HARGREAVEHALE

INVESTMENT BULLETIN

Spring Time in the Med

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SPRING TIME IN THE MED

Forget about the North African Spring, try the coming European Spring for size. Police have just cleared the protest camp on the Placa de Catalunya in the centre of Barcelona, occupied ever since the national protests on the 15th May, and it seems likely that similar camps will soon be cleared, in particular in the Centre of Madrid at the Puerta del Sol. From the visual evidence available on the world wide web, the clearances were violent with over 80 people injured/hospitalized. This is not Tunisia, it is not Egypt, it is not Bahrain, but it does have a common thread of protest, youth unemployment (over 40% in Spain) and high food prices. And it is unlikely to go away as Governments attempt to reduce their spending.

In the good old days, the IMF was able to impose deficit reduction programmes on emerging market economies with relative aplomb. Brazil for example in the 1980s/1990s was the subject of IMF imposed cutbacks which were decade long. In contrast, it is difficult to see the European middle classes putting up with similar deficit reduction programmes for any period of time. They have got used to buying broadly what they want and throwing away around 15% of the food they buy. It seems unlikely that they are going to put up with more than a couple of years of hardship without starting to throw bricks. Quite a large camp has just sprung up opposite the Spanish Embassy In London and it feels as if it isn’t going away sometime soon. The interesting thing about the North African Spring is that that Governments and think tanks and intelligence agencies did not really see it coming. And it has been a sharp reminder to Governments that real change and real challenges to their power comes from the grass roots, from the streets and can become unstoppable quite quickly.

It is true that the IMF has changed its somewhat harsh original lending model. It now maximises the flexibility of its loans. And a lot of good things have happened to the IMF in recent years. At the G20 meeting in 2009, a decision was made to enlarge the amount of funds available to help out the 187 member countries during a financial crisis. Funds available for lending were expanded from $250 billion to $750 billion. A lot of this facility was provided by China in return for some institutional changes in terms of voting rights, with China, Brazil, India and Russia being moved up to the top ten. However, European and US voting rights still account for just under 50% of the total. Even after the reweighting of the share structure the Netherlands has 1.7% of the total vote as against just 2.6% for India. Something of a farce. And the overwhelming likelihood is that the voting structure will change further to reflect where the real power lies.

This is particularly the case because, of the pot of IMF money available, over 80 percent of the money drawn to date has been allocated to European countries. This is most unusual and is why the Chinese are making something of a fuss about who should run the IMF post Strauss Kahn. In the words of Gao Haihong representing a think tank close to the Chinese Government; "The current power shift in the world economy mismatches the existing institutional arrangements, greatly hindering the global rebalancing process and international market stability."

All this does matter for UK investors. This is because China, particularly as a result of the fiscal weakness of the US, has become an important paymaster for Europeans and will have an increasing role to play in determining our standard of living in the future. As will the German public.

This is why the recent decision by China's most influential credit rating agency, Dagong, to downgrade the UK's credit rating is so important. The downgrade was from AA minus to single A plus. In a statement, Dagong said; "The downgrade reflects the true status of the deteriorating debt repayment capability of the UK and the difficulty in improving its sovereign credit level in a moderately long term into the future.......the UK's fiscal deficit is expected to be 9.8% of GDP above the target of 7.9% ..... the UK banks have £2 trillion of assets .... of which about 40% is exposed to risk."

Not a particularly good half term report. It could mean, if the Chinese are correct about the true extent of the fiscal deficit, a budget in the UK sometime later in the year. This would possibly involve further reductions in expenditure, and some attempt to encourage industrial growth via corporation tax cuts. The trigger would be the realization that tax receipts have been overestimated, as has GDP growth. The sad fact is that Spending, Taxation and Borrowing are all at unsustainably high levels and something has to give. In the very short term, it is clearly important for Western consumers in Spain, Greece, Portugal and Italy that the key decisions at the IMF continue to be made by the West. And what happens to them could dictate what happens in the UK over the next twelve months.

Certainly, Western politicians in power now are not in an enviable position. To date the conversation on European deficits have been confined largely to the ECB, the IMF and local Central Banks and it has been mainly horse-trading on debt deferment, and funding. Increasingly politicians are going to be sandwiched between lenders, with no particular loyalty to Europe and their own local electorates. Political tensions will be ratcheting up.

In the short term, the big test for the IMF will be in its handling of Greece. Greece is due to receive a £10.4 billion injection from European Central banks and the IMF on the 29th June and the ECB and the IMF are carrying out an audit to see whether the country can realistically guarantee its funding over the next 12 months primarily via asset sales, a key condition of any further IMF injections of cash. Failure to do so would put the burden of financing on the Europeans, and they are bitterly divided on the issue.

But, because of the weakness in the balance sheets of German Landesbanks, and because of the fragility of the Spanish mortgage banks, some sort of compromise will be thrashed out by Governments. It can be no coincidence that the recent draft legislation on the Basle 111 capital requirements has been significantly amended to allow the banks to continue to issue further hybrid capital and redefine the capital of insurance subsidiaries ,owned by banks, as part of core tier one capital. Desperate times, desperate measures.

The Eurozone will therefore have to cobble together some sort of deal, probably cutting interest payments on Greek Government debt, which will also have its maturity extended by five years plus. Some sort of haircut compromise which will have investors scurrying away from the Euro towards the perceived safety of US dollars and the US Treasury market. It might even result in a further run on gold despite a rising dollar. It certainly could have an impact on industrial commodity prices denominated in dollars with a double whammy effect as a result of the ending of the quantatitive easing policy in the US. Given the sluggishness of bank lending in the West, the evidence points to the money created by the QE programmes pouring into asset classes like commodities and equities. This puff will no longer be around. At the same time there is a school of thought that suggests that Western corporates are nearing peak utilization in terms of plant capacity so that cash will now be used more productively in capex rather than on cash buybacks. So Western equities look potentially vulnerable in the short term, even if a full scale banking and funding crisis is sucessfully avoided.

UK investors not in a perceived cash/bond safe haven whether it be US, Norwegian or perhaps Brazilian, and who have the stomach for equities should remain underweight in banks and big ticket domestic economy plays because any serious increase in consumer spend could be a generation away. They should confine their attention to the many UK equities providing secular growth opportunities, despite a dismal macro background because of their product offering and management skills. They still exist and a lot are populated within our Marlborough Special Situations and Microcap funds. To reduce overall risk the spread of investments these funds offer makes sense. Those investors happy to look at individual companies / sectors offering long term growth opportunities might like to consider the possibility that UK manufacturing has seen the worst.

The recent figures from LI & Fung would suggest that the World's largest goods sourcing company based in China is starting to find life much more difficult, with factories across Asia experiencing rapid wage inflation. Talking to and meeting recently with export led engineering companies in the Midlands was a heartening experience. The worm seems to have finally turned for the last men standing. The combination of wage inflation in China and just in time delivery problems experienced by end users partly as a result of the disruptions in Japan has meant that UK Engineering Plc is becoming a lot more competitive. Government action against the cost of regulations still being imposed on UK industry by the EEC would be helpful.

We have recently met two mid size engineering groups in this category, both trading ahead of recent expectations and both with good order book visibility. Titan Europe (High risk, market Cap £100m) supplies and manufactures large diameter steel wheels and undercarriages for large off highway vehicles. Its main markets are Mining and Agriculture, both areas of secular growth, because of climate change and infrastructure investment in Western China and other emerging markets. Clients are manufacturers such as Caterpillar, JCB and Komatsu. It is high risk, because it is small in market Cap terms and it also has a high level of debt. Because of its debt profile it is clearly not suitable for risk-averse investors. But it is in the top five of global players in its specialist markets, only 10% of sales are in the UK and the Group has operations in Brazil, India and China. And walking around the UK facility recently provided some interesting real evidence that UK manufacturing could be now becoming more competitive.

TT Electronics (High risk, market Cap £ 315m) supplies sensors and other electrical components to manufacturers such as BMW selling into emerging markets such as China from which it now derives 40% of its profits. Demand for product remains strong and new management has taken advantage of a favorable trading background to refocus the Group. In fact, it is something of a text book management success story. The directors are now eighteen months into the execution of a strategic plan to focus the Group away from its conglomerate past towards a more specialist electronics group, with higher margins. Management controls on working capital and costs have resulted in net debt falling by half in 2009 to £56m and falling a further £45m last year. Cost cutting, working capital controls and cash generated should result in elimination of all net debt by year end 2011. Whilst remaining a high risk equity, the improvement in the debt position and the focus on cash flows has made the Group a more interesting proposition. Certainly, the resulting margin improvement now being generated gives reasonable credibility to brokers forecasts for next year of £36m of profit. Again, less than one fifth of the Group's sales are in the UK, and the Group has a number of heritage businesses, particularly a secure power business in Mexico, with a 17% market share which do not necessarily fit in with the primary sensor operations. A disposal of such businesses could achieve an interesting valuation relative to the existing market capitalization. In the meantime the Group is building its expertise in sensors and broadening its market position, particularly in medical sensors.

For more risk-averse clients who are interested in the engineering sector, German quoted engineer Krones (Medium risk, market cap Euros 1.7 billion) appears to be trading on a relatively undemanding rating. Krones is the world's leading supplier of bottling equipment for the drinks industry with an estimated share of over 25% of the global market. In particular, the Group has an expertise in plastic containers for non-alcoholic drinks, with fruit and vegetable juices and bottled water growing at over 5% a year, well in excess of rates for alcoholic beverages. The strongest rates of growth are expected in China, forecast to be growing at 8% in 2012, where Krones has a major presence and in Africa/mid East, which is growing at 6.7%. Krones combines pricing power and international patent protection in bottling machinery and has developed a maintenance business which provides both visibility and cash flow. As a result there is no debt in the balance sheet. Cash at the end of the year is expected to be of the order of Euros 200m. Free cash flow is estimated to rise from 81m Euros last year to 191m Euros in 2012. 2012 per is just 13. Order books are at record highs with a promising start to 2011. In the first quarter of 2011, recently reported sales were up 14% year on year and EBITDA at Euros 51m was already equal to 40% of the previous years total earnings. Strong order profile, strong cash flows, no debt, and a business servicing emerging market consumers is an interesting proposition for longer term investors.

But the big investment call this year remains emerging markets. By contrast with Western markets, both China and Indian markets have been very poor performers. The Indian market for example has fallen by 6% this year and the Chinese market has fallen by over 20% in the past eighteen months. The Indian market is actually down by 4.4% in the past month and it is hard to be optimistic. Although Indian balance sheets ratios look OK, with cash flow to sales, EBITDA margins and capex to sales all above pre crisis levels, all this is negated by the macro economic risks. True, Indian interest rates have been raised systematically in response to inflation, but it has always been well behind the curve. Real interest rates remain negative. Stagflation is in prospect and Indian equities in general remain expensive in terms of price earnings ratios. The immediate outlook for the Chinese market is not much better. Prospective price earnings ratios are less pricey, in fact they are standing at 80% standard deviations below its 7 year average. And the Chinese Central bank has responded to higher inflation with higher interest rates. In fact real interest rates in China in marked contrast to the rest of the world ex Brazil are actually positive. As things stand the Chinese investor can achieve a two per cent return by putting money on deposit. In the UK, the investor would be lucky to get a minus two per cent real return for money on deposit. Hence perhaps the divergence of performance between UK and Chinese Stockmarkets year to date.

Opinion seems evenly split on China. There are plenty of bears around suggesting a hard landing for the economy in the latter part of 2011. The state of the property market is a sensitive issue. The Government has introduced tough restrictions on residential property trading, which has possibly diverted capital into the still booming commercial property market, especially in first tier cities. The Government has responded by tightening loans to the commercial property sector and has slowed down the approval process for foreign real estate investment. However, an oversupply of commercial property is on the horizon and a number of prime commercial properties recently completed in Shanghai are said to be experiencing problems in terms of tenant occupancy.

The weapons available to the Chinese Authorities in the fight against inflation are not just the ability to create real interest rate returns. They are also in the position to accelerate the strength of the yuan which would lower the cost of imported raw materials and manufactured goods. The opportunity for investors to buy into the Chinese market rests in part on the sequence of events which could arise if there was a Euro crisis which led to a sell off in commodities. A better than expected harvest in the US and in Russia would also help. The balance of probabilities then would lie with a reduction in global inflation rates signalling a topping out or fall in both Indian and Chinese interest rates going forward. This could prove a great one off opportunity for UK investors to climb aboard the Chinese and Indian domestic growth stories. Timing of course is everything.

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