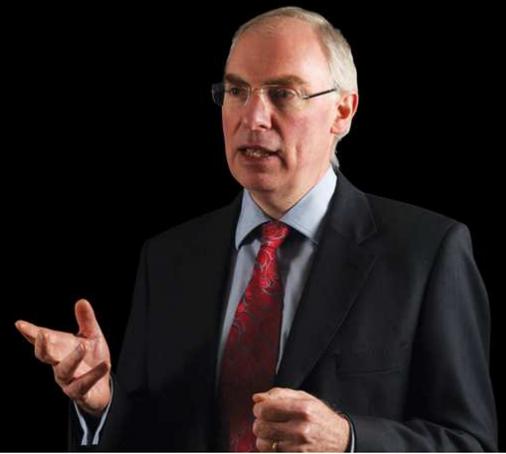


Strategy & Economics - Richard Jeffrey

A View from Moorgate

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Time to love the unloved

Defensive companies have been out of favour for so long, that any attempt to suggest that they may resurge is rightly met with some scepticism. The staid megacaps in pharmaceuticals, tobacco and telecoms may have been cheap, but there were few catalysts for a change in market sentiment. However, we believe that there is a confluence of factors that should create momentum for a number of these unloved giants.

Perhaps the first and most important point supporting a more defensive orientation to markets is that some of the notable success stories of the past few years are running out of steam. This is particularly true with the commodities trade that has so excited markets since the end of the credit crisis. This has created a bonanza in some of the mining and industrial sectors, which has left companies – at best – fully priced.

A lot of factors coalesced to create the commodities bubble. A strong recovery in industrial activity worldwide and supply chain factors combined to provide early momentum. Since then commodities markets have been rocket-fuelled by the combination of low interest rates and quantitative easing. This has also had an impact on a number of the cyclical areas that have performed well on the back of a significant improvement in earnings over the past eighteen months.

These factors are drawing to a close. World activity may still be expanding, but momentum is very obviously beginning to slow. Quantitative easing is coming to an end in the US. It is widely accepted that against the current background, it is extremely unlikely that US policymakers will put a third programme in place. If the US economy were suddenly to decelerate, there would be pressure from some quarters for more quantitative easing, but there is a persistent and growing body of opinion in the Federal Reserve that suggests it has already gone too far.

Chinese economic growth is slowing as it seeks to contain its own inflationary pressures. This may not be dramatic, but it has an impact on commodities prices at the margin. China had been stockpiling commodities earlier in the price cycle and this has also lessened.

This leads us to expect a weakening trend in commodities prices, not just in oil but across the spectrum up to and including metals and agricultural commodities. It should also be said that whenever there is a bubble of this kind, it tends to have within it the seeds of its own destruction. Commodities prices have moved up so aggressively that this in itself will slow world growth. Demand growth is already being hit by higher prices.

Equally, the domestic picture in the UK should support a move into more defensive areas. The economic outlook is weak and we feel that the consensus forecasts for the UK economy are still optimistic. Current forecasts are sitting at 1.6% for 2011, while we feel that 1.25% would be a more realistic level. We know that government demand and household spending are not going to grow. We take no solace from the recent retail sales numbers, which were likely to be weather related and just a sign that some of the summer spending had come early. Consumers are suffering

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and there is a huge squeeze on spending power. We are in a very low growth environment and the planned spending cuts are only just beginning.

Therefore, any growth in the UK economy is strongly reliant on net trade and strong capital investment. We can't see this happening to any great extent. If interest rates move higher – which eventually they must do – sterling is likely to see some strengthening. Manufacturing data is already weakening. Against this backdrop, it is difficult to predict significant expansion in these areas.

Valuations are also supportive for defensive areas. Over the past eighteen months, valuations for companies with the star quality of overseas earnings, particularly emerging markets earnings, have run up some way and many now look expensive relative to their own history and relative to the wider market. There is no doubt that many have seen solid earnings growth to support the expansion of their share price, but their future prospects are less sound.

Many defensives, however, have been conspicuously ignored by markets and as such their valuations now look more appealing. They may not have some of the appeal of their peers with exposure to high growth markets, but neither do they have their chunky price tag. There has already been a notable shift as investors have proved increasingly reluctant to pay up for overseas exposure. We have seen some restructuring of portfolios and movements within indices.

In the period ahead, we think this reorientation in markets will continue. As growth slows, investors will want to reduce risk and be orientated to more defensive areas that should provide better protection for their portfolios. It is likely to be sectors such as pharmaceuticals and other traditional defensive areas that will benefit.

Of course, government bonds would normally be the other choice for investors with significant worries about the macro-economic outlook. We would suggest that if investors take a broad view of equity market valuations, they are not unattractively valued, though there are pockets of high valuation. The same cannot be said of government bond markets.

We remain concerned about government bond markets at these levels, particularly around the 10-year part of the curve. There does seem to be a reasonable degree of over-valuation and we believe that yields in this area could rise much higher. Indeed given the UK's inflation trends, we would have expected 10 year yields to be much higher already. As a result government bond markets look, if anything, more vulnerable than equity markets at these levels.

Previous attempts to rehabilitate unloved defensives have focused simply on price. They were cheap, therefore they must go up. This has not proved to be the case. However, now there are a series of factors in their favour – a weakening in global growth, a weakening in the commodities bubble and a search among investors for safer havens for the next part of the economic cycle.

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