

A PERSONAL VIEW

Reflections on Difficult Markets

In the early summer, I was content that the corporate sector, both here and abroad, was achieving better profit growth than analysts' forecasts. This, against a background of weaker than expected GDP growth, plus the considerable headwinds of a higher oil price, the disruption to component delivery caused by the Japanese Tsunami and the reduction of money supply by deleveraging within the banking system. UK companies appeared able to take advantage of faster growth elsewhere.

Then, the warning signs. The Fed advised American banks to look more closely at the security of the European banks. Money was withdrawn and suddenly we had a liquidity squeeze, leading to a sovereign debt crisis. Why was that? I considered the default of Greece would not be a major calamity, given its economic size, but had not appreciated the extent to which European banks had invested in Greece and other endangered countries. Suddenly there was a real issue over default.

The establishment of the EFSF underscores the magnitude of the problem. Now we have a real crisis, disappointingly the solution exceeds the comprehension of politicians. Creation of the Euro was, in my view, a political, rather than economic, event designed to bring European countries closer together. But the concept was never grasped. While the economic aspects of the Euro may have been set out in the Maastricht Treaty, no one appears to have complied with its conditions, so it serves no useful purpose. Meanwhile, markets require a speedy resolution.

A break-up of the Euro would be calamitous as it would put thousands of cross-currency contracts into default across the world, potentially leading to a string of bankruptcies as the consequences tear through a fragile global financial system. Thus, my expectation of continued positive earnings growth from the corporate sector is placed in jeopardy since, against this background, no company would be immune from the effects of such an event, however well managed.

The Euro requires a responsible authority, able to borrow and to tax. The ECB can borrow and could be the issuer of Eurobonds to finance potential defaults. This level of QE within the Eurozone would lower the currency, benefiting Germany which is reluctant to contemplate such a move, given potential inflationary consequences. But the alternative is even less appealing, so politicians may make the impossible possible. However, democratic governments find it difficult to survive the austerity packages needed to correct previous prolific spending and are being toppled one by one.

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Back home, the B of E has once again revised downward GDP estimates, but expects inflation to moderate. Their credibility in forecasting inflation is patchy, but clearly the VAT rise last year will drop out soon. However QE has, thus far, simply pushed down gilt yields. More imaginative uses for this money, such as infrastructure spend, might benefit us more. What is clear, though, is that countries not saddled with enormous debt levels will continue to grow and leave the West behind.

So, how to invest against such an uncertain background? It still looks dangerous to hold substantial deposits within the banking system. I accept Mervyn King's comments that we must move away from the "too big to fail" concept for banks, which are no longer risk-free. Short-dated gilts appear suitable only for investors requiring capital security, while 10 year gilts look so overbought as to be ludicrously expensive in the light of the current inflation. Long-dated gilts offer sub-inflation yields, so are vulnerable. The only Government Stock I would consider is index-linked, but these are already priced to anticipate levels of inflation higher than the B of E is expecting.

The management of the corporate sector appears much improved, so investing in companies with recognised brands or income streams is a prudent way to deploy assets. High yields are available and thus a global brand delivering solid dividends seems a sound prospect. I also believe portfolios need more stocks than usual. I am a recent convert to the concept of gold as a store of value and would seek to include exposure. Property within the UK retains its long-term attraction and should be included. Diversification and quality remain the watchwords.

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The views expressed are those of John Dale, Senior Investment Manager. You should contact your JM Finn & Co adviser if you wish to take any action based upon this article.

ECONOMIC FOCUS

Making a drachma out of a crisis?

Most relationships progress through four stages. You form a relationship, work out what the acceptable norms are, test them with some storming arguments, then once everybody knows what is important, you move forward to performing. Forming – Norming – Storming – Performing.

The norms governing the “euro-rules” were to a degree cast in stone by the treaties and agreements that gave birth to the euro; so it was not surprising that it took a decade for the unwritten norms to be needed. Contrast this with a new domestic relationship where unacceptable behaviour is ironed out quite swiftly. There’s hell to pay if you smoke in the bedroom, but you can leave dirty boots in the hallway!

There were no rules or “norms” governing a Eurolander borrowing too much. We thought that markets would drive the profligate Eurolander’s interest rates higher to a point where the fiscally imprudent curtailed additional borrowing. Sadly, the natural brakes of economic common sense did not work.

The norms that have since emerged seem to be divided into the mostly protestant Northern Europe, lead by Germany, versus the mostly catholic South. The Northerners advocate lenders taking haircuts with austerity for reckless borrowers. The Southerners prefer monetising their debts with inflationary proxies for printing money, such as the European Financial Stability Fund (EFSF) buying otherwise unsaleable bonds.

The outcome of North vs South is important. One solution will give us a euro that looks more like the pesetas, lire and drachmas of old and the other, a Euro that looks more like a shiny and solid deutschmark. The “storming” poker game that has ensued has left me admiring Angela Merkel. This is my impression of what’s happened.

The Greeks: Merkel bought time. Waiting for Ireland and Portugal to begin to emerge, successfully, from their restructuring lessened the value of Greece’s MAD (Mutually Assured Destruction) threat of disorderly default and taking the rest of peripheral Euroland with them. Merkel started the bidding with few chips on the table whereas Greece had pretty much “gone all in”. For the summit of 22nd October, the market had been expecting substantial commitments from Greater Rhineland to finance the EFSF’s bond buying. All they got was a delayed suggestion that the EFSF could leverage itself by issuing a limited first-20%-of-loss insurance against default and by borrowing Chinese money. If it all started to fall apart then Germany could have walked away from an insolvent EFSF and paid nothing more.

So when the Greeks raised the stakes with a referendum they were easily “seen” with Greater Rhineland’s “actually-it’s-an-in-or-out-of-the-euro” riposte.

We now look to see how the Italian round evolves. On 9th November, the German government’s top independent economic advisers called a €2,300 billion jointly guaranteed European “debt redemption fund” to monetise Italian debt. I note that Merkel’s reaction to this was to insist on renegotiating treaties to include ceding fiscal policy to a Euroland Ministry of Finance. If Merkel, quietly, instigated the “debt redemption fund” publication, then this was akin to Merkel playing two aces; one being the “calm the markets” card as the effect was to bring the yield on Italian five year bonds back below 7%. Monetising Italian debt would share the cost with all of Euroland, as against Merkel’s “punish reckless lenders” stance.

“Merkel started the bidding with few chips on the table whereas Greece had pretty much ‘gone all in’.”

The second ace was to remind Southern Eurolanders that a one-off monetisation would cost them fiscal independence.

But back to relationships. What we are seeing now is the testing of the unwritten “norms” of Euroland. Greece has tested the importance that Germany attaches to fiscal prudence and austerity. And it has found Germany to be firm and unwavering. Italy is testing the same and my guess is that Merkel will stand firm once more. Berlusconi’s departure from high office looks like another hand won by Merkel.

If Euroland progresses through this perfectly natural “storming” stage intact - and everybody knows what is acceptable and what is not - then the next stage is “performing”. Post-crisis, Euroland can move ahead knowing what boundaries are cast in stone and also which ones are less important. Merkel’s canny politicking and negotiating leaves me more confident that she will avoid making a drachma out of a crisis and I increasingly look forward to a stronger Euroland once this crisis is resolved.

No wonder Sarkozy told the French to be more like the Germans.

John Royden
Research Officer

EDITORIAL

“I’m gonna bring it on home to you”

Annual wage and benefit hikes of 15-20% will slash the labour cost advantage of Chinese factories over low-cost, more productive regions of the US from the current 55% to nearer 39% by 2015. As labour is a small component in the supply chain for many products, savings from outsourcing to China may soon drop to single digit percentages. When transportation, supply chain risks, industrial real estate costs and so forth are added in, the cost-benefit of Chinese manufacturing over cheaper US states will become increasingly minimal. Interestingly, adding greater automation to Chinese production simply diminishes the attractive labour component still further.

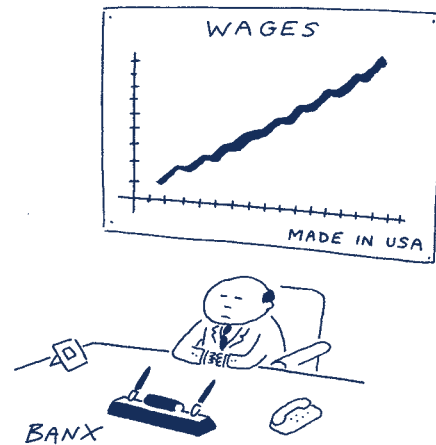
Asian income levels are rising and multinational companies will focus on the region, shifting other production back to North America. Others can operate as China once did, like Vietnam, Indonesia and Mexico. They suffer from infrastructure and domestic logistics constraints and lack skilled workers. There are also political and intellectual property risks and, with corruption high, productivity may be low.

“Even though there’s a tremendous cost saving when you go to China, in the end it really isn’t that much. It’s the hidden costs – the delays, the shipping costs, you pick all that up on a learning curve.” *Mark Krywko, Sleek Audio*

Undamaged by World War II, by the 1950s the US accounted for 40% of global manufactured goods. Helping Europe and Japan reconstruct themselves, the US experienced a collapse in its market share in colour TVs, steel, automobiles and computer chips. However, the 1990s saw US capacity dominating in microprocessors, aerospace, software and pharmaceuticals. Investment, output and jobs surged.

As Chinese wages rise, we approach the “Lewisian turning point”, or the stage where the West Indian Nobel laureate Sir Arthur Lewis (1915-1991) predicted that labour competitiveness is eroded and capacity shifts elsewhere. Since China entered the World Trade Organisation in 2001, the US has lost some 6m manufacturing jobs and seen China’s market share of furniture rise from 7.5% to 25.9%, for ships from 4.1% to 19.6% and for computer equipment from 4.9% to 32.6%. Yet a US resurgence is now underway, fuelled by growing Chinese wages, increased shipping costs and land prices. Post QE2, the Chinese currency is strengthening, eroding cost advantages. US wages, meanwhile, are static. South Carolina, Alabama and Tennessee are set to become some of the least expensive sites in the industrialised world. The US also has flexible labour and housing, whereas the coastally-fixed Chinese struggle when they chase lower wages inland.

Chinese wages grew by 150% from 1999-2006, outstripping productivity growth. A giant manufacturer, Foxconn



International, which employs 920,000 people in China alone, doubled wages at its huge Shenzhen plant after worker suicides. A Honda sub-contractor hiked wages last year by 47%, with minimum wages up 20% in 20 regions. Compound US wage growth from 2000-2015 has averaged 3%. Chinese productivity growth impresses at 8.5% out to 2015, but output per worker will grow at half the rate of wage increases.

Consider a motor part made in the US or in the Yangtze River Delta. In 2000 you bought Chinese, as wages were 20 times lower. By 2015 Chinese wages will still be lower but, even with huge improvements, productivity will be only 42% of a plant in the southern US. The labour cost advantage amounts to just 25% of the unit cost, so the total saving will be just 10%. By 2020, the equation might even reverse itself, with the US being cheaper. Electricity prices in China surged by 15% in 2010, imported thermal coal is rising and high energy consumer businesses are driving up utility rates for industry. Chinese land is now costlier than US, and the migration to seek cheaper labour inland neutralises the benefits of coastal clustering. Supply chains extend and reaction times to quality control issues lengthen.

Chinese multinationals should heed their familiar Asian markets more. By 2015, China’s economy should be 66% of the size of the US economy, with 90m households earnings circa US\$9,000 per annum. The US will compete better for products consumed in North America. Outside of the UK, European infrastructure and working practices will keep it uncompetitive. For David Cameron, trying to rebuild the economy, investment in high speed rail and relaxation of rural planning may allow more blue collar manufacturing to return. I see the UK as potentially a latter-day Hong Kong ready to trade into Europe, as Sir John Cowperthwaite did in the crown colony throughout the 1960s.

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Market Monitor

Equity markets reacted positively to news of some progress amongst policy makers as they face up to the reality of the broken system in the Eurozone. This positive reaction did not persist, given a failure to agree any concrete framework to afford the two things the market really wants- a large QE programme, run by the ECB, and then a mechanism for bonds to be issued in the collective name of the currency zone, rather than the constituent parts, to provide the Euro with a chance of survival.

At the same time the world faces continuing deleveraging – a “lost decade” in many developed markets. But the performance of equities during such periods has not always been poor and investors over the period have clearly focused on companies with attractive valuations and EPS growth. Many FTSE 100 constituents encompass this, which has aided recent performance.

The US has reported generally good corporate results and the wider economy has shown some tentative signs of life. The Dollar has responded favourably against Sterling. It is only the repatriation of non-Euro assets back to the ailing banks on the continent desperate for capital that has helped stop a greater swing against the Dollar over the same period for the faltering Euro.

How does 2011 finish? A much talked about year-end rally can happen if the reluctant Germans, understandably fearful of inflation, agree to Europe-wide QE. The more important issue remains long term demand trends in China. If their authorities can successfully manage the necessary contraction of the money supply, whilst keeping the economy growing, markets generally can make progress. The Dollar's strength against the Euro, particularly given the recent ECB rate cut, should continue. Of course, low and falling rates, risk aversion and long term inflation are highly supportive of the gold price.

	05/09/2011	21/11/2011	% change
FTSE 100	5103	5223	2.4
FTSE 350	2709	2753	1.6
S&P 500	1174	1193	1.6
Nikkei 225	8784	8348	-5.0
CAC 40	3000	2895	-3.5
Xetra Dax	5246	5606	6.9
Hang Seng	2768	2523	-8.8
FTSE UK Gilts Government All Stocks (Total Return)	2676	2785	4.1
GBP USD	1.61	1.56	-3.0
GBP EUR	1.14	1.16	1.7
GBP JPY	123.94	120.29	-3.0
NYMEX Gold \$	1874	1678	-10.4
Dated Brent Crude \$	112	108	-3.6

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