Canada Life™

Quarterly market update

Overview to September 2010

Stock markets had a strong third quarter, making up for the weakness in the second

The UK, Asia Pacific (excluding Japan), Europe and the US were all positive. Bonds and property remained positive, though not to the same extent as in the second quarter.

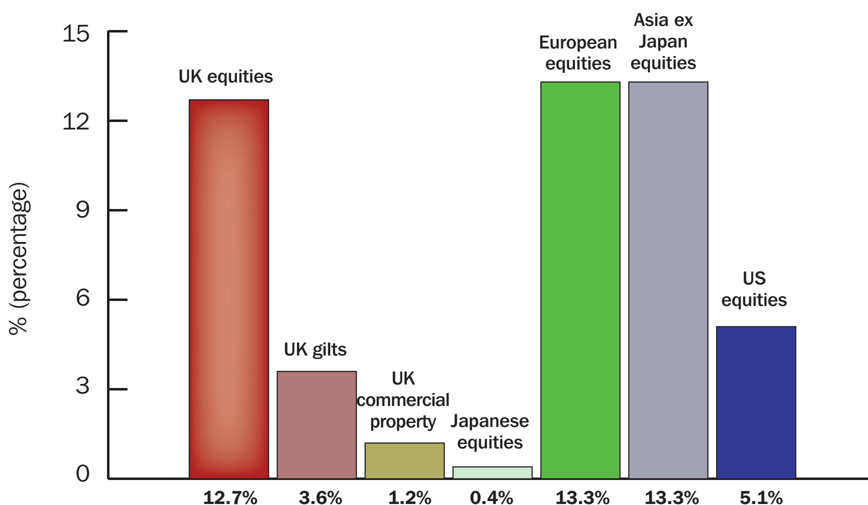
The UK economy appears on the road to recovery, though still at a slow pace. Output is rising and unemployment falling. Low interest rates and a surplus of corporate cash are encouraging an increasing trend of mergers and acquisitions. Headline inflation is still high, though, and it is not clear whether the government's planned cuts will be sufficient, or what will be the impact on the economy.

Germany and the Nordic region are recovering well, driven on export demand. However, new corporate investment is going to emerging markets rather than into domestic economies. The effect of public spending cuts in Ireland and southern Europe is likely to be severe.

Recovery in the US is especially slow, despite record-low interest rates and the ongoing effects of government stimulus. It is likely the central bank, the Federal Reserve, will return to quantitative easing – essentially pushing money into the economy – following Congressional elections in November.

Asian markets have grown quickly this year, though we expect a slower pace in the coming period. The Chinese property market appears to have cooled, while currency reform is likely to benefit Hong Kong. However, it is in south east Asian markets, such as Indonesia and Malaysia, where positive growth is likely to surprise. In Japan, recovery is held back by the strength of the currency, political uncertainty and continued deflation.

World markets – three months to 30 September 2010



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

Source of figures: Lipper Hindsight

UK Equity Market

Relative to expected company profits, the price of equities remains reasonable

It is unclear whether the government austerity measures will be large enough to address the deficit and that there will need to be further cost-cutting. The impact of spending cuts, higher tax and increased savings is also uncertain.

Inflation in the UK has been high relative to the US and developed Europe and will probably stay high into 2011 due to one-off effects. We continue to believe the base rate will remain low for some time.

Within the market, cyclical sectors such as engineers, chemical producers and the life insurance industry were big gainers in the third quarter. Aerospace & defence was hit by worries over government spending. Pressure on profits damaged food producers as purse-watching consumers and rising prices hurt profitability from both sides.

An agreement on less stringent financial regulations helped the banks.

Very low interest rates have encouraged bid activity across a range of sectors. This could continue to be a driver of markets.

Fears of a re-eruption of the European sovereign credit crisis, evident in the cost of borrowing, have been fuelled by news of additional bank support in Ireland.

The yield on equities is undoubtedly attractive. Bond investors are pricing in a low growth and low inflation outlook, while equity investors seem to be pricing in a slightly better outlook.

UK Fixed Interest

The overall background is neither boom nor collapse, but slow reconstruction

The UK economy is seeing a broad based recovery after the big contraction of the last two years. Recent data has shown strength in industrial output and unemployment falling. This points to a reasonably good year in 2011, with potential to surprise on the upside.

Recovery will be slow. The factors that fuelled the economic boom – easy finance, government spending, strong global background – are no longer present.

Manufacturing production in July was up 4.9% on a year earlier, and GDP rose 1.2% in the second quarter – equivalent to 5% per annum. Survey data for manufacturing, services and consumer confidence all point to a quietly positive underlying picture. Unemployment has been showing small falls, another sign of business confidence and helpful for consumer confidence.

On the negative side, inflation continues to outstrip wage rises. In the year to July average earnings were up 1.9%, while the Retail Price Index (RPI) rose to 4.8%. Falling real incomes continue to hold back people's readiness to spend, but are part of the adjustment mechanism to make the UK more competitive.

The coalition government has been well received by the financial markets, because they are viewed as having a strong mandate to push through cuts in the budget deficit. However, much of the story so far has been talk about cuts, with the action due in 2011. If the coalition fails to hold together, or the deficit does not fall as expected, there could be a loss in confidence in UK assets.

The price of gilts is expected to slowly fall in this environment.

UK Commercial Property

Recovery continues, but remains uneven

Growth in capital values has continued to slow since April, with August seeing only a 0.1% rise. At the moment, the south of England is showing more positive signs of economic growth and occupier demand is consequently better.

The initial yield* for all types of commercial property is currently 6.45%, which compares favourably with the return on both gilts and UK equities. Prime buildings with good lettings remain attractive while secondary properties continue to suffer.

The property investment market remains active, seeing £7.4bn transacted in the third quarter, just slightly more than the £7.1bn seen in the second quarter. UK institutions continued to be net investors while some overseas investors saw a net withdrawal.

New development continues to be subdued as it is difficult to raise finance and there is oversupply of property in some areas. The overall vacancy rate has reduced as some properties are let and others are demolished to avoid paying rates or to prepare for future development.

*The yield is a year's rent as a percentage of the property's value.

Europe

Moderate market valuations, solid corporate earnings growth

European governments have been forced to focus on reducing spending plans in order to reign in budget deficits. The strain has been felt in bond markets, with weakness in peripheral economies such as Greece and Portugal, contrasting with strength in Germany and Nordic countries.

Monetary authorities have been active, first with a stress test across the banking sector and then with a new regulatory framework to ensure the system is adequately funded.

Companies have continued to deliver a strong recovery in earnings, offering the prospect of continued growth as they begin to re-invest their profits into new opportunities. Many are rapidly expanding in emerging markets. But there are no plans to expand domestic activities and there is little sign of a let up in the high number of job losses generated by the financial crisis. With plans to reduce public sector jobs, it remains difficult to see European economies rebounding.

Doubt about the sustainability of global economic growth has forced equity markets to give back some of their earlier gains, and for a year, the market has been trading nervously within a narrow range, failing either to sell off sharply or break free on the upside.

The impressive performance of Germany, Europe's largest economy, provides some comfort that the outlook can improve.

United States

Housing and employment remain weak points in a slow recovery

The economy could best be described as being in a sub-par expansion with many indicators much lower than would ordinarily be expected this far into recovery. This is despite interest rates being at record lows and the economy still benefiting from fiscal stimulus.

The two most obvious issues remain housing and employment. The government targeted housing with tax breaks, but as soon as the benefit was taken away the market quickly dipped again. Employment is a bigger concern. There is still little or no new hiring.

In the industrial area of the economy, surveys of manufacturing conditions continue to be above the boom bust line of 50, suggesting a better time ahead.

The Federal Reserve has backed away from quantitative easing – essentially putting money into the economy – in recent months. However, whilst highly unlikely before the November Congressional elections, we see this policy restarting, possibly as soon as December.

In just the same manner as the short shallow cycles in the economy, the equity market is essentially range trading. Year to date the S&P500 Index is barely changed with a gain of just 0.94% – but it has been up as much as 9.2% and down as much as 8.3%.

Despite the lifeless, low volume markets there has been a strong theme of mergers and acquisitions in the network security and software space suggesting that despite small aggregate returns for the index overall there is plenty of action underneath. This could easily continue into a Nifty Fifty type market where narrow leadership can persist for some time.

Asia ex Japan

Investor sentiment for the region is likely to remain upbeat into the year end

While most economies in the Far East continued to grow strongly in the second quarter of this year, it is clear that they have reached their peaks. Marginally slower growth is expected for fourth quarter.

In China, indicators continue to point to a slowdown, though a soft landing is expected. Trade data is still robust. Export growth of above 30% is expected to slow sharply on the back of weaker demand from the US and Europe.

The central government's control of the property sector in China is still the most debated issue. Three months after the government adopted a series of stringent measures to cool housing prices, the market is expecting the government to ease the policy as it has become a threat to economic growth.

The Chinese government has undertaken an extensive renminbi reform which would lead to the ultimate convertibility of the Chinese currency. Numerous measures have been announced, with Hong Kong the natural beneficiary as the offshore renminbi centre.

The robust fundamentals of the south east Asian economies and their markets are getting a lot of attention. Singapore is maintaining an accommodative policy. In Malaysia, the consumer story is very strong, as indicated by underlying loan growth. A similar story is seen in Indonesia, with car sales and motorcycle sales hitting record highs. The worst of the political stalemate in Thailand is over and confidence is picking up.

Share prices in the region average about 11.5 times the earnings expected for next year, which we feel is not expensive.

Japan

Market sentiment is currently weak and valuations are low

Japanese equities moved slightly lower in the third quarter of the year due to concerns over fading economic growth and political uncertainty.

Equities were also hurt by Japan's appreciating currency. The yen, which has been seen over recent years as a 'safe haven' currency, appreciated to a near record high in September due to concerns about a slowdown in global economic conditions. This has been a headwind for Japanese markets.

Under these conditions we could see a rally in equities. Some market participants believe that the recent currency intervention is that catalyst.

We are cautious as we feel that intervention by Japan's government alone cannot stem the rise of the yen over the longer term. Should the global economy slow the yen could once again be seen as a safe haven currency and it could appreciate. However if the global economy turns positive then the yen could weaken further and concerns over a slowdown in Japan's economy could dissipate. In this instance we feel that Japanese equities would move higher.

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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