Investment Management Market Report
Source: Deutsche Bank Offshore, 05 July 2001

Global Overview

The major question facing all investors at this time is whether Global growth has hit the bottom. Investors have looked primarily to the US market, where the Federal Reserve has wanted to avoid a protracted downswing at all costs, and the frequency and extent of the rate cuts speak volumes.

Recent signs suggest that the Federal Reserve has indeed succeeded in its' task of preventing unemployment, and deflation. Worries about a US recession in the first half of this year have proved pessimistic, as consumer-spending growth remains surprisingly resilient.

Euroland has moved into the grips of its own slowdown, and the European Central Bank is following the trend of cutting rates that was started by the Federal Reserve in the US. Inflation has risen across Europe, which is suffering from the effect of higher industrial costs. Currency weakness and rising labour costs have added to Europe's problems, and we would expect to see a downward move in interest rates by the ECB to counter these inflationary factors.

The favorable performance of the British Economy in recent years was undoubtedly the major reason for the second labour Government landslide. The currency remains strong, and inflation remains under control. Indeed, we think it unlikely that there will be further interest rates cuts by the Bank of England, and it would be our view that the next move in UK interest rates will likely be upward.

The Bank of Japan have maintained the zero interest rate policy over the quarter under review. To little effect, with mounting bad debt and political difficulties, it is unlikely that foreign investors will see Japan as a home for investment monies over the coming quarter.

United States

The Federal Reserve has been most aggressive in its approach to interest rates, lowering by 275 basis points since the beginning of the year. With a further meeting due in August, we would not be surprised to see more of the same. Hand in hand with this approach, the fiscal authorities tax cut program should start to take effect during the summer months, as rebates are forwarded to the consumer. We believe this is likely to ensure that consumer spending remains buoyant, and this should be enough to keep the economy moving in a positive direction.

Company earnings are weak, with analysts generally continuing to reduce earnings forecasts, and disappointing results are leading to share prices coming under pressure. Looking ahead however, the positive effects of the reduction in interest rates since the beginning of the year should begin to feed through and have a positive effect. The prospect of further rate cuts, and the expectation of policy measures in the form of tax cuts should also impact positively as a confidence building measure. With regard to the valuation of individual sectors, it can be noted that cyclical basic industries including Energy and Financials show relatively moderate valuations and therefore still have price potential. Consumer and Telecom stocks for the most part look fairly valued, although in contrast, the valuation of most Tech stocks reflect a strong recovery in the development of business in the further course of the year. Given the strong momentum and sharp reduction in earnings expectations for the second quarter, higher prices are expected into the reporting season.

Economic fundamentals however still raise the question of the sustainability of any recovery in the US market, and the downside risks to the economy lie in both a retrenchment of consumer spending, and any decline in business fixed investment.

Europe

In Euroland the economic downswing is accelerating, as is the pace of inflation. Growth forecasts have been steadily scaled back, and in turn we have been forced to revise down our own expectations for growth. Despite the much discussed tax cuts, private consumption has weakened in 2001 as the rise in inflation driven primarily by oil prices, and recently by food prices, undermines real income. Labour market gains have also slowed, and this combined with softer global demand has had a negative effect. The ECB resistance to lowering interest rates was finally broken with a 25 basis point cut during May, and although residual inflationary concerns remain, the weakness of the currency would argue against a further rate cut, as this would put pressure on import prices.

The decision to cut rates in May in spite of the deterioration of the currency clearly signals that the ECB is quite optimistic about the inflation outlook, and has focussed its attention on the slowdown in growth. Moreover, recent announcements by ECB officials have expressed confidence that the persistent weakness of the Euro would not have a too negative effect on inflation, indicating that a weak but stable Euro is no longer an obstacle to the reduction in interest rates. We therefore believe there will be a further 25 basis point cut in rates during the summer months, and a final 25 basis point cut before the end of the year.

United Kingdom

As predicted by the opinion polls, Labour Prime Minister Tony Blair was returned to office with a huge majority at the general election on June 7. The wide margin of victory, was somewhat surprising, given that Tony Blair is well known to favour Britain joining the Economic and Monetary Union, even though a large majority of the British public remain opposed to adopting the Euro. It is however more likely that the favorable performance from the British Economy in the past four years, was the major reason behind the second labour landslide.

Economic activity continues to hold up remarkably well in the UK, with inflation remaining on a downward trend.

Although manufacturing output has fallen in the first half of the year, there is continued strength in domestic demand, with retail sales growth of 6.4% year on year in May, the strongest since July 1997. In addition the housing market remains in good shape, with mortgage lending rising sharply in May, but there are fears that this combination of low interest rates, a tight labour market, and strong net wealth will ignite a consumer boom. We however maintain a central view that unemployment will rise later this year, and although this is only expected to be modest, such a development will inevitably take the edge off domestic demand growth. Against most foreign counterparts the UK equity market has remained steady, assisted by its relatively low exposure to Technology stocks, and higher weighting in Financials Pharmaceuticals and Oils.

Given the reasonably healthy state of the economy, we do not think it likely that the Monetary Policy Committee will ease rates further, as it is unnecessary at this time. Indeed, we would argue that given our current outlook for the UK market, it is likely that the next move in interest rates will be in an upward direction.

Japan

In recent weeks the Tokyo market has focussed on two factors. Firstly the newly elected Prime Minister Koizumi, and secondly corporate results, as the reporting season develops.

Corporate earnings have so far been mixed, and do not point to any recovery from the current recession.

On the political front it is widely expected that the Koizumi Government will set about dealing with the Banks non-performing loans, and there are plans to write these off completely over the next two to three years. The Government is in the unenviable position of having to pursue fiscal and structural reform at a time of economic gloom. Whether it will be a long lasting Government will depend greatly on whether it can simultaneously push through structural reform while providing the necessary social support programs.

Given the continuing structural and economic problems presiding in the Japanese market, our policy will continue to see us underweight to this part of the globe.

Summary

Whilst we expect the summer months to remain relatively quiet, we believe that the fourth quarter will see company earnings reacting positively to the many interest rate cuts put in place by central bankers over the course of this year. Corporate earnings recovery holds the key to investor confidence, and it is likely that there will be a strong flow of cash reserves into equity markets, once some good news emerges. On a cautionary note, a retrenchment in consumer spending, or further pessimism regarding corporate earnings could hamper any recovery.

We believe that while these factors may come to the fore, and create some volatility in markets, that the generally positive earnings forecasts for 2002 will prove well founded.