

### IPS View: Betting on the St Leger

The old City adage of "sell in May and go away; don't come back till St Leger Day" has been particularly true so far this year. Since the end of April the FTSE 100 has lost -7.4% to date. Many bonds – the traditional safe harbour alternative – have gained over 8%. Now that the summer break is over (at least for those of us with children) we thought we would give our view on what happened over the last few months and ask the question whether St Leger Day (September 11th this year) will be the right day to get back into the equity market.

We think three debates have dominated the market over this period:

- 1. Sovereign Debt Risk: will Greece, Spain (and the rest) default?** This concern led the May sell-off. It has also, for now, become less of a market concern. First, Germany stepped in with a comprehensive bail-out fund that addressed the short term liquidity worries. Then the bank stress test results came out. Though we question how severe these stress tests were, they did give investors enough information to calculate their own downside scenarios. When the market ran its own numbers they did not, on the face of it, look that bad. Finally Germany – one third of the eurozone – came out with its own blockbuster second quarter GDP number of +2.2% (for the quarter). Leading indicators for Germany also continue to look strong. In the space of a few months Europe went from being the world's laggard to a leader. This would have been enough to drive markets higher had it not been for the second question that began to form in investors' minds.
- 2. Are we heading for a double dip?** Just as Europe began to perform better, the US got worse. Investors were looking for a solid follow-through from the 2009 recovery. In fact, the picture emerged of a slowing consumer focussed on repaying debt and no recovery in the housing market (unlike, interestingly, the situation in the UK). If you add to the fact that the government is starting to cut spending rather than provide stimulus you have a fairly negative outlook for what amounts to 85% of the US economy. The risk is that, as in 2008, a slowing US drags the rest of the world with it. Also, China may not be the help it was back then: Chinese authorities are looking to cool down the bubbly property market and there is always the danger this results in a harder than expected landing.
- 3. Are bonds in a bubble?** Or, are they, as in 2008, just ahead of the game? While we wrote at the beginning of the year that we expected volatility in the equity market, what we did not

expect was the bull market in bonds to continue quite so dramatically. The yield on the US 10 year has come in from nearly 4% in early April to 2.5% today. This is a significant move. It is hard to argue that the world has changed dramatically over the last five months. Is the bond market trying to tell us something (bad) is coming?

Now for our view on these issues and how we are positioned. First, a comment on our style. We are wary of putting all our clients' money on a single house view (e.g. inflation is coming, buy equities). The risk of course is that we are wrong and take a large loss because of it. We prefer to be as balanced and diversified as we can. This is particularly true in a year like 2010 when having conviction about where markets and economies are heading next has been tough and – as with Germany and the US – prone to change very quickly.

That said, in order to make money we need to have views and for our outlook to be right more often than not. On the latter of the two issues we are relatively bullish. We think the risks of a double dip are low – particularly if you have a global rather than a US only outlook. We would also rather own the FTSE 100 with a 3.6% dividend yield which would potentially rise in line with inflation than a 10 year gilt which yields 2.9% and which definitely won't. For those reasons we think there is value in equities in the medium term, though we remain wary of continued short term negative market sentiment. We also like corporate credit as the balance sheets of higher quality companies remain in very good shape. We don't think there is a bubble in government bonds – particularly with no inflation visible in the near term – but we don't think there is much value there either after the recent rally. For now, we are happy to leave alone.

Where we are less bullish is on the first issue, sovereign risk. It still seems likely to us that Greece will ultimately default and, more generally, that markets will be prone to periodic scares about heavily indebted countries. For that reason, we remain prepared for choppy markets to continue in the near term. We are therefore maintaining our exposure to trading funds that, we hope can navigate ups and downs rather than simply hoping for ups.

We will let others place their bets on St Leger Day. For now we are happy with our relatively cautious stance. We will wait to see how the economic outlook develops before making any significant changes to portfolio positions.

Chris Brown  
Co- Chief Investment Officer  
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IPS Capital LLP  
4 Eastcheap  
London  
EC3M 1AE

T: +44 (0) 20 7469 6830  
F: +44 (0) 20 7469 6831  
info@ipscap.co.uk  
www.ipscap.co.uk