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Simon Murphy fund manager,
Old Mutual UK Select Equity Fund reviews

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WINTER 2010 Asset Allocator

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2010: what now for UK equities?

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UK market overview

I am positive on the outlook for UK equities for 2010, and one element in that conviction is the capacity for positive surprises from company earnings.

I don't think we'll see vast economic growth – I see all the headwinds to economic growth as everyone else does – but certainly I think there will be some at least and that, combined with some very tight cost-control by companies over the last 18 months or so, will drive positive operational gearing and therefore strong earnings growth.

So where will the economic growth come from even if it is a fairly muted recovery? If you think about the constituents of GDP growth, we know that consumption is the biggest element of GDP, but its contribution to GDP growth tends to be relatively stable. The biggest swing factors in GDP growth, either positively or negatively, tend to be around inventories, either restocking or destocking; and around corporate capital expenditure. I think both have the capacity to surprise positively in 2010.

New orders currently globally are very high relative to inventories, and therefore restocking – where it hasn't already started – is a certainty during 2010. Restocking typically lasts three to four quarters and will provide a material boost to GDP growth.

With capital expenditure, corporates have been very reluctant investors for the last year or two, and arguably since the TMT bubble burst back in 2000. As a consequence, capital expenditure is at a very low level relative to GDP, whereas free cash flow for corporate generally is actually surprisingly high relative to GDP. As confidence in the economic outlook recovers I would expect a pick up in capital expenditure in 2010.

So I am quite positive about these two elements surprising in relation to GDP growth in 2010. And with the prospect of some economic growth and positive earnings surprises in combination with what I believe is a favourable valuation environment for equities, certainly when compared to gilts or cash or indeed property (especially as that asset is so illiquid), this is what drives my optimistic outlook for the year ahead.

Here in the UK we need to be aware of things like the vast public debt, and just how troublesome that is potentially for the economy into the medium term, and so I – along with everyone else – am expecting very significant cuts to public expenditure budgets following an election. I would expect some stringent measures in terms of taxation as well.

However, the UK market, particularly within the FTSE 100 Index, is very international in flavour which is a tremendous positive, because while I may not be particularly excited about the prospects for the UK domestic economy in the medium term, that doesn't necessarily translate to a gloomy outlook for the UK stock market.

Sector selection

There are several sector themes that I am positive on right now, one of which is commodities. I believe in the industrialisation of India and China and emerging markets generally, and that will take the best part of 20 years if not longer. So I think that's a powerful structural driver of demand and consequently the marginal cost of commodities will rise, particularly as these are industries that are well disciplined and consolidated from a supply perspective.

In financials – I stress the need to be selective here – but in some areas of financial services such as mezzanine finance or the hedge fund industry, I am positive on companies that I think are demonstrably getting better and stronger as a result of the credit crisis, primarily because their competition are considerably weakened and/or have exited the business leaving them to take greater market share.

In the more traditional defensive areas of the market I am quite keen on pharmaceuticals, where valuations have fallen to very low levels, and the healthcare reform in the US is unlikely to be as bad as many had feared in terms of its impact on the industry at large. Plus, there is a real increase in the numbers of new drugs being tested, and it's only a matter of time before some of those become new blockbuster drugs.

Within the consumer sectors, I am keen on auto suppliers and housing related companies, partly because the volumes of transactions in these markets fell so far below normal levels that we are likely to see material pickups in both, even in a modest recovery environment more generally.

Finally, with sales growth proving relatively difficult to find, those companies that manage to deliver genuine growth – perhaps due to a structural driver for their industry such as legislation change – should become ever more highly rated in the stock market.

In conclusion, whilst there are plenty of things for us to worry about when we consider the outlook for 2010 the combination of factors outlined above keep me in a positive frame of mind when it comes to the prospects for the UK stock market in the year ahead.

Simon Murphy is Fund Manager of the Old Mutual UK Select Fund

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The outlook for corporate bonds

The M&G Property Team talks about corporate bonds

2009 – A remarkable year for corporate bonds

The size of inflows into credit funds in 2009 was unprecedented. Although the banking crisis and fears of a depression-type scenario dominated the beginning of the year, central banks and governments introduced bold measures to stabilise the financial system and stimulate economic growth. The combination of record high corporate bond spreads, low real interest rates and significant monetary stimuli, produced an excellent environment for corporate bond returns.

Good returns possible in 2010

Fund manager Richard Woolnough expects that in 2010 interest rates will remain low, core inflationary pressure will be low and the Bank of England will start to unwind its extraordinary stimulus policy.

Against this background, he thinks that corporate bonds can continue to provide a good source of returns for investors, particularly as he expects accommodative monetary policy to continue into 2010. Although investment grade corporate bond spreads have rallied back to levels seen before the collapse of investment bank Lehman Brothers, a further tightening in spreads is likely in his opinion.

Furthermore, Richard thinks that corporate bond prices should continue to benefit from flows into the asset class as investors search for extra yield in an environment of very low returns for cash.

The improvement in credit markets in 2009 enabled many companies to issue new debt, often at very favourable yields. In Richard's view, debt issuance will likely remain strong in 2010 but lower than 2009 levels, particularly as companies bypass their traditional source of funding (banks and financial institutions) in favour of borrowing directly from capital markets.

Companies also undertook bondholder-friendly actions during the past year, such as equity rights issues and asset sales in order to de-lever and retire debt. In addition, many reduced debt-financed M&A and cut costs. This combination of restructuring and refinancing has resulted in more conservative balance sheets and should help to limit any increase in corporate default rates.

Gilts

Richard has a bearish outlook for UK government bond yields for 2010. This is entirely due to technical factors, rather than concerns about a structural increase in inflation. He believes that the huge supply of government bonds that are likely to be issued in order to fund the government's borrowing over the next couple of years will put upward pressure on yields, particularly once the support from the Bank of England's asset-purchase scheme has been withdrawn.

Stock selection the key to performance in 2010

In Richard's view, the main risk to the performance of corporate bonds in 2010 is a renewed bout of investor risk aversion. Under this scenario it is likely that spreads would widen but he thinks it is unlikely that they would reach the depression-type levels we witnessed in early 2009.

For Richard the key to successful corporate bond investing lies in 'avoiding the losers' rather than 'picking the winners', and he believes that in 2010 individual stock selection will be especially important. In a favourable, albeit challenging, economic environment, Richard thinks that fundamental bottom-up research into every bond will be critical to good investment returns in 2010.

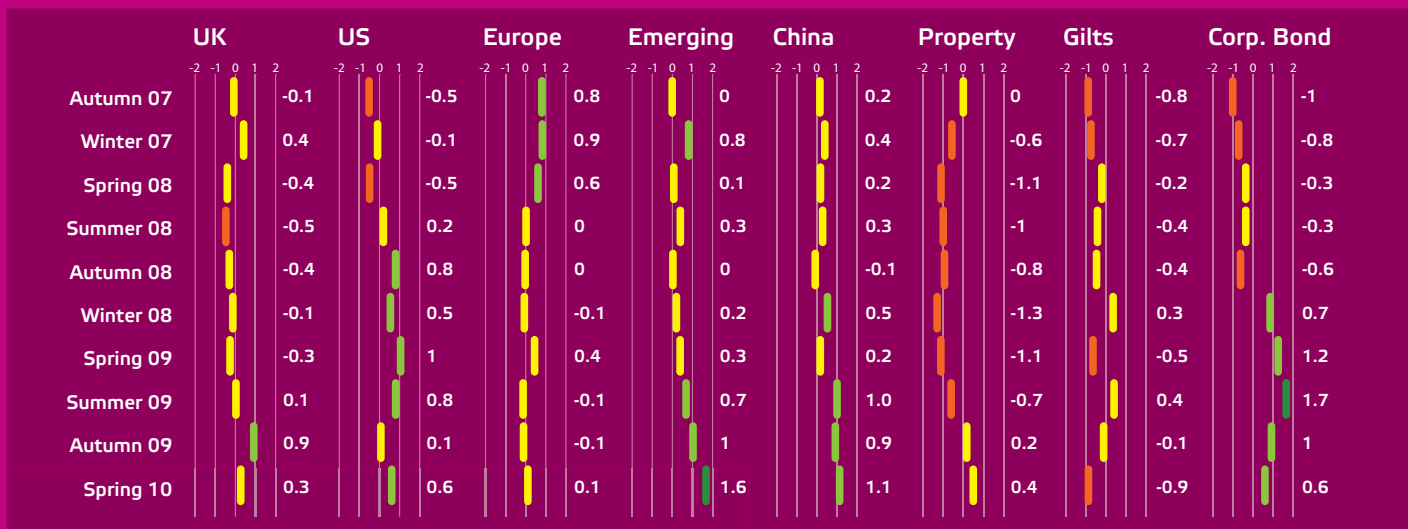
The view of the M&G Property Team



Global asset views

Consensus views on world markets and sectors drawing expertise from fund management groups.

	UK	US	Europe	Emerging	China	Property	Gilts	Corp. Bond
Aberdeen	-1	0	1	2	1	1	-1	1
BlackRock	1	2	0	2	1	-1	-2	2
Gartmore	0	1	0	1	1	0	-2	1
JP Morgan Asset Management	2	1	-2	2	2	0	0	0
M&G	-1	-1	1	2	1	2	-1	-1
Selftrade Research	1	1	1	2	1	0	0	0
Schroders	0	0	0	1		0	0	1
Scottish Widows Investment Partnership	1	1	0	0	0	1	-1	1
Threadneedle	0	0	0	2	2	1	0	0



Consensus

There is a sense of rather cautious optimism in this latest quarterly snapshot of leading fund manager investment views. As the world is dragged into recovery led by China and the emerging economies, it is little wonder that these two geographic sectors are among the strongest consensus ratings. Elsewhere, in the developed economies of the UK, Europe and the United States there appears a reluctance to convert the tentative signs of a return to growth to an outright positive view. This perhaps reflects recent warnings from the IMF of the possibility of a double-dip recession were fiscal stimulus packages to end prematurely. Perversely, it is perhaps the converse fear about British public finances which continues to put a dampener on Gilts.

