

ARTICLE FOR THE HERALD FUNDAMENTALS COLUMN

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From Colin McLean, Managing Director, SVM Asset Management

For stockmarkets, summer is a quiet time with low trading volumes. Investors go on holiday and there is little real news from companies. But in some years the summer months have been far from boring. Unexpected economic news or currency trends can trigger sharp stockmarket moves. It may take few buyers to shift share prices to new levels, possibly detached from reality. How should investors deal with this unusual period?

There are precedents that give good reason to distrust summer trading. July and August 2008 delivered a sharp rotation from resources into financials; an unjustified move that subsequently corrected. This year's surprise is a continuing strong recovery in commodity prices and in shares of economically sensitive businesses. This apparent recovery in investor confidence contrasts with warnings on current trading from many companies, and rising unemployment.

In fact, this year the stockmarket rise is quite broadly based - with retailers, pharmaceuticals and technology shares moving up along with banks and some industrials. The initial catalyst for the rally was news of exceptionally strong trading in investment banks, but encouraging growth in China has also lifted oil and other commodity prices. Many oil and mining shares have still not fully retraced last year's fall, but are moving strongly

back into profit. Investors should not dismiss the more positive stockmarket mood, even though overall trading activity remains light.

Undoubtedly, the UK economic background is still weak, but the unprecedented injection of money into banks is starting to feed into mortgage lending. There is still a large gap between the level of bank deposits and loans needed, but there are other ways to correct this. An extension of existing arrangements for the Bank of England to assist banks in funding mortgages could give a further boost to the economy. And the fact that the UK is doing some things right is shown by the strong performance of the Pound this year. The UK is proving a more flexible and resilient economy than Germany – not what many economists were predicting twelve months' ago.

The poor trend of UK unemployment may already be reflected in share prices. Fear that the stockmarket could fall back to the lows of early March has kept a lot of cash on the sidelines. That caution could be replaced after the summer by a scramble to invest, with the possibility that the low point of 2009 has already been seen. Already, this month, the US has seen its longest rally since the end of the last bull market in 2007. The rally could run on to the year end, even if it leaves some smaller companies, consumer stocks and utilities behind.

Since May, there has been greater realism in shares, with signs that the early euphoria of March and April has given way to investor discrimination. Some defensive sectors like pharmaceuticals and tobacco are recovering from their previous underperformance, but utilities are continuing to disappoint. Deflation is proving a tough environment for water companies, and if this continues many sectors will see further dividend cuts.

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SVM Asset Management Ltd, 7 Castle Street, Edinburgh EH2 3AH Tel: 0131 226 6699

This summer, the stockmarket may surprise. But investors should not just look ahead to next year's earnings recovery, but also try to assess future dividend risks. There may be no safety in high yields. However, it is not too late to buy into shares of some major companies with sustainable growing dividends.

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