

# **Market Commentary**

**October 2007**

**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**



<b>Contents</b>	<b>Page</b>
1. Economic Commentary	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	11
5. Cash	11
6. Note on Hedge Funds	12

### Risk Warnings

This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 1 October 2007. 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 Commentary

The steady upward progress in equity markets, that had characterised the early part of the year, ended in mid-July as investors endured a month of high volatility and steep market falls. In the month to mid-August equities fell by more than 11%, losing all of their gains for the year. Subsequently, equity markets regained a degree of calm and, aided by a 0.5% cut in interest rates from the Federal Reserve, the US central bank, made up almost all of their losses by the end of September.

The increased volatility and sharp setback for equities was caused by factors relating to financial markets themselves rather than any change in the macroeconomic outlook. Prior to the market turmoil, central banks were already attempting to bring the era of easy credit and accommodative monetary policy to a close. This was being achieved by gradual increases in interest rates. However, a sudden burst of concern about the inherent risks and potential impact of some of the new, highly geared financial instruments, brought the easy credit environment to an abrupt end. Short term lending by banks and other institutions dried up almost overnight. This raised concerns about a full-scale liquidity crisis, where insolvency threatens banks and investment funds that rely on funds from the short term money markets. In a demonstration of how seriously authorities viewed the situation, central banks injected large quantities of liquidity into money markets and made emergency funds available to ensure a broad credit crunch did not develop.

The strength of the recovery in equity markets indicates that investors are, for now, convinced that there will be no enduring impact from the credit market turmoil on the ability of businesses or consumers to access capital and, therefore, that the reasonably buoyant outlook for economies remains intact. Indeed, with the US economy slowing under the burden of a weakening housing market, and growth remaining very strong in the Far East and developing markets, we could see a more balanced growth path for the global economy. Reduced reliance on the US consumer to drive global growth, together with rapidly developing Asian consumer markets, could address economists' long-running concerns about the size of the US current account deficit and the resulting build up of dollar balances in the Far East.

Considering the outlook for equity markets, we remain of the view that developed market valuation levels are supportive with many continuing to trade at price/earnings ratios close to their long term averages. On balance therefore, we maintain our positive view on equities for the present while monitoring developments closely, particularly in the structured credit markets.

The FTSE World index has provided a total return of +6.51% over the last six months and +13.22% over the last year.

## 2. Equities

### 2.1. UK Equities

The UK economy has continued its remarkably strong and stable expansion. Figures for the twelve months to the end of the second quarter of 2007 show that the economy grew by 3.1%. However, with the impact of the credit market turmoil still unknown, it is unlikely that the Bank of England will raise interest rates again until the economic outlook becomes clearer. Given the potential negative impact of tighter credit conditions, together with the three increases in the bank rate this calendar year, it is likely that the economy will begin to weaken in 2008.

For the present, however, supportive economic conditions, together with the return of a degree of pricing power for the corporate sector, have resulted in excellent earnings growth for companies. This, coupled with strong dividend growth, has continued to support UK equities. Strong corporate profits growth has meant that UK equities do not look expensive in terms of price/earnings ratios, despite share prices having risen over the past four years.

We are mindful that, with growth likely to slow and credit conditions deteriorating, the outlook for equities is becoming less favourable. Corporate profit margins are at peak levels, while very high commodity prices are boosting profits at oil and resource companies, which are heavily weighted in the UK share indices. We are also aware of the valuation anomalies now apparent within the UK equity market, with mid. and small sized stocks looking more expensive. Our recent reweighting of portfolios towards larger companies addressed this. We remain holders of UK equities at current market levels.

The FTSE All Share index has provided a total return of +2.70% over the last six months and +12.19% over the last year.

## 2.2. European (excluding UK) Equities

Despite excellent performance in recent years, Continental Europe continues to be our favoured destination for overseas equity investment. Valuations remain reasonable and earnings are supported by economic growth – particularly in Germany which is benefiting from strong export growth and increasing consumer confidence. Growth in Europe is also underpinned by the structural improvements being made at the corporate level in areas such as capital efficiency and labour costs.

After raising interest rates to 4.00% in June, the European Central Bank (ECB) is likely to leave interest rates unchanged for the remainder of the year. The ECB's reputation for taking no risks with price stability has meant that the euro has strengthened considerably against other major currencies. This will act to slow eurozone exports and thereby put some downward pressure on economic activity. However, with demand for hi-tech European goods still very strong in the Far East, we believe the outlook remains positive. We are retaining our current overweight position in European equities.

The FTSE Europe (ex. UK) index provided, in euro terms, a total return of +4.85% over the last six months (+7.84% sterling adjusted) and +16.71% over the last year (+20.13% sterling adjusted).

### 2.3. North American Equities

The US is at the epicentre of the current economic debate. After years of strongly rising prices, the US housing market is now weakening sharply as the easy credit, which fuelled much of the boom, is withdrawn. Whether this drags the US economy into recession remains to be seen. The housing market woes will certainly have a material impact, but the economy was already slowing in response to monetary tightening that took interest rates from 1.00% to 5.25% in the two years to mid-2006.

The 0.50% interest rate cut implemented in September demonstrates that the Federal Reserve is ready to take aggressive action in an attempt to avert a recession. Whether it succeeds or not will depend on several factors, including how deeply rooted the sub-prime problems are, the resilience of the jobs market and the impact of falling house prices on consumer behaviour.

In the corporate sector, aside from those areas impacted by the housing market, profit growth has remained fairly resilient. This has been aided by the very weak US dollar which has aided profits growth at major US corporations with substantial overseas earnings. However, the weak currency has, of course, impacted returns for sterling based investors which as a result have been relatively disappointing.

Given the prolonged underperformance of the US stock market, which has left it looking more reasonably valued relative to other markets, we continue to recommend that portfolios maintain small allocations to US equities.

The S&P 500 index provided, in US dollar terms, a total return of +8.44% over the last six months (+4.39% sterling adjusted) and +16.44% over the last year (+6.76% sterling adjusted).

## 2.4. Japanese Equities

The Japanese economy and stock market performance continue to be mildly disappointing. Underlying economic growth is fairly steady at around 1.5-2.0% and employment conditions continue to exert upward pressure on inflation. However, domestic consumption remains weak and stubbornly low inflation continues to undermine the Bank of Japan's policy of gradually increasing interest rates. With interest rates at only 0.50% the yen is vulnerable to carry traders, who raise yen funds and switch them into other currencies, and domestic investors who transfer assets overseas to take advantage of higher yields available elsewhere. This weakness has undermined returns to international investors who bought into Japanese equities to participate in the long awaited economic recovery.

We remain of the view that Japan's steady progress on restructuring its economy will eventually bear fruit, resulting in stronger equity market returns and a stronger yen. We are therefore recommending that, despite the disappointing performance in recent months, allocations to Japanese equities are maintained.

The FTSE Japan index provided, in yen terms, a total return of -4.56% over the last six months (-5.67% sterling adjusted) and +2.60% over the last year (-3.44% sterling adjusted).

## 2.5. Asia Pacific Equities

The economic performance of the Asia Pacific (excluding Japan) region remains impressive. Decreasing reliance on Western export markets and sizeable foreign currency reserves mean that the periodic crises of the past are unlikely to be repeated. Additionally, strong economic growth and current account surpluses make it likely that Asian currencies will appreciate over the medium term. These factors make Asia Pacific equities attractive to international investors.

Large speculative capital flows mean that the Asia Pacific equity markets remain among the most volatile in the world and markets are certainly no longer cheap. We believe, however, that investors with a longer time horizon will earn excellent returns as the 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 +23.83% over the last six months and +40.25% over the last year (for sterling based investors).

## 2.6. Asia Pacific (excluding Japanese) Equities

Emerging market equities have risen very strongly over the four year equity bull market, driven in part by strengthening economic fundamentals. These improving fundamentals remain in place; strong growth has driven up employment and income, thereby creating a virtuous circle of consumer demand and further strong growth. The equity markets no longer offer the bargain valuations of 2003 but, with the long term growth story looking as strong as ever, we believe allocations to equities within the emerging regions should be maintained.

The FTSE All-World Emerging index provided a total return of +26.02% over the last six months and +45.03% over the last year (for sterling based investors).

### 3. Fixed Interest

Fixed interest investments have not fared particularly well over the past year as stronger economic growth has driven interest rates higher. As a result, yields are now more attractive and the value of government bonds as a portfolio diversifier has been fully demonstrated in the recent financial market turmoil.

Within the various classes of fixed interest instruments, we have long 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 wholly inadequate. We have therefore advised clients to focus fixed interest allocations on UK government bonds. This view has been vindicated by the recent credit market problems that have seen spreads widen very sharply. We are closely monitoring corporate and non-investment grade bond yields relative to those available on government bonds, with the view to increasing allocations to these areas when they look sufficiently attractive.

The ABI UK Pension Fixed Interest sector provided a total return of -0.65% over the last six months and -0.47% over the last year (for sterling based investors).

#### **4. Property**

Investments in commercial property in the UK have provided very strong returns over the last five years. However, rising capital values have not been supported by commensurate increases in rent, leaving yield based valuations looking stretched. Our Investment Bulletin of October 2006 set out our view that commercial property prices could suffer a period of consolidation as yields are forced back up to levels more attractive to investors. This consolidation now appears to be taking place. UK commercial property, as measured by the ABI Pension Property index, recorded a loss in the second quarter of 2007, its first quarterly loss since 2001.

Despite interest rates increases now looking less likely, the risk-adjusted returns available on cash deposits remain more attractive than those on commercial property and we continue to recommend reduced allocations to this asset class.

The ABI UK Pension Property index provided a total return of -4.33% over the last six months and +3.05% over the last year (for sterling based investors).

#### **5. Cash**

Cash deposits, earning approximately 5.75% p.a., look attractive relative to the yield currently available on fixed interest or commercial property. Cash holdings are also valuable from a defensive perspective and we continue to regard them as an important component of portfolios.

**6. Note on Hedge Funds**

Hedge fund returns have been slightly disappointing over the last year. While we continue to research the sector, we remain somewhat sceptical about the ability of most hedge funds to generate consistently positive total returns.

The Credit Suisse/Tremont Investable Hedge fund index provided a total return in dollars of +2.16% over the six months to the end of August and +7.49% over the year to the same date. For euro based investors the corresponding return figures are +1.26% and +5.33% respectively.

N.B. Unless otherwise noted, all performance figures are total returns (including income re-invested) for the six month period from 30 March 2007 to 28 September 2007 and the twelve month period from 29 September 2006 to 28 September 2007 (source: Lipper Hindsight).