Investment Bulletin

SAUNDERSON HOUSE

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CONFLICT-FREE FINANCIAL ADVICE

MAINTAIN ALLOCATIONS DESPITE GLOBAL TROUBLES

The world seems to have become a more dangerous place in recent weeks. Continued instability in the Middle East, together with a tsunami hitting Japan causing severe problems at the Fukushima Dai-ichi nuclear power station, has driven up energy prices and undermined equity markets. In summary, unless there is a major disruption to oil supplies, which at this point we believe unlikely, our view is that the global economic recovery will continue. We are therefore not proposing any changes to recommended asset allocations in response to these developments. Separately, we are recommending a move out of conventional corporate bond funds to protect portfolios against the threat of higher interest rates and bond yields. We cover this in the second part of this note.

1. Global Troubles

Earthquake and tsunami hit Japan triggering safety issues at nuclear power plant

On 11 March 2011, an earthquake of magnitude 9.0 struck North-Eastern Japan, with the bulk of the damage coming from the resulting tsunami which washed across the Tohoku region, particularly affecting Sendai, its largest city. We understand that this region accounts for about 7-8% of Japan's GDP and is mostly agricultural, with some light industry. In the days since the earthquake, power and water have been restored to most of the 1.4m people initially affected, although 300,000 are now homeless as a result of the tsunami. The death toll is expected to exceed 25,000.

In addition to the tragic human loss, the immediate economic impact of this natural disaster has been the loss of food crops, some manufacturing, but more importantly, power generation capacity. The implications are that Japan will probably see net imports of food increase and overall exports fall, thereby reducing its current account surplus slightly in the short term. However, we would note that the economic significance of these developments to Japan and the world is unlikely to be as bad as some fear. This is because:

- food prices (and agriculture's share of GDP) in Japan are artificially inflated due to protectionist trade policies, so food imports from neighbouring countries are actually much cheaper.
- the car manufacturing and chip-foundry plants in Sendai that were affected represented a fraction of total global output for firms like Toyota and Sony, and were destined for the local market, which operated on very thin net profit margins (or loss-making in some cases) anyway.
- fears of supply chain disruptions due to component shortages are overblown in our view, as companies like Qualcomm remind investors that alternative suppliers and input substitutes exist.

A second issue that has rightly captured the attention of the world's press is the threat posed by the Fukushima Dai-ichi nuclear power station. Our initial thought to the Nikkei 225 Index's 16% sell-off in the week beginning 14 March 2011 was that it would likely prove an over-reaction on concerns of an accident as severe as Chernobyl. The market has recovered 10% since then, and we believe that equity markets will continue to stabilise as the authorities make progress on the nuclear situation.

Considering the longer term issues, the problems at the Fukushima Dai-ichi power plant have caused a negative shift in public opinion, and governments are now re-considering their nuclear energy policies. We believe that this setback will divert energy demand towards conventional fossil fuels, which has longer-term implications for the price of oil and gas. This situation has been exacerbated by the developments in the Middle East and North Africa to which we now turn.

Political Turmoil in North Africa and the Middle East

The demonstrations and political unrest that began in Algeria in early 2011 have spread rapidly across North Africa and into the Middle East. Tunisian president Ben Ali lost his grip on power in January. Hosni Mubarak, president of Egypt, followed in February. Demonstrations have been staged in Jordan, Yemen, Bahrain and Syria, while Libya is teetering on the point of civil war as Colonel Gadaffi tries to hang onto power. The likelihood of Libya's leader employing the country's military forces against largely unarmed civilians has provoked the response from the international community seen in the last few days.

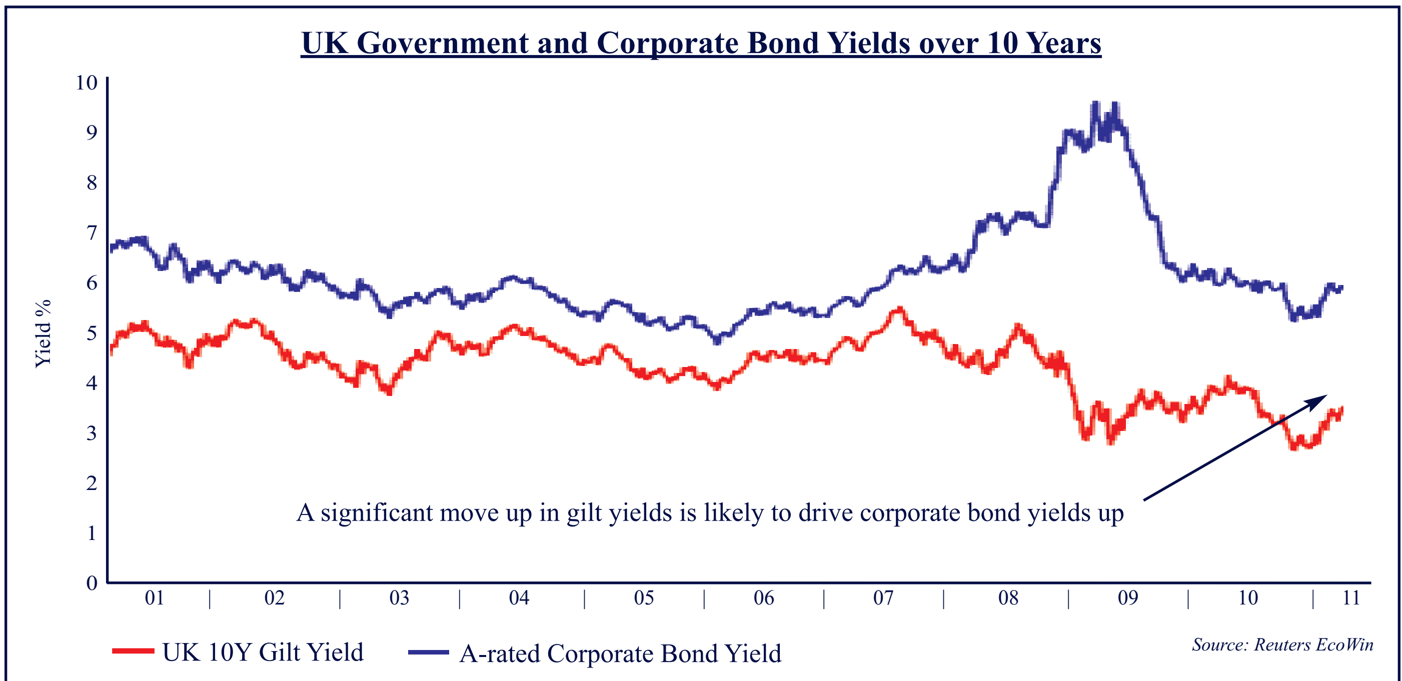
Libya accounts for slightly more than 2% of global oil supplies. Disruption to its oil exports has prompted Saudi Arabia and other OPEC members to increase output to cover the deficit. Nevertheless, oil prices have risen by close to 25% over the year to date. This, in our view, presents the key threat to the economic outlook, and thereby investment markets, particularly if disruption escalates in the major oil exporters. The six members of the Gulf Co-operation Council (GCC): Saudi Arabia, Kuwait, Oman, Qatar, UAE and Bahrain control about half of the world's total oil and gas reserves, and currently account for c.30% of global supply. Major political unrest here could see oil prices climb to their previous record highs of c.$150/barrel or beyond. In such a scenario, we believe that the global economy would suffer a renewed downturn. However, we view this outcome as unlikely. Oman and Saudi Arabia have already responded to calls for political change (and there have been no escalations of violence), while the UAE, Kuwait and Qatar have remained stable throughout this period. Bahrain, the poorest of the six, with help from fellow GCC members, also appears to have quelled its uprising. Thus, while further oil price strength cannot be ruled out, our expectation remains that this is unlikely.

2. Protecting Against the Prospect of Rising Interest Rates

In January 2009, we recommended that clients begin to add corporate bond funds to their portfolios. The yields available were extraordinarily high and, in our view, offered a rare opportunity to earn attractive returns from this normally defensive asset class. Over the past two years, as the financial crisis has eased, corporate bond prices have recovered and yields have fallen, resulting in strong returns for investors.

With UK interest rates and government bond (gilt) yields looking increasingly likely to rise in the coming months, we believe it is now time to switch out of conventional corporate bonds. We recommend that the proceeds are moved into strategic bond funds. These have broader investment mandates, giving them the flexibility to hedge out the risk of capital losses due to rising bond yields. This will leave our recommended portfolios with zero allocations to interest rate sensitive conventional gilts or corporate bond funds and, therefore, broadly insulated against rising interest rates and bond yields.

The chart overleaf shows the path of corporate bond and gilt yields over 10 years. Prior to the financial crisis, the relationship between the two was close, with corporate bonds commanding just a small additional yield above that available on gilts. The credit crisis led to a marked divergence, with risk aversion driving the price of gilts up (yields down) while corporate bond prices fell (taking yields higher). The high yields on corporate bonds in 2009 created the buying opportunity mentioned above, which many fund managers believed was a once in a career event.



In our view, the fall in corporate bond yields, which has provided strong returns for portfolios, has now run its course, and a rise in gilt yields is likely to drive corporate bond yields higher, resulting in capital losses. There are three factors that may cause gilt yields to rise:

- the continued easing of the financial crisis, together with ongoing, if lacklustre, economic recovery. This may undermine the safe-haven attractions of gilts, driving yields higher.
- the increasing threat of inflation. This would undermine the real value of gilts and thereby cause investors to demand a higher yield.
- the ongoing, heavy issuance of gilts as the government budget deficit remains high.

Our recommendation for reinvestment into strategic bond funds is based on their wider and more flexible mandates, which includes the scope to hedge out the impact of rising gilt yields as well as the freedom to invest in other types of fixed interest securities, such as high yield corporate bonds. We have identified a number of skilled strategic bond fund managers who, in our view, have both the ability and tools at their disposal to generate positive returns regardless of the direction of bond yields.

We are analysing individual portfolios and will write to you with specific recommendations as appropriate.

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