

# **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 July 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

Having provided the engine of world economic expansion for several years, the US economy, the world's largest, has now all but ground to a halt. In the first quarter of this year it expanded at an annualised rate of just 1.0%. Survey data suggest that the second quarter was slower still. Measures of consumer confidence, such as the University of Michigan Consumer Sentiment index, are showing lower readings than in the recessions of the early 1990s or of 2001. However, business surveys, such as the ISM Non-Manufacturing survey, are not quite so weak, having recovered from their January lows. Whether the US economy succumbs to recession remains to be seen but there is no doubt that the American consumer is feeling considerable financial pain. The effects of the credit crisis and weakening housing market have yet to ease – and they have now been compounded by sharp rises in petrol and food prices which have further undermined disposable incomes.

In contrast to many previous periods of economic weakness and financial crisis, the US authorities have taken aggressive action to mitigate the worst effects of the slowdown. Since last September, the Federal Reserve (the Fed) has reduced its main interest rate, the Fed Funds rate, by 3.25%, including a dramatic 1.25% reduction in January alone. US interest rates are now 2.00%. This action has been augmented by other monetary measures and a Federal economic stimulus package worth \$170bn. However, we may now be witnessing the limits of the authorities' powers to help the economy as the aggressive interest rate cuts have taken their toll on the US dollar and caused heightened inflationary concerns. While a weaker currency has helped exporters, thereby supporting one area of the economy, it is making imported goods, particularly energy, more expensive, thereby worsening the plight of the consumer.

This current dislocation in economies and financial markets has its root in the period of very low interest rates and rapid financial innovation in the five years from 2002 onwards. During this period, new financial instruments facilitated a very rapid expansion in the availability of credit. Consumers took advantage of this by increasing personal borrowing to fund additional consumption while investors used high levels of borrowing to 'gear up' the returns from assets generating stable cash flows. Asset prices and indebtedness both spiralled. This was most clearly apparent in the rapid appreciation of domestic and commercial property prices and the very low risk premiums paid on non-government fixed interest securities. We are now seeing a correction in the prices of such assets. Lower prices for property and the assets secured thereon have had knock-on effects on both consumers and the financial institutions left holding complex debt securities. Bank asset write-downs, provisions and emergency recapitalisations have followed.

The impact on economic growth of the credit crisis and weak house prices is now being compounded by a further unhelpful development, rising commodity prices. Strong global economic growth over the past four years has boosted demand for energy and industrial metals, driving prices higher. As economic growth has waned over the past six months, commodity prices have failed to ease and have, in fact, continued to rise. This has the dual effect of further undermining consumer disposable incomes, thereby exacerbating the downturn, and restricting the Fed's freedom to deliver rate cuts to ease the economic slowdown without taking risks with inflation.

Slowing growth and rising inflation, known as stagflation, is most unhelpful for investment markets. Weak economic activity risks undermining corporate earnings and thereby equity markets, while inflation erodes the real return from fixed interest investments. In response, some investors have begun to make allocations to commodities. However, such action risks creating a vicious circle of rising commodity prices and increased inflationary concerns that will end only when economic weakness finally undermines commodities prices. We are concerned, therefore, that investors, looking for a shelter from both slower economic growth and higher inflation, buy into commodities at precisely the wrong time. We note that assets held in funds tracking commodities indices, such as the S&P GSCI, have increased from \$10bn to \$250bn over the past eight years.

Following December's reduction in European equity allocations, client portfolios now have healthy weightings to cash and short and medium-dated government bonds. We will be looking to deploy some of these highly liquid and defensive assets into areas offering the potential for higher returns as opportunities present themselves. In the meantime, we continue to maintain current weightings to equities. Valuations, in most developed markets, are not extended and they should offer a degree of inflation protection.

The MSCI World Equity Market index has provided a total return of -10.23% in sterling over the last six months and -9.45% over the last year.

**MSCI World Equity Market index over 5 years**



## 2. Equities

### 2.1. UK Equities

Like the US, the UK economy is slowing rapidly. In the wake of the credit crisis, consumer confidence has deteriorated sharply, falling to its lowest level since March 1980, according to the GfK NOP survey. House prices are also falling and, according to Nationwide, are almost 6.3% lower year-on-year. To mitigate the impact of the slowdown, the Bank of England (the BoE) has reduced interest rates by 0.75% to 5.00% since December.

Credit market problems in the UK are also similar to those in the US. Banks are trying to rebuild their reserve ratios by curtailing loans, and improve profitability by increasing lending rates. This means that the BoE's interest rate reductions are not being fully reflected in loans available to borrowers.

Another similarity with the US is that inflationary pressures are now restricting the central bank's freedom to reduce interest rates. Data for May showed the Consumer Price Index at 3.3%, compared to the BoE's target rate of 2.0%, while the Retail Price Index, the inflation measure used for index-linked bonds, is higher at 4.3%. Though there is much concern about the threat that rising inflation poses, our view remains that this will prove short lived. We expect inflationary pressures to subside later in the year as declining global economic growth acts to slow demand for resources, including labour. This should free the hand of the BoE to reduce interest rates further, as appropriate.

Turning to UK equities, strong returns up until mid-2007 were driven by supportive economic growth conditions and the return of a degree of pricing power to the corporate sector. 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 previous four years, valuations on UK equities did not become extended. After the recent weakness, UK equities are, on first inspection, more attractively valued than they have been for several years. However, we are mindful that earnings expectations are likely to be pared back.

Our recommended funds are, in the main, positioned away from the vulnerable consumer-sensitive areas of the market including the much troubled banking sector. We are confident, therefore, that they will prove more defensive than the broader market and we recommend that current allocations to UK equities are maintained.

The FTSE All Share index has provided a total return of -11.16% over the last six months and -13.03% over the last year.

## 2.2. European (excluding UK) Equities

Until December's recommended reduction in allocations, Continental Europe had been our favoured destination for investments into international equities. This proved profitable as European (ex UK) equities outperformed those of the US, UK and Japan over the three years to the end of 2007.

The long term factors that had 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. One of the main reasons for the recommended reduction in allocations was the strengthening 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 key driver of the euro's strength is the European Central Bank's (ECB) reputation for taking no risks with inflation. This was demonstrated earlier this month when the ECB increased interest rates to 4.25%, despite clear signs that European economies are slowing. Eurozone inflation, currently at 4.0%, is at a 16-year high and double the ECB's target of below, but close to, 2.0%.

The core eurozone economies have remained fairly resilient to the slowdown in the US. Germany, for example, has benefited from strong investment growth as it has expanded capacity to meet export demand from the Far East. We believe, however, that the strength of the euro and an eventual slowing of demand from emerging economies will result in a sharp slowdown in the eurozone in the coming months.

Equity investors have, unsurprisingly, decided to take profits from this region and equities, in local currency terms, have fallen substantially further than those of the UK, US or Japan since the start of the year.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -18.59% over the last six months (-12.25% sterling adjusted) and -22.50% over the last year (-8.86% sterling adjusted).

### 2.3. North American Equities

The current global economic downturn is centred on the US in general and its residential property market in particular. After years of strong growth, house prices, according to the Case-Shiller Home Price index, were 15.3% lower in April compared to the previous year. Abundant mortgage finance, which fuelled much of the boom, has been withdrawn and reduced access to credit is now undermining consumer confidence and exacerbating the slowdown. Meanwhile, mortgage providers, investment banks and other financial institutions are suffering from the impairment of mortgage-backed assets and related financial assets such as collateralised debt obligations (CDOs).

Alongside interest rate reductions totalling a full 3.25% over the last ten months, the Fed has injected liquidity into money markets, introduced a term auction facility and allowed banks to swap top quality mortgage-backed securities for Treasury Bills (for 28 day periods). These aggressive policy responses demonstrate that the authorities are acutely aware of the risks credit and housing market problems pose to the whole economy. The combined actions of the Fed and the Federal government look likely to head off further headline-grabbing banking failures, such as Bear Stearns, but whether they can avert a recession looks more doubtful. The US consumer is already heavily indebted. Reduced access to credit, falling house prices and the squeeze on incomes from rising food and petrol prices is likely to cause a sharp correction in US consumer spending.

The US equity market has performed reasonably well compared to other developed markets. Sterling based investors have also benefited from a rally in the dollar versus sterling over the last six months. We believe that allocations to US equities should be maintained for the present.

The S&P 500 index provided, in US dollar terms, a total return of -11.91% over the last six months (-11.89% sterling adjusted) and -13.12% over the last year (-12.41% sterling adjusted).

## 2.4. Japanese Equities

The Japanese economy, like those of other developed countries, is slowing under the impact of higher resource prices. However, exports remain healthy, thanks to the strength of demand from emerging markets, and domestic consumption growth is proving resilient, albeit at subdued levels when compared to Japan's Western counterparts.

One positive factor for equity investors in Japan is that it remains one step removed from the global financial crisis. Japanese banks have little 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. However, the unfolding crisis has brought about an unwelcome development 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, supporting Japan's exporters. With the onset of the credit crunch, 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 impact of currency strength and the global economic downturn saw Japan's equity market perform very poorly in the first quarter of this year. However, during the second quarter investors began to reassess Japanese equities on the basis that they could prove defensive relative to other markets. This is in part due to Japanese consumers being much less indebted than their Western counterpart and also due to the Japanese banks ability to lend being largely unaffected by the credit crisis. Finally, Japanese equities are offering better value, both relative to their own history and by comparison with international counterparts.

We recommend current allocations to Japanese equities are maintained.

The FTSE Japan index provided, in yen terms, a total return of -9.92% over the last six months (-5.05% sterling adjusted) and -24.29% over the last year (-11.08% sterling adjusted).

## 2.5. Asia Pacific (excluding Japanese) Equities

The performance of the economies of the Asia Pacific (ex Japan) region has thus far remained strong in the face of the slowdown in the US. The economies of South Korea, Hong Kong, Singapore and Taiwan all grew by more than 5.0% in 2007 and, looking forward, all are forecast to sustain growth comfortably in excess of the developed economies. Importantly, 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. Moreover, strong economic growth and current account surpluses point to Asian currencies appreciating over the medium term. These factors make the Asia Pacific region an attractive destination for long term equity investors.

Investor enthusiasm for Asia Pacific equities has seen these markets perform very strongly in recent years and they no longer trade on their traditional discount to Western markets. We have, since 2006, recommended only small allocations to Asia Pacific equities in acknowledgement of the strong performance and historic volatility of the region's stock markets. As the global economic downturn has gathered pace, other investors have started to take profits from the region and Asia Pacific equities have begun to underperform those of the developed markets.

We believe 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 -12.93% over the last six months and -2.35% over the last year (for sterling based investors).

## 2.6. Emerging Markets Equities

Emerging markets (as defined by MSCI – see below) provided excellent returns over the four years to the end of 2007. This was driven, at least in part, by rapid economic growth and rising domestic consumption. While these strong fundamentals remain in place, equity market returns have come under pressure this year as investors have become concerned about the impact of slowing world growth on the emerging economies. Inflation is also a looming issue for many emerging economies and attempts to bring it under control, through exchange rate appreciation, interest rate increases or other policy measures, are likely to impact negatively on corporate profitability.

Equity market corrections in China and India, two former favourites of emerging market investors, have been severe. Over the first six months of the year Chinese shares listed on the Shanghai stock exchange have fallen by 48%, while those Indian companies with shares listed in Bombay have seen, on average, a 34% decline.

We are, however, taking a more positive view on Russia, which looks set to benefit from strong domestic consumer led growth and where equity market valuations are undemanding. It is also fairly well insulated from both the credit crisis and the slowdown in economic growth in the developed economies. We are recommending a small increase in allocations to emerging markets, through investments in Russian funds.

The FTSE All-World Emerging index provided a total return of -11.04% over the last six months and +5.65% over the last year (for sterling based investors).

\* MSCI includes 24 countries in its emerging markets indices: Argentina, Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, 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 stock (gilts) has demonstrated its value as an effective portfolio risk diversifier. From a peak of over 5.50% in mid-2007, the yield on the 10-year UK government bond retreated by over 125bps to a 4.25% low in mid-March. Gilts benefited from lower growth expectations (and therefore lower interest rate hopes), and also from their 'safe haven' status amid the turbulence in credit markets and falling equity prices. As investors' worst fears regarding the stability of the financial system have not materialised, yields have subsequently moved higher once more.

In contrast, corporate and non-investment grade bonds have suffered from decreasing risk appetite amongst investors amid concerns about credit quality and default risk. Within the various classes of fixed interest instruments, we have, for several years, 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 conventional and index-linked UK government bonds. This asset allocation decision tested our resolve as non-government bonds continued to outperform sovereign issues for some time. Developments in the credit markets over the last 12 months, however, have seen the price of government bonds appreciating while lower quality corporate and high yield bonds have fallen abruptly. Index-linked issues have performed particularly well due to ongoing concerns about inflation. As well as offering inflation protection, index-linked bonds are capital gains tax free. This includes the gains from the indexation of capital, and makes index-linked gilts especially attractive when held outside of a tax advantaged wrapper, such as a pension.

We are closely monitoring the now much more realistically valued investment grade and high yield bond sectors and selectively increasing the former.

The ABI UK Pension Gilt sector provided a total return of -2.29% over the last six months and +5.31% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +4.58% over the last six months and +15.00% over the last 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 abundance of low cost debt finance which characterised the credit bubble. Higher and higher quantities of debt were used to gear the steady but unexciting returns from commercial property. As the credit crisis unfolded from mid-2007 onwards, commercial property investors witnessed an abrupt change in the willingness of banks to lend at low rates against property purchases. This, together with reduced appetites for risk among investors, has served to drive commercial property yields sharply higher.

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 began in the second half of 2007. UK commercial property returns, including rental income, were negative in 2007 as measured by the ABI UK Pension Property index. This is the first time commercial property prices have fallen since 2001. Returns have remained under pressure thus far in 2008.

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 taking a more positive stance on commercial property in due course.

The ABI UK Pension Direct Property index provided a total return of -4.51% over the last six months and -17.38% over the last year.

#### 5. Cash

Sterling deposits or monies held in AAA-rated liquidity funds earn returns in excess of 5.00% p.a. at present. We regard these as attractive relative to the yields currently available on fixed interest and commercial property.

Our view is that UK interest rates will probably remain close to their current levels for the remainder of 2008, hence we continue to favour allocations to cash. 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.

The ABI UK Pension Money Market index provided a total return of +2.36% over the last six months and +4.97% over the last year.

## 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 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 much publicised demise of Peloton, the London based hedge fund group, exemplifies our view of the potential risks inherent in this asset class. Peloton's \$2bn flagship fund, the ABS Master fund, won the Eurohedge 'New Fund of the Year' award in February. The award was in acknowledgement of the fund's excellent performance in 2007, when it returned 87% after betting that US sub-prime mortgages would fall in value. However, 2008 saw a swift reversal in Peloton's fortunes. A combination of falling values in highly rated tranches of mortgage-backed securities (in which the fund was then invested), together with pressure from banks for more collateral to set against loans, caused the fund's collapse. Investors in the fund have lost 100% of their capital. Such events are by no means rare. In early July a London-based hedge fund, Endeavour Capital, reportedly lost a quarter of its capital in a single day after leveraged bets on Japanese government bonds moved against it.

For completeness, we have included below the HFRX Global Hedge Fund index figures for hedge fund performance. We are, as might be expected, somewhat sceptical about the integrity of these figures. In our view, the index will almost certainly overstate hedge fund returns. This is because the submission of performance figures to the index compilers is voluntary and it is unlikely that failed or poorly performing hedge funds would submit numbers for inclusion in the index.

The HFRX Global Hedge Fund GBP index provided a total return in sterling terms of +0.05% over the last six months and -1.65% over the last year.

N. B. The above commentaries reflect our views as at 1 July 2008. Any material changes in economic and market conditions between then and the time of writing would 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 December 2007 to 30 June 2008 and the twelve month period from 29 June 2007 to 30 June 2008 (source: Lipper Hindsight).