

## **Market Commentary**

**February 2010**

**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**



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### Risk Warnings

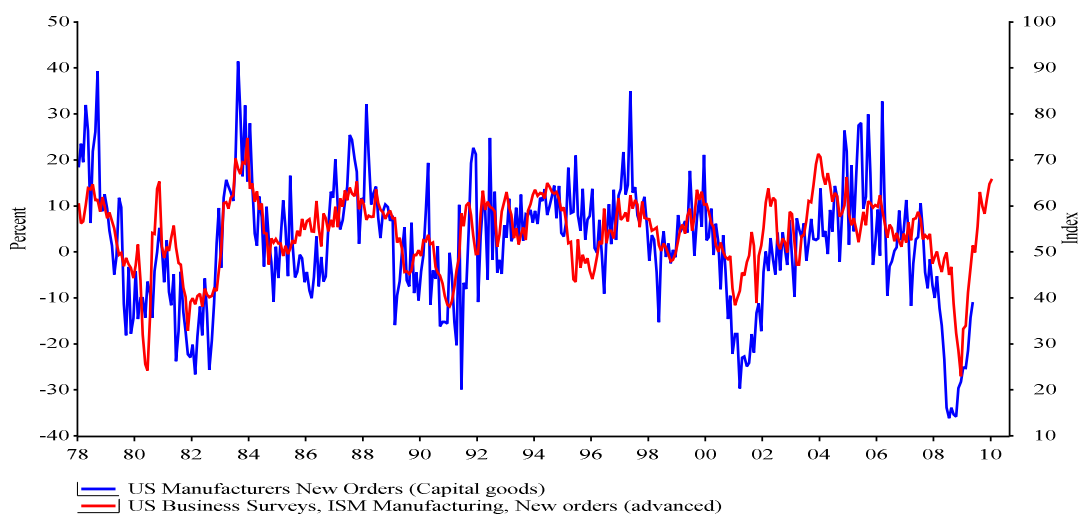
This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 17 February 2009. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments 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

Recently released economic data, together with forward-looking surveys of business and consumer sentiment, are indicating that the global economy is expanding once more. Governments and central banks will be relieved that their actions have helped the global economy to avoid a re-run of the Great Depression and the focus of debate is now moving onto the shape and durability of the recovery and the pace at which the policy measures can be withdrawn and interest rates normalised. The European Central Bank (ECB), for example, has already begun the process by closing its unlimited liquidity scheme, initiated at the peak of the financial crisis, while the Bank of England (BoE) has announced a pause in its programme of quantitative easing. After many months of downgrades, forecasts for economic growth are now being revised higher. For example, the International Monetary Fund, in its January World Economic Outlook paper entitled 'A Policy-Driven, Multispeed Recovery', upgraded its expectation for output growth in the developed economies in 2010 to 2.1% from a forecast of 1.3% made in October.

Recognition for the rapid improvement in the economic outlook, as exemplified by the ISM New Orders Survey in the US (see Fig. 1), is, in large part, attributable to the speedy and aggressive response to the credit crisis from both monetary authorities and governments. Ignoring warnings about the longer-term fiscal or inflationary consequences of their actions, central banks moved decisively to take official interest rates down to the lowest levels ever recorded and instigated other policy measures to ease credit market conditions. These measures appear to have had the desired effect of stabilising asset prices and steadying consumer sentiment. In response to this, policymakers have now begun to gradually reverse some of the steps taken to support the global economy. This has created a more challenging and volatile environment for investors.

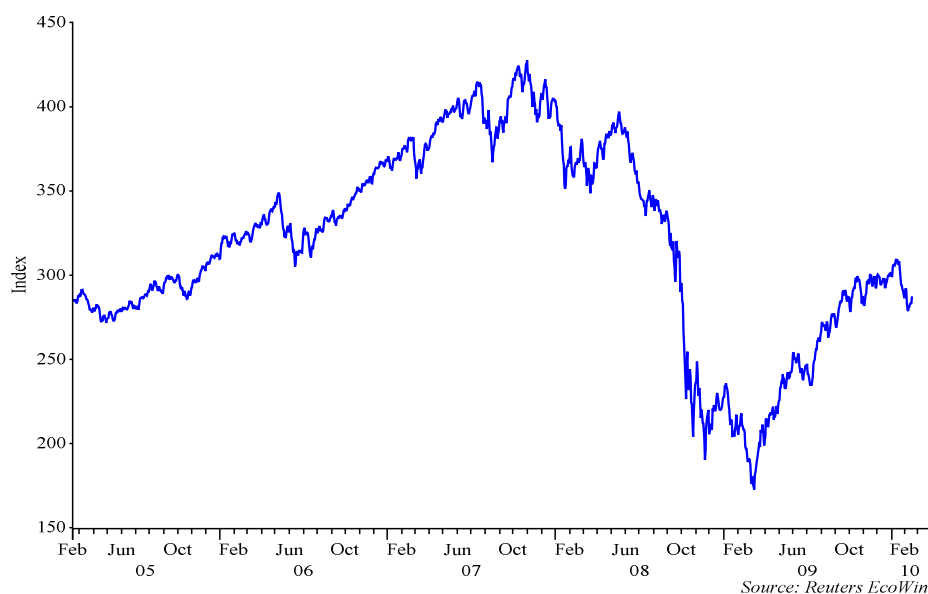
Fig. 1 ISM New Orders are signalling that the US Real Economy will gain momentum



Source: Reuters EcoWin

As might be expected, the improved economic outlook resulted in a bounce in equity markets from the depressed levels of March 2009 (see Fig. 2). The recovery in share prices has been supported by company earnings statements which have, in the main, met or exceeded analysts' forecasts. The drivers of better corporate earnings include inventory restocking by companies that had run stocks down as the financial crisis deepened as well as reduced costs due to the aggressive overhead reductions made in late 2008 and the first half of 2009. Cost pressures have also been alleviated by lower interest rates and lower raw materials prices.

Fig. 2 MSCI World Equity Market Index over five years



Along with the pace at which policy support is withdrawn, growth in corporate profits and dividends will be key determinants of equity market returns in 2010. Markets will focus on companies' abilities to deliver on expectations and, with a cyclical recovery now largely priced in, further progress is likely to be driven by companies' top line growth and earnings momentum.

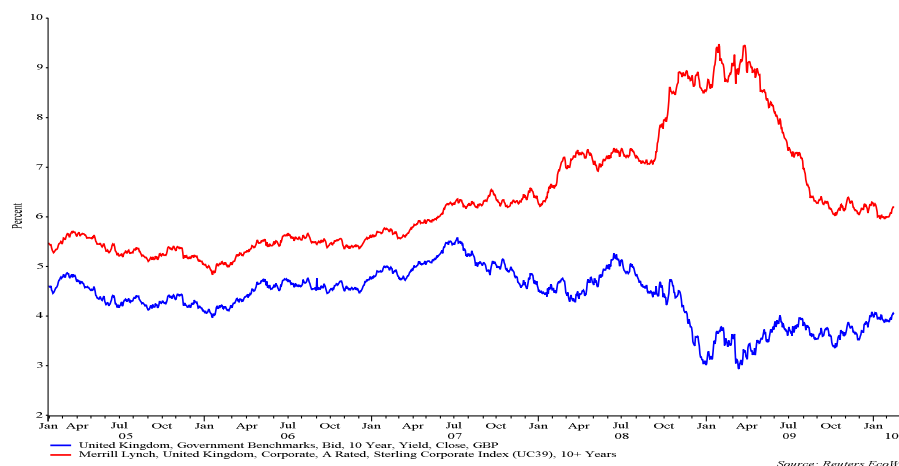
Considering valuation, the extreme weakness in equity markets in late 2008 and early 2009 saw dividend yields in most major equity markets move above their respective government bond yields. This was a clear indication of investors' extremely bearish expectations for both the sustainability of existing dividends and the prospects for future dividend growth. The rally since early 2009 has brought equity yields down once more but, unless earnings and dividend growth remain very subdued for a prolonged period, equities, particularly those of high-quality defensive businesses, remain attractively valued relative to both government bonds and cash deposits.

The MSCI World Equity Market index has provided a total return of +11.99% in sterling terms over the last six months and +23.63% over the last year.

Turning to other major asset classes, government bonds, which were the asset class of choice for investors in late 2008 and early 2009, performed poorly over 2009 as a whole. The downward pressure on sovereign bond prices resulting from the high levels of issuance appears, for now at least, to have been balanced by government policies designed to expand money supply, including the direct purchases of government bonds. Given the pausing of such unconventional measures and the potential for higher inflation, we believe that, with the UK 10-year benchmark now yielding 3.91%, the asset class remains unattractive.

In stark contrast to government bonds, corporate bond prices were driven to exceptionally low levels in early 2009, both by concerns about falling corporate earnings and forced selling by leveraged investors caught out by the ferocity of the financial crisis. The increase in the yields on corporate bonds was even more pronounced when viewed relative to their government counterparts (see Fig. 3) as investor enthusiasm for the defensive attributes of government bonds forced prices higher and yields lower. This situation began to correct in the first quarter of 2009, in response to the policy initiatives outlined above, since when corporate bond prices have made a rapid recovery and yields have been driven down. In our view, however, the yields available remain attractive, both in absolute terms, and relative to government bonds and cash on deposit.

**Fig. 3 Corporate bond yields remain attractive relative to conventional gilt yields**



Considering commercial property, a five-year bull market came to an end in mid-2007 when prices eventually began to weaken under the pressure of credit market dislocation. Property values continued to decline until the middle of 2009, as tighter credit market conditions removed an important source of funding for commercial property buyers and the deteriorating economy undermined tenant demand. While commercial property values have now begun to stabilise, rents may still have further to fall. However, with the asset class now yielding c7%, we believe it is attractive, both in absolute terms and relative to other assets. We have therefore been recommending additional allocations to this asset class.

The following sections consider our monitored asset classes, including hedge funds and cash, in more detail.

## 2. Equities

### 2.1. UK Equities

According to preliminary GDP data for the fourth quarter of 2009, the UK economy has now returned to growth, albeit at a rate of just 0.1% over the final three months of the year. In spite of aggressive policy action from the government and the BoE, the return to growth has proved weaker and arrived later in the UK than in other G7 nations and significant obstacles to sustained growth remain. Regardless of who wins this year's general election, the country's budget deficit will have to be addressed through a combination of tax increases and spending cuts. The deficit currently stands at c12% of GDP, and, as with Greece, Spain, Portugal and Italy, concerns are mounting that the servicing of this debt may prove troublesome. Considering the private sector, consumption is unlikely to drive strong economic growth as household balance sheets remain over-extended and in need of a period of higher savings and reduced spending.

Despite the severity of the UK's recession, there remain some key supports for the economy. Over the past three years, sterling has fallen by 25% on a trade-weighted basis. This is a key reason why the UK's issues are not as severe as those of Ireland or southern Europe, where the option of currency depreciation is not available due to euro membership. The weakening of sterling should make the UK more competitive and lead to an improvement in net trade as the global economy gains traction. Meanwhile the BoE Bank Rate seems unlikely to increase substantially in the near future. At an all time low of 0.50%, interest rates are easing the burden on leveraged consumers and businesses.

Turning to the corporate sector, companies dependent on domestic consumption are likely to find 2010 challenging as household spending is weighed down by higher taxes, the need to reduce debt and ongoing weakness in the labour market. However, it should be noted that, in aggregate, major UK-listed companies generate a substantial proportion of their revenues from overseas (c60% according to HSBC). They should, therefore, be able to grow their profits at a faster rate than the domestic economy and also benefit from enhanced profits growth as foreign earnings are translated into sterling. While the stock market is no longer as attractively priced as it was in March 2009, we believe that UK equities still offer reasonable value, as indicated by the high dividend yield on the market relative to cash and gilts, and have the potential to provide good returns over 2010. We therefore recommend that existing allocations to UK equities are maintained, where appropriate.

The FTSE All-Share index has provided a total return of +14.71% over the last six months and +33.24% over the last year.

## 2.2. European (excluding UK) Equities

The eurozone economy grew 0.1% in the fourth quarter of 2009, helped largely by France's 0.6% expansion in the final three months of the year. Inflation in the 16-country region hit an 11-month high in January with consumer prices rising 1.0% year-on-year, though this is still well below the European Central Bank's (ECB) target of close to but below 2.0%. European equity markets have been unnerved since the start of the year by mounting concerns over the potential of sovereign debt default by Greece leading to the contagion of other peripheral eurozone economies. Membership of the euro has denied such countries the option of currency devaluation and the process of addressing fiscal imbalances is likely to act as a further drag on economic recovery. The ECB left interest rates unchanged at 1.00% at its February meeting and, given such a subdued outlook, it is likely to keep policy rates on hold for an extended period of time.

Unemployment in the eurozone rose to 10.0% in December, the highest rate since August 1998. However, the data mask a considerable divergence within the region, with unemployment ranging from just 4.0% in the Netherlands to 19.5% in Spain. The jobless rate in several countries has been suppressed by government schemes to protect the labour markets, such as "short-work" schemes where employers have been subsidised to keep workers on their payroll. Retail sales growth was a disappointing 0.0% in December, suggesting that job losses continue to have an effect on consumer confidence and it may be some time before consumers play a full part in an economic recovery.

The health of the German industrial sector is likely to be central to the eurozone's economic recovery. German industrial production contracted by 2.6% month-on-month in December versus expectations of growth, while factory orders also disappointed, triggering concerns about the momentum of its recovery. Hence, recovery is likely to be fragile and it may take some time before manufacturing and export-orientated European companies see any significant growth in demand.

Having advised a reduction in weightings to European equities at the end of 2007, we recommend that remaining allocations are maintained, where appropriate.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +9.52% over the last six months and +34.55% over the last year. In sterling-adjusted terms, the returns are +11.09% over the last six months and +31.30% over the year.

### 2.3. North American Equities

A US economic recovery is underway thanks, at least in part, to the aggressive fiscal and monetary policy measures undertaken by the US authorities. These include the Obama administration's \$700bn fiscal stimulus package (the Troubled Asset Relief Program), sharp reductions in interest rates and the purchase of c\$1,450bn of mortgage-backed securities from the two government-sponsored housing enterprises, Freddie Mac and Fannie Mae, as well as the purchase of c\$300bn of US Treasury bonds.

Following four quarters of negative growth, the longest stretch of declines since quarterly records began in 1947, the US economy returned to growth in the third quarter of 2009, expanding by 2.2%. This was helped by a reversal in the inventory cycle, whereby companies rebuilt severely depleted stock levels to cope with steady demand. The recovery in manufacturing has continued to gain momentum, leading to an acceleration of economic growth to an annualised 5.7% in the final three months of the year.

Underlying consumer demand, however, remains fragile. Retail sales in December declined by 0.3% month-on-month, serving as a reminder that consumers continue to face significant headwinds. Despite recent signs that the deterioration in the labour market is slowing, an unemployment rate of 9.7%, remains at almost twice its rate just 18 months ago. As a result, income growth is poor and households are focusing on paying down existing debts; a return to the consumption patterns of the pre-crisis years appears unlikely. However, the Federal Reserve's commitment to maintaining exceptionally low interest for "an extended period" should support consumption to some degree.

Turning to the stock market, by the end of the first quarter of 2009, US equities had fallen to levels that could be considered inexpensive relative to historical valuations. However, aided by the loose monetary and fiscal conditions, the rally has taken them back, in our view, to broadly fair value. We therefore recommend that allocations to US equities are maintained for the present, where appropriate.

The S&P 500 index provided, in US dollar terms, a total return of +9.87% over the last six months and +33.14% over the last year. The fluctuations of the dollar mean that, when translated into sterling, the returns are +13.67% over the last six months and +19.78% over the year.

## 2.4. Japanese Equities

Despite some recent signs of improvement, concerns remain about the vitality of Japan's economy. These concerns were highlighted by the downgrading of third quarter GDP growth from an annualised 4.8% to a pedestrian 1.3%. Primary among Japan's troubles is a very unhelpful demographic profile. The population is aging and, as a result of minimal immigration, shrinking. Consequently, as individuals are deferring consumption in order to fund retirement, the tax burden is falling on a declining proportion of the population and the domestic sales base of the corporate sector is being eroded. Real wages have been trending lower since 1997 thus deflationary expectations appear ingrained and, to an extent, self-fulfilling.

Elected in an historic landslide victory on 30 August 2009, the Democratic Party of Japan (DJP) has declared its determination to stimulate domestic demand and combat deflation. However, with government debt at c200% of forecast 2010 GDP and interest rates near zero, it is unclear what more the state can do to stimulate the economy.

While we acknowledge the severity of Japan's structural economic issues, we believe the corporate outlook is brighter. Aggressive cost cutting measures have been undertaken and Japan's companies and equity market should now be in a relatively strong position to benefit from a recovery in global demand, particularly within Asia. However, the yen's strength since the onset of the credit crisis continues to disadvantage Japan's all-important export sector. Though the new finance minister, Naoto Kan, has made headlines with his vocal support of a weaker yen, foreign exchange markets have continued to value the 'safe haven' status of the yen, thereby supporting the currency. A sustained improvement in global risk appetite, perhaps in response to evidence that economic growth can be maintained after policy support is removed, might be accompanied by a weakening yen – a development that would be warmly welcomed by Japan's export sector.

In recognition of the significant structural issues facing Japan, the equity market has been a long-term laggard among the developed markets. Consequently, Japanese equities appear inexpensive on a range of measures, both in historical terms and relative to other markets. We believe that the normalisation of global monetary policy may present opportunities to increase allocations to Japanese equities, but recommend that, for now, current weightings are maintained, where appropriate.

The FTSE Japan index provided, in yen terms, a total return of -4.13% over the last six months and +16.98% over the last year. The fluctuations of the yen mean that, when translated into sterling, the returns are +4.15% over the last six months and +4.27% over the year.

## 2.5. Asia Pacific (excluding Japanese) Equities

Contrary to the expectations of those espousing the Asia Pacific ‘decoupling’ theory, the past two years have served to emphasise the cyclicity of the region’s equity markets. The global crisis in 2008 impacted the Asia Pacific region not through banking channels, but through the sharp contraction in international trade that resulted from the collapse in consumer demand in the west. As export volumes declined, industrial production fell, economic growth estimates were revised lower and equity indices fell sharply. Subsequently, supportive policy measures and the return of growth in the developed economies have delivered a better economic outlook and Asia Pacific equities have recovered strongly (see Fig. 4).

**Fig. 4 FTSE All-World Asia Pacific ex Japan compared to MSCI World since 2008 (rebased)**



With high savings ratios, cheap labour and strong public sector finances, many Asian economies have the potential to achieve rapid economic growth. Having benefited from strong export-led growth, Asian policy makers are now making a concerted effort to stimulate domestic demand which, with increasing levels of prosperity, should stimulate further economic growth over the medium term.

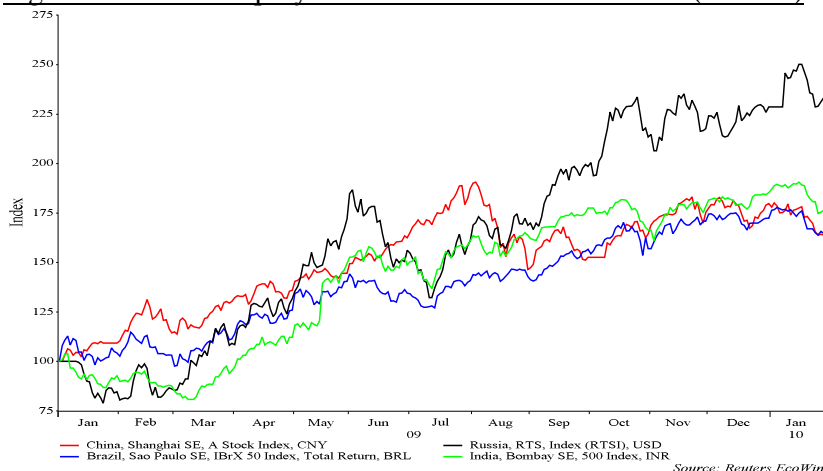
Funded by loose monetary conditions, investors have sought to benefit from Asia’s long-term growth potential. As a result, equity valuations quickly rose, particularly within consumer-focused sectors, to levels we consider slightly expensive. In 2010, however, fears of monetary tightening have prompted something of a correction and valuations are now approaching levels that, in our opinion, more accurately reflect the region’s growth potential. We are seeking opportunities to raise allocations to Asia Pacific equities but recommend current allocations are, for now, maintained where appropriate.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +5.05% over the last six months and +55.98% over the last year. In sterling-adjusted terms, the returns are +12.62% over the last six months and +59.57% over the year.

## 2.6. Emerging Markets Equities

After the steep losses recorded in 2008, emerging equity markets\* enjoyed a strong 2009 (see Fig. 5). Reacting to the collapse in global trade, many emerging market governments embarked upon fiscal stimuli, largely focused on infrastructure development, to support economic growth. Together with signs of recovery elsewhere, the resilience of the developing economies has encouraged a renewed optimism to which their equity markets have responded strongly.

**Fig. 5 The 'BRIC' equity markets since the start of 2009 (rebased)**



Investors have, in 2010, had cause to re-assess their risk appetite. Mirroring the west's retreat from ultra-accommodative monetary policies, many emerging markets have also begun to withdraw liquidity from their economies. The Chinese state has been at the forefront of this, ordering the nation's banks to curb lending, while India has also imposed higher capital requirements on its banks. In response, investors have drawn back from these markets, thereby justifying, to a degree, our concerns that emerging equity markets were latterly driven by liquidity, rather than the underlying fundamentals.

While acknowledging the growth potential of the emerging economies, we have been cautious of high equity valuations. The correction in emerging markets in 2010 has gone some way to addressing this and, we believe, may soon present an opportunity to increase allocations. For the present, however, we recommend current allocations are maintained, where appropriate.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +12.68% over the last six months and +84.20% over the last year. In sterling-adjusted terms, the returns are +16.58% over the last six months and +65.73% over the year.

\* MSCI includes 22 countries in its emerging markets index: Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

### 3. Fixed Interest

For more than a year, we have been recommending that clients avoid conventional government bonds. Our views reflect the low yields on western government debt following sharp price appreciation in 2008, the high level of issuance expected over the coming years and the vulnerability to rising inflation. We consider the latter a meaningful risk as a result of central banks reducing base rates to record low levels and adopting unconventional policies, such as quantitative easing, to support money supply. A sustained dose of inflation would be a convenient way for leveraged borrowers, including governments, to erode the real value of their debt, though would damage the credibility of their central banks. The impact on nominal government bonds of higher inflation would be an increase in yields and a corresponding fall in prices.

With inflation a significant risk on the horizon, we retain our positive stance on inflation-linked bonds. These have their capital and coupon values linked to a measure of inflation (such as the retail prices index in the UK). As a consequence, they can broadly preserve their purchasing power in an inflationary environment. Although real yields, particularly on UK index-linked gilts, look low in absolute terms, we see such bonds as useful insurance against the risk of rising prices.

We also continue to favour funds of corporate bonds. We recommended increasing allocations to investment grade bonds thirteen months ago, since when the asset class has performed strongly. With all but distressed bonds trading close to their par values, we expect that returns will now come increasingly from income rather than capital appreciation. However, yields remain attractive both in absolute terms and relative to those available from conventional government bonds. Mindful that official interest rates must rise in the medium term, we have latterly been recommending that allocations are invested in strategic bond funds, in which managers can hedge out interest rate risk and allocate money to areas where they perceive value within the asset class. Such funds are also our preferred route for obtaining exposure to non-investment grade corporate debt, which is less sensitive to interest rates but carries greater default risk than higher rated credits. Some strategic bond funds also have the flexibility to invest in emerging markets bonds. The latter differ from country to country, but many developing nations look fundamentally attractive, typically being far less indebted than those in the western world, while offering higher yields. The higher expected economic growth from emerging markets could drive long term currency appreciation, thereby providing an additional source of return to investors.

The ABI UK Pension Gilt sector provided a total return of +3.67% over the last six months and +4.89% over the last year. The ABI Pension Sterling Corporate Bond sector provided a total return of +12.66% and +25.95% over the same periods. The ABI UK Pension Index-Linked Gilt sector provided a total return of +5.94% over the last six months and +6.59% over the last year.

#### 4. Property

According to figures compiled by Investment Property Databank (IPD), UK commercial property prices fell by c44% between June 2007 and July 2009. This correction far exceeds the previous sharpest fall recorded, which was 27% in the three years to mid-1992. In the bull market that ran until mid-2007, property was a major beneficiary of the easy monetary environment that also induced price bubbles in several other asset classes. Property deals were often structured with high levels of low cost debt financing, the availability of which was curtailed by the credit crisis. This removed a key prop for commercial property prices. This effect was exacerbated by the deteriorating economy, which further undermined property values by putting downward pressure on rents.

The extent to which prices fell over the two years to mid-2009, together with the accompanying rise in yields, means that commercial property once again appears attractive to value-focused investors. Risks remain, particularly the threat of ongoing, downward pressure on rental values and occupancy rates arising from the weak economic environment and additional supply from developments now approaching completion. A further factor complicating the outlook for the sector is the c£225bn of outstanding loans backing UK commercial properties held by banks. Much of this will need to be either refinanced or repaid over the next five years. So far, banks appear to have been willing to extend or refinance loans in return for higher coupons and injections of additional capital into financial structures.

According to the IPD All Property index, UK commercial property now yields c7%, which looks attractive, both on an absolute basis and in relation to other asset classes. This offers, in our view, sufficient compensation for the risks outlined above. Our preference is for commercial property allocations to focus on funds holding predominantly prime and ungeared, or lowly geared, property portfolios, though these carry correspondingly lower yields. We also favour more opportunistic funds whose managers can add significant value through asset management initiatives.

The ABI UK Pension Direct Property index provided a total return of +12.66% over the last six months and +5.65% over the last 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 and we continue to favour small overweight positions in the asset class, particularly where attractive 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 provided a return of +0.25% over the last six months and +0.55% over the last year.

## 6. Note on Hedge Funds

Our view that hedge funds are riskier than generally perceived has gained wider acceptance during the financial crisis. While we continue to research the sector, 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.

Almost one in ten hedge funds closed in 2008, according to Chicago-based research group Hedge Fund Research. Despite a partial economic and financial recovery, many more funds ceased trading in 2009. We note with interest that the managers of several of these funds have opened new operations. We believe that many may have done so in order to reset the 'high water marks' above which performance fees can be levied, having fallen some way below them while managing their previous funds. Investor expectations of positive, uncorrelated returns from hedge funds have clearly been disappointed and, in our view, the industry's ability to justify high charges and performance fees remains questionable.

The fallout from Bernard Madoff's fraudulent investment scheme persisted through 2009 as the estimate of the true extent of the scheme's losses has grown to \$21.2bn, far higher than earlier estimates. Allegations of insider trading and fraud at hedge funds Galleon Group and K1 respectively go some way to justifying our view that the transparency of many funds, and funds of hedge funds, are not up to the requisite standard for us to recommend investing.

The hedge fund industry has emerged from the financial crisis in a very different shape. There are now fewer funds, charging, on average, lower fees and offering better reporting, transparency and liquidity. These, in our view, are all welcome developments.

For completeness, we include the HFRX Global Hedge Fund index figures for hedge fund performance below. We are, as might be expected, somewhat sceptical about the validity of these figures. In our view, the index will almost certainly overstate returns. This is because the submission of data to the index compilers is voluntary and it is unlikely that failed or poorly performing funds will submit numbers for inclusion. The effect will be that the index figures overstate the true performance that might be expected from a range of hedge fund investments, perhaps by as much as several percentage points.

The HFRX Global Hedge Fund GBP index provided a total return in sterling terms of +5.88% over the last six months and +12.08% over the last year.

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**The above commentaries reflect our views as at 17 February 2010. 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 July 2009 to 29 January 2010 and the twelve month period from 30 January 2009 to 29 January 2010 (source: Lipper Hindsight).**