

## Global Investment Review – January 2008

As 2008 commences the outlook for financial markets is remarkably clear. Inflationary pressures will rise despite slowing global growth, as credit becomes scarcer and more expensive. Rapidly accelerating money supply (in the US it is already at a 47-year peak), high commodity prices, an appreciating Chinese currency and growth in Asian wages are all combining to push inflation up. US import inflation has just hit 11%, the highest since records began in 1982. As the credit crunch unravels, central banks will be forced to print more money to inflate away the debt. Given this backdrop, bonds look very poor value, as does cash; commercial and residential property values will inevitably suffer too. It will be a tough year in *all* asset markets, as volatility increases and risk appetite contracts. Surprisingly, the asset class that looks the most attractive is selective equities. Globalisation of capital flows means few regions or countries will escape the clutches of rising inflationary pressures and lower growth. We are particularly sceptical of the broad consensus that emerging markets will be able to decouple from the industrial world, especially US consumption. These are strong headwinds which transcend national boundaries. The key issue for equities is, which sectors and companies will benefit from the huge piles of cash that will be printed as central banks try and inflate away the debt burden?

The winners will be those companies with strong franchises and therefore the ability to control or to increase their profit margins and to pass on rising costs. 'Pricing power' will remain the holy grail of stock picking. Such companies will be re-rated upwards as investors place a premium on reliable visible earnings streams with healthy dividends. In recent years returns have been heavily skewed to growth, capital gains and balance sheet trickery. Increasingly, investors will have to rely on income and dividends. Such companies will also be recipients of increased attention from trade buyers, as larger groups will look to grow through consolidation.

As stock pickers we believe the key will be making sure our clients' money is focussed on companies with such pricing power. For example, the rising inflationary trend is terrific news for precious metals and the agricultural sector, given their favourable supply and demand dynamics. Other sectors due to re-rate are telecoms, pharmaceuticals and companies geared to the increasing government spend on power and infrastructure. In contrast, banking and property (aside from pockets of value such as Hong Kong and Japan) are two sectors that are in the very early stages of a considerable down-trend. As we have been highlighting since the summer, the West's credit splurge of the last ten years is well and truly history. It is now payback for the banking and property sectors. Global banks were forced to raise \$83 billion of new capital in the second half of 2007 as loans turned bad. They have been forced to write down other loans, exposing large holes in their capital base. Expect more of the same in 2008 as they try and shore up their balance sheets. As we write, Merrill Lynch and Citigroup have announced plans to raise \$7b and \$15b in new capital, with the latter cutting its dividend by 41%. Many investors have been asking how much lower western financial stocks can fall. As we highlight later, the answer is, "way to go".

### **Forever blowing bubbles**

The global debt bubble of the last ten years, where the US and the UK were the leading protagonists, is now only at the early stages of unwinding. Propelled by the availability of cheap credit, rising asset prices (most importantly property) convinced people that there was no need to save. This has pushed the savings rate in both countries to an unprecedentedly low level. In America, the savings rate dropped to *minus* 0.5% in November from +0.3% in

October. Such a one month shift is extraordinary; it means all spending was being funded through debt. Savings rates will now have to rise as the decline in asset prices will force people to saving out of income. This process has barely begun. US house prices fell 6% in October, the most in six years. Inventories continue to push higher, foretelling a broad downturn in profits in 2008. Meanwhile UK house prices are showing several signs of weakness, such as mortgage approvals collapsing. The number of housing loans fell by 12% in October vs. September, and by 31% vs. the previous year, to its lowest level since 2005. As shown below, the Halifax House Price Index has fallen for three months in a row. In summary, house prices on both sides of the pond have much further to fall as banks pull in their credit lines in the face of rising delinquencies and shrinking capital bases. For example, Paragon (the UK's 3<sup>rd</sup> largest buy-to-let lender) is raising £280m of new capital. Once completed, the company is unlikely to offer any new loans as the cash has to be used to plug an existing hole. Another case is Northern Rock: at its peak it accounted for 15-18% of new UK mortgages. Debating how far the fall will be is futile; the important point is to know the trend. Falling house property prices have negative implications for consumption and global growth, as savings rates are pushed higher.

Chart 1: UK house prices

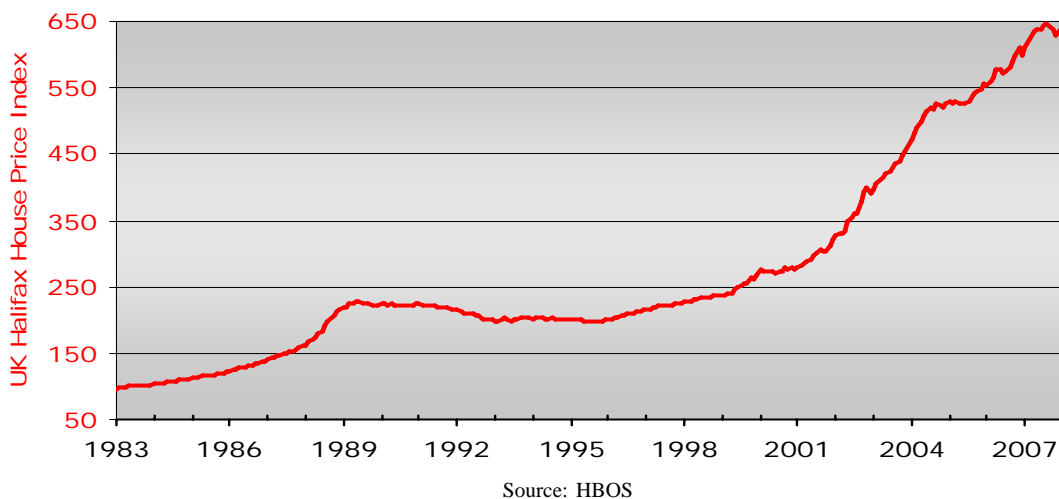
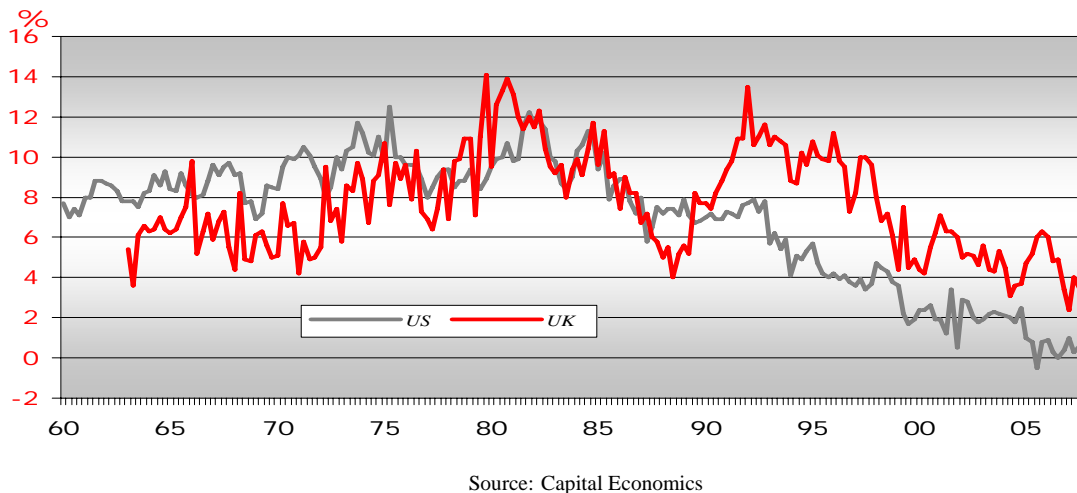
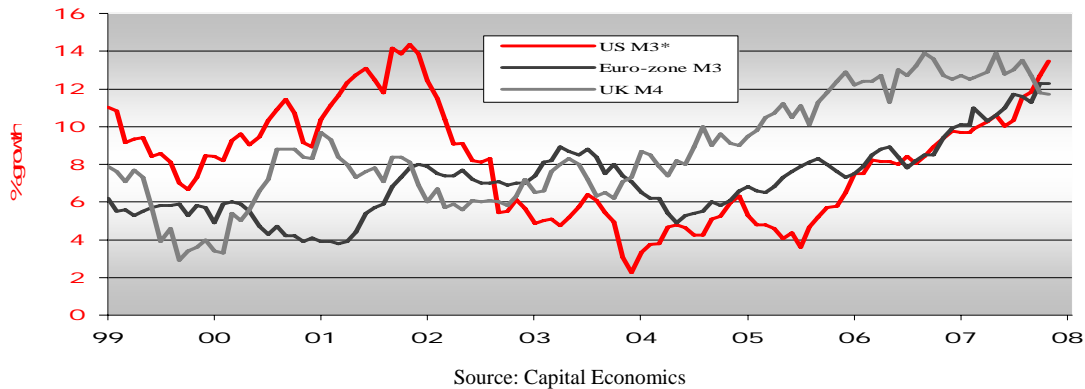


Chart 2: UK/US savings rates



The threats from falling asset prices have not been lost on central banks. In conflict with their official mantra of “targeting inflation”, across the world they are now printing money at a frenetic rate. US money supply growth is running at a 47-year high as the authorities seek to inflate away the debt bubble and prop up house prices. Clearly printing such huge amounts of money is not great for the exchange rate. A weak dollar has forced the hand of other central banks as they try and keep their currencies competitive with it. As shown below, the European Central Bank is running hot on their heels to try and keep the euro competitive. Welcome to the era of competitive depreciation.

Chart 3: Money Supply



The rising inflationary trend, driven by monetary growth, increasing commodity prices (notably agriculture and oil) and China’s steady currency appreciation, has not been ignored by the gold market. It is now appreciating versus all major currencies. This trend will continue as long as central banks try to maintain currency competitiveness and print excess money. Gold recently exceeded \$900 per oz., up 34% from the August low. Although a short term correction would not be a surprise, the supply-demand dynamics remain favourable. World gold mine production fell by 3% in 2006 and is up only +1.7% in the first nine months of 2007. The World Gold Council announced that demand jumped by 19% in the third quarter of last year, driven by investment from Asia and the Middle East and by Indian jewellery demand.

Chart 4: Gold prices - price per oz. in various currencies. June 2002 = 100

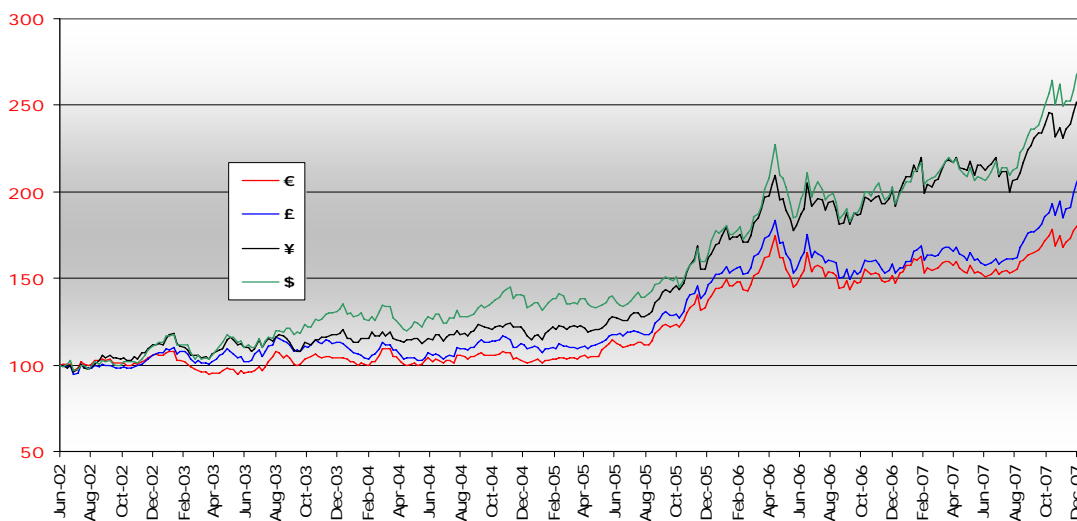
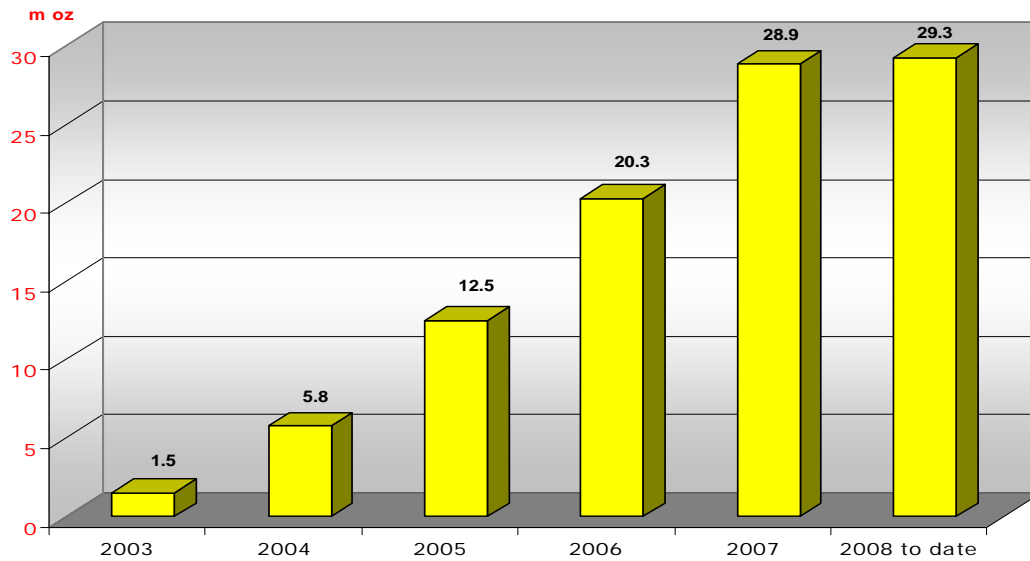


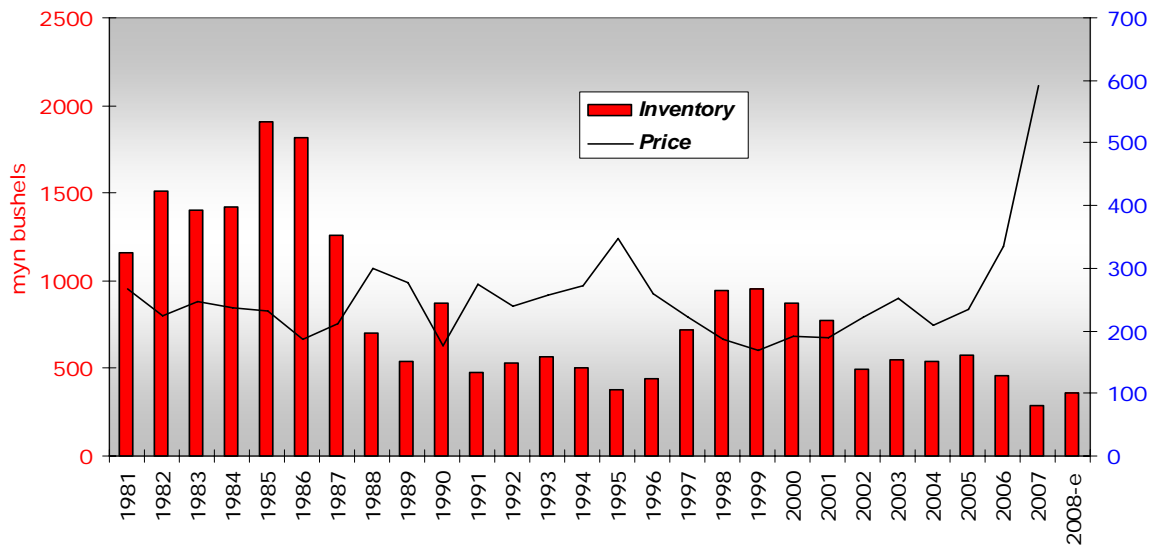
Chart 5: Gold ETFs



Source: CLSA Asia-Pacific Markets

The scale of investment in gold, as retail and professional investors try and preserve their savings in the face of rising inflation, is now dwarfing central banks. This can be seen in the growing size of gold Exchange Traded Funds (ETFs). Their emergence has made it easy for retail investors to buy gold and importantly, to remove supply from the market. ETFs now hold an estimated 29m ozs. (912 tonnes), up from 20m ozs. at the end of 2006. The single largest gold ETF now holds 639 tonnes of gold - more gold than either the Chinese central bank reserves (600 tonnes) or the European Central Bank (605 tonnes).

Chart 6: US wheat inventories and spot price (Indexed)



Source: Bloomberg

Another commodity in a structural uptrend is grain, particularly corn, wheat and soybeans. It's the old story of rising demand and a lack of supply, with inventories hitting all-time lows. High grain prices and the resurgence of agriculture are just 18 months old, reversing a 40-year-long decline. The US Department of Agriculture recently announced that, despite record

high grain prices, farmers are barely increasing the sowing of cereal crops. The planned increase in acreage is only 3.6% this year, under half of what the market expected. Meanwhile wheat inventories are at 47-year lows; those for corn fell a massive 20% last year. Demand from developing countries and for bio-diesel remains firm. Another wave of food inflation is on its way. The resurgence of grain prices has provided a massive boost to farm incomes. This in turn has had a huge knock-on effect for demand in areas such as agricultural machinery, fertilisers, better seeds, and pesticides to boost crop yield. One of our investments, phosphate and potash producer Mosaic, recently reported that in the quarter to November its selling prices were \$417 per tonne and \$171 per tonne respectively - increases of over 50% in under a year. The current spot phosphate price in Florida is \$550/tonne while the Saskatchewan potash price is \$320. Given it takes two months for spot prices to feed through to their realised price, we expect a bumper fourth quarter for the company. The whole sector is benefiting from these favourable trends. Companies producing farm machinery, fertilizers, seeds and crop protection are all seeing strong demand - and pricing power.

The one area of commodities where we remain sceptical is those geared to industrial production, more specifically oil and base metals. Our funds retain negligible exposure to either. Although inventories may be low, it takes only a marginal reduction in demand (say slightly slower car sales) to push inventories higher and prices lower. We cannot find a credible story to reverse a slowdown in global demand for these commodities. As such it is worth noting that the index of physical premium (charges associated with metal deliveries) has halved since April 2007 while the London metals index of spot prices has fallen by 25%. In general, when inventories of metal are low and markets are tight, physical premiums rise, reflecting the scarcity value. Thus spot prices and the physical premium should move together. It is also worth noting that some of the steepest declines in physical metal premiums relate to delivery to US sites, pointing to weaker industrial activity there. POSCO (third largest steel producer) recently revealed sales down 20% in the fourth quarter due to weak demand for stainless steel. Meanwhile Duferco, the world's largest steel trading company, noted that it expects a slowdown in prices as from the second half of 2008. It may happen sooner than they think.

### Developed versus developing?

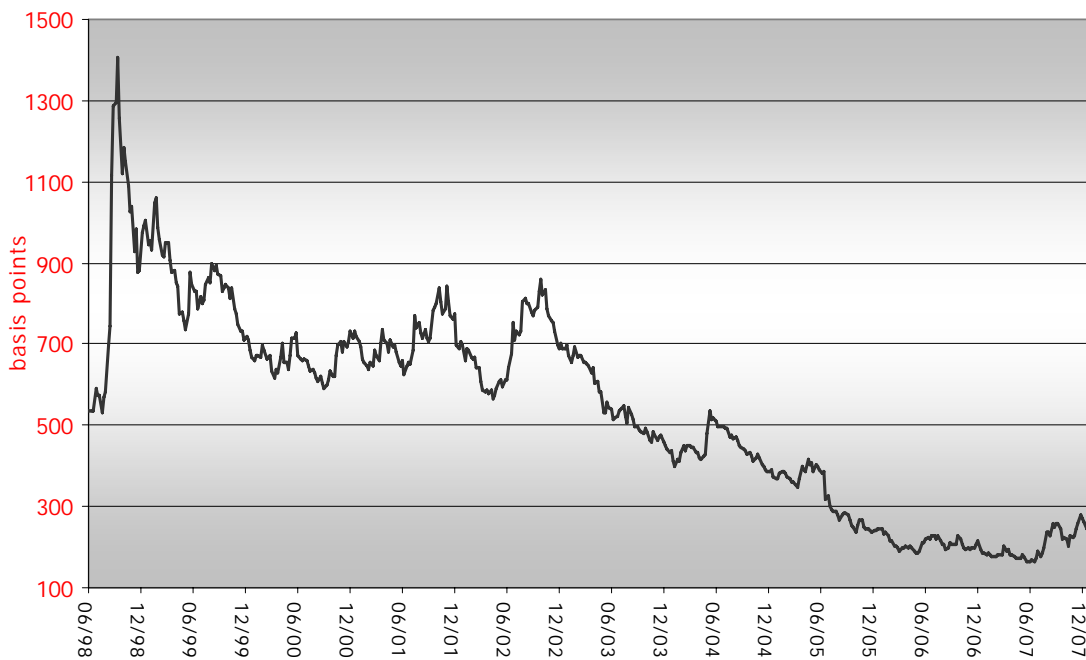
Chart 7: Asian exports as a % of nominal GDP

<b>Total Exports as a % of nominal GDP</b>		
	<b>2001</b>	<b>Last 12m</b>
<b>China</b>	<b>20</b>	<b>38</b>
<b>India</b>	<b>10</b>	<b>15</b>
<b>Korea</b>	<b>31</b>	<b>38</b>
<b>Malaysia</b>	<b>95</b>	<b>97</b>
<b>Singapore</b>	<b>87</b>	<b>114</b>
<b>Taiwan</b>	<b>45</b>	<b>65</b>

Source: CLSA Asia-Pacific Markets

Many commentators on Asia ex-Japan have been suggesting that strong domestic consumption, together with intra-Asian trade, will ensure that growth will decouple from the industrial West. Yet Asia's reliance on exports has actually increased since the beginning of the decade. In addition, the correlation coefficient between intra and extra-Asian trade since 1998 is 95%. Logic dictates that the strength of domestic demand must be affected by robust earnings growth of exporting industries and the liquidity generated by large and growing current account surpluses. Thus although Asia - and similarly Germany and Japan - does not have the excessive debt burden of many western countries such as the UK and the US, they cannot be immune to slower global growth through their trade account. As from July last year slower growth started to be priced in to bond markets with the spread of emerging market bond yields over US treasuries on a firm upward trend. It has further to go.

*Chart 8: Emerging market bond spread vs. US treasuries*



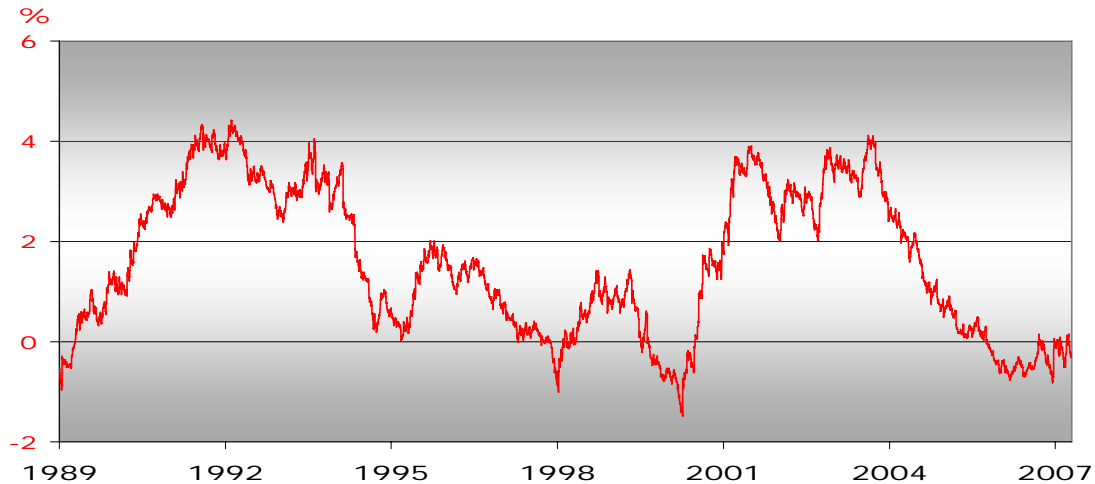
Source: Bloomberg

Asia is particularly susceptible to rising inflationary trends, given rising dollar denominated commodity prices and because most currencies there are linked to the dollar. These two negative trends are already visible. Countries across the emerging market asset class are all experiencing rising inflation. This has sparked riots in Chinese supermarkets, protests in Indonesia and unrest in Vietnam as inflation hit double digits. Several governments are now in panic mode, fuelling the fire. In China for the last three months import growth has exceeded that of exports. This has been driven partly by commodity prices. The Chinese government has also announced curbs on general price increases (the Communist Party, and mentality, remains alive and kicking) while also introducing a tax on grain exports. In summary, many developing governments, fearful of social unrest, will now be looking to shift the burden away from disposable income to corporate profitability. Latin America is no better. Brazilian inflation has just hit a two-year high. It may well be that investors will have to scale back their expectations for interest rate cuts in Brazil and therefore domestic demand. We believe stock picking in emerging markets will be no different from that of developed. Growth stories will be harder to come by. Making money will be a case of ensuring your

investments are in sectors that have the ability to pass on any cost pressures through either having strong franchises or favourable industry supply and demand dynamics.

### Lack of allure from cash and bonds

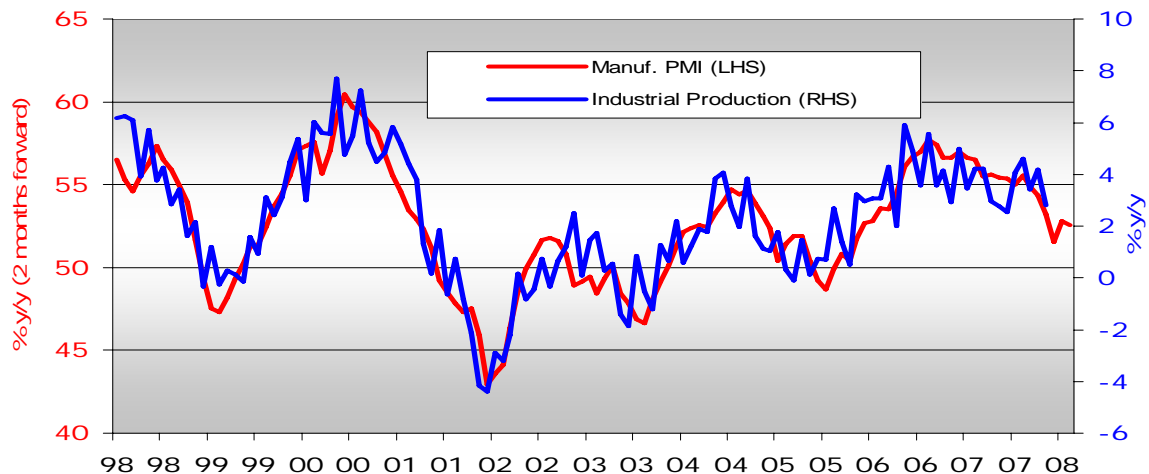
Chart 9: Gap between US 10-year bonds & Fed rates



Source: Bloomberg

Given the prospect of capital shrinkage within the global banking system, interest rates at the short end have to fall sharply. Even so, we struggle to see the attractiveness of long dated government bonds. It is notable that the US yield curve is certainly not yet steep enough to start bailing out the banks. Thus the Federal funds' rate is now 0.4% above the 10-year Treasury bond yield. This compares with 1992 when the Fed funds' rate was 3.9% below the 10-year rate. Thus although short term rates are headed south, the yield on long term paper may well be heading north. Interest rate falls will undoubtedly be the greatest in countries with the biggest debt problems, i.e. the UK and US. Even so, the size of rate cuts may not be as big as hoped, or expected, given rising inflation.

Chart 10: Europe production slowdown



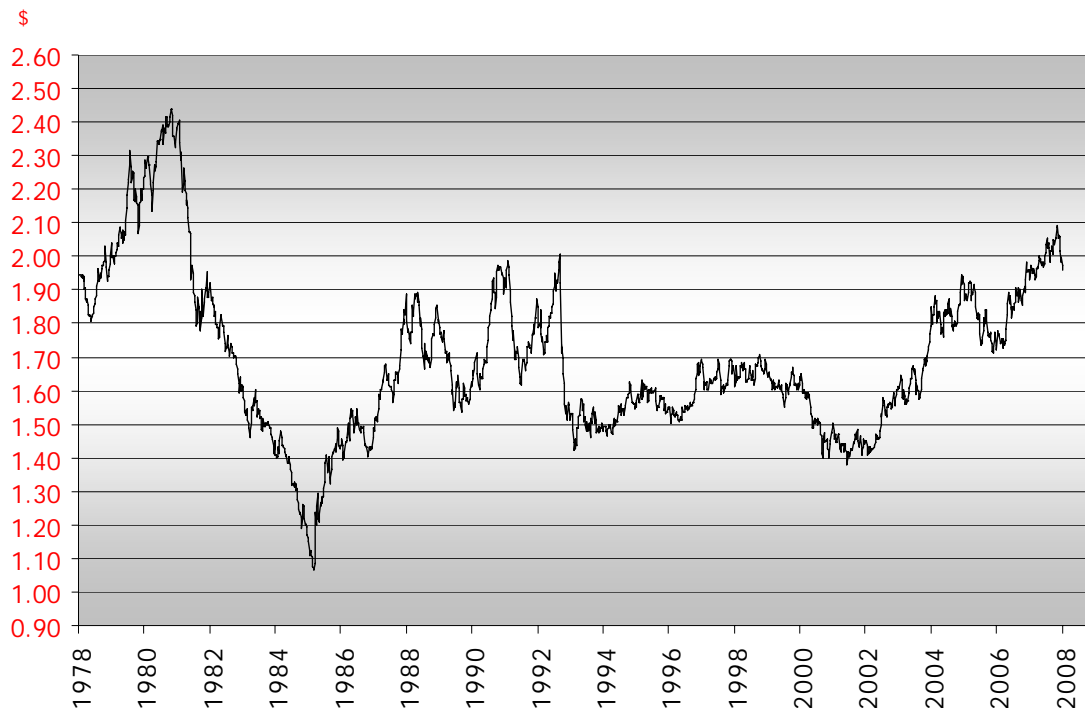
Source: Capital Economics

We are not convinced that many parts of the world will be able to escape from the slowdown, be it Europe or emerging markets. In Europe, business confidence and industrial production has been easing: credit conditions are now tightening. This should not be a surprise; the European Central Bank had to inject \$500 billion in one day in December, simply to keep the financial system ticking over. We expect the ECB to start cutting rates later this year as growth slows across the Euro-zone, although the reductions will not be as pronounced as in the UK and the US.

Perversely, Japan may well end up being the only major industrial country where interest rates rise. Consequently it could well have the strongest currency out of the big four. In line with global trends, Japanese inflation is rising. The prime culprit is again food and energy prices but recent surveys show expectations are rising sharply. In addition to this cost-push inflation, there is the possibility of wage inflation for the first time in years. Production has been at full capacity with the labour market continuing to tighten. More importantly, the Keidanren (Japan's equivalent of the CBI – the great and the good of corporate Japan) are pushing for salaries to be hiked in the spring. Thus a nominal rise of 1-2% in salaries is a distinct possibility. This is all inflationary. If Japanese rates rise and rates in western economies fall, the interest rate differential could narrow quite sharply. Thus the yen may well end up as the strongest currency versus not only the dollar and sterling, but also the euro. A further impetus for yen will be the currency strength of the Asian block in the face of the further appreciation of the Chinese currency.

### Anything but Sterling

Chart 11: Sterling versus US\$ (since 1970)



Source: Bloomberg

Out of the four major currencies, sterling is the one most in danger. Even though the US has stolen the headlines in terms of weakness in both its property and currency markets, the UK

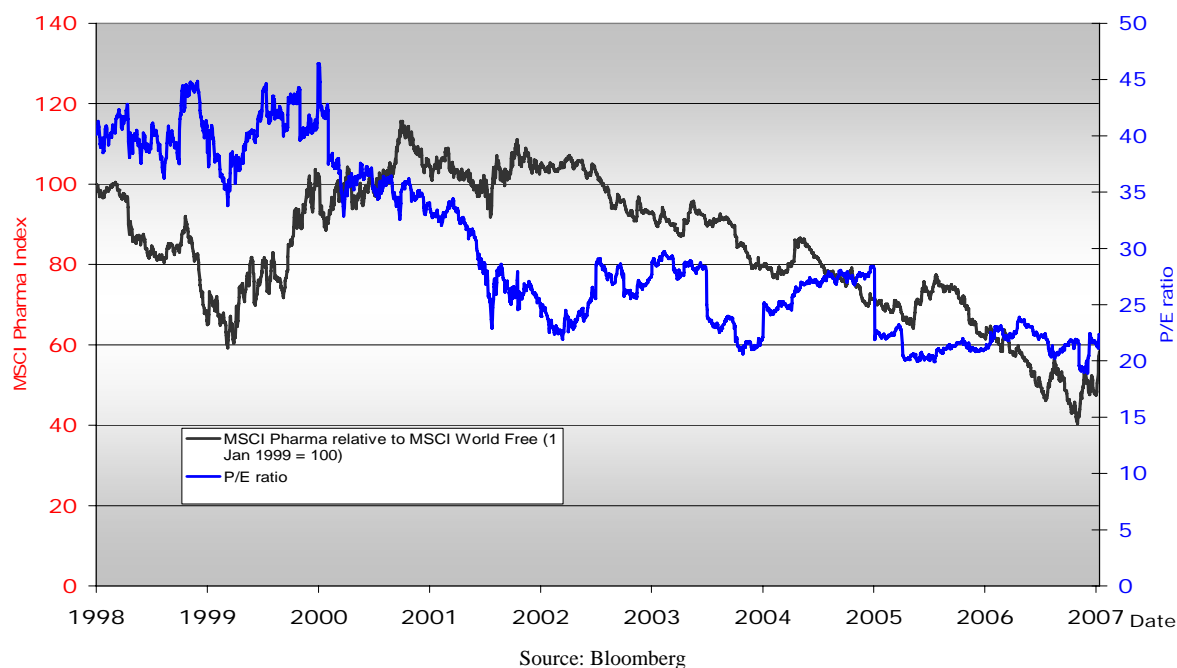
economy is in a much weaker position. The local property market is in a bigger asset bubble than the US. For example, mortgage debt is 126% of GDP versus 104% for America. In terms of competitiveness, the current account recently hit its worst ever deficit as 5.7% of GDP. This comes at a time when global growth is set to slow. Not only is Britain at risk from a consumer slowdown as the savings rate is forced to rise, but it is set to lose on the export front as well. Unfortunately this comes at a time when the public sector must tighten its purse strings. In November, public sector debt also hit a record level at \$23bn. It is noticeable that the government has been vociferous in pressing for public sector wage restraint. To us the bankruptcy of Northern Rock in the summer shows the flakiness of UK economic growth and the weakness of the banking system. Sterling investors are faced with a deflating economy and weak currency. It is worth noting that at \$1.95, sterling is 18% above its 10-year average. It is not too late to move out of sterling. It will weaken further and then probably over-shoot. So far the euro has been the currency suffering dollar weakness the most, with the big Asian currency block (and Middle East) still pegged (some hard, some soft) to the dollar. This is likely to change as inflationary trends across developing countries in Asia and the Middle East force governments to adopt faster appreciation, thereby limiting inflationary pressures.

### **Equities**

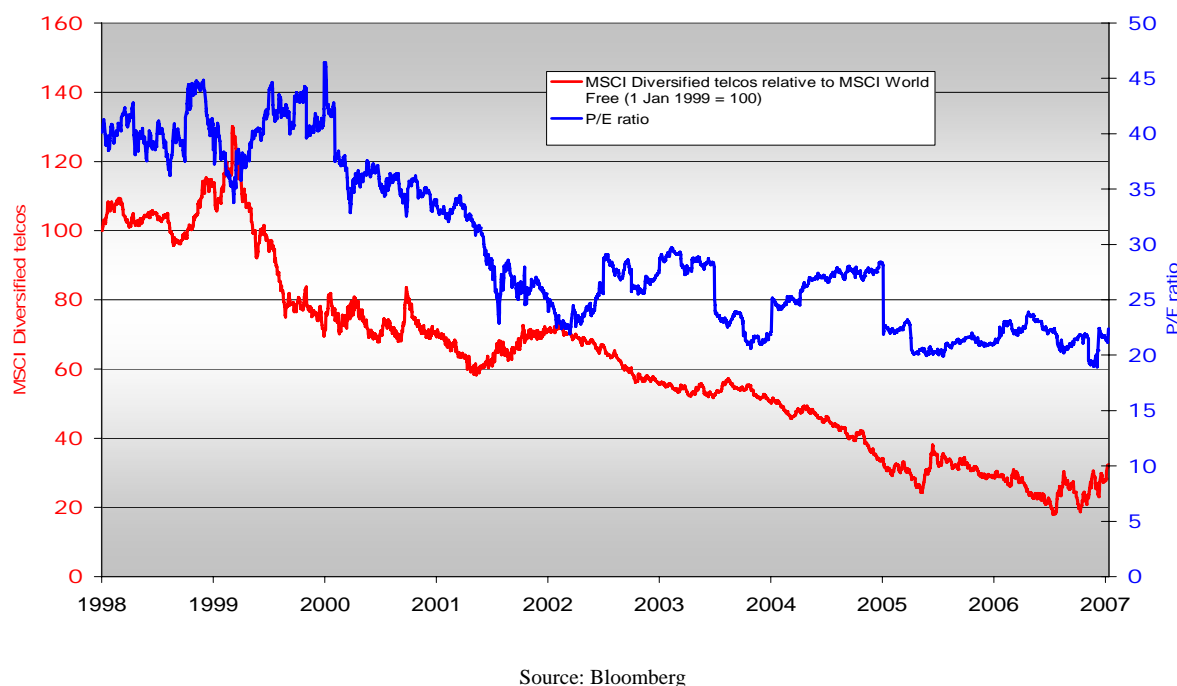
Following the stellar returns of the last five years, equity investors need to revise down their expectations. Single digit returns are likely to be the norm. As noted above, we find it very difficult to bang the drum on any one region or country. The most over-gearred will suffer the most, but even the lowly indebted countries of Germany, Asia and the Middle East will experience slower growth through the trade account. In our view the money will be made by getting the sector themes correct and ensuring each company has strong pricing power and hence the ability to protect, and ideally grow, margins and earnings. These types of companies will also be the beneficiary of industry consolidation.

The sectors that stand out within commodities are precious metals and agriculture. As discussed above, both are constrained in terms of supply. In the precious metals sector, the lack of new gold production has forced the big players to grow through acquisition. Hence a decent chunk of our clients' precious metal position is within the two mid cap producers of Agnico Eagle (8<sup>th</sup> largest in the world) and Lihir Gold (9<sup>th</sup> largest). Both are ungeared and unhedged, with good production, growth prospects and exploration potential. All our gold companies are valued on their proven and probable reserves, based on an average realised price in 2009 of \$850/oz. less cash costs. Even on these conservative assumptions, upside remains in all four precious metal holdings. Given the gold price is currently trading around \$900, the risk to our earnings and target price remains firmly upwards. Similarly, the agriculture sector is at risk from further upwards earnings' revisions as 2008 proceeds.

The other two sectors that we view favourably are pharmaceuticals and telecoms. As below, both sectors have seen a massive de-rating over the last decade. For the pharmaceutical sector, the concern has been their dwindling pipeline of new drugs. This is compounded by the fact that many drugs are set to come off patent over the next 2-4 years. While we share this concern, valuations are now largely discounting these facts and are at 15-year lows. In addition there are still some firms, such as Novartis, that have a strong drug pipeline. Unlike many of the majors, only 5% of drugs in use are set to disappear over the next couple of years with the group having 104 compounds in Phase II and Phase III clinical trials.

*Chart 12: Pharmaceuticals*


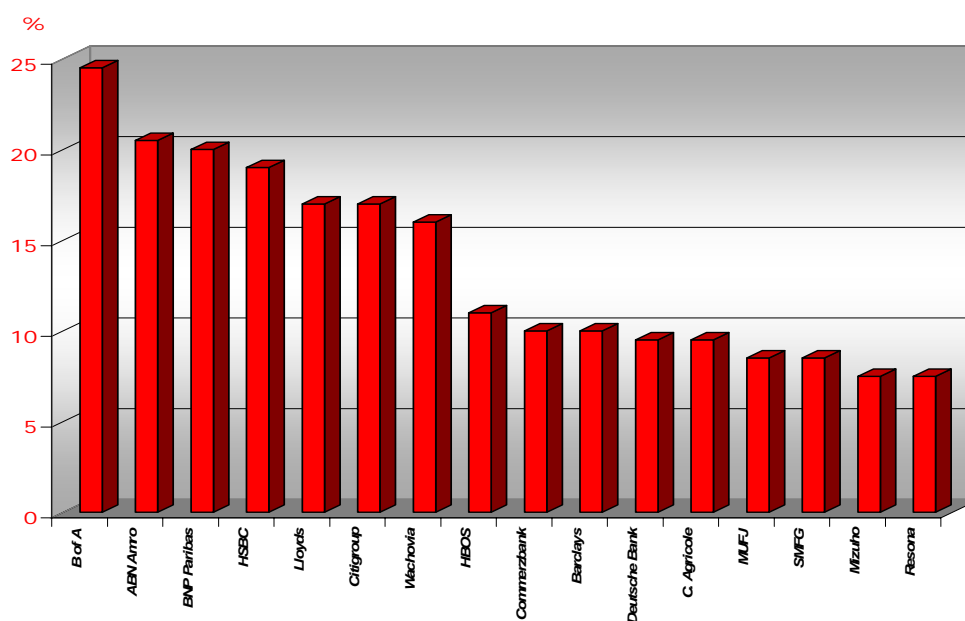
The de-rating on the telecom sector has continued to the point where in almost every country the incumbent telecom player stacks up as an attractive valuation. We are buying up companies where the dividend yield is not only the same as the government bond yield but, equally important, is twice covered by free cash flow. In our Global fund we have invested in seven telecom stocks that fit our process. It is a diverse global spread from France to Malaysia. Combined, they currently offer a dividend yield of 5.7% in 2008, well covered by a free cash flow yield of 9.6%.

*Chart 13: Telecoms*


Other sectors that stack up well are the power and infrastructure sector. Many governments, both in developed and developing countries, have under-invested in infrastructure for many decades both. This is now reversing. As an example there was a surge in new power plants back in the 1970's. The typical plant life time is around forty years. Hence there is now a massive global requirement for the upgrading and building of new plants in developed countries. Emerging economies are a further boost to demand. Countries such as India, China and Russia are now accelerating infrastructure spending in order to iron out the massive bottlenecks to future growth. Industry leaders such as Siemens and Alstom are seeing a surge in their order book. On the property front although the global property market looks dire there are pockets of value, namely Hong Kong and Japan. We expect Hong Kong interest rates to collapse over the next 12-24 months fuelling demand. In Japan you could drive a bus through the yield gap. The 10 year Japanese bond yield is 1.4% while the yield on prime Tokyo office space is 4-4.5%. In addition the supply of office space is set to fall sharply from 1.6m square metres in 2006 to around 800,000 in 2008 and 450,000 in 2009. The vacancy rate is 1.4% and rents are rising at 8-15%. Now that's what we call pricing power!

If the telecom and pharmaceutical sectors offer attractive valuations, then banking sits on the opposite side of the equation. This is one sector that is bound to get far cheaper, particularly in the highly indebted western economies. Even financials in lowly geared economies will be adversely affected through counter-party risk. We view the sector as almost impossible to analyse; no-one yet knows the time bombs lurking in their balance sheets; this includes bank boards.

Chart 14: Banks



Source: CLSA Asia-Pacific Markets

Many investors are currently trying to guess where the bottom lies. They blink at seemingly cheap price-to-earnings and price-to-book ratios. We believe they will be a lot lower. The reality is that if some were to write down their balance sheets to the true position, they would have no earnings and very little book. The extent of the problem can be seen in the size of the securitised debt market which totalled US\$97trillion at the end of 2006, up from US\$46tr at the end of 2004. This amount, which excludes good old fashioned bank lending, is equivalent

to double world GDP. A better approach is to look at market capitalisation as a percentage of deposits. Thus HSBC, Citigroup and Barclays are now trading at 19%, 17% and 10% of deposits, with other western banks at between 10-25%. History suggests that in a credit downturn, banks tend to reach a bottom at around 3-8% of deposits. As shown above, the large Japanese banks look the best of a bad bunch at 7-9%. In contrast to UK, US and Continental Europe Japan is still not experiencing any credit tightening by the banks indicating they are less exposed. Even so we don't believe they will be immune..

**Bedlam Asset Management Plc**  
**January 2008**