Head of Old Mutual UK Mid & Small Cap team

Daniel has been the manager of the Old Mutual UK Select Smaller Companies Fund since 2004. He was appointed head of OMAM's highly successful UK Mid & Small Cap team and manager of the Old Mutual (Dublin) UK Select Smaller Companies Fund in January 2009.

Daniel was previously a smaller companies manager at Gerrard Investment Funds, which merged with OMAM in 2001. Daniel has over 13 years' investment experience of UK smaller companies. He is IIMR qualified.

UK mid & small cap update

With developed world equity markets having rallied around 30% from their March lows, we naturally find ourselves trying to answer one fundamental question - is what we have seen merely a bear market rally, or is this rather the beginning of a new bull market?

Global macro economic data, while 'better' now than was the case six months ago, still points only to activity declining at a slower rate across the developed world, rather than to a resumption of global growth. In the near term, developed world economies remain in a significant synchronized contraction. With the benefit of a little hindsight, it is understandable that markets have reacted very positively to signs of stabilization in economic conditions. At the recent nadir of the market, p/e multiples for a range of indebted and cyclical UK mid and small cap companies reflected the expectation that they would become insolvent. The evidence of recent weeks is that conditions are stable enough and refinancing options exist for such companies at least to trade through this downturn, and with the threat of imminent failure lifted, riskier companies have been rerated up from distressed levels. However, the path of any ongoing market appreciation from here will depend increasingly on the timing and strength of the economic recovery.

Could economic growth surprise on the upside? While it is too early to be sure, it is nonetheless interesting to note how many economists in recent days have been revising upwards their forecasts for growth in 2010. Should we be particularly surprised by this? The global financial system has been flooded with liquidity, significant stimulus is being (or will soon be) applied directly to economies. Toxic assets within the banking sector have been socialized, effectively deferring their potential impact. Surely, the question should be what derails a return to growth in the US and UK by the end of this year or the start of next? Reflation and an ongoing rise in risk appetite look more likely than not.

All of this points, in our view, to the current equity market rally persisting, albeit at a lesser pace. The issues that could weigh anew on markets, in particular the existence of unprecedented large deficits across the developed world which governments are unable to finance, can't be dismissed. However paradoxically, should markets try and confront the root cause of these imbalances - too much consumption in the developed (particularly Anglo Saxon) world and too little in the developing world - then the outcome would be one which suits no-one.

Please see important information overleaf

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For the time being, the symbiosis at the heart of the global economy, whereby the US consumer over-consumes and is financed by Chinese purchasers of US Treasuries surely has to continue. As developing world economies mature, so a more appropriate balance between consumption and production globally can arise and structural imbalances be worked through. However, such a rebalancing is likely to take place over a generation, rather than over a short term horizon.

If this thesis proves correct and policymakers have successfully established the conditions across the developed world for a resumption of growth, then we should not be surprised to see equity market leadership follow a conventional business cycle path.

With this in mind, we have established overweight positions in a range of early cycle consumer sensitive sectors such as retail, travel and leisure, housebuilders, and in the consumer electronics subsector of IT Hardware, which benefit from the impact on consumers' discretionary spending power of very low interest rates. If, by way of example, we focus specifically on the retail sector, it has, in the early stages of these sectors' recent outperformance, typically been the lower ticket, less discretionary more defensive names such as WH Smith that have outperformed. As risk appetite has grown, more indebted, higher ticket retailers (such as Topps Tiles, Debenhams and Inchcape) have begun to lead the sector. Our response has been to rotate out of the more defensive retailers into the more cyclically sensitive names - if a reliable economic recovery is in train, then companies which are trading on low multiples of their historic peak profits should offer greater potential to outperform than those defensive names that have nowhere in particular to recover to.

Conversely, later cycle sectors such as industrial engineers and electronics are only now beginning to feel the effects of the downturn, and while the market will attempt periodically to look through the cycle and place these companies on large multiples of what it believes are trough earnings, the magnitude of ongoing downgrades is likely to be such that it will outweigh any attempt by the market to rerate these sectors.

As economic reflation across the developed world takes hold, and while the developing world in general and China in particular continues to grow, commodities prices look increasingly likely to continue their recent upwards move. Accordingly, we have moved overweight both the oil production and mining sectors.

Given our growing belief in the economic recovery, as we have sought to identify attractively valued cyclical stocks, so we have progressively sold down hitherto overweight exposures in a range of defensive areas such as support services and healthcare, which offer more limited recovery prospects. Moreover, these sectors have benefited in recent years from significant growth in government spending. As public finances are brought back under control as they will surely have to be after the next election (whichever party wins), the environment is likely to become considerably tougher for companies exposed to UK government spending.

We have to understand that this time round any economic recovery will be far from 'normal', to the extent that both its genesis and sustainability depend critically on successful action by policymakers. While there is significant spare capacity across developed world economies, making the reassertion of inflationary forces unlikely in the near term, the policies currently being pursued are ultimately inflationary. Policymakers will have to reconcile the need to tighten liquidity early enough to forestall the emergence of inflation without acting too soon, thus choking off any recovery before it has had a chance to take hold.

While we can begin to feel more confident about the prospects for equity markets, we are already through the phase of being able indiscriminately to buy risk assets. Within economically sensitive sectors, the market is differentiating between those stocks that retain the ability to recover and those where the likely extent of any profits recovery is already priced in. Careful stock selection will therefore become increasingly important from here.

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