

Global Perspectives

August 2009

24 months ago (July 2007), we were about to enter one of the most disruptive financial storms ever.

Where do we stand today (August 2009)?

1. The economy and corporate profits.

The world economy is still facing major headwinds but it seems likely that the worst is over and that we will not go into a major depression, as everybody feared less than six months ago.

The main challenges will come from **growing unemployment, soaring budget deficits and very difficult access to credit** for all but the biggest companies. Social unrest and rising taxes seem inevitable and the temptation to inflate us out of trouble irresistible.

After a massive recapitalization of the major "systemic" banks, with private and public money, **the risk of a systemic domino-like collapse of the financial system** (our fear in August 2007) **seems quite remote now**, but we admit this was already our perception 12 months ago (in August 2008, pre-Lehman Brothers and pre-AIG).

The good news is that companies have dramatically **reduced inventories** (this has reinforced the downturn post-Lehman) and that production has to pick-up from the current very depressed levels.

Companies are still in the process of **reducing operating expenses** which, in the medium term, will continue to weigh on economic uncertainty but, on the other hand, has already had a significant positive impact on corporate profitability.

1st half 2009 corporate earnings are, in general, not as bad as feared ! In some instances they are even quite good, which illustrates a major point about companies, **THEY ARE ADAPTABLE.**

Other good news is that the **cost of debt financing has come down** significantly over the last six months, at least for the biggest and soundest companies, which means that the share of profits for the equity owners, after financial charges, will be higher.

2. Inflation and Interest rates.

The overriding objective of asset management is to maintain and possibly grow the purchasing power of the assets you have been entrusted with. Current and future inflation is therefore central to the thinking process.

Inflation and inflation expectations have been on a roller-coaster ride over the last two years.

Early 2008, inflation expectations went through the roof on the back of rising commodity prices, notwithstanding a global credit contraction.

Late 2008, expectations for the foreseeable future plunged well into negative territory. Deflation was the new buzzword and built into the yield curve.

Early 2009 we went through some "normalization" process with inflation expectations back in the 1% to 2% range for the US and Europe. The quantitative easing (another word for printing money) by central banks is now a major source of worry.

Throughout this roller-coaster, **our view on inflation has remained stable.**

When the whole world is in a credit contraction phase, inflation tends to be very low (possibly negative).

When the world will get out of the contraction phase (slowly but surely), central banks should let the acquired assets mature and withdraw the printed money.

There is so much over-capacity in all industries that inflation should remain low for a long time.

If inflation stays low, interest rates should stay low too, especially on low-risk instruments. If this turns out to be the case, some investors will face cash-flow problems. In other words, they currently run "reinvestment risk".

We therefore advise people to think about the potential impact of lower interest rates on their economic well-being and, if needed, to envisage longer-duration bonds.

3. Sentiment and investor psychology

The 2Q rally doesn't mean investors have suddenly become overly optimistic again.

Investors have just gone from a state of "blind panic" to one of "healthy scepticism".

A reminder: investors are always convinced economic slowdowns are bad times to invest. Actually the contrary is true, slowdowns are great times to invest.

Why ?

During slowdowns, many prices come down among which the price of money (low interest rates). Companies are under pressure and are forced to raise productivity.

Sooner or later economic activity picks up again (recessions are never forever !) and company profits along with it.

There is still a long way to go in terms of economic growth and investment returns to reach a level of "confident optimism".

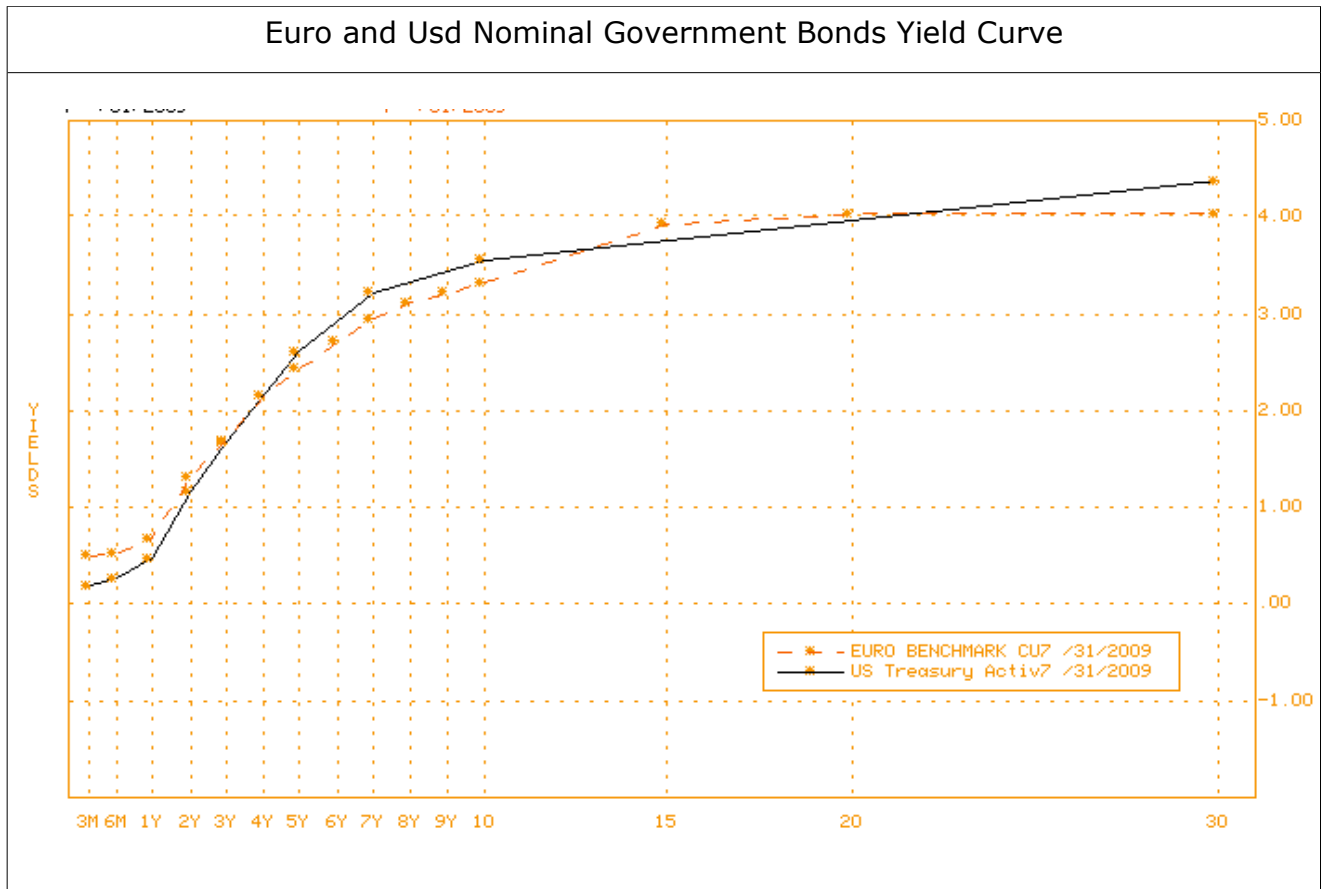
We think we are years away from any form of "irrational exuberance".

On the other hand, cynics and pessimists are becoming nervous. They will, as usual, advise to wait for the inevitable corrections which may or may not happen.

In short, the psychological environment is close to being perfect.

4. Asset valuations and expected returns.

4. 1. Nominal Government Bonds



With government bonds, the main topic is inflation-risk.

In light of our benign view on inflation, we think that, after the recent rise in long rates, there is again a little bit of value in Government bonds.

From an asset allocation perspective, this is an asset class with returns which have a low to negative correlation with returns on corporate assets. Therein lies its true value.

We have raised our fixed income allocation dedicated to Government bonds to 20%.

4.2. Inflation-linked Government Bonds

Euro and Usd Real Government Bond Yields and Expected Inflation			
Aug 1, 2009			
EUROPE-EURO			
	Nominal Bond Yields	Real Bond Yields	Discounted Inflation
1 yr	0.60	0.40	0.20
3 yrs	1.70	0.70	1.00
5 yrs	2.45	1.40	1.05
10 yrs	3.30	1.55	1.75
20 yrs	4.05	1.75	2.30
30 yrs	4.05	1.70	2.35
USA-USD			
	Nominal Bond Yields	Real Bond Yields	Discounted Inflation
1 yr	0.50	0.65	-0.15
3 yrs	1.65	1.15	0.50
5 yrs	2.60	1.30	1.30
10 yrs	3.55	1.70	1.85
20 yrs	4.10	1.95	2.15
30 yrs	4.35	2.10	2.25

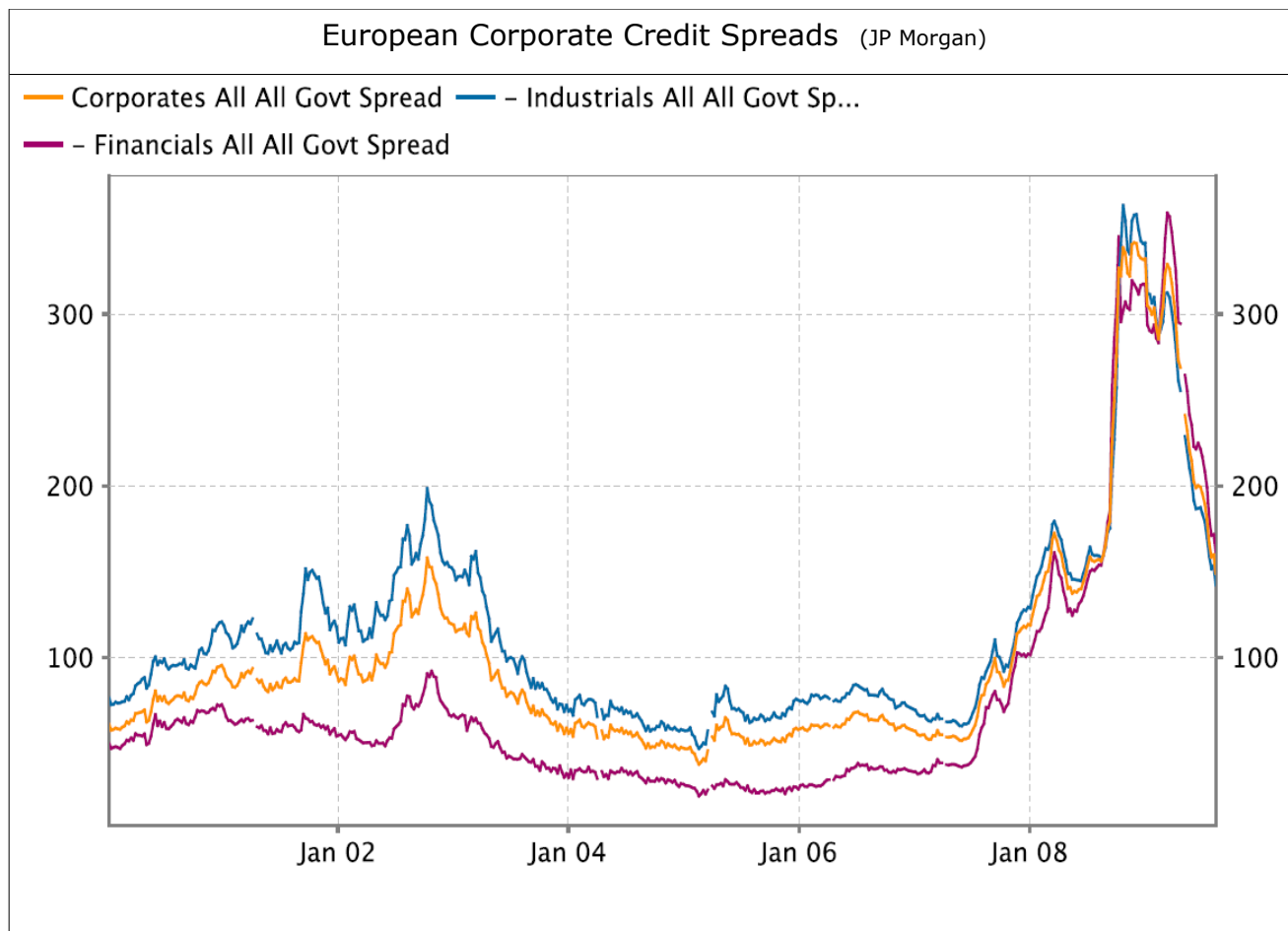
Above expected inflation numbers are basically in line with our benign view of (0% to 2%) inflation.

We therefore think that there is not a lot of value in Inflation-linked Government bonds anymore.

From an asset allocation perspective this is an asset class with returns which have a low to negative correlation with returns on corporate assets and, most importantly, potentially also with nominal government bonds (in a scenario of rising inflation). Therein lies its true value.

We have reduced our fixed income allocation dedicated to Inflation-linked Government bonds to 20%.

4.3. Corporate Bonds



The above graph shows the extent of the panic and of the recovery. When corporate spreads shoot through the roof it means markets are very worried about credit risk, the risk of not getting all their money back.

The 2002 crisis of confidence (induced by the Enron & Worldcom frauds) was serious enough, but compared to the events of 2008 it now looks like a picnic.

We think the above rise in yields has created a unique opportunity to buy future income.

An opportunity which obviously does not come without risks (it never does) but with risks that can be managed.

Credit risk can be managed through analysis, selectivity and diversification.

60% of our fixed income allocation is dedicated to corporate bonds.

The corporations of which we own bonds are continuously and thoroughly analysed. We try to own bonds of companies with only reasonable leverage, with debt repayments which are spread over time and with business models which are sustainable. Our corporate bond funds are up 12% (accrued interest + higher prices) on average so far this year, while the average yield to maturity is still close to 5% with a duration of **6** yrs.

It is somewhat of a puzzle why many people still keep their money

1. at their bank,
2. at very low rates (1% to 3%),
3. on short term deposits ...

... while there are three simple and straightforward reasons to move out of bank deposits.

1. Banks still have (and always will have) the most leveraged balance sheets around. Of course governments have tried to reassure depositors with regards to the safety of their deposits.
2. Available rates with quality corporates bonds can be substantially higher (4% to 7%) with manageable risks.
3. You can lock in these attractive rates for much longer (5yrs to 15yrs). If you have a benign view on inflation (our case) this is still a major opportunity.

4.4. Corporate Equity

This is, by far, the most difficult asset class to assess, as all parameters are highly uncertain and fluctuating over time.

Corporate revenues are uncertain and fluctuating. Luckily, some costs are variable (they go down in synch with lower revenues), fixed costs can be managed and adapted (with some lag) and some outlays (growth capex) can be delayed, cushioning this fundamental uncertainty.

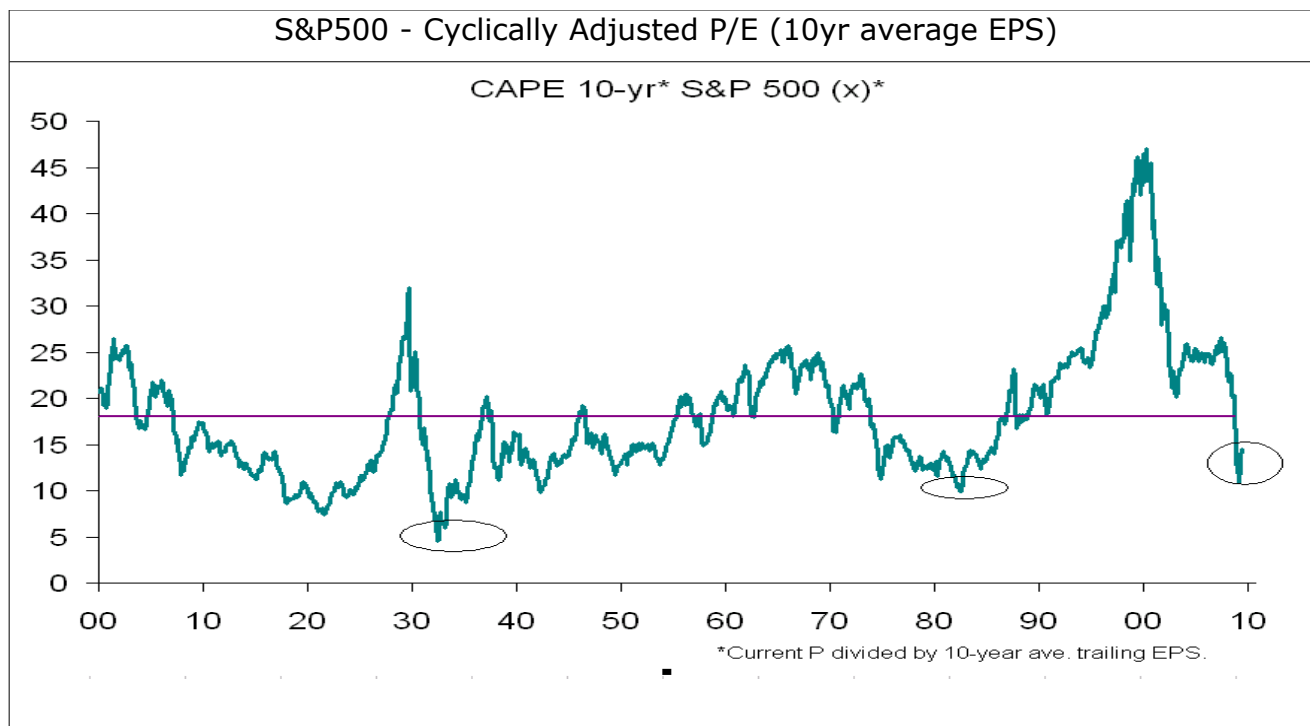
The flows to the shareholder (FCF => Dividends) are therefore uncertain and volatile but thanks to corporate flexibility and adaptability possibly less risky than one imagines in the middle of a downturn.

The corporate cost of capital is volatile too and (!) highly correlated with the uncertainty surrounding the economy and corporate revenues.

When times are good, markets are discounting high corporate profits at a low cost of capital and when times are bad, markets are discounting low corporate profits at a high cost of capital.

This, of course, leads to very different and sometimes very extreme outcomes.

This is, simply stated, why equity prices have always been and will always be volatile.



Q: How do you work around that inevitable volatility of equity prices ?

A1: You don't allocate all your capital to this most volatile asset class !

A2: You try to keep things into perspective !

The above graph does just that.

Earnings are volatile but, through the cycles, corporations are flexible, adapt, and on aggregate survive and stay profitable. Extreme profits and losses are smoothed out over a 10 year average period to get to "normalized" or "cyclically adjusted" trailing earnings. You can then use this normalized past earnings stream and current prices to get to a normalized or **Cyclically Adjusted P/E** or CAPE.

This graph has a simple message: **Stocks are cheap !**

Over the last 110 years, equity prices have, on only two occasions, been potentially cheaper than today, in the mid 1930s and in the early 1980s. On every occasion major bull markets have followed.

Markets have been discounting low to very low earnings with a high to very high cost of capital.

At CapitalatWork we think markets will slowly but surely discount decent earnings with a normalized cost of capital and therefore provide handsome returns (dividends & price gains) to calm and discerning investors.

5. Investment Strategy.

In light of all of the above, at CapitalatWork we have the following indicative asset allocation for our balanced (max 50% Equities) portfolios.

Asset Classes			
Sub-Asset Classes			
Cash 5%			
Corporate Cash 50%	Government Cash 50%		
Fixed Income 60%			
Nominal Govies 20%	Inflation-Linked 20%	Corporate Bonds 60%	Other 0%
Equities 35%			
American Equities 20%	European Equities 43%	Asian Equities 10%	Other 27% Contrarian Equities 25% Emerging Mkts ETF 2%

The CapitalatWork funds have, so far this year, produced outstanding absolute and relative performances.

CapitalatWork Funds	31st of July 2009 - Ytd return – in Euro
Cash+ at Work	+3,94%
Cash+ Opportunities	+1,64%
Inflation at Work	+2,05%
Government Bonds at Work	+2,03% (launched on 15 th Jun09)
Corporate Bonds at Work	+12,88%
European Equities at Work	+14,97%
American Equities at Work	+17,72%
Asian Equities at Work	+37,84%
Contrarian Equities at Work	+23,37%
Contrarian Euro Equities at Work	+11,17%
Global Opportunities at Work	+19,39%

Don't hesitate to call upon us for more explanations, for a portfolio discussion or for any other subject which relates to the management of your assets and liabilities.

CapitalatWork, member of the Foyer Group, August 2009.
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