Market Commentary

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SAUNDERSON HOUSE

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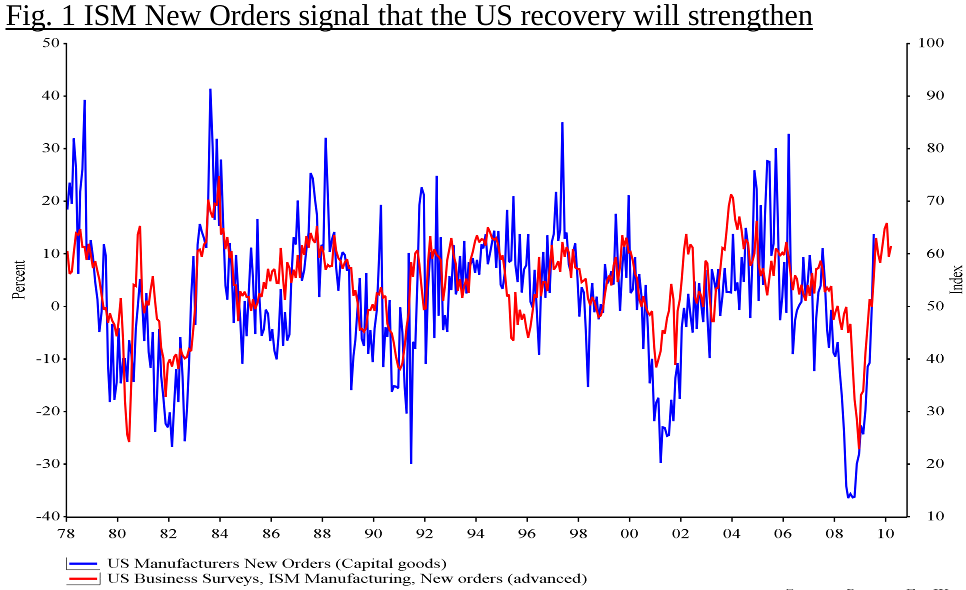
1. Economic and Investment Outlook

Thanks to concerted action by governments and central banks, the global economy has returned to growth. Genuine concerns that the financial crisis was so severe that it would be beyond the scope of governments to avert a prolonged global slump have thankfully proven misplaced. The chief concern among economists and investors now is the longer-term costs of the remedial measures taken to deal with the crisis, particularly the expansion of public debt.

The new year saw the first steps by the authorities to withdraw the extreme policy support put in place though 2008 and 2009 to address the crisis. The European Central Bank (ECB), for example, has closed its unlimited liquidity scheme, initiated at the peak of the financial crisis. This has triggered problems in Greece. The Bank of England (BoE), meanwhile, has announced a pause in its programme of quantitative easing and last month the Federal Reserve (the Fed) put to an end its $1,250bn program of mortgage bond purchases, its own version of quantitative easing. These are early signals of intent from policymakers, though in developed economies it seems unlikely that investors will face higher interest rates in the near future.

The improvement in the economic outlook can be seen in a wide array of data, such as retail sales and the ISM New Orders Survey (see Fig. 1). This series has a strong record of forecasting the strength of manufacturing new orders in the US six months in advance and is, therefore, signalling further economic strength.

Fig. 1 ISM New Orders signal that the US recovery will strengthen

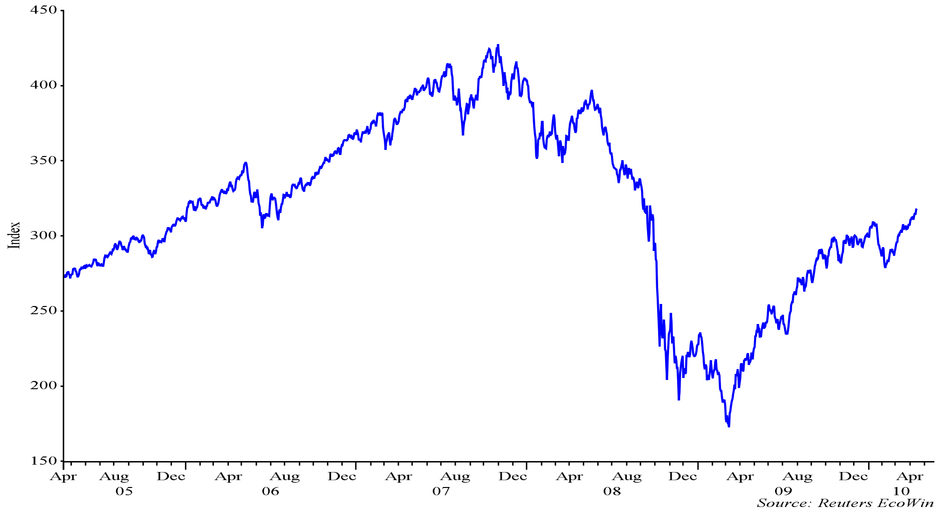


Source: Reuters EcoWin

Forecasts for economic growth are also now being revised higher. For example, the International Monetary Fund, in its January World Economic Outlook paper entitled ‘A Policy-Driven, Multispeed Recovery’, upgraded its expectation for output growth in the developed economies in 2010 to 2.1% from a forecast of 1.3% made in October.

As might be expected, the improved economic outlook has resulted in a sharp recovery in equity markets from the depressed levels of March 2009 (see Fig. 2). This improvement in share prices has been supported by encouraging company results which have, in the main, met or exceeded analysts' forecasts. The drivers of better corporate earnings include inventory rebuilding by companies that had run stocks down through the financial crisis, as well as lower costs due to aggressive overhead reductions made in late 2008 and the first half of 2009. Costs have also been helped by low interest rates and lower raw materials prices while the recession has brought opportunities for market share gains and corporate activity for stronger, well-financed businesses.

Fig. 2 MSCI World Equity Market Index over five years



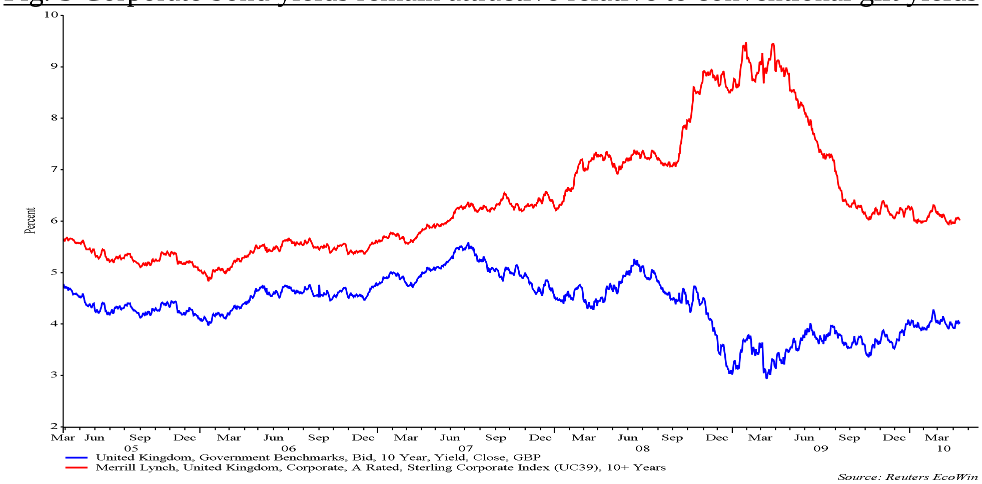
With the recovery arguably 'bought' through government stimulus measures and low interest rates, there remains some risk of economic setbacks and market volatility, particularly from shocks in debt markets or inflation surprises. High unemployment rates coupled with elevated levels of debt, particularly in developed economies, are risks to both growth and sentiment as stimuli are removed and interest rates are raised. However, we believe that on balance the outlook is positive for risk assets. Considering valuations, the extreme weakness in equity markets in late 2008 and early 2009 saw dividend yields in most major equity markets move above their respective government bond yields. This was a clear indication of investors' extremely bearish expectations for both the sustainability of existing dividends and the prospects for future dividend growth. The rally over the last 12 months has brought equity yields down once more but, unless earnings and dividend growth fall materially short of current expectations, equities, particularly those of high-quality defensive businesses, remain attractively valued relative to both government bonds and cash deposits.

The MSCI World Equity Market index has provided a total return of +13.52% in sterling terms over the last six months and +44.79% over the last year.

Turning to other major asset classes, government bonds, which were the asset class of choice for investors in late 2008 and early 2009, have performed poorly relative to other classes of fixed interest since the beginning of 2009. This has been due to concerns about the high levels of issuance and the possible return of inflation. However, the downward pressure on sovereign bond prices has been, to a degree, offset by very low interest rates and concerns that economic growth may disappoint. Weighing these factors, our view is that the UK 10-year benchmark government bond, now yielding 4.03%, remains fair value at best.

In stark contrast to government bonds, corporate bond prices were driven to exceptionally low levels in early 2009, owing to both forced selling by leveraged investors caught out by the ferocity of the financial crisis and concerns about falling corporate earnings. The increase in the yields on corporate bonds was even more pronounced when viewed relative to their government counterparts (see Fig. 3), as investor enthusiasm for the defensive attributes of government bonds forced prices higher and yields lower. This situation began to correct in the first quarter of 2009 in response to policy initiatives, since when corporate bond prices have made a rapid recovery and yields have fallen once more. In our view, however, the yields available remain attractive, both in absolute terms and relative to government bonds and cash on deposit.

Fig. 3 Corporate bond yields remain attractive relative to conventional gilt yields



Considering commercial property, a five-year bull market came to an end in mid-2007 when prices eventually began to weaken under the pressure of credit market dislocation. Property values continued to decline until mid-2009, as tighter credit market conditions removed an important source of funding for commercial property buyers and the deteriorating economy undermined tenant demand. While commercial property values have now begun to recover, rents may still have further to fall. However, with the asset class yielding close to 7%, we believe it is now attractive, both in absolute terms and relative to other assets. We have therefore been recommending additional allocations to this asset class.

The following sections consider our monitored asset classes, including hedge funds and cash, in more detail.

2. Equities

2.1. UK Equities

The UK economy has finally emerged from recession, with output expanding by 0.4% in the fourth quarter of 2009. In spite of aggressive policy action from the government and the BoE, the return to growth has proven weaker and arrived later in the UK than in other G7 nations. Significant obstacles to sustained growth remain, not least among these is the government's budget deficit, which is forecast to amount to 12.8% of GDP this year. Continuing deficits will necessitate the issuance of c£550bn of gilts in the next three years and have triggered a debate on the sustainability of the UK's triple-A credit rating.

The UK economy has been overly reliant on household spending and financial services as growth drivers in recent years. Both areas, via the housing and mortgage markets, were at the eye of the financial storm. As such, it is perhaps unsurprising that the UK has fared less well than many other developed economies. Moreover, the ongoing need for households to save more despite rising taxes, together with the likely increases to bank regulation resulting from the financial crisis, may act as a drag on growth for several years to come.

These considerations are, perhaps, less important for investors than it might at first appear. The UK stock market is, at best, a highly distorted mirror of the UK economy, with more than 70% of the revenues from FTSE 100 companies derived from abroad (according to Morgan Stanley). This means that a portfolio of UK-listed equities can benefit substantially from the better growth dynamics of many overseas economies as well as translation benefits from a weaker domestic currency. Equity valuations, although no longer at the distressed levels of a year ago, do not appear stretched and the high dividend yield on the UK stock market, relative to yields on cash, gilts and the highest rated corporate bonds, remains attractive. We remain positive, therefore, on the outlook for UK equities.

However, when taking full account of the UK-specific political risks related to the impending general election and the potential impact an uncertain outcome could have on sterling, we believe that there is merit in re-weighting portfolios away from the UK and towards the US, Asian and emerging markets, as discussed in our investment bulletin of Friday 19 March.

The FTSE All-Share index has provided a total return of +12.24% over the last six months and +52.30% over the last year.

2.2. European (excluding UK) Equities

The eurozone economy failed to grow in the fourth quarter of 2009, highlighting the lacklustre rebound experienced by core European economies and the weaknesses of some peripheral countries, such as Ireland, where output declined by 2.3%, and Greece, which recorded a 0.8% contraction. Inflation in the 16-country currency bloc increased to its highest level in fifteen months in March, with consumer prices rising 1.5% year-on-year, from 0.9% in February. However, with unemployment reaching 10.0% in February and wage growth falling, the rise in inflation is expected to be temporary. It is likely to be some time before the European Central Bank (ECB) raises interest rates from their current historic low of 1.0%.

Eurozone retail sales fell 0.6% in February following a 0.2% fall in the previous month, which suggests that aggressive fiscal tightening measures and concerns over job security will continue to have an effect on consumer confidence and it may be some time before consumers play a full part in an economic recovery. With weak domestic spending, the prospects for growth in the eurozone are likely to be heavily dependent on a renewed pickup in exports, and particularly manufacturing. Unfortunately, data here has also been fragile, with German industrial production unchanged in February following a downward revision to the January growth figure to just 0.1%.

This year, European equity markets have been unnerved by mounting concerns over the potential for sovereign debt default in Greece, and the possibility of contagion to other troubled eurozone economies. Membership of the single currency has denied such countries the pressure release of devaluation and the process of addressing fiscal imbalances is likely to act as a significant obstacle to economic recovery. Moreover, with domestic demand subdued and manufacturing and export-orientated European companies unlikely to see any significant growth in demand in the near term, eurozone growth is anticipated to remain lacklustre.

Having advised a reduction in weightings to European equities at the end of 2007, we recommend that remaining allocations are maintained, where appropriate.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +7.15% over the last six months and +54.48% over the last year. In sterling-adjusted terms, the returns are +4.59% over the last six months and +48.76% over the year.

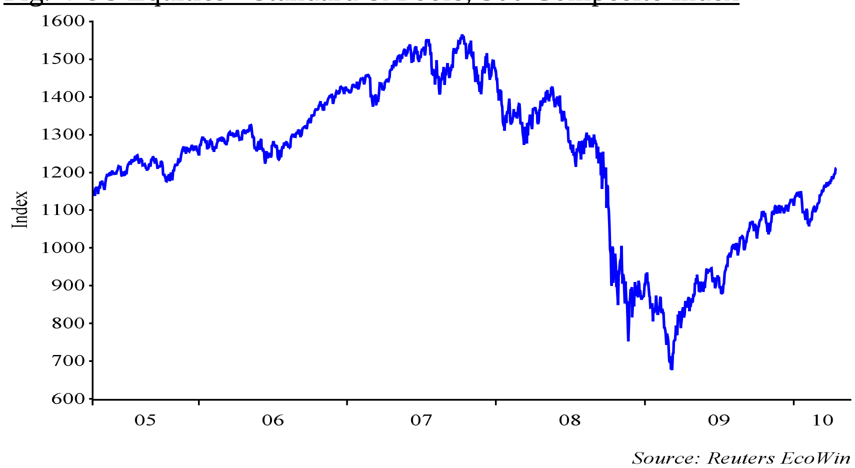
2.3. North American Equities

The recovery in the US economy appears to be gathering pace. At its March meeting, the Fed highlighted improving business spending, particularly on equipment and software, together with the stabilising labour market, as reasons for upgrading its outlook for the economy. Similarly, in a recent speech Larry Summers, senior economic advisor to the US President, expressed the view that the US economy is near to 'escape velocity'; the point at which recovery becomes self-sustaining.

Further evidence of gathering economic strength comes from retail sales, which grew by 1.6% month-on-month in March, and are 8.2% ahead over one year. Thus, while consumers continue to face significant headwinds, including a lack of wage growth and the need to reduce personal debt, the Fed's commitment to maintaining exceptionally low interest rates for "an extended period" is clearly providing some support to consumption.

Turning to the stock market, by the end of the first quarter of 2009, US equities had fallen to levels that were discounting a severe and prolonged economic slump. However, the supportive monetary and fiscal conditions, together with a gradual improvement in the economy, has underpinned a sustained rally which, given the strong position of the US corporate sector has, in our view, further to run (see Fig. 4). We are therefore recommending that allocations to US equities are selectively increased.

Fig. 4 US Equities - Standard & Poors, 500 Composite Index



The S&P 500 index provided, in US dollar terms, a total return of +11.75% over the last six months and +49.77% over the last year. The fluctuations of the dollar mean that, when translated into sterling, the returns are +17.82% over the last six months and +41.52% over the year.

2.4. Japanese Equities

Despite some recent signs of improvement, concerns remain about the vitality of Japan's economy. These concerns have been highlighted by the downgrading of GDP growth estimates in both the third and fourth quarters of 2009. Primary among the issues facing Japan is a very unhelpful demographic profile. The population is aging and, as a result of minimal immigration, shrinking. Consequently, a growing proportion of the tax burden is falling on a declining number of taxpayers. Moreover, as individuals save in order to fund retirement, the domestic sales base of the corporate sector is being eroded. Real wages have been trending lower since 1997, thus deflationary expectations appear ingrained and, to an extent, self-fulfilling.

The Democratic Party of Japan (DPJ), elected in an historic, landslide victory on 30 August 2009, has declared its determination to stimulate domestic demand and combat deflation, and has prompted the Bank of Japan to expand its quantitative easing programme accordingly. However, with government debt at c200% of forecast 2010 GDP and interest rates near zero, the authorities' ability to take further effective measures appears limited.

While we acknowledge the severity of Japan's structural economic issues, we believe the corporate outlook is brighter. Aggressive cost cutting measures have been undertaken and Japan's companies, and therefore its equity market, should now be well placed to benefit from the global recovery, particularly within Asia. However, the yen's strength since the onset of the credit crisis continues to disadvantage Japan's all-important export sector. Though the finance minister, Naoto Kan, has made headlines with his vocal support of a weaker yen, foreign exchange markets have continued to prize the 'safe haven' status of the yen, thereby supporting the currency. A sustained improvement in risk appetite, perhaps in response to evidence that economic global growth can be maintained after policy support is removed, might be accompanied by a weakening yen – a development that would be welcomed by Japan's export sector.

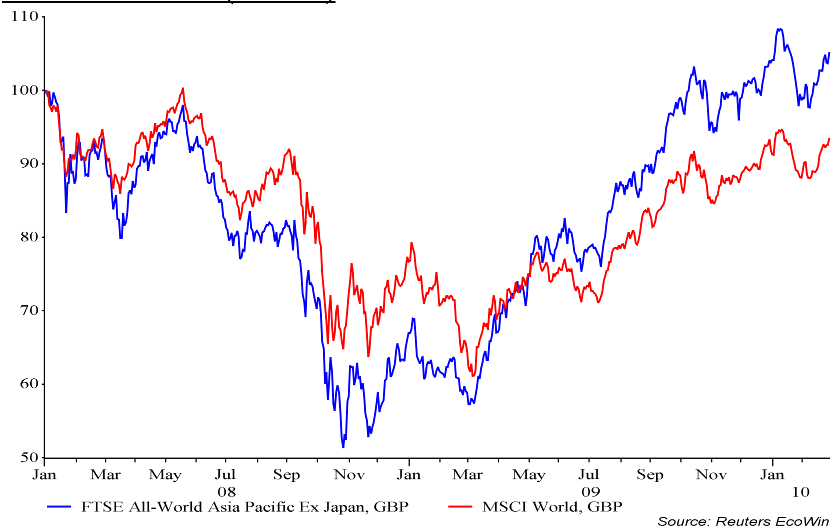
As a result of the significant structural issues facing Japan, the equity market has been a long-term laggard among the developed markets. However, Japanese equities now appear inexpensive on a range of measures, both in historical terms and relative to other markets. We believe that the normalisation of global monetary policy may present opportunities to increase allocations to Japanese equities in the future, but recommend that, for now, current weightings are maintained, where appropriate.

The FTSE Japan index provided, in yen terms, a total return of +9.63% over the last six months and +29.75% over the last year. In sterling-adjusted terms, the returns are +10.76% over the last six months and +29.60% over the year.

2.5. Asia Pacific (excluding Japanese) Equities

Asian equity markets suffered a mild correction in early 2010 as investors became concerned about the future path of monetary policy (see Fig. 5). Boosted by government stimuli, robust domestic demand and the strong recovery in international trade, the region's economies have enjoyed rapid growth in recent months. However, rapid growth brings with it the risk of inflation and thus the need for more restrictive monetary policy. Furthermore, a normalisation of policy in the developed economies would also pose a threat to Asian equities if it prompted investors to withdraw the liquidity that had supported these markets throughout 2009.

Fig. 5 FTSE All-World Asia Pacific ex Japan compared to MSCI World since 2008 (rebased)



That the correction was not more severe suggests that the region's markets are in fact relatively well underpinned and not simply dependent on low interest rates globally. While economic growth is likely to ease from the very high rates recorded in the first quarter of 2010 (Singapore, for example, expanded at a record annualised rate of 32.1% in the first three months of the year), it looks likely to continue to exceed that seen in the developed markets.

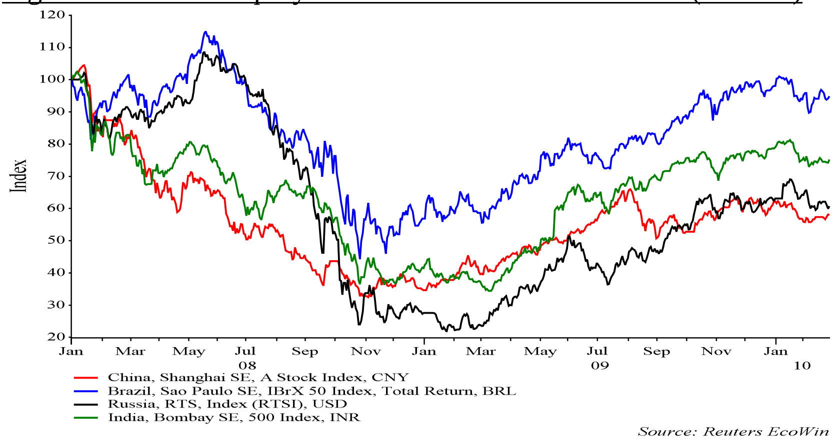
Turning to the region's equity markets, on measures such as price to book value, valuations are comparable with their long-term average levels. In the context of the region's attractive growth prospects, such valuations appear undemanding. We believe there is now an opportunity to raise allocations to Asia Pacific, where appropriate.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +5.78% over the last six months and +57.31% over the last year. When translated into sterling, the returns are +14.68% over the last six months and +69.32% over the year.

2.6. Emerging Markets Equities

After the steep losses recorded in 2008, emerging equity markets[*] enjoyed a strong 2009 (see Fig. 6). The implementation of fiscal stimuli in many emerging economies, together with the recovery in the developed markets and rejuvenated international trade, encouraged a renewed optimism about the growth prospects of the emerging economies. Funded by low interest rates, investors directed record sums towards emerging markets equity funds over the course of 2009.

Fig. 5 The 'BRIC' equity markets since the start of 2008 (rebased)



Investors have since had cause to re-assess their risk appetite. Mirroring the west's retreat from ultra-accommodative monetary policies, many emerging markets have begun to withdraw liquidity from their economies. China has ordered the nation's banks to curb lending, while monetary conditions would also be tightened should the renminbi be allowed to appreciate. India, meanwhile, has imposed higher capital requirements on its banks and raised interest rates. In response, investors have drawn back from these markets, thereby justifying, to a degree, our concerns that performance was latterly being driven by liquidity, rather than the underlying fundamentals.

While acknowledging the growth potential of the emerging economies, we have been slightly cautious of the relatively high equity valuations investors have been asked to pay for growth. However, the more measured returns of the equity markets, relative to the heady gains recorded in 2009, has increased our conviction that these markets are now fairly well underpinned and we believe there is now an opportunity to increase allocations where appropriate.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +11.57% over the last six months and +84.69% over the last year. In sterling-adjusted terms, the returns are +17.64% over the last six months and +74.52% over the year.

[*] MSCI includes 22 countries in its emerging markets index: Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

3. Fixed Interest

For more than a year, we have been recommending that clients avoid conventional government bonds. Our views reflect the low yields on western government debt following sharp price appreciation in 2008, the high level of issuance expected over the coming years and the vulnerability to rising inflation. We consider the latter a meaningful risk as a result of central banks reducing base rates to record low levels and adopting unconventional monetary policies, such as quantitative easing, to boost money supply. A sustained dose of inflation would be a convenient way for borrowers, including governments, to erode the real value of their debt, though it would clearly damage the credibility of central banks. The impact on conventional government bonds of higher inflation would be an increase in yields and a corresponding fall in prices.

With inflation a significant medium term risk, we retain our positive stance on inflation-linked bonds. These have their capital and coupon values linked to a measure of inflation (such as the retail prices index in the UK). As a consequence, they can broadly preserve their purchasing power in an inflationary environment. Although real yields, particularly on UK index-linked gilts, look low in absolute terms, we see such bonds as useful insurance against the risk of inflation.

We also continue to favour funds of corporate bonds. We first recommended increasing allocations to investment grade bonds in January 2009, since when the asset class has performed strongly. With the additional yield available on corporate bonds over their sovereign counterparts now much narrower, we expect that future returns will come less from capital appreciation and more from the income yield. However, this yield remains attractive both in absolute terms and relative to that available from conventional government bonds and cash deposits. Mindful that official interest rates must rise in the medium term, we have latterly been recommending that allocations are invested in bond funds with more strategic mandates. The managers of these funds can hedge out interest rate risk and also allocate to those segments of the asset class offering the best prospects. Such funds are also our preferred route for obtaining exposure to non-investment grade corporate debt, which is less sensitive to interest rates but carries greater default risk than more highly rated credits. Some strategic bond funds also have the flexibility to invest in emerging markets bonds. At present, many emerging economies are far less indebted than those in the developed world, but still offer higher yields and therefore potentially attractive opportunities for bond fund managers.

The ABI UK Pension Gilt sector provided a total return of -1.54% over the last six months and +1.13% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +3.41% over the last six months and +9.77% over the last year. The ABI Pension Sterling Corporate Bond sector provided a total return of +6.63% and +32.98% over the same periods.

4. Property

The UK commercial property market reached its low point in the summer of 2009, approximately three months later than equity and corporate bond markets. The initial property rally was muted, with investors still cautious on the asset class, due in part to its dependence on a weak domestic economy and concern that there would be a wave of sales from banks as a result of leveraged property investors either defaulting or being unable to refinance loans.

Attractive yields relative to cash and gilts and, where available, attractive borrowing rates, have overcome investors' concerns and UK commercial property consequently performed strongly through the second half of 2009. According to data from Investment Property Databank (IPD), the total return from their UK Monthly index of predominantly prime-quality commercial property over the final quarter was 9.45%. This was the highest return since they started collecting data in 1986 and reflected substantial buying from UK institutional and overseas investors, the latter attracted in part by the weak pound. Supply, meanwhile, has been tight, with a limited number of prime properties (modern buildings in good locations and on long leases to financially sound tenants), coming to market. As a result, initial yields on the IPD index have been pushed down from nearly 8% at the market's low point to 6.7% as at the end of March. Lagging the investment market is the occupier market, though this is now showing signs of stabilising. Rental values are still falling but the rate of decline has slowed in most areas. One exception is City of London offices, where competition for limited grade-A space is resulting in rental growth. This improvement in the rental market is supported by a general fall in vacancy rates, from their peak in October 2009.

Given this stabilisation in commercial property market fundamentals, we are optimistic that the asset class can deliver attractive returns relative to cash and gilts. Prime assets, in our view, are to be preferred, despite lower yields. This is where institutional demand is focused and banks are becoming more willing to lend against such properties. Secondary quality assets, which are not as well supported by fundamentals or investor demand, have rallied less than prime property. However, they can still be acquired on double digit-yields and, selectively, offer attractive investment opportunities.

The ABI UK Pension Direct Property index provided a total return of +12.78% over the last six months and +13.50% over the last year.

5. Cash

Sterling deposits and monies held in AAA-rated liquidity funds presently earn returns broadly in line with the BoE Bank Rate of 0.50% p.a. Despite low rates, cash still has attractions, particularly where attractive rates from government-backed or good quality institutions can be secured. Cash, whether on instant access deposit or placed in a liquidity fund, also brings flexibility to portfolios, enabling investors to take advantage of opportunities in other asset classes as and when they arise. Cash invested at the BoE Bank Rate would have provided a return of +0.25% over the last six months and +0.50% over the last year.

6. Note on Hedge Funds

Our view that hedge funds are riskier than generally perceived gained wider acceptance during the financial crisis. While we continue to research the sector, the transparency of many hedge funds' investment processes is not sufficient for us to be comfortable recommending their inclusion in portfolios. Liquidity, valuation of assets and the level of charges are all areas where we believe investors deserve, and should demand, more clarity.

Almost one in ten hedge funds closed in 2008, according to Chicago-based research group Hedge Fund Research. Despite a partial economic and financial recovery, more funds also ceased trading than opened in 2009. We note with interest that the managers of several of the closed funds have opened new operations. We believe that many may have done so in order to reset the 'high water marks' above which performance fees can be levied, having fallen some way below them while managing their previous funds. Investor expectations of positive, uncorrelated returns from hedge funds have clearly been disappointed and, in our view, the industry's ability to justify high charges and performance fees remains questionable.

The fallout from Bernard Madoff's fraudulent investment scheme persisted through 2009 as the estimate of the true extent of the scheme's losses has grown to $21.2bn, far higher than earlier estimates. Allegations of insider trading and fraud at hedge funds Galleon Group and K1 respectively go some way to justifying our view that the transparency of many funds, and funds of hedge funds, are not up to the requisite standard for us to consider recommending them to clients.

The hedge fund industry has emerged from the financial crisis in a very different shape. There are now fewer funds, generally employing lower leverage, charging, on average, lower fees and offering better reporting, transparency and liquidity. These, in our view, are all welcome developments.

For completeness, we include the HFRX Global Hedge Fund index figures for hedge fund performance below. We are, as might be expected, somewhat sceptical about the validity of these figures. In our view, the index will almost certainly overstate returns. This is because the submission of data to the index compilers is voluntary and it is unlikely that failed or poorly performing funds will submit numbers for inclusion. The effect will be that the index figures overstate the true performance that might be expected from a range of hedge fund investments, perhaps by as much as several percentage points.

The HFRX Global Hedge Fund GBP index provided a total return in sterling terms of +3.81% over the last six months and +14.23% over the last year.

The above commentaries reflect our views as at 16 April 2010. Any material changes in economic and market conditions between then and the time of writing your report will be reflected in our recommendations.

Unless otherwise noted, all performance figures are total returns (including income re-invested) for the six month period from 30 September 2009 to 31 March 2010 and the twelve month period from 31 March 2009 to 31 March 2010 (source: Lipper Hindsight).