

Market Review



JULY 2009

Exuberance proves premature, if not irrational!

“how do we know when irrational exuberance has unduly escalated asset values” – Alan Greenspan, Chairman US Federal Reserve, 5th December 1996.

Reported sightings of the ‘green shoots’ of economic recovery, were enough to whet investors appetite for risk once more. In the second quarter of 2009, global equity markets posted their best quarterly gain since 1987. The UK market under-performed during the period, but the FTSE 100 still rose more than 20% from its early March low point. Much of the improvement was predicated on a ‘V’ shaped economic recovery, rather than a double-dip recession. With leading indicators like consumer confidence and mortgage approvals bottoming-out at very depressed levels, the subsequent rebound has been interpreted as a one-way road back to growth.

Nowhere has this opinion been more emphatically reflected, than in commodity prices. The prices of metals and minerals have risen significantly this year in an anticipation of demand increasing due to economic recovery. The oil price has nearly doubled to \$70 over the last 6 months, and base metals such as copper have risen over 70%. The influence of Chinese demand on metal prices is considerable. It is by far the world’s biggest consumer of metals – it manufactures huge quantities of goods for export, and is itself undergoing rapid urbanisation requiring substantial investment in buildings and infrastructure. As the global recession intensified, demand for manufactured goods fell, and Chinese economic growth slowed markedly. To counter this the Chinese government instigated an economic stimulus package worth over \$500bn. Much of this money appears to have been used to rebuild inventories of goods and raw materials, pushing prices up. With any real pick-up in economic activity still to be detected, the danger is that prices of raw materials, and equities, are now too far ahead of the fundamentals.

The theme of the 3rd quarter looks set to be ‘a dose of reality’. Recessions of this magnitude take a long time to unwind. A big gap has opened up between the level of output the UK economy is capable of, and what is actually being produced. This means there is plenty of ‘spare’ capacity in the economy. As a consequence, there will be no upward pressure on prices in the near term and inflation will remain low. Normally interest rates are increased to fend off inflation, and as equities recovered, markets began to price-in rising interest rates before the end of the year. Now the view is changing,

and rates are expected to remain at historic lows, well into next year.

Continued low rates will allow the banks to repeat their first quarter performance, when underlying earnings grew strongly due to vastly improved margins. Bank and Mining stocks led the market recovery, but now their performances look set to diverge. Mining stocks (along with Oils) are likely to under-perform in the near-term, due to the factors mentioned above, but Banks should out-perform as Q2 results impress. Also those sectors which lagged in the early stages of recovery, such as Telecoms and Pharmaceuticals, now look to offer relative value. In essence we see a more defensive equity market until investors’ *irrational exuberance* is fully dissipated.

3 month performance

	30/06/09	31/03/09	Change
FTSE 100	4249.21	3926.14	+8.2%
FT All Share	2172.08	1984.17	+9.5%
US Dow Jones	8447.0	7608.92	+11.0%
Nasdaq Comp	1835.04	1528.59	+16.7%
FTSE Eurotop 300	850.17	700.95	+21.3%
Japan Nikkei	9958.44	8109.53	+22.8%
APCIMS Growth	2546.23	2424.26	+5.0%
APCIMS Balanced	2317.6	2230.48	+3.8%
APCIMS Income	1889.06	1823.69	+3.6%
£/\$	\$1.6463	\$1.4299	+15.1%
Euro/£	€1.1720	€1.0808	+8.4%
Gold (per ounce)	\$930.26	\$919.9	+1.1%
Brent Oil	\$68.37	\$47.74	+43.2%

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Stock Selections (prices as at 10th July 2009)

FTSE 100

Invensys

Sector - Software & Computer Services

Price 215p Yield 0.7% PE 9.93

Mkt.Cap. £1,727m High/Low 300p/115p

Invensys works with the world's major companies to improve their performance. It provides products, software and equipment to monitor, control, automate, and optimise processes.

There has been a huge transformation at Invensys over the last 6 years from a loss-making group, over £3bn in debt, to the much more focused and financially strong proposition of today. May's full year results showed a 4% fall in operating profit, but orders rose 21% in constant currency terms, with the growth in the order inflow accelerating in the second half. It ended the year with net cash of £309m, and announced the resumption of dividends after a 6 year gap.

British Land

Sector - Real Estate

Price 364p Yield 8.1% PE n/a

Mkt.Cap. £3,108m High/Low 712p/295p

British Land invests in offices, retail sites, leisure, industrial and distribution spaces, with more than a quarter of its portfolio city office space.

The group raised £740m in a successful rights issue to underpin its balance sheet in February, and went on to sell a 50% stake in its Meadowhall Shopping Centre in Sheffield for £587m. This should allow the group to avoid breaching banking covenants, and ride-out the property bear market. In the early 1990's bear market, commercial property fell 27%. Values now are down about 44% from peak levels, with markets pricing in about another 15% fall, so we believe shares have seen the worst and there is plenty of potential upside, on any hint of more positive news.

United Utilities

Sector - Gas & Water Utilities

Price 485p Yield 6.7% PE 18.33

Mkt.Cap. £3,310m High/Low 737p/450p

United Utilities (UU) provides water supply and distribution, and wastewater services to approximately 7 million people, primarily in the North West of England.

The company has highly predictable earnings so its value as a whole depends to a large extent on its planned capital expenditure, its debt position, and the current regulatory regime. Twelve months ago the share price was close to 700p, debt costs were rising, and the regulator, OFWAT, was unfriendly. Now the outlook is better. For the new price regime in November, the regulator has pointed to continued high investment but with a structure more friendly to UU on customer pricing, whilst debt costs are falling. At the same time the share price is below 500p.

FTSE 250

Greene King

Sector - Travel & Leisure

Price 413p Yield 5.1% PE 17.42

Mkt.Cap. £891m High/Low 547p/225p

Greene King has over 2,500 pubs, mainly in the South of England and Scotland. It also brews and retails beer with brands including IPA and Speckled Hen.

A successful rights issue raised £207m giving the group the firepower to buy quality pubs from distressed sellers, and buy back its debt (at about half face value). Recent results from the group highlighted its sector-leading performance. The first 8 weeks of the financial year showed like-for-like sales at Greene King Retail were +5.2%, and brewing volumes +12.1%, well ahead of the market. The group has also managed to pay down debt while maintaining its capital investment and holding its dividend.

Carillion

Sector - Support Services

Price 249p Yield 5.2% PE 8.79

Mkt.Cap. £987m High/Low 355p/172p

Carillion is one of the UK's leading support services and construction companies, with annual revenue of around £5bn and operations across the UK, Europe, the Middle East, Canada, and North Africa.

This month the company reported strong underlying first half earnings growth and said it is on track to achieve its target of "materially enhanced" earnings in fiscal 2009. It also reported a strong order book and better than expected cost savings from its acquisition of Alfred McAlpine. Trading on 6.7 times forecast earnings for this year, the shares look good value.

Bellway

Sector - Household Goods

Price 622p Yield 1.4% PE n/a

Mkt.Cap. £715m High/Low 802p/383p

Bellway is a UK builder of starter or first time buyer homes, mainly two and three bed semi-detached houses, apartments and terraced houses.

Bellway remains one of the most conservatively positioned in the sector, with approximately £100m net debt for fiscal year 09, and average gearing of 11% for 2010. It should be sufficiently funded for any further house price weakness, or for steady investment in stable conditions. It is also one of only two builders forecast to report an underlying profit for this year, a year where the housing market recession is expected to trough.

Bellway's share price bottomed-out last year and is already improving - in anticipation of the housing market starting to turn positive in 2010.

Take profits on the following...

Barclays

Sector - Banks

Price 288p Yield 0.0% PE 4.87

Mkt.Cap. £31,792m High/Low 475p/47.3p

We suggested buying Barclays in January at 165p, on hopes that the bank would not need to raise any further capital, and a belief that most of the bad news was priced-in.

At the peak of the financial crisis in the fourth quarter of last year, substantial investment from two Middle Eastern funds, saved Barclays from having to take UK taxpayers money, allowing it to retain its independence. The subsequent agreed sale of Barclays Global Investors for \$13.5bn, will further strengthen its capital position. The improvement in the balance sheet, coupled with evidence of robust underlying trading during the first half, have led to a 75% rise in the share price.



Kingfisher

Sector - General Retailers

Price 188p Yield 2.8% PE 944.0

Mkt.Cap. £4,457m High/Low 204p/89p

Our January recommendation to buy Kingfisher at 136p was based on two factors. Firstly the recognition that Kingfisher had been dealing with its own recession for a couple of years, and had therefore already restructured, and secondly we expected retail stocks in general to preempt the recession bottoming-out, with a rally. Kingfisher's recent trading updates have been more positive, with B&Q recording its first underlying sales increase for two years. Half the increase was attributed to better weather this year, compared to last. The market has extrapolated these trends and pushed the share price up accordingly - the shares look fully rated for now.

Vedanta Resources

Sector - Mining

Price 1357p Yield 1.97% PE 28.76

Mkt.Cap. £3,702m High/Low 2135p/358p

Although we anticipate further sector weakness followed by a buying opportunity before year-end (see page 4), Vedanta's price remains sufficiently elevated to present a profit-taking opportunity.

Vedanta's main revenue comes from copper production – the price of which is more sensitive to economic conditions than other metals. During the recent equity market rally, inspired by hopes for economic recovery, Vedanta's price rose by more than 400% over a six month period. Optimism has been overdone and reality is gradually returning, leading to a readjustment downwards in prices. Having recommended the shares at 625p, profits can still be locked-in.



Mining stocks to present another buying opportunity!

We expect further selling pressure in the Mining sector in the short-term, but this will ultimately lead to a buying opportunity.

In our Market Review of July 2008 we suggested that the 'bubble' had burst in the Mining sector, and recommended selling. At the time we acknowledged that it was boom time for miners with profits at record levels, but it was unlikely to get any better, and there were signs of the run coming to an end. Our timing was good – the sector index fell more than 60% over the next 4 months.

By the first quarter of 2009 we moved back to the buy side, sensing that the sell-off had been overdone. Demand for metals was certain to be lower due to the global recession, but unlikely to collapse altogether. This is what prices were indicating. The single largest consumer of metals, China, had seen its annualised GDP growth rate halve from 12% to 6% - but the rate is expected to bounce back to 7.8% in the second quarter. This is still strong growth by most standards. When the US economy returns to growth (forecast to next year) metal prices will be pushed higher again. Mining shares will rise in anticipation of this, probably before the end of the year.



Buy Xstrata (599p) on a pull-back to 500p.



Buy Rio Tinto (1900p) at 1700p.

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