



Ted Scott on the wire

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Ted Scott's 10 Predictions For 2010

Ted Scott, F&C's Director of Strategy, considers some of the risks and opportunities facing equity investors as we enter a new decade.

1. A strong rally in the dollar

One of the principal features of the economic backdrop in 2009 was the weakness of the dollar. The US currency, still a global safe haven, saw its value eroded by a sharp increase in appetite for riskier assets over the course of the year. However, the US economy is improving and as long as the market is not too unsettled by fears of inflation and the need to finance the burgeoning fiscal deficit, the dollar should enjoy a significant rally. Much of its weakness has been due to speculative selling and, as the dollar will not fall to zero, the rebound could be quite sharp when it comes.

2. Gold continues its ascent

Perhaps the most important reason for gold's strength in 2009 is that it accurately reflected the ongoing fragility of the global financial system. After the scare over the possible debt repayment default by Dubai there could be further alarms this year given the explosion of government debt since the crisis started. This has also raised fears of a currency crisis and has contributed to the weakness of the dollar, which is all good news for gold. Gold is likely to be viewed as an increasingly attractive asset in this uncertain world and, with the likelihood that the pace of the global recovery will falter in 2010, the metal should benefit.

3. Markets fret about inflation

The main reason to be concerned about inflation is the continuation of ultra-loose monetary policy. With interest rates likely to remain near zero in the short term and quantitative easing still being applied, the massive monetary stimulus could have serious inflationary consequences. Quantitative easing has also helped keep bond yields low (because the Bank of England has been buying gilts aggressively as part of the programme) and when it finishes bond yields should rise as a precursor to higher inflation. This could happen sometime this year but probably in the second half. For equity markets, the rise in bond yields anticipating inflation before it happens will make further positive progress more difficult.

4. Early cyclical stocks underperform

I would expect the sector performance in the market to reflect the build up in inflationary and interest rate expectations. Early cyclical sectors such as autos, general retailers, leisure and house builders have generally done very well since the market rallied. This is not surprising as they are geared into the recovery and draw strength from interest rates at record lows. However, early cyclical stocks are now discounting a reasonable recovery in earnings following their strong share price performance. Higher bond yields will probably lead to these sectors underperforming whether or not interest rates have been raised. Later cyclicals, such as miners and industrials, should do better as they are less interest rate sensitive and enjoy higher exposure to the strong growth of the emerging markets.

5. Sovereign debt becomes a major issue

Government borrowing cannot keep growing and indebted countries need to make the choice of trying to reduce debt by cutting spending and/or raising taxes or risking impairing future prosperity by effectively borrowing from later generations. If aggressive monetary policy is continued the risk of excessive inflation will also rise. For the UK, it is unlikely that we will be faced by any risk of default on our debt although the credit rating of the UK may come under more scrutiny if debt levels continue to climb. I would expect concern over sovereign debt to be much more of a topical issue in 2010 because it is likely to be a constraining factor for economies in a low growth environment.

6. The Conservatives introduce an austere Budget

After the collapse of the economy in the last two years, a change of government in this year's general election would initially be seen as positive. Financial services have become an increasingly important part of the economy in the last 20 years with the liberalisation of markets and, although that may be partially reversed due to the banks' role in the crisis as more regulation is brought in, a Conservative administration would be more amenable to the City. On the other hand, a severe budget would run the risk of tipping the economy into a double dip recession and that would clearly be negative for the market. It is a difficult balancing act but the time to address the parlous state of the country's finances is drawing near.





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7. Heightened risk of a major terrorist attack

With escalating tension in Afghanistan and Pakistan and heightened concerns over the nuclear intentions of North Korea and Iran, there is no doubt that the geo-political landscape deteriorated in 2009. With investors having become hardened to the tribulations of international politics, a major terrorist event would be a wake up call. Thinking laterally, a war or a short-term geo-political crisis would provide an opportunity to buy the market, as was proved after the invasion of Iraq or the London bombs in July 2005. Clearly, this depends on the nature and severity of the event, but we should be thinking about its possibility in a world that is becoming more dangerous ahead of it happening and, if it does, how we should respond.

8. The China economic miracle will continue

There has been much speculation that the dramatic rebound in China's economic growth in 2009 will become a bubble that will burst this year. I believe that China should be able to maintain its rapid expansion in 2010, largely because the economy's huge bias towards exports will start to reduce. Importantly, the balance of payments surplus - the source of significant tension with the US - should diminish quickly as the Chinese consumer dips into its high personal savings to increase spending. The Chinese authorities have proved adept at handling the economy through past crises and it would be unwise to bet against them now.

9. The Bank of England changes its mandate

In the near to medium term there has to be doubt as to whether the Bank can keep to its mandate of 1-3% inflation. By using quantitative easing to inject liquidity into the economy there is a major risk that inflation will become endemic and rise well above 3%. Also, if inflation were to show signs of rising the Bank of England might not want to increase rates to counter it because a pre-emptive move may threaten what is likely to be a fragile recovery. For these reasons, I believe the Bank may be forced to suspend or even change its mandate of a low inflation range, a move that would leave it discredited.

10. More mergers and acquisitions

Despite the rise in equity markets there has been a relative lack of mergers and acquisitions. However, M&A tends to lag the cycle and confidence in the economy should increasingly be reflected in 2010. Supporting this are the stronger balance sheets companies are enjoying after a period of retrenchment, cost cutting and in many cases recapitalisation. Overall, in a recessionary environment there will always be distressed M&A as companies look for bargains or are forced into the arms of another from a position of weakness, but for a stronger takeover climate to emerge bids will also come increasingly from positions of strength. It always takes time for deals to become a reality but there are several compelling reasons why 2010 should be a good year for corporate activity.

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