Canada Life™

Quarterly market update

Overview to June 2010

Global stock markets suffered large falls over the last three months and are now down year to date. The well publicised problems in Greece and the Eurozone and governments plans to cut spending are the main reasons why markets are nervous. More recently concerns over growth in China have added to investors worries. The overriding worry is could this cause global growth to stall and result in a 'double dip' recession for many countries.

In the UK the new coalition government's emergency budget has been well received by investors, although the cuts will make it difficult to achieve growth in the economy. The stock market has fallen alongside other global markets. Gilts have been the main beneficiary of the budget and concerns over the Eurozone and global growth. The commercial property market is beginning to slow down, but offers a decent income from rents.

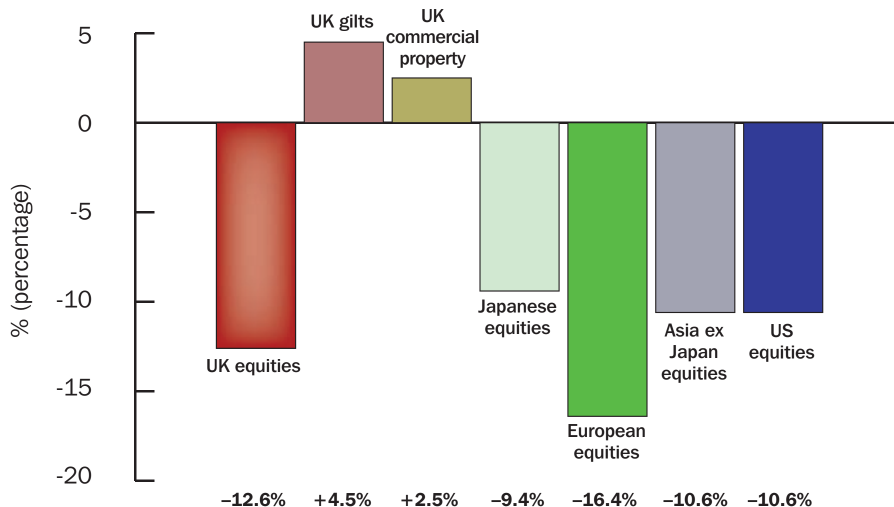
In Europe sovereign debt is a major concern. While governments remain focused on cutting spending, the prospects for improvement in the economy remain limited.

The US continues to enjoy economic recovery. However, we have some real concerns about unemployment and the housing market. Without job creation and a decent housing market the recovery may not be sustainable.

In Asia the main story is the Chinese authority's attempts to slow the economy, which is causing concerns for short term growth in the region.

The local economy in Japan continues to recover. However Japan is very dependent on exports and concerns over the global economy have led to falls in the stock market.

World markets – three months to 30 June 2010



See note 1 for explanation of indices. All returns converted into sterling.

Source of figures: Lipper Hindsight

UK Equity Market

Monetary policy looks set to remain relaxed for some time yet, and equities could easily go higher in the short term

The coalition government has started to deliver the necessary measures to bring government deficits back into balance. International confidence in the UK is increasing. This means that the country's debt should no longer be downgraded and thus interest repayments should remain manageable.

There is little doubt that the economic recovery will moderate further. Forecasts for growth are being cut. We will probably continue with a jobless recovery for the next few years. Interest rates are likely to remain low despite a temporary pickup in inflation.

We continue to see some valuation support for equities. Based on companies forecast earnings the value of shares is below the long term average. Equities also look cheap compared to fixed interest securities.

Despite a weakening economic outlook companies continue to enjoy earnings upgrades in the region of 40%. This is helped by the international earnings of UK companies and the fall in the value of the pound. UK companies have on average only 27.8% exposure to the UK economy.

We remain cautious on the market as the international government debt crisis has not yet been resolved and we are concerned about global growth. However many leading economic indicators remain fair, and investors are well aware of the problems. Monetary policy looks set to remain relaxed for some time yet, and equities could easily go higher in the short term.

UK Fixed Interest

The coalition government's action to reduce the budget deficit is making gilts look more attractive to international investors

The UK economy is recovering slowly, but low growth, low inflation, and low interest rates will be the norm for some time.

Three factors are particularly worth noting. First, inflation is higher than wage growth. This has been squeezing people's spending even before the measures announced in the emergency budget.

Second, Western economies are facing intense competition from Asia. This means the road out of recession will be tougher than in the early 1990's.

Third, in the high spending countries (US, UK, Club Med) consumers are looking to pay off debt, and governments are looking to cut spending. At the same time, countries with big trade surpluses are looking to resume export led growth rather than encourage domestic spending. This could become very deflationary.

The Monetary Policy Committee (MPC) continues to balance the weak economy against the big budget deficit and higher than expected inflation. However their priority continues to be economic recovery, and with only weak growth expected in 2010, interest rates are likely to be kept at 0.5% throughout the year.

The coalition government's action to reduce the budget deficit is making gilts look more attractive to international investors. The threat to the UK's AAA credit rating has also receded. However on the international scene interest rates are starting to creep up as growth recovers. So the likely outcome is for gilts to hold their present levels, while rates rise elsewhere.

UK Commercial Property

Expectations are for a slowdown in the second half of 2010

The current UK All Property Yield (IPD Monthly Index) is 6.57%. This compares to other UK investment sectors where it is difficult to find a 5% yield. As economic growth remains choppy and interest rates stay low, property provides a relatively less volatile income stream.

After seeing capital growth of 5.3% in the year to date (end May 2010), expectations are for a slowdown in the second half of 2010. Demand has been subdued. The only area it has been pronounced is for office space in Central London, particularly the City. It is here where developers and property companies are starting on site, with estimated completion dates two to three years from now. Development in other locations and sectors is mainly demand led where there is already an agreement with the potential occupier.

The UK real estate market still has its allure for the international investor in terms of its transparency and liquidity, but other European countries are beginning to look cheaper. However, it is unlikely that there would be a mass exodus from the UK market.

The investment market is seeing less activity as the market digests the new coalition government and the impact of the budget on the UK economy.

Note: Source of figures is the Investment Property Databank (IPD) monthly statistics.
The yield is a measure of the current rent from a property over the value.

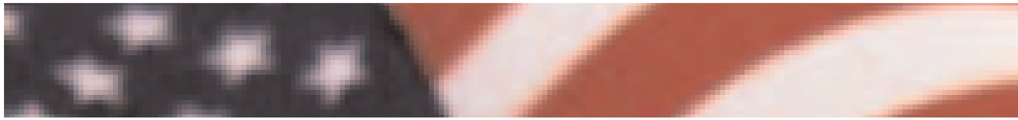
Europe

The big question is can the fragile recovery remain in place while governments slash spending plans to reduce debt?

Governments' debt is now a major concern. Certainly the phase of government action to stimulate growth in economies has ended. Interest rates in Europe may not yet be on the rise, but government spending is being cut. The implications for economic growth are negative. Now the big question is can the fragile recovery remain in place, while governments slash spending plans to reduce debt?

For some the problems are very real and if this spills over into more economies there is increased risk of a further downturn in economic activity. The European debt crisis has provided an excuse for the market to rotate away from companies benefiting from the recovery and back into companies with solid long term growth prospects, that had been left behind in the sharp stock market rally. Likewise, we have seen a big sell off in Greek, Spanish and Italian companies, and strong returns in Germany, Sweden and Denmark.

Economic growth in Europe remains well below that of other areas in the world. While governments remain focused on cutting spending, the prospects for further improvements in the economy remain limited. Whilst the valuation of the European stock market compares well with other global markets, it is not compelling and prospects for the Euro remain negative.



United States

This could just be a short pause in growth and therefore an opportunity to buy markets

In the US most indicators are reflecting a decent economic recovery. This is most obvious in manufacturing where industrial production is strong. On the flipside there are still real concerns in respect of employment and housing. With the removal of government benefits the property market is turning sharply lower. Despite being several quarters into recovery there is little evidence of new jobs being created. The unemployment rate is stubbornly high at 9.7% (17% when those forced into part-time or lower paid work are included). Improvement is needed before we can see a self sustaining recovery.

The US stock market has been rather bumpy. Despite a good start to the year, buoyed by very strong corporate earnings and decent macroeconomics, concerns over growth have taken hold. The stock market has fallen 13.7% from its 2010 high at the time of writing.

This brings us to the most important question. If the economy is going to slip back into recession then the market may well get much worse. But equally, this could just be a short pause in growth and therefore an opportunity to buy markets. We believe the economy is in a period of short shallow cycles and this seems to be exactly what we are getting. In the short term we are positive on markets, but further out we still have deep concerns about the durability of recovery and also for the stock market outlook.

Asia ex Japan

We consider Asian markets to be cheap based on forecast earnings of companies. However the fallout from Europe's problems could have a negative impact on the region

Asian economies grew strongly during the first quarter of 2010, led by growth in exports and local consumers spending more. Inflationary pressure has started to build up in the region. A number of countries have taken action to normalise their respective monetary policies, replacing policies designed to generate growth.

China remains the focus of attention. The administrative measures to control the property market and bank lending have led to a slowdown in economic activity. While property transactions have fallen dramatically, the average selling price is yet to correct. Inflationary pressure is building up, due to food prices and wage growth.

The European Union (EU) crisis is a risk to the region. The EU accounts for 25% of China's exports. The EURO has fallen 18% against the Chinese currency (Renminbi). This could mean weaker exports from China in the future. However there is no indication that the Chinese authorities will change their policy of slowing growth, as property prices have yet to correct and inflation is still above its target of 3%.

China announced it would reform the Renminbi exchange rate regime by assuming an official daily trading band of +/-0.5% against the US$. There will be no one-off revaluation, but over time this could lead to the currency strengthening against the US$ and make exports more expensive. This is something the US had been pressing for.

We consider Asian markets to be cheap based on forecast earnings of companies. However, the fallout from Europe's problems could have a negative impact on the region.

Japan

We are becoming more cautious on the Japanese stock market for the coming year

Japan's economy continues to recover. It has now recorded four successive quarters of growth. Corporate earnings are also rising strongly and the government continues to add new stimulus measures to support the economy. For example a new child allowance is paid to families with children.

Under these conditions we should expect a strong stock market. However recently this has not been the case. Concerns regarding the health of the global economy have been a drag on the market. In Europe many countries are raising taxes and cutting spending to lower their national debt.

In China the government has been taking action to slow growth. Since Japan's economy is dependent on exports, concerns about the global economy have led to falls in the Japanese market over recent months.

We feel that the Japanese market is not expensive compared to its historic valuations and believe that it can rise over a long term horizon. However we accept that global economic conditions can have a major impact on the Japanese economy and stock market. Given the uncertainty over prospects for the global economy, we are becoming more cautious on the Japanese stock market for the coming year.

Notes

1. *The indices used for the returns on the bar chart are as follows;*

UK Equities – FTSE All Share capital return

UK Gilts – A British Government All Stocks total return

UK Commercial Property – ABI Direct Property Pension Fund Index

Japanese Equities – Nikkei capital return

European Equities – FTSE Europe ex UK capital return in GBP

Asia ex Japan equities – FTSE Asia Pacific ex Japan capital return in GBP

U.S. Equities – S&P 500 capital return

Past performance is not a guide to the future. The value of your investments can fall as well as rise. Currency fluctuations can also affect performance.

The above summarises the views of the Canada Life Investment Team at the time of publication. The views expressed are subject to change at any time without notice and should not be taken to constitute a recommendation for investment in any area or product.

Canada Life

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