



IML investment comment: July 2009

Green Shoots and Market Fundamentals

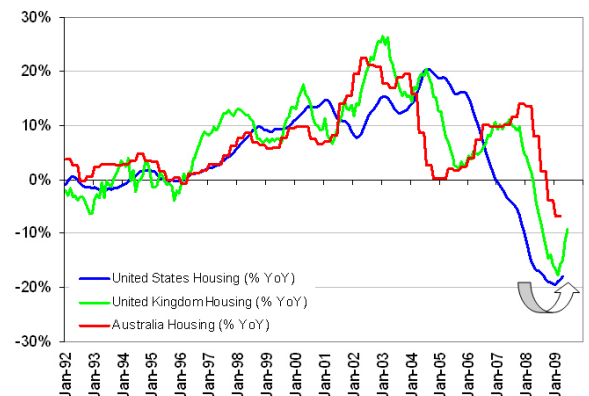
There has been much discussion in the markets around the “green shoots” of the economic recovery. These signals have spurred a circa 30% rally in broad share market indices. We examine the “green shoots” as well as the market fundamentals and conclude that whilst the rate of decline has slowed and optimism is returning to the market, it is unlikely that we will see a V-shaped economic recovery. As a result we expect the share market to be range bound for the remainder of 2009 with a slow but sustained recovery thereafter.

Investment implication: a focus on good quality value stocks with sustainable dividends will likely outperform over the next few years.

Tracking the “Green Shoots”

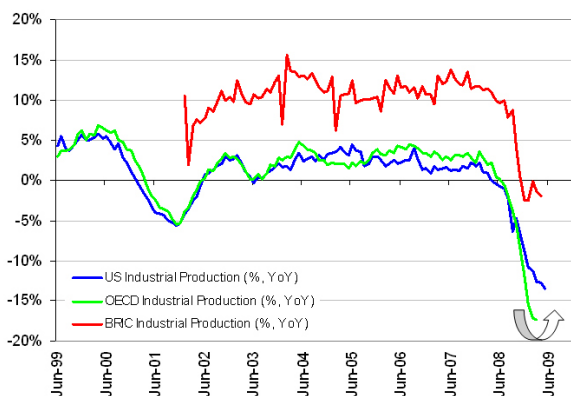
Markets have rallied hard since their lows on March 6th with the US and Australian markets up some 36% and 24% respectively. This places them on a PE multiple of 18.2x and 15.1x next year’s earnings. What has driven this rally are the “green shoots” of economic recovery. Specifically, it was the downturn in housing that caused the credit markets to freeze and the knock on from that was the collapse in industrial production, consumer confidence and retail sales. It comes as no surprise therefore that any indication of stability in these indicators has assisted share markets in finding a base.

House Prices: United States, United Kingdom, Australia (% YoY)



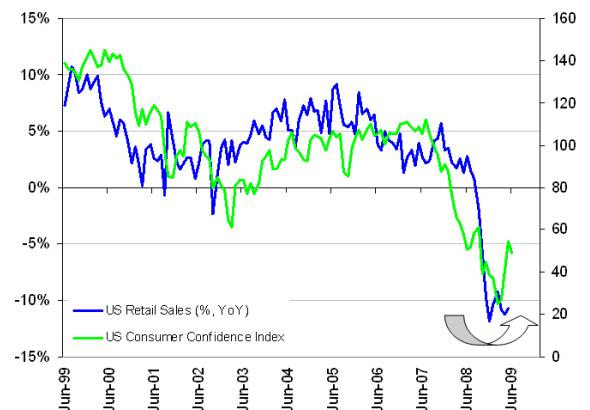
Source: FactSet

Industrial Production: United States, OECD, BRIC (% YoY)



Source: FactSet

Retail Sales and Consumer Confidence: US (% YoY)



Source: FactSet

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The Fundamentals

Whilst we are pleased to see signs of the economy stabilising, we remain cautious on the shape of the recovery. Importantly, the US consumer makes up around three quarters of US GDP; and given that in the US (and indeed Australia) household debt levels relative to disposable income remain at historic highs (around 150%), there will be a strong headwind for equities over the next few years as consumers continue to reduce their leverage to a more sustainable debt-to-income ratio (of around 80 to 100%) and increase their savings.

So what does this mean for equities? In the years 1947 to 1982 (that is the pre-credit bubble era), debt levels grew 0.5% faster than GDP and real earnings growth for the equities market was around 2.6% per annum. During the credit bubble, debt levels grew at around 2.9% faster than GDP resulting in a real earnings growth rate of 6.7% per annum. The implication is that in a de-leveraging environment, a consumer that is de-gearing and saving more is going to contribute less to GDP as well as to corporate profits. Consequently, we believe that the recovery will be long and slow with sub-par earnings growth over the medium term.

Conclusion

Clearly while the risks of a 'Great Depression II' have faded; it seems that many share markets have over-shot the mark and some are now pricing in a rapid economic and earnings recovery. Given the prospect of de-leveraging for the next few years our view is that earnings and economic growth will likely be sub-par going forward and as a result the share market should trade on a lower multiple (around 12 to 14x) to what we have been used to in the last few years.

Consequently, in the second half of 2009 we expect share markets to remain range bound.

Given that earnings growth is likely to be subdued in the coming years, we believe that investors should focus on good quality value stocks with sustainable dividends as these will likely outperform and we continue to skew our portfolios to these types of stocks.

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