Investment Bulletin

SAUNDERSON HOUSE

28 SEPTEMBER 2011

CONFLICT-FREE FINANCIAL ADVICE

CONTINUED EUROZONE WOES AND MARKET VOLATILITY

In the six weeks following our Financial Crisis MkII note sent on 10 August 2011, equity markets staged a rally of close to 10%, before falling back once more. Last night the FTSE 100 closed at 5,294, more than 700 points lower than its value at the beginning of the year. This note sets out our reasons for believing that the current spell of volatility is temporary and that, therefore, current allocations to equities should be maintained.

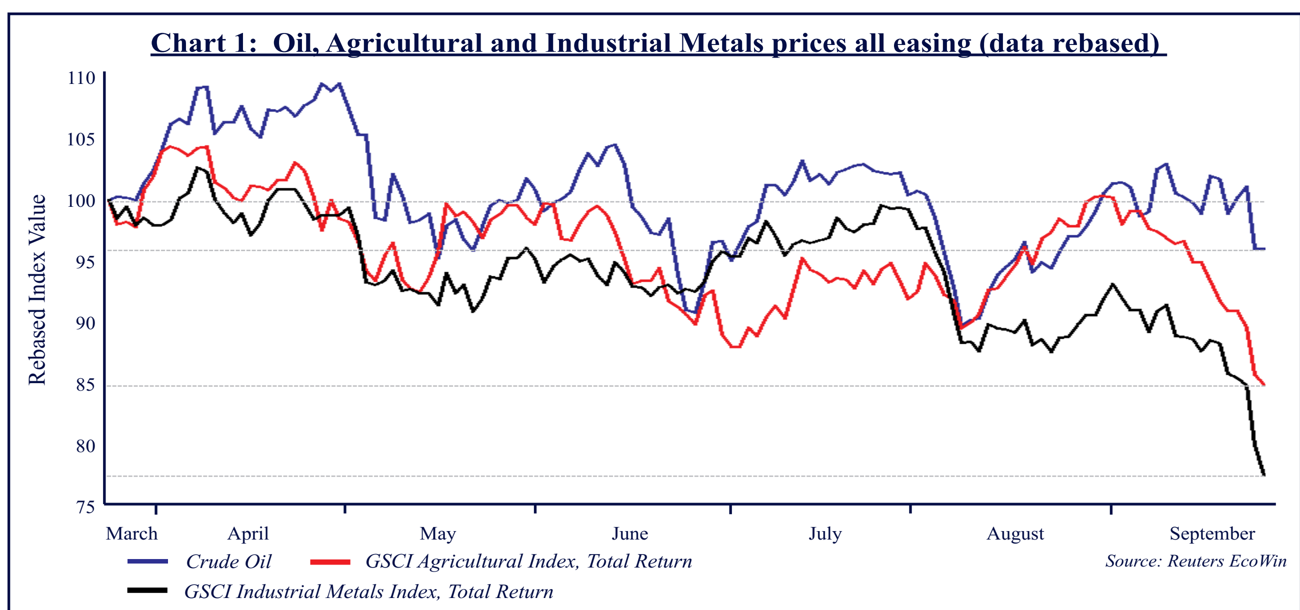
Concerns about the stability of the global financial system continue to dominate investor sentiment. A stream of weak economic data, combined with doubts about the ability of European leaders to tackle the eurozone debt crisis, are working to undermine confidence and thereby increase the likelihood of renewed financial crisis and global recession.

While weak equity markets, extreme volatility and the seemingly intractable European sovereign debt woes are disconcerting, we remain of the view that the current economic squall will pass in due course for the three reasons set out below:

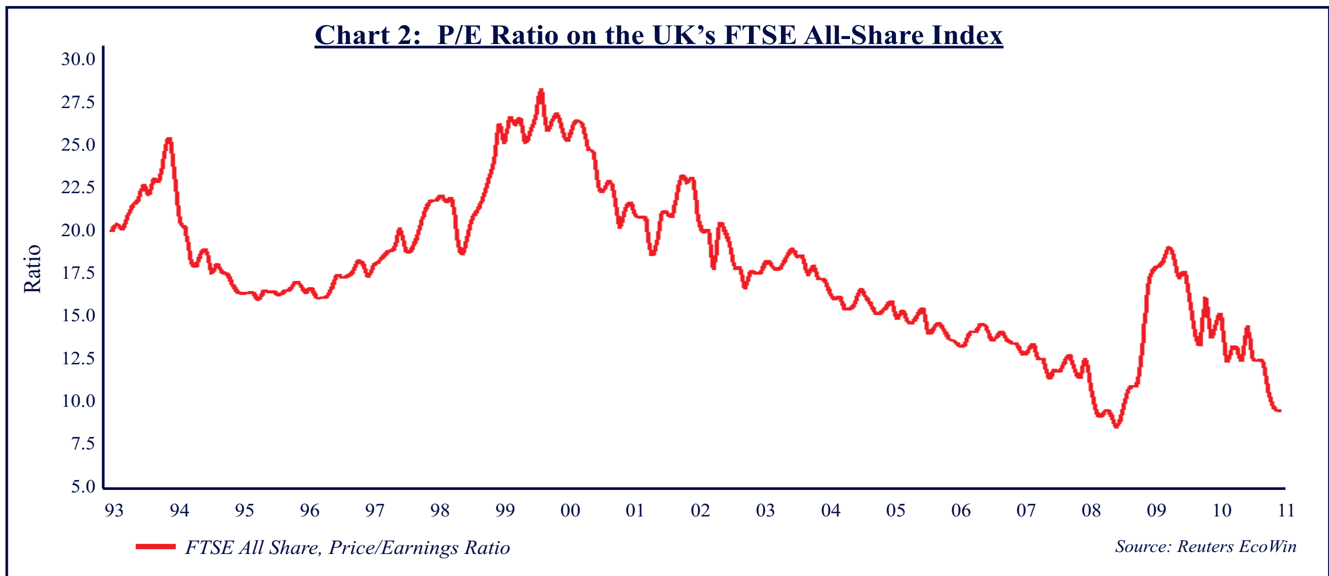
(i) The present air of crisis is forcing European policy makers to face up to the structural issues within the eurozone and deliver a lasting solution. Thus, the outline of a €2 trillion plan to address Europe's problems emerged from last weekend's meeting of the heads of the G20 nations. This is to include the recapitalisation of a significant number of European banks together with a controlled Greek default, allowing it to stay in the euro, while reducing its debt to more manageable proportions.

(ii) Further policy measures are available. The Bank of England hinted last week that, should economic conditions warrant it, further quantitative easing (QE) will be undertaken here in the UK. The US central bank, the Federal Reserve, disappointed investors last week by resisting calls for more QE and instead unveiled a technical plan to ease monetary conditions. Referred to as 'Operation Twist', this is intended to induce a change in the shape of the US yield curve through purchases of longer-dated Treasury bonds financed by the sale of short dated ones. However, as with the UK, we have little doubt that further QE will be forthcoming if necessary.

(iii) Commodity prices are easing (see Chart 1 below). This should reduce the pressure of high prices on consumers and allow policy makers in emerging markets to begin to loosen monetary policy. As a result, we should see faster growth from emerging economies in due course, with a positive impact on the developed world.



Considering these factors, and the lowly valuations on which equity markets now trade (see Chart 2 below), we believe that current allocations to equities should be maintained, and, where appropriate, further purchases should be made to rebalance portfolios.



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