

# **Market Commentary**

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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 1 February 2008. 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

The New Year opened with very weak economic data in the US. Poor employment figures and a very disappointing ISM survey (a closely watched indicator of business confidence) convinced investors that the credit market issues, together with the impact of falling house prices, would drag the US economy into recession. As a result, January saw extremely high equity market volatility and sharp falls in share prices. At their worst, equities, as measured by the MSCI World Equity Market Index, had fallen by 13%. A partial recovery left equities down 8% over the month.

In an indication of the extent of the concern about the outlook for the US economy, the Federal Reserve (the Fed) cut interest rates by 1.25% over the month. Combined with cuts in September, October and December last year, this amounts to a very aggressive easing of monetary conditions. US interest rates now stand at 3% compared to 5.25% in August 2007. The likelihood remains that there will be further interest rate reductions in the first half of the year.

The current problems in Anglo-Saxon economies are rooted in the excessively loose credit conditions that have existed over the last few years. These came about as a result of low interest rates and abundant availability of credit financing, itself the result of innovation in financial markets. Easy credit conditions have been abruptly curtailed over the last six months as financial institutions have suffered losses on complex financial instruments and have become increasingly concerned about the quality of other assets on their balance sheets.

Governments and central banks have rightly concluded that a rapid contraction in credit availability, compounded by weakening asset prices, has the potential to be very damaging. The possibility for a severe credit squeeze, driven by asset price falls, to generate debt defaults and further contractions in credit availability was judged to necessitate decisive action from the US central bank. The Fed has not disappointed in this respect.

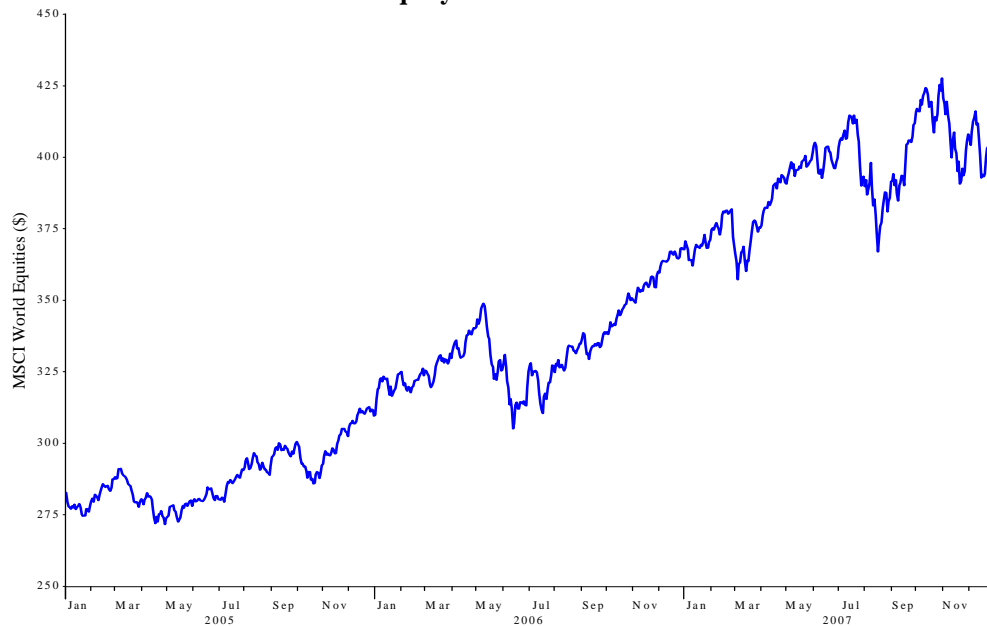
The current financial crisis has been centred on the excessive use of leverage to gear the returns from investments generating stable cash flows, such as property and corporate bonds. The result has been that valuations on commercial property, non-government fixed income securities and many other assets were driven to unsustainable levels by leveraged investors. By contrast, equity valuations, (based on price to earnings ratios) have not moved far above their long-term average. However, equities are clearly impacted by (a) losses at financial institutions and (b) slower company earnings growth as the pace of economic expansion declines - hence the late, but substantial, correction in equity prices.

Equities now join commercial property and high-yield corporate bonds on investors' list of 'least favoured' asset classes. This situation is not new; we reached the same point in the last business cycle in early 2003. Investors are now focussing on the defensive qualities of cash and government bonds and the protection offered by absolute return funds. Such an investment landscape will offer opportunities for value-orientated investors in 2008.

With December's reduction in European equity allocations, client portfolios now have high weightings to cash and short and medium-dated government bonds. We will be looking to deploy a portion of these highly liquid and defensive assets into areas offering the potential for higher returns as opportunities present themselves in 2008.

The FTSE World index has provided a total return of -3.01% over the last six months and +0.02% over the last year.

**MSCI World Equity Market Index since 2005**



## 2. Equities

### 2.1. UK Equities

The pace of economic growth in the UK is set to ease in 2008. Evidence for this, such as falling house prices, declining consumer confidence and weaker retail sales is already apparent and prompted the Bank of England (the BoE) to cut interest rates in December.

The full impact of the sub-prime crisis on credit availability is not yet clear but reports of tighter lending standards and more stringent credit scoring by the banks are now appearing frequently in the press. Tighter credit terms for consumers fully justify further interest rate reductions from the BoE. However, its scope to implement further rate cuts will depend, at least in part, on the path of inflation. Data for December showed the Consumer Price Index at 2.1%, marginally above the Bank's target rate of 2.0%. RPI, the measure used for inflation-linked bonds, is much higher at 4.0%. This pressure on price stability stems from higher energy and food prices which have been driven by international factors such as rapid growth in emerging economies. It is vital for UK economic growth that inflation subsides over the course of the year, freeing the hand of the BoE to deliver interest rate cuts as necessary. We fully expect inflationary pressures to ease as declining global economic growth acts to slow demand for resources. Meanwhile, sterling is weakening against other major currencies which should cushion the impact of slower growth on the corporate sector.

Strong returns from UK equities until mid-2007 were driven by supportive economic growth conditions, together with the return of a degree of pricing power to companies. These factors helped companies report excellent earnings growth and enabled them to deliver healthy dividend increases. Strong corporate profits growth meant that, despite share prices having risen over the past four years, UK equities did not become expensive in terms of price to earnings ratios. After the recent falls, UK equities are more attractively valued than they have been for several years.

Nevertheless, we are mindful that with growth likely to slow and the credit market deterioration as discussed above, the earnings outlook for companies is becoming less favourable and profits may struggle to grow from the levels of recent years.

We recommend that current allocations to UK equities are maintained.

The FTSE All Share index has provided a total return of -7.51% over the last six months and -3.57% over the last year.

## 2.2. European (excluding UK) Equities

Continental Europe has been our favoured destination for international equity allocations since 2004. This has proved very profitable, with European (ex UK) equities outperforming those of the US, UK and Japan over the last three years.

Many of the factors that have driven strong returns from European equities, such as corporate restructuring and the opening up of the former communist states in Eastern Europe, remain in place. However, with the credit markets in turmoil, there are clearly grounds for a more cautious approach. As a result, we recommended a reduction in allocations to European equities in December.

One of the main reasons for this change of view is the recent strength of the euro. While this has boosted returns for sterling based holders of European equities, it presents a significant handicap for continental Europe's exporters and, therefore, for the wider European economy. One cause of the euro's strength is the European Central Bank's reputation for taking no risks with inflation by holding interest rates higher than might otherwise be the case. With rates falling in the US and UK, delays in rate cuts in Europe risk driving the euro higher still, making any slowdown in the European economy more acute.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -13.64% over the last six months (-4.52% sterling adjusted) and -9.09% over the last year (+1.99% sterling adjusted).

### 2.3. North American Equities

The US is at the epicentre of the current economic turmoil. After years of strongly rising prices, the US housing market is now weakening rapidly as the easy access to mortgage finance, which fuelled much of the boom, is withdrawn. The economy was already slowing in response to the monetary tightening that took interest rates from 1.00% to 5.25% in the two years to mid-2006; declining house prices and reduced access to credit have exacerbated this slowdown.

Interest rates have already been pared back by a full 2.25% since September, demonstrating that the Fed is ready to take aggressive action to avert a recession. Whether it succeeds or not will depend on several factors including how deeply rooted the sub-prime related issues are, the resilience of the job market, the impact of falling house prices on consumer behaviour and the extent to which economic activity outside the US remains healthy.

The S&P 500 index provided, in US dollar terms, a total return of -4.32% over the last six months (-2.20% sterling adjusted) and -2.31% over the last year (-3.81% sterling adjusted).

## 2.4. Japanese Equities

The performance of both the Japanese economy and stock market continues to disappoint. While overall growth has been fairly steady, domestic consumption remains weak, and stubbornly low inflation continues to frustrate the Bank of Japan's policy aim of gradually increasing interest rates. However, the crisis in credit markets has brought about a sea-change in currency markets. Previously, the yen had been a source of cheap funding for 'carry traders' who borrowed in yen to fund investments in higher yielding assets. This drove the yen down to very low levels. The reduced availability of speculative capital, together with a greatly reduced appetite for risk, has seen this carry trade start to unwind, driving the yen higher against both the dollar and sterling. The yen has appreciated by 10.5% against the dollar and by 12.0% against sterling in the last six months.

While an appreciating yen is helpful for sterling based holders of Japanese assets, it is not helpful to the export-orientated Japanese economy. Slowing world growth is also an unwelcome development for Japan's export sector. These factors mean that the long-awaited strong performance from Japanese equities may, yet again, be delayed. However, Japanese companies have almost no exposure to the credit related problems besetting other economies and Japanese equities are looking very good value, not least relative to Japanese government bonds. We therefore recommend current allocations to Japanese equities are maintained.

The FTSE Japan index provided, in yen terms, a total return of -20.09% over the last six months (-8.54% sterling adjusted) and -20.35% over the last year (-10.78% sterling adjusted).

## 2.5. Asia Pacific (excluding Japanese) Equities

The economic performance of the Asia Pacific (ex Japan) region remains impressive. The economies of South Korea, Hong Kong and Taiwan are all estimated to have grown by more than 5% in 2007 while Singapore is expanding even faster, with a growth rate of almost 8%. Decreasing reliance on Western export markets and sizeable foreign currency reserves mean that the periodic crises of the past are less likely 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 the Asia Pacific region an attractive destination for long term equity investors. Large speculative capital flows, however, mean that the Asia Pacific equity markets remain among the most volatile in the world. In addition, after strong upward moves, these markets are no longer cheap.

We believe, however, that investors with longer time horizons will earn good returns as the long-term 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 -2.91% over the last six months and +15.65% over the last year (for sterling based investors).

## 2.6. Emerging Markets Equities

Emerging markets equities rose very strongly through the four-year global equity bull market, driven, at least in part, by strong economic growth and rising domestic consumption. These improving fundamentals remain in place; expanding economies have driven up employment and income, thereby creating a virtuous circle of consumer demand and further strong growth.

Investors are currently favouring the markets of the 'BRIC' economies: Brazil, Russia, India and China. While the economies in these regions are exhibiting very strong growth, we are concerned that investor appetite, particularly for Indian and Chinese shares, is taking on speculative proportions. Valuations look quite high and we are cautious about recommending further allocations to BRIC funds at present. Elsewhere within emerging markets, we are maintaining current allocations, while remaining mindful that the current pace of appreciation in equity prices is unlikely to be sustainable.

The FTSE All-World Emerging index provided a total return of +1.14% over the last six months and +22.72% over the last year (for sterling based investors).

### 3. Fixed Interest

Fixed interest investments did not fare particularly well in the early part of 2007 as strong economic growth drove interest rates higher. In contrast, the second half saw government bond yields falling back in anticipation of slowing economic growth, and therefore lower interest rates. These factors have remained dominant thus far in 2008. Government bonds have also benefited from 'safe haven' status amid the turbulence in credit markets and have fully demonstrated their value to investors as the most effective portfolio risk diversifier. In contrast, corporate and non-investment grade bonds have suffered from decreasing risk appetite amongst fixed interest investors.

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 inadequate. We have therefore advised clients to focus fixed interest allocations on UK government bonds. This view has been fully vindicated by recent developments, which have seen spreads widen very rapidly. 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 the non-government sector when valuations become compelling.

The ABI UK Pension Gilt sector provided a total return of +5.37% over the last six months and +5.68% over the last year (for sterling based investors). The ABI UK Pension Index-Linked Gilt sector provided a total return of +8.79% over the last six months and 10.71% over the last year (for sterling based investors).

#### 4. Property

After several years of strong returns, investors in UK commercial property suffered a major setback in 2007. In recent years, bank borrowing has been increasingly used to fund property purchases. However, the availability, at low cost, of abundant debt financing had driven prices up to levels where yield-based valuations looked extremely stretched. Mid-2007 saw an abrupt reduction in the willingness of banks to lend at low rates against property purchases, which, together with reduced appetites for risk among investors, has served to undermine commercial property valuations.

Our Investment Bulletin of October 2006 set out our view that commercial property prices could suffer a period of consolidation as yields were forced back up to levels more attractive to investors. This consolidation began in the second half of 2007. UK commercial property returns, including rental income, were negative over the last year as measured by the ABI UK Pension Property index.

For now it remains our view that the risk-adjusted returns available on cash deposits are more attractive than those on commercial property. However, value is beginning to return to the asset class and we are monitoring this closely with a view to turning more positive towards commercial property at some point in 2008.

The ABI UK Pension Direct Property index provided a total return of -13.77% over the last six months and -13.23% over the last year (for sterling based investors).

#### 5. Cash

Sterling cash deposits, earning approximately 5.50% p.a. at present, are attractive relative to the yield currently available on fixed interest or commercial property. While UK interest rates will fall in 2008, we continue to favour allocations to this asset class. From an asset allocation perspective, cash deposits offer strong defensive qualities (provided the appropriate credit risk due diligence has been undertaken). They also bring flexibility to portfolios, enabling investors to take advantage of opportunities in other asset classes as and when they arise.

**6. Note on Hedge Funds**

While we continue to research the sector, we are concerned that hedge funds are riskier than generally perceived. In our view, the transparency of many hedge funds' investment processes is not sufficient for us to be comfortable about recommending their inclusion in portfolios. Liquidity, valuation of assets and the level of charges are also areas where we believe investors should demand more clarity.

With regard to performance, we remain cautious about the ability of hedge funds to generate consistently positive total returns in all market conditions.

The HFRX Global Hedge Fund GBP index provided a total return in sterling of -2.79% over the six months to the end of January and +0.98% over the year to the same date.

**7. Addendum**

The above commentaries reflect our views as at 1 February 2008. Economic and market conditions can change rapidly in response to events and news not available to us at the time of writing. As a consequence, some of the opinions stated may not reflect market conditions or our latest views at the time of reading.

Since the beginning of February, the Bank of England has lowered the bank rate of interest by 0.25% to 5.25%. The European Central Bank has left its key interest rate unchanged at 4.00%.

N. B. Unless otherwise noted, all performance figures are total returns (including income re-invested) for the six month period from 31 July 2007 to 31 January 2008 and the twelve month period from 31 January 2007 to 31 January 2008 (source: Lipper Hindsight).