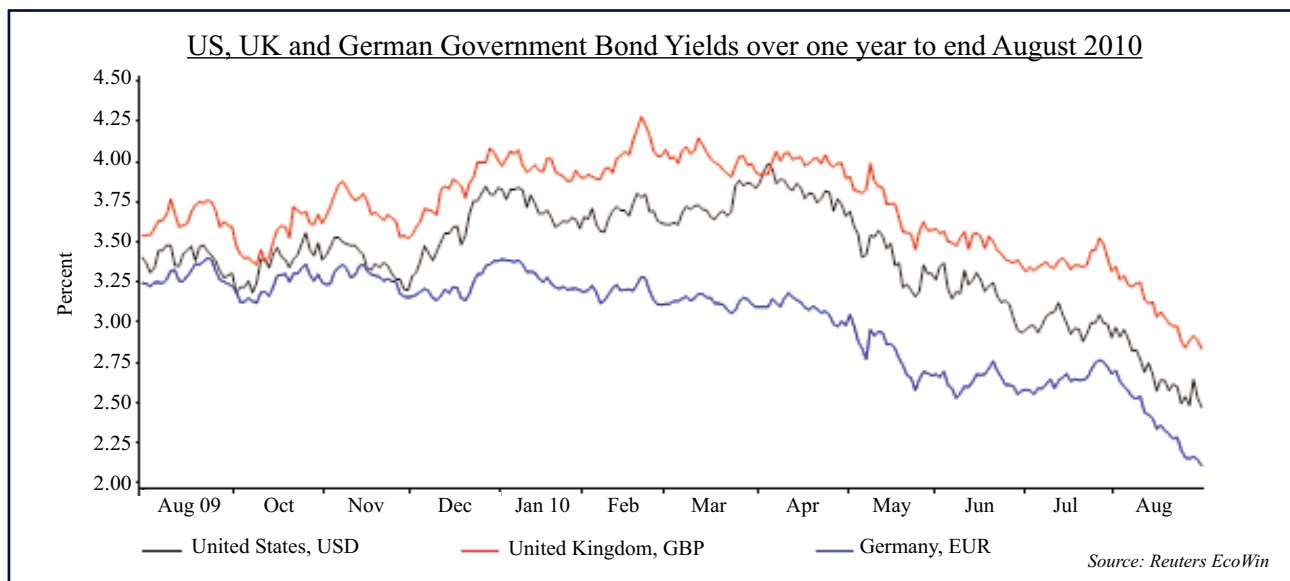


Double Dip Unlikely - Part II

Last month we set out the reasons why we believed that a double dip recession was unlikely. Since then a further deterioration in economic data has increased concerns about the economic outlook and prompted some investors to reduce risk assets and move back to the perceived safety of government bonds. Despite the weakening macroeconomic picture, we remain convinced that investors should maintain allocations to risk assets for the reasons described below. First though, we examine the economic data that triggered the recent market weakness.

Key economic releases in August included data suggesting that the US housing market is weakening once more. Sales of existing homes (as distinct from new houses) fell by 27.2% during the month to a level not seen since 1995. New home sales were not much better, declining by more than 12%. Poor news from the housing market was reinforced by disappointing jobs data. Unemployment remains stubbornly high at 9.5%, while the weekly tally of those applying for benefits for the first time is rising once more. Elements of this picture are echoed here in the UK. For example, house prices, according to Nationwide, have recorded their first back-to-back monthly price declines since February 2009.

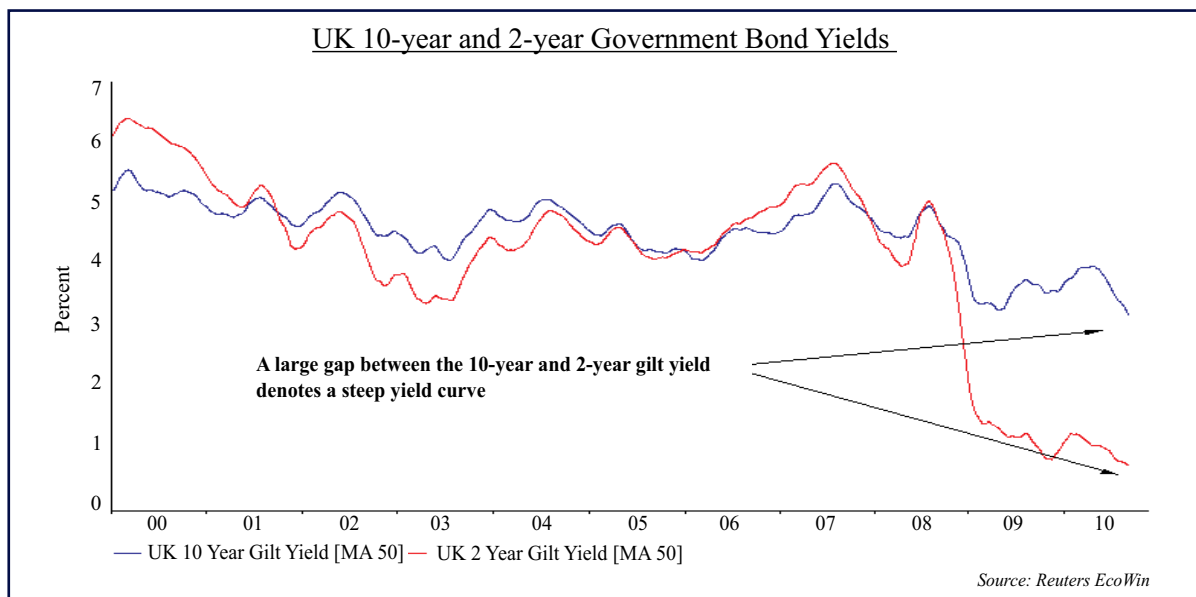
Given the disappointing news flow, it is unsurprising that equity markets have weakened. The closely watched S&P 500 Index of the US's leading companies declined by 5% during August. Of greater note, US government bond yields fell from more than 3.0% to less than 2.5% (i.e. prices rose strongly) as investors flocked to defensive assets (see the following chart).



Despite falling equity markets and bond yields, we maintain that we should resist shifting portfolios towards more defensive assets, for the following reasons:

- Developments in the global economy are proceeding broadly as we expected. After a strong rebound in 2009, the pace of recovery was always likely to ease (as indeed we suggested in our February 2010 note, ‘Withdrawal Symptoms?’)
- Central banks and governments are prepared to take further action to deflect their economies away from a bout of deflation; the only scenario which would justify such low bond yields. For example, Ben Bernanke, Chairman of the US Federal Reserve, set out his options for boosting the US economy in a speech on 27 August.

- ‘Safe-side’ assets are extremely unattractive; the interest paid on cash deposits is exceptionally low and government bond yields are at generational lows in the UK and Germany.
- Risk asset valuations are attractive. For example, despite the fact that dividends should grow over time, the yield on UK equities is higher than that on the 10-year UK government bond.
- Finally, we note that, while 10-year government bond yields have fallen, they remain high relative to shorter dated bonds, such as the UK 2-year gilt (see chart below). This steep yield curve signals that growth is expected to recover in due course; bond investors are prepared to lend to the government at low rates on a two year view, but for ten year bonds they require a higher yield. If bond investors expected ten years of low interest rates, accompanied by deflation, they would be prepared to buy 10-year bonds on yields substantially lower than current levels. This point is well illustrated by the price of Japanese bonds. Expectations of continued weak growth and deflation in Japan explain why the yield on 10-year bonds issued by the Japanese government has remained below 2% since 1998. This yield is currently 1.4%.



To conclude, unless or until 10-year bond yields fall to ‘flatten’ this yield curve, we maintain our conviction that we are witnessing a prolonged, though uneven, economic convalescence – not the beginnings of a bout of depression.

* * * * *

Stephen Green

Finally, we are delighted to note that Stephen Green, guest speaker at our last Saunderson House Half-Yearly Investment lunch, has decided to take on the role of trade minister in the new coalition government. This is good news for UK plc, and we wish him every success.

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