

RLAM market view

Recent events are bound to impact an already fragile economic situation in the UK and will hit global growth in the second half of the year. We remain hopeful, although somewhat sceptical, that central banks and politicians can respond in an appropriate manner. The emerging bloc accounts for half the global economy and any policy response to recent events must include these countries, albeit that dealing with government debt levels in the developed world remains at the heart of the problem. In the short term the situation is bound to remain volatile, although looking further out, our experience in markets suggest that it is the relative valuations of assets that count in the long run, and we are long term investors. We also note that, in contrast to 2008, money markets remain under no great stress, while strong corporate balance sheets underpin dividends. We have a preference for equities over government debt in our asset allocation strategy.

Equity markets are very cheap, assuming the economy continues to 'muddle through' and not enter a double-dip recession. Schiller P/Es (which use 10 year average earnings, rather than current earnings that are possibly at the top of the cycle) suggest that global equity markets generally look fair value to cheap. On this measure they have yet to fall to the extremely cheap levels seen in 2008, although this time around companies are in a much better position financially to withstand a slowdown in demand, given that they have stronger balance sheets and have generally already lowered their cost bases. The dividend yield on the FTSE 100 has risen to 4% following this year's dividend increases and the fall in equity prices, therefore equities are yielding significantly more than bonds for the first time in 40 years, other than for a short period in 2008 when dividends were about to be cut.

Within bond markets, government debt remains fully valued at current levels, having already priced in a very weak economic scenario. The gilt market is especially vulnerable, given likely downgrades to economic growth and the knock-on effect on fiscal consolidation plans. Recent civil unrest has additionally made the political situation quite delicate. In contrast, the corporate sector is in a much stronger position financially and we therefore retain our preference for corporate over government credit.

In summary, the likelihood is that recent events will cause a weaker economic outlook than we were anticipating, given the likely impact upon corporate and consumer confidence. This has not been helped by the relatively disappointing response of policymakers in both the EU and US to growing financial market concerns. It should be increasingly apparent that the deterioration in market confidence requires far more meaningful policy measures in order to restore medium term confidence and hence financial market stability and appreciation. It is our view that recent events will prompt such measures and therefore that we shall see improvement in confidence and resumed upside. Current valuations give opportunities for wealth appreciation, but the path is unlikely to be smooth until policy can help restore confidence.

Source: rlam as at 10 August 2011 unless otherwise stated.

This article is for professional customers only. The views expressed are the author's own and do not constitute investment advice.

rlam is a marketing brand including the following companies: Royal London Asset Management Limited registered in England & Wales number 2244297; Financial Services Authority (FSA) register number 141665. Royal London Pooled Pensions Company Limited registered in Scotland number SC048729; FSA register number 110456. Royal London Unit Trust Managers Limited registered in England & Wales number 2372439; FSA register number 144037. Royal London Cash Management Limited registered in England & Wales number 19632; FSA register number 121844. All of the above are authorised and regulated by the Financial Services Authority. It also includes Royal London Asset Management Bond Funds Plc registered in Ireland number 364259 and regulated by the Central Bank of Ireland. All these companies are subsidiaries of The Royal London Mutual Insurance Society Limited registered in England and Wales number 0099064 (FSA registration number 117672). Head office: 55 Gracechurch Street, London EC3V 0RL. Our ref: 319-PRO-08/2011-CC