SARASIN
& PARTNERS

Strategy Outlook

Newsletter
No. 25 | October 2010

Editorial

While in the West the monetary fire hoses are again being readied in an attempt to counter renewed deflation risks, the opposing challenges in Asia remain continuing food, wage and asset price inflation. Without meaningful currency adjustments to reflect this (namely, developed world currencies weakening versus their Asian counterparts) a new period of 'hyper-convergence' may now beckon, seeing savings climb in the West, as consumers and governments accelerate debt reduction, with consumption continuing to boom in Asia, as emerging world asset prices rise and wage growth climbs. Rebalancing global growth in double-quick time is the hoped for outcome, but risks of asset bubbles and policy error always exist. Setting the right global investment strategy to reflect this, though, could be surprisingly rewarding…

Guy Monson
Chief Investment Officer and Managing Partner

Subitha Subramaniam
Chief Economist and Partner

Economic and Strategy Outlook

Preparing for Hyper-Convergence

The monetary fire hoses are readied in the West…

The global economic temperature is still warm enough to keep inflation and food prices above target in Asia and the emerging world, but uncertain enough to leave indebted Western policy makers desperate to keep any monetary anti-deflationary tools available if growth deteriorates significantly. In Japan's case, this was 'shock and awe' in the form of a rumoured 2 trillion yen (US$23 billion) of currency purchases on September 15th, aiming to halt the yen's rise above its 1995 high against the US dollar. Authorised by the newly confirmed prime minister, Naoto Kan, this was the first intervention since 2004, and – while unilateral action is not normally successful – the fact that Japanese economy has near zero rates, with semi-permanent deflation, policy makers do not need to 'sterilise' these vast foreign exchange purchases. Potentially, this means that intervention can continue in larger volumes, for far longer, in what is effectively a 'Quantitative Easing' (QE) programme by another name.

In pursuing this strategy of deliberate monetary reflation, Tokyo is of course in very good company. In the same week as the announcement of the yen intervention, the Swiss National Bank reminded investors that – with the Swiss currency near to all time highs –they too could reactivate their unilateral currency intervention. The language in the statement was clear:

> *"Economic recovery is not yet sustainable. Downside risks predominate. Should they materialise and result in a renewed threat of deflation, the SNB would take the measures necessary to ensure price stability."*
> *(Zurich, 16 September 2010).*

Note, however, that – in sharp contrast with the Japanese situation – the SNB warned of the long-term inflationary risks induced by its extra-loose monetary policy.

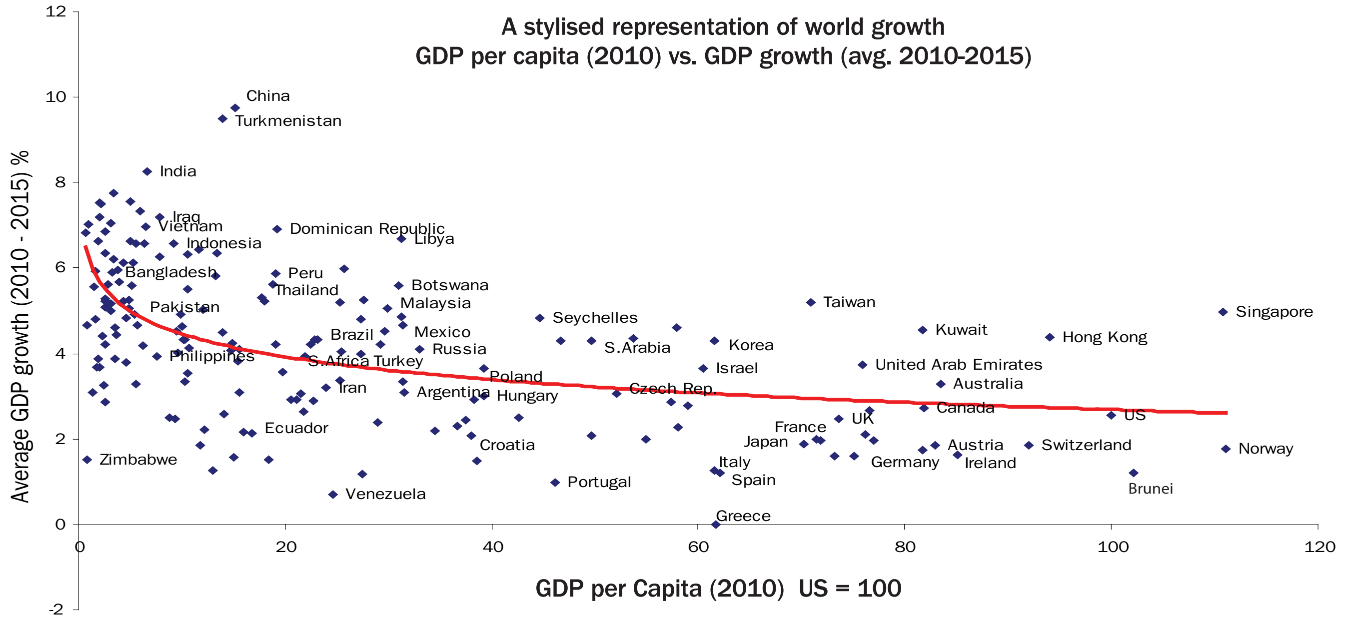
Rather than selling their own currency, the Bank of England's September policy minutes make clear a similarly determined intention – for some members – to be prepared to resume the purchase of government bonds in their own QE 'classic'. Their September minutes state:

> *"Most members thought that the current [monetary policy stance] remained appropriate. But risks were substantial, and these members stood ready to respond in either direction as the balance of risks evolved. For some of those members, the probability that further action would become necessary to stimulate the economy and keep inflation on track to hit the target in the medium term had increased."*
> *Source: Bank of England, September 9th 2010*

Meanwhile, of course, at the September 21st FOMC meeting, the Federal Reserve not only confirmed that it would continue to reinvest any principal payments from its securities holdings into longer-term treasuries but also announced that they stand ready to act, potentially through further bond-purchases, in what is being dubbed "QE II":

> *"The Committee will continue to monitor the economic outlook and financial developments and is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate."*
> *Source: FOMC, September 21st, 2010*

Chart 1: It's a two-speed world, built on the dynamics of economic convergence



Source: Sarasin & Partners, IMF and WEO April 2010.

While Asia and the emerging world maintain their reluctance to use currency appreciation to slow their own asset, food and wage inflation…

Of course these intra-G4 currency movements (and associated moves) are likely to be a zero sum game, with each currency competing against its neighbour in a 'competition of the ugliest.' However, imbalances between the G4 and the emerging world in particular will continue to be sizeable, as stubbornly undervalued dollar pegs across Asia, the Middle East and Latin America not only supply low dollar interest rates today, but also promise them in the future (an anaemic US recovery is expected to delay interest rate normalisation well into 2011/2012). There is certainly some political will to change, but it will be slow (mid-September saw Malaysia's Central Bank buy renminbi-denominated bonds for its reserves, as Beijing's attempts to internationalise the use of the Chinese currency advance), but in the short term even the abnormal 1.4% appreciation in the renminbi/dollar rate this month is probably too little, too late.

A positive interest rate shock for the emerging world

The result for Asia and much of the emerging world is a period of hyper-convergence, where naturally higher growth rates (due to favourable demographics, low intensity of capital and the ability to leapfrog technology generations) are magnified and propelled even higher by a powerful low interest rate shock. Essentially, negative or very low real interest rates lift naturally high growth rates even higher, creating a virtuous cycle of hyper growth and convergence.

Since the onset of the global recovery, many emerging markets are exhibiting hyper growth rates. Retail sales are typically increasing at a double digit pace, often as fast as 20%. The ultra low interest rates are also magnifying investment cycles with capital expenditure increasing by roughly 20% in key markets (see Chart 2).

In the world of hyper-convergence, 'intra-emerging' trade has emerged as a valuable buffer from the secular decline in G4 demand. There has been a big step up in China's exports to other emerging markets – a pattern widely seen across all emerging markets, where the intra-emerging market trade is becoming a new source of demand (see chart 3). Again in China, this year, net exports are expected to contribute negatively to GDP growth and we expect the economy to rebalance away from exports towards domestic demand driven by urbanisation and infrastructure investment. This trend is likely to be more and more prevalent across other emerging markets as well.

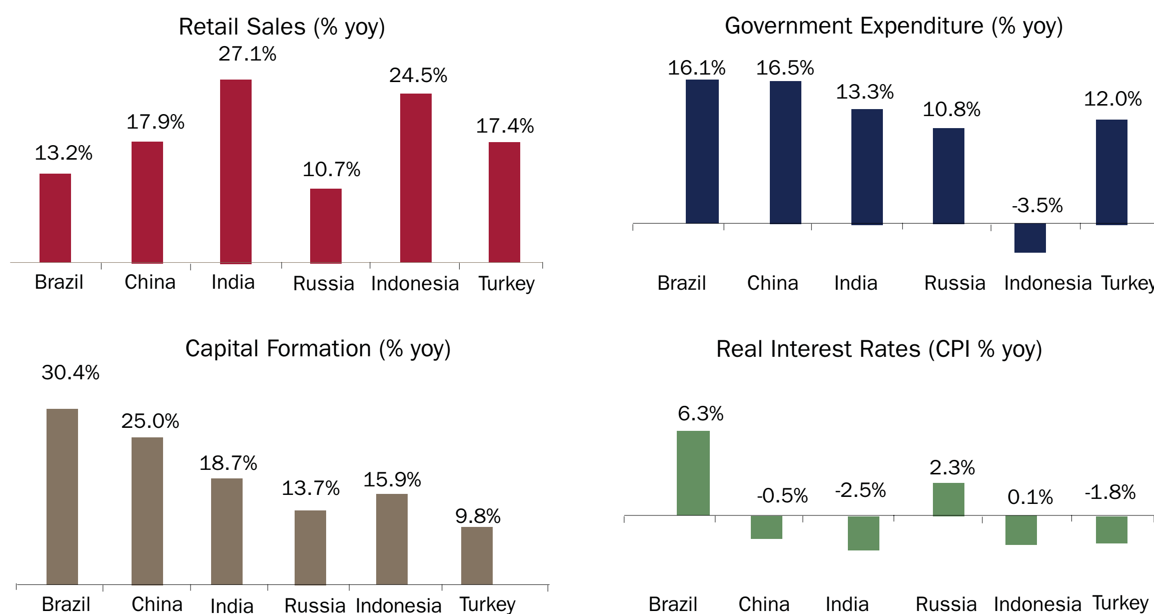
Hyper-convergence is not trouble free - it also brings with it growing pains in the form of unsustainable increases in asset prices, domestic wages and inflation. There are rebalancing mechanisms: emerging markets can allow their currencies to appreciate and arrest the speed of convergence. However, most policy makers appear addicted to cheap pegs and their accompanying gargantuan current account surpluses, so the most likely outcome is unsustainable, fast emerging world growth, accompanied by asset/price inflation. The lop-sided two-speed world economy of the past year is likely to become even more so in the months and years ahead.

This hyper-convergence trend is powerful enough to eclipse even the headline grabbing problems in the euro zone

Reflected in this light, even the recent problems within the euro zone seem less daunting – despite Irish spreads over bunds reaching record levels this week. Notwithstanding the severity of their problems, the smaller members of the periphery each represent just 1.5% and 3% of euro area GDP. Spain is, of course, a larger challenge (with GDP and bank assets representing about 15% of euro zone GDP), but the vehicle to manage any bailout – the European Financial Stability Facility – is now up and running, with its AAA rating confirmed.

Along with the IMF facility, total funds available are €750billion – enough to fund three years of borrowing needs for the periphery, including Spain. Set against this, the real issue for investors is that the weakness in the euro induced by the crisis has opened the door to super-normal export opportunities for the giant manufacturers not only of Germany, but also of France and Italy. In other words, a currency 'crisis' for low inflation, export driven economies may be a 'manageable' crisis after all, if emerging world demand continues to grow at super-normal rates.

Chart 2: But for the emerging world, US level interest rates are much too low for the fundamentals



Source: Datastream, August 2010

Corporate M&A also becomes an essential tool, not only in securing sources of raw materials, but also in winning control of intellectual property, technology, brands and distribution

Equity markets are finally responding to the ever more generous monetary conditions in both the developed and emerging worlds. Backed by consistently strong global earnings (the result of costs reductions in the US and Europe and booming export opportunities in the emerging world) investor sentiment and interest is starting to tentatively switch from bond to equity markets.

M&A activity is surging, with – for the first time – more acquisitions in the emerging world than those targeting Europe (China was the largest beneficiary, receiving $133bn of acquisitions). The ability of the Brazilian energy giant Petrobras to expand its share issue (already the world's largest) to more than US$35 billion (in addition to the US$42.5 billion issued to government for 5 billion of oil rights!) in September, supported by sovereign wealth fund interest, is just the latest example. Elsewhere, the news that Chinese state owned conglomerate Sinochem might consider ways of blocking BHP Billition's $39bn hostile bid for Potash-Corp shows how key strategic assets – wherever they are globally – are being bid up to secure the raw materials for emerging world growth. Korea's national oil company also launched the country's first cross-border hostile takeover to win control of UK oil company Dana Petroleum.

We do not see this policy reversing, and indeed find that Western valuations for much key intellectual property, strategic raw materials and established brands are at near multi-year lows. This suggests to us that core thematic equity holdings across emerging and Western markets will start to become strategic 'must-haves' for longer-term emerging market sovereign wealth funds and Western retirement funds.

So what does this mean for global strategy?

Investment Policy:

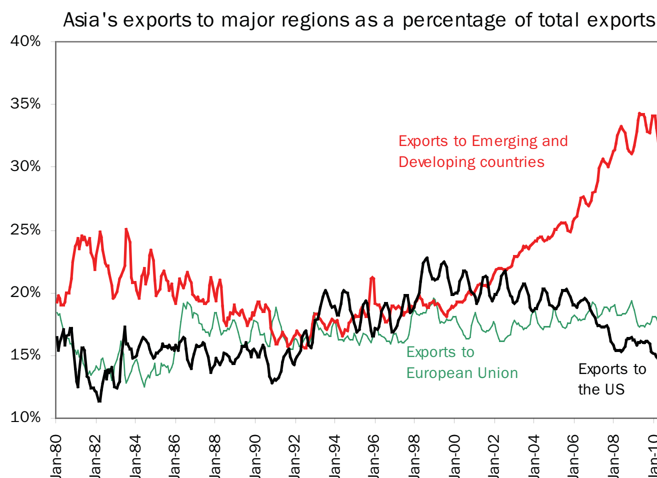
1. So powerful is the desire for reflation in the West, and the wish to manage currency in the emerging world, that we view rising global inflation as a bigger risk than Japanese style, multi-year deflation for the world economy. With this in mind, we are naturally cautious of today's super-low world bond yields as income producing assets, and would look to equity income, emerging world currencies with an ultimate backdrop of gold as preferable to developed world bond markets. While bonds provide very low income, their risk-diversification properties play a key role in a global portfolio context.

2. Ultimately, euro, US and Japanese competitive devaluations are a zero sum game, with the major crosses not far from fair value. The Japanese yen appears moderately overvalued, and – supported by unsterilised intervention (see above) – is likely to weaken. Sterling, by contrast, looks cheap and – barring a break down in credible coalition spending plans (due next month) – looks likely to strengthen. Our stronger conviction calls clearly relate to emerging world currencies, where we see further appreciation as inevitable. We continue to favour Western issuer and super-nationals issuing in emerging market currencies, and would advise Asian investors to hedge Western bond and equity portfolios back into home currencies where practicable.

3. In our last monthly strategy, we somewhat glibly advised investors to "be patient, sit back and enjoy the unusually strong cash flow and dividend growth of our cash rich 'Nifty Fifty' equity selection." That advice has broadly proved correct, with equity markets rising sharply over the month, with yields stocks (at last) delivering compelling out-performance of lower yielding government bonds. We expect this trend to continue, and still see global equity income as protected in a deflationary outcome by strong cashflow and cash-rich corporate balance sheets, and in the face of an inflationary outcome by strong dividend growth prospects, well in excess of likely inflation. This 'each-way' bet will increasingly be favoured by endowment, retirement and sovereign wealth investors.

4. Our thematic research team finds an environment of 'hyper-convergence' very fertile ground for our thematic opportunity sets, covering both emerging and developed market equity opportunities. The rise of the emerging consumer stretches from luxury goods (China and

Chart 3: Hyper-convergence is raising emerging market resilience against sustained weakness in the G4



China and India: Contribution to growth - projections (percentage points)

Source: Reuters EcoWin & IMF, WEO database, September 2010

Hong Kong are already the largest markets for luxury watches) to the massive emerging market for Indian hair care. The demand for base load electricity – with US per capita consumption still five times Chinese levels and 25 times Indian levels – offers opportunities in coal and power technology, while the massive growth in port handling and inter-Asian shipping trade means a boom for companies such as A P Moller MAersk, Cargotec and Boskalis: three global leaders interestingly all based within a couple of hundred miles of each other in Northern Europe. Similarly, a new age of rail beckons across East and West alike, and with it massive export opportunities for state of the art global rail manufacturers. Once again, industry and country borders are blurred, as procurement and production becomes truly global.

5. Spot gold touched US$1280, a record high for a fourth consecutive session, while silver has moved to within a few cents of a 30 year peak. We continue to hold our physical gold positions, despite the obvious speculative activity in the market – as evidenced by the explosion in ETF demand (up by 414% year on year to 30th June according to the World Gold Council) – because of the unique role precious metals continue to play as 'insurance policy' against an orderly currency realignment.

6. While we find it difficult to find compelling value in corporate bond markets today, the recent Basel III proposal is positive for banks' credit quality and valuations of existing subordinated debt securities. When implemented, these regulations should lead to better capitalised, better funded, less cyclical and more liquid institutions.

Existing subordinated bank paper (both T1 and T2) does not have the loss absorbing feature required by Basel III, and will not count in the future for capital purposes, and as such we believe these bonds should be called during the transition phase (amortising grandfathering period) at the first possible call date. Interesting opportunities for income and charity based investors lie across the spectrum of bank debt, as these regulations are finalised and interpreted.

Guy Monson
Chief Investment Officer and Managing Partner
Telephone +44 (0)20 7038 7000

Subitha Subramaniam
Chief Economist and Partner
Telephone +44 (0)20 7038 7061
subitha.subramaniam@sarasin.co.uk

Disclaimer
This document has been issued by Sarasin & Partners LLP which is authorised and regulated by the Financial Services Authority in the UK and passported under MiFID to provide investment services in the Republic of Ireland. It has been prepared solely for information purposes and is not a solicitation, or an offer to buy or sell any security. The information on which the document is based has been obtained from sources that we believe to be reliable, and in good faith, but we have not independently verified such information and no representation or warranty, express or implied, is made as to their accuracy. All expressions of opinion are subject to change without notice. Please note that the prices of shares and the income from them can fall as well as rise and you may not get back the amount originally invested. This can be as a result of market movements and also of variations in the exchange rates between currencies. Past performance is not a guide to future returns and may not be repeated. For your protection, telephone calls may be recorded. Sarasin & Partners LLP and/or any other member of the Bank Sarasin group accepts no liability or responsibility whatsoever for any consequential loss of any kind arising out of the use of this document or any part of its contents. The use of this document should not be regarded as a substitute for the exercise by the recipient of his or her own judgment. Sarasin & Partners LLP and/or any person connected with it may act upon or make use of the material referred to herein and/or any of the information upon which it is based, prior to publication of this document. If you are a private investor, you should not act or rely on this document but should contact your professional advisor.

Sarasin & Partners LLP
Juxon House
100 St. Paul's Churchyard
London EC4M 8BU
Tel +44 (0)20 7038 7000
Fax +44 (0)20 7038 6850
www.sarasin.co.uk

Sarasin & Partners Fund Operations
Tel: +44 (0) 20 7038 7002
Fax: +44 (0) 20 7038 6864
Email fundoperations@sarasin.co.uk

Marketing Enquiries
Tel: +44 (0)20 7038 7005
Fax: +44 (0)20 7038 6864
Email marketing@sarasin.co.uk