Sorting the real from the imagined as fear takes grip on financial sector

By James Henderson, Divisional Director - UK Investment

The financial sector continues to dominate the headlines, with the results season heavily focused on the concerns surrounding writedowns of the value of banking assets. As is often the case, some of these concerns are real and some are imagined. When fear takes a grip it becomes difficult to separate the two. However, there are some areas of the market still holding up relatively well. The industrial sector, for example, has been reporting satisfactory numbers and forecasts for future profits have remained intact.

Indebtedness is a major source of anxiety at present, but does not fully apply to the UK industrials, which on aggregate are in rude health. Interest cover, the ratio between profits and interest costs, is higher than it has been anytime in the last twenty years. The reason is that return on capital and the margins on sales continue to come in at a very high level, resulting in substantial cashflow generation. As this continues to come through, interest rate cover will further improve.

What is remarkable is that this strong performance has been achieved during a period of substantial cost pressures, and over a period when energy and utility prices have risen dramatically. The success is down to a combination of strong corporate management and the boom in global industrial activity inspired by the new economic powerhouses of the emerging economies. Those UK companies that are providing goods, services and knowhow to these countries have been rewarded with expanding order books and enviable operating margins.

The technology-based manufacturing businesses operating in the Western world are also being given a fair degree of insulation from the consumer downturn in their economies by a welcome boost in Far and Middle East demand. The aerospace sector in particular has large forward order books that are no longer dependent on the weakened Western carriers but are benefiting from the fast growing Eastern operators. This is resulting in what will be a much longer-lasting and more robust aerospace cycle. The order book stretches well into the future as the next generation of planes such as Boeing's 787 Dreamliner finally come into production (expected towards the tail-end of 2009). UK companies such as component manufacturer **Senior** will therefore continue to be beneficiaries.

Some domestic-orientated businesses that are not operating on the High Street or financial services have come in with good results during this reporting period. Infrastructure spending on roads, schools, hospitals and, further out, Olympic related projects are providing significant opportunities for capital goods companies. **Balfour Beatty** and **Carillion** are two notable examples of companies performing well in this area.

Away from the doom and gloom of the media headlines there are many businesses in the UK that are performing very satisfactorily. They are also well-placed to weather the choppy economic times ahead as there are strong balance sheet and little under-utilised capacity. Interest rates falls will also be of benefit, as will the weakness of sterling which is increasing the competitiveness of the UK especially within Europe. A large and unexpected bonus would be a fall in the oil price, which would reduce costs, improve margins and increase the extent of interest rate falls as inflation worries would subside. If this were to happen the commentators would have something more positive to write about, in the shape of substantial profit growth from much of Corporate UK.

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28 April 2008
This article first appeared in Investment Week