Market Commentary

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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

<u>Risk Warnings</u>

1. Economic Outlook

After shrinking in 2009, the global economy grew by 5.0% in 2010, according to figures from the IMF. While this is a healthy rate of expansion, growth has been very much skewed in favour of developing, rather than developed, 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).

December's tax-focused US fiscal stimulus, accompanying the second draught of QE from the US central bank, the Federal Reserve (Fed), evidences the anaemic economic recovery in the United States. 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 ahead to the remainder of 2011 the global economy is, in our view, likely to continue 'muddling through', much as it did in 2010. Governments and central banks in the developed world appear keen to begin the process of policy normalisation, but will need to remain mindful of the risk of choking off growth and sending their economies back into recession. In emerging economies, inflation is the principal threat and monetary tightening is already taking place to ensure this 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 31 March 2011

	6mth Return (£)	1yr Return (£)	6mth Return (LC)	1yr Return (LC)
FTSE All Share	8.48%	8.72%	8.48%	8.72%
FTSE Europe ex. UK	10.61%	7.48%	8.24%	8.30%
S&P 500	15.33%	9.44%	17.31%	15.65%
TOPIX	5.13%	-3.16%	6.10%	-9.23%
FTSE All World Asia Pacific ex. Japan	7.77%	13.06%	6.17%	13.49%
FTSE All World Emerging Markets	6.77%	11.91%	8.60%	18.26%
FTSE UK Gilts 5-15 Years	-2.93%	6.13%	-2.93%	6.13%
FTSE UK Index Linked Gilts 5-15 Years	2.01%	7.99%	2.01%	7.99%
BarCap World Government Inflation Linked	0.63%	5.54%	0.63%	5.54%
BofA Merrill Lynch Sterling Corporate Bond	-1.30%	5.93%	-1.30%	5.93%
BofA Merrill Lynch Sterling Broad Market	-2.47%	5.31%	-2.47%	5.31%

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

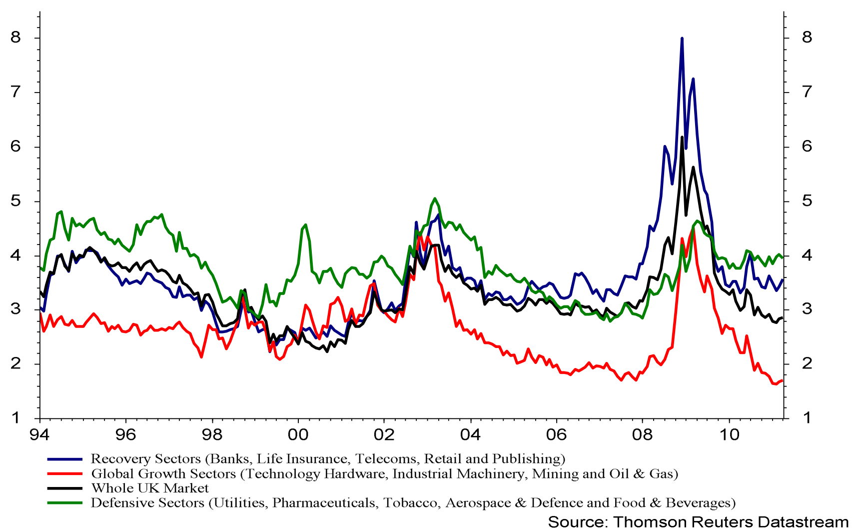
2. Equities

2.1. UK Equities

After a 0.5% quarter-on-quarter contraction in UK GDP at the end of 2010, we expect to see a reasonable rebound in economic activity when data are released for the first quarter of 2011. The current forecast range is 0.2-0.8% growth. This expectation is supported by surveys of purchasing managers pointing towards robust growth across the manufacturing, construction and services sectors. Looking further ahead, however, tax rises, government spending cuts and inflation are likely to keep economic growth subdued.

Despite the uncertain backdrop, 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 regardless of the state of the UK economy. While this provides a fundamental case to favour such stocks over UK-centric peers, we remain mindful of valuation. Fig. 2 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.

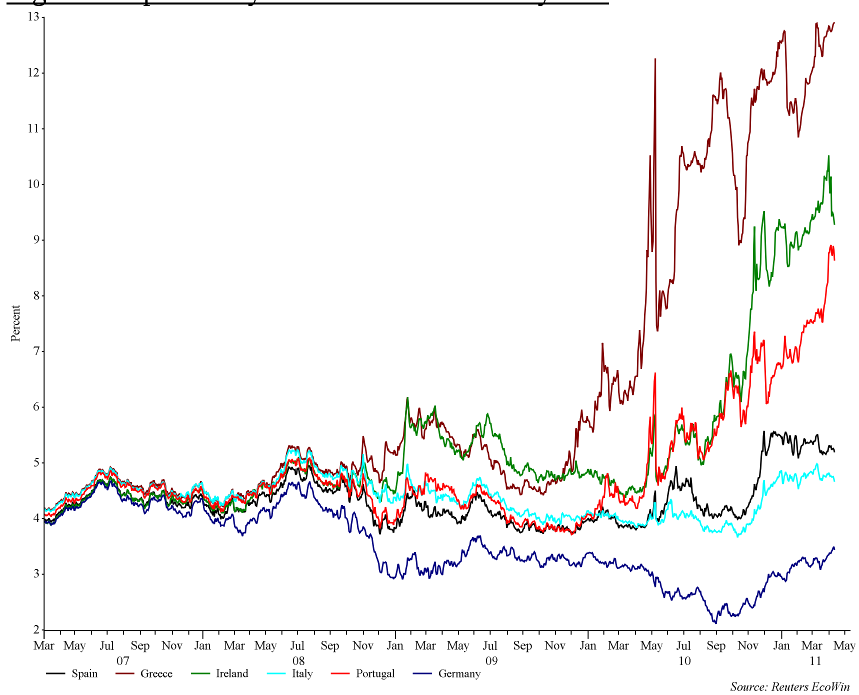
Fig. 2 Dividend Yield on UK Equities



2.2. European (excluding UK) Equities

January's debut bond offering by the European Financial Stability Facility (EFSF) saw strong demand, with orders attracted from more than five hundred investors and totalling €44.5bn, almost nine times the €5bn of paper on offer. This formed part of the increase in the EFSF's lending capacity from €250bn to €440bn. Its first test is likely to be in Portugal, where a formal bailout could amount to c€70-80bn, following a sharp rise in the cost of its borrowing (Fig. 3). The rescue package should enable the government to meet its immediate financial obligations including €4.3bn in bond redemptions in April and another €5bn due in June.

Fig. 3 European 10-year Government Bond yields

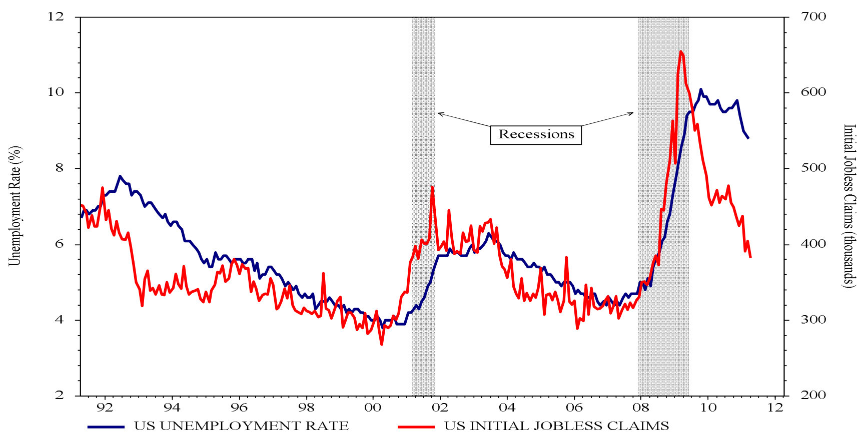


The beginning of April saw the ECB deliver its first interest rate rise in three years, the first of the major, developed market central banks to do so. The increase in rates from 1.00% to 1.25% was defended by ECB president, Jean-Claude Trichet, as being "in the interest of all members of the European market and single currency". Given the current strength of their economy, Germans welcomed the ECB action. With industrial production growing 14.8% year-on-year in February, and factory orders growing at an annual pace of 20.1%, 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.

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 economic fundamentals which, in the US, include a raft of positive data releases providing cause for optimism on the recovery. Most noteworthy has been the continued strength in the manufacturing sector, which expanded for the 20th successive month in March, while consumer spending, which recorded a 4.4% annualised increase in the fourth quarter, advanced 0.7% and 1.0% month-on-month in January and February respectively. Encouragingly, labour markets are now also showing a modest improvement; the unemployment rate has fallen from 9.8% to 8.8% in the last four months and weekly initial jobless claims are now below the 400,000 level associated with steady jobs creation.

<u>Fig. 4 US Employment Improving</u>



Source: Thomson Reuters Datastream

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 country's fiscal deficit, which has grown tenfold since 2001 to $1,230bn, equivalent to 8.0% of GDP. 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

An earthquake of magnitude 9.0 struck North-eastern Japan in the middle of March. The tsunami that followed swept across much of Tohoku, a largely agricultural region which accounts for about 7-8% of Japan's GDP. Preliminary estimates put the cost of the disaster in the region of $200-300bn. The tsunami also caused problems at the Fukushima Dai-ichi nuclear power plant, which continues to experience issues, although the situation appears to have calmed considerably in the past month. However, there remain unresolved questions around radiation levels and the longer-term effects that they may have on Japan’s economy. Economic indicators released in March continued to be fairly downbeat: consumer confidence unexpectedly fell and the Tankan survey of business confidence revealed a pessimistic outlook for the next quarter.

Figure. 5 USD/JPY Exchange Rate

The Japanese currency has been volatile in the wake of the earthquake. The yen strengthened to a record high against the US dollar, briefly touching the $/¥76.3 level, before co-ordinated central bank intervention from the G7 economies helped to bring the currency down to the present $/¥85.0 level. The current market level is broadly in line with the average rate of $/¥83.9 budgeted for by Japanese manufacturers (according to the most recent Tankan survey).

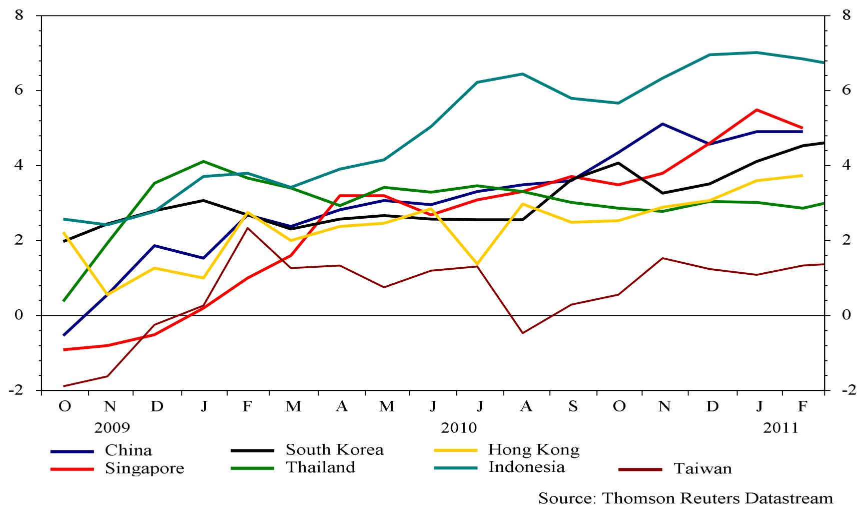
The March earthquake adds to Japan’s list of headwinds, but in our opinion, this is adequately reflected in the relatively low valuations on which Japanese equities trade, compared to their international peers. On a positive note, the tragedy may bring about much needed change: political unity, looser monetary policy and the prospect of a GDP boost from reconstruction. Recent events have not, however, 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

March was a positive, albeit volatile, month for stock markets in the region, as the benchmark MSCI AC Asia Pacific ex. Japan index dropped more than 5% following the Japanese earthquake, but rebounded almost 10% thereafter, regaining levels not seen since 2008 (before the bankruptcy of Lehman Brothers).

Ongoing political turmoil in the Middle East has caused the price of crude oil to remain elevated, complicating government efforts to curb inflation in many of the Asian economies. Consumer price inflation (CPI) continues to be a key concern, with countries like China, South Korea and Indonesia still reporting CPI figures of 5% or higher. All three have raised interest rates in the past month.

Figure. 6 Asian Consumer Price Inflation



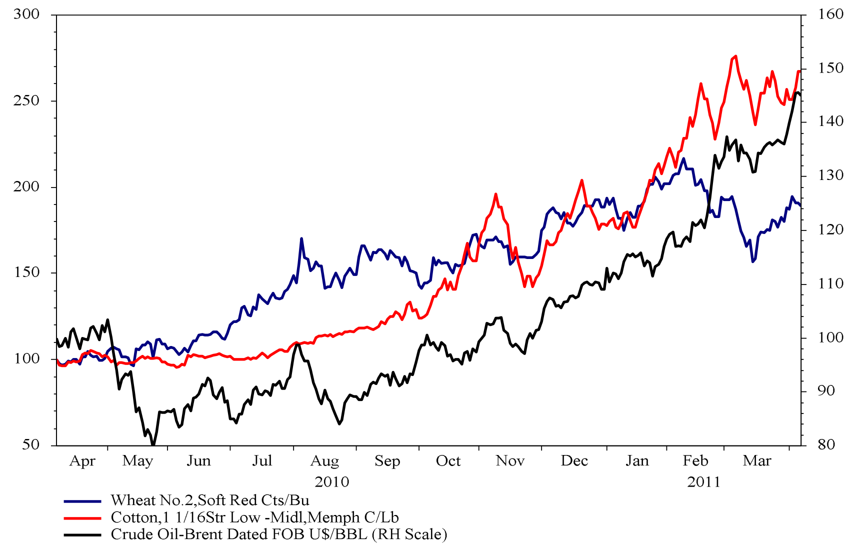
Hong Kong-based conglomerate Hutchison Whampoa spun off its Chinese port holdings, creating a $5.5bn Singapore-listed trust. However, investor enthusiasm for the initial public offering (IPO) was muted. Shares of Hutchison Port Holdings fell 7% in their first day of trading and remain 2% below their IPO price at the time of writing. The poor reception is a sign that rising interest rates and a general tightening of monetary policy across the region may be starting to take effect, reducing investor appetite for riskier assets.

Despite the possible economic and policy headwinds described, we believe the Asia Pacific ex. Japan sector should continue to benefit from the region's strong economic fundamentals and favourable demographics. We recommend that current allocations to the sector are maintained where appropriate.

2.6. Emerging Markets Equities

Following six months of underperformance since last August, emerging markets, as measured by the MSCI Emerging Markets index*, outperformed their developed world counterparts by c5% in March, largely ignoring the earthquake, tsunami and subsequent nuclear fall-out in Japan, which caused developed markets to retreat. Much of the recent underperformance can be attributed to fund out-flows, as investors rotated away from emerging market equities in favour of western markets, and rising inflationary pressures.

Fig. 7 Commodity and Food Prices



Source: Thomson Reuters Datastream

In order to combat rising food and commodity prices, many emerging market governments have started to tighten monetary policy and have implemented taxes on foreign capital inflows. However, despite concerns that over zealous monetary tightening may cause a slowdown, growth prospects remain strong. Emerging markets are expected to grow by 6.5% in 2011 versus 2.5% for developed markets (IMF World Economic Outlook).

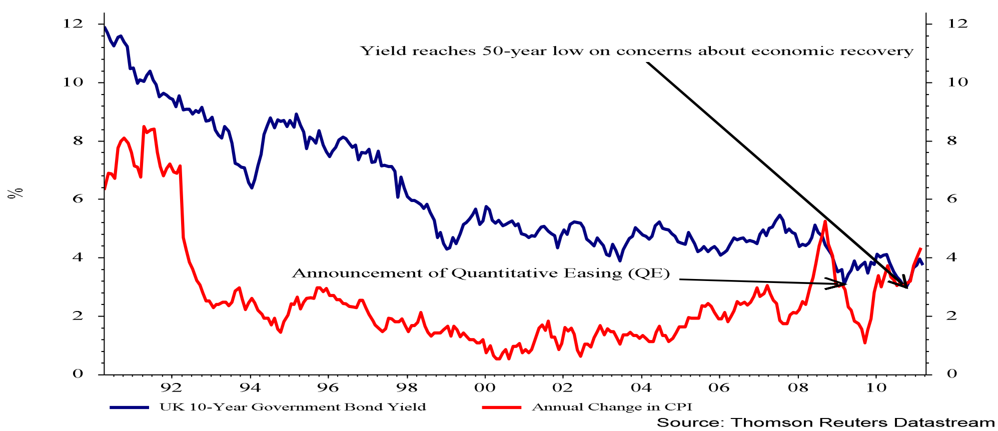
The political turmoil in the Middle East has reminded investors of the risks inherent in emerging markets. However, the subsequent underperformance of the region's equity markets has caused valuations to fall and, based on historical earnings, emerging market equities now trade at a discount to developed 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, where appropriate.

* 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

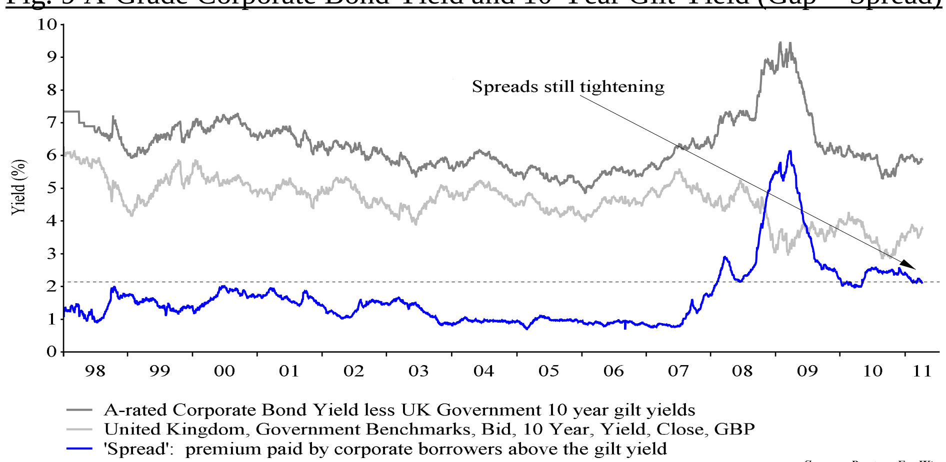
The 20-year period of falling government bond yields appears to have ended, with the benchmark 10-year gilt now yielding 3.82%, almost a percentage point higher than the low of 2.83% reached in August 2010. This reflects both confidence in the sustainability of the economic recovery and the persistence of inflation (Fig. 8). While tax rises and commodity price increases will eventually drop out of the annual inflation numbers, costs of imported goods are continuing to rise, driven by higher wage costs in developing markets. The risk is that more expensive imports prompt domestic consumers to demand higher wages, thereby allowing inflation to become entrenched. This could necessitate bond yields moving sharply higher.

Fig. 8 The End of the Government Bond Bull Market



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. Figure 9 shows that corporate bond yields are now close to the average level at which they have traded over the past decade. However, this yield can be separated into two key components: the underlying government bond yield and the credit spread, reflecting the additional yield paid to compensate investors for the risk of default and the illiquidity of the bonds.

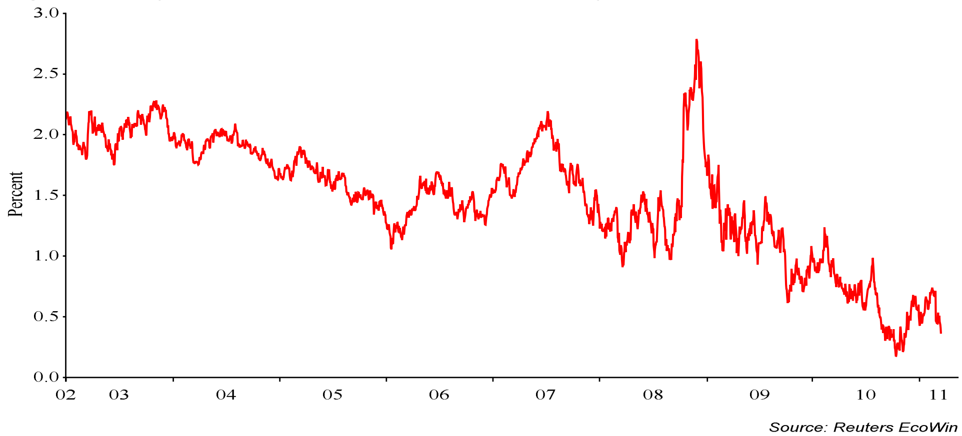
Fig. 9 A-Grade Corporate Bond Yield and 10-Year Gilt Yield (Gap = Spread)



Considering the above, the underlying gilt yield is unattractively low, but the credit spread remains wide relative to history. We therefore favour "strategic bond" funds, whose managers have the scope to separate these two sources of risk and return from portfolios of corporate 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.

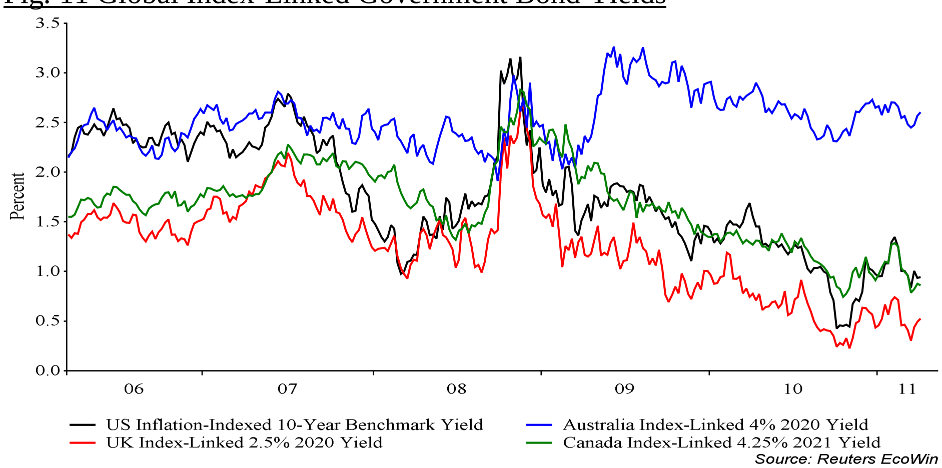
Another area of bond markets that we favour is index-linked bonds, where coupons and capital values are linked to measures of inflation. Historically, we have preferred index-linked gilts (ILGs), though now consider them to be fairly fully valued. Fig. 10 shows that the real yield on the 2½% Index-Linked Treasury Stock 2020 is low relative to its own history.

Fig. 10 Real yield on 2½% Index-Linked Treasury Stock 2020



While real yields on ILGs remain so 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. 11), 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. 11 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 through 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 tight. 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, which they may now begin to sell. 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 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 presently earn returns broadly in line with the BoE Bank Rate of 0.50% p.a. Despite low rates, cash still has attractions, particularly where better rates from government-backed or good quality institutions can be secured. Cash, whether on instant access 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. Cash invested at the BoE Bank Rate would have returned +0.25% over the last six months and +0.50% over the last year.

The above commentaries reflect our views as at 13 April 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 30 September 2010 to 31 March 2011 and the twelve month period from 31 March 2010 to 31 March 2011 (source: Lipper Hindsight). LC = Return in Local Currency.