IPS View

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IPS View: The Horrible Business of Making Forecasts

It is the time of year when “investment professionals” feel the need to make their predictions for 2010. This year, more than ever, this feels like a particularly precarious activity. For example, a year ago it looked certain that the world economy was about to embark on a long, deep recession. UK residential housing markets looked particularly vulnerable. There had clearly been a bubble which had to burst, mortgage lending was more costly and far harder to obtain and unemployment was heading sharply up. Why buy a house now if it would be much cheaper in a year’s time? The futures market was pricing in a --15% fall for 2009 with around a total -40% peak to trough drop overall. Anyone who thought otherwise “didn’t get it” and should, at best, be completely ignored.

In fact, UK house prices have *risen* by +4.2% in 2009 for the year to November. We mention this just to emphasise that the world economy remains an uncertain place and prone to (possibly dramatic) change. Nearly all forecasters have got it horribly wrong at least once in the last 24 months: bulls (i.e. most people heavily invested in equities at the start of 2008) had an annus horribilus in 2008. Meanwhile, none of the bears, mostly triumphantly right in 2008, predicted the dramatic recovery that has taken place in both the markets and the world economy since the spring of 2009.

That said, our job as investors requires us to have a view on the risks and rewards on offer in various financial markets. With a deep breath we present here some of our higher conviction views for the start of the 2010. We do, however, remain more committed than ever to remain liquid in 2010 and to respond quickly if the facts and the investing environment change.

Before that however, we would like to take this opportunity to wish all our clients, introducers and friends a happy and prosperous 2010 and to thank you for your continued support of IPS Capital.

- **Bonds** - We do not like government bonds right now. The French (who have so far avoided the worst excesses of the crisis) have a joke which is that their banks only lend to those who do not need the money. Many governments – and not just Greece, but also Italy, Spain the UK and the US – fail this test today. Put simply: a 4% annual return to lend to the UK government for 10 years does not feel large enough to compensate for the potential downside risks involved, particularly when quantitative easing (a large source of demand for gilts) is due to end in 2010. Index-linked gilts, though inflation protected, are in some ways worse value: they offer a real yield of less than 1% for the next 10 years. We think there is better risk-adjusted value elsewhere.

- **Equities** are harder to call. Any asset up over 50% in 9 months needs to be handled with care and we would be cautious when adding significant exposure this late in a rally. Having said that, we do not see much in the near term that will de-rail the upward trend. In fact, one “risk” for 2010 is that growth is far sharper in developed markets than is currently being priced in. Historical relationships between the scale of the decline in GDP during a recession and its subsequent rebound show the recovery can be 2 to 3 times the size of the decline. Peak to trough GDP declines were -3.9% in the US, -5.2% in Euroland and -6.1% in the UK. If we get anything like the slingshot recoveries seen after previous recessions then growth will be

significantly above consensus in 2010. This, combined with a low rate environment, is likely to be very good for equities. Given the uncertainty over potential outcomes, we also like higher alpha, **trading based equity strategies** over the simple beta of owning the market.

- Why is this scenario a risk? For one thing it would mean our view that interest rates will stay low for a while yet will come under threat. Interesting recent research from Goldman Sachs suggests that using the Bank of England's own latest economic forecasts (i.e. before any slingshot type bounce as discussed above) UK interest rates might need to be at 4.5% by the end of 2011 (compared to the sub-2% rate currently priced in by the forward market). This would make the yield on most **Investment Grade** bond funds (which have seen dramatic inflows over recent months) of under 4% look pretty unattractive. This change in risk versus reward on Investment Grade has led us to trim our clients' exposure.

- We continue to like **Commercial Property**. As we have written in previous "IPS Views", it is hard to get excited by the fundamentals of the property market. Voids are still trending up and rents are likely to remain under pressure. However, the technical picture remains strong: money is flowing back into the sector and (for now) supply of properties remains limited. After a -40% peak to trough fall the risk/reward for the sector feels skewed to the upside, particularly for a naturally inflation protected asset. Interestingly, the UK IPD futures market is pricing in a +10% total return for investors for 2010. We give our clients exposure to this by buying selected open-ended commercial property unit trusts.

- **Private equity** is not a consideration for us currently, simply because the implicit illiquidity is difficult to pallet. For us, it is more important to remain flexible in fast changing markets than to lock money up for 5 or more years, however attractive the opportunity may seem today.

Chris Brown
Co- Chief Investment Officer
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The content of this email does not constitute investment advice and should not be relied on as such. Specific advice should be sought about your individual circumstances. We should remind you that the value of investments and the income from them can go down as well as up, and investors may not get back the full amount originally invested.

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