

JANUARY 2010

THE DECADE IS DEAD, LONG LIVE THE DECADE

The new year is upon us, bringing an end to the profligate Noughties, and ushering in the Teen-Age of austerity. And how like a big debaucherous New Years Eve Party the decade has been. We binged for most of it, demanding excess after excess that we could ill afford, and boring others about how great we were. So now it's New Year's Day and we are suffering an enormous hangover, the biggest in living memory. Of course, we will vow never to binge again, but currently the only medicine on offer is more excess, the biggest Bloody Mary



ever mixed, and it's government approved. The government need us to start enjoying ourselves again, but all we can focus on is the enormous bar bill. (Perhaps there are limits to how far that analogy can be taken...)

However, 2009 was the year when sentiment around the globe swung from the despair back to euphoria. The scale of the bounce in sentiment suggested that the financial crisis hadn't really had any lasting impact after all!

YOU TAKE THE HIGH ROAD . . .

So some of the world's equity markets have rallied strongly since March, but it is worth remembering the extent of disparity in performance of different sectors of the economy. Those firms that were at the most risk of going bust earlier in the year, such as car retailers, have recovered the most. Those firms whose business models have been the most robust, such as utilities & pharmaceuticals, have participated the least. As our US cousins say; go figure.

MELTDOWN AVERTED

Our principles & DNA would never allow us to take excessive risk in times of extreme uncertainty, and the sheer scale of the last year's liquidity-driven rally certainly took us by surprise. 2009 saw the world emerge from the deepest contraction since the 2nd World War. However, 2009 was significant not just for how output fell, but for how catastrophe was avoided. Only one year ago, the panic caused by Lehman's bankruptcy pushed global financial markets close to collapse. Global economic activity was falling faster than in the 1930s, but this time, massive, rapid,

coordinated action successfully stopped the decline. The Great Recession could well have turned into The Great Depression without the intervention. Armageddon-sized fiscal stimulus, the loosest monetary conditions, and eye-watering bail outs of firms that were deemed 'too big to fail' combined to stop the panic, prop up the financial system and reverse the collapse in private demand. 2009 will also be remembered for the biggest fraud in US history (Madoff) plus many smaller ones beside.

FROSTY TRUTHS

So the disaster has been averted, but damage has been done and the recovery is fragile. Take out the temporary effects of firms' restocking, and global demand is still heavily dependent on government support. Old problems have not gone away and new sources of risk have been created. The effects of the credit crunch will continue to be felt in 2010 and for many years to come. Investors will have to negotiate a series of potential Crevasses in the coming year:

CREVASSE NUMBER 1: CONFIDENCE IN PUBLIC FINANCES

According to the IMF, the aggressive stimulation of demand and low GDP growth forecast will lead gross government debt in advanced countries to reach 106% of GDP in 2010, over 35% higher than in 2007. The scale of the debt is staggering, and implies a rate of increase which will eventually lead to default.

Credit Watch

The US & UK economies face some serious headwinds over the coming months and years.

As shown here, UK's debt levels as a percentage of its economic output will be 98.3% in 2014, with the US at 108.2%. Although this is not as high as Italy (128.5%) and Japan (245.6%), the ratings agencies will eventually be forced to demote countries such as the US and UK from their AAA status; a humiliation indeed. The deterioration already started last May when S&P downgraded the UK from "AAA stable" to "AAA negative" for the first time since it started analysing the UK's public finances in 1978.

Gross Government Debt as a percentage of GDP (IMF November 2009)				
	2007	2010	% change	2014
UK	44.1%	81.7%	85%	98.3%
US	61.9%	93.6%	51%	108.2%



The Tightrope

In 2010, policymakers will have to start to walk a fine line of short term looseness vs. longer term control of finances. Each country will need a different

strategy, and those strategies will be influenced as much by politics as much as economics. In the UK, the new conservative government will take extreme measures to cut the deficit, wanting to get a lot of the bad news out of the way early on.

One thing is certain, eventually governments will have to cut spending and raise taxes. History tells us this warrants considerable caution. In both 1937 in the US and 1997 in Japan, tax increases led to a slip back into recession. In addition, we will see a brain drain as the realisation dawns that for the highest paid across the western world, they are working for more than half a week simply to pay their the tax. We perceive a sense of perfectly responsible successful people feeling that the social contract they have with their government being broken. Tax the rich to save the country wins votes but ultimately only prolongs the initial problem...

Investor Confidence

Despite this outlook, so far, government bond yields have stayed low. Inflation has remained subdued, and many investors have remained risk averse, driving prices up. In addition, central banks have been buying the same bonds, holding the yield down artificially. To prevent a rapid rise in government bond yields in 2010, governments will need to convince investors with plans to cut their extreme deficits. However, if governments do not walk this tightrope carefully, investors are likely to sell bonds, pushing up yields anyway, causing a tightening of monetary conditions by default.

CREVASSE NUMBER 2: SUPER CONSUMER TO THE RESCUE?

Governments are relying on consumers and businesses to pick up the tab where they leave off. US consumers, the biggest spenders in the world, have historically accounted for 70% of GDP in the US. However, the US consumer might not return to previous spending patterns for a long time to come, due to high unemployment, less availability of credit, a reduced appetite for credit, and the rising savings rate.

US household debt relative to income is only slightly below its peak and still 30% above its level a decade ago. British households are in a worse position. The question is whether the long period of credit expansion, the debt super cycle, is now over. This would imply much lower spending than we have been accustomed to in recent history.

CREVASSE NUMBER 3: MORE CRUNCH FROM FROZEN CREDIT MARKETS

Credit conditions are not improving in the real economy yet and there is the unfinished task of restructuring devastated financial sectors. For example in the US in October, the Federal Deposit Insurance Corporation reported 522 banks holding \$345.9 billion in assets on its problem list - the highest level since 1993.

Small Is Not Always Beautiful

Life has got easier for big firms this year. The bond and commercial paper markets and the stockmarket have ensured access to capital. However, smaller firms that rely on banks for capital are not surviving so well. Demand for credit may have weakened, but

there is a risk that when small firms do need capital, lenders will not respond due to fears of further losses and uncertainty over stronger rules on their own capital. Small businesses account for most private sector employment in US and Europe.

Too Big To Fail, Too Big To Succeed

The number of lenders that are deemed 'too big to fail' has grown, meaning that the scope for another crisis is growing too. We've just been through a financial crisis, so you would expect banks to be defensive, reduce their balance sheets and reduce their risk exposure. However, the opposite has occurred. European bank assets have grown by 25% over the last 3 years, 20% increase at US lenders. 15 European banks now have assets and liabilities larger than their domestic economies, compared with 10 lenders 3 years ago. This means significant risk of 'systemic' shock, as governments will not be in the position to bail out another bank or two.

Credit where credit is due

Further down the line, credit needs to grow again. Employment and house prices need to stabilise. Bank balance sheets need to recover via a resurgence in operating earnings and capital raising to offset the write downs of massive overhang of bad debts, while leaving some capital to resume lending.

CREVASSE NUMBER 4: WRITEOFFS AND REFINANCING

By 2010 Moody's estimate total global debt will be over \$49 trillion, and the IMF reckons that banks have probably written off less than half their \$2.8 trillion losses. **In addition, \$9 trillion global debt will need to be refinanced between 2010 and 2012, nearly twice the amount refinanced between 2007 and 2009.** Governments will need to continue borrowing, too. This scale of demand for money will drive up long-term interest rates. Borrowers, forced to compete for scarce cash, will have to pay more.

CREVASSE NUMBER 5: US DOLLAR WEAKNESS AND THE UNWINDING OF THE CARRY TRADE

If a government is seen to have lost control of its finances, this is likely to result in falls in currency. Whilst the US may be happy with an orderly fall in its currency, a collapse is clearly damaging to the global recovery. A collapse of the dollar is unlikely however, firstly because of the vested interests of the world, but also because as soon as there is a global scare, the dollar tends to do well as investors move to 'safer' assets.

Since early last year there has been a close relationship between dollar weakness and risk appetite. Positive news creates appetite for risk, which causes a weak

dollar as investors sell safe US holdings to invest in higher risk assets like commodities. Bad news causes a reversal as investors sell risk assets for the safety of the dollar. The real underlying reason for the correlation is the carry trade. Since March, investors have been borrowing in dollars at low interest rates and investing in higher yielding assets overseas. Short positions in the dollar are close to record highs. The carry trade is probably inflating all kinds of assets from gold to property in Asia. The problem comes when the dollar starts to appreciate and investors need to cover short positions by selling the risk assets.

CREVASSE NUMBER 6: YEAR OF THE TIGER - EMERGING ECONOMIES TO TAKE UP THE SLACK?



The gap between the deficit levels in rich and poor nations (projected by IMF to be 114% vs. 35% in 2014) will eventually cause rich nations to lose out. The world needs China and India (and to a lesser extent Brazil and Indonesia) to take up the slack from the advanced nations. Whilst US government spending continues to serve to prevent a lapse into recession, China's surge in investment is allowing its economy to gain ground. However, surplus economies such as China have not yet rebalanced their economies to rely on private domestic demand, and external demand and flows of foreign investment and credit will remain weak. China's refusal to allow the Yuan to appreciate is restricting the economy's shift to consumption. In addition, emerging economies face asset bubbles and other distortions as governments keep conditions too loose for too long.

China is an interesting case study of a bubble. In 2008 and 2009, demand for China's manufacturing dried up. People lost their jobs, factories closed, credit was scarce. Then the state controlled banks went into lending overdrive. In 1H 2009 lending was 50% higher than in 2008.

Most of this ended up in infrastructure projects. This kind of spending can boost sentiment, reduce unemployment, and the infrastructure is good for business anyway. However, the loans are unlikely to have been based on good credit quality, and have potentially created massive excess capacity.

International Trade To Save The Day

International trade will also be key to sustaining the recovery. Collaboration worked well at the height of the crisis, but it is likely to be more difficult when the threat of global meltdown is not looming. Countries will recover at different speeds. However if some countries tighten too soon, this could derail the global recovery. In addition, rather than collaboration, we are much more likely to see counterproductive protectionist measures such as US tariffs to challenge China's unfair currency position.

CREVASSE NUMBER 7: MORE SOVEREIGN CONCERNS

Following the problems with Dubai World's debt, it is clear that there will be more defaults in the region. This will of course mean more losses for foreign banks holding the debt. In addition, Fitch has cut its rating on Greece's debt to BBB, and other members of the eurozone are also at risk. Further, Moody's have warned that Britain needs to take control of its debt, but the government is not showing commitment to cutting the deficit yet.

There are other potential dangers as ever, such as a surge in oil prices or commodity prices in general which could derail the recovery as it has in history. Regulation and disincentives restrict the contribution that finance industry can contribute to global growth going forward. In addition, some capacity will have been destroyed by the crisis and the post war baby boomers are now starting to retire which will also reduce potential labour force capacity. Whether the world economy continues to recover will depend on how well the above challenges are addressed.



NEW YEAR PARTY?

However, there are reasons to expect more euphoria at the start of 2010. With near zero interest rates, investors are encouraged to invest in risk assets. Indeed investors don't have much alternative. Secondly, governments will have to keep interest rates low to avoid derailing the recovery. Thirdly, although deflationary pressures are the more immediate risk, at least this means inflation risk is far away. High unemployment and massive spare capacity means that inflation will remain low, and consumers' expectations are likely to stay low too. However, although inflation will be subdued, asset bubbles are inflating everywhere, especially in Asia as the regions policy makers prevent their currencies from appreciating against the dollar. Commodity prices are likely to rise rapidly too.

We expect that stockmarkets may well edge up as governments err on the side of loose financial conditions, perpetuating the liquidity rally. However we expect significant volatility according to the risks /shocks expected above, especially as governments begin to attempt to rebalance the drivers of growth away from government support.

NEW YEAR'S RESOLUTIONS: OPPORTUNITIES FOR INVESTMENT

Despite the challenging outlook detailed above, there are significant opportunities for 2010.

Quality Street

The good news is that quality stocks were largely been left behind in the rally, and this presents a very positive investment scenario. If the rally falters, investors will search for quality. If the rally continues, or if there is significant volatility, then the recovery should widen out to the more defensive sectors of the economy. Following our 'value' based investment ethic, the best time to invest is when valuations are low and sentiment is low. These opportunities are rare. When sentiment is low, it is best to buy young,

volatile, unprofitable firms (sometimes known as junk) - this is really the only time when it might be right to buy junk, and these are the firms that have performed very well since March. When sentiment is higher, which it is now, it is best to buy older, stable profitable firms (also known as 'quality'). **The current market dislocation implies a massive relative undervaluation of quality cash generative, dividend paying companies.**

To Protect and Serve

Equity market participation should only be considered now with care. The current run up in markets should be regarded with scepticism, and hence protection is needed. Carefully selected structured products can provide that protection, effectively reducing risk for every unit of return.

Distressed Sellers, Not Distressed Assets

Sectors that continue to feel the after effects of the credit crunch are mostly those that have suffered the effects of leverage and tightened credit markets. Property and the secondary market for private equity face this headwind. We are continually on the search for undervalued assets, but target distressed sellers of healthy assets rather than assets which are in distress themselves. We anticipate a long term trend here and expect to see assets being sold below value for the whole of 2010 and beyond as credit markets struggle to return to normality.

Tiger, Tiger, Burning Bright

We continue to view China as a great economic growth story, but a dangerous investment premise. Hence we access the opportunity via derived demand. This means we continue to invest in the long run trend towards greater demand for resources, commodities, metals. In addition, China's industrialisation and massive construction plans lead to the growth of the mass middle class.

Hence we are targeting international companies that have exposure to growth in demand for consumer staples, and discretionary goods from the large emerging economies. More specifically this means agricultural commodities, healthcare, electronics, travel, housing, cars, recreation, and Asian beachfront land.

Technology, The Sequel

The technology media and telecoms industries have still not recovered fully from the bursting of the tech bubble nearly 10 years ago, and yet the growth in that industry continues apace. This fits our value based investment approach.

Post-War Baby Boom to Post-Crunch Waiting Room

The worldwide post war baby boom generation born from 1945 onwards are now reaching retirement age. An ageing population needs healthcare, biotechnology, and medical devices.

Construction Boom

Similar to the trend above, global infrastructure that was built in the reconstruction boom after World War Two is deteriorating. The focus on global warming and the downturn has created a distraction from this, which means that reconstruction is needed even more. Global population pressures and the industrialisation of China compound this problem.

Inflation after the Long Slow Puncture

Following a decade of low inflation due to the influences of the internet on cost and price and China's cheap production costs, we don't expect inflation to rear its ugly head significantly in 2010, but eventually.

Protection against inflation comes in the form of equity investment, in income paying companies, and investment in commodities. Index linked gilts are also a possibility, but offset by the dynamic in the bond market, see below.

Bonds

We remain concerned about this sector, as we expect a rise in long term interest rates which will offset the shorter term tendency for credit spreads to narrow.

CONCLUSION

The fact that the world is uncertain is now certain. When you think about this short sentence, an unexpected comfort becomes apparent. The icebergs may be big but compared with a year ago we know where most of them are now. We have been very cautious in 2009 because we value our client's capital more than any other thing. Why take unquantifiable risk to achieve an unknown outcome? Now, we feel far more validated in buying great assets at fair prices; assets that can benefit from choppy waters. We have stayed true to our principles of always seeking value. Now more than ever we focus on three real risks of investment; Valuation risk - it's always a risk if you buy an asset for more than it is worth; business risk - the risk that a company may go bust or investment may suffer catastrophic loss; and lastly financing risk - the risk of leverage (borrowing). Our diversified investment philosophy, Mosaic and the team who deploy it are fit and well and looking forward to 2010.

RISK WARNING

Readers should note that investments and the income from them can fall as well as rise. Currency fluctuations may also have an adverse or favourable affect on investment values.

We invest in a wide variety of financial instruments, each of which exhibits different levels of risk. We define 'risk' as the magnitude of price volatility (that is to say, the rate at which the price of a financial instrument moves up or down) measured over periods of time.

Certain investments such as hedge funds and private equity funds cannot be bought and sold on a daily basis and sometimes cannot be sold for periods measured in years. This may mean that certain investments cannot be immediately sold even if an individual ceased being a client of this firm.

Sometimes, investments include exposure to derivative contracts albeit these are generally, but not always, used to manage risk.

Any investment related views expressed in this paper or by any other media are those of our team at the time and may well change in future.

Past performance and other statistics cannot and should not be used as a guide to the future. Crucially, all readers must take personal responsibility for any action taken resulting from the content of this paper.