Market Commentary

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1. Economic Outlook

Optimism about the strength of the recovery in the global economy began to wane in the second quarter of the year, and evaporated almost entirely in August. This was the result of rising concerns about the sustainability of sovereign debt burdens in the eurozone and US, coupled with weaker business confidence surveys that suggested a second recession in three years was a real possibility.

Such a recession could be brought about by Greece defaulting on its sovereign debt and contagion to Spain and Italy – triggering a re-run of 2008's financial crisis, when a lack confidence in the banking system undermined credit markets and came close to bringing the global financial system to a halt. While not impossible, we regard renewed financial crisis as highly unlikely. Central banks and governments now have the tools to address the issues, as we have seen with the European Central Bank's (ECB) purchases of eurozone member government bonds and with mid-September's coordinated efforts by five major central banks to ease tensions in interbank markets by making three-month dollar loans available to European banks.

Thus, it remains our central case that developed economies can avoid a slide back into financial crisis and recession, enduring instead an extended period of uneven and lacklustre growth. Our conviction in this view is bolstered by the support from continued, strong growth in the emerging economies, which provides demand for western goods. This, combined with the maintenance of interest rates at exceptionally low levels and further monetary policy action in the developed world, should counteract the recessionary forces of financial dislocation, over-indebtedness and global imbalances.

We are likely to continue to endure extraordinary economic conditions for some considerable time. Such conditions have their genesis in the accession of China to the free market part of the global economy, causing a shock to the labour market on a scale never before seen, or ever likely to be repeated. The adjustments to this shock are unlikely to be completed within a timescale of a few years.

Selected Index Performance to 31 August 2011

	6mth Return (£)	1yr Return (£)	6mth Return (LC)	1yr Return (LC)
FTSE All Share (UK)	-7.95%	-7.26%	-7.95%	-7.26%
FTSE Europe ex. UK	-13.34%	3.41%	-16.77%	-3.30%
S&P 500 (US)	-7.33%	11.85%	-7.23%	18.50%
TOPIX (Japan)	-12.24%	1.42%	-18.00%	-2.14%
FTSE All World Asia Pacific ex. Japan	-3.17%	6.70%	-5.74%	3.72%
FTSE All World Emerging Markets	-5.66%	2.47%	-5.56%	8.56%
FTSE UK Gilts 5-15 Years	9.51%	5.51%	9.51%	5.51%
FTSE UK Index Linked Gilts 5-15 Years	7.86%	10.01%	7.86%	10.01%
BarCap World Government Inflation Linked	6.32%	6.26%	6.32%	6.26%
BofA Merrill Lynch Sterling Corporate Bond	3.26%	1.10%	3.26%	1.10%
BofA Merrill Lynch Sterling Broad Market	7.12%	3.55%	7.12%	3.55%

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

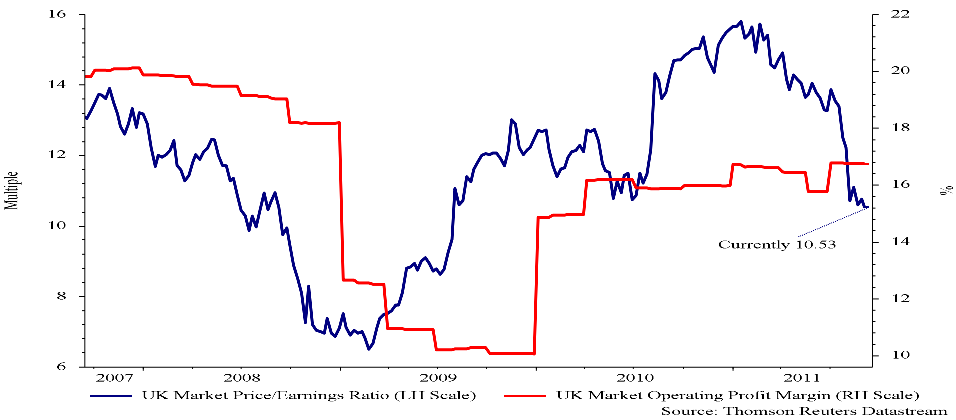
2. Equities

2.1. UK Equities

The sharp fall in UK equity prices since early July demonstrates the sensitivity of perceived company valuations to global economic and political factors, regardless of their underlying profitability. While austerity measures and debt overhangs are likely to weigh on US and European economic growth (as we have seen in the UK over the past three quarters), the extent to which this will undermine corporate profits is less clear. Corporate balance sheets are far stronger than in 2008, which should mean that companies are now better able to weather the challenging environment.

In the recent correction, we have seen the shares of defensive companies with resilient earnings fall nearly as far as cyclical stocks. This suggests that the sell-off has been indiscriminate, with valuations losing touch with fundamentals. As the chart below (Fig. 1) shows, the UK market's price/earnings multiple (blue) is back to where it stood during the sovereign debt crisis of 2010.

<u>Fig. 1 The UK Equity Market's Valuations and Operating Margins</u>



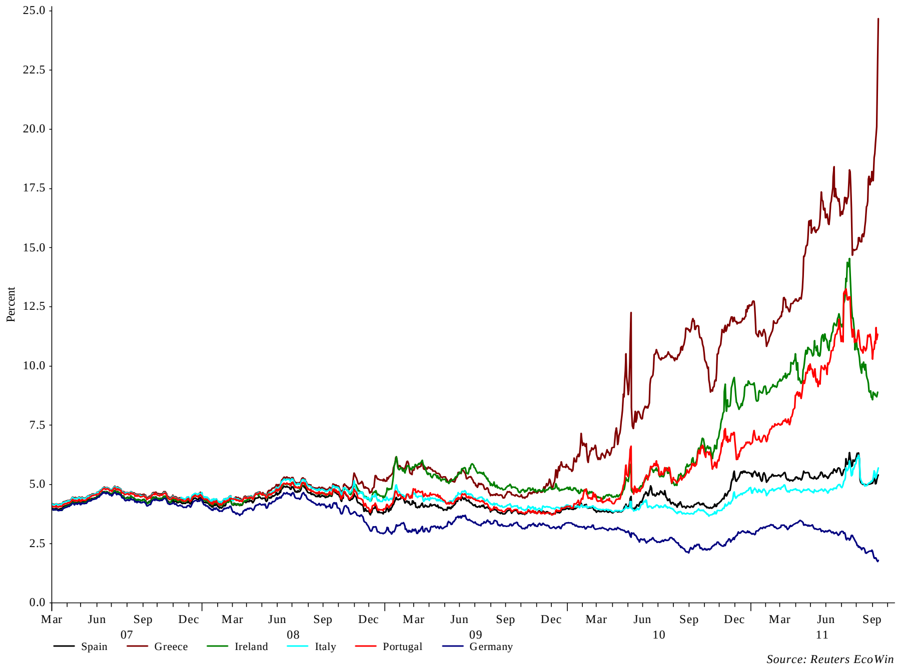
The chart also shows the operating profit margin (red) of companies traded on the UK market. This has risen strongly from its 2009 trough, driven largely by companies aggressively cutting costs during the recession and staying lean in the recovery. As such, they have been able to remain highly cash generative, even in an environment of anaemic economic growth. Risks to margins come from higher input prices and wage costs, though we are relatively sanguine about both. High levels of unemployment and planned public sector job cuts should act to keep wage pressures low, while recent commodity price falls, in response to concerns about global growth, should act to reduce input costs and thus help to support profitability.

In summary, we believe that UK equities are well placed to recover recent losses and recommend clients maintain current allocations. We propose that portfolios are focused on more cyclically-exposed funds where valuations appear most attractive. These should benefit most from a recovery in risk appetite, as well as any signs that economic growth might not be as weak as currently discounted in share prices.

2.2. European (excluding UK) Equities

The continuing eurozone sovereign debt crisis has highlighted the widening gap between the eurozone's northern core and the struggling peripheral nations. The shock resignation in September of Jürgen Stark, Germany's member of the ECB's executive board and its chief economist, demonstrates how divided the organisation is over the ECB's decision last month to implement a purchase programme for Italian and Spanish government bonds. While the programme initially drove yields lower, reducing borrowing costs for these countries, continued investor concerns over potential contagion and the strength of the European banking sector has seen these costs start to rise once more (Fig. 2).

Fig. 2 European 10-year Government Bond Yields



Despite the threat from the ongoing eurozone debt crisis and concerns that growth is beginning to slow outside of core northern eurozone countries, the ECB held interest rates at 1.5% in September. However, ECB president Jean-Claude Trichet indicated the bank's willingness to reverse July's 0.25% rate hike if the economic outlook continues to deteriorate. The Swiss National Bank, meanwhile, sought to put a ceiling on the Swiss franc and prevent its export-sapping strength pushing its economy into recession.

While negative news flow from the peripheral eurozone countries is likely to continue to dominate headlines for the time being, the core eurozone region hosts many companies that generate a significant proportion of their revenues overseas and therefore should be relatively immune to 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 half of the year from natural disasters in Japan, political unrest in North Africa and the Middle East, and sovereign debt concerns in the eurozone, a strong corporate environment helped drive the market ahead to record a c5% gain up to mid-2011 (in US dollar terms). However, risk assets have since come under intense selling pressure, with US equities experiencing weakness in July and sharp declines in August. Investor sentiment has been hit by (i) renewed and proliferating sovereign debt crises in the eurozone, (ii) a last-gasp agreement to raise the US government debt ceiling and, (iii) a deterioration in economic data, suggesting that growth is slowing once more. Standard & Poor’s, the rating agency, reacted to what they believed was an unsatisfactory deficit reduction deal by downgrading the US’s long-term credit rating from AAA to AA+.

Investors are also concerned that, given the current loose monetary conditions and considerable stimulus measures that have already been employed, US policymakers will struggle to find new ways of tackling the challenges facing the economy, raising the risk of a dip back into recession. Federal Reserve (Fed) officials have responded to such fears by promising to keep benchmark interest rates “exceptionally low” until at least mid-2013, and are discussing a “range of policy tools available to promote a stronger economic recovery.” President Barack Obama, meanwhile, has proposed a $447bn stimulus plan aimed at tackling the country’s unemployment problem. It remains uncertain, however, whether Congress will approve this package, and although one would expect Fed action to be positive for the economy and markets in particular, it is unlikely to have as direct an impact on boosting economic growth, given the relative ineffectiveness of QE2.

Against the flagging economic backdrop, the corporate environment continues to look strong. Reported second quarter earnings for the S&P 500 show 70% of companies beating estimates, 9% in-line with estimates and only 21% below. Year-on-year earnings growth for the period, meanwhile, was 12%. Standard & Poor’s forecasts earnings for the S&P 500 will reach a new peak of $99 per share by the year-end, giving the index a P/E ratio, based on current prices, of 11.8. 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 willingness to deploy capital, with merger and acquisition (M&A) activity, dividends and share buy-backs all on the rise.

The US economy clearly faces a number of headwinds, but with the market some c25% 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

The Japanese equity market has been weak over 2011 to date, largely due to the effects of the major earthquake and subsequent tsunami in March. The Japanese stock market had clawed back almost all of its losses by the end of the second quarter, but surrendered most of these gains in August as global equities fell due to debt-related concerns in the US and Europe. As a result, the benchmark Nikkei 225 is down c17% (in local currency terms) since the start of the year, underperforming the MSCI World benchmark of global equities, down c11% over the same period.

Despite the recent market volatility, total returns to UK-based investors in Japanese equities have proven to be relatively steady, thanks in large part to the offsetting effect of yen appreciation. Over the past two months, the yen has risen more than 6% against sterling, over 3% against the dollar and almost 7% against the euro.

Exporters are likely to revise their earnings forecasts lower for the third quarter, as the yen/dollar exchange rate trades stubbornly around the 77.0¥/$ level despite central bank efforts to artificially weaken the currency (Fig. 3). This is significantly stronger than the average 82.6¥/$ level budgeted for, according to the Bank of Japan's most recent quarterly Tankan survey, taken in July.

Fig. 3 USD/JPY Exchange Rate, Year to Date

In the political arena, Naoto Kan has now stepped down from his position as Prime Minister, handing over the reins to Finance Minister Yoshihiko Noda – the country's sixth leader in five years. Markets reacted favourably to the news as Noda is a vigorous supporter of increasing taxes to balance the budget and, in the past, has pushed the central bank to weaken the yen to improve export competitiveness.

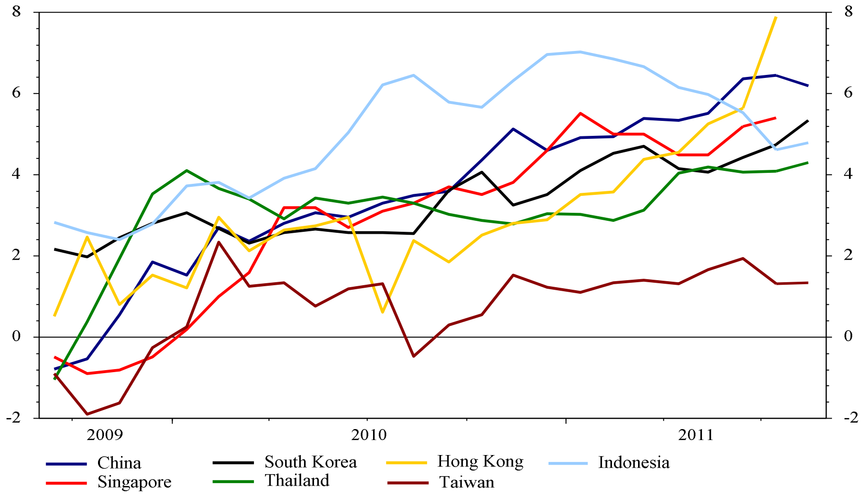
Japanese equities continue to trade on relatively low valuations compared to their international peers, however, this is reflective of the headwinds the economy faces. Recent events have not fundamentally altered our view on the investment prospects for Japan and we are not, therefore, recommending increased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

2.5. Asia Pacific (excluding Japanese) Equities

The MSCI Asia Pacific ex. Japan index has fallen in tandem with global equities (as represented by the MSCI World index) over the course of this year (both falling c11%), due to rising concerns regarding political gridlock in the US and the threat of debt crisis contagion in the eurozone.

Over the past twelve months, Asian policy makers have been in "monetary tightening mode" in an attempt to fight rising inflation, driven in large part from escalating food and commodity prices. Recent data suggests that this is working, with inflation starting to moderate (Fig. 4). In China, for example, annualised inflation fell to 6.2% in August, down from 6.5% in July, and it is expected to fall further during the fourth quarter of this year as the global economic slowdown adds to downward pressure on prices. As a result, it appears that the attention of Asian central bankers has now shifted to concerns about the pace of global growth. Over the last two months, export-dependent economies, such as Australia and South Korea, surprised markets by resisting interest rate increases, citing uncertainty in business conditions and a reluctance to have currency strength further erode competitiveness. The central banks of Indonesia, Malaysia and the Philippines also held off raising rates. However, given that the main component of Asian CPI, food prices, remain elevated, a return to looser monetary policy is unlikely in the short-term.

Fig. 4 Asian Consumer Price Inflation



Source: Thomson Reuters Datastream

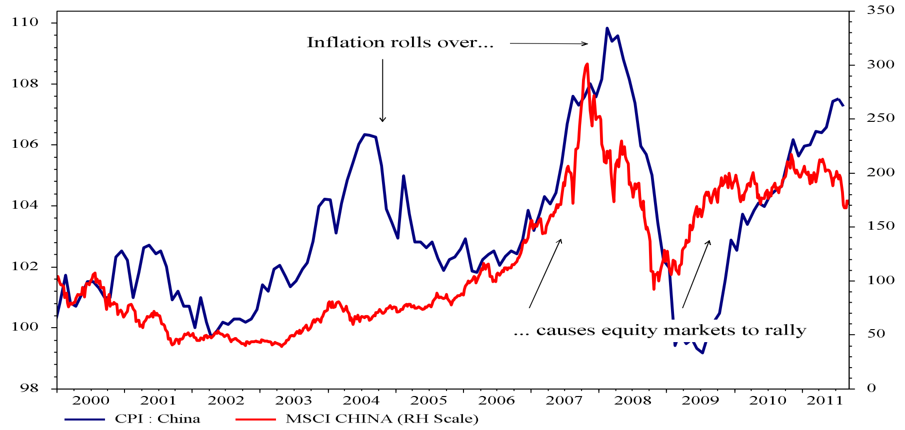
We are conscious that the risk of further corrections exists as, despite signs that regional inflation may be about to roll-over, it remains elevated and market volatility is high. In addition, the weak outlook for global growth and policy error out of China remain key concerns. However, we would balance these obstacles 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 region are maintained.

2.6. Emerging Markets Equities

Emerging market equities, as represented by the MSCI Emerging Markets index*, have come under pressure over the course of this year. Geopolitical tensions in the Middle East and North Africa, coupled with inflationary pressures at the start of 2011, caused equity markets to fall sharply. After a period of calm, stocks in the region have once again sold off, due to the spiralling eurozone sovereign debt crisis and deteriorating global economic outlook.

Unlike developed markets, controlling inflation has been the primary focus of policy makers in emerging markets over the course of 2011. Numerous tightening measures have been implemented including rising interest rates, increases to the reserve requirement ratio, as well as some unorthodox measures such as taxes on foreign investment. Recently, there have been some signs that inflation may be starting to roll over. Historically, this has been positive for equity markets (Fig. 5) as an easing of inflation allows interest rates to come down, boosting growth and therefore resulting in equity markets rallying. At the end of August, Brazil lowered its benchmark interest rate (the Selic) by 50bp to 12% - the country’s first rate cut since June 2009. If inflation pressures continue to ease, it should signal the start of the monetary loosening cycle throughout emerging markets.

Fig. 5 Chinese CPI and Equity Market



Source: Thomson Reuters Datastream

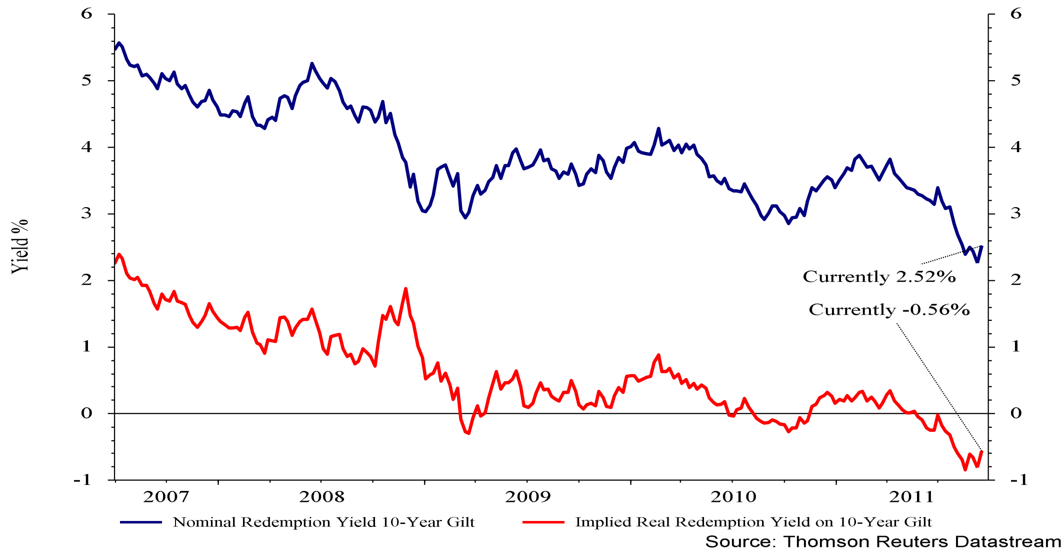
The uncertain outlook for the global economy has adversely affected the stock markets of developing economies, reminding investors that emerging markets are not insulated from the problems faced in the West. However, we believe that they should benefit from strong long-term growth prospects and economic fundamentals, including favourable demographics. The recent market weakness means valuations are now more attractive and, based on forward earnings, emerging market equities now trade at a discount to their historical average and in line with developed markets. We view this valuation as favourable and recommend that current allocations are maintained.

* The MSCI Emerging Markets index 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

The weakening of global economic data, combined with political inertia in the US and eurozone, has triggered a flight to quality. One beneficiary of this has been the UK gilt market, where the yield on the 10-year benchmark issue fell to a low of 2.20% on 12 September. Yields have since risen slightly to 2.52% (Fig. 6) at the time of writing. At this level, adjusting for anticipated inflation (derived from the 10-year inflation swap rate), the real yield on the benchmark gilt is -0.56%. US and German government bonds have also benefited from their ‘safe haven’ status, despite the former’s credit rating downgrade by S&P to AA+ in August, and the 10-year issues of both now also trade on negative real yields.

Fig. 6 Nominal and Real Yields on the 10-Year Gilt

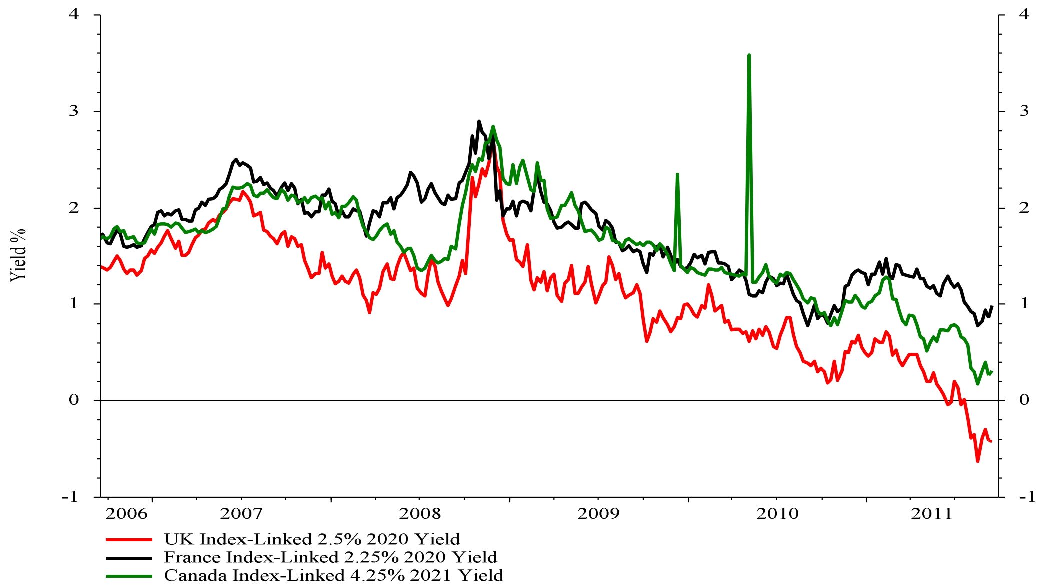


On such low yields, these bonds are only attractive if the economic picture deteriorates further and inflation expectations fall sharply. Given how accommodative monetary policy remains in the developed world, suggestions from the Federal Reserve that further quantitative easing (QE) would be forthcoming if warranted, and the proposed $447bn package of redirected spending to encourage job creation in the US, we believe that a double-dip recession can be avoided. If economies manage to muddle through, or endure only a modest contraction in growth, we believe that core Western government bonds could perform poorly as investors regain their appetite for risk. We therefore continue to recommend zero allocations to conventional government bonds.

Where we do still see an opportunity in government bonds is via inflation-inked issues. Although the real yields on UK index-linked gilts (ILGs) are all currently below 0.5%, with some in negative territory, we consider it plausible that inflation in the Western world, particularly the UK, could surprise on the upside over the next decade. This view is driven by exceptionally low interest rates, in conjunction with the use of QE, to increase the quantity of money in circulation. These actions, combined with the fact that a dose of higher inflation would be helpful for governments that need to bring their debt to GDP ratios down, lead us to believe that inflation-linked bonds still merit a place in portfolios, despite their low real yields.

We also think that, with UK ILGs currently offering particularly low yields, thanks in large part to strong institutional demand, investors should hold some of their inflation-linked allocations in funds of overseas bonds. Fig. 7 shows the additional yield available on French and Canadian inflation-linked bonds of similar maturity relative to their UK counterparts. In addition to this yield pick-up, the managers of these funds can exploit duration and relative-value opportunities. 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.

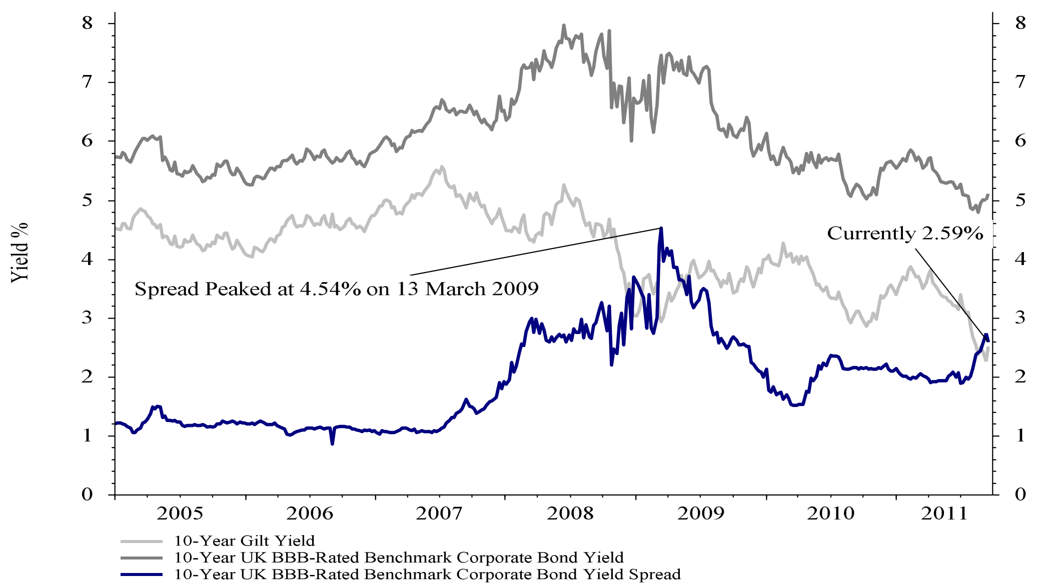
Fig. 7 Global Inflation-Linked Government Bond Yields



Source: Thomson Reuters Datastream

Turning to corporate bonds, yields have remained relatively stable during the recent period of risk aversion. However, the yield spread on corporate bonds relative to the equivalent government bonds has widened substantially over August and September to date as government bond yields have fallen (Fig. 8).

Fig. 8 The BBB-Rated Corporate Bond and 10-Year Gilt Yields (Gap = Spread)



Source: Thomson Reuters Datastream

Although credit spreads remain considerably tighter than at their peak in March 2009, when we were at the height of the financial crisis, they appear to now be pricing in a bleak environment for corporates. According to F&C Thames River, the investment grade bond market is currently pricing in the failure of one-in-eight European and one-in-ten US blue chip companies in the next five years. In high yield, credit spreads have risen to c7.5% on BB to B-rated indices, implying that between one third and a half of all sub-investment grade companies will default within five years.

Our view is that, outside a very deep recession, these implied default rates are much too high and yield spreads should therefore fall over time. This belief is supported by the extent to which companies have strengthened their balance sheets and cut costs since the last recession. Corporate cash levels are now much higher than in 2008, meaning that a withdrawal of liquidity by banks, as occurred following the collapse of Lehman Brothers, would be less likely to lead to a sharp rise in bankruptcies. Companies have also used low borrowing rates over the past three years to refinance much of their existing debt prior to maturity. As a consequence, most investment grade and sub-investment grade companies should be able to get through to 2014 without the need to refinance large amounts of maturing debt.

However, we are mindful that risks remain, particularly in terms of the impact of a default by Greece on the European financial system. Until there is greater clarity on peripheral Europe, we believe that higher volatility will continue to be a feature of bond markets. As such, we prefer corporate bond allocations to be invested in more strategic funds, whose managers have the flexibility to adjust both their credit and interest rate risk exposure to fit economic and market conditions as they evolve.

4. Property

According to Investment Property Databank, the initial yield on the UK commercial property market currently stands at 6.3%. Year to date, the market has been characterised by modest capital growth and broadly flat rental values. In our view, this situation looks likely to persist into 2012, 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 much weaker, 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 drive prices higher. 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 that forced sales of properties 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 re-lettings. Such asset management initiatives should help to provide an attractive and stable income for portfolios with 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 was 4.5% in August, 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 16 September 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 28 February 2011 to 31 August 2011 and the twelve month period from 31 August 2010 to 31 August 2011 (source: Lipper Hindsight). LC = Return in Local Currency.