

Market Commentary

July 2011

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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 15 July 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

The global economy grew by 5.0% in 2010 and, according to forecasts from the IMF, it should grow by 4.3% in 2011. While this is a reasonable rate of expansion, forecasts have been gradually revised lower over the past year as the strength of the recovery from the financial crisis has disappointed relative to expectations. This continues to be the case despite the continuation of ultra-accommodative monetary policies, including the lowest interest rates on record and quantitative easing (QE). In the US, the implementation late last year of a second tranche of QE, together with tax-focused fiscal stimulus, demonstrates that American policymakers believe that the economic recovery remains unsatisfactory. Stubbornly high unemployment provides clear evidence that this is indeed the case. In the eurozone, crises in Greece, Ireland, Portugal and Greece once again, have required EU and IMF intervention to stave off sovereign default. In Japan, a concerted effort from the world's major central banks has been required to halt the strengthening yen in the wake of March's earthquake and resultant tsunami. By contrast, many emerging markets are achieving strong economic growth without government support.

Looking to the remainder of 2011, the global economy is, in our view, likely to continue to see lacklustre, but positive, growth, much as it did in 2010. Risks remain, not least in the fiscal arena with the US, as well as the eurozone periphery, vulnerable in this respect. Thus, while central banks appear keen to put interest rate normalisation on the political agenda to address rising inflation, the fragility of economic growth is making this all but impossible. In Europe, despite the problems of the periphery, the eurozone's central bank, the ECB, has begun to raise rates. However, we are doubtful that historic interest rates can be regained for many years. In emerging economies, inflation is also a serious threat and policy is being directed to ensure that it does not become entrenched. Other risks to the continuation of the recovery include a major disruption to oil supplies and a sharp slowdown in China's economy. Notwithstanding these threats, we believe there is sufficient momentum in the global economy to justify a positive view on risk assets, including equities.

Selected Index Performance to 30 June 2011				
	6mth Return (£)	1yr Return (£)	6mth Return (LC)	1yr Return (LC)
FTSE All Share (UK)	2.96%	25.63%	2.96%	25.63%
FTSE Europe ex. UK	9.01%	29.56%	3.43%	17.45%
S&P 500 (US)	3.10%	21.07%	5.72%	29.92%
TOPIX (Japan)	-6.33%	5.30%	-4.36%	3.12%
FTSE All World Asia Pacific ex. Japan	-0.58%	21.25%	-0.59%	17.20%
FTSE All World Emerging Markets	-3.03%	17.50%	-0.56%	26.09%
FTSE UK Gilts 5-15 Years	2.70%	4.12%	2.70%	4.12%
FTSE UK Index Linked Gilts 5-15 Years	5.42%	8.86%	5.42%	8.86%
BarCap World Government Inflation Linked	4.57%	6.77%	4.57%	6.77%
BofA Merrill Lynch Sterling Corporate Bond	3.27%	6.09%	3.27%	6.09%
BofA Merrill Lynch Sterling Broad Market	2.19%	4.00%	2.19%	4.00%

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

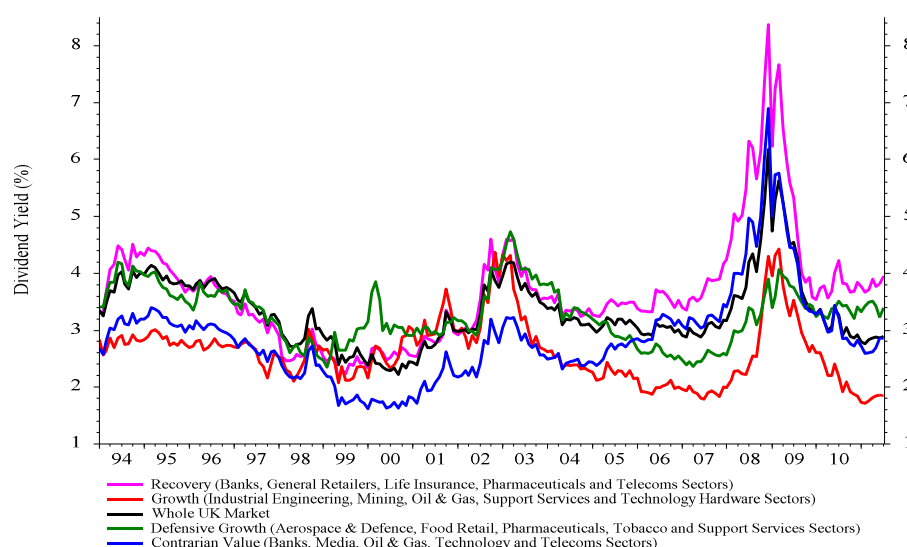
2. Equities

2.1. UK Equities

Although economic growth in the UK remains lacklustre, due largely to the debt overhang from the financial crisis, many areas of the UK corporate sector are in rude health. This reflects the fact that British companies, in aggregate, generate about three-quarters of their sales abroad and are therefore less sensitive to the travails of the domestic economy. The strength of the global economic recovery, particularly in the Far East, has meant that profit margins for UK companies have risen strongly from their lows in the recessionary trough of late-2009. That said, the extent of the recovery differs across sectors. Those benefiting from strong growth in emerging markets have seen margins return to peak levels, while those dependent on the UK consumer are taking longer to revive.

While this provides a fundamental case to favour companies with high overseas earnings over their UK-centric peers, we remain mindful of valuation. Fig. 1 shows the dividend yield on the overall market (black), sectors of the market that are beneficiaries of strong global growth (red), defensive sectors where there are structural growth stories (green), out-of-favour sectors such as banks, media and technology (blue) and more domestically focused sectors where there is either cyclical or self-help recovery potential (pink). This illustrates that, on a c3% yield, the broad UK market offers reasonable value and that allocations to UK equities should be maintained. However, the yields on global growth stocks are now low relative to their own history and the market. This suggests that a continuation of strong earnings growth is largely priced in. In contrast, defensive stocks trade on high yields compared to their history and to the market, while recovery stocks appear even more attractive. We therefore believe that UK allocations should not be solely focused on overseas earners.

Fig. 1 Dividend Yield on UK Equities

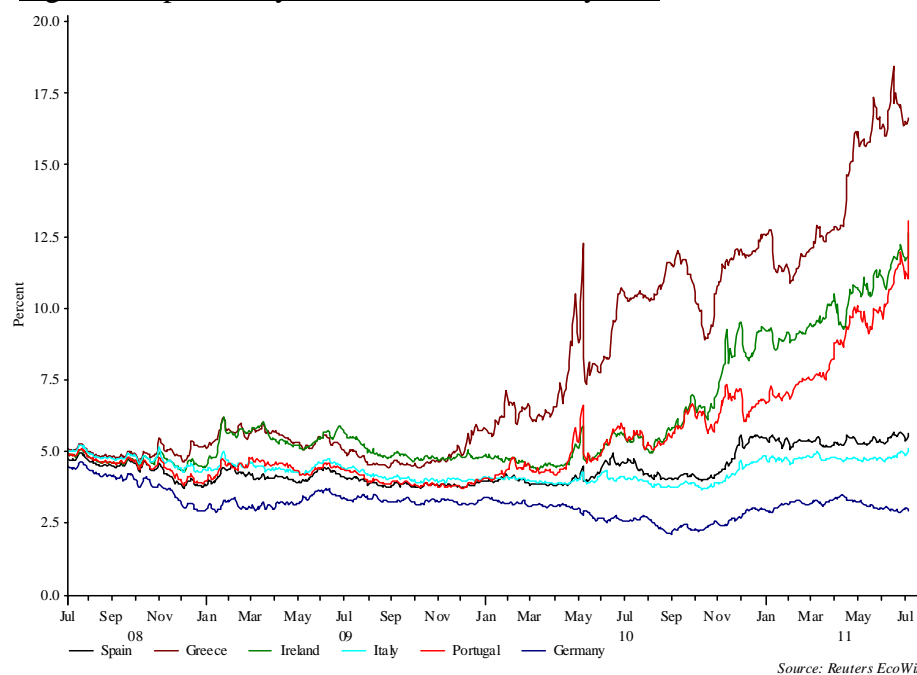


Source: Thomson Reuters Datastream

2.2. European (excluding UK) Equities

Early this month the Greek parliament narrowly passed a vote approving the austerity measures needed to secure the critical next €12bn instalment of loans from the IMF and EU. At the same time, a French plan that would involve private sector holders (mostly German and French banks) rolling over c70% of Greek debt maturing in 2014, ran into difficulties as Standard & Poor's said it would constitute a technical default and lead to a further downgrade in Greek sovereign debt. With Portugal's credit rating also being downgraded four levels by Moody's, yields on government debt issued by peripheral European economies continue to trade at distressed levels (Fig. 2).

Fig. 2 European 10-year Government Bond yields



July has also seen the ECB raise official interest rates for the second time this year, from 1.25% to 1.50%, despite the threat from the continuing eurozone debt crisis and concerns that growth is beginning to slow outside of Germany. The German economy continues to prosper, with industrial production jumping 1.2% in May and factory orders growing 23% year-on-year, led by increased demand from the likes of Volkswagen and BMW to meet export orders, particularly from emerging Asian consumers. However, with eurozone inflation at 2.7% in June, the ECB will not want to see inflation becoming embedded and feeding through into broader wage growth.

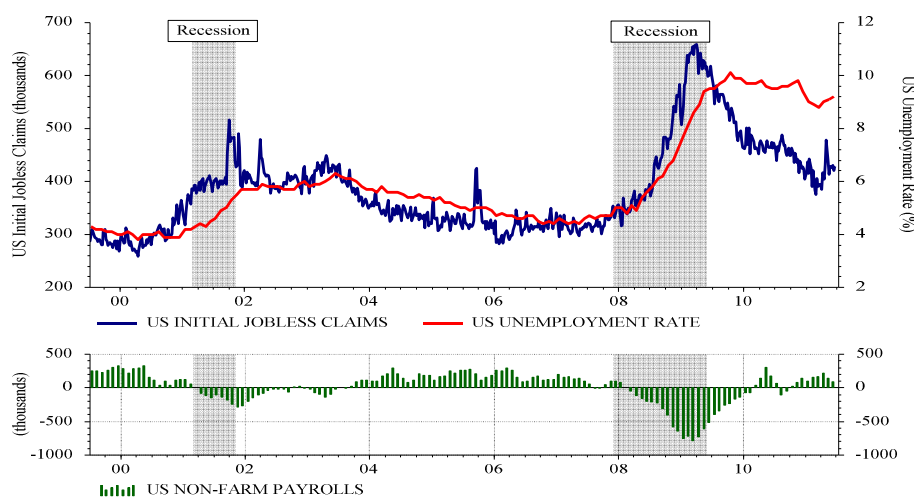
While news flow from the peripheral eurozone countries continues to dominate headlines, the core eurozone region hosts many companies that generate a significant proportion of their revenues overseas and therefore should be relatively immune from the persistent weakness in the periphery. Moreover, these companies are attractively valued relative to their history and global peers. We therefore recommend that current allocations to the region are maintained.

2.3. North American Equities

Despite setbacks in the first quarter driven by natural disasters in Japan and political unrest in North Africa and the Middle East, the US equity market posted solid gains, and by the end of April had reached a three-year high. However, the upward momentum proved to be short-lived as US economic data releases in May and June disappointed, peripheral eurozone default concerns came to the fore, and the Fed's second QE programme reached an end. A late rally in the final week of the quarter, however, helped the market record a modest c6% gain for the first half of the year (in local currency terms).

On the domestic front, the manufacturing sector, which had been notably strong, is now beginning to slow, as supply disruptions from Japan impede production and high commodity prices temper demand. The recovery in the jobs market is also weakening, with the recent downward trend in initial jobless claims stalling, the unemployment rate climbing back above 9.0% and last month's non-farm payrolls showing a weaker-than-forecast increase of just 18,000 jobs (Fig. 3).

Fig. 3 Improvement in US Jobs Market Stalling



Source: Thomson Reuters Datastream

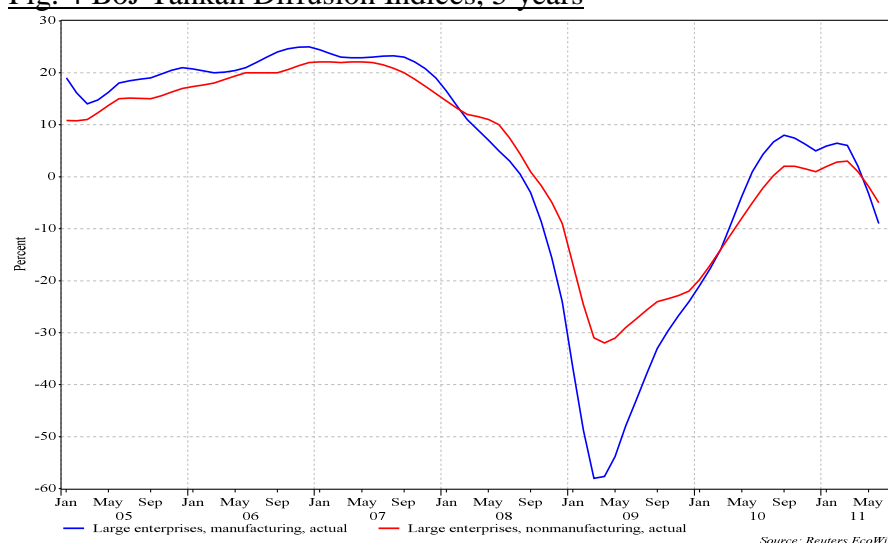
Despite the mixed economic backdrop, the corporate environment in the US remains strong. Analysts at Standard & Poor's forecast earnings for the S&P 500 index to grow 17.5% over 2011, to a new peak of \$98 per share. Having undertaken significant cost-cutting in recent years, companies are operating with greater efficiency and have built considerable cash reserves. Encouragingly, we are starting to see corporate confidence displayed through management's willingness to deploy capital, with merger and acquisition (M&A) activity, dividends and share buybacks all on the rise. With free cash flow yields at near record highs, we anticipate further M&A activity and dividend increases this year and next, which should be positive for US equities.

While the US economy faces a number of headwinds, with the market some c16% off its 2007 peak and earnings forecast to reach new highs this year, we believe US equities are well placed to make progress. We therefore recommend that current allocations are maintained.

2.4. Japanese Equities

After falling heavily in March following the devastating earthquake and resultant nuclear crisis in north-eastern Japan, the Japanese equity market has staged a steady recovery, rallying to record just a c4% loss for the first half of the year (in local currency terms). However, while investor sentiment has improved, the domestic environment continues to struggle. The Bank of Japan's latest Tankan survey revealed that business confidence dropped in the second quarter, as damage to infrastructure and temporary restrictions to electricity supply burden large parts of the country. The survey's headline diffusion index, which gauges sentiment among Japan's largest manufacturers, slumped to minus 9 in June, from plus 6 three months earlier (Fig. 4).

Fig. 4 BoJ Tankan Diffusion Indices, 5 years



On a more positive note, Japan's official unemployment rate fell in May to 4.5%, as more temporary jobs were created by the reconstruction effort. Meanwhile, inflationary pressures are picking up, with the latest consumer price inflation figure reported at 0.6% year-on-year. However, Japan's exporters continue to suffer from a strong yen (currently trading at c80.0¥/\$), as renewed concerns over a Greek debt crisis and broader eurozone contagion fuel demand for the 'safe haven' asset.

On the political front, incumbent Prime Minister Naoto Kan is expected to step down before the end of the year, taking responsibility for what the public has perceived as poor management of the disaster response. Kan has also revived plans to raise the consumption tax from 5% to 10% by March 2016, reiterating his pledge to put Japan on track to balancing its budget by 2021.

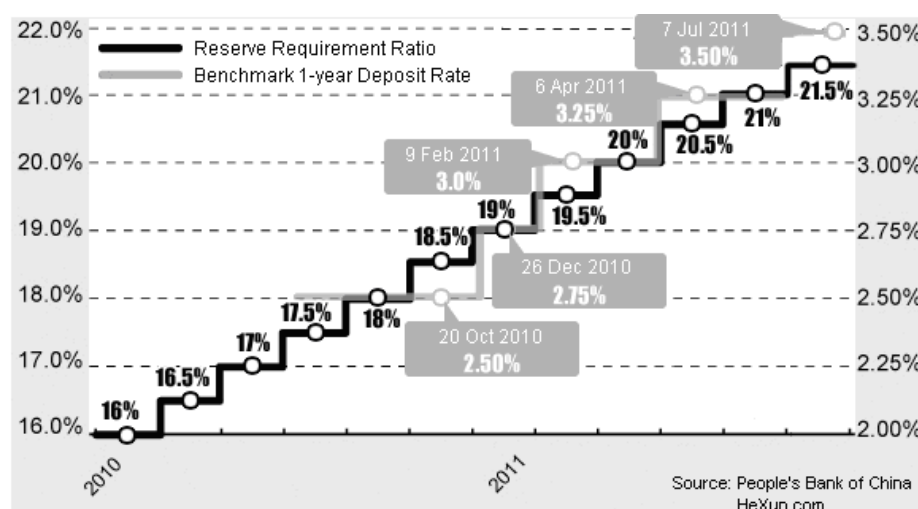
Japanese equities continue to trade on relatively low valuations compared to their international peers, however, this is reflective of the headwinds the economy faces. Recent events have not fundamentally altered our view on the investment prospects for Japan and we are not, therefore, recommending increased allocations.

2.5. Asia Pacific (excluding Japanese) Equities

Over the year to date, the MSCI Asia Pacific ex. Japan index has fallen c1% in local currency terms, versus a gain of nearly 3% in the MSCI World index. Investors have become increasingly concerned about the debt problems in the eurozone, while persistent weakness in the US labour market and signs of additional slowing in China's economy has further dented investor risk appetite.

Despite continued monetary tightening by central banks, inflation in the region remains elevated, although the pace of increases appears to be tapering off. The central banks of South Korea, Taiwan and India all raised interest rates in June, while, at the start of July, China lifted both its benchmark deposit and lending rates, and the reserve requirement ratio of Chinese banks to 21.5% – a record high (Fig. 5).

Fig. 5 Reserve Requirement Ratio, Benchmark Rate, China



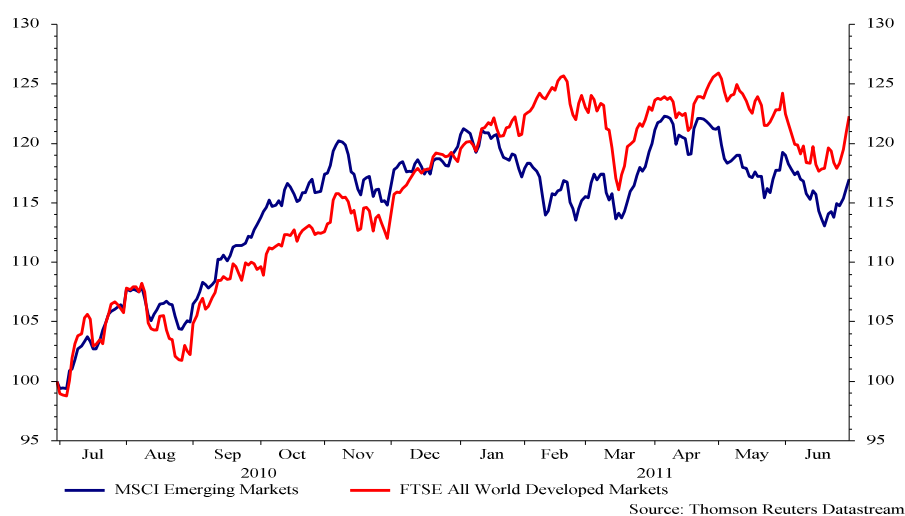
Investor confidence in Asian stocks was also affected by allegations of serious fraud at Canada-listed Sino Forest Corp. (SFC), a company that owns timberland assets in China, and had a market cap. of over \$5bn less than a month ago. Shares of SFC have fallen by c90% since questions about the existence of purported assets first surfaced in June. The case is notable for a number of factors: i) the size of the firm, ii) the length of the alleged fraud (over 16 years), and iii) that high-profile investors like John Paulson and Christopher Davis were significant shareholders.

We are conscious that the risks of a correction (from market or policy-led factors) are significant, as valuations and inflation remain elevated. However, we would balance these concerns against the fact that the Asia Pacific ex. Japan region is still supported by strong economic fundamentals and growth factors (e.g. a rising middle class consumer). We recommend that current allocations to the sector are maintained.

2.6. Emerging Markets Equities

Over the course of the last twelve months, emerging markets, as measured by the MSCI Emerging Markets index^{*}, have underperformed their developed market counterparts (Fig. 6). During this period, investor risk appetite has faded due to concerns regarding the pace of global growth and the potential for a Greek debt default, coupled with the natural disasters in Japan and the geopolitical tensions in the Middle East and North Africa. In addition, developing markets have also been negatively impacted by inflationary pressures, mainly due to rising food prices and a surge in the price of crude oil.

Fig. 6 Emerging Markets vs. Developed Markets Performance



Fighting rising inflation, while maintaining strong growth, has been top of the agenda for many emerging market policy makers in recent months, notably the larger BRIC (Brazil, Russia, India and China) economies. Increases in reserve requirement ratios and rising interest rates have been the policy tools of preference, however, the impact of such measures has been mixed. In China, Premier Wen Jiabao recently stated that the government “will be able to keep price rises firmly under control” and that inflation-tackling measures have worked. However, in India, finance minister Pranab Mukherjee believes that inflation is still a major concern.

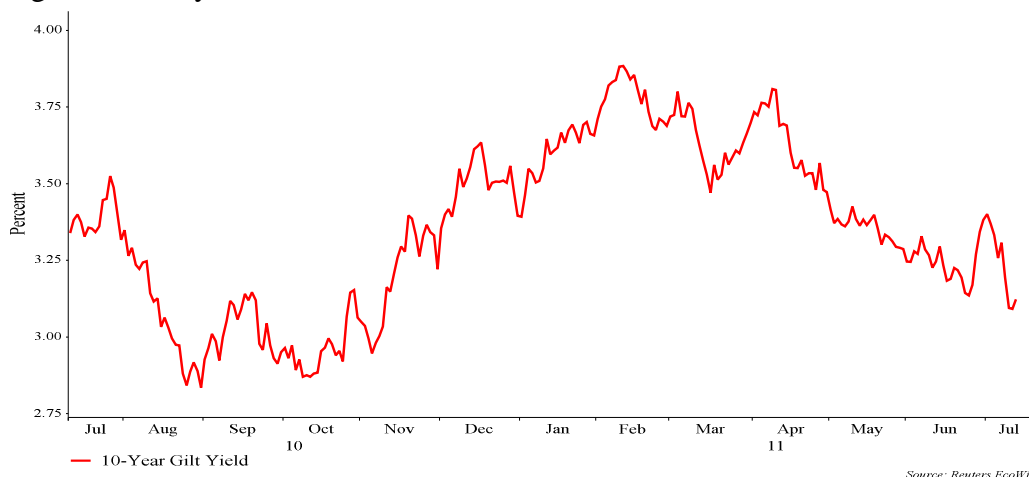
The uncertain outlook for the global economy has adversely affected developing markets in recent months. However, this under-performance has made valuations more attractive and, based on historical earnings, emerging market equities now trade at a discount to both developed equity markets and their historical average. We view this valuation as fair and believe that emerging markets should continue to benefit from strong growth prospects and economic fundamentals, including favourable demographics. We therefore recommend that current allocations are maintained.

* 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

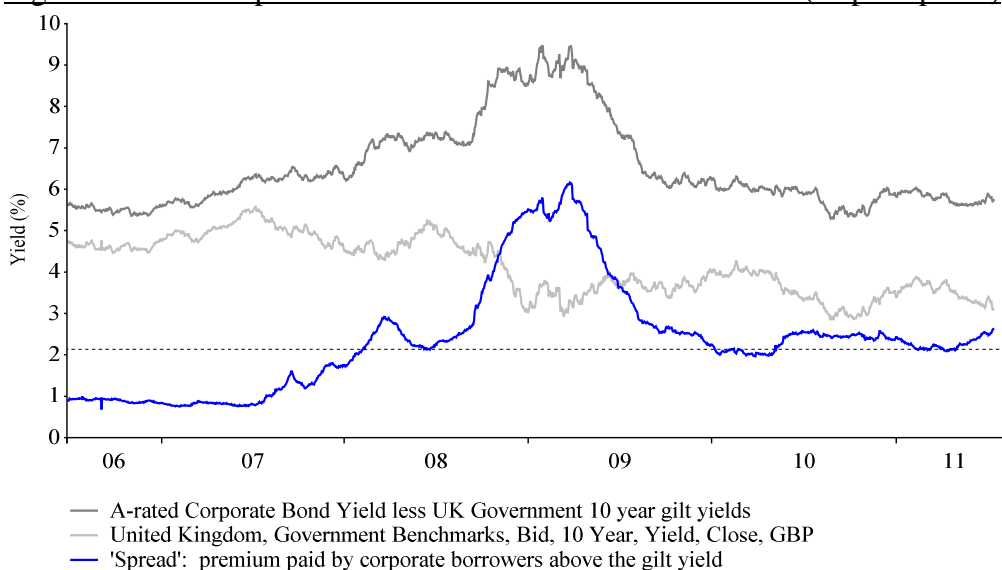
In the developed world, anaemic economic growth and relatively high inflation are sending conflicting signals to bond markets. The result is a high degree of volatility, as evidenced by movements in the benchmark 10-year gilt yield over the past year (Fig. 7). We believe that this volatility could continue for some time, though the historically low levels of government bond yields suggests that, over the longer term, the direction of yields will be upwards.

Fig. 7 Volatility in the 10-Year Gilt Yield



We do not, therefore, recommend holding conventional gilts or bond funds that, through long duration (a measure of sensitivity to yield movements), are closely correlated to gilts. This includes investment grade corporate bonds, which had been our preferred area of the fixed income universe since January 2009. Fig. 8 shows that corporate bond yields are now close to the average level they have traded at over the past decade. However, this yield can be separated into two components: i) the underlying government bond yield and ii) the credit spread. The latter reflects the additional yield paid to compensate investors for the risk of default and the illiquidity of the bonds.

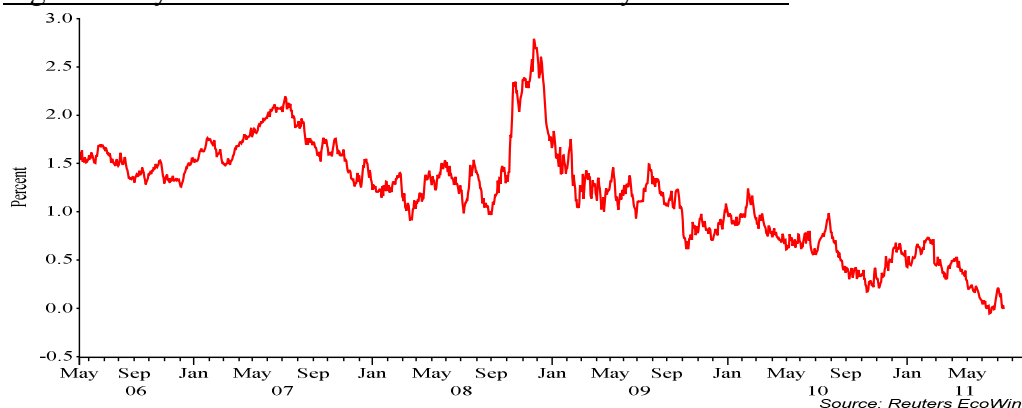
Fig. 8 A-Grade Corporate Bond Yield and 10-Year Gilt Yield (Gap = Spread)



Considering the above, the underlying gilt yield is unattractively low but the credit spread remains wide relative to history. This leads us to favour “strategic” bond funds whose managers have the scope to separate these two sources of risk and return from portfolios of bonds, and capture the opportunities that they deem most attractive. At times of positive sentiment towards risk assets, this may be the credit spread on corporate bonds, though their flexible mandates also allow them to profit from falling government bond yields in times of risk aversion.

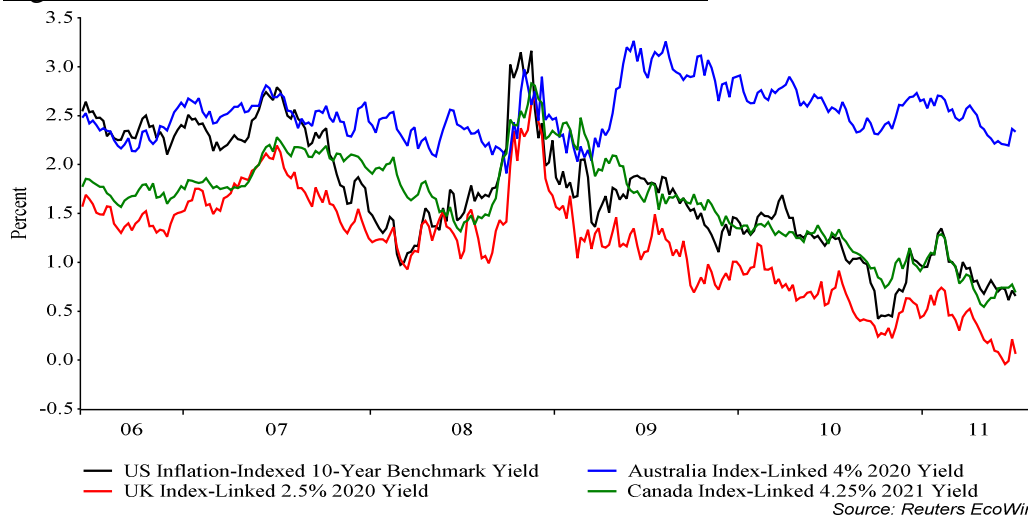
Another area of fixed income markets that we favour is index-linked bonds, where coupons and capital values are linked to measures of inflation. Historically, we have preferred index-linked gilts (ILGs), though short dated issues now look expensive and longer dated issues have seen their yields squeezed by strong institutional demand. Fig. 9 shows that the real yield on the 2½% Index-Linked Treasury Stock 2020 is low relative to its own history.

Fig. 9 Real yield on 2½% Index-Linked Treasury Stock 2020



While real yields on ILGs remain low, we continue to recommend that, where appropriate, investors obtain inflation protection through sterling-hedged funds of global index-linked bonds. These provide access to bonds with significantly higher real yields than on their UK counterparts (see Fig. 10), and their managers may 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. 10 Global Index-Linked Government Bond Yields



4. Property

The yield on the UK commercial property market has been virtually static at c6.5% since May 2010, reflecting limited capital growth and broadly flat rental values. In our view, this situation looks likely to persist for the remainder of 2011, with the occupational market outside central London remaining weak. The capital is much more integrated into the global economy than the rest of the UK, and is seeing strong occupier demand and rental growth, despite spending cuts and the recent weakness of the domestic economy. Outside London, and particularly in regions with high unemployment and a dependence on the public sector for jobs (such as Liverpool and Middlesbrough), the occupier market remains sluggish, with falling rents and high vacancy rates.

Turning to the investment market, the supply of prime quality assets popular with institutional and overseas investors remains limited. This is providing some support to current valuations. However, bank lending is still heavily rationed, particularly for properties in poorer locations and those with short leases, limiting the scope for leveraged buyers to enter the market and bid prices up. Banks (notably Lloyds, RBS and Irish “bad bank” NAMA) also hold a substantial number of property assets on their balance sheets that they are now starting to dispose of. However, while this may weigh on prices, the impact it would have on banks’ balance sheets gives us confidence that disposal programmes will be extended and orderly.

As long as the above concerns and uncertainties persist, we believe it remains appropriate for property allocations to be invested in funds of prime and near-prime UK commercial properties, whose managers can add value through refurbishments and relettings. Such asset management initiatives should help to provide stability of income and the potential for some capital growth over the medium term.

5. Cash

Sterling deposits and monies held in AAA-rated liquidity funds currently earn returns broadly in line with the BoE Bank Rate of 0.50% p.a. In comparison, consumer price inflation (CPI) was 4.2% in June, while retail price inflation (RPI) was recorded at 5.0%. Given the low real yields available on cash, we have recommended clients reduce the proportion held in portfolios in order to access higher yielding investments, primarily through increasing exposure to strategic bond funds.

The above commentaries reflect our views as at 15 July 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 31 December 2010 to 30 June 2011 and the twelve month period from 30 June 2010 to 30 June 2011 (source: Lipper Hindsight). LC = Return in Local Currency.