

CHARLES STANLEY

Economic and Bond Briefing

22 June 2009

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1. Global developments – Recession losing its grip – Recovery more doubtful

(a) Equities

- Falling trading volumes and indecisive economic statistics left equity markets to give up ground by slow degrees.
 - the FTSE index is now approximately 5% below its closing peak of 4506.19 established on 01/06/09. Thus far this is a technical setback that does not invalidate the major upward trend until the reaction reaches 10% or approximately FTSE 4055.
- The economic message seems to be that the grip of recession was loosening but the hopes for a sharp rebound in these coming months was being seriously challenged. There appears to be no spending power particularly in the Anglo-Saxon economies and the current recovery is not going anywhere fast.
- An assessment of the global economic situation according to Credit Suisse is summed up as follows:
 - in the Anglo –Saxon economies recession will end sometime in mid 2009 but there will not be a return to trend growth quickly.
 - in the Eurozone, growth will resume behind the Anglo-Saxon economies.
 - in Japan, growth will lag behind the Anglo and Euro block.
 - in China economic growth is accelerating. The rest of Asia ex Japan should benefit from the recovery in global trade. Ex Japan Asia is the most dynamic economic region and has considerable resources to support internal growth and should outperform the developed economies.

(b) Bonds

- The calmer mood in Government bonds was boosted in part by weak equities and wider credit spreads.
- However impending supply weighed on the UK & US markets in particular.
 - the US this week will sell a record US\$104bn of new debt.

(c) Currencies

- The US\$ shrugged off pressure that its reserve currency status might be threatened as Brazil, Russia, India and China considered accepting each other's currencies in the course of trade.
- The Euro has been under strain for some time because
 - slow pace of economic growth.
 - the exposure of many developing Eastern European economies to foreign currency debt that in many cases have been arranged or financed by Eurozone based banks.

(d) Comment

Falling trade volumes, indecisive economic statistics left equity markets losing ground by small degrees.

FTSE 5% drop below its closing peak of 4506.2 established on 01/06/09 is insufficient to declare that the 03/09 recovery has been broken.

Economic statistics suggest that the grip of recession was loosening but hopes of a vigorous rebound was being severely challenged.

Credit Suisse maintains that the strength of recovery will be led by Asia, ex Japan, followed by the Anglo block, the Eurozone and finally Japan.

Calmer bond conditions were in part due to the rise in weakness in equities and wider credit spreads. However impending supply weighed on sentiment.

The US\$ shrugged off pressure of its currency status.

The Euro came under pressure as many developing East European countries have foreign currency borrowings arranged by Eurozone based banks

2. The UK shapes of Economic recovery – ‘W’ shaped recovery gaining ground

(a) Background

- EBB on 15/06/09 examines the prospect of economic recovery. It was felt that the recession as its absolute low point might have occurred in 03/09. Thereafter conditions would improve gradually thus producing a ‘U’ shaped recovery.
- However, many believe that the problems with the banks in particular will return to haunt the financial system and instead of having a slow but consistently improving economic uplift in the shape of a ‘U’, there is a strong possibility that deterioration will once again become evident, making the recovery resemble a ‘W’ shaped pattern.

(b) The first dip and recovery in the ‘W’ formation

- In the first stage of the downturn the economy
 - Absorbed a credit crunch
 - Had to absorb a breakdown in confidence
 - Was beset by a banking crisis.
 - Had to meet curtailed consumer and business spending.
 - Had to absorb a savage phase of destocking where stocks declined faster than demand.
- Most of these factors have exerted their negative influence and it is likely that the first part of the dip and recovery of the ‘W’ formation has been completed. In support of this view are the following:
 - The lead indicators have picked up pointing to better times.
 - Manufacturing output has crept up.
 - The NIESR who have an excellent track record claim that the UK economy grew in 04/09 and 05/09, albeit marginally.
 - The UK economy may have bottomed in 03/09.

(c) Start of the second dip in the ‘W’ formation

- The cause of a second dip could be that
 - New businesses are still finding it difficult to gain access to credit and where it is available the cost is spiralling.
 - Pricewaterhouse estimate that the margins for corporate credit are 2-3% above the historic average.
 - The BofE cautioned that lending to UK businesses is at its lowest since 06/2000. For non-property business lending is actually contracting.
- However, for existing borrowers, it is strange to state that banks should be lending even less, and that comparative generosity is simply delaying the effects of the recession.
- Many of the banks are exercising forbearance, lending distressed companies even more cash to keep them out of bankruptcy and consequently reducing the provisions and write-offs that would otherwise had to be charged to their balance sheet.
- By extending credit to doomed enterprises, the banks may be adding to the losses that they will eventually be forced to own up to and may even make the plight of the companies concerned even worse.
- Either way, bankruptcies and unemployment will continue to rise.

- A similar version of the banking scheme is being pursued by HM Treasury. The Inland Revenue is unusually sensitive to pleas for more time to pay bills. The Business Payment Support Services has helped 110,000 businesses obtain £2bn of support.
- The third source of unorthodox support being given to the economy which is bound to be temporary is coming from the workforce who are co-operating by cutting wages and hours and generally easing the task of management.
 - The most extreme example of this situation is BA, where the staff is being asked to follow the chief executive and work for nothing.
- However, sooner or later pay will have to return to normal and when it does, more firms may be tipped over the edge.
- Hence, when the banks, HMT and workers run out of cash and patience, there will be a wave of bankruptcies and redundancies. The latter is likely to be exacerbated by a trend to higher interest rates and the growing impact of crowding that.
- It will remain to a weak £ to ensure that the second upward leg of the 'W' develops.

(d) Comment

Whilst investors would prefer a 'V' or 'U' shaped recovery as it would represent a developing momentum in the economy and corporate profits, a stumble could develop leading to a 'W' shaped recovery becoming a distinct possibility.

The first downward leg of the 'W' probably is behind its market and it is time to be seeking causes for the second downward decline.

In this respect lenient banking attitude towards weak companies may prevent further bad debt provisions in the short term but not in the longer term. The Japanese example is abundantly clear.

HMT subsidies and workers' voluntary pay cuts are not viable long term strategies.

The final pick up in the 'W' formation will come from a rebalanced export orientated economy.

3. Equities – Rights issues will not sink UK equities

(a) Background

- Q = Could the cash calls stall the rally or at worse sink it?
- In the year to date UK companies have raised £31.3bn which compares with £46.3bn for the whole of 2008 and £19.4bn in 2007.
- In 2008 £55bn of dividends were paid out and compare to a total market capitalisation of £1.3trillion.
- The dividends paid out give an indication of the amount of cash that can be used to back equities.

(b) The European Dimension

- Goldman Sachs estimates that a shift out of money market funds could unleash £235bn to cover equity issuance across Europe.
- Assets in money market funds increased sharply in 2008 and are equal to 27% of the market capitalisation of European equities vs. a 5 year average of 17%.
- A return to the historical average of 17% would provide £350bn or 10% of Europe's current market capitalisation.

(c) Concerns

- Several commentators have noted that rising bond yields have the potential to choke off investment in equities.
- However even if only part of the money is allocated to equities which when combined with dividend reinvestment will provide enough cash to cover further equity issuance, provided there is not another blow up in the banking system.
- The pace of issuance in H2 2009 could slow now that several issues viz HSBC and Xtrata have been completed.

(d) Comment

There are many reasons to think rising issuance of equities will not undermine the rally in equities and the direction of the stock market in H2 2009 will be determined by factors such as economic data, the level of government bond yields and valuations.

4. Summary and conclusion

- FTSE index at approximately 5% below the recent high of 4506.19 has not invalidated the 10% reaction rule which might indicate a change of direction.
- The economic message of the moment seems to be that the grip of recession was loosening but the hope of a sharp rebound in coming months was being seriously challenged.
- Credit Suisse reaffirmed the known preferences of investment destination. The latter being emerging markets in Asia ex-Japan, the Anglo economies, the Eurozone and Japan.

- The US\$ shrugged off pressure that its reserve currency status would be lost.
- The Euro is under pressure as emerging East European economies face concerns regarding their foreign current borrowing. Eurozone based banks remain vulnerable.
- EBB report of 16/06/09 painted a picture of a 'U' shaped recovery that would support an improving pace of momentum and rising corporate earnings and dividends.
- Alas, a case of 'W' shaped recovery is gaining ground due to
 - Availability and rising cost of credit for 'new' borrowers.
 - Inadequate provisions by banks for existing borrowers.
 - Withdrawal of HMT help given to the corporate sector.
 - Temporary abstention for higher incomes by some workers.

These factors will combine to cause the second downward leg of the 'W'; formation. The final upward leg will be brought about by rising exports.

- Could cash calls stall or sink the equity market rally?
- The current high level of cash in money market funds plus the £50bn of dividend payments in the UK should cover the cash requirement of UK companies.
- Factors which will determine market direction include economic progress, bond yields and valuations.

5. Forthcoming key statistics

23/6/09	Eurozone	6/09	Flash PMI manufacturing & services
23/8/09	US	5/09	Existing homes sales
24/6/09	US	6/09	FOMC decision on US interest rates
24/6/09	US	5/09	Durable goods orders
24/6/09	US	5/09	New home sales
25/6/09	US	Q1	Final GDP annualised
25/6/09	US	5/09	PCE deflator

5. Stock recommendations for Private Clients

S&P Ratings	Moody's Rating	Stock	Price	Flat Yld %	GRY Yld %	Yield to 20%	Yld to 40%
		Treasury 2.5% 2013	244.95				
		Treasury 2.5% 2016	278.45				
		Treasury 1.25% 2019	101.80				
AA		Land Secs 4.625% 3/2/11	99.08	4.67	5.22	4.18	3.13
BBB-	Baa3	M&S 5.875% 29/5/12	100.42	5.85	5.63	4.50	3.38
A	A2	Morgan Stanley 5.375% 14/11/13	96.26	5.58	6.36	5.08	3.82
BBB-	Baa3	M&S 5.625% 24/3/14	99.72	5.64	5.61	4.49	3.37
BB+	Ba1	AlliedDomecq 6.625% 12/6/14	98.16	6.74	6.96	5.57	4.18

Potential buyers of Equities should ensure that the underlying Bond is not on an inordinately high yield as to indicate financial pressure.

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