

## Briefing Note – Equities

21 June 2011

Equity markets have been falling recently, with the FTSE 100 dropping from around 6,050 in early April, to just above 5,700 as I write today. This is a drop of around 5.7%.

We have seen a fairly sustained period of falls, due principally to two main reasons.

Firstly, US economic data has consistently been coming in at below expectations. As a result, investors are now concerned that the global recovery is stalling.

We have been positive about equities for some time, but warned that at present earnings levels they look only “fair value” as opposed to being cheap. The rally earlier in the year had been driven partly by expectations that earnings would grow. If the recovery is not as strong as thought, then earnings are likely to grow less than analysts had estimated.

Secondly, investors have become more and more worried about the situation in Greece.

### Market Correction?

A market correction is defined as a 10% fall, so this is not yet a correction. We have had only one correction since the recovery in 2009, which was in the period from April to July 2010. This correction was caused mainly by the first worries about a Greek default. It is perfectly possible that these same worries could cause the recent dip to become the next correction, which would occur if markets fell to about 5,470.

Last year there was concern that Greece could default on its debts. To reassure markets, Greece had implemented a huge raft of austerity measures, cutting spending dramatically. There were strikes and riots as the Greek public protested. This is happening again.

Last week, Standard & Poor's cut Greece's credit rating to CCC – the lowest rating for any country in the world. Further austerity measures are required by both the IMF and the EU in order for Greece to receive the support it needs. The Greek government are finding it hard to gain support for these measures from both the public and politicians.

Germany has been particularly vocal in their concerns about continuing to fund Greece. The problem for Germany, is that their banks hold significant amounts of Greek bonds, so a default would hit them hard. The European Central Bank itself owns almost 50bn Euros of Greek bonds. It is therefore ultimately in their interests to ensure that Greece does not default.

If the bailout is not agreed, then the likes of Ireland and Portugal would be more likely to default as well, so “contagion” is a huge risk. Default could cause a financial crisis of similar proportions to the Lehman Brothers default in 2008. Policymakers know this, and as a result they will do everything to find a solution.

If a satisfactory agreement over the bailout is reached, we would expect an equity recovery. After the last Greece-related correction, markets recovered their losses within around three months. Past performance is of course no guide to future performance.

## Reasons to be Cheerful?

Despite the ongoing doom and gloom, we still see reasons to be cheerful with regard to the equity market. There are still companies making decent profits and growing their earnings. By investing in these companies we believe we could make good long term returns, even if sentiment drives down prices in the short term.

Although most equity holdings have fallen in value in the short term, in general we have managed to protect value as we have been investing more in defensive equity income type funds. These have typically outperformed other types of equity fund of late.

For discretionary portfolios we are generally overweight in equity, meaning we believe we are well placed to benefit if there is a market rebound.

## Action Required

Last October we wrote to you about cash returns, which remain at all time lows. **If you have more cash than you need for an emergency fund, we suggest you consider investing it now while markets are at relative lows.**

In October we said:

*“According to Which? magazine, savers are losing £12 billion a year in interest by leaving their cash in low paid accounts.*

*With interest rates at record low levels, our view on cash as an asset class has been strongly negative for some time.*

*We score each asset class based on its outlook with a score between -5 and +5. Our long term average assumption for cash is 3% net of basic rate tax. Our outlook score for cash is currently -5, meaning we expect returns of less than 1.5% pa net.*

*For many people, 1.5% is wildly optimistic. The Which? figures compare returns to the best cash rates around, however even the top accounts are not that great. The best instant access Cash ISA rate according to Moneyfacts is currently 2.8% pa, but that includes a temporary bonus of 2%. Most accounts pay less than 1.5% pa unless you are willing to tie up your money for some time.*

*We don't see interest rates climbing much for a while and therefore we recommend clients generally hold the minimum amount of cash appropriate for their needs. We believe most clients should have an emergency fund equivalent to around 1 year's expenditure, plus any capital expenditure you need in the next three years.*

*We suggest you take a moment to calculate whether you have more cash than required. If you do, we recommend you consider investing the excess.”*

Of course we can't predict the future, and markets could easily fall further before they go back up. However, if you do feel you have more cash than you need, then we believe now could be a good time to invest. Please get in touch with your adviser if you would like to consider taking this opportunity.

**The information in this briefing does not constitute advice. Please do not take any action without speaking to your adviser. Past performance is no guide to the future.**