



# Stewardship Update

March 2009

## Economic perspectives for 2009

**In this update, Hilary Aldridge and Phil Doel, joint managers of the F&C Stewardship funds, give their view on the prospects for a global economic recovery and the potential implications for ethical funds.**

Given the almost unprecedented flux in the global economy, subscribers to the decoupling theory may need to revise their timelines. It had been supposed that when the developing economies of the West entered a cyclical downturn, the rampaging growth of China, Brazil and India would be there to take up the slack. But as tumbling GDP rates in these emerging economic 'powerhouses' attest, we are now enduring a slump of truly global proportions. Indeed, some commentators are now suggesting that 2009 will see the world economy contract for the first time since World War II.

### US influence still critical

With the US still accounting for around 30% of aggregate economic activity, the corporate and consumer health of America remains pivotal to global growth. In the initial analysis, however, things are set to get worse for the world's largest economy. In the fourth quarter of 2008, as consumer confidence plumbed new lows and unemployment continued its steep upward trajectory, US GDP shrank at an annualised rate of 6.2%. With the number of jobless still growing and the bellwether car industry coming cap in hand for state rescues, most forecasters are now pushing out their recovery expectations into 2010.

From an investor perspective, the arrival of the new Obama administration has thus far failed to have the hoped-for effect. Tim Geithner, Hank Paulson's replacement as US Treasury Secretary, has hardly enthused the market with the clarity of his plan. Some argue that he has no plan at all, and rumours of nationalisation have further destabilised the financial sector, sending the stock market spinning. There is also a perception that the new president, in trying to end the credit crisis, rejuvenate health care and lead a green revolution, is wanting too much.

### The worst could be over

At F&C, we are taking a more sanguine view. Our belief is that the cycle of downgrades is almost finished now that consensus growth estimates for 2009 have been lowered to -2% for the US and

Europe ex UK and even -3% for the UK. Indeed, we see 2010 being a good deal better than the anaemic recovery of 1% the consensus expects. Our assumption that a V-shaped recovery is the most likely scenario is based on the following arguments:

First, several key inventory cycles will be at an absolute low going into the second half of 2009. We estimate the unstoppable, pent-up demand for items such as cars, houses, durable goods and replacement investments will kick in some time after the third quarter.

Second is the prospect of a return of consumers' appetite for non-essential items. As Americans batten down the hatches in the recessionary storm, they habitually postpone their 'big ticket' spending plans and set aside spare capital. The savings rate rose from zero to 3.6% in December and, with the influence of tax rebates and fears of deflation, it could rise by a further 6% over the course of the year. We believe that, once this rate peaks after the end of the third quarter, spending intentions will start to recover.

At the same time, the US economy should also start to feel the impact of the recent monetary and fiscal stimuli. Investors will nevertheless need to be patient as the Obama plan has slated emergency measures only for 2009, with \$100 billion of infrastructure spending not coming on tap fully until after 2011. This level of spending over such a timeframe will not be sufficient to offset the contraction in capital expenditure and construction.

### Heavy funding for green projects

The fiscal package has been well received by environmental campaigners, with Obama having allocated around \$80 billion for projects relating to energy efficiency, clean energy and green transportation. The new president hopes his plan will create or save 3.5 million jobs over the next two years, and a sizable chunk of them are expected to be so-called "green-collar jobs".





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Indeed, some commentators estimate that America's transition to a more sustainable economy will be the key engine of job creation going forward. According to the University of Massachusetts economist Robert Pollin, "spending the same amount of money on building a clean energy economy will create three times more jobs within the US than would spending on our existing fossil fuel infrastructure."

### **Bad earnings already discounted**

In terms of corporate earnings, investors can take heart that consensus estimates already discount much of the bad news. We are optimistic that numbers released in the second half of the year will not be as bad as feared and that good earnings numbers will return in 2010. That said, a V-scenario cannot be guaranteed given the huge pressure on final demand due to the financial crisis and the savings shock. Moreover, the downturn of fixed investments has only just started, leading some market observers to conclude that a long, deep recession without a recovery - the so-called L-scenario - is looming large.

### **Depression is unlikely**

We view this as being too pessimistic since the L-scenario is in fact an extremely rare phenomenon, with Japan's 'lost decade' in the 1990s being the only notable example. As deflation or low inflation helps purchasing power and thus consumption, the fear of depression should recede in coming months. The more likely threat, and one that is gaining credibility, is the W-scenario. Here, the cyclical recovery brought about by fiscal and monetary stimuli proves to be a false dawn while saving rates continue to rise.

Crucial to the arrival of a V-shaped scenario is a solution to the credit crisis. For this to happen there needs to be significantly more capital injections, lower mortgage rates and an aggregator bank to buy credits to stop losses on toxic debts, preferably with higher prices reflecting going concern instead of liquidation value.

The buying of agency debt in the US since December has been successful in lowering credit spreads and the monetised buying of credits should be more effective still. The outcome could be enhanced through a scenario combining more aggressive monetary policy (with the authorities

printing money to buy credits/mortgages), successfully functioning aggregator banks and higher confidence on the back of an improving profit outlook later in 2009.

All these events are far from certain. The credit crisis could easily deteriorate again because of policy errors (for example no or a wrong bad aggregator bank), big bankruptcies, unknown extraneous shocks or a collapse of emerging markets. Then a false recovery - or W scenario - will be the outcome with negative consequences for equities.

Although a V-shaped recovery is positive for equities and negative for yields, investors should not get too carried away. Stock markets remain mired in poor fundamentals: earnings forecasts are still being revised down, bankruptcies are coming and the inventory cycle has further to deteriorate before recovering. For 2010, the fundamentals are improving but not yet convincingly enough for risk appetite to return. However, equity markets usually recover before year-on-year economic growth reaches its low - which we see happening in Q2/Q3 2009 - so the longer-term prospects for equities are more encouraging.

### **Better outlook for ethical funds**

As the recession in the major developed economies deepens, there is some good news for ethical funds. The oil majors will see sharply lower revenues as the effect of low crude prices finally feeds through to profits. Both oil and another non-qualifying grouping, the pharmaceutical mega-caps, could also see the value of overseas earnings eroded if the pound rallies.

Though large-cap defensives in the oil and pharmaceutical sectors should still continue to be among the market leaders, the Stewardship funds can replicate the characteristics of stable earnings and attractive dividends in areas like telecoms and utilities through stocks such as Vodafone, National Grid, SSE and Centrica.





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At the other end of the capitalisation scale, a recovery in smaller companies will help reinvigorate the ethical universe. With much of the bleak outlook now factored into share prices, small caps will be attractively geared into any rebound in confidence.

## How are the Stewardship funds positioned?

It would be reasonable to assume that whilst mega-caps and defensives lead the market, the Stewardship funds are likely to underperform. Nevertheless, they have a strong bias towards early-stage cyclicals and these sectors are beginning to show signs of outperformance. Once the market starts to look through the current downturn, the structural bias, caused by the ethical screens, should switch from being a considerable headwind to a helpful tailwind for performance. As mentioned previously, equity markets are habitually ahead of the curve in terms of predicting economic recoveries and the Stewardship funds are positioned to take prompt advantage of any return of risk appetite.

## Stewardship Income

With the prospect of further volatility in mind, we continue to overweight defensives with a bias towards utilities. However, the barbell strategy juxtaposing defensives and cyclicals should help the Fund to perform well in relative terms in broadly rising or falling markets, rather than markets driven by sectors largely screened out on ethical grounds.

We have increased the holding in corporate bonds to protect the premium yield of the Fund without having to invest in riskier high-yielding financials.

The key risks to the Fund are the underperformance of utilities and the outperformance of large-caps. Our view for the short term is that the 'safe' yields in the former and the risk of further fund-raising for the latter will continue to benefit the Fund.

The valuation of the market is at historically low levels. However, we expect the positive yield gap to continue whilst investors remain risk-averse and concerned about deflation.

While we maintain our defensive bias given the risk to earnings in the short-term, we have gradually been buying more consumer-sensitive stocks as valuations look attractive.

## Stewardship Growth

The top ten holdings reflect the defensive bias of the Fund and we continue to prefer well capitalised, higher yielding equities such as Vodafone, Scottish & Southern Energy and BG Group whilst earnings downgrades are rife and credit is restricted.

The Fund is well placed to benefit from any market rally via a skew to consumer related stocks and these areas have begun to outperform the wider market in recent months. We expect this broadly to continue albeit there is significant risk on an individual stock basis.

On valuation grounds we have also been buying selected early stage recovery stocks, such as the building materials supplier Wolseley.

## Smaller company focus remains

For both the income and growth funds, our continued preference for small caps remains predicated on their more attractive valuations and stronger growth potential over the medium term. Encouragingly, we have seen in the VIX index some reduction of the volatility in the market, although we need to see this trend establish itself before sustained smaller company outperformance returns. When the debt markets finally reopen, the process should be accelerated by a recovery of mergers and acquisitions. The sector is littered with bargain opportunities and ripe for consolidation.

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