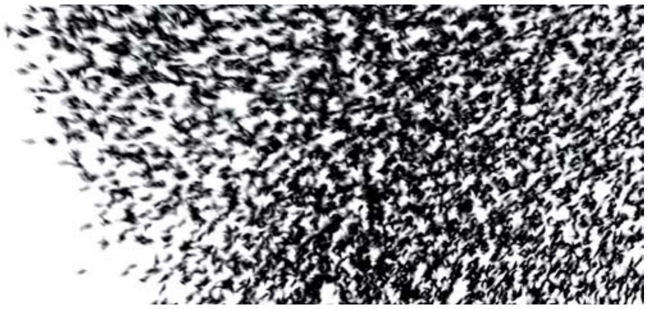
A view from Veitch

15 June 2010



Most investors were caught unprepared by the recent stockmarket sell-off. Companies that reported in March and April delivered good results and share valuations remained inexpensive. The recovery in the bank sector was continuing, with share prices up strongly from the lows of early 2009. So what has caused the FTSE Index to fall by more than 10% since mid-April? Could an economy as small as Greece's really undermine the UK market to such an extent?

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Initial delays in supporting Greece were followed by a string of mixed messages from politicians and vaguely reassuring statements. Eventually, in early May, the ECB went 'all-in' and announced it would directly purchase the bonds of the peripheral European economies. This caused a brief, sharp rally in equities. However, the initial optimism regarding the scale of support quickly faded as investors fretted over the political implications and the stated intent of authorities to sterilize the additional liquidity. Sterilisation would force the ECB to drain liquidity from the core of the Eurozone to support the periphery. Such a move will only serve to export deflation from the periphery to the core and, ultimately, the rest of the world. As a result, equities swiftly resumed their decline.

This ongoing tug of war between improving 'bottom-up' company fundamentals and 'top-down' structural concerns continues to dominate the London market. Across the board, companies are beating earnings expectations and commenting upon the improving operating environment. Indeed, we have recently met a number of companies that have just had their best quarter ever and were increasingly bullish about prospects for the future (to avoid doubt, these were not insolvency practitioners)! However, over time it has been well-established that company management have been overly optimistic about the outlook for the economy. Structural concerns remain about the overleveraged global economy and the grand game of 'pass the parcel' which has seen debt transferred from the private to the public sector. Given the efficiency of financial markets at spreading anxiety between regions, the impact of the Eurozone debt crisis on business and consumer confidences cannot be ignored and must be carefully monitored.

With the UK market currently trading on an estimated PER of 10.5x, equities continue to offer good value despite the aforementioned uncertainties. While there is potentially some risk attached to earnings, current valuations provide a degree of protection. For instance, the yield on the FTSE All-Share exceeds that of 10-year Gilts – historically a good indicator of value. Furthermore, for those investors concerned about the inflationary impact of current monetary policy equities offer the prospect of a growing income (at least in nominal terms). However, as the current issues around BP's dividend demonstrate, investors should not hold a share simply for the yield because if dividends are cut there may be little support for the share price.

There will be no doubt some investors out there who contend that optimists such as ourselves just don't get it and that we are about to enter the 'second act' of the financial crisis. A 'greek tragedy' that will only end when the excesses of the last 10-15yrs are washed out of the system through a period of sustained deflation. Under such a scenario equities would remain under pressure and bonds would be the asset of choice. While such a scenario is theoretically possible our base case is that the fallout from the current crisis is manageable. Structural concerns will linger but we expect the economic fundamentals continue to improve (albeit with slowing momentum) and valuations remain attractive. At prevailing exchange rates UK assets look very attractive to potential acquirers and as confidence returns we expect a pick-up in M&A activity. An additional consequence of the crisis is that interest rates are likely to remain low for a prolonged period, providing further support to risk assets.

Neil Veitch is the Fund Manager of SVM UK Opportunities Fund, which is unconstrained in terms of market cap and seeks to hold a balanced portfolio comprising the 50 most attractively valued UK stocks.

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