Investment update

23 January 2012

Kevin Lilley, manager of the Old Mutual European Equity Fund

Kevin Lilley joined OMAM in October 2011 as a Europe ex UK equity manager. He was previously senior portfolio manager, European equities, at Royal London Asset Management, where his funds saw strong medium to long-term performance and he was A-rated by CityWire. Prior to RLAM, he managed Continental European equities for TT International and NPI. Kevin is a Fellow of the Chartered Institute for Securities & Investment (FCSI).

Banks are the focus of risk

The global economy is starting to look a bit better and the eurozone slightly less frightening. As the market turns, getting the banks right will be key to performance

The world at the beginning of 2012 seems a marginally better place than it was at the end of 2011. Is it time to start shifting our portfolios toward a slightly more positive stance?

There is now wide – if not complete – agreement that the US economy is back on the road to recovery. The downward revision of third quarter GDP was disappointing, but the final revision of 1.8% remains positive in itself, while more recent underlying data has tended to show improvement. Last month's non-farm payrolls were especially encouraging as employment, of course, is key. But numbers for exports, business confidence and retail sales – including automotives – were all pulling in the right direction.

China, though a more difficult market to read in terms of statistics, also appears to be stabilising. Overall economic growth has moderated, but remains at a high absolute level. There are signs that inflation is also falling, particularly in the politically and socially important area of staple food prices. This has allowed a small easing of monetary policy, the first in a fairly long period.

One result is that the competitive round of GDP downgrades that the sell-side economists were engaged in now seems to have abated. This has in turn led to the apparent bottoming of earnings downgrades that were a semi-automated knock on from the lower growth forecasts. If nothing else, having to read a bit less about possible future gloom should help calm investor nerves.

The overhang of eurozone sovereign debt continues to cast a shadow. But the recent successful sovereign debt auctions in Spain and Italy suggest that investors are starting to adjust to a less negative scenario than I believe the market is pricing in. At the very least, as crisis-points have unfolded and successive political summits come and gone, the issues – and the costs – are out in the open and we can draw our own conclusions.

In terms of European equities, the focus of risk is the banks. Investors have been worried that banks could find it difficult to refinance the debt due to mature in 2012. However, the introduction of the European Central Bank's Long-Term Refinancing Operation will allow banks access to unlimited funds at a 1% coupon on three year redemption. There has already been significant take up of the facility and in our view it seems to likely to herald a turning point for Europe's banks. Is it time to re-invest? On the negative side lies the risk of further unravelling of the eurozone. On the positive side, the banks have underperformed for two years, valuations are low and investors are generally underweight.

In my own portfolio, I am already overweight high beta BNP, which I regard as a good quality company whose exposure to sovereign debt is adequately discounted in the current price. I have also been adding to BBVA, the Spanish bank, another good quality institution and one

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which will benefit from improved costs of finance as Spanish yields continue to tighten. For the most part, we have been funding exposure to the banks at the expense of Nestle, one of last year's strong performers.

Looking at such a complex set of factors – and with markets bruised following the volatility of 2011 – it is hard to predict which way valuations will jump. But it seems safe to say that investors who call the banks right over the next few weeks are likely to have fairly happy year in 2012.

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