

Global Perspectives

March 2009

1. The economy and company earnings.

The economic situation has become a lot clearer over recent months: we find ourselves caught up in a global credit contraction, which is causing economic contraction, which in turn, means contraction of company earnings.

The crisis we are witnessing is the result of a fatal combination of **excess debt** and **bad capital allocation**. To maintain or increase returns, some (mainly the banks) took greater and greater risks.

Since this toxic cocktail was mixed on a grand scale over many years, it appears ever more likely that the effects will be profound and enduring.

We are therefore subject to the boomerang effect of this prolonged excess debt, **the forced unwinding of debt and credit contraction**, which hurts, really hurts the economy and all its stakeholders, especially, of course, the most debt-laden.

In times of credit contraction and economic contraction, it is debt on the one hand and earning stability on the other hand which will make the difference between **survival and bankruptcy**.

So, with the safety of your assets as our objective, we are focusing our attention on these two ideas - **limited amounts of debt and earning stability**.

Some good news amid all this depression:

Not everybody is party to this historic error. The excesses were mainly to be found in the finance sector, banks at the fore, whose leverage was at times astounding. Many companies are not at all in the same precarious situation, on the contrary.

Governments have taken a crisis approach and are quite determined not to make the same mistakes as were made in the 1930s. The resistance is rallying. Perhaps too slowly, and at times too chaotically, with sadly nationalistic outlooks... but rallying all the same. In the USA in particular, the Obama administration has impressive fire power. That is what it will take to kick start the system.

Some **prices are falling** heavily, among them the price of raw materials and the price of silver. This is very good news. A drop in oil price to around 40 or 50 USD per barrel alone will lighten the energy bill by around USD 1,500 billion in 2009 compared to 2008, which represents a fall of 2% to 3% of global GDP. This is obviously not good news for oil producers.

The ECB monetary policy is at least six months late, but despite that we finally have visibly lower rates. Despite the general scepticism, **this decrease in rates** should start to be felt from the second or third quarter of the year.

Some very large markets are showing signs of life. We are looking in particular at the **corporate bond** market. Companies with reasonable levels of debt have managed to issue quite a lot of new paper, in quite favourable conditions (for both issuer and investor), showing that there was abundant liquidity available to simple placements with reasonable rates of risk.

We are seeing a pick up in the announcement of **strategic transactions**. We think that this is just the beginning. The diverging fortunes of companies and historically low costs of credit are creating opportunities that the most solid companies are going to earning from.

The yield curve is on the rise again, which historically has been an excellent pre-indicator of economic revival. As always in a recession, it seems quite difficult to believe since the dislocation has been so brutal, but we will see.

The very bad news then is the failure of the banking system, once the largest sector in the world in terms of market cap.

In many cases (see Belgium), owners/equityholders and subordinate lenders have simply dropped off the map.

Will senior lenders emerge unscathed? If you look at bond prices, no.

Will savers emerge unscathed? If you believe governments, yes.

The big question to come (very soon) is how are States going to finance their current intervention?

Of course there are no simple solutions.

Inevitably the tax payer will need to pay more tax, in cash and in years of work. In other words, taxes and the retirement age are going to increase (not a moment too soon).

2. Falling interest rates.

We have regularly brought to your attention the inevitable and large fall in rates during an economic downturn and the risks (reinvestment risk) this implies for those who live off capital.

If you have decided you no longer want to bear the inevitable volatility of prices and returns associated with risky investments, and you have, for example, invested short term in government paper or in your bank, your returns are fast approaching ZERO.

Luckily there are alternatives! Alternatives which are certainly not without risk (there is no such thing as risk-free) but whose risks can be managed and diversified.

Corporate bonds (issued by companies) offers historic high returns which you can take advantage of, while at the same time boosting the economy.

Note **selectivity** and **diversification** are the keywords!

3. Investor psychology.

In more normal times, the psychology of investors is difficult to capture.

Now, though, one thing is clear: **rarely, perhaps never, have investors been more pessimistic.** Justifiably pessimistic, you say. Of course, at least as justifiably as during the previous crises, if not more so.

The issue, and the opportunity, is that **pessimism is contagious, provoking landslide movements and often irrational behaviour.**

In fact, the more financial assets fall in price and get cheaper, the more owners want to get out of them. It is extraordinary!

Indeed, we never encounter any investor interested in investing in equities any more, despite the incredibly low valuations!

4. Share valuations and expected returns.

4.1. Government bonds:

Government rates (in serious countries at least) are at their lowest and represent little or no value. It is only in the context of profound and prolonged depression and deflation that returns of 1% to 3% can appear attractive. Obviously this is not our long-term outlook.

4.2. Corporate bonds:

As a result of millions of investors spending 18 months seeking out the least risky assets, returns on risky assets, corporate bonds, are at a high. As mentioned above, we believe that there is a lot of value here.

It is a bit of a mystery to us that so many savers keep their money in bankdeposits in short-term investments with rates leaning towards zero instead of lending to a diversified selection of companies at higher rates than available in the banks for longer periods.

Our analysts are doing remarkable work in differentiating between companies with reasonable debt and the rest. Companies whose debt we own in portfolios have an average net debt level corresponding to 6 months' to 2 years' worth of operating cash flows. This is very manageable.

4.3. Equities:

Never ... Never have we seen equity valuations as low as they are now and it is our belief that, give or take a little, never again will we see such low prices as we have seen during this crisis.

This is not a big surprise, since we can easily say that since 1930/35, never has there been such a dislocation in the financial markets followed but such an abrupt halt to economic growth.

A rude test of conviction and character.

Companies whose equities we own in our portfolios, based on very conservative estimates, generate free cash flow averaging at 6% to 12% of their market cap. This is huge! Especially when government rates are so low.

In conclusion:

The historic opportunity resides in company financing, whether via bonds or equities!

There is risk to manage, but the returns are significant.

Equities are currently so cheap that no particularly impressive economic growth is required to see returns. Moderate growth, not too inflationary, will do nicely.

Those who would prefer not to take any risk (which is understandable) will soon be looking at returns of around zero percent! Not to act would be a huge mistake.

Yours sincerely,

Ivan Nyssen, CEO & CIO CapitalatWork
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