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INVESTMENT BULLETIN

Interest Rates On The Way UP &

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In the developed Western Economies, interest rates that bank customers can get on deposit are nothing to a jam tart. Inflation adjusted they are nothing to a minus figure. Some wise person once said: “Always put your money on deposit when interest rates are lousy and always take your money off deposit when interest rates are very generous." Doing what looks stupid is how you get the Stockmarket cycle right.

What you are seeing at the moment is not a normal cyclical recovery from a normal cyclical downturn. This is because Western Central banks decided to do whatever it took to avoid a depression, shoving down interest rates to nothing and printing notes with abandon.

This has had the effect of artificially supporting the bond markets, the equity markets and the property markets in the Western economies as bank customers and institutional investors took their money off deposit. Western savers did start saving but they also did not stop spending, so emerging economies still grew their export trade and their GDP. This despite a weakening dollar, sterling and Euro, mainly because the renminbi/dollar rate is effectively fixed. Fixed being the right word if you speak to China's trade competitors.

All well and good, but the consequence of all this artificial monetary expansion and interest rate manipulation could be inflation.

Could remains the right word because inflation in the developed economies is not yet a fact. This is because the jobs market remains shaky and the banks do not want to increase their overall loan books. Most people reckon it will take three years at least before the US employment market normalises. This means years of very slow growth in wages and continued subnormal rates of capacity utilisation. With historically weak balance sheets, the US banks remain cautious in their lending. All of this appears to have neutralised so far the impact of the purchase by the Fed of US1.7 trillion of securities between December 2008 and March 2010 in its first "quantitative easing" programme.

The Fed's statement last week still just about looks credible: "For the twelve months to November, prices for personal consumption expenditures rose by 1%, and inflation excluding the relatively volatile food and energy components was 0.8% down from 1.7% a year earlier”. Average earnings over the same period rose by 1.6%. It is hard to avoid the conclusion that inflation in the US is not yet a serious threat despite the spike up in oil and food/industrial commodity prices. That said, despite this weeks sluggish US employment figures, there remains a chance that US consumer prices spike up more than expected over the next three months, causing some serious ripples in what has been the flat pond of the US bond market for longer than people can remember. In Euroland, inflation rose to 2.2% in December, exceeding the ECB's target of 2% for the first time in two years. It could be the start of many more nasty surprises.

In the UK things look even dodgier. What the Governor of the Bank of England is saying is: Do not worry too much that inflation at 3.3% is now well above the 2% target. His story is that this is all about rising VAT rates, itself deflationary and past sterling weakness impacting on import prices. According to the Governor this will not last. These factors are one offs and inflation is likely to fall back, reflecting continued downward pressure from the persistent margin of spare capacity and higher unemployment. But the level of spare capacity in the UK economy is much smaller than in the US, whilst the relative reliance on imported products and commodities is higher. The Bank concludes that inflation will rise further during the current year only to fall back towards 2% by 2013. O lord make me virtuous but not quite yet.

The immediate threat to developed markets is not yet immediately higher interest rates triggered by the onset of meaningful inflation. More likely the trigger for higher rates could come from the fiscal deficits. Last year the problems in financing sovereign debt in Greece flared up very quickly and took everybody by surprise. But this year, the Chinese and the Germans are well prepared and all Central Banks are fully aware what sovereign debt needs to be rolled over and when. Thankfully, UK sovereign debt has an average redemption period of 13 years. In the US, the facts of the budget deficits have been around so long that nobody really believes that there will be any consequences. Even the doomsters are getting discouraged. As the Chairman of the Fed said last week;".... the US fiscal deficit is projected to fall from its current level of about 9% of GDP to 5% by 2016...but then.... is projected to deteriorate rapidly ......   federal debt held by the public is projected to reach 185% by 2035 compared with the current 60% ". 2016 is too far away for hedge funds to care. The immediate is what concerns everybody. If anything odd happens to destabilise the dollar, it is more likely to come from an unexpected sort of crisis in say the Municipal Bond market, which catches everybody by surprise.

But the real pressure cooker for higher rates comes from emerging markets. GDP growth and demand pressures are obviously stronger than in the West. Inflation in China and India has been consistently higher than expected, not helped by pressure on food and general commodities partly as a result of floods and failed harvests. It is no coincidence that the Chinese Stockmarket fell by 16% last year and it is no coincidence that the Indian Stockmarket is 13% off its twelve month's high. Stockmarkets are supposed to fall when interest rates rise and to their credit the Chinese Central banks, almost alone in the world have real interest rates, adjusted for inflation of one percent and they have been quick to increase the reserve asset requirements of the banks to reduce lending. The Chinese have no problem with financing their own Government borrowing requirement so they can actually afford to do the right thing and actually raise interest rates in real terms. By contrast, the UK has negative interest rates of nearly 3%, and banks are busy shrinking their loan books where possible, and the Bank of England is engaged in the delicate game of trying to persuade overseas holders to continue to buy UK sovereign debt whilst being behind the curve when raising rates.

Chances are inflationary pressures will continue and the judgment must be that Western Central banks will do what they can in terms of inflating away debt. The Central bank in China and to a lesser extent in India can be much more proactive in raising rates because of their comparative fiscal strength but again there is a very delicate balance to be struck between inflation and employment.
The Chinese of course have a particularly powerful weapon to hand which no other major Central Bank has. They could be tempted to allow their currency to rise, thus reducing imported inflation, concentrating on expanding their domestic

economy and making the judgment that export margins on products manufactured with imported raw materials would still be competitive despite higher local wage costs. This of course would have very serious inflationary consequences for western consumers and reported inflation in Western economies.

The prospects of rising inflation and increasing "negative" interest rates are the prime drivers behind the buoyancy of Western markets. In this environment, opportunities abound in global equities and what better way for our resident pointy head technology guru Guy Feld to see the New Year in than Las Vegas at the Consumer Electronics show, where some of the fastest growing corporates in the world were exhibiting.

Background theme: interconnectivity over a range of devices

The Consumer Electronics Show in Las Vegas is the world's largest trade show of its kind and the 2011 iteration was the best attended in the last couple of years with a total 140,000 entrants comprising a record 30,000 visitors from overseas.

CES is a world showpiece for device and technology companies and keynote addresses featured CEOs from world class companies including: **Microsoft, Ford, Time Warner, WPP, Audi and Verizon**. The boom in consumer electronics drives big money not just for the technology vendors, but also for the media, automotive and telecommunications industry in a world where '**connectivity'** is exploding: internet-connected computing is at the heart of this. According to the US CEA, by 2014 some 70% of all US consumer electronic products will connect to the internet. The growth in data going over both wireline and wireless networks is set to leap over the next few years, with Verizon claiming that wireless data is doubling annually and that video will go from c50% currently to around 90% of data traffic over the Web in a few years.

Key themes at CES 2011

A key theme for some time that shows no abatement in mobile computing is the **smartphone.** The latest in these high end mobiles have processing power that would have graced full-blown desktop PCs not so long ago, such as Motorola's Droid Bionic. In addition, many of these devices can enjoy new superfast wireless data delivery over emergent 4G/LTE networks, which have been pioneered by Verizon in the US. 4G data speeds run at over 8x those of current 3G networks, and analysts expect an expensive rollout of this technology by network operators across the globe over several years.

Probably the hottest theme of all at the moment is that of the new **tablet** computers. These machines resemble blown up touchscreen smartphones and typically feature a 7 or 10 inch touch display and are ideal for email, web surfing, reading e-books and watching video. Apple pioneered this segment with its iPad, but CES featured a shower of new tablets mostly based on the Google Android operating system. Most notable arrivals were Blackberry's Playbook and Motorola's Xoom. The segment continues to grow quickly and is taking share off netbooks and laptops.

3D technology was a notable force last year and even bigger in 2011, given the floor space devoted to it by all the leading TV manufacturers. Sony and Samsung had video walls made of fifty+ screens showing 3D video watched by swathes of visitors wearing 3D glasses. The initial take-up of 3D TV has been less than totally convincing, however, and critics cite issues with price premia for the sets, the cost of glasses and the relative lack of content. But 3D is getting a big push not just from the TV makers, but also the broadcasters such as Time Warner and Sky. My view is that the technology needs refining for TV, but it will ultimately become a standard. Perhaps of greater note was the promotion of **3D on other platforms** such as computer games for PCs, set top boxes and mobile devices. I can see some of these markets showing greater momentum than TV in the short-term.

In a keynote address the CEO of Time Warner told a packed audience that **TV is currently in a 'golden era'**. Home entertainment is going through nothing short of a revolution thanks to software and communications technology and choice is exploding. Internet connected TVs are mushrooming and enable the consumer to take all sorts of content from the internet including movies, TV shows and general web search. TVs now even have their own app stores. The industry is in a great state of uncertainty as the new models of content delivery develop, and this is having profound effects on the share prices of set top box makers, cable companies, telecoms and software companies, broadcasters and studios and others as the market tries to second guess the next generation losers and winners.

A rather theatrical show from Audi showcased what I see as a big long-term theme that is perhaps underplayed: **infotainment** in cars. The latest wireless and processor technologies facilitate the transfer and music from the home into the car which can then be played and displayed wirelessly, together with full internet access, navigation and diagnostics assistance and accident prevention technology including voice recognition. I believe you will see a race from manufacturers over time to incorporate these technologies into their models in order to differentiate from competitors.

<u>Ways to play for the UK investor</u>

The UK investor may play the above themes in a variety of ways at all capitalisation levels. I highlight some of the proxies below.

The standout UK technology company is FTSE 100 constituent, **ARM Holdings.** ARM is probably the only truly world class British technology stock, and its processor designs are the 'brains' for over 90% of mobile devices globally: it is effectively an industry standard. The stock is hitting new highs on the back of the announcement by Microsoft's CEO at CES that the next generation of its ubiquitous Windows operating system would for the first time be compatible with ARM's architecture (as opposed to Intel's) for servers and PCs. Intel's nemesis, AMD, is also working on ARM's architecture in this market. The valuation at around 50x this year's earnings reflects ARM's singularity, yet upgrades are still possible with new and end markets continually evolving opportunity for ARM. ARM's cores address nearly all the themes mentioned above: phones, tablets, TVs, set top boxes, automotive, games consoles, etc and with only c20-30% shares in TVs and set top boxes there is plenty more market share to take.

The substantial investment that need to be made in data networks to cater for exploding traffic is an opportunity for both **Spirent (Mid 250)** and **Anite (FTSE**

Smallcap). Both companies sell testing and assurance kit to network operators and handset makers, with Spirent allowing investors to play the growth in both wireline (Ethernet) and wireless/4G networks. Anite's share price rise has been driven by its testing exposure to 4G, where the market is pricing in more certainty in forecasts and the prospects of a long and profitable investment cycle in the technology.

AIM-quoted Welsh semiconductor wafer maker **IQE** also merits a mention. IQE makes the 'base of the cake' for chips that feature in phones, tablets and many other devices. The stock has been highly cyclical and is having a strong run as earnings are recovering fast. IQE has a strong relationship with Intel and is at the heart of next generation technologies in data networks, LED lighting, laser projection, solar cell technology and a host of other areas.

Braver and more speculative investors may consider interesting smallcap and AIM stocks such as **DDD Group.** DDD is a software company with world class algorithms in the generation of 3D images or the conversion from 2D to 3D between devices. The calibre of its IP is underlined by a royalty deal with no. 1 TV maker Samsung and Intel has showcased DDD's technology for computer games. The company is moving from loss to profits, but DDD offers investors a unique play on the 3D phenomenon across multiple platforms such as TV, PC, Blu Ray players, mobile phones, and set top boxes. As markets develop, profits accruing from potential royalty streams can make a material impact relatively quickly.

Outside of Anite and Spirent one of the few other ways of getting exposure to the wireless network capex boom appears to be FTSE Fledgling stock, **Filtronic,** whose Isotek business makes filters addressing interference and efficiency issues for base stations amidst the upgrade paths to 3G and 4G technologies**.**

Amino Technologies on AIM is a maker of internet 'over the top' set top boxes and associated software. This allows telecom operators to offer TV content over the open internet and Amino has closed a large Tier 1 operator in Telecom Italia. Additional wins of this type would propel the shares materially.

The revolution in mobile has also brought with it the generation of a new opportunity for the advertising industry. Both Google and Apple have bought specialists in mobile advertising in an attempt to monetise further their share of mind with consumers. Note that while some c.2bn people use the internet, 5bn use wireless devices. Industry players and consumer brands want to get to consumers everywhere at any time: mobile is the conduit and US mobile advertising is expected to exceed $1bn in value in 2011 versus c$743m in 2010. Greek AIM-quoted plays **Velti** and **Internetq** sell services to brands and network operators for mobile advertising and marketing.

A final mention must go to an AIM software stock that offers entertainment on the mobile phone – **Probability.** Mobile users can gamble on casino favourites such as Blackjack, roulette and slots for modest stakes. It has been the case for some years that Probability has been ahead of its time, but there are signs that its time has now come. Why? The increasing penetration of smartphones such as iPhone and Android phones has made the user experience much more convenient and appealing. Recent third quarter figures show iPhone revenues soaring from start-up in August now to comprise 30% of total business. Probability also addresses the key Android market, has a Gibraltar gaming license, specialist domain expertise both in software and gaming expertise, all of which represent good barriers to entry and strategic value to a potential online gaming predator.

Note: The author has personal positions in several of the stocks mentioned in this article.

Guy Feld

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