developments into account and also that you mentioned that stock picking based on excellent research is very, very important this year. **How do you see the style bias?** Also income provided by equities - we read a lot about **dividend paying stocks** - so what is your view about this?

Andreas Utermann: It's a very good question and I am glad you raised it. I do think that one of the longer-term consequences of this current financial market crisis will be a rediscovery of the dividend. In terms of corporates focussing more again on dividends, on increasing their dividend to investors as opposed to buying-back shares, as well as investors themselves looking at dividend paying stocks to provide some measure of longer-term income while getting the opportunity for capital appreciation.

I think dividend stocks will continue to be in focus. Typically dividend stocks have been stocks with the value bias. What I am going to say next sounds a little bit counterintuitive in the sense that I do think that large cap growth stocks with well financed balance sheets will do well in 2010, but we also think that companies with the ability to pay significant dividends will also do well. And therefore I do not think that "style bias" in and of itself is going to be a major factor in 2010. But I do think larger cap stocks, stocks that pay good dividends, and well financed stocks will do well over the course of the year.

Bibi Tabisim: Andreas, thank you. Our time this morning is rapidly drawing to a close, so on behalf of RCM thank you for joining us this morning. And as always if you have any further questions, please do contact us or your relationship manager. We would like to wish everyone all the very best for the year ahead. Thank you for joining the call.

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