

Market Commentary

May 2011

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Contents	Page
1. Economic and Investment Outlook	3
2. Equities	4
2.1. UK Equities	4
2.2. European (excluding UK) Equities	5
2.3. North American Equities	6
2.4. Japanese Equities	7
2.5. Asia Pacific (excluding Japanese) Equities	8
2.6. Emerging Markets Equities	9
3. Fixed Interest	10
4. Property	12
5. Cash	12

Risk Warnings

This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 17 May 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 by the IMF, it should grow by 4.4% in 2011. While this is a healthy rate of expansion, growth remains skewed towards the developing economies. More importantly, what growth there has been in developed economies has been achieved only with the support of ultra-accommodative monetary policies, including low interest rates and quantitative easing (QE). In the US, the implementation in late 2010 of a second tranche of quantitative easing (QE2), together with tax-focused fiscal stimulus, demonstrates that policymakers there believe that the economic recovery remains unsatisfactory. In the eurozone, crises in Greece, Ireland, and now Portugal have required EU and IMF intervention to head 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, notably those of the Far East and South America, have achieved strong economic growth without government support.

Looking to the remainder of 2011, the global economy is, in our view, likely to continue 'muddling through', much as it did in 2010. Risks remain, not least inflation driven by rising commodity prices. Central banks appear keen to put interest rate normalisation on the political agenda but are mindful of the fragility of economic growth. In Europe, despite the problems of the periphery, the eurozone's central bank, the ECB, became the first major central bank to raise interest rates in this economic cycle, albeit by only 0.25%. In emerging economies, inflation is also a serious threat and policy is being directed to ensure that it does not become entrenched. Other threats to the continuation of the recovery include: (i) a major disruption to oil supplies, caused by an escalation of conflict in Middle Eastern oil producing nations, (ii) a deepening of the eurozone crisis, this time perhaps engulfing major economies such as Spain and Italy, (iii) 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 April 2011

	6mth Return (£)	1yr Return (£)	6mth Return (LC)	1yr Return (LC)
FTSE All Share	9.09%	13.68%	9.09%	13.68%
FTSE Europe ex. UK	12.05%	16.94%	9.51%	14.21%
S&P 500	11.54%	7.57%	16.36%	17.22%
TOPIX	1.19%	-6.23%	6.35%	-11.81%
FTSE All World Asia Pacific ex. Japan	6.71%	12.53%	6.22%	14.97%
FTSE All World Emerging Markets	3.31%	9.91%	7.78%	19.77%
FTSE UK Gilts 5-15 Years	-0.54%	7.13%	-0.54%	7.13%
FTSE UK Index Linked Gilts 5-15 Years	3.62%	8.56%	3.62%	8.56%
BarCap World Government Inflation Linked	1.69%	6.23%	1.69%	6.23%
BofA Merrill Lynch Sterling Corporate Bond	1.24%	7.23%	1.24%	7.23%
BofA Merrill Lynch Sterling Broad Market	0.55%	6.64%	0.55%	6.64%

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

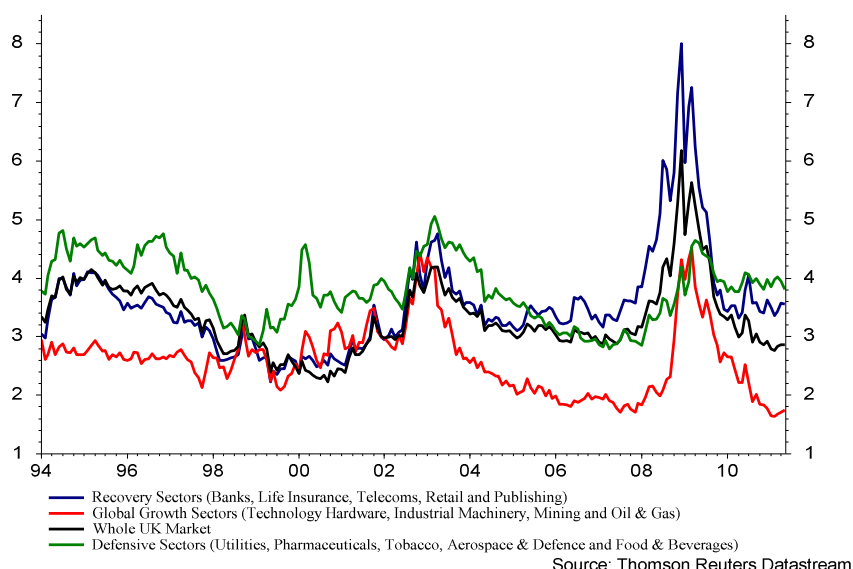
2. Equities

2.1. UK Equities

The UK economy expanded 0.5% over the first quarter of 2011, following an equivalent contraction in GDP over the last three months of 2010. From here, the course of the economic recovery is hard to predict, with fiscal tightening and rising commodity prices weighing on growth. Loose monetary policy, meanwhile, is acting to support the recovery and we expect the Bank of England (BoE) to keep short term interest rates at historically low levels until growth becomes self-sustaining.

Regardless of the uncertain backdrop for the UK economy, it is important to note that just c25% of UK-listed companies' profits are derived from the domestic economy. Firms that generate the bulk of their revenues overseas, particularly in faster growing emerging economies, are enjoying strong earnings growth. While this provides a fundamental case to favour such stocks over 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), non-cyclical, defensive sectors (green) and out of favour sectors with high dependence on the domestic economy (blue). This indicates 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 out-of-favour recovery stocks also appear relatively cheap. We therefore believe that UK allocations should not be solely focused on overseas earners.

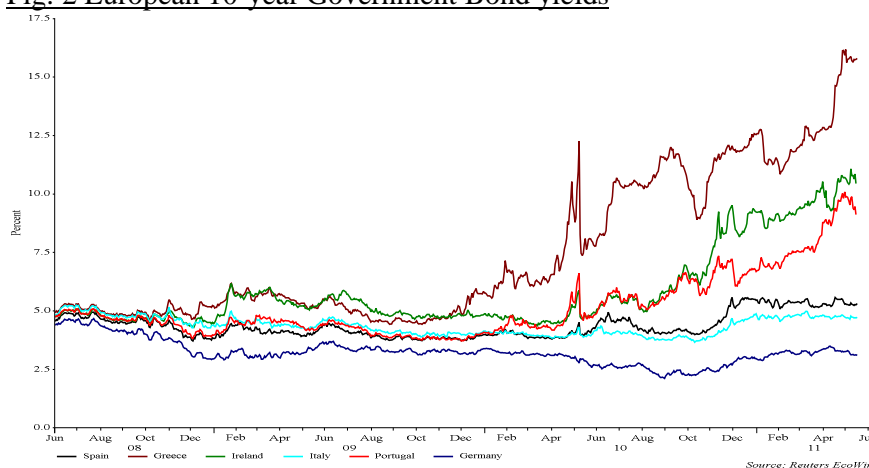
Fig. 1 Dividend Yield on UK Equities



2.2. European (excluding UK) Equities

Portugal became the third eurozone economy, after Greece and Ireland, to reach an agreement on a bail-out from the IMF and EU at the start of May. The rescue plan, (c€78bn) will require the country's government to reduce its deficit from last year's 9.1% of GDP to 3% by 2013. Harsh austerity measures look certain for both public and private sector employees. An estimated €550m is expected to be cut from the country's health expenditure, public sector wages frozen or cut, and state pensions reduced. Yields on government debt issued by peripheral European economies reached record levels amid speculation they will be unable to avoid further restructuring (Fig. 2).

Fig. 2 European 10-year Government Bond yields



In April, the ECB delivered its first interest rate rise in three years, from 1.00% to 1.25%, the first of the major, developed market central banks to do so. Given the current strength of their economy, Germans welcomed the ECB action. While factory orders unexpectedly dropped 4.0% in March, their biggest monthly fall since January 2009, the German manufacturing sector remains particularly healthy, expanding at the second highest pace on record in April, driven by an acceleration in output growth. Germany is keen not to see inflation becoming embedded and feeding through into broader wage growth, particularly given the country's unemployment rate of 7.1%, its lowest in 20 years. However, peripheral eurozone governments are likely to be less enthusiastic about the ECB's actions, remaining concerned that further rate rises could increase the chances of the weaker economies experiencing a prolonged period of stagflation or recession.

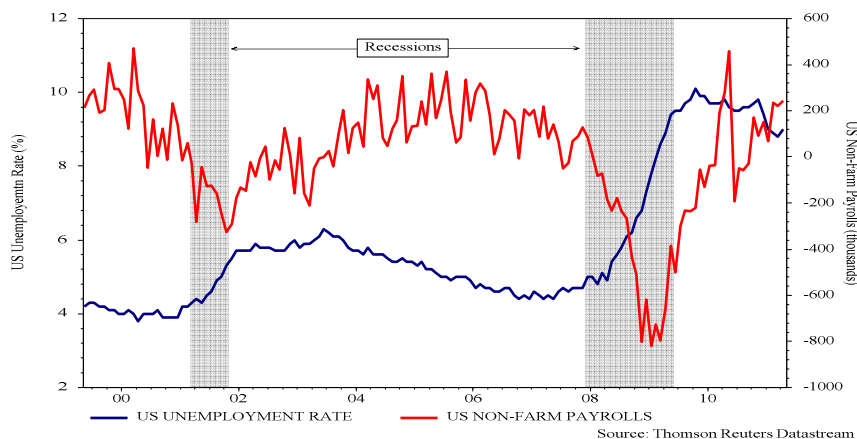
While news flow from the peripheral eurozone countries is likely to dominate headlines for the time being, the core eurozone region hosts many companies that generate a significant proportion of their revenues in the US, Asia and emerging markets and therefore should be relatively immune from continued 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

With headlines dominated by natural disasters and political unrest across the globe, it may seem somewhat surprising that US equities posted their best first quarter return for 13 years; the S&P 500 index finished 5.77% higher in US\$ terms. In contrast to 2010, when global tensions had more lasting effects on market sentiment, investors have been quick to refocus on fundamentals which, in the US, include a raft of positive economic data releases and forecast-beating corporate earnings, providing cause for optimism on the recovery.

The US economy expanded at an annualised rate of 1.8% in the first quarter, showing steady growth after the 2.9% expansion for 2010. Encouragingly, labour markets are now also showing a modest improvement; the unemployment rate has fallen from 9.8% to 9.0% since November, and non-farm payrolls are showing sustained progress, marking their largest gain in April for 11 months.

Fig. 3 US Employment Improving



The Fed recognised the improving economic climate in its January policy meeting by upgrading its forecast for 2011 GDP growth to a range of 3.4%-3.9% from its previous forecast of 3.0%-3.6%. Rising food and oil prices, however, are beginning to dent consumer confidence, most notably among the lower income households, who also continue to suffer from weakness in the housing market. While Fed Chairman Ben Bernanke believes commodity price inflation will prove transitory, should it persist, it may act as a significant drag on the economic recovery. Policymakers, meanwhile, will at some point need to address the mounting fiscal deficit which, at \$1,300bn, caused Standard & Poor's (S&P) to put a negative outlook on the country's AAA credit rating in March. It is unlikely, however, that any fiscal retrenchment will begin this year.

Looking at the corporate environment, US companies continue to report strong growth 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.

2.4. Japanese Equities

Data released in April revealed a large decline in consumption and trading activity, largely attributable to the magnitude 9.0 earthquake that struck north-eastern Japan on 11 March 2011. Household spending for the month of March fell 8.5% yoy, versus consensus estimates of a 7.0% decline, while trade data suggested that Japan's export growth had begun to slow in February, even before the natural disaster affected production capacity.

The situation at the Fukushima Dai-ichi nuclear power plant has been brought under control and radiation concerns have receded. However, a large proportion of Japan's power generation capacity remains offline, raising concerns that rolling blackouts could affect economic activity in the summer months, when electricity demand typically spikes. Officials estimate that Japan will have to cut its power consumption in the months between June and August by 15% - 25%, failing which, it may be necessary to implement electricity rationing.

Fig. 4 USD/JPY Exchange Rate



The Japanese currency has resumed its trend of strengthening against the US dollar despite post-earthquake monetary intervention from the G7 central banks. Considering the average rate of \$/¥83.9 budgeted for by Japanese manufacturers (according to the most recent Tankan survey), estimates for Q2 2011 corporate earnings could be revised lower if the yen holds around the current \$/¥80.0 level.

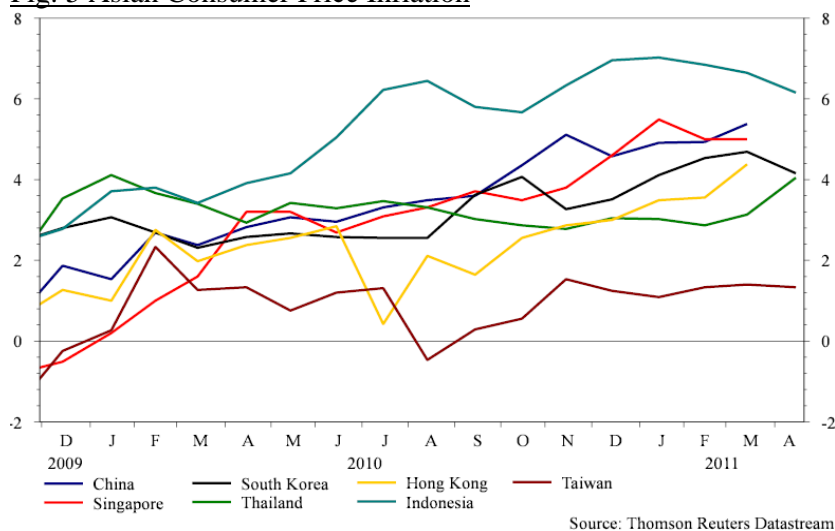
Japanese equities continue to trade on relatively low valuations compared to their international peers, however, this is reflective of the headwinds the country faces. Recent events have not fundamentally altered our view on the investment prospects for Japan and we are not, therefore, recommending increased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

2.5. Asia Pacific (excluding Japanese) Equities

Regional markets began April relatively muted as aftershocks in Japan and S&P's downgrade of the US credit rating outlook impacted investor sentiment. However, the benchmark MSCI Asia Pacific ex. Japan index ended the month c3% higher after the announcement that China's Q1 GDP rose 9.7% yoy, exceeding analyst expectations for 9.4% growth. Investors were also surprised by the strong growth in domestic credit: despite a string of monetary tightening measures and new laws to curb property speculation, Chinese banks still issued 740bn yuan of new loans in April, significantly higher than the government target of c600bn yuan per month.

Inflation continues to be a key concern of governments in the region, as the costs of living (especially housing) are rising faster than wages, fuelling social discontent. A number of countries, including China and Singapore, have responded by enacting punitive taxes on property transactions. This increases the risk of policy errors, which could end up affecting GDP significantly in the medium term.

Fig. 5 Asian Consumer Price Inflation



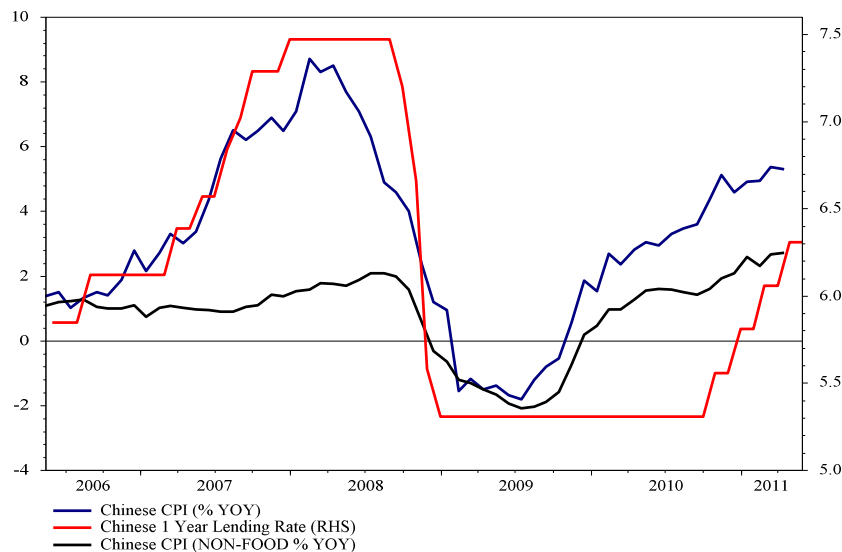
Investors may also be showing signs of fatigue: the initial public offering of the 25bn yuan (£2.2bn) Hui Xian REIT, Hong Kong's first yuan-denominated listing fell 11% on the first day of trading, despite expectations of strong interest. The REIT holds assets spun off Cheung Kong, the flagship holding company of Asia's richest man, Li Ka-shing. The poor reception was reminiscent of the March 2011 debut of Hutchison Port Holdings, which fell 7% in its first day.

We are conscious that the risks of a correction (from market or policy-led factors) have increased, as markets continue to move higher, but we would balance that against the fact that the Asia Pacific ex. Japan region is still supported by strong economic fundamentals and secular growth factors (e.g. a rising middle class consumer). We recommend that current allocations to the sector are maintained.

2.6. Emerging Markets Equities

Emerging markets, as measured by the MSCI Emerging Markets index, finished April broadly flat in local currency terms but underperformed their developed market counterparts for the third month (out of four) this year. Concerns about inflation continue to impact investor sentiment; food prices in emerging markets have risen c10% over the last year, while the price of crude oil is c50% higher.

Fig. 6 Chinese CPI and Lending Rate



Source: Thomson Reuters Datastream

In an attempt to combat rising inflation, emerging market policy-makers have increased interest rates and bank reserve requirement ratios, and imposed taxes on foreign investments. While these measures have proved effective in certain countries, some of the larger, high growth economies have struggled to bring inflation under control. Inflation in India (8.7%) and Brazil (6.5%) remains elevated despite the respective central banks of both countries having raised interest rates by 125bps since November 2010.

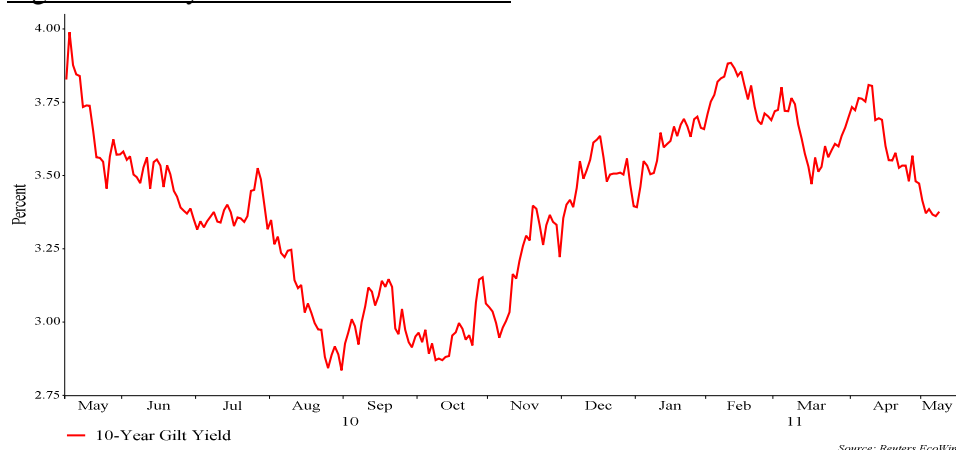
The continued inflationary pressures, along with the current political turmoil in the Middle East, have reminded investors that there are a number of risks in emerging markets. However, the recent under-performance of the region's equity markets has made valuations more attractive and, based on historical earnings, emerging market equities now trade at a discount to developed equity markets and in line with their historical average. We view this valuation as fair and believe that the 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. This view is supported by implicit messages from central banks that they are willing to tolerate above-target inflation for the foreseeable future.

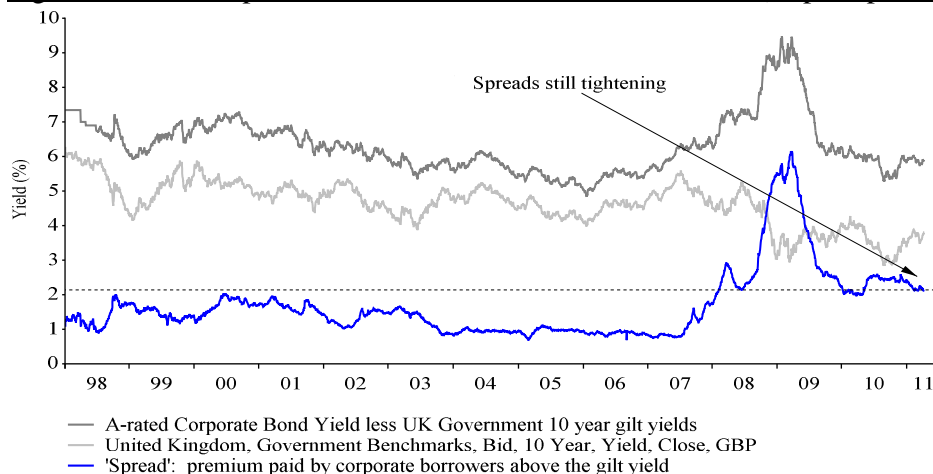
Fig. 7 Volatility in the 10-Year Gilt Yield



Source: Reuters EcoWin

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: the underlying government bond yield and 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)

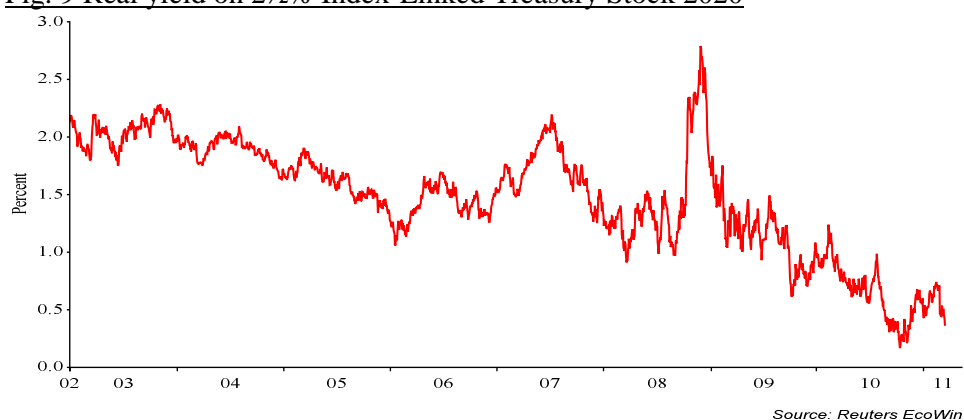


Source: Reuters EcoWin

Considering the above, the underlying gilt yield is unattractively low, but the credit spread remains wide relative to history. We therefore 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.

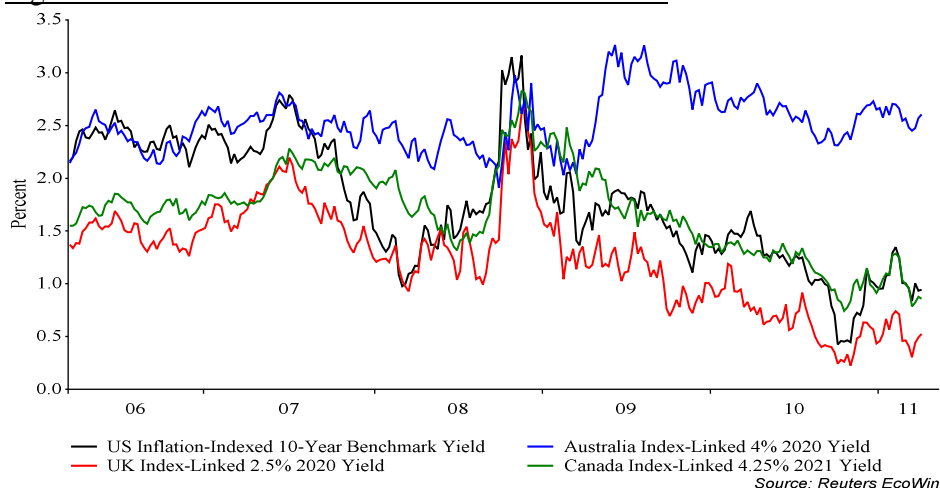
Another area of bond markets that we favour is index-linked bonds, where coupons and capital values are linked to measures of inflation. Historically, we have preferred index-linked gilts (ILGs), though now consider them to be trading at fair value. Fig. 9 shows that the real yield on the 2½% Index-Linked 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 part of their 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 (such as Liverpool and Middlesbrough) with high unemployment and a dependence on the public sector for jobs, 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 lot 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 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 coming year.

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 reached 4.5% in April, while retail price inflation was recorded at 5.2%. 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 17 May 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 October 2010 to 30 April 2011 and the twelve month period from 30 April 2010 to 30 April 2011 (source: Lipper Hindsight). LC = Return in Local Currency.