

# **Market Commentary**

**January 2009**

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### Risk Warnings

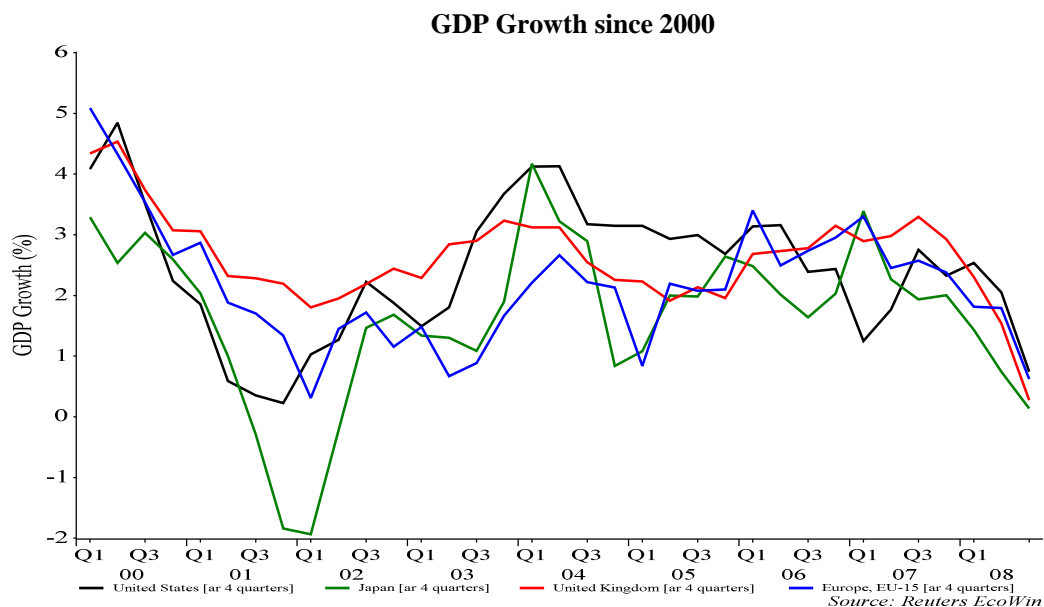
This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 16 January 2009. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments 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

Investment market sentiment remains fragile as governments continue to wrestle with inadequately capitalised banks and malfunctioning credit markets. However, the aggressive action taken by the authorities in September and October to underpin the financial system does appear to have met with some success. As a result, confidence among depositors has risen and the extreme risk aversion witnessed in mid-October has eased.

Meanwhile, central banks have continued to deliver aggressive interest rate cuts, with the Federal Reserve reducing rates to “between zero and 0.25%”, and have made available huge quantities of liquidity in an attempt to unfreeze money markets. These actions are aimed at preventing the second phase of the economic crisis – a deep global recession turning into a prolonged slump caused by credit starvation and deleveraging by investors, businesses and consumers. Economic data are unremittingly weak and, while a complete collapse in the banking sector looks to have been averted, the impact of such seismic events on business and consumer confidence is only now becoming apparent. Residual concerns about the financial system will reverberate through the real economy for months to come and it is not clear that the injections of capital into banks will improve credit availability for companies or consumers.

As the chart below shows, the major economies of the world have entered into a sharp, synchronised slowdown. Key factors in determining how long and how deep the recession will be include the extent of further falls in house prices, particularly in the US, and how far unemployment rises with the attendant secondary effects on asset prices, consumer discretionary spending and confidence.



During the last 12 months, we have seen the impact on investment markets of the withdrawal of cheap short term debt. Many businesses built on the assumption that almost limitless credit was a permanent feature of the financial landscape have failed. Northern Rock in the UK and Washington Mutual in the US are two high profile examples. There are also many others, from investment banks such as Lehman Brothers to hedge funds that were borrowing short term money and investing in higher yielding, longer term assets (the now infamous carry traders). The problems among the car manufacturers are also closely related to credit availability, as they were heavily reliant on the availability of easy finance terms to allow consumers to purchase new vehicles. In an attempt to prevent the collapse of their auto industry, the US government announced a \$17.5bn bailout of General Motors and Chrysler in December.

Within the mainstream asset classes, equities have suffered greatly as expectations of lower profitability are priced in. Arguably, stock markets have also become victims of their own liquidity. As markets for other assets such as high yield bonds, property and structured debt instruments have seized up, investors, particularly hedge funds facing increased redemption requests and needing to raise cash, have sold their most liquid assets; equities. Moreover, because so many investors have used leverage to gear market returns, the number of forced sellers (those who need to sell regardless of price), appears to be greater than in previous market downturns. That equity markets never enjoyed high ratings in the current business cycle has provided no protection. Equities have suffered as growth expectations have deteriorated and as forced sellers have taken advantage of the liquidity available.

Turning to other asset classes, commercial property had been a major beneficiary of cheap credit and has suffered from its withdrawal. In fixed interest markets, risk aversion has become acute. This has resulted in government bonds performing very strongly relative to corporate bonds, particularly non-investment grade issues. The corporate bond market remains illiquid. This is one of the reasons why corporate bonds are now trading on some of the widest spreads over government bonds ever recorded and are offering attractive opportunities for investors prepared to take a longer term view. Non-investment grade bond markets are effectively closed.

Considering our recommended asset allocations, reductions in equity weightings at the end of 2007 have helped to protect portfolios from some of the market falls but, with perfect foresight, we should have gone much further. However, after the sharp falls towards the end of 2008, equity markets now look attractive on a range of measures versus their long term averages. Even making generous allowance for earnings downgrades and dividend cuts, the yields on many blue chip equities look appealing when compared to those available on other asset classes.

The MSCI World Equity Market index has provided a total return of -7.98% in sterling terms over the last six months and -17.39% over the last year.

## 2. Equities

### 2.1. UK Equities

After recording zero growth in the second quarter of 2008, the UK economy shrank by 0.6% in the third. This was the first quarterly decline in output since 1992. Quarter four is expected to show a further 1.0% contraction in the economy. The weakening economy is also apparent in the labour market. Unemployment is now moving gradually upwards and reached 6.0% in September, 0.5% higher over the quarter. Inflation, not long ago a major policy concern, is now declining rapidly. The latest figures show a 0.1% fall in the Consumer Price Index (CPI). The annual rate of increase is down from 4.5% in October to 4.1% in November.

Falling inflation has freed the hand of the Bank of England (BoE) to embark on a policy of aggressive interest rate cuts, including reductions of 1.50% and 1.00% in November and December, respectively, and a 0.50% cut on 8 January. This has taken the Bank Rate to 1.50%, its lowest level since the creation of the BoE in the seventeenth century.

The Chancellor's Pre-Budget Report in late November was used by the government to announce a fiscal stimulus package worth up to £30bn, including a cut of 2.5% in the rate of VAT and the bringing forward of £3bn of capital projects scheduled for 2010-11. In addition to the fiscal measures, the government has been using its newly acquired power over the banking sector to urge banks to pass on the BoE's rate cuts to borrowers.

In taking such bold policy measures, the UK authorities are acknowledging that the prospects for the UK economy are worse than they have been since at least the early 1990s. Consumers are under pressure from a deteriorating jobs market, falling house prices and rising utility and fuel bills. The latter are likely to subside in the coming months as they reflect the recent fall in the oil price. However, reduced access to credit as the banking sector retrenches may well undermine any positive benefits from such falls.

Turning to the stock market, the path of UK equities from here will depend crucially on the depth and shape of the economic slowdown and the extent to which earnings downgrades are already reflected in share prices. Our view is that the sizeable correction in equities seen to date means that shares offer value in all but the very worst outcomes for corporate earnings. We are, therefore, recommending that current allocations to UK equities are retained, where appropriate.

The FTSE All-Share index has provided a total return of -21.13% over the last six months and -29.93% over the last year.

## 2.2. European (excluding UK) Equities

Until our recommendation to reduce allocations to European equities at the end of 2007, the Continent had been our favoured destination for investments into overseas markets. Clients were well rewarded by taking this stance, as European (ex UK) equities outperformed those of the US, UK and Japan over the three years to the end of 2007.

One of the main reasons for the recommended reduction in allocations was our view that the eurozone would not prove immune to the credit crisis or the accompanying economic slowdown that was already impacting the US and UK. This has proved to be the case, although the core eurozone economies remained resilient for longer than the US or UK, thanks to their status as net exporters, which allowed them to benefit from sustained demand from the Far East, and the less indebted position of their consumers. However, with exports falling under the impact of the weakening global economy and the recent strength of the euro, and European banks affected by the credit freeze, economic activity has now begun to falter. Eurozone GDP fell 0.2% in the third quarter. The European Central Bank (ECB), which was increasing interest rates as late as July in response to the threat of inflation, joined other major central banks in delivering co-ordinated rate cuts in early October. It then reduced rates by a further 0.75% in early December and followed this with a 0.50% cut in January, leaving interest rates at 2.00%. Inflation in December was 1.6%, down from 2.1% in the previous month and below the central bank's 2% target. The rapidly deteriorating economic picture, together with receding inflation, will increase pressure on the ECB to deliver further interest rate cuts.

The core countries of continental Western Europe, including Germany, France and the Benelux nations, remain less dependent on domestic consumption than the US and UK. They are also set to be long term beneficiaries both of Far Eastern demand for exports and the continuing development of Eastern Europe. After the recent weakness, we therefore recommend that current allocations to European equities are retained, where appropriate.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -29.07% over the last six months and -42.25% over the last year. In sterling-adjusted terms, the returns are -13.38% over the last six months and -23.99% over the year.

### 2.3. North American Equities

In what was an historic statement, the Federal Reserve cut interest rates from 1.00% to “between zero and 0.25%” on 16 December and stated that it will leave rates at exceptionally low levels for as long as it takes to get the US economy functioning properly again. This represents monetary easing on a grand scale; a little over one year ago rates were 5.25%. In an attempt to avert a deep recession, interest rate cuts have been accompanied by a Federal economic stimulus package, the passage into law of the \$700bn Troubled Asset Relief Program (TARP), and an injection of capital into US banks similar to that used in the UK rescue. The central bank has also stated its intention to employ further measures, such as quantitative easing; buying long-dated treasury bonds to force liquidity into the financial system. President-elect Barack Obama is already proposing a major fiscal expansion via public infrastructure works to take effect after his inauguration as President on 20 January.

US retail sales, so long the mainstay of the US economy, are now being undermined by falling house prices and rising unemployment. US house prices, according to the Case-Shiller Home Price index, were 18.0% lower in October (the latest data available), compared to the previous year. November saw the US economy suffer its worst month of job losses in 34 years, shedding 584,000 workers. This was followed in December by the loss of a further 524,000 jobs, taking unemployment up to 7.2%, its highest level in 16 years. The virtuous circle of easy credit availability driving house prices ever upwards has turned into a vicious circle. The banking sector, paralysed by losses already incurred on structured mortgage assets, has retrenched, reducing the availability of credit to consumers, thereby exacerbating house price falls and further undermining consumer confidence. However, falling government bond yields may offer some relief to homeowners. In contrast to the UK, US mortgages are predominantly determined by reference to the 10-year government bond yield. As this falls, mortgagors have the chance to refinance at lower rates, thereby reducing their monthly outgoings.

After the recent weakness, US equities look inexpensive relative to their history. However, we are aware that the US economy and the US corporate sector have yet to experience the full consequences of recession. We believe that allocations to US equities should be maintained for the present, where appropriate.

The S&P 500 index provided, in US dollar terms, a total return of -28.48% over the last six months and -37.00% over the last year. The strengthening of the dollar, means that, when translated into sterling, returns are -1.00% over the last six months and -12.77% over the year.

## 2.4. Japanese Equities

Japan, as a major exporter of manufactured goods, is extremely sensitive to the health of the global economy. As such, Japan's economy has suffered as demand for its exports has waned. The impact of declining global growth has been exacerbated by a resurgent currency. The yen has been boosted by the narrowing of interest rate differentials as rates have been cut aggressively around the world. It has also strengthened as a result of the reversal of the carry trade, where borrowers sold yen to invest in higher yielding assets denominated in other currencies. Currency strength has further undermined demand for export goods and Japan's economy has dropped into recession, shrinking by 0.5% in the third quarter, with falling industrial output being the major contributing factor.

Japan is slightly removed from the centre of the global financial crisis. Japanese banks have much less exposure to the sub-prime assets that have damaged their US and European counterparts and the economy has not suffered from excessive house price increases. In fact, the health of Japanese financial institutions is allowing them to make strategic acquisitions overseas. In recent months, Mitsubishi UFJ Group has purchased a stake in Morgan Stanley and Nomura has acquired the non-US businesses of Lehman Brothers.

Japan's already very low interest rates were cut further, to just 0.10%, in December. The interest rate reduction was accompanied by a step up in the Bank of Japan's programme of buying Japanese government bonds.

During the calendar year 2008, the yen appreciated by 41.39% against sterling, mitigating, to some degree, the very weak performance of the Japanese equity market. Nevertheless, Japanese equities remain deeply out of favour with international investors, despite now appearing attractively valued versus both their own history and by comparison with international counterparts. We therefore recommend current allocations to Japanese equities are maintained, where appropriate.

The FTSE Japan index provided, in yen terms, a total return of -35.67% over the last six months and -42.05% over the last year. In sterling-adjusted terms, the returns are +4.13% over the last six months and -1.12% over the year.

## 2.5. Asia Pacific (excluding Japanese) Equities

For several years until 2008, equity markets in the Asia Pacific (ex Japan) region had provided excellent returns. Rising markets were driven by strong regional economic growth, investor enthusiasm for markets linked into the Chinese development story and the expectation that Asian currencies would appreciate over the medium term. However, as the global economic outlook has deteriorated and investor risk aversion has increased, Asian equities have begun to underperform their western counterparts (see chart).

We have, since 2006, recommended only very small allocations to Asia Pacific equities in acknowledgement that the strong performance was driving markets to relatively high valuations. We do, however, continue to believe that investors with longer time horizons should earn good returns as the long term economic fundamentals remain very promising. Though valuations have become significantly more attractive after the recent sell-off, we continue to recommend that clients maintain their current low tactical equity weightings to the region, where appropriate.

The FTSE All-World Asia Pacific ex Japan index provided, in local terms, a total return of -32.25% over the last six months and -42.38% over the last year. In sterling-adjusted terms, the returns are -20.77% over the last six months and -31.01% over the year.

### FTSE All-World Asia Pacific ex Japan equities underperformed developed markets over 2008 (rebased)



## 2.6. Emerging Markets Equities

Hopes that emerging markets (as defined by MSCI \*) could continue to grow rapidly despite the sharp slowdown in developed economies were dashed in 2008. Upward pressure on inflation as economies have begun to encounter capacity constraints, together with slowing demand for exports as the developed world economies slow rapidly, means that many emerging markets are now slowing from the impressive rates of growth seen in recent years.

Assisted by robust economic growth, emerging markets equities had provided excellent returns over more than four years to early 2008. As the outlook for the global economy has deteriorated, however, emerging markets equities have started to underperform. Having risen very strongly, to the point that many were trading on significant valuation premiums to their developed counterparts, emerging equity markets were vulnerable to sharp reversals. These have been occurring. Equity market corrections in the BRIC economies (Brazil, Russia, India and China), former favourites of emerging market investors, have been severe. Over the calendar year 2008, the Brazilian Bovespa index fell 41.22%, while the Russian RTS dropped 72.41%. In Asia, the Bombay Sensex saw a 52.45% decline, while the Shanghai Composite fell by 65.39%.

Along with equities in the Asia Pacific region, we have been recommending only small allocations to emerging markets equities for the last two years. This caused client portfolios to miss out on some upside in 2007 and early in 2008 but, driven by strong speculative inflows, these markets had been looking increasingly overvalued for some time. As in developed markets, we are likely to see opportunities to increase weightings to emerging markets in due course. For now we recommend maintaining current holdings, as appropriate.

The FTSE All-World Emerging index provided, in local terms, a total return of -37.72% over the last six months and -44.74% over the last year. In sterling-adjusted terms, the returns are -26.69% over the last six months and -34.78% over the year.

\* MSCI includes 25 countries in its emerging markets indices: Argentina, Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

### 3. Fixed Interest

Over the last year, UK government fixed interest stocks (gilts) have demonstrated their value as effective portfolio risk diversifiers. From a peak of over 5.50% in mid-2007, the yield on the 10-year conventional gilt has retreated by nearly 250bp to 3.02% by the end of 2008. This has generated capital gains that have helped to offset some of the losses on equity holdings. Gilts are benefiting from lower growth and inflation expectations and, importantly, their 'safe haven' status amid the turbulence in credit markets and falling equity prices. Exposure to index-linked gilts proved beneficial earlier in the year due to concerns over inflation. As these concerns faded and investors focused instead on the possibility of deflation, yields on index-linked gilts rose in the latter months of 2008 before falling again in December.

While gilts have proven highly attractive to investors, lower quality classes of fixed income securities, such as corporate and non-investment grade bonds, have suffered from increasing risk aversion. Concerns about credit quality and default risk, together with the until-recently inadequate yield premiums available on non-government debt, meant that their appeal to investors was limited. They have, accordingly, underperformed their government counterparts.

Our long-held belief that corporate fixed interest securities offered little value has meant that our recommended allocations to fixed interest have been weighted towards sovereign debt. While this has had a positive effect on portfolio returns, conventional gilt yields are now very low and may be vulnerable to rising inflation expectations. We are therefore selectively taking profits in this area and looking to invest in the now much more realistically valued corporate bond sectors. The lack of liquidity in either the primary or secondary European high yield bond markets means we are more cautious on the non-investment grade sector and recommend allocations to fixed interest are focused on the higher grades of corporate bonds.

The ABI UK Pension Gilt sector provided a total return of +13.84% over the last six months and +11.26% over the last year.

The ABI UK Pension Index-Linked Gilt sector provided a total return of -2.33% over the last six months and +2.10% over the last year. Shorter dated index-linked stock has performed considerably better than this. For example, index-linked gilts with less than 5 years to maturity (as measured by the FTSE Index-Linked British Government under 5 years index), have provided returns of -0.52% over the last six months and +3.34% over one year.

#### 4. Property

After several years of strong returns, investors in UK commercial property have suffered a major setback with property values receding substantially. Until 2007, the sector had been a major beneficiary of the vast quantities of low cost debt finance that characterised the credit bubble. Increasing levels of gearing were used to leverage the steady but otherwise unexciting returns from commercial property, spurring development and, eventually, oversupply. As the credit crisis has unfolded over the last year, commercial property investors have witnessed an abrupt change in the willingness of banks to lend at low rates against property purchases. This, together with reduced appetite for risk among investors, and the implications of the slowing economy for property demand, has served to drive commercial property yields sharply higher and prices correspondingly lower.

Our Investment Bulletin of October 2006 set out our view that commercial property investments could suffer as prices were forced down to levels more attractive to investors. This consolidation has been under way since early 2007. UK commercial property returns, including rental income, were negative in both 2007 and 2008 as measured by the ABI UK Pension Property index. Given the degree of oversupply, commercial property valuations are likely to remain under pressure for some time. We are monitoring developments closely with a view to taking a more positive stance on this asset class in due course.

The ABI UK Pension Direct Property index provided a total return of -15.36% over the last six months and -19.14% over the last year.

#### 5. Cash

Due to the elevated level of money market interest rates, sterling deposits or monies held in AAA-rated liquidity funds can presently earn returns in excess of the BoE Bank Rate of 1.50% p.a. due to the premium at which the inter-bank rate trades. National Savings and Investments are also offering attractive rates at present. However, we expect the interest rates available on both deposits and liquidity funds to trend down towards the Bank Rate in the coming months.

Despite lower rates, cash still has its attractions and we continue to favour an overweight position in the asset class, particularly where attractive fixed rates from government backed, or good quality institutions can be secured. From an asset allocation perspective, cash deposits offer strong defensive qualities (provided the appropriate credit risk due diligence has been undertaken). Cash, whether on 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 +2.07% over the last six months and +4.68% over the last year.

## 6. Note on Hedge Funds

Our view that hedge funds are riskier than generally perceived is gaining wider acceptance. 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. The recent arrest of hedge fund manager Bernard Madoff for alleged fraud highlights the lack of disclosure in such vehicles and our consequent unease with the asset class.

According to Hedge Fund Research, hedge funds suffered their worst performance since records began in 1990. Among the casualties are some high profile names; Citadel Investment's flagship fund, which at \$10bn is one of the industry's largest, lost 13% in November and is estimated to have fallen 53% over 2008 as a whole. Similar performance from Atticus European took year-to-date losses to more than 43%. Others employing high levels of gearing have found themselves even more severely impacted. As credit availability has decreased, geared hedge funds have had little choice but to sell their underlying assets at whatever prices are available in the market. This forced selling looks set to intensify in the fourth quarter as hedge fund investors continue to file significant redemption requests.

For completeness, we include the HFRX Global Hedge Fund index figures for hedge fund performance below. We remain, as might be expected, somewhat sceptical about the integrity 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 would 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 -22.74% over the last six months and -22.68% over the last year.

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**The above commentaries reflect our views as at 16 January 2009. 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 June 2008 to 31 December 2008 and the twelve month period from 31 December 2007 to 31 December 2008 (source: Lipper Hindsight).**