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VIEWPOINT

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Newsflash

A new month and the 56th issue of Viewpoint from FP.

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May was a difficult month for market participants with a number of economic disappointments and other generally negative events conspiring to sap momentum from the markets' nascent 2011 progress. Generally speaking the trend for economic data so far this year has been below consensus. This can be seen from the Citigroup Economic Surprises Indices below:

Throughout 2010 economic releases generally surprised on the upside compared to analysts' forecasts. Recently, however, this trend has reversed. The rapid move into negative territory for the Citigroup G10 surprise index could suggest that developed economies are stalling. This may be the case and is clearly a risk that investors must appraise, but it could also be, in part at least, a symptom of over exuberance on the part of the analyst community. Expectations may have simply become too high on the back of a solid recovery from the short term economic slump in mid 2010. Through May it is true that much economic data followed this below consensus trend, but further analysis of the information is imperative. It is worth noting, for example, that current inventories are not excessive, which suggests that manufacturing is not approaching a peak which could precipitate a GDP trough. Furthermore, data such as retail sales and production have not been too disappointing. For the sake of balance, however, it is also worth noting that housing and employment continue to underwhelm relative to previous recovery phases. Survey data, such as business climate and consumer confidence studies, also became less attractive for the developed markets in May, although it is important to remember that expectations data are sentiment driven and can be affected by less rational factors such as media reports. Overall the recovery is fragile and relatively slow but it remains a recovery nonetheless. The world's policy makers continue to tread a narrow and unforgiving path between reigning in obstinate inflationary pressures and offering continued accommodative monetary policy aimed at ensuring as little risk of deflation and recession as possible.

In last month's news, Dominique Strauss-Kahn, head of the International Monetary Fund (IMF) and frontrunner to lead the Socialist Party at the next French elections, was arrested following allegations of an attack on a hotel maid in New York. Mr. Strauss-Kahn resigned from his position as head of the international lender, with French Finance Minister Christine Lagarde emerging as the frontrunner to assume the helm at the IMF. It is interesting to note that there is significant support from within Europe for Mr. Strauss-Kahn's replacement to be 'home grown', with the German government's spokesperson stating "Europe's particularities, the currency questions and also the political circumstances" tend against upsetting the status quo. Elsewhere murmurs persist that this resignation provides an ideal opportunity for the IMF to appoint a head whose provenance better reflects the growing significance of the developing world.

On the second day of the month, a small troupe of US Navy SEALs shot dead Osama bin Laden in his hideout in Pakistan. The event raises difficult political questions, especially with respect to Pakistan's links to terrorism, along with the US's apparent disregard for territorial sovereignty. There are many that believe it untenable that the leader of Al-Qaeda lived in comfort within a few hundred metres of a major military installation without attracting the attention of the local authorities. As Senator Joe Lieberman noted, "This is going to be a time of real pressure on Pakistan to basically prove to us that they didn't know that bin Laden was there". Senior Pakistani officials have denied that bin Laden was being protected.

Despite a gradual shift from the front pages of the newspapers, tensions remain elevated in North Africa. Colonel Gaddafi's regime continues to suffer from defections and diplomatic pressure mounts on the embattled leader to step down. The South African President, Jacob Zuma, travelled to Tripoli late in May to hold talks with Colonel Gaddafi on how to resolve the conflict there. Both NATO and Libya's rebels have rejected a proposed ceasefire on the basis that it does not require Colonel Gaddafi's resignation.

The returns from equity markets over the course of the month were consistent with the old adage "sell in May and go away…" with the MSCI index of global shares falling in value by 2.1% in US dollar terms. This return was slightly ahead of emerging markets, which returned -2.6%. The return differential between developed and emerging markets equities has been a recurring phenomenon recently and year to date developed equities have returned 7.0% compared to their emerging counterparts' return of 2.5%. All of the major equity regions posted small single digit negative returns in local currency terms, but the relative strength of the US dollar versus other majors resulted in a lower global equity return when translated into USD.

Correspondingly, May saw a degree of strength in the bond markets as investors' attention shifted from the speculative

Source: Momentum Global Investment Management / Bloomberg/ May 2011 attraction of equities to the relative safety of the fixed income markets. In local currency terms government paper posted gains, but again these returns were diluted when translated into a strengthening USD reporting currency. Over the month, the US Treasury index gained 1.6%, European government paper added 1.2% and UK gilts gained 1.3% in local currency terms. In US dollar terms both global government bonds and the Citigroup index of Broad Investment Grade paper returned 0.0%. The higher risk and return sections of the fixed income market mirrored the behaviour of the equity markets as risk aversion grew; for example US convertibles returned -1.5% during the month. The peripheral European sovereigns continued to suffer publicly in May, with Greece downgraded by Fitch. Standard and Poor's downgraded Greek government debt again, from BB- to B, whilst Moody's similarly moved to place the beleaguered sovereign on negative outlook for its B1 rating. Italy was placed on negative outlook watch by Standard and Poor's towards the end of the month, on the basis of weak growth prospects and a faltering political commitment to productivity-enhancing reforms.

Global property securities outperformed the developed markets in May with gains of 0.5% for the global developed index. In local currency terms, the largest regional gain was experienced by Europe ex UK with an increase of 3.2%. The UK's returns in sterling are greatest year to date, however, with a gain of 15.1% in the five months.

A large volume of commentary year to date has centred on the performance of the commodities markets on the back of continued geopolitical risks, which have caused oil and gold to rally. Furthermore difficult harvests and unhelpful weather in many of the world's major growing regions have similarly prompted agricultural commodities to increase. This has potentially significant ramifications for inflation, especially in the emerging world, where energy and food comprise a proportionately larger fraction of the consumption basket than in the developed world. In May this increasing trend reversed somewhat with the broad commodities index receding by 5.2% from a month earlier. Agricultural commodities fell by 1.6%, whilst oil and gold fell by 8.5% and 0.5% respectively. Year to date, however, the returns from commodities are 7.2%, with notable gains of 22.8% for oil and 8.9% for gold in US dollar terms.

Source: Momentum Global Investment Management / Bloomberg / May 2011

Asset Class Performances

Asset Class/Region	Index	Currency	To 31st May 2011 May	To 31st May 2011 Year to date
Equities				
United States	S&P 500 NR	USD	-1.2	7.6
United Kingdom	FTSE All Share TR	GBP	-0.7	3.4
Continental Europe	MSCI Europe ex UK NR	EUR	-0.8	4.9
Japan	Topix TR	JPY	-1.6	-5.7
Asia Pacific (ex Japan)	MSCI AC Asia Pacific (ex Japan) TR	AUD	-2.1	5.4
Global	MSCI World NR	USD	-2.1	7.0
Global Emerging Markets	MSCI World Emerging Markets TR	USD	-2.6	2.5
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	1.6	2.7
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.3	5.0
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.4	4.1
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	0.6	6.1
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	1.3	2.4
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	0.9	4.0
Euro Government Bonds	Citigroup EMU GBI TR	EUR	1.2	0.4
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.9	1.9
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	0.6	6.4
Australian Government	JP Morgan Japan Government Bond Index TR	AUD	0.5	0.2
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	1.4	3.7
Global Government Bonds	JP Morgan Global GBI	USD	0.0	3.7
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.0	4.3
Global Convertible Bonds	UBS Global Convertible Bond	USD	-1.5	6.0
Global Emerging Market Bonds		USD	1.5	3.7

Source: Momentum Global Investment Management Limited / Bloomberg / Lipper Hindsight. May 2011

			To 31st May 2011	
Asset Class/Region	**Index**	**Currency**	**May**	**Year to date**
Property				
US Property securities	MSCI US REIT TR	USD	1.3	13.6
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	2.8	15.1
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	3.2	9.4
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	-0.6	-2.2
Australian Property securities	FTSE EPRA/NAREIT Australia TR	AUD	-2.6	7.8
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	0.5	8.8
Currencies				
Euro		USD	-3.1	7.2
Sterling		USD	-1.3	5.1
Yen		USD	-0.1	-0.2
Australian Dollar		USD	-2.6	4.0
Rand		USD	-3.5	-3.1
Commodities				
Commodities	RICI TR	USD	-5.2	7.2
Agricultural Commodities	RICI Agriculture TR	USD	-1.6	1.6
Oil	ICE Crude Oil CR	USD	-8.5	22.8
Gold	Gold index	USD	-0.5	8.9
Interest rates	**Last meeting**		**Current rate**	**Change at meeting**
United States	22 June 2011	USD	0.25%	-
United Kingdom	9 June 2011	GBP	0.50%	-
Eurozone	9 June 2011	EUR	1.25%	-
Japan	13 June 2011	JPY	0.10%	-
Australia	3 May 2011	AUD	4.75%	-
South Africa	12 May 2011	ZAR	5.50%	-

Momentum Global Investment Management / Bloomberg / Lipper Hindsight. May 2011.

Focus: Why record profitability is not necessarily good for equities

The outlook for corporate profitability is an important factor to consider when assessing asset class valuations. Key components of this assessment must include both the current level of profitability, in an historical context, and also expectations for future profitability.

The collapse in corporate profitability during the recent recession was considerably faster and sharper than in most previous recessions. Accordingly the subsequent recovery has been rapid; even though headline economic growth across most developed economies has not rebounded to the same extent, corporates have benefited from soaring profits. Along with accommodative monetary policy, these robust profits have provided support to equity markets.

The rise in profitability has been driven to a large extent by a steady increase in margins from their trough in Q4 2008. This has resulted in corporate profits growing to represent a larger share of GDP, partly at the expense of wage earners. Some commentators point to the recent sharp increase in corporate profits as a source of anxiety but these increases must be considered in the context of the prior contraction. As a share of GDP, profits are at a four-year high so there is clearly a risk of mean reversion, especially given that high margins will generally attract new market entrants. However, in the US at least, this share is still well below the highs achieved in the 1940s and 1950s.

Expectations for corporate earnings remain high and the normalisation scenario has not been priced in. Analysts are expecting S&P 500 operating earnings to hit a record level this year, well in excess of the pre-crisis record. For the current year, the average profit margin for US large caps is expected to be 9.5% according to Bloomberg, increasing further to lofty levels of 10.2% and 10.8% over the next two years. Among the reasons that could justify this are historically low interest rates and minimal upward pressure on wages as a result of continued high unemployment. Also, when considering margins in the context of longer term history, the high and rising foreign content of profits could potentially justify them representing a greater share of GDP than in the past. This would probably be most applicable for a well-developed economy that has taken full advantage of opportunities to outsource production globally. However, it is rare that such "this time is different" arguments are proven correct. An obvious challenge to corporate profits is found in rising commodity prices: only the most dominant franchises are likely to be able to maintain their margins by passing on the full impact of rising costs to consumers and additionally demand may fall as a result of lower household disposable incomes.

Historical context is vital, but it is equally important to challenge assumptions. An assumption that many investors likely make without even realising it is that margin compression would cause stock prices to fall. Viewpoint has always stressed the importance that valuation plays in determining investor returns and such fundamental matters as earnings (which are related to margins) must be considered relative to the price being paid. Indeed the impact of valuation multiple expansion/contraction may explain the output of analysis conducted by BCA Research, which found that there is no apparent correlation between periods of margin compression and stock market performance. Indeed, since 1950 the S&P 500 has delivered positive returns 12 months after profit margins peaked 90% of the time. For example, in the latest cycle margins peaked in Q3 2006 while stock prices only peaked in Q4 2007.

Therefore, although sustained margin erosion would inevitably result in falling profits and probably a bear market in equities, it is premature to adjust equity allocations on the basis of expected margin compression.

The current high level of profits may in fact seem like a sensible reason to buy equities. It even feels like this could be a great contrarian trade. While others are worrying about austerity and double dips, an opportunity to enter the market at attractive levels may present itself. As with all things in life, it is worth examining the logic of this a little more, given that markets are invariably less straightforward.

Before deciding to buy equities on the basis of this season's profits, investors should ensure they have considered the following questions:

Source: Momentum Global Investment Management / Bloomberg / May 2011

1) Should one be more interested in what earnings might be next quarter or what earnings might be over the next decade? Long term investors should be interested in long term results

2) Do next quarter's earnings tell us much about the earnings of corporates in the long term? This quarter's earnings, whether they come from boom or bust conditions, tell us only a little about long term corporate earning power

In fact, focusing on today's earnings can lead one to make serious mistakes in timing the market. Investors should instead focus on valuation levels, whilst remaining mindful of the drawbacks inherent across different approaches. As an example, one commonly used metric is obtained by comparing earnings with today's prices in the form of the price/earnings ratio (PE ratio). PEs suffer from some serious drawbacks which investors must be wary of:

1) Pro-cyclicality

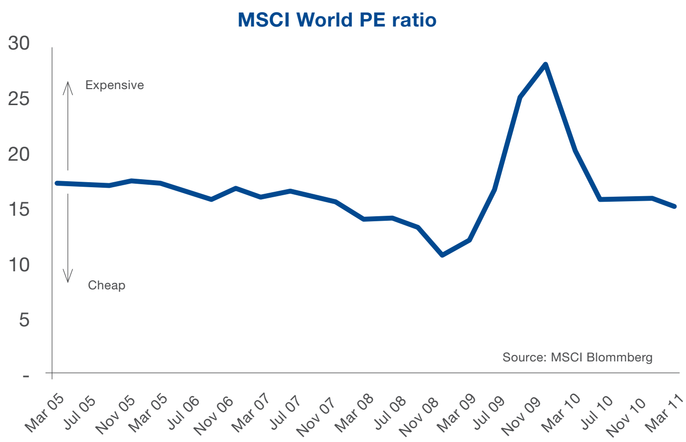
Boom earnings make markets look cheap at the top of the cycle, and bust earnings make markets look expensive at the lows. This is the precise inverse of how valuation measures should guide investors. For example: investors watching PEs in 2007/08 were confronted by exactly this issue.

In 2006/07, the PE ratio did not flag to investors that the market was expensive. By the summer of 2008 PE ratios were falsely signalling the market was cheap as the equity market had started to slide. By the spring of 2009, as earnings were overrun by large financial losses, PEs soared to record highs, making the market look very expensive.

2) Lack of comparability

Using profits, which can be easily manipulated by management, makes comparing valuations across time and geographic regions problematic. Different countries may have their own accounting standards. Indeed accounting standards themselves evolve through time.

As an example, historically Japan has had very different accounting standards to the US. While many of these differences are far smaller now, comparing PE ratios between the US and Japan becomes problematic and investors can be lulled into value traps or conversely miss opportunities as they are comparing apples with oranges.



Savvy asset allocators should pay less attention to the quarterly earnings cycle. High earnings can make markets look erroneously cheap, as in 2007. Instead, one should try to ignore the noise and make a dispassionate assessment of what earnings power is provided by a stock market. Using today's earnings in valuation measures, such as PE ratios, may be quick and easy but it can lead to serious mistakes.

Source: Momentum Global Investment Management / Bloomberg / May 2011

Recent Manager Meetings

MANAGER	ASSET CLASS	DATE	WHERE
	LONG ONLY		
HB Capital Partners	Indonesian Equity	04 May 2011	Jakarta
Schroders	Fixed Income	04 May 2011	London
Aberdeen	Indonesian Equity	05May 2011	Singapore
Firth	Asian Equity	05 May 2011	Singapore
Havenport	Asian Equity	06 May 2011	Singapore
Absolute Asia	Asia	06 May 2011	Singapore
JPMorgan JF	Asia	06 May 2011	Singapore
Grindrod	Property	10 May 2011	London
Barclays	Fixed Income	13 May 2011	London
GMO	Global Equity	13 May 2011	London
Deutche Bank	Fixed Income	13 May 2011	London
HB Capital Partners	Indonesia	13 May 2011	London
Global Evolution	Fixed Income	16 May 2011	London
Schroders	Property	16 May 2011	London
Franklin Templeton	Fixed Income	16 May 2011	London
Advisory Research	Global	16 May 2011	London
Neovara	Fixed Income	17 May 2011	London
Pzena	Global / GEM Equity	18 May 2011	London
Loornis Sayles	Fixed Income	18 May 2011	London
Thornburg	Global	19 May 2011	London
UBP	Fixed Income	19 May 2011	London
Muzinich	Fixed Income	20 May 2011	London
Yacktman	US Large Cap Equity	24 May 2011	London
Scottish Windows	Fixed Income	25 May 2011	London
BDT	Asia	25 May 2011	London
Rivoli	Fixed Income	26 May 2011	London
Artisan	Global	26 May 2011	London

MANAGER	ASSET CLASS	DATE	WHERE
	Hedge Fund		
	Credit	04 May 2011	London
	Event	05 May 2011	London
	Credit	10 May 2011	London
	Distress	10 May 2011	London
	Macro	16 May 2011	London
	Fixed Income	18 May 2011	London
	Commodities	27 May 2011	London

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