

# **Market Commentary**

**June 2008**

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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 2 June 2008. 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

Having provided the engine of world economic growth for several years, the world's largest economy, that of the United States, is now growing at a very subdued pace. In the first quarter of this year it expanded at an annualised rate of just 0.9%. Whether it can maintain some growth momentum or it slides into recession in the second half of the year remains to be seen. Forward looking indicators, such as the ISM survey of business sentiment, have recovered from low levels earlier in the year. However, measures of consumer confidence, such as the University of Michigan Consumer Sentiment index, suggest increasing caution. The American consumer is clearly at the forefront of the current slowdown with falling house prices, and rising petrol and food prices undermining his disposable income.

In sharp contrast to some previous periods of economic weakness, the US authorities have taken aggressive action to mitigate the worst effects of the slowdown and head off the risk of a serious recession. Since last September, the Federal Reserve (the Fed) has reduced its main interest rate, the Fed Funds rate, by 3.25%, including a dramatic 1.25% reduction in January and a 0.75% reduction in March. US interest rates are now 2.00%. This action has been augmented by other monetary measures and a Federal economic stimulus package worth \$170bn. However, we may now be witnessing the limits of the authorities' powers to mitigate the effects of the slowdown as the aggressive interest rate cuts have taken their toll on the US dollar. While this has helped exporters, thereby supporting one area of the economy, it is making imported goods, particularly energy, more expensive, thereby worsening the plight of the consumer. The US consumer's key problem is the housing market. After years of strong growth, house prices, according to the Case-Shiller Home Price index, were 14.4% lower in March compared to the previous year.

The crisis in world financial markets is closely related to the troubled US housing market. Investors have lost confidence in many types of synthetic bonds, including those that have interest payments secured on mortgages. This has led to price falls and the loss of liquidity in markets for such securities. Bank asset write-downs, provisions and emergency recapitalisations have followed. This current dislocation in markets has its root in the period of low interest rates from 2002 onwards. During this time, the aggressive use of borrowing to 'gear up' the returns from investments generating stable cash flows, such as property, corporate bonds and mortgages, resulted in valuations for commercial property, non-government fixed income securities and many other assets being driven to unsustainable levels. We are now seeing a correction in the prices of these assets.

The impact on economic growth of the credit crisis and weak house prices is now being compounded by a further, unhelpful development; rising commodity prices. Strong global economic growth over the past four years has boosted demand for energy and industrial metals, driving prices higher. As economic growth has waned over the past six months, commodity prices have failed to follow and have, in fact, continued to rise. This has the dual effect of further undermining consumer disposable incomes, thereby exacerbating the downturn, and restricting the Fed's freedom to deliver rate cuts to ease the economic slowdown without taking risks with inflation.

Slowing growth and rising inflation, known as stagflation, is most unhelpful for investment markets. Weak economic activity risks undermining corporate earnings and thereby equity markets, while inflation erodes the real return from fixed interest investments. In response, some investors have turned to commodities. While we acknowledge that these should provide an effective hedge against inflation, they are vulnerable to weaker economic growth. Moreover, it is becoming increasingly likely that strong rises in commodity prices are being driven by investment inflows rather than genuine industrial demand. This leaves commodities vulnerable to a sharp correction.

We continue to maintain weightings to equities. Valuations, in most developed markets, are not extended, yields are attractive and they should offer a degree of inflation protection. In addition, within our UK equity allocations, our favoured value managers have mostly avoided the poorly performing banking sector and the speculative froth in the resource stocks, though the latter has yet to prove additive to performance.

With last year's reduction in European equity allocations, client portfolios now have healthy weightings to cash and short and medium dated government bonds. We will be looking to deploy some of these highly liquid and defensive assets into areas offering the potential for higher returns as opportunities present themselves.

The MSCI World Equity Market index has provided a total return of +0.16% in sterling over the last six months and -3.06% over the last year.

**MSCI World Equity Market index since 2003**



## 2. Equities

### 2.1. UK Equities

The UK economy is slowing rapidly. In the wake of the credit crisis, consumer confidence has continued to deteriorate, falling to an 18 year low in May, while house prices, according to Halifax, are almost 4% lower year-on-year. To mitigate the impact of the slowdown, the Bank of England (BoE) has reduced interest rates by 0.75% to 5.00% since December.

Credit market problems in the UK are similar to those in the US, though they are perhaps less severe. Banks are trying to rebuild their reserve ratios by curtailing loans, and rebuild profitability by increasing lending rates. This means that the BoE's interest rate reductions are not being fully reflected in rates available to borrowers. Another similarity with the US is that inflationary pressures are restricting the central bank's freedom to reduce interest rates. Data for April showed the Consumer Price Index at 3.0%, a full one percent above the BoE's target rate, while the Retail Price Index, the inflation measure used for index-linked bonds, is higher at 4.2%. We remain optimistic that inflation will subside later in the year as declining global economic growth acts to slow demand for resources. This should free the hand of the BoE to reduce interest rates further, if appropriate.

Turning to UK equities, strong returns up until mid-2007 were driven by supportive economic growth conditions and the return of a degree of pricing power to the corporate sector. These factors helped companies report excellent earnings growth and enabled them to deliver healthy dividend increases. Strong corporate profits growth meant that, despite share prices having risen over the previous four years, UK equities did not become expensive in terms of price to earnings ratios. After the recent falls, UK equities are, on first inspection, more attractively valued than they have been for several years. However, we are mindful that earnings expectations are likely to be pared back. Returns from UK equities over the next twelve months will therefore depend on the magnitude of downgrades and the extent to which these are already discounted in valuations. Our recommended funds are, in the main, positioned away from the vulnerable consumer sensitive areas of the market including the much troubled banking sector. We are confident, therefore, that they will prove more resilient than the broader market and we recommend that current allocations to UK equities are maintained.

The FTSE All Share index has provided a total return of -4.16% over the last six months and -7.12% over the last year.

## 2.2. European (excluding UK) Equities

Until December's recommended reduction in allocations, Continental Europe had been our favoured destination for investments into international equities. This proved profitable; European (ex UK) equities outperformed those of the US, UK and Japan over the previous three years.

Many of the factors that have driven strong returns from European equities, such as corporate restructuring and the opening up of the former communist states in Eastern Europe, remain in place. However, with the credit markets in turmoil, there are clearly grounds for a more cautious approach. One of the main reasons for the recommended reduction in allocations was the strengthening euro. While this has boosted returns for sterling based holders of European equities, it presents a significant handicap for Continental Europe's exporters and, therefore, for the wider European economy.

A key driver of the euro's strength is the European Central Bank's (ECB) reputation for taking no risks with inflation by holding interest rates higher than might otherwise be the case. Eurozone inflation, currently at 3.6% is at a 16 year high, and close to double the ECB's target of below, but close to, 2%. While the core European economic growth has proved resilient thus far, this has only served to drive the euro higher still. It recently reached all time highs against sterling and the dollar. With the European economy, and particularly Germany, heavily reliant on exports, we believe that the strength of the euro may exacerbate the slowdown in the coming months. Investors, unsurprisingly, have proved sensitive to these factors and Continental European equities, in local currency terms, have fallen twice as far as those of the UK and the US since the end of November.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -9.32% over the last six months (-0.11% sterling adjusted) and -13.60% over the last year (-0.13% sterling adjusted).

### 2.3. North American Equities

The current economic downturn is centred on the US in general and its residential property market in particular. After doubling in the last seven years, US house prices are now falling, as abundant mortgage finance, which fuelled much of the boom, has been withdrawn. The economy was already slowing in the two years to mid-2006, in response to monetary tightening that took interest rates from 1.00% to 5.25%. Declining house prices and reduced access to credit are now undermining consumer confidence and exacerbating this slowdown.

Alongside interest rate reductions totalling a full 3.25% over the last nine months, the Fed has injected liquidity into money markets, introduced a term auction facility and allowed banks to swap top quality mortgage-backed securities for Treasury Bills (for 28 day periods). These aggressive policy responses demonstrate that the authorities are determined to avoid recession if at all possible. Moreover, both candidates for the Presidency are actively discussing measures to support indebted homeowners. It therefore seems likely that further policy measures will be forthcoming once a new President is installed in the White House.

Whether the combined actions of the Fed and the Federal government succeed in averting a recession will depend on several factors, including: how deeply rooted the sub-prime related issues are, the resilience of the job market, the impact of falling house prices on consumer behaviour and the extent to which economic activity outside the US remains strong.

The US equity market has proven reasonably resilient when compared to other developed markets. Sterling based investors have also benefited from a rally in the dollar versus sterling over the last six months. We believe that allocations to US equities should be maintained for the present.

The S&P 500 index provided, in US dollar terms, a total return of -4.47% over the last six months (-0.61% sterling adjusted) and -6.70% over the last year (-6.61% sterling adjusted).

## 2.4. Japanese Equities

Along with other developed economies, Japan is slowing. Its economy grew at its slowest pace in three years in the first quarter of this year due, in part to lower capital investment. More positively, exports remain strong, thanks to the strength of emerging markets demand, and domestic consumption growth is proving resilient, albeit at low levels.

One positive factor for equity investors in Japan is that it remains one step removed from the global credit crisis. Japanese banks have little exposure to the sub-prime assets that have damaged their US and European counterparts and the economy has not suffered from excessive house price inflation. However, the unfolding crisis has brought about an unwelcome development in currency markets. Previously, the yen had been a source of cheap funding for 'carry traders' who borrowed in yen to fund investments in higher yielding assets. This drove the yen down to very low levels, supporting Japan's exporters. With the onset of the credit crunch, a greatly reduced appetite for risk has seen this carry trade start to unwind, driving the yen sharply higher against both the dollar and sterling. The yen has appreciated by 5.08% against the dollar and by 9.33% against sterling over the last six months. The impact of currency strength and the global economic downturn has seen Japan's equity market perform very poorly compared to other developed markets. However, for sterling based investors, the yen's strength over the last six months has turned losses from Japanese equities into small gains.

Currency appreciation and economic slowdown mean that the long awaited recovery of Japanese equities may, yet again, be delayed. However, Japanese equities are looking good value relative to other markets, historical valuations and Japanese government bonds. The catalyst for a strengthening in equity markets is not obvious at present. Possible candidates include a resumption of yen weakness, political change or a return of international investors attracted by the low valuations. We therefore recommend current allocations to Japanese equities are maintained.

The FTSE Japan index provided, in yen terms, a total return of -7.09% over the last six months (+1.57% sterling adjusted) and -18.82% over the last year (-5.62% sterling adjusted).

## 2.5. Asia Pacific (excluding Japanese) Equities

The performance of the economies of the Asia Pacific (ex Japan) region has thus far remained resilient in the face of the slowdown in Western economies. The economies of South Korea, Hong Kong, Singapore and Taiwan all grew by more than 5% in 2007 and, looking forward, all are forecast by the IMF to sustain growth comfortably in excess of the developed economies. Importantly, decreasing reliance on Western export markets and sizeable foreign currency reserves mean that the periodic crises of the past are less likely to be repeated. Moreover, strong economic growth and current account surpluses point to Asian currencies appreciating over the medium term. These factors make the Asia Pacific region an attractive destination for long term equity investors.

Large speculative capital flows, however, mean that the Asia Pacific equity markets remain among the most volatile in the world and, after strong upward moves in recent years, these markets no longer trade on their traditional discount to developed markets. Also, it remains to be seen how great an impact the slowdown in the US will have on the region. One view is that the economies of the Asia Pacific region have reached a level of maturity at which they can effectively decouple from the West. The contrary view is that the maintenance of strong regional growth is still ultimately dependent on the health of the developed economies. Regardless of this debate, the stock markets of the Asia Pacific countries corrected more sharply than those of developed markets in the first quarter and have subsequently rallied more strongly.

We believe that investors with longer time horizons will earn good returns as the long term economic fundamentals remain very promising. We recommend that equity weightings to the region are maintained.

The FTSE Asia Pacific (ex Japan) index provided a total return of -1.93% over the last six months and +11.32% over the last year (for sterling based investors).

## 2.6. Emerging Markets Equities

Emerging markets (as defined by MSCI – see below) have provided excellent returns over the four year global equity bull market. This has been driven, at least in part, by strong economic growth and rising domestic consumption. These improving fundamentals remain in place; expanding economies have driven up employment and income, thereby creating a virtuous circle of consumer demand and further strong growth.

The economies of India and China have delivered particularly strong growth and investors have enjoyed very strong returns. We have for some months, however, been concerned that investor appetite for shares in three of the four ‘BRIC’ markets (Brazil, Russia, India and China), has taken on speculative proportions. Valuations in India and China remain quite high, despite recent corrections, and a significant proportion of the corporate earnings growth has become dependent on continued rises in share prices and maintained strong global economic growth. Brazil is more reasonably valued, but has been the recipient of massive inflows of foreign investment. This leaves Russia, which looks set to benefit from strong domestic consumer led growth and where equity market valuations are undemanding. It is also fairly well insulated from both the credit crisis and the slowdown in economic growth in the developed economies.

Since the turn of the year, our cautious stance towards India and China has been justified. Chinese shares listed on the Shanghai stock exchange have fallen by almost 35%, Indian shares listed in Bombay by almost 20%. In stark contrast, Brazil’s Bovespa index has risen nearly 13%. Russian equities, meanwhile, have risen 6%. We are now recommending a small increase in allocations to emerging markets, focusing particularly on opportunities in Russia.

The FTSE All-World Emerging index provided a total return of +3.62% over the last six months and +21.36% over the last year (for sterling based investors).

\* MSCI includes 25 countries in its emerging markets indices: Argentina, Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

### 3. Fixed Interest

Over the last year UK government fixed interest stocks (gilts) have demonstrated their value as an effective portfolio risk diversifier. From a peak of over 5.5% in mid-2007, the yield on the 10 year UK government bond retreated by over 125bps, to a 4.25% low in mid-March. Gilts benefited from lower growth expectations (and therefore lower interest rate hopes), and also from their 'safe haven' status amid the turbulence in credit markets and falling equity prices. As investors' worst fears regarding the stability of the financial system have not yet materialised, yields have subsequently moved higher once more.

In contrast, corporate and non-investment grade bonds have suffered from decreasing risk appetite amongst investors amid concerns about credit quality. Within the various classes of fixed interest instruments, we have, for several years, held the view that the additional yield available on corporate and non-investment grade bonds relative to their government counterparts, known as the 'yield spread', has been inadequate. We have therefore advised clients to focus fixed interest allocations on conventional and index-linked UK government bonds. This asset allocation decision tested our resolve as non-government bonds continued to outperform sovereign issues for some time. Developments in the credit markets over the last 12 months, however, saw the price of government bonds appreciating while lower quality corporate and high yield bonds have fallen abruptly. Index-linked issues have performed particularly well due to ongoing concerns about inflation. As well as offering inflation protection, index-linked bonds are capital gains tax free. This includes the gains from the indexation of capital, and makes index-linked gilts especially attractive when held outside of a tax advantaged wrapper, such as a pension.

We are closely monitoring the now much more realistically valued investment grade and high yield bond sectors and selectively increasing the former.

The ABI UK Pension Gilt sector provided a total return of -0.91% over the last six months and +4.21% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +3.08% over the last six months and +11.95% over the last year.

#### 4. Property

After several years of strong returns, investors in UK commercial property have suffered a major setback. In recent years, bank borrowing has been increasingly used to fund property purchases. However, the availability, at low cost, of abundant debt financing had driven prices up to levels where yield based valuations looked extremely stretched. As the credit crisis unfolded from mid-2007 onwards, commercial property investors witnessed an abrupt change in the willingness of banks to lend at low rates against property purchases. This, together with reduced appetites for risk among investors, has served to undermine commercial property valuations.

Our Investment Bulletin of October 2006 set out our view that commercial property prices could suffer as yields were forced back up to levels more attractive to investors. This consolidation began in the second half of 2007. UK commercial property returns, including rental income, were negative in 2007 as measured by the ABI UK Pension Property index. This is the first time commercial property prices have fallen since 2001 and returns have remained under pressure thus far in 2008.

For now, it remains our view that the risk adjusted returns available on cash deposits are more attractive than those on commercial property. However, value is beginning to return to the asset class and we are monitoring this closely with a view to taking a more positive stance on commercial property in due course.

The ABI UK Pension Direct Property index provided a total return of -9.03% over the last six months and -16.52% over the last year.

#### 5. Cash

Sterling deposits or monies held in AAA rated liquidity funds earn returns in excess of 5.00% p.a. at present. We regard these as attractive relative to the yields currently available on fixed interest and commercial property.

Our view is that UK interest rates will probably remain close to their current levels for the remainder of 2008, hence we continue to favour allocations to cash. From an asset allocation perspective, cash deposits offer strong defensive qualities (provided the appropriate credit risk due diligence has been undertaken). Cash, whether on 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.

The ABI UK Pension Money Market index provided a total return of +2.53% over the last six months and +4.98% over the last year.

## 6. Note on Hedge Funds

While we continue to research the sector, we are concerned that hedge funds are riskier than generally perceived. In our view, 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.

The much publicised demise of Peloton, the London based hedge fund group, exemplifies our view of the potential risks inherent in this asset class. Peloton's \$2bn flagship fund, the ABS Master fund, won the Eurohedge 'New Fund of the Year' award in February. The award was in acknowledgement of the fund's excellent performance in 2007, when it returned 87% after betting that US sub-prime mortgages would fall in value. However, 2008 saw a swift reversal in Peloton's fortunes. A combination of falling values in highly rated tranches of mortgage-backed securities (in which the fund was then invested), together with pressure from banks for more collateral to set against loans, caused the fund's collapse. Investors in the fund have lost 100% of their capital.

For completeness, we have quoted below performance figures for hedge funds using the widely followed HFRX Global Hedge Fund index. We are, as might be expected, somewhat sceptical about the integrity of these figures. In our view, the index will almost certainly overstate hedge fund returns. This is because the submission of performance figures to the index compilers is voluntary and it is unlikely that failed or poorly performing hedge funds would submit numbers for inclusion in the index.

The HFRX Global Hedge Fund GBP index provided a total return in sterling terms of +0.68% over the last six months and -1.03% over the last year.

N. B. The above commentaries reflect our views as at 2 June 2008. Any material changes in economic and market conditions between then and the time of writing would 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 November 2007 to 30 May 2008 and the twelve month period from 31 May 2007 to 30 May 2008 (source: Lipper Hindsight).