



This weekly Briefing Note aims to pick out some of the key financial and economic issues touched on in the press over recent days and from time to time includes the views of some of our independent fund managers.

Food for Thought

Global stock markets were given a much needed boost last week as news emerged of a hostile bid for Canada-based PotashCorp, the world's largest listed fertilizer producer, by BHP Billiton, the world's largest and most cash-rich mining company. However, BHP's \$39 billion offer was dismissed by PotashCorp as "grossly inadequate", thus setting the stage for a takeover battle which is likely to include China's Sinochem. In the interim, shareholders of Potash saw the price of their shares jump some 27% on the news, above the BHP offer, suggesting investors see a higher offer. BHP is making a big bet that agricultural fertilizer ingredients – including potash, nitrogen and phosphate – will rise in price as the developing world requires more meat and plants, according to **The Financial Times**. World potash consumption is growing again after falling during 2008–09 but at c\$300 per tonne, the price is well below the \$1,000 per tonne seen in early 2008.

As the world's developing economies grow, so too do standards of living as the growing middle classes eat more meat, which puts pressure on crops as the volume required to feed a cow is far greater than the amount needed for crop production related to human consumption. Greater demand, along with poor grain harvests in Russia, has pushed up prices: wheat is up 50% from a year ago and corn up 30% and this feeds through into food inflation. Last week, inflation in the eurozone accelerated to its quickest pace for 20 months, triggered by higher food and energy costs – consumer prices rose at an annual rate of 1.7%. However that compares favourably to Britain where the latest figures show that the UK has one of the highest inflation rates in Europe – whilst the Consumer Price Index fell to 3.1% last week, it is still significantly above the BoE's 2% target.

And the issue of increased future demand for food staples means governments are adopting new strategies. According to **The Times**, more than a dozen countries across East Asia are preparing to create a massive emergency rice reserve to protect the region's two billion people from environmental disaster and runaway inflation. Russia has already imposed a temporary ban on wheat exports. Against this backdrop investors are seeking out ways to capture this opportunity so it was no surprise that UK supermarket groups like J Sainsbury are benefitting from the food inflation story. More globally, the demand for soft and hard commodities is very much down to the growth of the emerging markets and, according to **The Sunday Telegraph's** experts, owning emerging market funds is a good way to participate in this opportunity.

M&A Mania?

BHP's bid for PotashCorp also threw the spotlight on other merger & acquisition activity – both real and rumoured. **The Sunday Times** attributed the recent increase in activity to John Maynard Keynes' so-called 'animal spirits', which he used to describe how emotion and confidence play a major part in shaping the economy. The paper opined that following the Great Recession, corporate leaders are once again putting their heads above the parapets and reviewing their strategies: they are also cash-rich, with many companies coming out of the downturn stronger than they went in following aggressive cost-cutting and balance sheet rebuilding.

In recent weeks there have been a number of bids announced. HSBC is close to a £7bn takeover of Nedbank of South Africa, Intel is buying MacAfee, Rank has just paid \$5bn for Pactiv and here in the UK, Royal & Sun Alliance has offered £5bn for part of its rival, Aviva. And there's more too. Shareholders in Cairn Oil are set to receive a cash payment after Cairn India sold a controlling stake to Vendanta Resources, whilst Korea's state oil company has gone hostile with a bid for North Sea oil explorer Dana. Add to the shopping list a possible bid for BG (the former British Gas) by Shell, the possibility of Campbell Soup swallowing part of United Biscuits and it's all washed down with a bid for Fosters by brewing giant SAB Miller. So whilst the economic backdrop may have faltered temporarily the slack has been taken up by renewed excitement in the boardrooms of some of the world's most respected corporations, which is good news for the equity markets.

Setting Sun

Investors took flight from equities back into government bonds last week as worries about the health of the US and Japanese economies resurfaced. Japan recently ceded its position as the world's second largest economy to China based on GDP, but its contribution to global growth remains significant so news that its economy had grown by a mere 0.4% last quarter – down from 4.4% – sent investors scurrying. With output shrinking so dramatically credence has been given to the possibility of a double-dip recession and so once again the yen – perhaps perversely – continued its seemingly inexorable rise, hurting its exporters. Against this backdrop the Japanese government has intensified pressure on the Bank of Japan to try to halt the rise

of the yen which threatens to derail economic recovery. “The cause [of the yen’s rise] is the difference in approach between the US Federal Reserve and the Bank of Japan,” said Japan’s minister Koichiro Genba. The US Fed announced more easing measures last week whilst the BoJ has made no changes to its monetary policy.

But the recent move by the Fed appeared to have back-fired in the short term with financial markets unnerved following a string of poor economic data – the latest being an unexpected rise in US jobless claims on Friday. A senior Federal Reserve official said last week that the negative reaction to the central bank’s move towards an easier monetary policy was “unwarranted” because the US economy was not in worse shape than investors thought before the decision. Either way, investors were unimpressed and maintained their preference for US, Japanese and German government bonds, the yields of which all touched major lows – record lows in the case of 10-year German Bunds – as prices rose to reflect increased demand. This left the equity markets to drift once more and seemingly following a pattern of rising early in the week only to fall back again. Most markets succumbed with indices falling around 1% despite the tonic of a spurt of M&A activity.

But it wasn’t all bad news. Global trade has recovered to 2008 levels, according to one of the world’s largest port operators DP World and Danish shipping operator Maersk, with both companies reporting improved earnings. As testimony to this UK manufacturers are planning their greatest hiring push for more than a decade, according to Bank of England research. The feedback from the BoE’s regional agents showed that there were widespread reports of businesses looking to export into new markets amid soggy demand in the eurozone. Elsewhere in the UK economy, retail sales continued to be buoyed by the warmer weather but, conversely, clouds are continuing to build in the property market with vendors cutting prices in order to sell their properties. According to Rightmove, the property website, there was a rush of new sellers in July but with a dearth of new buyers, prices were being cut.

A Contrarian View

Fund manager Andrew Green of GAM is well-known for his deeply contrarian approach to investment – preferring to avoid investment fashions and instead seek out low-valued companies that are deeply disliked by the markets but which are fundamentally good businesses looking for a recovery catalyst. The last ten years have not been particularly kind to equity investors but Andrew has a proven track record of out-performance over the longer term. He recently shared his views on the markets and how these affect his portfolio strategy.

“Current economic data is still mixed and suggests that recovery in developed economies remains weak and potentially at risk. How authorities in these areas respond to this, given their fiscal constraints and current monetary policy settings, remains a significant question for investors. With the risk of a policy mistake as high as it has ever been, sentiment is likely to remain nervous and markets febrile so the main challenge has been to keep out of trouble as equity markets whiplash to and fro.

With this in mind we raised the portfolio’s allocation to cash at the end of the second quarter – back up to around 18% – although the overall strategic positioning of the fund remained otherwise unchanged. The cash allocation weighed on the portfolio’s performance as the market rose in July, though its impact was partly offset by gains in our banks and insurance holdings. In particular, portfolio performance benefited from an announced bid for long-term holding SSL during the month – it was a good solution to realizing a 300% profit – and I have also taken gains of 160% from Spirent. In the US the pharmaceutical stocks have done well along with Sara Lee and El Paso. In the UK, banking stocks have done well and in the long term they will continue to recover as they remain a crucial component to financial stability and economic recovery.

Although Japan has significantly under-performed global markets my conviction that it is entering a period of out-performance remains robust – it has become totally loathed by investors which for me, as a contrarian, is positive and I am comfortable maintaining my 23% exposure to this area. Japanese bond yields are back to their lows of 2003 and with companies having so much cash on balance sheet it really only needs for the government to tilt the tax system in favour of payment of dividends for a renaissance in investor interest to begin. The strength of the yen is problematical and likely to be reversed so within the portfolio the exposure has been reduced via hedging. Our holdings have performed relatively well – they have beaten the Japanese market in each of the last five years – and I continue to concentrate on the IT, telecom and banking sectors.

Overall I am gradually moving away from small and medium cap stocks into larger companies where I see greater safety in the near term. People are obsessed with Emerging Markets and whilst undeniably we are seeing the West cede power to the East, it is a long-term story and in the short term those markets are very expensive in my view. So whilst I am very positive in terms of new ideas, the earnings outlook remains opaque and I anticipate using the elevated cash levels in the portfolio to take advantage of opportunities presented over the medium term by ongoing volatility in the equity markets.”

Andrew Green manages the St. James’s Place Recovery Fund and GAM Managed Funds.