

View from the European equity desk Q&A with John Botham, fund manager and team head

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In this article we discuss the outlook for the global economy, with a focus on European equities, highlighting our key sector likes and dislikes.

Let's start by looking at the current financial and economic picture around the globe. With stock markets now up circa 63 per cent* since hitting multi-year lows in March, what would you say led to the sharp turnaround in fortunes?

Clearly the turnaround was sparked by the enormous amount of policy action taken by governments and central banks around the world, such as the introduction of near-zero interest rates and so-called Quantitative Easing (QE) programmes in countries including Britain and America. In late 2008 and early 2009 monetary stimulus measures injected an unprecedented amount of liquidity into the global financial system, which subsequently helped to prevent a systematic collapse in global banking and avert an L-shaped economic depression.

What programmes such as QE did for the global economy was to exert a significant amount of downwards pressure on short-term government bond yields; thereby enabling banks to rebuild their battered balance-sheets and corporate bodies to access investment capital at reasonable rates. In fuelling the turnaround, massive fiscal stimulus packages also played an important role, most notably in China, where a 4 trillion yuan* or \$586 billion* government spending plan focused on boosting domestic consumer demand, helped China pull the global economy out of recession. With improving growth indicators helping to erode fears of a depression post March 2009, cash-rich investors were once again encouraged back into financial markets, especially with risk-free returns looking unappealing and equity valuations trading at their cheapest levels for a generation.

Based on your assessment, do you believe the current equity run is sustainable?

Our view is that the recovery is sustainable, in the sense that we do not foresee stock markets in the current cycle returning to levels last seen in March, May or even June 2009. However, should investors expect stock valuations to grow 30 or 40 per cent over the short-to-medium-term? The answer is no. We must bear in mind

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that the first year of a recovery is always the most profitable in terms of market returns, and given the strength of the current rebound, it is unlikely that this aggressive growth momentum would persist over an extended period.

Nonetheless, over the next two-to-three years, we expect investors to earn a positive return from holding equities; which we see easily outpacing risk-free investments such as money market securities and government bonds on an absolute return basis. Providing support for this view is the fact that the global economy has entered what appears to be a moderate growth phase. Notwithstanding that, we expect the economy to grow at a slower pace than it has following previous recessions, owing to poor credit availability and private sector retrenchment.

What in your opinion are the greatest uncertainties surrounding your central scenario?

In terms of downside risks, we see the main challenge to the recovery coming from premature policy normalisation; as central banks and government may be inclined to start withdrawing their significant monetary and fiscal stimulus packages prior to economic growth becoming entrenched. It is our understanding that at some point in 2010, central banks would seek to normalise the monetary policy situation, as there are real concerns that abnormally low borrowing costs are creating price distortions and asset bubbles.

Furthermore, there are fears within the market that without near-term rate hikes the outlook for medium-term inflation could push bond yields sharply higher, which could hamper corporate borrowing. Specifically, we see short term rates starting to creep up across Europe and America by the middle of 2010; although markets are likely to start discounting rate hikes as early as the first

quarter. We also anticipate more fiscal retrenchment or stabilisation in the form of tax hikes and public spending cuts, as government's move to slash budget deficits. Although we are bullish about 2010 with economic growth sustained and the stimulus withdrawn in an orderly way -- we are less positive about 2011 as growth begins to be affected by fiscal drag and more normalised monetary conditions.

Do you see any impact from the Dubai crisis?

Regarding the situation in Dubai, investors should bear in mind that Dubai World's liabilities, at \$59 billion*, are comparatively modest, when viewed in light of the \$3.4 trillion* the IMF estimates the global financial sector has had to write-off in relation to the recent credit debacle.

Therefore we do not see the Dubai crisis severely impacting the banking sector or global equity markets for that matter. It may, however, remind some investors of the risks associated with investing in emerging markets, which are currently trading at very high levels in terms of valuations versus developed markets. Indeed in Europe, we are cautious on some sectors of the market that are particularly exposed to Dubai, such as Capital Goods. However, in this case our reservation is due more to the fact that European Capital Goods stocks are already discounting a return to 2007 business conditions in their valuations.

Considering your view of the global economy, can you tell us on what sectors you currently like and dislike and why?

At the moment we are very bearish on Industrials, not because we do not see profits rising, because we do; but because we believe this positive outlook has already been discounted by the market. With banks, however, we are not as bearish, as it is inevitable that governments would assist their re-capitalisation efforts over next couple of years by allowing them to generate super normal profits. Nonetheless, we are underweight the sector as: balance sheet de-leveraging remains a multi year headwind; many banks have already undertaken highly dilutive rights issues; and tighter regulations such as the imposition of greater capital requirements are likely to lower returns on a permanent basis.

** Source of market data: Bloomberg, FactSet*

What do we like? Healthcare tops the list, as many of these stocks are trading at the lower end of their long-term ranges and appear best positioned to withstand the volatility anticipated in western equity markets over the coming years. Furthermore, we believe that fears over well documented problems in getting new blockbuster drugs to market have been overdone.

Gaining exposure to the optimistic long term growth prospects of emerging market economies is a key theme facing European investment managers in 2010. Although our portfolios tend not to be macro focused and instead aim to do well irrespective of economic conditions; it is very possible that in 2010 we could target selective cross-sector opportunities in stocks that we see benefiting from emerging market exposure. However, in this instance, structural as opposed to cyclical growth would be the main motivator; particularly amongst our value managers, who remain wary of the China-led cyclical story.

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