



## Caution Yes, but Don't Panic yet Mr Mainwaring

9<sup>th</sup> February 2010

**Commenting on recent market volatility, Tom Becket, CIO of PSigma Investment Management said:**

- Expect 2010 to be a volatile year
- Concerns have "surfaced", but all are explainable
- There remain economic & corporate positives to focus on
- Remain diversified and vigilant in your strategies
- Use weakness to add to favoured positions

"As goes January goes the year", according to market folklore. If the last six weeks are a leading indicator for the year as a whole, we could be in for a bumpy ride! As we have detailed previously, **we expect 2010 to be a year of great volatility, following the tremendous rally we saw across most asset classes in 2009**. Clearly uncertainties over the stability of parts of the global economy and the valuations of many asset classes have created many waves in recent weeks. **However, we do not believe now is the time to start panicking.**

At the start of the year, the positive sentiment that swamped markets from last year continued, with many global equity markets claiming fresh highs, whilst corporate bonds and commodities made further headway. However, shortly in to the month, optimism turned to realism and investors began to question whether many asset classes had rallied too hard, too quickly. There have been a number of immediate causes that have spooked investors. Firstly, problems on the periphery of Europe, in particular Greece, have reminded investors that many of the problems created last decade had not simply vanished under the tidal wave of government liquidity. **However, because of the association with Europe, Greece will not go bust or default. Nor will Spain, Ireland or Portugal. This "nuclear" scenario will just not be allowed to happen, although predicting politics is inherently difficult.** We believe that we are likely to see more European integration and an eventual fall in the peripheries risk premium. The economic situation of these countries might cause problems in the short term, but we believe with the right action they are containable.

Clearly, structural government deficits and the financing cliff that has to be scaled are terrifying long term problems that have to be addressed. The developed world cannot operate with the same insane attitude to debt creation that has been witnessed in the last decade. **However, whilst we cannot find any reason to currently hold Treasuries or Gilts, we believe that these issues should not be creating such concern in equity markets at present.** If there is no visible path from the delusional and destructive debt debacle, we will become more worried, but we hope that governments will wake up and "smell the coffee" before the Bond Vigilantes come back with a vengeance.

Following a consistent trend of stronger than expected global economic data, economists have begun to question whether the ultra-loose monetary policy of central banks and governments' stimulus deluge would be retracted earlier than had been anticipated. This was particularly the case with the booming Chinese economy, where unnerved government officials tried to rein in their over-enthusiastic banks. Whilst **we think that fears of interest rate hikes are premature**, any reduction in liquidity is likely to have negative implications for risk assets. We continue to maintain a heightened focus upon liquidity, but are not overly-concerned at the moment. **We believe that for the time being easy policy is here to stay. Central banks in the developed world seem set to keep rates low and stimulus high.** Looking at China specifically, surely reining in credit and tightening policy have to be good moves. On back of the envelope calculations, China's economy was outputting at a rate of about 16% the New Year and credit growth went ballistic. **In our opinion, China is merely trying to cool its economy rather than spark another "big leap backwards".**

The final worry for markets has been over the increasingly populist Mr Obama's bank plans. Whilst it is too early to predict their eventual impact, as the devil will be in the detail, we expect them to be watered down hugely from the headline grabbing statements that hit the screens. In our opinion, should banks' prop

desks be curtailed, this could be a long term positive for markets. **Our reading of the situation is that Mr Obama has been backed in to a corner over Massachusetts and Healthcare and has to be seen to be fighting.** Bankers are an easy and popular target.

Taken in isolation, any one of the above issues would be a negative for markets. When combined at the same time, following an enormous rally in the previous months, they are more than enough to trigger the necessary and healthy correction that we are experiencing.

However, all is not lost and many positives abound. **We think that the latest sell-off is a painful correction, which is likely to give way to a recovery in equity markets in the months ahead.** The corporate reporting season has begun with a bang, with most companies easily exceeding erroneous expectations. Notably, the response from investors was to sell off shares, suggesting that the positive earnings were already priced in. Importantly revenues are coming in ahead of expectations. **Whilst we are concerned over lofty predictions for 2011, we should be pleased with the profits growth seen in Q4 '09 and 2010 should be ok.** We are recommending that you use any pronounced weakness in individual shares to add to favoured long term investments.

Let us not forget as well that the nascent global economic recovery has become entrenched. The world is growing again and business confidence is improving. Even in the UK! **Although we are still not firing on all cylinders, the patient's medicine is working and things are gradually getting back to normal.** Whilst we still need to be vigilant, watching for any further deterioration later this year, even the longer term employment backdrop is getting better.

Therefore, **it seems that the correction that we are seeing is probably merely a reflection that markets got ahead of themselves early this year and some of the momentum is now subsiding, rather than being anything more macabre.** However, in uncertain times it pays to be "on your guard" against any possibilities. Since the start of the year we have met with over half of our Buy list managers, working hard to find a general picture and formulate our views for the year. Notably, speaking to some of our contacts in Asia, they are just not seeing the panic that they were a year ago. **Whilst the falls look bad, we should remember quite how hard and fast the markets rallied last year.**

It is at times like these that our strategies tend to outperform. This is a good time to be diversified, have defensive stances in equities, conviction in things you like (high yield, long/short strategies) and be taking risk on when the markets are nervous. We have gradually been urging a little bit of additional risk taking in the last couple of days, as it has been rewarding in the last couple of quarters to buy more risk when others are fearful. Even if this stance is wrong initially, we still believe we can make headway in H1, although we will have to be really flexible and change tack quickly if we are wrong. Reassuringly, we can still find certain asset classes and individual investments that are attractively priced. However, **we expect to have to be very proactive in our strategy to reflect the constantly changing economic and market environment. 2010 is shaping up to be a tiring and testing year.**

So far this year, we have managed to escape relatively unscathed, as we hold many investments that have produced decent returns, including property, high yield, absolute return funds, index-linked bonds, RMBS and Japanese equities. Though equity markets might well struggle to regain the highs set early this year and could be very volatile in a wide trading range. We feel absolutely comfortable that our portfolios are currently well positioned for the uncertain times ahead.

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