



Hasta la Vista.....Sovereign debt, Europe's own Terminator returns

On 1st August 2011 the various popularly quoted indices opened as follows:-

FTSE 100	FTSE All Share	Eurostoxx 50	Dow Jones	Nikkei
5,815	3,025	2,589	12,144	9,907



All sat at close to their highest levels all year. Then almost as if waiting for the date, on Wednesday 3rd August being my last day in the office before going to Spain, the markets went into downturn mode and a few days later hit their lowest levels for over a year, nearly 15% down. During the day of Monday 9th the FTSE 100 Index fell to 4,791 before climbing back to over 5,000 by the end of that day. During the two weeks that followed we saw daily movements up and down, sometimes by as much as 5% for most of the indices. It really was a crazy period with almost unprecedented levels of volatility.

All indices have settled to some extent and are currently about 11% down month to date as shown in the following table. Figures are as at close of business 31st August 2011 and show change since 1st August.

FTSE 100	FTSE All Share	Eurostoxx 50	Dow Jones	Nikkei
5,395	2,801	2,293	11,614	8,955
-7.22%	-7.40%	-11.43%	-4.36%	-9.61%

My message to this office on arrival in Spain was to inform clients who called not to panic and sit this downturn through as I believed it would be short lived and was not the start of a major market meltdown. This did not stop a few poolside conversations (much to my fellow holiday maker's amusement) with clients needing reassurances who were understandably worried about their investments.

So why did this happen and what is in store next?

Debt concerns have made the markets very fragile and investors are nervous. In the early part of the month Italy and Spain were in the firing line. Yields on their ten-year debt were at euro-era highs – and perilously close to the 7% mark that signalled bail-outs for Greece, Ireland and Portugal. Attempts by politicians to calm market jitters were largely ineffective and their protestations were lost in the rush for the exits; equity markets around the world slumped. The European Central Bank purchased government bonds for the first time since March to try to shore up confidence. Its efforts were fruitless.

The ratings agencies were having a field day and threatened to downgrade the US's AAA rating. With their President saying that the politicians and not the ratings agencies should determine their status the US finally agreed to raise the nation's debt ceiling. After much debate and compromise between the parties congress agreed a hike that meant the US could pay its bills, thereby staving off default -- for now.



But while politicians were making crazy, markets were becoming increasingly worried about the health of the global economy. Recent data had been dreadful. The UK's growth forecast for the second half of the year has been reined in again. Manufacturing activity has contracted, raising doubts about the government's plans to rebalance the economy. Consumer spending is on the wane. Shoppers in the US have also been counting the pennies, with spending in June falling for the first time in two years. Speculation is mounting that the world's largest economy could be headed back into recession. You get the picture.

Throughout all this, equities were about as sought after as rump steak at a vegetarian BBQ and a number of below-forecast earnings reports from the corporate world did little to enhance their appeal.



As the month progressed and amid a backdrop of riots, burning buildings, and looting in England, (42" plasma...anybody?) global stock markets threatened to go haywire. Markets plummeted before rebounding sharply. Over the second week of August the FTSE All-Share was down just 1.6% but this masked the volatility that was much higher than usual.

Initially, the catalyst was the decision by Standard & Poor's, one of the world's big three ratings agencies, to strip the United States of its prized AAA credit rating despite the legislators having just hammered out a hard-won deal to raise the country's debt ceiling. Investors continued to shun "risk" assets such as equities, and share prices continued to tumble. The paradox for investors is that US government debt might be risky, but what's the alternative?

As we all know, a significant alternative – the euro – is in the throes of a huge crisis. In previous months, this crisis has been focused on the budgetary problems of Greece, Portugal and Ireland. But now two much larger economies, Spain and Italy, have pushed their way to the front of the stage.



At the start of week three the European Central Bank was the first to attempt to restore market equilibrium. On the Monday, it bought enough Italian and Spanish bonds to push yields down by one percentage point – an enormous impact in the short term. But will it be enough? Meanwhile, the US Federal Reserve moved to freeze its short-term interest rates for two years, and hinted at more quantitative easing. That sent Treasury yields sharply lower. However the investor saw these measures as no more than putting a plaster over a gaping wound and equity markets nosedived again. By the end of week three global markets were at almost their lowest point in the month.

On Monday 23rd I returned from Spain!! Over the weekend we heard news that the US would consider QE3 as would the UK. We also heard that the Chancellor would 'cut the level of higher rate tax' in the UK. These announcements, designed as economic stimulants, have been received as positive and the markets globally have all started to go up. Nothing to do with my return from holiday.....honestly!

Looking forward

The key to explaining market movements over the past few weeks is investor confidence. Or, more precisely, a lack of confidence in the European and US authorities' abilities to sort out the growing problems. The US and European actions have been perceived by many as all bluster – transparent attempts at reassurance backed up by little policy content. Artificially reduced borrowing costs for Italy and Spain are unlikely to resolve Europe's debt crisis. Nor will the US pledge of very low interest rates for a prolonged period suddenly restore faith in the Fed. Instead of providing reassurance, some investors appear to believe that if such desperate measures are necessary, they might be best to steer clear of the market until things look a little better.



We do not agree with this gloomy prognosis. While it is true that equities have fallen sharply and quickly, we should set this move within its recent historical context. In some markets, share prices remain above their 2010 lows. Yet valuations based on price/earnings relationships are attractive, particularly when considering the strong rates of earnings growth that many companies have generated over the last year.

We have been asked if, at the beginning of the month or at least when the markets started to decline if we should not have put all of our client's money into cash. It could be perceived as an easy decision and maybe a good move at the time. However after a decision like this what comes with it is an even more difficult decision: when to go back into the market and with what strategy.

"History shows that time, not timing, is the key to investment success.

Therefore, the best time to buy stocks is when you have money."

Professionals pontificate about the likely next move in financial markets. The truth is no one knows what will happen next and certainly not what will be happening next year. All we can know, with any degree of assurance, is that, over time, capitalism has demonstrated the tendency to generate wealth for those hardy enough to own productive equity. Hoarding cash has been a losing strategy. In short, in order to win it, you've got to be in it. Don't mess about.

I first read the article on the following page many years ago. I cannot remember who the author was but full credit to him as it is as true today as it was when written.

When market climate is uncertain, investors become nervous and simply sell off their holdings, losing their long term investment goals.

Not that it's wrong, you're just one of those lost lambs adopting the "sheep flock mentality", aka it's better to lose money together than just losing money alone. Many would pull out, thinking it's better to reinvest when the funds, stocks stabilize. But don't forget, you're selling on the cheap. Take a long term view, what's the rush? It is often best to hold onto investments through periods of volatility.

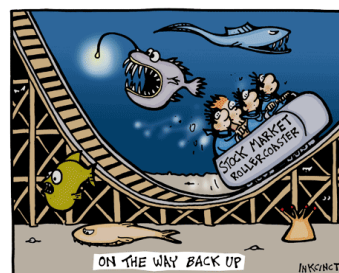
The pitfalls of market timing. Of course all investors would like to be able to predict the movements of the market, buying at the bottom and selling at the top. This is called market timing. Unfortunately, it is very difficult to time movements in and out of the market, particularly in a period of extreme volatility. If full-time day traders find it next to impossible to catch the timing, what more chance do you stand when you'll still have to man your own day job? Getting it wrong can significantly affect the performance of investments, and a very heavy fee to pay for the lesson learnt. Selling at the first sign of a downturn can prove particularly bad. Sharp falls in the market are followed by sharp gains. While it may be tempting for investors fearing further losses to sell their investments, they risk **locking in losses and missing out on gains**. Now that's a situation nobody wants to be in.



Remember. History has taught us that equities/unit trust performances will increase in the long run, and there is no need to time the markets. Research shows that investments made when the markets had already begun to recover, and those made when it is falling, have still paid dividends. Take any unit trusts from China/India, they aren't being spectacular these days, but do you really expect these 2 countries to suddenly flip over and die these days? My advice: Buy them on the cheap, and watch them explode in value once the winds of uncertainty blows over.

Moral of the Story. In contrast, waiting for a better time to invest can cost investors dearly. Take a look at any stock market graph and you will notice that investors who remained invested over the last five years would have received returns around 50%. Many of the stock markets best days have come immediately after sharp falls. The bottom line is that trying to time the markets, often always goes wrong. Invest using all the old time strategies and make some solid returns. You may be lucky raking in good money by market timing, but remember, in the long run, **there's no such thing as luck**.

We believe that it will take quite some time before these over-indebted economies are back on a sustainable path. This means we can expect markets to remain prone to bouts of volatility. Through careful fund selection we've been taking steps to insulate our portfolios from the impact of this type of environment. The first line of defense is ensuring the portfolios are well diversified and not over concentrated in areas sensitive to the economic cycle, like banks and the consumer sector.



Our view is that at some stage the authorities are going to have to get ahead of the curve, most likely through a globally co-ordinated bout of quantitative easing. Getting to this decision, however, is going to be complicated and we may well need a catalyst in the form of a significant market crisis to make this happen. Indeed we may be seeing the beginnings of this crisis now.

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