

 Threadneedle thinks
Conference call highlights

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MANAGED FUNDS UPDATE – SEPTEMBER 2011

Slow growth backdrop

Recent data releases have confirmed that economic activity in the developed world is slowing. We have downgraded our forecasts for GDP growth over the past few months and now expect the US economy to grow by just 1.5% this year and next. Meanwhile, the UK is likely to be even more anaemic, growing by 1.25% this year and 1.0% in 2012, and the eurozone's expected growth rates of 1.8% and 1.1% are also lacklustre. These forecasts may prove too optimistic if the eurozone crisis deepens, but we expect that a solution to the crisis will ultimately be found. This solution may involve one or more of Europe's weaker economies defaulting or exiting the euro, but we believe that the bulk of the eurozone will hold together.

Emerging market strength

In contrast, emerging market economies remain robust and we are forecasting growth in excess of 4% in Brazil, Mexico, Russia and Turkey this year, with India and China likely to come in at 7.5% and 9% respectively. Overall, we expect the global economy to post modest growth over the coming year.

Inflation under control

Inflation in the UK has been stubbornly high over the past year but, with commodity prices now stable to weaker and significant spare capacity still present in the economy, we expect CPI to drift lower over the remainder of 2011 and into 2012. A similar picture is evident in the other developed economies and the muted inflationary backdrop will allow interest rates to be kept at their current historic lows over the medium term. However, the two-speed global economy is also evident in inflation terms: inflation is much higher in the emerging world, where commodity prices are a larger proportion of the CPI basket and wage growth is also a feature. This has led to monetary tightening in several emerging markets.

Gilt yields unappealing

Low growth, rising risk aversion and the minimal chance of interest rate increases have combined to drive gilt yields to historic lows. At these levels, the scope for further significant gains appears limited and we see little value in the asset class. We believe that investment grade, high yield and emerging market bonds offer better opportunities. Yields in all three of these categories imply far higher rates of default than we deem likely. As such, investors are being amply rewarded for the risks involved.

Equities are very attractively valued

The weakness seen in global stock markets over the summer has left equity valuations at very attractive levels. On a price to earnings basis, valuations are discounting a significant fall in corporate earnings. We would certainly agree that companies will find it harder to make money in the slower growth conditions we are forecasting over the next two years. However, we are not expecting earnings to collapse by the levels implied by current valuations.

Good dividend support

Meanwhile, companies have been generating healthy cash flows and we have seen a number of businesses increasing their dividends recently. This has led to a situation where the dividend yield on equities is significantly above the yield on a government bond in the UK, US and Europe. The last recession saw widespread dividend cuts but we do not expect this to be a feature in the coming months. Dividend cover – the number of times companies could afford to pay their dividends out of cash flows – is at levels that have been seen only a handful of times in the past 40 years. This means that companies have plenty of insulation against falling profits before they have to consider reducing their dividends.

Scope for M&A activity

Companies are currently able to raise money at interest rates that are substantially below the likely return on investment. Furthermore, cash held on balance sheets is earning meagre returns and management teams will be looking to boost their companies' growth potential given the muted economic background. With a wide range of quality businesses available on cheap valuations, growing by acquisition is likely to be a popular route. We expect M&A activity to be a feature across the sector spectrum, helping to realise the value that we see in equity markets.

Overweight equities

All of these factors, combined with the limited return potential from government bonds, lead us to maintain an overweight position in equities in our managed funds. We have trimmed the risk exposure of the funds in recent months, moderating our overweight in equities and lowering our positions in Asia and emerging markets to reflect the risk-averse market tone. However, we continue to prefer equities on a medium-term view and remain convinced of the long-term case for emerging markets.

Equity themes

Within our equity funds we are focusing on companies offering sustainable earnings growth against the slowing economic background. This may come through exposure to fast-growing markets in Asia, or from having niche products or access to a secular growth theme such as ageing populations. With interest rates and bond yields at such low levels, investors are increasingly turning to equities as a source of income, and companies with strong balance sheets are best placed to meet this challenge by offering healthy dividend growth. These companies will also be best-placed to conduct earnings-enhancing corporate activity.

Pricing power key

Although commodity prices have moderated recently, companies are still suffering higher input prices than was the case a year ago. The ability to pass these increases on to consumers will be a key differentiator in the coming months, so pricing power is another quality that we are seeking. Finally, we are finding lots of attractively valued opportunities among defensive sectors such as healthcare and consumer staples and we remain cautious about banks, where the eurozone crisis is likely to result in further recapitalisation.

Summary

The global economy is likely to grow modestly over the next year, with emerging markets leading the way. Equity markets have sold off significantly in recent months and now offer very attractive valuations. Although further volatility is likely, we continue to favour equities over bonds on a medium-term view. Within our equity portfolios we have adopted a more defensive approach lately and continue to focus on companies with strong balance sheets and pricing power. In the developed world, interest rates will be kept low but we see little value in government bonds: we prefer investment grade corporate, high yield and emerging market bonds within fixed income.

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