

# MARKET OUTLOOK



## HITESH THAKRAR ON GLOBAL EQUITY – AUGUST 2008

Hitesh Thakrar, manager of the New Star Global Equity Fund, comments below on the current pressures on global equity markets and considers whether a turning point may be approaching. Hitesh, who took over management of the fund at the beginning of May 2008, notes tentative signs that the US housing market crisis is nearing the bottom and explains where he sees the most compelling opportunities.



The long commodities, short financials trade that has worked so well for much of the past year seemed to unwind during July as financials rebounded and commodity sectors sold off.

Over recent weeks there has been a growing sense that the worst may be over for the financials sector. The liquidity crisis is slowly resolving and, while write-downs are likely to continue, particularly given the traditional effects of a downturn, the bulk of the aggressive losses from sub-prime securitisation and esoteric financing may be behind us.

A significant shift also appears to be occurring in investors' perception of the financial sector. Until recently, financials were viewed as a homogenous group. Few banks have escaped announcing losses, write-downs and capital raising activity but some businesses have proved particularly resilient. We appear to be entering the next phase in the financial crisis in which investors begin to differentiate between the superior banks and the weak ones. Such discernment is often the first sign of a return to stability.

Improving trends are noticeable in some of the US financials with strong performance from JP Morgan, State Street, Northern Trust and Wells Fargo, all of which have low exposure to sub-prime lending and housing markets. Some banks are outperforming the MSCI World Index for the first time in 18 months. Overall, we favour large banks that have completed or been early in their fund raising activity, such as JP Morgan, Royal Bank of Scotland and Citigroup. That said, a wholesale return to the sector is not to be encouraged at this stage. Selective investment is vital as there is still significant downside risk stemming from exposure to the traditional credit deterioration that occurs in a downturn.

While financials have been the pariah sector, the US, as the source of the sub-prime meltdown, has been unloved at a country level. Now may be the time to re-evaluate the market. In its favour is time; since the US was the first to enter the downturn, it has already suffered much pain and may, therefore, be among the first to recover.

Furthermore, with its high percentage of large capitalisation and financial stocks, the US equity market has historically proved to be a defensive bolthole during slowdowns. For example, US equities outperformed global markets from the recession that began in 2001 and continued to deliver strong relative performance until mid-2003 when global equity markets began to recover and emerging markets took centre stage.

Given its sheer size, the US is also blessed with a wide choice of big companies, which are likely to offer the best prospects during the late stages of the business cycle. Small and medium-sized companies are typically the most vulnerable in a slowdown as they tend to be more exposed to the domestic economy. Earnings momentum and consistency are crucial at this stage of the cycle and large stocks typically outperform as they have greater flexibility and cashflow.

There are tentative signs that the US housing market crisis is nearing the bottom. There has been an 18% year-on-year price decline but while growth in the sector remains negative, the pace of decline is slowing. According to the S&P Case Schiller futures index, while the absolute numbers will remain negative, a market trough is anticipated in the next six months. An improving rate of change will be of primary significance in determining the direction of the US housing market. Until this changes, the outlook for US housebuilding stocks is not encouraging.

The apparent resilience of the US has been endorsed by the International Monetary Fund's latest forecasts. Among the major economies, the US has received the largest upgrade – annualised growth is forecast at 1.3% in 2008, up from forecasts of just 0.5% in April. That said, second-quarter figures, released at the end of July, showed lower than expected annualised growth of 1.9%, although up from 0.9% in the first quarter.

Investors should perhaps be more concerned about the prospects for the eurozone and the UK, where central banks' monetary policy has been behind the curve. In Europe the lagged impact of the credit crisis is beginning to hit inventories and order books.



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There has been much debate about whether the Asian economies can decouple from the US and withstand any sharp American downturn. Insulation from a global equity fallout seems unlikely, however, as the region remains heavily dependent on the US as the final destination of its exports and its supply chain is integrated with America's prospects. A good example is Apple's Ipad where over 90% of the components are made outside the US, mostly in Asia.

Factories that manufacture technology products in Asia perform well when sales volumes are healthy and will struggle this year if they do not receive the same volume of business. It is becoming increasingly apparent that the Federal Reserve's rate cuts have led to worsening inflationary side effects in Asia. With low margins and short order times, it appears that these less developed economies and less sophisticated corporations are not as well positioned to manage profits in such an environment.

Inflation is high on the agenda across the globe but for Japan, recent data suggesting the return of inflation are a positive catalyst for its financial markets after a decade-long struggle with deflation. This is based on the theory that when the country was struggling with deflation, consumers expected prices to continue to fall so they saved and postponed new purchases in anticipation of lower prices. With prices rising, consumers have greater incentive to spend. These beneficial effects have not yet been reflected in the market, however, as companies are absorbing rising prices. While this may hurt corporate profitability, much of this risk has already been priced in with many Japanese stocks trading at book value. At present, currency effects are the most significant driver of returns in the Japanese equity market with dollar strength and the weaker yen both good news for exporters.

If the oil price flattens then global inflationary pressures should subside, particularly on one-year comparables, easing concerns that central banks will have to raise interest rates despite the slowdown. One of the main issues will be whether US and emerging economy resilience will be offset by gathering weakness in Europe.



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