

## ECHOES OF 1987

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We are in the fifth year of this bull market and forward looking valuations are starting to look extended, compared to previous cycles. There are echoes of 1987 about the equity market this year. Bond yields have been rising consistently, as happened in 1987 and the equity market has, so far, ignored the signs like it did until October 1987. History doesn't necessarily repeat itself but it often rhymes and if the market continues to chase cyclical assets and avoid the defensives the risk of a meaningful correction will increase. Most cyclical companies are telling us things have never been so good. Most companies (apart from consumer related) continue to report strong earnings growth but ratings are high and in our view vulnerable for what is likely to be the peak of the cycle. Cyclical companies in 2007 are as buoyant now as they were depressed in 2003 – when equities were statistically very cheap.

The UK market is starting to see some dispersion in returns, with industrials and commodities still in the sweet spot of the market but with domestic firms such as consumer and financials not doing so well. Ratings for engineering companies like Weir Group, for example are trading at 21x historic earnings, a sign that investors are rating cyclicals as growth companies. For us, it will be a triumph of hope over experience if an engineer like Weir can maintain its current margins in a period of weaker demand. Looking at it historically, these aren't prices where you rush out and buy and expect to make a decent return.

Globally, we believe inflation is looking pretty sticky and we still believe we are in an environment of rising interest rates and rising bond yields. Usually monetary tightening leads to a moderation in growth. We did partly see that in the US economy last year which has led the Fed to keep rates on hold for a year now. The market, until recently, has been convinced that the next move in US interest rates is down, but we are not convinced. Yes the US housing market is very weak but it has not led to a serious slowdown in the rest of US economic activity and with rebounding commodity prices and a plunging dollar (which incidentally looks good value to us) we are not surprised that Bernanke is still mindful of incipient inflationary pressures.

For us, the golden period of low global inflation is over. Goods prices, which were in structural decline through the 1990's and early part of this decade, are now rising. Both soft and hard commodities have seen huge rises and rising oil and food prices are diluting individuals' spending growth. The surprise to us is that there has not been greater upward pressure in wage inflation. We suspect it will follow.

Because global demand has been so strong, companies are currently enjoying very strong pricing power, leading to high margins and returns on capital. They have used the excuse of cost push inflation to drive prices higher – at some point this strategy will either lead to a slowdown in demand or increased wage demands.

With this background we can understand why the UK's Monetary Policy Committee is still broadly hawkish. Interest rates have yet to peak, 6% is a certainty. But will that be sufficient to slow some of the UK inflationary pressures? I'm not sure. Could UK housing start to suffer like it has in the US? Yes. We are a very interest rate sensitive nation with high levels of home ownership. The wealth effect created by housing is what is making investors wary of UK consumer plays and life will get tougher for these companies.

We do expect UK consumption growth to slow over the next year but we think the MPC is unlikely to cut rates too early this time around following their mistaken cut in August 2005. They will want to see CPI firmly back to, or even beneath, target before they do.

With regards our UK Growth & Income Fund positioning, our central view of rising interest rates leading to an eventual slowdown in economic activity has led us to be heavily weighted in value and growth defensives. We have been too early on this call but we are not minded to change our defensive positioning.

We have been underweight in commodity, cyclical, particularly mining stocks, which has been costly to relative performance as investors have chased these as a play on inexorable Chinese growth.

The chief executive of BHP recently said we were at the start of a multi-decade boom in commodities but who knows? Lord Browne (ex BP) told us in 2003 he did not think oil would go above \$25! What we are sure of is that mining stocks are hugely operationally geared and if central bankers are to contain current inflationary pressures, there will be a slowdown at some stage. Being low value added in the long run commodities should trade at a small premium to the cost of getting it out of the ground but investors need to remember that spot prices can come down as rapidly as they rose – for instance nickel is down around 30% in the last 6 months as a result of stainless steel demand faltering.

As we have been positioning for a slowdown in the cycle, which has yet to happen, we have been weighted in sectors like food, food retailers, tobacco and pharmaceuticals, which we see as defensive plays. Shareholders in Glaxo and Astra will not feel these shares have been defensive in the last few years. They have been heavily de-rated from over 20x earnings to around 12x earnings as investors have fretted about generic competition, shorter patent lives, product failures, litigation, pricing to name a few issues. Getting new blockbuster drugs to market is harder than ever before and the cost of trials is increasing meaning R&D costs at these firms are still rising, whilst efficiency is falling. We believe this bad news is now in the price, although they may still not perform well until we have a severe market correction. Big pharmaceuticals are now on multiples lower than tobacco companies, which is ironic when you consider the end product of the two industries. I haven't seen pharma on lower levels than tobacco in my entire career.

At the beginning of 2007 we predicted a year of low double digit returns but suspected the market would move towards large cap stocks. There were signs in the second quarter that this was happening but, sadly for us, this was largely as a function of the strong performance of oil and mining shares. Merger and acquisition activity has migrated towards the FT-SE 100 with bids for Boots, Sainsburys, Reuters, Hanson and ICI and surprisingly little activity in the mid 250 but this surge in m&a is usually a late cycle phenomenon. The credit markets have woken up in recent weeks that they might not have been pricing risk correctly. Central bankers will be hoping that this leads to higher lending growth because, so far, their tightening has had little impact on global liquidity. If it does, then it is probable that the current boom in equity markets will have to pause – which could suit our more defensive positioning.

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