

# **Market Commentary**

**August 2009**

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### Risk Warnings

This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 14 August 2009. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments and any income therefrom can go down as well as up and you may not get back the full amount you invested. Levels and bases of, and reliefs from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor.

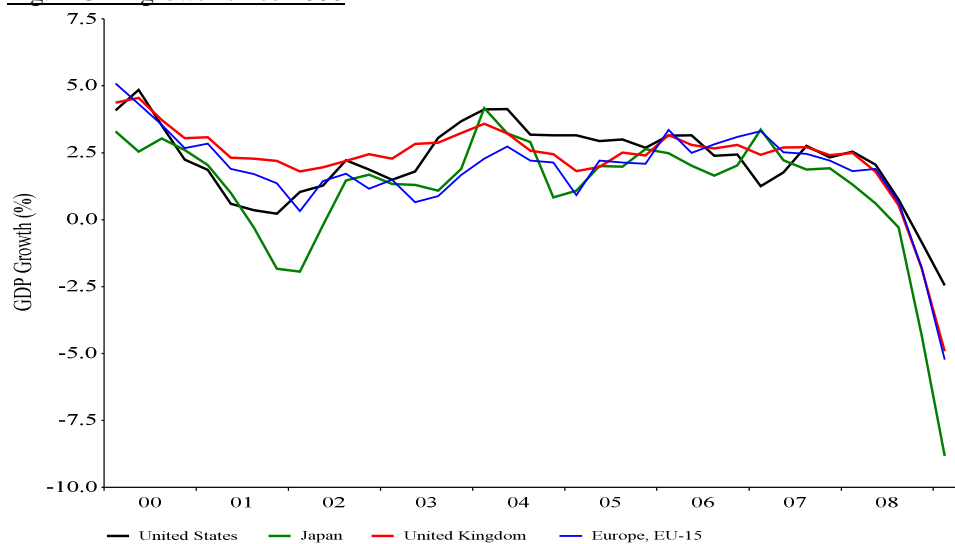
## 1. Economic and Investment Outlook

In its most recent 'World Economic Outlook', the International Monetary Fund (IMF) forecast that total global output will decline by 1.4% this year with the greatest impact being felt by the larger developed economies. For 2010, the growth forecast for the global economy has been raised to 2.5% from 1.9%. Notably, the US economy is forecast to return to growth of 0.8% next year and the Japanese economy to grow by 1.7%. According to the IMF, sluggish growth in advanced economies will continue to be supported by stronger growth in emerging economies, in particular China, India and Africa.

Governments across the world have taken aggressive action in an attempt to prevent what is already a severe recession turning into a self-sustaining depression, or multi-year slump, similar to that seen in the 1930s. As well as Keynesian-style fiscal stimuli, a bewildering array of new policy initiatives is now in place both to ease credit markets and support economic activity. Such forceful policy intervention appears to be having a positive impact and has consequently begun to restore market confidence. The agreement at April's G20 summit to support vulnerable countries and regions, such as Eastern Europe, by increasing IMF funding threefold to \$750bn has also worked to boost investor sentiment.

Fig. 1 shows the magnitude and degree of synchronisation of the economic slowdown in major economies. There are a number of factors crucial in determining how long and how deep this slowdown will be and whether a prolonged recession can be avoided. These include the extent of further falls in asset prices, particularly houses, and how far unemployment rises, with the attendant secondary effects on asset prices, consumer spending and confidence.

Fig. 1 GDP growth since 2000

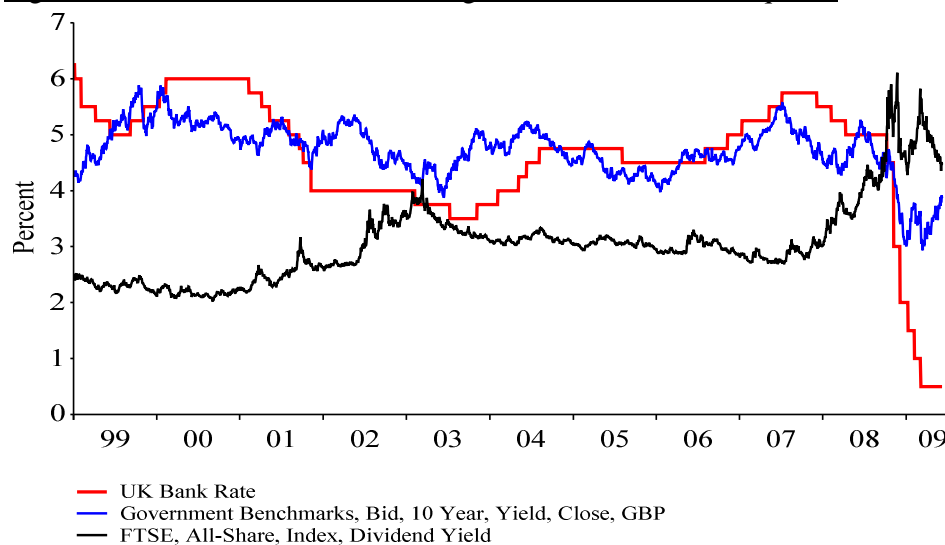


The last 18 months have seen the assumptions on which confidence in an ever-expanding global economy and strong financial markets were built, turned on their heads. One such assumption was that, when credit availability stalled, those economies enjoying credit-fuelled consumption growth, such as the UK and the US, would fare much worse than countries with trade surpluses, such as China, Japan and Germany. However, as demand from consumers in the US and other developed countries slumped, those economies reliant on exporting their goods and services have also been severely impacted.

Recent economic indicators suggest that the worst of the global recession may now be behind us and data, particularly in the US, France, Germany and Japan, appear to be stabilizing, albeit at lower levels. While it is a relief that the aggressive measures taken by governments and central banks have prevented a complete failure of the financial system, this has given way to an understanding that the global economy is in line for several years of below-trend growth. Both governments and businesses will need to adjust to a post-credit crisis world of higher interest rates, increased savings ratios, lower consumer demand and increased regulation.

Within the mainstream asset classes, equities have suffered acutely as expectations of much reduced economic growth, and therefore lower corporate profitability, have been reflected in valuations. While equities did not appear to reach levels at which they were expensive on measures such as price-to-earnings ratios, with hindsight, it can now be seen that corporate profits had been driven to unsustainable levels by the over-expansion of credit. As profit expectations were reduced, equity prices fell, taking yields, on an historic basis, to levels not seen in the last ten years (see Fig. 2). Since March this year, yields have fallen sharply as investors have returned to risk assets.

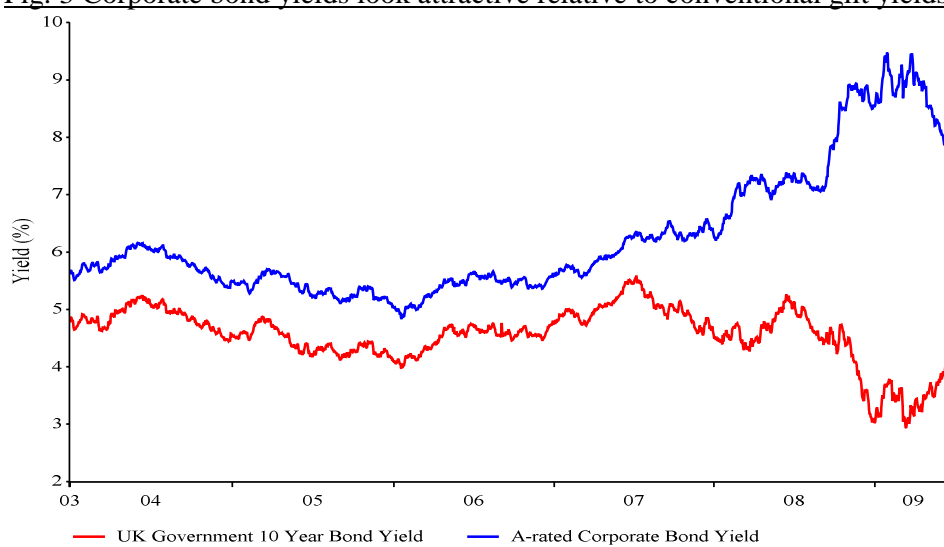
Fig. 2 Yields on UK assets: cash, UK government bonds and equities



*Source: Reuters EcoWin*

Turning to other asset classes, fixed interest markets have seen a very marked rise in risk aversion as investor appetite for complex structured instruments, such as collateralised debt obligations (CDOs), has evaporated. As a result, government bonds performed strongly relative to all other fixed interest instruments, including corporate bonds, from July 2007 to March 2009. Concerns about falling corporate earnings and forced selling by leveraged investors also pushed corporate bond yields much higher relative to those offered on government bonds (see Fig. 3). The easing of credit markets in response to the policy action from governments and monetary authorities has caused corporate bond yields to fall and the spread over government bonds to narrow somewhat but, in our view, corporate bonds still present an attractive opportunity for investors prepared to take a longer term view.

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



Considering commercial property, values rose strongly for five years until mid-2007 but have since been undermined both by the withdrawal of debt financing and the economic downturn, which has weakened tenant demand. Although commercial property remains economically sensitive and rents may yet fall, asset yields and valuations are starting to look more attractive and we are beginning to see opportunities in the asset class.

Our recommended asset allocations shifts, including reductions in equity weightings during 2007, have helped to protect portfolios from some of the market falls but, with perfect foresight, these should have gone much further. However, portfolios have benefited from the rally in equity markets from their March lows and while there has been a re-rating of the asset class, the yields on many blue chip equities still look appealing when compared to those available on other assets.

The MSCI World Equity Market index has provided a total return of +10.40% in sterling terms over the last six months and -5.69% over the last year.

## 2. Equities

### 2.1. UK Equities

Conditions in the UK economy have deteriorated rapidly as a result of the global financial crisis. As measured by provisional GDP figures, the economy recorded a 0.8% fall in the second quarter, its fourth consecutive quarterly decline, dampening any hopes that the UK had managed to pull out of recession. Data from the labour market also remain negative with the unemployment rate rising to 7.7% in June from 7.2% the previous month. This has reduced pressures for higher wages and consequently, inflation is now less of a concern for policymakers. On the government's target measure, the Consumer Prices Index (CPI), prices rose by 1.8% p.a. in June, down from a recent peak of 5.2% in September. The more familiar Retail Prices Index (RPI) has fallen faster still and is now showing prices, in aggregate, declining at a rate of 1.6% p.a. The main differences between the two measures are that mortgage interest payments and house price depreciation, both components of the RPI, are excluded from the CPI.

With inflation no longer a threat in the short term, the Bank of England (BoE) has reduced interest rates aggressively. Reductions of 1.50% and 1.00% in November and December 2008 respectively and further 0.50% reductions in each of the first three months of this year have taken the Bank Rate to 0.50%. This is far lower than at any time since the creation of the BoE more than three hundred years ago and gives a clear indication of the scale of the economic crisis. In March, the government introduced a programme of quantitative easing in order to increase money supply in the economy and encourage bank lending to consumers. Emphasising the ongoing nature of this recession, the Bank of England recently extended this facility.

Turning to the stock market, the path of UK equities from here will depend crucially on the depth and longevity of the recession and the extent to which future earnings downgrades are already discounted in share prices. Our view is that the recent rally in equity markets from the lows of March was warranted by the stabilisation of the financial system but that the magnitude and uncertain duration of the downturn means that increased allocations are not appropriate at present. We recommend that current weightings to UK equities are maintained, where appropriate.

The FTSE All-Share index has provided a total return of +16.15% over the last six months and -10.51% over the last year.

## 2.2. European (excluding UK) Equities

Continental European economies, barring some peripheral nations, do not have balance of payments deficits of the same magnitude as the US and UK and their consumers are much less indebted. Eurozone GDP was 0.1% lower in the second quarter of 2009 following a 2.5% fall in the first quarter, with the improvement aided by both France and Germany unexpectedly returning to growth. The 16-country region also continues to experience deflation, with consumer prices falling at an annualised rate of 0.6% in July following a 0.1% p.a. drop in June. The European Central Bank (ECB) had been less willing than its Anglo-Saxon counterparts to reduce interest rates and its official rate now stands at 1.00% – higher than base rates in the UK, US and Japan. Although this has prompted criticisms that the ECB is not being sufficiently aggressive, the central bank's injection of €442bn of one-year funds into the eurozone banking system in June at an interest rate of just 1% shows that it is taking aggressive and supportive action. European banks now have access to effectively unlimited cheap liquidity until the summer of 2010. As a consequence, the ECB's balance sheet is now bigger as a proportion of eurozone GDP than that of the Federal Reserve relative to US GDP.

Unemployment, which rose to 9.4% in June, has not prompted aggressive fiscal policy responses from European governments. Due to their more generous welfare systems, headline-grabbing policies similar to those in the US have been judged less crucial. These social safety nets, plus lower consumer indebtedness, should mean that European consumers can cope with higher levels of unemployment and continue to spend. However, domestic consumer spending is a less important driver of GDP in Europe than it is in the US and the UK. Continental Europe is instead more reliant on exports and it is here that the strength of the euro in 2008 and the sharp fall in world trade have been particularly painful. Although the euro has weakened somewhat over recent months and improving economic data has started to emerge, principally in France and Germany, the recovery is likely to be fragile as it will take time before export-orientated European companies see any significant growth in demand. Having advised a significant reduction in weightings to European equities at the end of 2007, we recommend that remaining allocations are retained where appropriate.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +22.85% over the last six months and -17.18% over the last year. The fluctuating value of the euro means that, when translated into sterling, the returns are +18.19% over the last six months and -10.08% over the year.

### 2.3. North American Equities

In what was an historic statement, the Federal Reserve (the Fed) cut interest rates from 1.00% to “between zero and 0.25%” on 16 December 2008 and stated that it will leave rates at exceptionally low levels for as long as it takes to steer the US economy away from a deflationary slump. The Fed’s response to the crisis has been impressive; the Fed funds rate (base rate) was 5.25% as recently as September 2007. Interest rate cuts have been accompanied by a Federal economic stimulus package, the passage into law of the \$700bn Troubled Asset Relief Program (TARP), and injections of capital into US banks similar to those used in the UK.

These measures appear to be having their desired effect with economic output in the second quarter contracting by a less-than-projected 1.0% p.a., a marked improvement on the 6.4% p.a. contraction in the first quarter. Stabilising consumer demand is prompting companies to rebuild inventories and is consequently triggering outright gains in production and orders. This is beginning to impact labour markets with unemployment having receded from 9.5% in June to 9.4% in July.

Consumer demand, however, remains fragile. Though improving employment prospects should encourage personal expenditure, a return to the credit-fuelled consumption patterns of previous years is doubtful. Consumer credit continues to contract as the household sector deleverages, and the need for US consumers to rebuild their savings is likely to create a meaningful headwind for end demand.

Given the scale and speed of the policy response from the Federal government and the flexibility of the US corporate sector, which suggests restructuring can take place rapidly, we believe that the US will be one of the first economies to emerge from recession.

While US equities had begun to look inexpensive relative to historical valuations, the recent rally has taken them back to broadly fair value. We therefore recommend that allocations to US equities should be maintained for the present, where appropriate.

The S&P 500 index provided, in US dollar terms, a total return of +21.18% over the last six months and -19.96% over the last year. The fluctuating value of the dollar means that, when translated into sterling, the returns are +5.38% over the last six months and -4.36% over the year.

## 2.4. Japanese Equities

With GDP having contracted at an annualised rate of 14.2% in the first quarter of 2009, the current recession in Japan is the most severe in the post-war period. Moreover, the slowdown has been sharper and deeper than those seen in the other major developed economies. Japan, however, stands alone in that its recession is probably more cyclical than structural. Having learned stark lessons from the bursting of its own asset price bubble in the 1990s, Japan's banks have less exposure to the sub-prime assets that have damaged their US and European counterparts. Furthermore, corporate and household debt levels are significantly below those of other developed economies. As a major exporter of manufactured goods, however, Japan is highly sensitive to the health of the global economy and it has suffered as export demand has declined. The impact of the global downturn has also been magnified by the sharp strengthening of the yen.

While economic recovery in the US and Europe will need to be tempered by a rebalancing of private sector debt, there is no such need in Japan. Consequently, there are signs that the recession may be relatively brief compared to those elsewhere in the developed markets. Among improvements in sentiment surveys and forward-looking indicators, export growth in each of the three months to the end of June may offer the greatest cause for cautious optimism. However, these improvements are from a low base and are heavily reliant on the health of global demand.

Despite now appearing attractively valued versus both their own history and their international counterparts, Japanese equities remain deeply out of favour with international investors. The economic outlook is highly uncertain and consequently we believe it is too early to increase recommended allocations to Japanese equities. Current allocations should be maintained, where appropriate.

Though the yen has fallen 21.89% against sterling in the six months to 30 June it has, in aggregate, appreciated by 26.29% against sterling over the past twelve months. This has had a significant bearing on investment returns for sterling based investors. The FTSE Japan index provided, in yen terms, a total return of +22.02% over the last six months and -26.58% over the last year. The currency fluctuations mean that, when translated into sterling, the returns are +0.11% over the last six months and -0.39% over the year.

## 2.5. Asia Pacific (excluding Japanese) Equities

Believers in the theory that the economies and equity markets of the Asia Pacific region had decoupled from their western counterparts suffered a very uncomfortable 2008. Increased intra-regional trade and proximity to Chinese growth offered little protection to the export-led Pacific economies in the midst of the synchronised global slowdown. GDP growth forecasts for the region, while still relatively healthy in comparison to those for the western economies, have now been revised downwards.

Economic indicators began to show signs of improvement in the second quarter of this year and, together with announcements of fiscal stimulus packages in several Asia Pacific countries, have prompted investors to focus once more on the region's growth potential. Investors have also taken note of the region's relatively low levels of government, corporate and consumer debt. Subsequently, Asian equity markets have begun to outperform once more (see Fig. 4).

**Fig. 4 FTSE All-World Asia Pacific ex Japan compared to MSCI World since 2008 (rebased)**



While we believe the long term prospects for the markets of the Asia Pacific region are good, we retain our focus on valuations. On a price-to-book basis, valuations are very close to the long term average. With growth in the developed markets likely to remain below trend for some time, we believe 'average' valuations are not sufficiently attractive to merit an increase in current allocations to Asia Pacific equities.

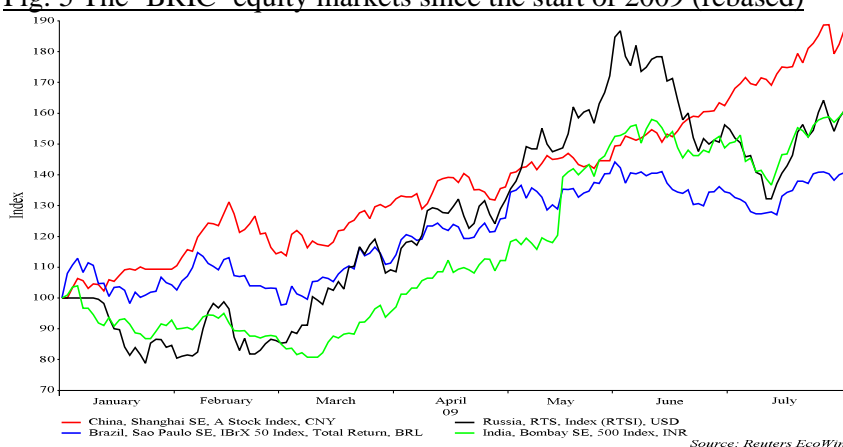
The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +48.48% over the last six months and -0.39% over the last year. In sterling-adjusted terms, the returns are +41.69% over the last six months and +8.33% over the year.

## 2.6. Emerging Markets Equities

Equities in the emerging markets\* suffered sharp setbacks as the financial crisis developed. Like the equity markets of the Asia Pacific region, emerging markets were hit hard by the wave of risk aversion throughout 2008 and undermined by downgrades to growth forecasts.

Sightings of possible ‘green shoots’ of recovery in early 2009, together with an increase in risk appetite, have had a significant impact on emerging equity markets, particularly in China (see Fig. 5). Though supported to an extent by robust economic growth, we are concerned that this growth has been underpinned by unsustainable, and potentially indiscriminate, increases in bank lending, on the orders of the state. Our concerns are two-fold. Firstly, with little need to increase productive capacity, much of the credit recently extended may instead have found its way into the equity market, forcing valuations to extremely high levels. Secondly, an increase in default rates seems probable – a development unnervingly similar to that recently experienced in the western economies.

**Fig. 5 The ‘BRIC’ equity markets since the start of 2009 (rebased)**



Whilst acknowledging that emerging markets are, in general, less indebted and better supported by domestic demand growth than their western counterparts, we remain concerned that this, and more, is already reflected in the valuation of these markets. We do not currently recommend increases to existing allocations.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +63.47% over the last six months and -16.09% over the last year. In sterling-adjusted terms, the returns are +42.15% over the last six months and +0.26% over the year.

\* MSCI includes 23 countries in its emerging markets indices: Argentina, 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

Sovereign debt, including UK government fixed interest stocks (gilts), performed very well over the course of 2008 and early 2009 as investors sought the safety of government-backed securities. As risk aversion rose and interest rates and inflation expectations fell, 10-year conventional gilt yields fell from a peak of more than 5.50% in mid-2007 to below 3.00% in mid-March 2009. This generated capital gains within portfolios that went some way to offsetting losses on equity holdings.

Having cut the Bank Rate to an historic low of 0.50% in March, the BoE announced its intention to increase money supply by commencing a process of quantitative easing (QE). This initially involved the purchase of £125bn of mostly conventional gilts, plus some commercial paper and corporate bonds. The BoE hoped that, in so doing, it would expand the money supply, leading to an increase in lending to businesses and consumers, and preventing deflation. Money supply has yet to respond meaningfully to QE and, on 6 August, the BoE announced a further £50bn of asset purchases over the next three months. Although this weight of money should provide support to gilt prices, with the 10-year gilt yielding just 3.80% at the end of July, we believe that these remain unattractive investments. Record issuance of new gilts in the near term and, if the BoE is successful in its aims, the eventual return of inflation will provide significant headwinds for conventional gilts.

Index-linked gilts remain an asset class we favour. However, investor interest in these has waned over the last year as concerns over the possibility of a long period of deflation have trumped inflation risk. While the current economic weakness makes near term price rises unlikely, our view is that the monetary policies being employed by the BoE are likely to result in significantly higher inflation over the next decade. We believe that the 10-year inflation rate implied by the gilt market of just 2.54% p.a. at the end of July underestimates this.

Our current favoured fixed income assets are corporate bonds. Since late January, when we recommended increasing allocations to investment grade bonds, this sector has rallied strongly. With all but the most distressed bonds trading close to their par value, we expect that returns will now come primarily from income than capital appreciation. Mindful of future rises in interest rates, we have latterly been recommending that new money go into strategic bond funds, whose managers can hedge out this risk and allocate assets to wherever they see value, be it in government bonds, corporate bonds or emerging markets debt.

The ABI UK Pension Gilt sector provided a total return of +1.20% over the last six months and +7.47% over the last year. The ABI Sterling Corporate Bond sector provided a total return of +12.06% and -1.64% over the same periods. The ABI UK Pension Index-Linked Gilt sector provided a total return of +0.64% over the last six months and -1.25% over the last year.

#### 4. Property

The UK commercial property market has, based on data from Investment Property Databank (IPD), lost 37% from its peak in July 2007. The driver of this collapse was the withdrawal of low cost debt finance, which had, until 2007, been used to leverage the steady but unexciting returns from commercial property, spurring development and, eventually, oversupply. As the credit crisis unfolded, banks became less willing to lend at low rates to fund commercial property purchases and, as property prices fell, highly leveraged property funds and companies came close to breaching their loan covenants. This led to further forced selling and, together with the effect of the slowing economy on property demand, has served to drive commercial property prices down.

The extent to which commercial property prices have fallen over the past two years, and the fact that these declines have begun to moderate, has made the asset class start to look interesting again. Yields of c7.7%, according to IPD, appear attractive relative to other assets, though we are aware that rental values and occupancy rates may still fall as a consequence of the weak economic backdrop. We are monitoring developments closely with a view to taking a more positive stance on this asset class in due course. In the meantime, allocations to property within client portfolios are being met through vehicles, such as closed-ended funds and institutional pension funds, where we are satisfied that the underlying property assets are first class and where any gearing employed is manageable.

The ABI UK Pension Direct Property index provided a total return of -6.25% over the last six months and -21.79% over the last year.

#### 5. Cash

Sterling deposits and monies held in AAA-rated liquidity funds can presently earn returns of around 0.15% over the BoE Bank Rate of 0.50% p.a.

Despite lower rates, cash still has its attractions and we continue to favour an overweight position in the asset class, particularly where attractive fixed rates from government-backed or good quality institutions can be secured. From an asset allocation perspective, cash deposits offer strong defensive qualities (provided the appropriate credit risk due diligence has been undertaken). 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 +0.30% over the last six months and +2.09% over the last year.

## 6. Note on Hedge Funds

Our view that hedge funds are riskier than generally perceived has 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.

According to Hedge Fund Research, the returns from a composite index of hedge funds fell 19% in 2008, the biggest annual decline since the company began tracking data in 1990. Among the casualties are some high profile names; Citadel Investment's flagship fund, which at \$10bn is one of the industry's largest, fell 55% in 2008. Atticus European, meanwhile, lost investors more than 43% over the year. Meanwhile, hedge fund veteran John Meriwether, co-founder of Long Term Capital Management, has announced the closure of his flagship fund after losing 44% from September 2007 to February 2009. Others employing high levels of gearing have found themselves even more severely impacted. As credit availability has decreased, geared hedge funds have had little choice but to sell their underlying assets at whatever prices are available in the market. This forced selling intensified in the fourth quarter of 2008 as hedge fund investors continued to file significant redemption requests.

We expect the hedge fund industry to emerge from the financial crisis in a very different shape. There will certainly be fewer funds, 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 remain, 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 would 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 +5.86% over the last six months and -15.22% over the last year.

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**The above commentaries reflect our views as at 14 August 2009. 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 31 January 2009 to 31 July 2009 and the twelve month period from 31 July 2008 to 31 July 2009 (source: Lipper Hindsight).**