

## **Market Commentary**

**January 2010**

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### Risk Warnings

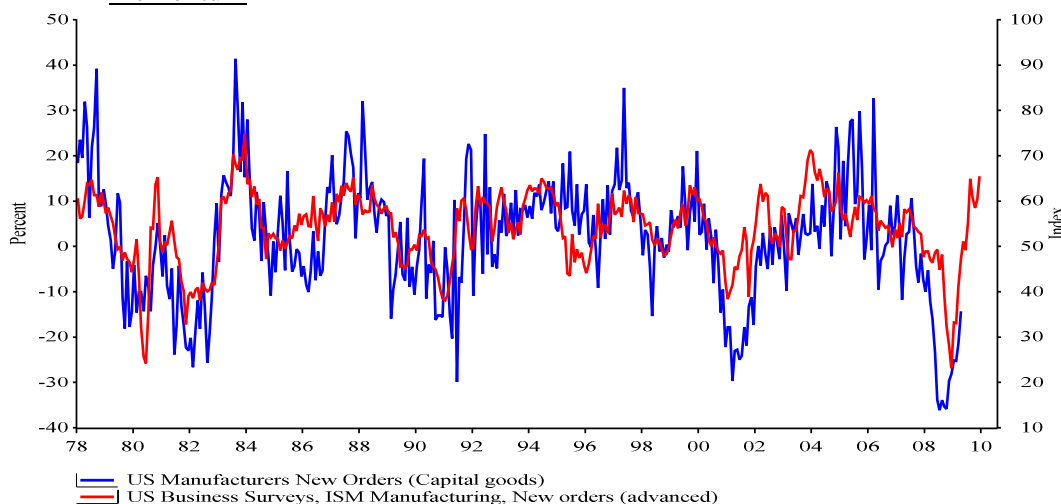
This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 19 January 2009. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments 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

Recently released data, together with forward-looking surveys of business and consumer sentiment, are indicating that the global economy is expanding once more. Financial stabilisation and a return to growth have come earlier than many observers dared hope only a few months ago. Governments and central banks will be reassured that the extraordinary policy measures implemented have had their desired effect in enabling the global economy to avoid a multi-year depression, not unlike the Great Depression of the 1930s. The discussion among policymakers and economists will now be centred on the shape and durability of the recovery and the pace at which the policy measures can be removed and interest rates raised. After many months of downgrades, forecasts for economic growth are now being revised higher. For example, the International Monetary Fund, in its October World Economic Outlook paper entitled 'Sustaining the Recovery', upgraded its expectation for economic output growth from the developed nations in 2010 to 1.3% from a forecast of 0.6% made in July.

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 costs or inflationary consequences of their actions, central banks have moved decisively to take official interest rates down to the lowest levels ever recorded. Governments, meanwhile, have launched fiscal packages to support demand in their economies. A wide array of other policy measures are now in place to ease credit market conditions, support mortgage holders and new homebuyers, and extend loans to key businesses, such as car manufacturing and container shipping. As a result, financial markets have stabilised, consumer sentiment has steadied, and businesses have begun to rebuild inventories.

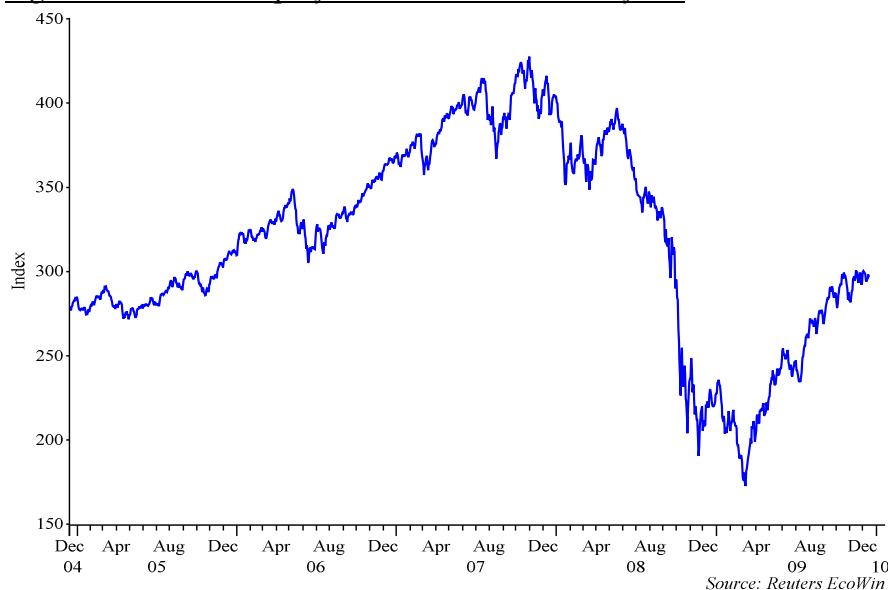
**Fig. 1 ISM New Orders are signalling that the US Real Economy will gain momentum**



Source: Reuters EcoWin

As might be expected, the improved economic outlook has 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 them down as the financial crisis deepened, as well as benefits to costs as companies have reaped the rewards of the aggressive overhead reductions made in late 2008 and the early part 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**



After falling for most of 2009, the dollar's unexpected recent rebound may reflect the increased likelihood of a change in monetary policy in the US. Crucially, the dollar has staged a recovery without an associated rise in risk aversion, as was the case during the economic downturn when the currency acted as a 'safe haven'. Further strengthening will be dependent, again, on the shape of the economic recovery and the pace of removal of stimulus measures.

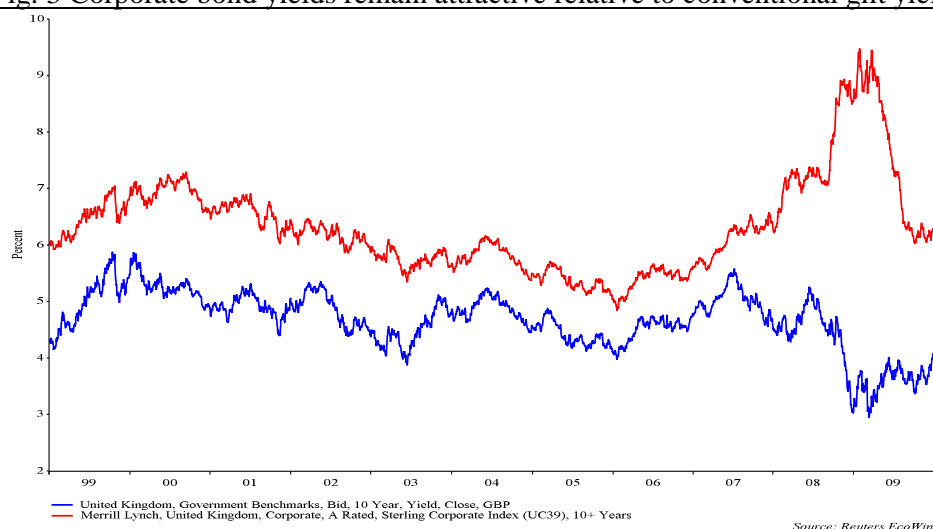
The path of economic growth, and therefore corporate profits and dividends, will be the key determinant of equity market returns in 2010. Considering valuation, the extreme weakness in equity markets in late 2008 and early 2009 saw dividend yields in most major equity markets move above their respective 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 over the past nine months has brought equity yields down once more but, unless earnings and dividend growth remain very subdued for a prolonged period, equities remain attractively valued relative to both government bonds and cash deposits.

The MSCI World Equity Market index has provided a total return of +24.91% in sterling terms over the last six months and +16.45% over the last year.

Turning to other major asset classes, government bonds, which were the asset class of choice for investors in the final quarter of 2008, struggled to make progress in 2009. 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 supplies, including the direct purchases of government bonds. Despite the UK 10-year benchmark now yielding c4.01%, almost a full percentage point higher than at the end of 2008, we believe 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). This was due to investor enthusiasm for the defensive attributes of government bonds forcing prices higher and yields down. 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. In our view, however, corporate bonds still present opportunities for investors given the attractive yields available in comparison to both 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, yields are at appealing levels, 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

Despite the UK government acting quickly to support the banking system and the Bank of England (BoE) cutting interest rates aggressively and implementing a large quantitative easing programme, the UK has lagged other G7 nations in emerging from recession. Preliminary GDP data for the fourth quarter of 2009, due to be published on 26 January, are expected to show that the UK economy has now returned to growth. Nevertheless, the upturn in the UK may not prove as robust as in other economies. Regardless of who wins this year's general election, the new government will have to address the country's budget deficit through a combination of tax increases and spending cuts. In this respect, the November Pre-Budget Report, in our view, represents a missed opportunity to set out a clear path back towards a sustainable fiscal policy. 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 25% on a trade-weighted basis, which should lead to an improvement in net trade as the economic recovery in the rest of the world 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 supportive to leveraged consumers and corporates.

What does this mean for the UK stock market? 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, UK equities may already be pricing in these issues, and any unexpected strength in the UK economy should have a positive impact on earnings. It should also be noted that, in aggregate, major UK-listed companies generate a substantial proportion of their revenues from overseas (c60% according to HSBC). They should 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 to 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 and have the potential to provide good returns over 2010. This view is supported by the high dividend yield on the market relative to cash and gilts. We therefore recommend that existing allocations to UK equities are maintained, where appropriate.

The FTSE All-Share index has provided a total return of +29.07% over the last six months and +30.12% over the last year.

## 2.2. European (excluding UK) Equities

The eurozone economy grew 0.4% in the third quarter of 2009 (the latest figures available), the first quarter-on-quarter expansion in a year-and-a half, following a 0.2% fall in the second quarter. Inflation in the 16-country region hit a 10-month high in December with consumer prices rising 0.9% year-on-year, though this is still well below the European Central Bank's (ECB) target. The ECB has been slightly less willing than its Anglo-Saxon counterparts to reduce interest rates and its official rate has been kept at 1.00% since June last year – a rate ECB President Jean-Claude Trichet regards as appropriate given the subdued inflationary pressures.

Unemployment in the eurozone rose to 10.0% in November, the highest rate since August 1998. However, the data mask a considerable divergence within the region, with unemployment ranging from just 3.9% in the Netherlands to 19.4% 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. The 1.2% month-on-month fall in retail sales in November suggests 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 rose by a less-than-expected 0.7% month-on-month in November while factory orders also disappointed, triggering concerns about the momentum of the recovery. Though economic data and surveys have indicated a degree of recovery, this has been largely due to government stimulus packages and temporary inventory effects. The recovery, therefore, is likely to be fragile and it may take some time before 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 retained, where appropriate.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +24.82% over the last six months and +30.67% over the last year. The fluctuations of the euro mean that, when translated into sterling, the returns are +30.21% over the last six months and +20.09% 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, economic output in the third quarter of 2009 grew by 2.2%. This was helped by a reversal in the inventory cycle, as aggressive cost-cutting and limited wage growth prompted a recovery in corporate earnings, enabling companies to rebuild stock levels. The pick-up in production should offer support to the manufacturing sector and help drive economic growth, at least in the short term.

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. With unemployment at 10.0%, almost twice its rate just 18 months ago, income growth poor, credit conditions tight and households focused on paying down existing debts, a return to the consumption patterns of the pre-crisis years is unlikely. However, consumption should be supported, to some degree, by the exceptionally low interest rates and a recovery in confidence. Attention will also be focused on the extent to which growth can broaden out to include a stronger export performance.

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 recent rally has taken them back, in our view, to broadly fair value. We therefore recommend 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 +22.59% over the last six months and +26.46% over the last year. The weakening of the dollar in the second quarter of 2009 means that, when translated into sterling, the returns are +25.02% over the last six months and +12.60% over the year.

## 2.4. Japanese Equities

With GDP having contracted at an annualised rate of 14.2% in the first quarter of 2009, Japan's recession was its most severe in the post-war period. It was also sharper and deeper than those seen in the other major developed economies. Though acute, the contraction proved relatively short-lived as the economy returned to growth in the second quarter of the year, thanks largely to a recovery in international trade.

Despite 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 much more pedestrian 1.3%. At the heart of Japan's problems lie unfavourable demographic trends that are undermining efforts to stimulate consumption. As the population ages, the workforce shrinks and government tax revenues fall while, faced with an extended retirement, those still working are likely to increase savings rather than consumption. Furthermore, expectations of deflation appear embedded and therefore, to a degree, self-fulfilling. The Democratic Party of Japan (DPJ), elected in an historic victory on 30 August, faces significant obstacles in its attempts to encourage consumer spending in a population that has, with good reason, developed a profoundly cautious attitude.

Political instability has not eased the plight of the DPJ. At the end of December, finance minister Hirohisa Fujii resigned on grounds of ill health. His replacement, Naoto Kan, appears to favour much more expansionary policy than his predecessor and has made headlines with his vocal support of a weaker yen. The yen's strength since the onset of the credit crisis has disadvantaged Japan's all-important export sector, particularly when compared to South Korean competitors who have, until recently, benefited from a weaker currency. Should the government redouble its attempts at fiscal stimulation, the yen might be expected to weaken – a development that would be warmly welcomed by the nation's export sector.

In response to Japan's economic difficulties, international investors have largely shunned its equity market. Consequently, Japanese equities appear inexpensive both in historical terms and relative to other equity markets. 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. We recommend current allocations are maintained, where appropriate.

The FTSE Japan index provided, in yen terms, a total return of -0.74% over the last six months and +8.66% over the last year. The fluctuations of the yen mean that, when translated into sterling, the returns are +4.91% over the last six months and -5.80% over the year.

## 2.5. Asia Pacific (excluding Japanese) Equities

The global crisis impacted the Asia Pacific region not through banking or finance channels, but through the sharp contraction in international trade that resulted from the collapse in trade finance and the steep falls in consumer demand in the west. As export volumes declined, industrial production fell, economic growth estimates were revised lower and unemployment increased. The failure of the Asia Pacific economies to ‘decouple’ and thereby avoid the problems of the developed world, together with much higher risk aversion among investors, caused the region’s equity markets to underperform in 2008. However, as policy measures have delivered a better economic outlook and risk appetite has improved, 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 Asia Pacific economies have the potential to achieve rapid economic growth. Having benefited from strong export-led growth over past decades, 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. However, more immediately, Asian growth is likely to remain closely linked to the health of the global economy.

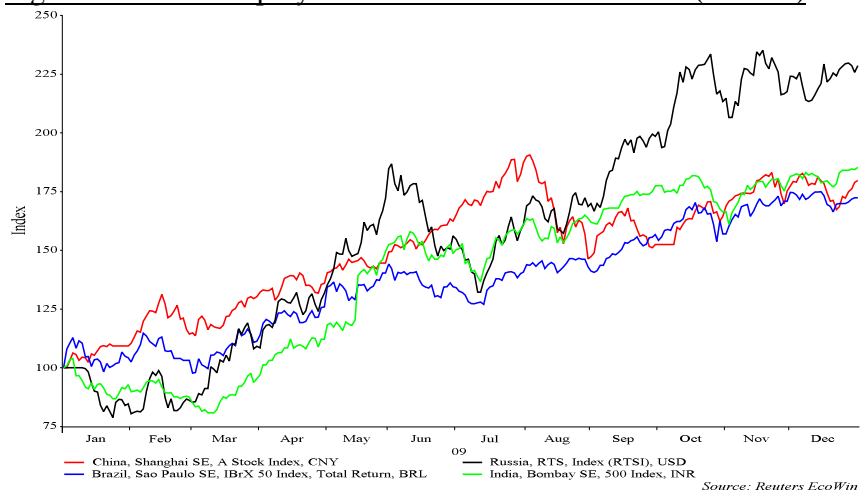
Such has been the strength of the equity market rally in Asia that valuation measures are now above their long-term averages and appear to reflect expectations of a swift global economic recovery, an outcome that is, as yet, by no means certain. Though we recognise the region’s long-term potential, we do not currently recommend increasing allocations.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +23.65% over the last six months and +60.33% over the last year. In sterling-adjusted terms, the returns are +32.54% over the last six months and +55.54% 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)**



While the rebound in equity markets is, to some extent, justified by the improving economic background, there are suggestions that loose global monetary conditions are having a disproportionate effect on the emerging markets. Interest rates at historic lows in the developing world are encouraging investors to seek the strong growth potential of the emerging markets. The resulting capital inflows risk destabilising this growth story, a fact highlighted by Brazil's attempts to curb speculative capital inflows. As in the developed economies, policy makers must balance their growth aspirations against the risk of encouraging asset price inflation. Indeed, China has already begun to rein in its monetary stimulus.

Though we believe the long-term outlook is positive, emerging equity markets valuations appear full. We therefore do not recommend adding to allocations for the present.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +32.43% over the last six months and +82.56% over the last year. In sterling-adjusted terms, the returns are +35.05% over the last six months and +62.54% 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

The UK Debt Management Office, on behalf of HM Treasury, is set to issue £225bn of UK debt securities in the current fiscal year. This is almost £100bn more than the 2008/9 issuance, which was itself far higher than earlier years. Meanwhile, the Bank of England has extended its quantitative easing policy of purchasing gilts from non-public holders by £25bn to £200bn. The aims of these seemingly conflicting policies are in fact clear: to fund government borrowing requirements and at the same time force additional liquidity into the financial system. In the US, debt issuance will be approximately \$2,000bn, though American repurchases are being focused on the debt of the mortgage agencies as well as on US treasury bonds.

The presence of the authorities as both the issuer of government bonds and buyer of a substantial portion thereof is almost certain to result in price distortion. In the UK, the 10-year conventional gilt yielded 4.01% at the end of December, sharply up from 3.52% a month earlier. This rise followed the Chancellor's Pre-Budget Report, which failed to set out decisive action to improve the UK's fiscal situation, and the downgrading of Greece's sovereign debt by ratings agencies. Despite this rise in yields, we believe that conventional gilts remain unattractive given the medium term threat of higher inflation and the fact that repurchases, which are clearly supporting prices, will end long before issuance levels fall back to pre-crisis levels.

In contrast to conventional government bonds, index-linked gilts in our view remain an attractive asset class. Returns have been strong over the past year, reflecting concerns over inflation risks in the medium term and the asset class' lowly valuation at the tail end of 2008 when deflationary concerns dominated. While the current economic weakness makes a near term inflation problem unlikely, the monetary policies being employed by the BoE significantly raise the risk of higher inflation over the next decade and, consequently, the inflation protection qualities of index-linked gilts remain appealing.

We also continue to favour funds of corporate bonds. We recommended increasing allocations to investment grade bonds twelve months ago, since when the asset class has rallied 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, where managers can hedge out interest rate risk and allocate money to areas in which they perceive value within the asset class.

The ABI UK Pension Gilt sector provided a total return of +0.76% over the last six months and -1.32% over the last year. The ABI Pension Sterling Corporate Bond sector provided a total return of +13.44% and +17.67% over the same periods. The ABI UK Pension Index-Linked Gilt sector provided a total return of +3.44% over the last six months and +5.72% 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 induced price bubbles in several asset classes. Property deals were often structured with high levels of low cost debt financing, which disappeared at the onset of the credit crisis. With it went 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 have fallen 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. However, there remains a risk that lenders will be less flexible in future and force the sale of properties, thereby increasing supply and depressing prices further.

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 and offers, in our view, sufficient compensation for the risks outlined above. We have therefore been recommending, where appropriate, increases to commercial property allocations. To mitigate risk, we are recommending that increased allocations are focused on established funds, holding predominantly prime and ungeared, or lowly geared, property portfolios, though these carry correspondingly lower yields.

The ABI UK Pension Direct Property index provided a total return of +10.60% over the last six months and +0.79% 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 +0.64% 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.

We expect the hedge fund industry to emerge from the financial crisis in a very different shape. There will certainly be 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 +7.35% over the last six months and +13.15% over the last year.

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**The above commentaries reflect our views as at 19 January 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 30 June 2009 to 31 December 2009 and the twelve month period from 31 December 2008 to 31 December 2009 (source: Lipper Hindsight).**