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Strategy Outlook

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Editorial



The ebb and flow of macro economic and political news seem to be driving markets instead of robust corporate earnings reports. While stories of Greek budget woes, rumours of tighter Chinese policy and a largely symbolic move in the US discount rate make for good headlines, they mask the underlying health of earnings from global corporate.

We recommend that investors use this backdrop as an opportunity to buy real, income producing, inflation protected assets. This means cash flow rich global blue-chip equities with yields at or close to government bonds. Our vision is for a new 'Nifty-Fifty' universe of international super-cap stocks that start to enjoy a renaissance in equity valuations, driven primarily by institutional investors trying to escape sovereign bond risks. Our focus on dividend flows linked to the global economic growth is also intended to protect against inflation – the continuing risk for longer-term endowment and private client assets.

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Economic Outlook

Buy corporate cashflow – it has rarely been this cheap...

Financial markets find themselves, for the moment at least, driven more by the ebb and flow of macro-economic and political news than by the increasingly consistent and robust flow of corporate earnings reports that are appearing across global markets. The ongoing Greek budget woes, rumours of tighter Chinese policy (a precursor of Chinese revaluation?) and a largely symbolic move upward in the US discount rate make better stories than consistent earnings recovery, record levels of cashflow and ambitious dividend growth from many of our Thematic 'Blue Chips.' In our view, this is an opportunity for investors, and a precursor to what may turn out to be a renaissance in equity valuations for a new global 'Nifty Fifty' of international super-cap stocks.

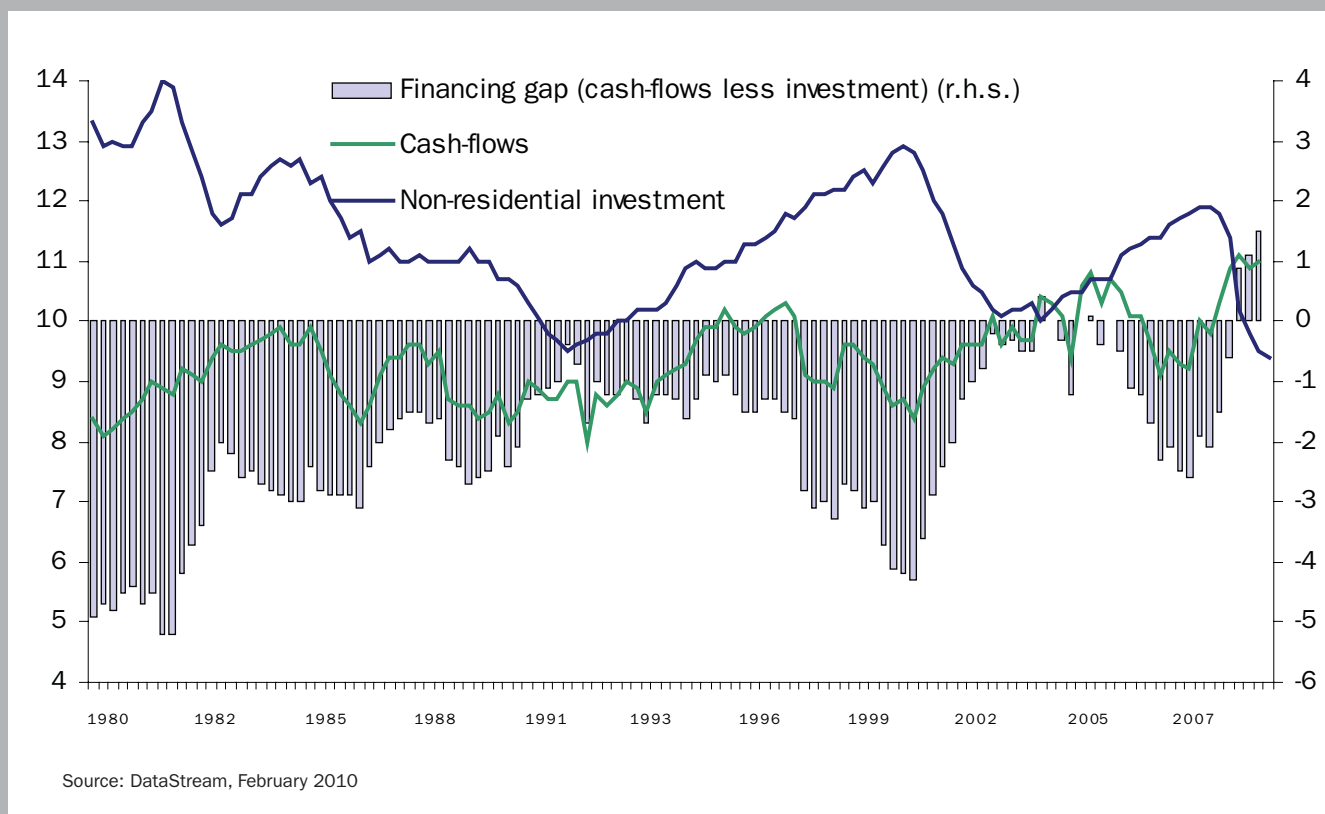
That corporate cashflow is exceeding expectations should not come as a surprise to investors as the global recovery continues. The IMF has upgraded its 2010 growth estimates from 3.1% to 3.9%, US GDP (admittedly helped by inventories) rose to a blistering 5.9% in the fourth quarter of 2009, and last month's ISM (along with a raft of other global manufacturing surveys) reached 58.4 – a much stronger reading than expected, and its highest since April 2004. The relatively disappointing performance of world stock markets this year, against such a robust industrial backdrop, has been coloured by fears over tighter money and the withdrawal

of exceptional policy stimulus. Realistically, the risk of changes in core interest rates is only truly evident in the emerging world and other commodity linked economies; tighter bank reserve requirements are either being implemented or forecast in China, India, and several of the smaller Asian economies, all of which are seeing rising headline inflation, especially where they have pegs to the US dollar.

Ultra loose money will persist in the developed world

However, this is offset to some extent by the perception of easier money for longer in Europe as markets expect the European Central Bank (ECB) to be reluctant to tighten into the unfolding budgetary crisis in peripheral states; the yield on German two year bonds, for example, has fallen by 24bp in the last three months by way of response. In Japan, deflationary fears are back, with last month's GDP deflator falling by 3%, the largest decline on record. The new finance minister, Naoto Kan, is determined to beat the worsening deflationary backdrop, claiming last week in the Yomiuri newspaper, *"There are many ways to go about achieving such goals... The government will undoubtedly do all it can. I also hope the Bank of Japan will conduct monetary policy appropriately."* In other words, ultra loose monetary policy, quant-ative easing and massive liquidity creation will remain policy in Japan for many months yet.

Chart 1: A positive financing gap is boosting cashflow dividends, and ultimately, 'CAPEX'



Source: DataStream, February 2010

Corporate cashflow continues to improve

Against this backdrop we continue to recommend a bias toward real, income producing, inflation protected assets. This, for the most part, means cashflow rich, global blue-chip equities with yields at or close to government bonds. Our vision of a new global 'Nifty Fifty' stock universe – which increasingly becomes the natural home for institutional investors trying to escape sovereign bond risks – aptly captures our investment theme of 'The Strong get Stronger'. We also continue to lift our emerging world bond holdings (as currency appreciation in the region persists) while our western market bond holdings remain short dated in order to avoid Sovereign issues in structurally 'challenged' economies (including the UK) until we detect a real political commitment to multi-year budgetary cuts.

Most of all, though, our deliberate focus on corporate cash and dividend flows, linked to the global economic growth, is intended to protect against inflation as the soft way out for embattled politicians. Even the IMF's chief economist recently commented on the desirability of higher inflation rates. "If you flirt

with inflation," quipped former German Federal Bank President Otmar Emminger twenty years ago, "you end up marrying it"; this is still for us the real risk for longer-term endowment and private client assets over the remainder of the decade.

The economic backdrop

A multi-speed world...

The world economy continues to enjoy a broad-based, multi-speed economic recovery. In developed economies, ultra low interest rates have not only offset pernicious debt and deleveraging cycles but have also laid the groundwork for a sustainable – albeit muted – economic recovery. At the same time, across much of the emerging world, fixed exchange rate regimes continue to funnel ultra low G7 interest rates into strong domestic economies. Growth is rebounding robustly, bringing with it an urgent need for monetary independence or a more flexible (better) exchange rate arrangement.

...that is tentatively moving from an inventory to a capital expenditure cycle

In the US, the inventory cycle has moved into an investment-led recovery, as illustrated by the 18.2% quarter-on-quarter annualised rate

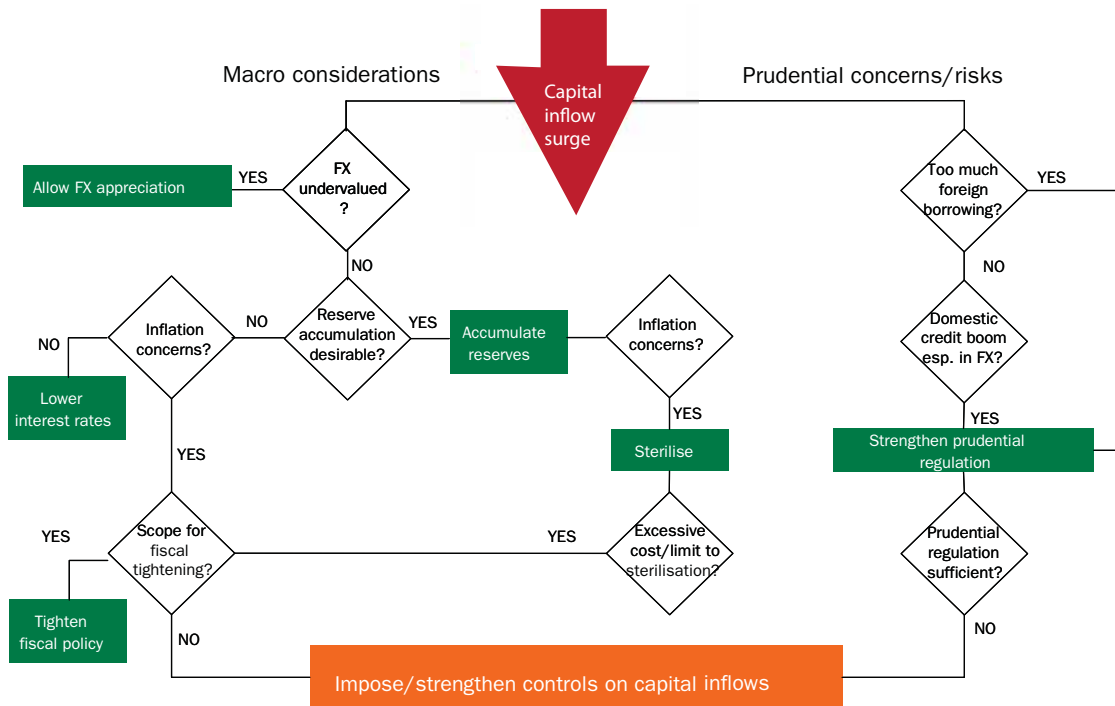
increase in equipment investment in Q4 2009. Given the rapid depletion of IT goods, together with a massive drop in investment at the peak of the crisis, companies now urgently need to replace obsolete equipment. On aggregate, they do have sufficient internal funds to finance such investments; as a result of cost-cutting measures, the US financing gap (the difference between cashflow and capital expenditure) currently stands at an historical high of 1.5% of GDP. However, the labour market and the consumer remain the missing link for a full-speed recovery.

Europe appears, for the moment, to be stuck in slow motion, combining the worst of two worlds: the need to deleverage an over-indebted household sector in Spain and Ireland, and to restore both competitive-ness and public finances in the euro periphery. This is only partially offset by the relative stronger position of Germany – and, to a lesser extent, France – and by the recent euro depreciation.

Europe exports must be toasting the Greek Treasury

But the position at the corporate level is different – valuations are exceptionally cheap and German and French exporters must be

Chart 2: It's getting complicated: The IMF's not very simple recipe to deal with capital inflows



Source: Capital Inflows, The role of controls. IMF, February 2010

toasting the Greek Treasury for a fiscal crisis that has weakened the trade-weighted euro by a much needed 5.5% since the crisis flared up in November. We continue to expect a 'bail-out' as the simplest and cheapest way to cap the current risks of contagion within the peripheral economies – in this respect Greece is probably just "too small to fail...", and if the euro is weakened it can only be good for corporate profits.

Asia and China in particular, have been a step ahead of the rest of the world. Massive fiscal stimulus along with rapid credit growth triggered an investment recovery as early as Q2 2009. Indeed, China's investment spending rose 32.5% year-on-year in the second half of 2009.

The Fed fights back, against Capital Hill...

One month after the drama of Ben Bernanke's reappointment, and as the Congress continues to debate the future shape of its power, the abrupt and unexpected resignation of the Fed Vice-Chairman Donald Kohn, 67, announced on March 1st added to the uncertainties surrounding the US monetary policy. US politics will again be involved in the Fed monetary process as in addition to Mr

Kohn replacement, two other FOMC Members will have to be nominated. Nevertheless, the Fed has begun to implement its exit strategy by announcing the end of several exceptional liquidity programs and, in a bold move, increasing the discount rate by 25bp to 0.75%.

However, the discount rate hike clearly intends to signal that the Fed's independence remains intact. It is also of course a statement of confidence in the wider strength of the US economic recovery, and with a host of Fed officials lined up to reassure investors that the decision was merely a decision to unwind the extraordinary lending facilities will be increasingly viewed as a positive by world markets. In the short term though this unconventional tightening is likely to further complicate the task of macro economic management of those countries with tight dollar pegs, which are linked to more convention policy instruments like the Fed funds rate. Low policy rates will keep emerging markets awash with liquidity.

In Europe, difficulties in the periphery are forcing aggressive fiscal consolidation packages and have clearly pushed back the

timing of any rate hikes, at least until early 2011.

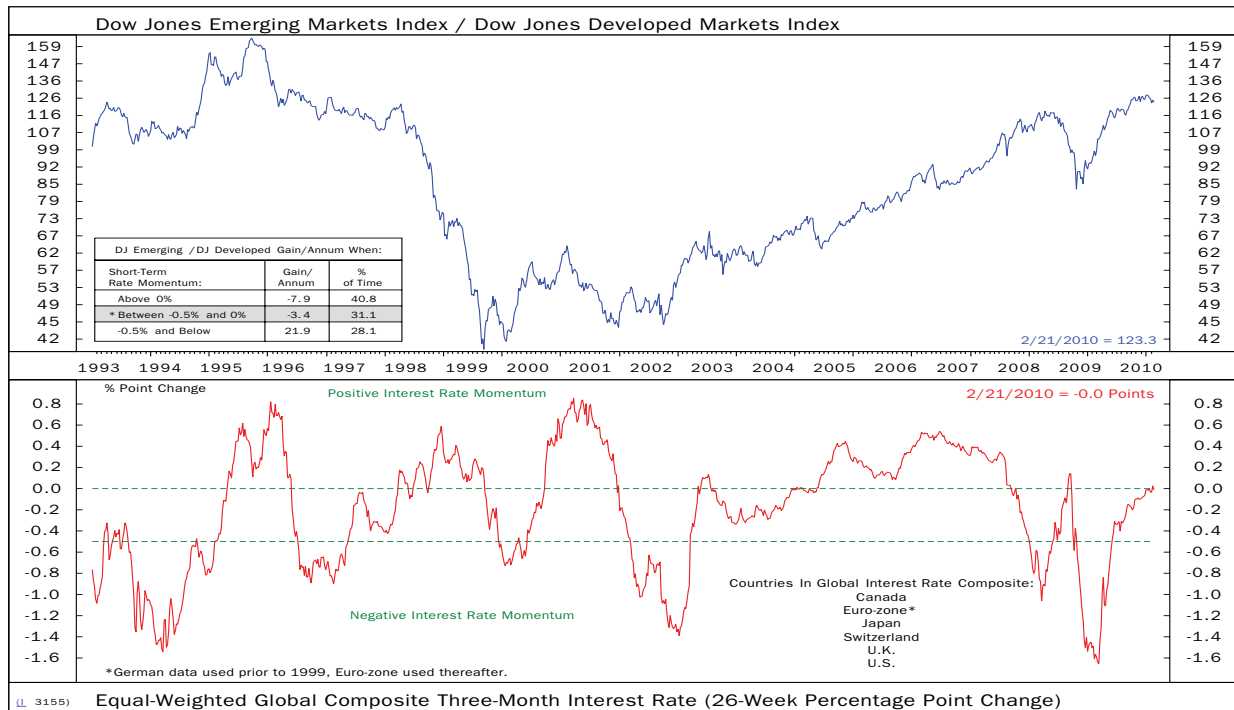
A renminbi revaluation would certainly ease the pressure

In an environment of rampant liquidity, high credit growth and mounting inflationary pressures in China, rumours of a pending yuan revaluation by the Chinese authorities have resurfaced. While the timing of such a move is unpredictable, the consequences are likely to be significant.

Theoretically, a stronger Chinese currency should lead to more balanced global growth: a weaker dollar would be positive for US exports while a stronger yuan would allow liquidity inflows to slow, ultimately calming the credit cycle and risks of asset price bubbles.

However, whilst this may prove encouraging for equity markets in the medium term, an increase in volatility and renewed downward pressures on share price cannot be ruled out in the short term – certainly emerging world equities have tended to materially underperform in (i) a tightening interest rate environment and (ii) periods of exchange rate volatility.

Chart 3: Emerging markets typically underperforms in a rising rate environment



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Source: Ned Davis, February 2010

Finally, we can expect other Asian currencies to follow in the footsteps of the Chinese renminbi, notably those with a solid external balance. This would lead to a loss of competitiveness in the region's exporters, potentially weighing on local equity markets. Conversely, this should boost not only US companies but also those from countries which have recently lost ground against China in terms of market share, namely frontier countries such as Mexico, Morocco, and even Vietnam – a bias toward frontier emerging markets and away from the 'BRICs' may also be appropriate.

Will the UK fall prey to 'second round effects'?

Since the end of last year, global financial markets have been hit by the second-round effect of the crisis: firstly Dubai's debt restructuring drama, then the Greek tragedy. Looking ahead, the markets will continue to focus on the most vulnerable – and most indebted – economies. While the euro periphery is set to remain under the spotlight, we believe that the UK is at risk of being tested in the run-up to the general elections, with the odds of a hung parliament potentially elevated. Gilt yields have pushed firmly

through the 4% level, now seeming unlikely to retrace their steps as they did previously in 2009. On each of the four occasions when the ten-year gilt hit the 4% yield area last year, it subsequently fell back following quantitative easing (QE) announcements. Now that QE has been suspended, however, the issue is what the true level of yields should be, without the Bank of England support. While we are starting to see value in some UK domestic assets, risks in housing, a still fragile banking system and unstable money markets leave still considerable UK event risk for H1 2010.

Earnings and capital expenditure

Almost 29% of the European main market has reported fourth quarter earnings, with net balance of positive less negative surprises of 19%; above the historical average of +16%. This broadly parallels the US earnings season; the fourth quarter has seen 73% of companies in the S&P 500 beat expectations, second only to the rate of 78.7% for the third quarter of last year. Earnings and revenue (ex-financials) grew by 13.8% and 3.6% respectively, exceeding expectations by 9.6% and 1.9%

correspondingly, which – amidst strong cost control – explains the strong cashflow seen globally.

Of particular note is the technology sector. Here, in the fourth quarter, earnings grew by 57% (against 24% expected) and revenues by 9.3%, with the handover from an inventory to a 'Capex' led recovery disproportionately benefitting this sector. The IT capex can be deferred for a while, the contract size can be reduced, and consultants can become partners in the savings produced by the capex, all of which have the effect of smoothing capex out across the cycle. This is not explicit, and in the case of Telco operators, some big software shifts from wire line management to mobile management are evident, which may prove to be a zero sum game or the beginning of a vast new upgrade cycle. In financial services, despite pent up demand, the resources are not yet available to replace large legacy systems with new architecture (while optimisation software relating to business information tools and the start of virtual desktops are the areas that particularly interest us).

The CEO's of our core equity holdings are increasingly confident...

Perhaps the best testimony to the corporate earnings opportunities we see in our portfolios comes from the management of the companies we own. Of Cisco's latest results (in our Strong get stronger theme) for example John Chambers stated:

"During the quarter we saw dramatic across the board acceleration and sequential improvement in our business in almost all areas...We are confident that our aggressive strategy of investing in the business during the downturn and our focus on innovation, operational excellence, and productivity are driving our momentum and growth in the market. We believe that we are extremely well-positioned – by geography, in our customer segments, and in our key product categories – as economies around the world continue to improve and our customers increase their technology investments."

Of Nissan's recent upgrade to 2010 estimates and last quarter results (held in our Corporate Restructuring Theme) CEO Carlos Ghosn stated;

"Additional sales volumes was driven by scrapping incentives in major markets, sales volume growth in China and the effective execution of countermeasures put in place following the global financial and economic crisis."

While of John Deere's extraordinary fourth quarter results (held in our Pricing Power theme) Samuel R.Allen, president and chief executive officer noted,

"We are clearly seeing benefit from efforts to win customers with advanced new products while taking cost and asset discipline to an even higher level."

It is the earnings, cashflow and ultimately dividend growth that such global companies can produce from diversified businesses across our thematic portfolios which remains at the heart of Sarasin's global investment strategy.

Investment Policy Implications

Strategy Outlook: The investment challenges of a two-speed world

We face a mixed and inconsistent investment picture. Undoubted positives (healthy and accelerating corporate earnings and revenues, declining volatility, attractive equity and 'risk asset' valuations) are confronted by headwinds in leading indicators rolling over, the gaining momentum of monetary tightening, the risk of longer-term interest rates rising, and European sovereign risk spreading. So, in these circumstances, how should we navigate portfolios?

1. We continue to back our 'Nifty Fifty' theme. Preconditions exist for a 'Nifty Fifty' renaissance, but this time on a global (rather than solely US) scale. The return, risk, cashflow and yield characteristics of a select range of large, well capitalized stocks, overlooked and derated over the past two years, now compare very favourably with AAA and AA bonds which, by contrast, have performed strongly and now look richly valued. This profile provides a measure of defensiveness and growth should there be a hiatus in activity. AAA bond holdings alone are larger than the US, European and Japanese stock markets combined so even a modest re-allocation of funds would have a significant impact.
2. We are cautious about emerging market equity, particularly in the case of China, due to risks of higher inflation and the impact of US tightening. In residual holdings, we favour domestic focused consumer, health, education and life insurance stocks. Longer term we see merit in emerging world equity and bond exposure, and will look for a significant correction to rebuild positions.

3. Until now, we have been happy to be exposed to beneficiaries of resource intensive growth in the emerging market, but tightening fears are now weighing on positive sentiment, especially toward energy and commodities. The threat of a supply response to higher prices, particularly in energy (shale gas, deep water drilling, nuclear, etc) heightens short-term risks. We therefore recommend reductions in commodity, energy and cyclical holdings.

4. A surge in inflation is not our central case, but we favour various assets/strategies to hedge against this risk. History demonstrates that dividend growth exceeds inflation in the medium term, and so we favour well capitalized equities with progressive yields. To guard against price rises driven by both structural factors (eg, demand for higher protein diets) and supply shock (eg, energy), we advocate commodity-linked investments; for instance, general funds, targeted ETFs (eg, platinum), and companies providing leveraged exposure (eg, E&P and gold mines). We also favour infrastructure companies with investments in road or port revenues linked to uplifts in Consumer Price Index (CPI).

5. Within fixed interest, now that spreads have narrowed we favour attractive sovereign opportunities at the expense of corporates. Attractive government markets comprise low indebtedness, strong primary surpluses, and income supported by resources and sustainable exports (eg, Norway, Canada and, in the emerging world, Brazil and Indonesia). We favour

currencies in these countries too. We dislike larger problem countries with high and expanding debt burdens, or those reliant on international financing. However, some problem countries that have already suffered sell-offs but for prudential reasons are taking bold and unpopular measures to reduce deficits and debt (eg, Ireland and Greece) now look attractive on valuations and may justify limited judicious buying.

6. High government bond issuance raises questions not just about investor appetite but, longer-term about the soundness of money itself. We still like gold as an independent

store of wealth and a hedge against bond yields backing up and/or a market or geopolitical shock.

7. We believe the US dollar's rally from oversold levels will gain traction as growth continues to surprise on the upside and expectations of an acceleration in monetary tightening increase. Despite the recent weakness relative to the US dollar, it is difficult to make a compelling buy case for either the euro or the yen. Both are heavily encumbered with debt and rates will likely be kept low to nurture economic recovery. We will look to trim positions further. We are also becoming more negative on

sterling which has similar indebtedness issues and likely fiscal policy paralysis ahead of the spring general election.

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