

# **Market Commentary**

**June 2009**

**Saunderson House Limited  
1 Long Lane  
London EC1A 9HF**

**020 7315 6500 (Switchboard)  
020 7315 6550 (Fax)**

**Authorised and Regulated by the Financial Services Authority**

**SAUNDERSON HOUSE**



<b>Contents</b>	<b>Page</b>
1. Economic and Investment Outlook	3
2. Equities	6
2.1. UK Equities	6
2.2. European (excluding UK) Equities	7
2.3. North American Equities	8
2.4. Japanese Equities	9
2.5. Asia Pacific (excluding Japanese) Equities	10
2.6. Emerging Markets Equities	11
3. Fixed Interest	12
4. Property	13
5. Cash	13
6. Note on Hedge Funds	14

### Risk Warnings

This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 11 June 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

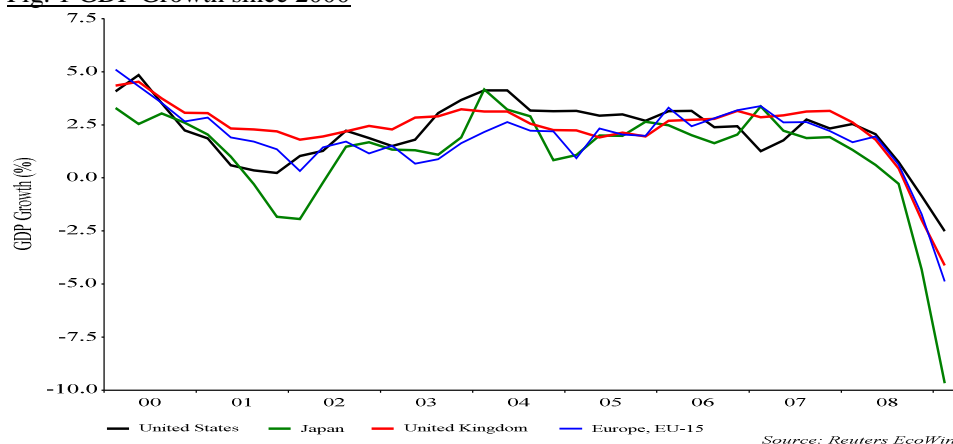
In its most recent 'World Economic Outlook', the International Monetary Fund (IMF) forecasts that total global output will decline by 1.3% this year with only a modest recovery in 2010. For the world economy to achieve no growth in aggregate is without modern precedent, but the pace of the decline is perhaps more disarming still. As recently as October 2008 the IMF was forecasting positive growth of 3.0% for the world economy in 2009, only slightly lower than the 3.2% growth recorded for 2008.

Governments across the developed world, already struggling with banking crises and dysfunctional credit markets, have resorted to Keynesian-style fiscal stimuli in an attempt to breathe life back into their faltering economies. A bewildering array of new policy initiatives is now in place and early indications are that these are having a positive impact. Aggressive action taken over the past nine months to underpin fragile financial systems also appears to have achieved its objective. The agreement at April's G-20 summit to increase IMF funding threefold to \$750bn has also boosted confidence.

Having reduced official interest rates as far as practicably possible, monetary authorities in the US and UK have now turned to unconventional measures to support their economies. These policies entail expanding the quantity of money in the economy (so-called quantitative easing) to drive the cost of borrowing money down, force liquidity into the financial system and support the value of financial assets. Such actions are aimed at preventing the current deep recessions turning into self-sustaining depressions or multi-year slumps as investors, businesses and consumers reduce their borrowings.

Fig. 1 shows the extent of the slowdown in major economies. There are a number of factors crucial in determining whether a prolonged depression can be avoided or how long and how deep recessions will be. These include the extent of further falls in house prices and how far unemployment rises, with the attendant secondary effects on asset prices, consumer spending and confidence.

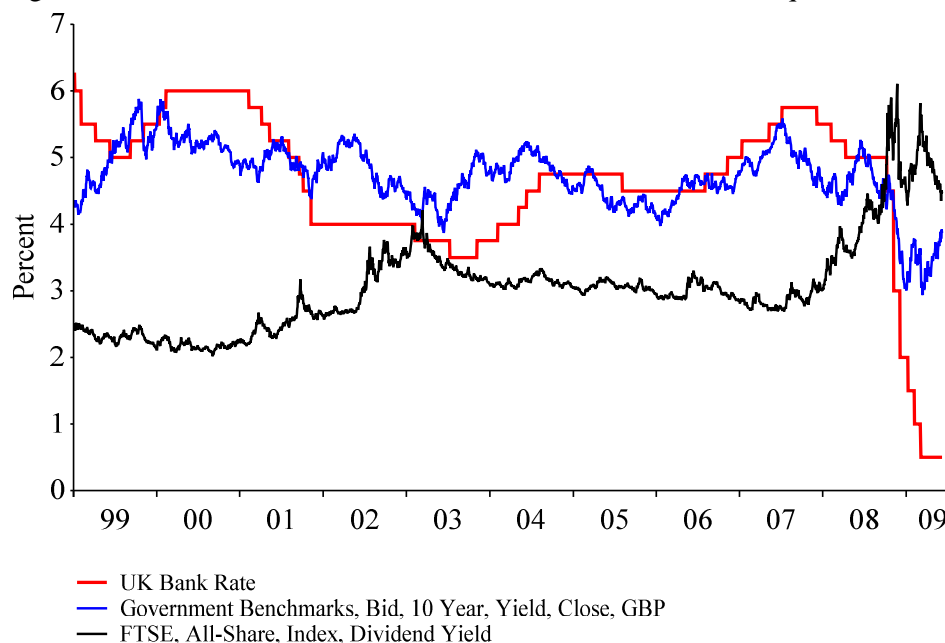
Fig. 1 GDP Growth since 2000



During the last 18 months, many of the assumptions on which confidence in an ever-expanding global economy and strong financial markets were built have been turned on their heads. One such assumption was that, when credit availability stalled, those economies enjoying credit-fuelled consumption growth, such as the UK and the US, would fare much worse than countries with trade surpluses, such as China, Japan and Germany. This has proved not to be the case. As demand from consumers in the UK and, particularly, the US slumped, those economies reliant on exporting their goods and services have been severely impacted. The impact of the credit crisis has therefore been global. Over-extended consumers are no longer able to access credit to fund purchases, while producers suddenly find themselves with excess inventory and production capacity. The global economy has now moved into a deleveraging process as consumers seek to increase their savings rates and companies reduce output to match the new, lower level of demand. Where this process stops is extremely difficult to determine and the outlook for financial markets remains uncertain.

Within the mainstream asset classes, equities have suffered acutely as expectations of much-reduced economic growth, and therefore lower corporate profitability, have been priced into valuations. Superficially, equities did not appear to have reached levels at which they were expensive on measures such as price to earnings ratios in the current business cycle. However, it can now be seen that corporate profits had been driven to unsustainable levels due to excessive credit expansion. Equity prices subsequently fell, taking yields to levels not seen in the last ten years (see Fig. 2).

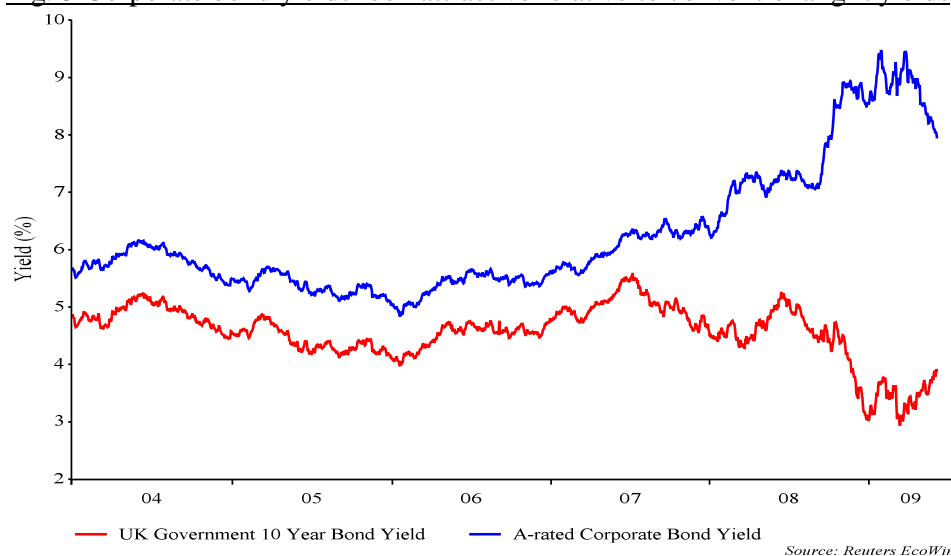
Fig. 2 Yields on UK assets: cash, UK Government Bonds and Equities



Source: Reuters EcoWin

Turning to other asset classes, fixed interest markets have seen a very marked rise in risk aversion over the last 18 months as investor appetite for complex structured instruments, such as collateralised debt obligations (CDOs), has evaporated. As a result, government bonds, until recently, performed strongly relative to corporate bonds. Though corporate bonds are not complicated instruments, prices fell due to the exceptionally high level of risk aversion, concerns about falling corporate earnings and forced selling by leveraged investors. As a result, corporate bonds are now currently offering very high yields relative to government bonds (see Fig. 3). The easing of credit markets in response to the policy action from governments and monetary authorities has recently caused this spread to narrow somewhat, but our view remains that corporate bonds still present an attractive opportunity for investors prepared to take a longer term view.

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



Commercial property values rose strongly for five years until mid-2007. Values have now been undermined both by the withdrawal of debt financing and the economic downturn which has weakened tenant demand. The prospects for the asset class are probably still deteriorating and we consider opportunities here appear to be receding into 2010.

Considering our recommended asset allocations, reductions in equity weightings during 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, equity markets now look relatively 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 assets.

The MSCI World Equity Market index has provided a total return of +5.36% in sterling terms over the last six months and -19.58% over the last year.

## 2. Equities

### 2.1. UK Equities

Conditions in the UK economy have deteriorated rapidly as a result of the global financial crisis. As measured by GDP, the economy recorded its third consecutive quarter of contraction in the first three months of this year. At -1.9% compared to -1.6% in the final quarter of 2008, the rate of decline is still increasing and the UK is now in the midst of its worst recession since at least the early 1980s. Recession is also evident in the labour market, with unemployment rising to 2.1m in the three months to the end of March. This equates to an unemployment rate of 7.1%. With unemployment rising rapidly, inflation is less of a concern for policymakers. On the government's target measure, the Consumer Price Index (CPI), prices rose at 2.3% per annum in April, down from a recent peak of 5.2% in September. The more familiar Retail Price Index (RPI) has fallen faster still and is now showing prices, in aggregate, declining by 1.2% per annum. The main differences between the two measures are that mortgage interest payments and house price depreciation, both components of the RPI, are excluded from the CPI.

With inflation no longer a threat in the short term, the Bank of England (BoE) has reduced interest rates aggressively. Reductions of 1.50% and 1.00% in November and December 2008 respectively and further 0.50% reductions in each of the first three months of this year have taken the Bank Rate to 0.50%. This is far lower than at any time since the creation of the BoE in 1694 and is indicative of the scale of the economic and financial crisis.

To bolster the ailing economy, the government has announced a fiscal stimulus package worth up to £30bn, including a temporary cut in VAT. In addition to the fiscal measures, the government has continued to support the banking sector. However, falling tax revenues have resulted in a gaping hole in the public sector finances, necessitating sharp tax increases and reduced tax-exempt allowances, especially for the higher paid.

Turning to the stock market, the path of UK equities from here will depend crucially on the depth and longevity of the recession and the extent to which future earnings downgrades are already discounted in share prices. Our view is that the recent rally in equity markets is warranted by the stabilisation of the financial system but that the magnitude of the economic downturn means that increased allocations are not appropriate at present. We recommend that current weightings to UK equities are retained, where appropriate.

The FTSE All-Share index has provided a total return of +7.97% over the last six months and -23.66% over the last year.

## 2.2. European (excluding UK) Equities

Continental European consumers are not as indebted as their US or UK counterparts and most European economies do not have the corresponding balance of payments deficits seen in these two countries. Continental Europe, however, has not proved immune to the credit crisis or the accompanying economic slowdown. Eurozone GDP was 2.5% lower in the first quarter of 2009 when compared with the previous year, while unemployment in the 16-country region rose to 9.2% in April, its highest level since September 1999.

In Germany, GDP fell by 3.8% in the first quarter, weighed down by a slide in industrial production as global demand for its exports has receded since September 2008. Germany is particularly dependent on overseas markets; in 2008 it exported goods of value equivalent to 47% of its GDP – far higher than any other major developed economy (the comparable figure for the UK is 21%). German exporters have been long term beneficiaries of both Far Eastern demand for capital goods such as machine tools, and the ongoing, strong growth in Eastern Europe. Both these regions have been impacted by the credit crisis and, in April, German exports were 28.7% lower than a year before – the steepest fall since records began in 1950.

The strength of the European single currency has exacerbated the Eurozone's economic woes. The European Central Bank (ECB) has been slow to reduce interest rates and has only recently adopted a modest form of quantitative easing as a policy option, despite criticism from German chancellor Merkel who argued against asset purchases by the central bank. A 0.25% reduction in early May took official rates down to 1.00% but was not followed up by a further cut in June. This leaves interest rates in Europe above those in the US, UK and Japan, which helps to support the euro relative to the dollar, pound and yen. We remain of the view that the ECB will join the Federal Reserve, the BoE and the Bank of Japan in reducing interest rates to close to zero and fully embracing quantitative easing in due course.

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

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +5.83% over the last six months and -33.09% over the last year. The strengthening of the euro means that, when translated into sterling, the returns are +12.34% over the last six months and -25.31% over the year.

### 2.3. North American Equities

In what was an historic statement, the Federal Reserve (the Fed) 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 steer the US economy away from a deflationary slump. The Fed’s response to the developing crisis has been impressive; interest rates were 5.25% just eighteen months ago. 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 injections of capital into US banks similar to those used in the UK rescue.

These measures appear to be having their desired effect with recent economic data showing some early signs of an improving economy. Non-farm payrolls declined by a less than expected 345,000 in May while consumer confidence in April enjoyed its largest upward move since 2003. The data drove a sharp rise in short-term treasury yields at the beginning of June as investors priced in a sooner-than-expected rise in interest rates. However, other economic data is less encouraging. Unemployment increased to 9.4% in May, its highest level since 1983. US retail sales, so long the mainstay of the US economy, have declined very steeply. In April they were 10.1% lower than a year earlier. Recovery here will depend on a return to stability in house prices and better labour market conditions. According to the Case Shiller index, US house prices were 18.7% lower in March (the latest available data), compared with the previous year. With prices more than 30% lower than their mid-2006 peak, the impact on household wealth has been considerable. Meanwhile, a number of those banks which accepted government bailouts are choosing to repay TARP funds and reduce government intervention in their business, possibly hindering any nascent economic recovery.

Given the scale and speed of the policy response from the Federal government, we believe that the US will be one of the first economies to emerge from recession. Also the US corporate sector is highly flexible and restructuring is likely to take place rapidly.

US equities now look inexpensive relative to their history. We will be looking for opportunities to increase weightings when the outlook for the global economy becomes clearer; in the meantime, we 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 +4.05% over the last six months and -32.57% over the last year. The fluctuating value of the dollar means that, when translated into sterling, the returns are -0.99% over the last six months and -17.36% over the year.

## 2.4. Japanese Equities

Having learnt stark lessons from the bursting of Japan's asset price bubble in the 1990s, Japanese banks have less exposure to the sub-prime assets that have damaged their US and European counterparts. Furthermore, corporate and household debt levels are significantly below those of other developed economies. As a major exporter of manufactured goods, however, Japan is highly sensitive to the health of the global economy and its economy has suffered as export demand collapsed, with the impact of the global downturn magnified by the sharp revaluation of the yen. As export demand has fallen, Japan's trade balance turned negative for the first time in thirteen years and economic growth has given way to recession. Output shrank at an annualised rate of c15% in both the fourth quarter of 2008 and the first quarter of 2009 making this Japan's worst recession in the post war era.

Though Japan's recession is set to be the deepest in the developed world, there are early signs that the contraction may at least be relatively brief. Among improvements in sentiment surveys and forward-looking indicators, consecutive months of export growth in March and April may offer the greatest cause for cautious optimism. However, Japan remains heavily reliant on the health of global demand and any improvements in Japan's economic situation are being made from a low base.

Despite now appearing attractively valued versus both their own history and by comparison to their international counterparts, Japanese equities remain deeply out of favour with international investors. We must also consider the uncertain economic outlook and consequently believe it is too early to increase recommended allocations to Japanese equities. Current allocations should therefore be maintained, where appropriate.

Though the yen has fallen 18.10% against sterling in the five months to 29 May, it has in aggregate appreciated by 26.22% against sterling over the past twelve months. This has, to some degree, mitigated the weak performance of the Japanese equity market. The FTSE Japan index provided, in yen terms, a total return of +9.25% over the last six months and -36.01% over the last year. The currency fluctuations mean that, when translated into sterling, the returns are +3.73% over the last six months and -13.27% over the year.

## 2.5. Asia Pacific (excluding Japanese) Equities

The theory that the economies and equity markets of the Asia Pacific region had decoupled from their western counterparts has now been disproved. Increased intra-regional trade and proximity to Chinese growth offered little protection to the export-led Pacific economies in the midst of the synchronised global slowdown. GDP growth forecasts for the region, while still relatively healthy in comparison to those for the western economies, have now been revised downwards.

Strong economic growth drove several years of excellent returns for Asian equity markets, but also pushed them to relatively demanding valuations at which they proved vulnerable to the evaporation of growth prospects and risk appetite which accompanied the credit crunch. Thus Asian equity markets underperformed markedly over 2008. However, economic indicators have begun to improve in the second quarter of this year, prompting investors to focus once more on the region's growth potential and subsequently fuelling the outperformance of Asian equity markets (see Fig. 4).

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



While we believe the long term prospects for the markets of the Asia Pacific region are good, we retain our focus on valuations. The recent rally has caused Asian equities to re-rate and, until the sustainability of a global economic recovery becomes more certain, we continue to recommend clients maintain their current tactical equity weightings to the region, where appropriate.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +33.30% over the last six months and -22.36% over the last year. In sterling-adjusted terms, the returns are +38.38% over the last six months and -14.46% over the year.

## 2.6. Emerging Markets Equities

Having been a favourite destination for developed market investors, equities in the emerging markets\* suffered sharp setbacks as the financial crisis developed. Like the equity markets of the Asia Pacific region, emerging markets were hard hit by the wave of risk aversion.

While the emerging Asian and Latin American regions largely avoided the debt-funded asset bubbles which were the root cause of the credit crunch, the same cannot be said of central and eastern Europe. Rapid increases in property prices encouraged high levels of borrowing, often in a foreign currency, and many emerging European nations are now being forced to turn to the IMF and other transnational institutions for financial rescue. This has placed considerable pressure on eastern European currencies, and equity markets have suffered significant losses (see Fig. 5).

**Fig. 5 Emerging European equity markets have come under pressure**



We have been recommending fairly small allocations to emerging markets equities for the last two years as, driven by strong speculative inflows, we believed these markets had become overvalued. The sell-off had gone some way to address this issue but improved risk appetite has seen emerging markets driven sharply higher once more, with Brazilian, Russian, Indian and Chinese equity markets now between 58% and 120% above their respective 52-week lows. We recommend current allocations are maintained for the present.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +50.76% over the last six months and -33.34% over the last year. In sterling-adjusted terms, the returns are +43.46% over the last six months and -18.30% over the year.

\* MSCI includes 23 countries in its emerging markets indices: Argentina, 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

Sovereign debt, including UK government fixed interest stocks (gilts), performed very well over the course of 2008 and early 2009 as investors sought the safety of government-backed securities. Ten-year conventional gilt yields fell from a peak of more than 5.50% in mid-2007 to below 3.00% in mid-March 2009. This generated capital gains within portfolios that went some way to offsetting losses on equity holdings. As well as the attraction of their 'safe haven' status amid the turbulence in credit markets and falling equity prices, conventional gilts benefited from declining interest rates and inflation expectations.

Having cut the Bank rate to an historic low of 0.50%, the BoE announced its intention to increase money supply by initiating a process of quantitative easing. This involves the purchase of £125bn of conventional gilts from banks, pension funds and insurance companies, who will, it is hoped, place the funds on deposit to be used for lending to businesses and the consumer. However, such measures, together with the UK government planning record levels of new gilt issuance, have raised concerns about resurgent inflation and a lack of appetite for newly issued gilts. Ten year gilt yields have now risen from their sub-3.00% lows to 3.73% at the end of May.

Exposure to index-linked gilts also proved beneficial early in 2008 due to concerns about commodity-driven inflation. However, as these concerns faded and investors focused instead on the possibility of recession and deflation, yields on index-linked gilts rose sharply in the third quarter of 2008 before falling back once again. Since the start of the year, index-linked gilts have performed slightly better than conventional stock thanks to the easing of concerns about an extended spell of deflation.

Our long-held belief that corporate fixed interest securities offered little value has meant that, since 2004, our recommended allocations to fixed interest have been weighted almost entirely towards government bonds. While this has had a positive effect on portfolio returns, conventional gilt prices are now, in our view, too high and are therefore vulnerable to rising inflation expectations. We have therefore been advising clients, where appropriate, to take profits in this area and look to invest in the now much more attractively valued corporate bond sector. The lack of liquidity in the European high yield bond market means we are more cautious on the non-investment grade sector and recommend allocations to fixed interest are focused on higher grades of corporate bonds.

The ABI UK Pension Gilt sector provided a total return of +0.86% over the last six months and +8.97% over the last year. The ABI Sterling Corporate Bond sector provided a total return of +0.50% and -9.61% over the same periods. The ABI UK Pension Index-Linked Gilt sector provided a total return of +7.90% over the last six months and +0.12% over the last year.

#### 4. Property

The UK commercial property market has lost 41% in capital terms from its peak in June 2007. The driver of this collapse was the withdrawal of low cost debt finance, which had, until 2007, been used to leverage the steady but unexciting returns from commercial property, spurring development and, eventually, oversupply. As the credit crisis unfolded, banks became less willing to lend at low rates to fund commercial property purchases and, as property prices fell, highly leveraged property funds and companies began to breach their loan covenants. This led to further forced selling and, together with the effect of the slowing economy on property demand, has served to drive yields sharply higher and prices correspondingly lower.

Although commercial property yields now look attractive relative to government bonds, and the speed of the market's decline has slowed in recent months, the level of oversupply continues to increase while the deterioration of the economic backdrop is still undermining demand. Commercial property valuations, therefore, are likely to remain under pressure throughout the remainder of 2009 and the market in property derivatives is suggesting that property values may have another 10% to fall. We are monitoring developments closely with a view to taking a more positive stance on this asset class in due course. In the meantime, allocations to property within client portfolios are being met through vehicles, such as closed-ended funds, where we are satisfied that the underlying property assets are first class and where any gearing employed is manageable.

The ABI UK Pension Direct Property index provided a total return of -13.63% over the last six months and -24.15% over the last year.

#### 5. Cash

Sterling deposits and monies held in AAA-rated liquidity funds can presently earn returns of around 0.50% over the BoE Bank Rate of 0.50% p.a. National Savings & Investments are also offering relatively attractive rates at present.

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 +0.52% over the last six months and +2.85% 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.

According to Hedge Fund Research, a composite index of hedge funds fell 19% in 2008, the biggest annual decline since the company began tracking data 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, fell 55% in 2008. Atticus European, meanwhile, lost investors more than 43% over the year. 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 likely to have intensified in the fourth quarter as hedge fund investors continued to file significant redemption requests.

According to BarclayHedge, in the first five months of 2009, just 40 new funds were launched compared to the same time last year when 240 new funds started trading. We expect the 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 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 +3.98% over the last six months and -19.25% over the last year.

---

**The above commentaries reflect our views as at 11 June 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 28 November 2008 to 29 May 2009 and the twelve month period from 30 May 2008 to 29 May 2009 (source: Lipper Hindsight).**