

Global Equity Quarterly Newsletter June 2010

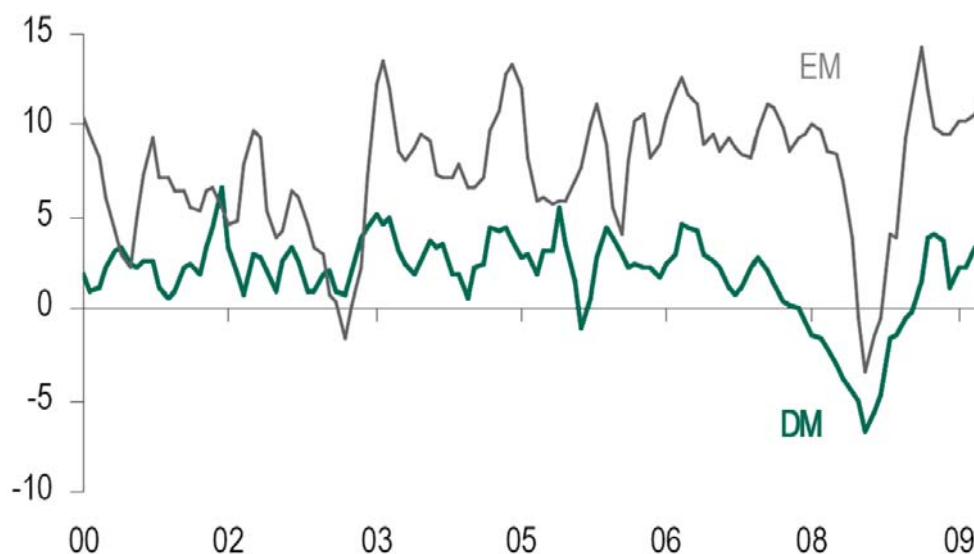
Market Review

Over the past three months global equity markets more than retraced the gains seen in the first quarter as investors ‘ran for the hills’ swamped by a deluge of ‘bad news’ that took away any appetite for risk. The majority of the world’s major equity markets recorded double-digit declines with the MSCI World Index down over 13%. The culprits from a sentiment perspective were, in no particular order, a sovereign debt crisis in Europe, the flash crash in the United States and worries over Chinese growth in Asia. Add in some disappointing employment data in the U.S. and the bears certainly had plenty to feast on.

During the past several millennia the Greeks have often led humanity down many new paths but few commentators would have suspected that concerns over their public finances would lead to a full-blown sovereign debt and Euro currency crisis. Lack of clarity in Greek finances led to them being shut out of the capital markets at a moment when they faced significant refinancing requirements. Initial grudging offers of support from the European Commission startled investors who began to look under other rocks such as Spain and Portugal and concluded that something was rotten within the European Union. By the time the Commission, the IMF and the ECB took unprecedented action to ensure liquidity in sovereign bond markets through a special purpose vehicle to act as buyer of last resort, it was too late and investors had voted with their feet, pushing the Euro down some 10%. Perhaps of even greater concern was the realization that the austerity measures needed to rebuild the public finances throughout the European region would significantly dampen the nascent economic recovery and potentially lead to a double dip recession.

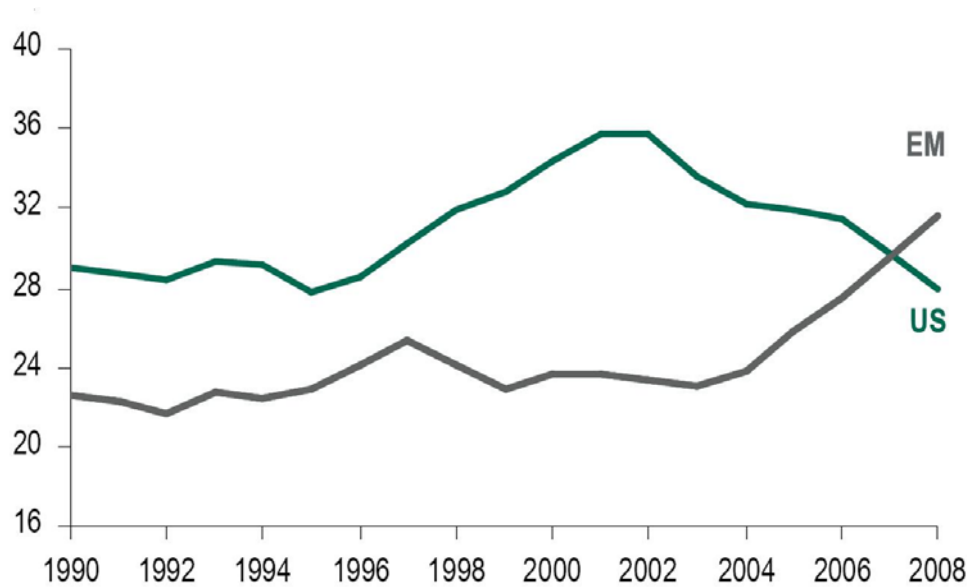
In the United States the flash crash and poor employment data also undermined investor sentiment and concerns began to mount over the debt position of the U.S., particularly once the level of state deficits was factored into the equation. This in turn began to raise concerns about a double dip recession in that region as well. So if signs of economic recovery were being undermined in the developed world, what of growth in the emerging markets which have become so important to overall global growth?

Figure 1- Emerging Market & Developed Market Retail Sales Momentum (%3m/3m saar)



Source: J.P. Morgan economics, March 2010.

Figure 2- Emerging Market Consumption Overtook U.S. Consumption in 2008



As we can see in Figures 1 and 2, not only has emerging markets consumption overtaken the U.S. in importance but it has bounced back significantly faster than in the developed markets. As a result, overall growth still appears robust but moves in China to pull back the government stimulus package led to concerns that this engine was also stalling. In truth, we do not believe that to be the case. However, with growth falling back to approximately 8% in the next few quarters from 12% over the last few months, a slow down may well feel like a hard landing. In other areas such as India and Brazil, fears of inflation had also caused the authorities to begin to tighten monetary policy which has also unnerved investors.

Taking all these concerns together provided something of a perfect storm for equities and investors suffered a significant bout of risk aversion preferring to accept 'safe' low returns in core sovereign debt, notably German bonds and U.S. treasuries, where the 10-year yield fell below 3%. As we have commented before, this looks anomalous to us but fear is a powerful motivator.

Portfolio Review

During the quarter we added Apple back to the portfolio believing the company is undervalued in relation to its growth prospects. While Apple's Macintosh PCs, iPhone cell phones, and iPod music players are skyrocketing in popularity, Apple remains a relatively small player, albeit one with significant momentum on the world stage. Apple's unit share of the global PC and cell phone markets, which in aggregate total \$430 billion, is approximately 4% and 3% respectively, suggesting a massive runway of opportunity still ahead. Beyond the simple, intuitive user interface of Apple's products, historically their primary differentiator, Apple is now widening its competitive moat through its App Store, making iPhone & iPod users ever more dependent on their devices while also drawing in new users seeking to do more with their mobile phones. We believe this App Store-driven ecosystem will enable Apple to sustain its industry-leading pricing & margin structure, driving the iPhone's accretive economics through the business model as this high-growth product line increases in the mix.

Additionally, Apple has just embarked upon two more legs of growth opportunity, the iPad and the iAd mobile advertising platform, which are similarly rooted in the App Store ecosystem and could drive material upside to our long-term revenue and earnings growth estimates of 10% and 12%. Despite the stock's strong performance over the last year, we think it's priced quite reasonably at under 16x estimated forward 12-month earnings; and note that if the company's prodigious cash generation continues on its current trajectory, Apple will boast nearly \$200 billion in cash in five years – over 80% of its current market capitalization. We previously played the mobile opportunity through chipmaker Qualcomm, but have decided that Apple, with its more stable device economics, is the better vehicle for participating in this long-tailed growth industry.

We also initiated a position in Louis Vuitton Moët Hennessy. LVMH is a holding company of numerous luxury goods brands ranging from the eponymous leather goods and champagne but also watches, perfumes and selective retailing mainly through its Sephora brand. While the stock is not cheap at this juncture, we find it to be reasonably priced provided the groups' star brands continue to deliver consistent growth. LVMH still has much deeper penetration to go within the U.S., as well as the emerging markets, and is a true beneficiary of Euro devaluation since they manufacture almost exclusively in the region.

Investment Outlook

At the current moment, equity markets offer something of a conundrum. Investors lack the confidence to push markets higher but seem only to gain confidence from rising markets. We firmly believe that equity valuations are underpinned at these levels with the S&P 500 trading at approximately 12.5x forecast earnings for 2010. This is not far away from the lows of just over 11x reached at the market's bottom at the beginning of 2009 when there were fears of a return to the Great Depression. Global growth is still expected to be solidly positive in 2010 and 2011 albeit somewhat skewed to the emerging markets. Corporate balance sheets are very robust, productivity has never been higher and earnings growth remains strong even on somewhat reduced estimates. Factoring in a slow-down in GDP growth in the mature western world post 2011 is certainly reasonable and reflects the 'new normal', promoted by commentators such as Bill Gross and Nouriel Roubini. However, even in this scenario, equities should offer significantly better returns than bonds or cash. This hypothesis may take some time to be proven as equities are only likely to grind slowly upward in the face of this challenging environment. However, we do strongly believe this is the right way to position the portfolio.

The key for us at W.P. Stewart is to make sure we can find companies that can grow even in this challenging environment. If we are able to do this we not only believe we will provide returns equivalent to that earnings growth but also see some P/E expansion to reflect the paucity of growth that is to be found elsewhere. We certainly take some comfort from the fact that, in the month of June, high-quality growth companies began to out perform for the first time this year.

One thing is certain -- there is a lot of bad news around and many people are now forecasting a double dip recession. On the basis that the consensus has been consistently wrong over the past few months, this does suggest the 'bad news' may already be in the price.