

# **Market Commentary**

**January 2011**

**Saunderson House Limited  
1 Long Lane  
London EC1A 9HF**

**020 7315 6500 (Switchboard)  
020 7315 6550 (Fax)**

**Authorised and Regulated by the Financial Services Authority**

**SAUNDERSON HOUSE**



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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 19 January 2011. 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.

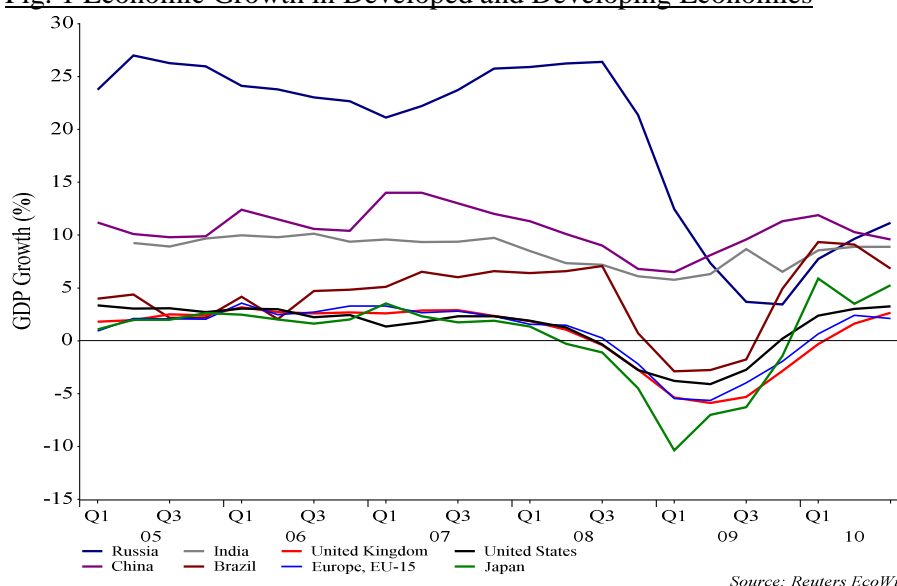
## 1. Economic Outlook

After shrinking in 2009, the world economy looks likely to have grown by about 4.5% in 2010. While this is a healthy rate of expansion, growth has been very much skewed in favour of developing, rather than developed, economies (see Fig. 1 below). More importantly, the growth in developed markets has been achieved only with the support of ultra-accommodative monetary policies including low interest rates and quantitative easing.

December's tax-focused US fiscal stimulus, accompanying the second draught of quantitative easing (QE) from the US central bank, the Federal Reserve, stand testament to the unsatisfactory nature of the economic recovery in America. Meanwhile, in the eurozone, crises in Greece and Ireland have required EU and IMF intervention to stop sovereign default. Only in the emerging markets of the Far East and South America has strong economic growth been achieved without government support.

Looking ahead, 2011 is likely to see the global economy continuing to 'muddle through', much as it has in 2010. Governments and central banks in the developed world will be keen to begin the process of policy normalisation, but will need to remain mindful of the risk of choking off growth and sending their economies back into recession. In emerging economies, inflation is the principal threat and monetary tightening is already taking place to ensure this does not become entrenched. Three other threats to the continuation of the recovery that can be easily identified include: (i) a recurrence of crisis in the eurozone, this time engulfing perhaps major economies such as Spain and Italy, (ii) a sharp slow down in China's economy and, (iii) a deterioration in the US fiscal position.

**Fig. 1 Economic Growth in Developed and Developing Economies**



The following sections discuss the outlook for selected markets and asset classes.

## 2. Equities

### 2.1. UK Equities

The UK economy grew by 0.7% in the third quarter of 2010. This was somewhat slower than the 1.1% growth in the second quarter, but better than economists' consensus forecasts. Over 12 months to the end of the third quarter, the economy grew by 2.7%, though output remains c4% below its pre-recession level.

While growth has provided pleasant surprises, inflation is proving problematic. Figures reported in December showed that prices were 3.7% higher over one year on the CPI measure and 4.8% on the RPI measure. Inflation has exceeded the Bank of England's 2% target (for CPI) in 41 of the last 50 months. Perhaps of even more concern is that it is almost 2% above the Bank's inflation forecast for the end of the year.

In leaving interest rates at 0.5%, despite the elevated level of inflation, the Monetary Policy Committee of the Bank of England is calculating that countervailing forces will drive inflation down to target within an acceptable timeframe. These forces include the deflationary impact of the government's austerity measures and the fact that the increase in VAT and the recent strength in food prices are one-off pressures that will eventually drop out of the annual inflation numbers.

Considering the investment outlook, we remain of the view that UK equities are attractive. During the economic downturn, many UK businesses cut costs aggressively and raised fresh capital to strengthen their balance sheets. This has left them in good financial shape, with scope to expand profit margins as sales recover but wage growth remains contained by high unemployment. As a result, any increase in revenues should translate into significantly higher profits. This view has been borne out by the strength of the earnings recovery to date.

Valuations in the UK remain relatively low and the stock market offers an attractive dividend yield relative to the yields available on cash, gilts and the highest rated corporate bonds. Historically, this has been a good indicator of future returns, though we are mindful that investor sentiment is a strong driver of the market in the short term. Given the value case for UK equities and our belief that the risk of a double-dip recession is small, our recommendation is that current allocations are maintained.

The FTSE All-Share index has provided a total return of +22.01% over the last six months and +14.51% over the last year.

## 2.2. European (excluding UK) Equities

The initial €5bn issue of bonds by the European Union to fund its €85bn bailout of the Irish government and banking sector saw strong investor demand at the beginning of the year. With markets anticipating that Portugal, and eventually Spain and Italy, may also require a bailout, an expansion of the €440bn European Financial Stability Facility (EFSF) is likely. This may include increasing the special purpose vehicle's effective lending capacity from its current €250bn or give the EFSF the flexibility to buy the government bonds of troubled countries in the secondary market. This could provide support earlier, capping bond yield rises and preventing further full-blown crises.

It is therefore perhaps surprising that recent economic data in the region has been encouraging. While the eurozone economy managed growth of 0.3% in the third quarter of 2010, this was heavily reliant on the German economy. Here, industrial production was up 7.4% in November while factory orders grew 5.2%, almost five times faster than analysts expected. This was mainly driven by demand from outside the eurozone. However, the data has also shown signs of a domestic pickup. Meanwhile, confidence in the European economic recovery rose to a three-year high in December, suggesting that, at least for now, the improving global outlook is offsetting the troubles in the peripheral eurozone economies. The rise in the main economic sentiment indicator, from 105.2 to 106.2, points to annualised GDP growth of almost 3%, well above the 1.9% seen in the third quarter.

While we expect the negative implications of the peripheral government bailouts to dominate headlines for the time being, the core eurozone region contains many companies that generate a significant proportion of their revenues in the US, Asia and emerging markets and should therefore be relatively immune from continued weakness in the non-core eurozone economies. German companies, for instance, have spent much of the past two decades establishing strong footholds in emerging Asian and Latin American economies. Meanwhile, the weaker euro will have increased the competitiveness of, and thereby the demand for, European exports. Moreover, valuations remain undemanding relative to history and to other asset classes.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +13.55% over the last six months and +9.66% over the last year. When translated into sterling, the returns are +18.84% over the last six months and +5.75% over the year.

### 2.3. North American Equities

Optimism about the US recovery has risen in recent months, fuelled by a raft of positive economic data releases. The economy grew by 2.6% p.a. in the third quarter of 2010, which was faster than the preliminary estimate of 2.0% p.a. and the 1.7% p.a. recorded in the second quarter. Consumer spending, meanwhile, grew by 2.8% p.a. in the same period, its fastest increase in four years. With consumption accounting for approximately 70% of economic activity in the US, this development is particularly encouraging.

Other economic indicators, however, still give reason for concern. Although unemployment improved in December, at 9.4% it remains stubbornly high and has been above 9% for over 20 months, the longest period on record. Disappointingly slow progress here prompted the Fed to proceed with a second round of QE in November. It plans to purchase an additional \$600bn of Treasuries through to June 2011, expanding its record stimulus of \$1.7trn in asset purchases. President Obama followed this by announcing an agreement with the Republicans to extend expiring income tax cuts for all Americans, renew jobless benefits for the long-term unemployed, and grant a one-year reduction in Social Security taxes. Whilst these measures should help boost growth, they exacerbate the country's fiscal deficit, which has grown tenfold since 2001 to \$1,230bn, equal to 8.0% of GDP. An expanding economy will obviously help America's budgetary position, though the vast level of debt will need addressing soon. This is the next challenge for US policymakers, who will want to keep the recovery on track as we enter an era of austerity.

Against the mixed economic backdrop, company news flow has been encouraging, helping the US equity market return to pre-Lehman crisis levels. According to Standard & Poor's, S&P 500 operating earnings per share are forecast to show a 47.0% increase for 2010 as a whole, implying the biggest annual gain in corporate earnings since 1988. There has also been positive news from the companies that received bail-outs during the credit crunch. Last month, the US Treasury sold its final tranche of shares in Citigroup, realising an overall profit of \$6.85bn on the \$45bn worth of shares it acquired as part of the rescue in 2008. The insurer AIG is also making progress towards repayment, announcing recently that it has raised \$37bn towards repaying \$180bn. A buoyant corporate environment looks set to continue into 2011 and, in our opinion, US equities are attractively valued both against history and versus US government bonds. We believe the US equity market is well placed to make progress and recommend that current allocations are maintained.

The S&P 500 index provided, in US dollar terms, a total return of +23.27% over the last six months and +15.06% over the last year. In sterling terms, the returns are +17.79% over the last six months and +18.68% over the year.

## 2.4. Japanese Equities

Macroeconomic indicators released in December were mostly downbeat. Deflation appeared to stabilise but remained firmly entrenched, as prices fell 0.5% yoy. Household expenditure continued to contract, down 0.4% yoy, despite the economy having firmed since 2009. This was most likely caused by an unexpected drop in wages, as average cash earnings fell 0.2% yoy (against consensus forecasts for a 0.6% increase). The downside surprise is particularly significant considering that companies typically give out biannual cash bonuses in November to enable employees to purchase gifts ahead of the year-end holiday season. Therefore, the year-on-year drop in earnings is most likely the result of smaller bonuses, which could be a sign of decreased corporate profitability or, at the very least, heightened caution about the general business outlook.

Japan's PMI Manufacturing index, a measure of purchasing managers' intentions and widely regarded as a good forward indicator of economic growth, was 48.3 in December, the fourth straight month it has recorded below 50.0, which signals contraction. This is in marked contrast to better than expected figures from the US and German PMI indices. As a result, corporate Japan continues to take steps to cut costs and consolidate operations. Toshiba, the country's largest chipmaker, announced the sale of its struggling graphics chip division to Sony, and revealed plans to outsource production of other lower-margin chips to Korean rival Samsung.

The yen strengthened again in December, possibly helped by the repatriation of profits at multinational firms, rising c3% against the US dollar in the month. As at the time of writing, the yen/dollar rate trades about the 82.0 mark, which remains significantly stronger than the average rate of 86.5 budgeted for the first quarter of the year, according to the most recent Tankan survey, a poll of Japan's largest manufacturers. Hence, if the yen continues to hold around current market levels, it is likely that overall corporate profitability will be negatively impacted.

Japan faces a number of headwinds, but this is, to some degree, reflected in the low valuations on which Japanese equities trade relative to their international peers. Furthermore, we note that large companies continue to adapt to the strong-yen environment by engaging in aggressive cost cutting. Many companies, world leaders in their own right, continue to trade close to or at a discount to their balance sheet value. On balance, we believe the normalisation of global economic conditions will offer opportunities in due course, but are not, for now, recommending increased allocations.

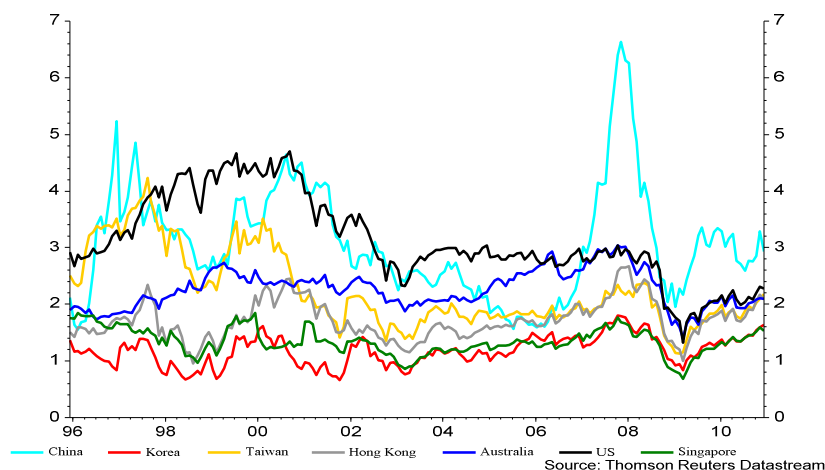
The FTSE Japan index provided, in yen terms, a total return of +8.37% over the last six months and +0.54% over the last year. Yen strength means that, in sterling-adjusted terms, the returns are +12.99% over the last six months and +19.03% over the year.

## 2.5. Asia Pacific (excluding Japanese) Equities

December proved to be a good month for stock markets in the region, as the benchmark MSCI AC Asia Pacific ex Japan index rose c7%, buoyed by generally positive sentiment in developed equity markets. Relative weakness in Chinese equities detracted from the region's overall performance, as China recorded annual consumer price inflation of 5.1% in November, which surpassed most analyst estimates, prompting the central bank to raise interest rates for the second time in three months and increase bank reserve requirements once again. China's PMI Manufacturing index also fell unexpectedly in December, a likely reflection of the continued tightening of monetary policy in 2010.

High inflation and yuan appreciation have been generally positive for the other major economies of the region. Australia has benefited from a 48% yoy increase in prices for its commodity exports, Hong Kong and Singapore have seen demand for their financial services jump on the back of higher corporate activity, and manufacturing rivals South Korea and Taiwan have become more competitive due to currency and inflation factors. In our view, the Asia Pacific ex Japan sector should continue to benefit from the region's strong economic fundamentals and favourable demographics.

**Fig. 2 Price to Book Ratio of Asia Pacific and US Stock Markets**



On fundamental measures of value, such as price to book (see Fig. 2), equity valuations in the region trade a touch above their long-term averages, but well below their historical peaks, and in line with the developed world. We do not think these valuations are expensive given the higher growth potential of these markets. We recommend that current allocations to the sector are maintained where appropriate.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +17.90% over the last six months and +13.24% over the last year. When translated into sterling, the returns are +21.95% over the last six months and +23.88% over the year.

## 2.6. Emerging Markets Equities

Emerging markets enjoyed a strong 2010; the MSCI Emerging Markets index gained nearly 19% over the year in dollar terms. December proved to be a particularly strong month, with the index gaining c7% as investors reacted positively to President Obama's announcement that the Bush-era tax cuts would be extended, further reducing the likelihood that the US economy would fall back into recession. Despite the strong performance of the broad market base, a notable laggard over the year was China; the Shanghai Composite finished c14% lower and is 45% off its October 2007 high.

Although many emerging market economies continue to grow at a rapid pace (China is expected to record GDP growth of 10% for 2010 and India 8.5%), there are a number of headwinds that policy makers are struggling to overcome, the most notable being inflation, particularly in food prices. Food prices are around 12% higher than at the end of 2009 and, given adverse weather conditions and structural increase in demand, prices appear unlikely to soften in the short term. Investment inflows have also been challenging. Record amounts of money have been deployed in the region, resulting in a significant appreciation of many emerging market currencies. The Brazilian real has appreciated by 13% since May, while the Taiwanese dollar reached a 13-year high versus the US dollar in December. Many economies have imposed taxes on foreign investment in an attempt to cool speculative inflows. South Korea, for example, has introduced both a withholding tax on government bonds and a cap on derivatives trading in the last two months. During 2011, we expect monetary tightening in the region to continue as liquidity, created in the West, continues to flow into the emerging markets, and puts upward pressure on inflation.

The MSCI Emerging Markets index\* has rallied c150% from its March 2009 low to date. While there remain some disparities between the growth prospects of various emerging market economies and the valuations of their equity markets, the broader market, as represented by the MSCI Emerging Markets Index, does not look overpriced – trading on c16x forward earnings, which is broadly in line with developed markets. We view this valuation as fair given the high growth potential but more volatile, economically sensitive nature of the emerging markets. We therefore recommend that current allocations are maintained, where appropriate.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +26.80% over the last six months and +19.82% over the last year. In sterling-adjusted terms, the returns are +21.17% over the last six months and +23.58% over the year.

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\* MSCI includes 21 countries in its emerging markets index: Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

### 3. Fixed Interest

Having fallen for much of the year, 10-year government bond yields in major western economies reached a nadir in the third quarter of 2010 and have since risen. Despite this recent rise, in the US, UK and Germany (among others), yields remain below their levels at the beginning of last year, meaning that there have been capital gains for bondholders. As much as the easing of the pace of economic recovery took yields down, building optimism about growth this year, together with a related pick up in inflation expectations, has driven yields higher once more.

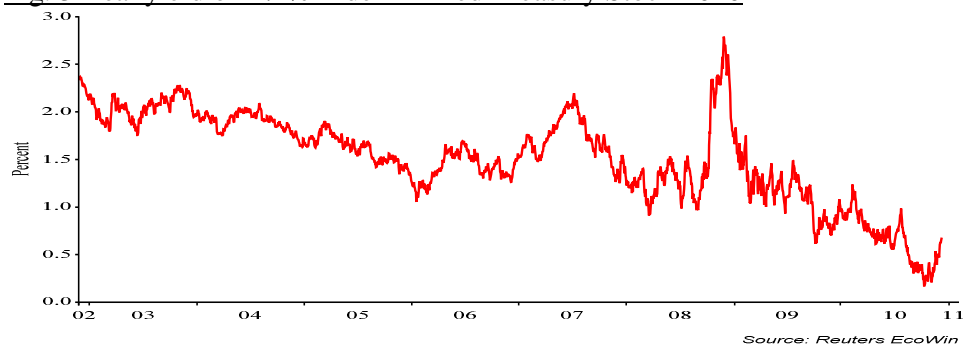
The final burst of strength in US 10-year Treasury bonds, which saw the yield reach a year low of 2.38%, was driven, at least in part, by the expectation of further monetary stimulus from the Fed. In addition to reinvesting c\$250-300bn of cash flows from the mortgage-related debt it bought in the original round of QE, it now also plans to purchase a further \$600bn of US Treasuries by the end of June. As is often the case, when details of the measures were finally announced in early-November, much of the expected positive impact was already reflected in market prices; thus, yields subsequently rose.

In the UK, the stronger than expected economic growth and persistent above-target inflation have meant that the Bank of England's Monetary Policy Committee (MPC) has not extended its QE programme. However, should the UK economy prove less resilient to the impending fiscal squeeze, more QE is likely to be forthcoming.

While we believe that the diversification value of gilts is attractive, particularly in the event of a Japan-style deflation scenario, the insurance they offer, in our view, comes at too high a price. We therefore continue to recommend zero allocations to conventional gilts, being mindful that they could incur further capital losses if the economy continues to grow more strongly than the market is expecting, or if policy errors lead to an inflation shock or a loss of confidence in sovereign credits.

The extraordinary monetary stimulus employed to counter the effects of the financial crisis has, in our view, created a risk that inflation rises meaningfully at some point in the future. As a result, we recommend maintaining existing allocations to inflation-linked bonds. However, we view UK index-linked gilts (ILGs) as fairly fully valued. Fig. 3 shows the real yield on the 2½% Index-Linked Treasury Stock 2020 is low relative to its own history.

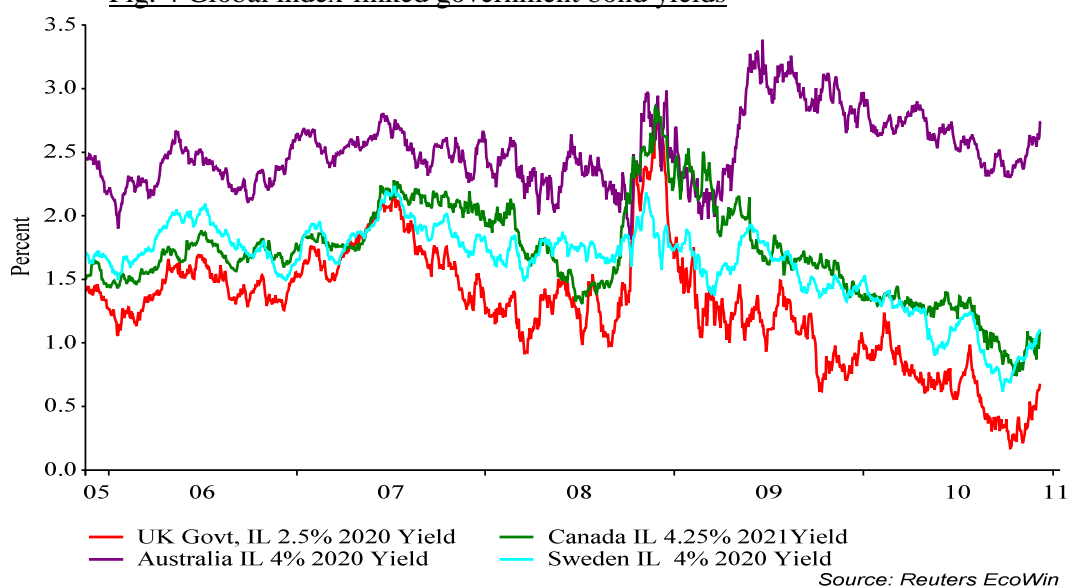
Fig. 3 Real yield on 2½% Index-Linked Treasury Stock 2020



A key driver behind the low yields on ILGs is the need for pension and insurance funds to buy them, almost regardless of price, in order to match the real liabilities of inflation-linked pensions. This structural demand for index-linked bonds is largely UK-specific. As such, Canadian, Swedish and Australian inflation-linked bonds, among others, offer significantly higher real yields than their UK counterparts (see Fig. 4).

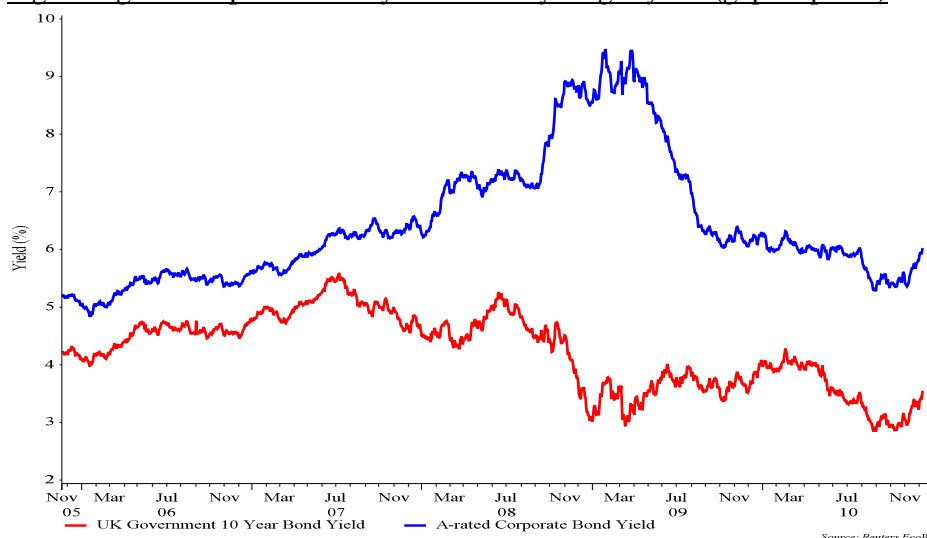
We therefore recommend that, where appropriate, allocations to index-linked bonds are weighted towards sterling-hedged funds of global inflation-linked bonds. As well as obtaining higher real yields, managers of such funds may also exploit duration and relative value opportunities to add further value. Our view is that such funds will offer a degree of protection if real yields on ILGs revert to the levels at which they have traded in the past.

Fig. 4 Global index-linked government bond yields



Turning to our preferred defensive asset class, corporate bonds, we still believe that valuations are attractive despite the compression of absolute yields since early-2009. Spreads over government bonds remain wide relative to recent history (see Fig. 5). Implied default rates are low and, in aggregate, corporates have strong cash balances due, in part, to the outsourcing of labour and component sourcing to cheaper areas overseas. According to the Financial Times, companies now have c9% of their assets in cash. This figure is forecast to rise to 12%, one-third higher than at the peak of the last business cycle. This healthy cash position can be observed by the recent increase in takeover activity including HP's acquisition of 3Par and Intel's purchase of both McAfee and Infineon's wireless division. More recently, US biotechnology company Genzyme has received a c\$20bn bid from Sanofi-Aventis, and Rupert Murdoch's News Corp is seeking to buy the 61% of BSkyB that it does not already own.

Fig. 5 A-grade corporate bond yield and 10-year gilt yield (gap = spread)



While continuing to favour corporate bonds we do acknowledge that they may be vulnerable to a further increase in government bond yields, and we certainly do not expect a repeat of the substantial capital gains seen in 2009. We have therefore been recommending that corporate bond allocations are invested in bond funds with more strategic mandates. The managers of these funds invest where they believe the market is rewarding them appropriately for risk, while avoiding areas that look expensive. They can also hedge interest rate risk and exploit arbitrage opportunities between different bond issues to protect and add value. 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.

The ABI UK Pension Gilt sector provided a total return of +1.00% over the last six months and +6.43% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +4.13% over the last six months and +8.14% over the last year. The ABI Pension Sterling Corporate Bond sector provided a total return of +2.71% and +8.73% over the same periods.

#### 4. Property

After a 36% correction (in total return terms), ending in June 2009, the UK commercial property market has staged a healthy recovery and is now, in our opinion, fairly valued. Property yields are, on average, c6.4%; broadly where they stood at the beginning of 2004 before the long bull-run which took them down to c4.5%. At current levels, commercial property yields offer a reasonable spread over gilt yields. This is necessary and warranted compensation for depreciation, the illiquidity of commercial property and the risk of default by tenants. However, yields vary across regions and sectors. Central London offices now offer yields as low as 4%, with investors anticipating a strong recovery in rents as the capital's economy recovers and occupiers pay up for limited space – a consequence of a dearth of construction during the credit crisis. In contrast, regional industrial assets can still be purchased on yields above 9%.

Despite the relatively attractive yield on offer, the recovery in commercial property has slowed recently. In our view, this is the result of several factors which are likely to persist over the coming months. Firstly, after strong gains over the last year, some investors will be taking profits. Secondly, we note that there has been a fall in the number and value of purchases, particularly from institutional investors, since the start of the summer. Simultaneously, there has been an increase in sales, particularly by banks.

We believe that, in order for capital values to make significant progress from here, rents need to start rising again. This is likely to depend on the pace of the economic recovery in the UK, as rental growth has historically been closely correlated with GDP growth. While the recovery to date has been strong, its pace has been slowing since the end of the second quarter of 2010. Therefore, rental growth, except in areas of constrained supply, such as London offices, may still be some way off. However, that does not mean we are pessimistic on the prospective returns from UK commercial property over the coming year. If prices remain static, an income yield greater than that offered by cash and gilts is still attractive. We also believe that, in a reasonably stable environment, skilled and well-resourced fund managers should be able to add capital value through asset enhancement, lease extensions and re-lettings.

The ABI UK Pension Direct Property index provided a total return of +2.85% over the last six months and +10.57% 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 better 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 returned +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 of 2008 and early 2009. 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.

In 2008 and 2009, more than 1,000 hedge funds were liquidated each year, according to Chicago-based group Hedge Fund Research. A number of high profile hedge fund managers have decided to close their funds, including Stanley Druckenmiller, who has begun the process of returning capital to investors in Duquesne Capital Management because he was "dissatisfied" with its performance. The third quarter of 2010 saw hedge fund launches overtake liquidations for the first time since 2008. As investment banks have downsized their proprietary trading desks, a number of traders have taken the opportunity to set up their own funds. However, the number of liquidations may yet climb higher since, as at the end of the third quarter, 44% of hedge funds were yet to meet their high-water mark for the year, a serious issue for those managers without substantial assets under management.

In our view, the industry's ability to justify high charges and performance fees remains questionable. Nevertheless, the hedge fund industry has emerged from the financial crisis in a very different shape. A smaller universe of funds, generally employing lower leverage, charging, on average, lower fees and offering better compliance standards, higher levels of communication, greater transparency, more appropriate and independent valuation methods and greater liquidity are, in our view, 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. We believe that the index almost certainly overstates 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 +6.50% over the last six months and +5.19% over the last year.

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**The above commentaries reflect our views as at 19 January 2011. 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 June 2010 to 31 December 2010 and the twelve month period from 31 December 2009 to 31 December 2010 (source: Lipper Hindsight).**