

Market Commentary

June 2011

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Contents	Page
1. Economic and Investment Outlook	3
2. Equities	4
2.1. UK Equities	4
2.2. European (excluding UK) Equities	5
2.3. North American Equities	6
2.4. Japanese Equities	7
2.5. Asia Pacific (excluding Japanese) Equities	8
2.6. Emerging Markets Equities	9
3. Fixed Interest	10
4. Property	12
5. Cash	12

Risk Warnings

This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 10 June 2011. 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 Outlook

The global economy grew by 5.0% in 2010 and, according to forecasts by the IMF, it should grow by 4.4% in 2011. While this is a healthy rate of expansion, growth remains skewed towards the developing economies. More importantly, what growth there has been in developed economies has been achieved only with the support of ultra-accommodative monetary policies, including low interest rates and quantitative easing (QE). In the US, the implementation in late 2010 of a second tranche of quantitative easing, together with tax-focused fiscal stimulus, demonstrates that American policymakers believe that the economic recovery remains unsatisfactory. In the eurozone, crises in Greece, Ireland, and now Portugal have required EU and IMF intervention to head off sovereign default. In Japan, a concerted effort from the world's major central banks has been required to halt the strengthening yen in the wake of March's earthquake and resultant tsunami. By contrast, many emerging markets, notably those of the Far East and South America, are achieving strong economic growth without government support.

Looking to the remainder of 2011, the global economy is, in our view, likely to continue 'muddling through', much as it did in 2010. Risks remain, not least inflation driven by rising commodity prices. Central banks appear keen to put interest rate normalisation on the political agenda but are mindful of the fragility of economic growth. In Europe, despite the problems of the periphery, the eurozone's central bank, the ECB, became the first major central bank to raise interest rates in this economic cycle, albeit by only 0.25%. In emerging economies, inflation is also a serious threat and policy is being directed to ensure that it does not become entrenched. Other threats to the continuation of the recovery include: (i) a major disruption to oil supplies, caused by an escalation of conflict in Middle Eastern oil producing nations, (ii) a deepening of the eurozone crisis, this time perhaps engulfing major economies such as Spain and Italy and (iii) a sharp slowdown in China's economy. Notwithstanding these threats, we believe there is sufficient momentum in the global economy to justify a positive view on risk assets, including equities.

Selected Index Performance to 31 May 2011				
	6mth Return (£)	1yr Return (£)	6mth Return (LC)	1yr Return (LC)
FTSE All Share (UK)	10.81%	20.36%	10.81%	20.36%
FTSE Europe ex. UK	17.10%	24.25%	12.07%	20.14%
S&P 500 (US)	8.84%	11.18%	15.03%	25.95%
TOPIX (Japan)	-3.81%	-3.73%	-1.41%	-2.68%
FTSE All World Asia Pacific ex. Japan	5.07%	18.35%	5.53%	21.14%
FTSE All World Emerging Markets	2.18%	12.00%	7.99%	26.87%
FTSE UK Gilts 5-15 Years	1.77%	5.97%	1.77%	5.97%
FTSE UK Index Linked Gilts 5-15 Years	6.19%	10.39%	6.19%	10.39%
BarCap World Government Inflation Linked	4.36%	7.00%	4.36%	7.00%
BofA Merrill Lynch Sterling Corporate Bond	4.42%	8.68%	4.42%	8.68%
BofA Merrill Lynch Sterling Broad Market	2.87%	6.32%	2.87%	6.32%

The following sections discuss the outlook for selected markets and asset classes.

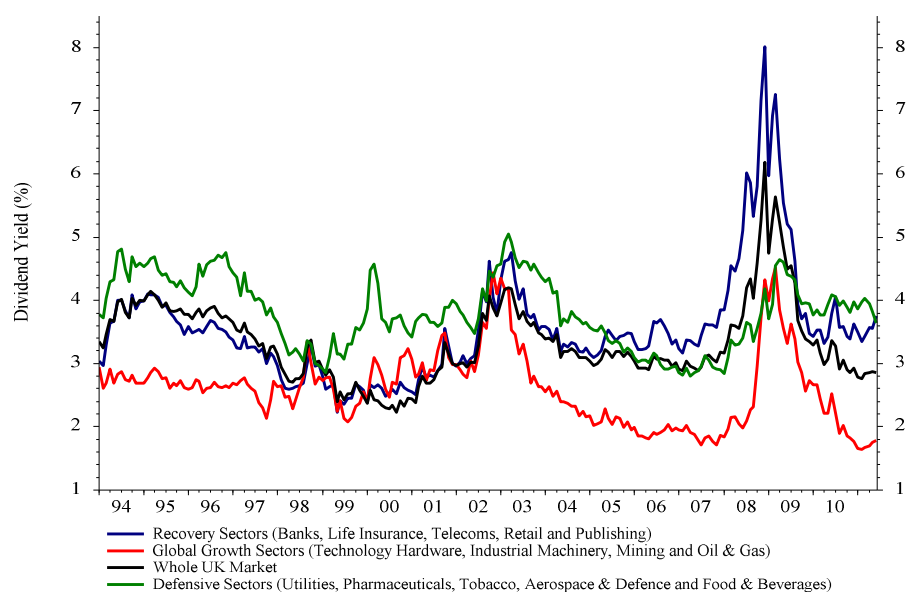
2. Equities

2.1. UK Equities

The UK economy expanded by 0.5% over the first quarter of 2011, following an equivalent contraction in GDP over the last three months of 2010. From here, the course of the economic recovery is hard to predict, with fiscal tightening and rising commodity prices weighing on growth. Loose monetary policy, meanwhile, is acting to support the recovery and we expect the Bank of England (BoE) to keep short term interest rates at historically low levels until growth becomes self-sustaining.

Regardless of the uncertain backdrop for the UK economy, it is important to note that just c25% of UK-listed companies' profits are derived from the domestic economy. Firms that generate the bulk of their revenues overseas, particularly in faster growing emerging economies, are enjoying strong earnings growth. While this provides a fundamental case to favour such stocks over their UK-centric peers, we remain mindful of valuation. Fig. 1 shows the dividend yield on the overall market (black), sectors of the market that are beneficiaries of strong global growth (red), non-cyclical, defensive sectors (green) and out-of-favour sectors with high dependence on the domestic economy (blue). This indicates that, on a c3% yield, the broad UK market offers reasonable value and that allocations to UK equities should be maintained. However, the yields on global growth stocks are now low relative to their own history and the market. This suggests that a continuation of strong earnings growth is largely priced in. In contrast, defensive stocks trade on high yields compared to their history and to the market, while out-of-favour recovery stocks also appear relatively cheap. We therefore believe that UK allocations should not be solely focused on overseas earners.

Fig. 1 Dividend Yield on UK Equities

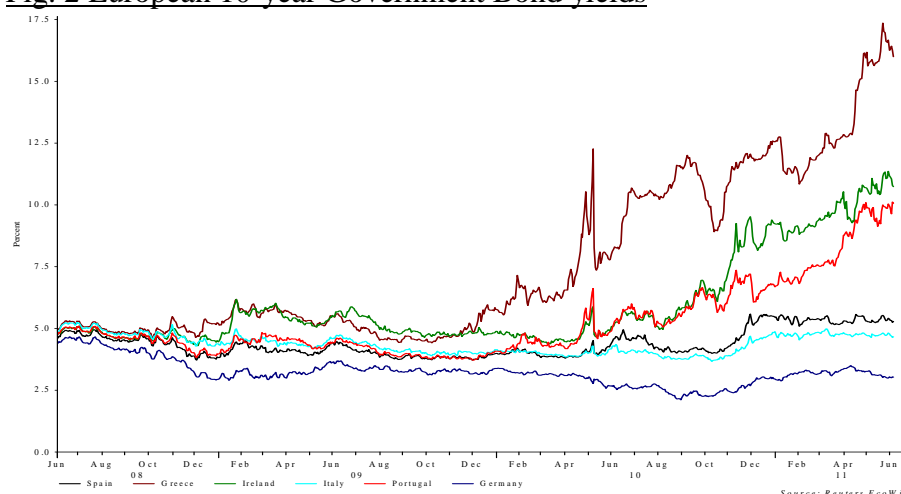


Source: Thomson Reuters Datastream

2.2. European (excluding UK) Equities

At the start of May, Portugal became the third eurozone economy, after Greece and Ireland, to agree a bail-out from the IMF and EU. The rescue plan includes loans of c€78bn and will require the Portuguese government to reduce its deficit from last year's 9.1% of GDP to 3% by 2013. Harsh austerity measures look certain for both public and private sector employees. Meanwhile, the ECB has backed the rolling over of Greek debt as a way of avoiding a technical default and directly involving the private sector in the country's financing. Yields on government debt issued by peripheral European economies reached record levels at the end of May before receding slightly (Fig. 2).

Fig. 2 European 10-year Government Bond yields



In April, the ECB delivered its first interest rate rise in three years, from 1.00% to 1.25%, the first of the major, developed market central banks to do so. This move was appropriate for the core eurozone countries such as Germany. Here, factory orders grew 2.8% in April as companies increased investment and hired staff to meet export demand, particularly from emerging Asian economies. Germany is keen not to see inflation becoming embedded and feeding through into broader wage growth, particularly given the country's unemployment rate of 7.0%, its lowest in 20 years. However, peripheral eurozone governments are likely to be less enthusiastic about the ECB's actions, remaining concerned that further rate rises could increase the chances of the weaker economies experiencing a prolonged period of stagflation or return to recession.

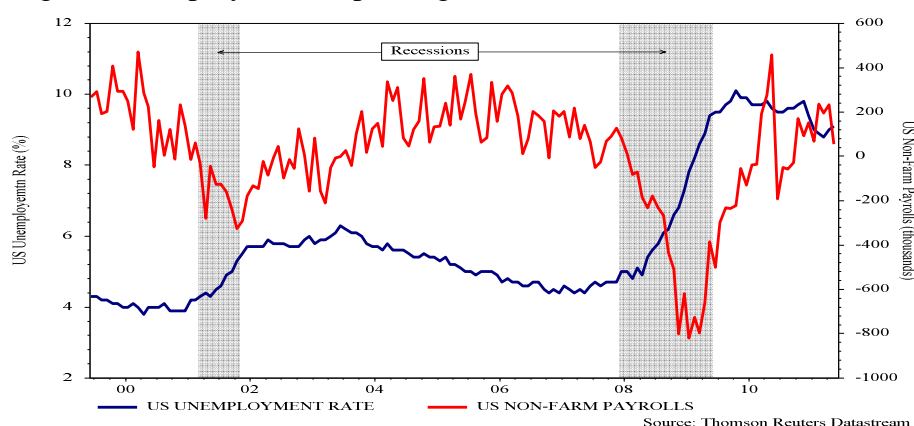
While news flow from the peripheral eurozone countries continues to dominate headlines, the core eurozone region hosts many companies that generate a significant proportion of their revenues in the US, Asia and emerging markets and therefore should be relatively immune from the persistent weakness in the periphery. Moreover, these companies are attractively valued relative to their history and global peers. We therefore recommend that current allocations to the region are maintained.

2.3. North American Equities

Despite setbacks to sentiment in the first quarter from natural disasters in Japan and political unrest in North Africa and the Middle East, the US equity market posted solid gains, and by the end of April had reached a three-year high. However, disappointing US economic data releases in May, coupled with uncertainty over the Fed's stance on further QE and concerns over the strength of the global recovery, has resulted in a moderate sell-off in the last month.

On the domestic front, the manufacturing sector, which has been notably strong, is beginning to slow, as supply disruptions from Japan impede production and high commodity prices temper demand. The recovery in the jobs market is also weakening, with the recent downward trend in initial jobless claims stalling, and the unemployment rate ticking back above 9.0%. Nonetheless, there has been significant improvement here, and one can take some encouragement from the fact that employers continue to add jobs, as seen by the eighth successive positive monthly reading of non-farm payrolls (Fig. 3).

Fig. 3 US Employment Improving



Despite the mixed economic backdrop, the corporate environment in the US remains strong. Analysts at Standard & Poor's forecast earnings of \$96 per share for the S&P 500 index in 2011, a new peak. Having undertaken significant cost-cutting in recent years, companies are operating with greater efficiency and have built considerable cash reserves. Encouragingly, we are starting to see corporate confidence displayed through management's willingness to deploy capital, with merger and acquisition (M&A) activity, dividends and share buybacks all on the rise.

With free cash flow yields at near record highs, we anticipate further M&A activity and dividend increases this year and next, which should be positive for US equities. Furthermore, given that the market is some c13% off its 2007 peak and earnings are forecast to reach new highs this year, we consider US equities an attractive asset class. We believe the US equity market is well placed to make progress and recommend that current allocations are maintained.

2.4. Japanese Equities

Data released in May revealed that the Japanese economy bounced back in April, suggesting that the impact of March's earthquake may not have been as bad as some analysts feared. Machine orders unexpectedly rose by almost 7% year on year (yoy), while the monthly trade deficit came in at c¥500bn (£3.8bn), significantly less than the consensus estimate of over ¥700bn. Inflation was stable at 0.3% yoy, as higher food and energy costs were offset by the deflationary effects of the natural disaster, while retail sales rebounded from an exceptionally weak March, up 4.1% on the month.

The situation at the Fukushima Dai-ichi nuclear power plant has been brought under control, although a complete shutdown of the reactors has proven difficult. It is now likely that the site will continue to release non-lethal levels of radiation over an extended period of time. The more pressing issue though is that Tokyo is forecast to have one of the hottest summers on record, and this should drive up power demand even as a large proportion of the city's generation capacity remains offline. Officials have asked individuals and companies to reduce their electricity consumption by 15%-25%. However, in the event that this fails, the state will mandate rolling blackouts to ration electricity, which industry leaders have warned will adversely affect economic activity in Tokyo (c40% of Japan's GDP).

Fig. 4 USD/JPY Exchange Rate



The Japanese yen remained strong against the US dollar as concerns over a slowdown in the US economy drove speculators back into "safe haven" currencies like the yen and the Swiss franc.

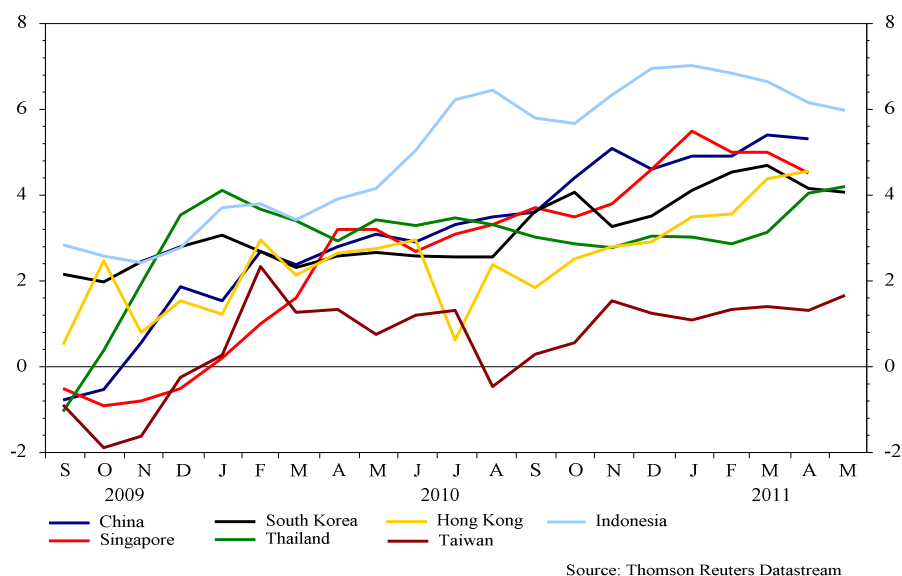
Japanese equities continue to trade on relatively low valuations compared to their international peers, however, this is reflective of the headwinds the economy faces. Recent events have not fundamentally altered our view on the investment prospects for Japan and we are not, therefore, recommending increased allocations.

2.5. Asia Pacific (excluding Japanese) Equities

The MSCI Asia Pacific ex. Japan index fell 3% in May as weak macro data from China and the US negatively impacted investor sentiment across the export-dependent Asian economic region. HSBC's purchasing managers' index slipped to a ten-month low of 51.6 in May, indicating a slowdown in business activity, while foreign direct investment rose just 15.2% yoy in April (much lower than the 36% growth expected), signalling a drop in overseas interest for Chinese assets. Credit ratings agency Moody's added to the overall downbeat outlook by following Standard & Poor's lead, warning that the US faced a downgrade to its AAA credit rating if politicians did not agree to raise the federal debt limit by the August deadline.

Inflation continues to be a key concern of governments in the region, as the cost of living (especially housing) is rising faster than wages, fuelling social discontent. A number of countries, including China and Singapore, have responded by enacting punitive taxes on property transactions. This increases the risk of future policy errors, potentially leading to a significant economic correction. The central banks of South Korea, Malaysia, Philippines and Thailand all raised interest rates by 25 basis points in the last month, and policymakers reiterated their commitment to keeping consumer price inflation in check. China is expected to raise interest rates in June, according to implied probabilities derived from the futures market (source: Bloomberg).

Fig. 5 Asian Consumer Price Inflation

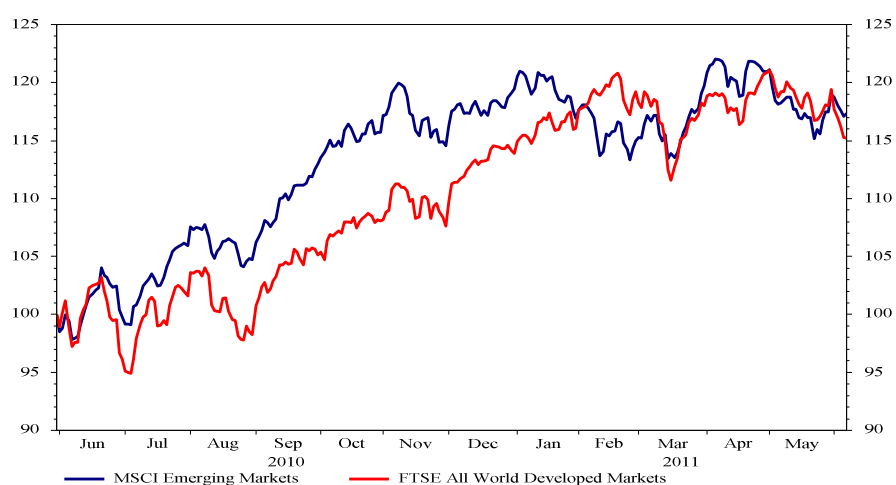


We are conscious that the risks of a correction (from market or policy-led factors) are significant, as valuations and inflation remain elevated. However, we would balance these concerns against the fact that the Asia Pacific ex. Japan region is still supported by strong economic fundamentals and growth factors (e.g. a rising middle class consumer). We recommend that current allocations to the sector are maintained.

2.6. Emerging Markets Equities

Emerging markets, as measured by the MSCI Emerging Markets index^{*}, underperformed their developed market counterparts in May. A rise in risk aversion during the month, due to an increasing probability that Greece will default on its debt and concerns regarding the strength of the economic recovery in the West, impacted global equity markets. Emerging markets have also been negatively impacted by inflationary pressures, mainly due to rising food prices and a surge in the price of crude oil over the last year. However, despite these headwinds, emerging markets have still outperformed Western equity markets over the last twelve months (Fig. 6).

Fig. 6 Emerging Markets vs. Developed Markets Performance



Source: Thomson Reuters Datastream

In an attempt to cool inflationary pressures, emerging market governments have increased interest rates and bank reserve requirement ratios, as well as imposing taxes on foreign investments. While these measures have proved effective in some countries, the larger, high growth economies have struggled to bring inflation under control. Inflation in China (5.3%), India (8.7%), Brazil (6.5%) and Russia (9.6%) remains elevated despite the central banks of these countries having tightened monetary policy over the last year.

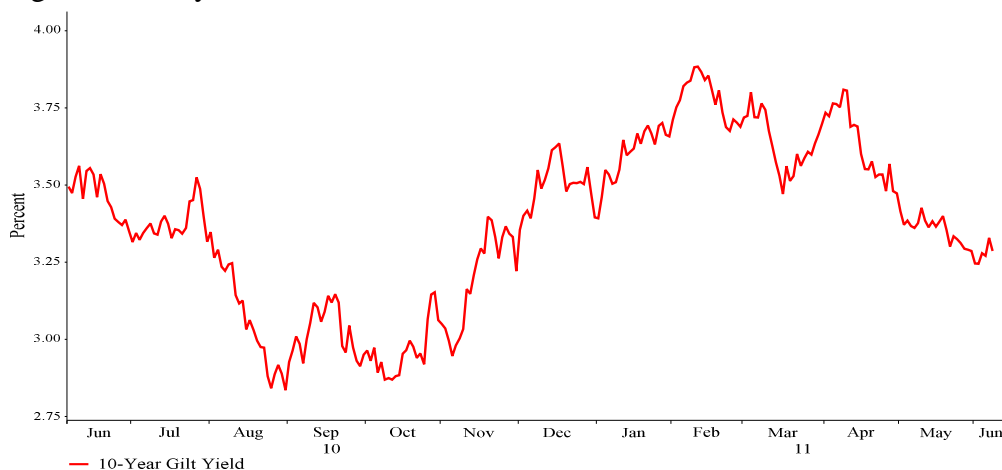
The continued inflationary pressures, along with the political turmoil in the Middle East, have reminded investors of the risks in emerging markets. However, the recent under-performance of the region's equity markets has made valuations more attractive and, based on historical earnings, emerging market equities now trade at a discount to both developed equity markets and their historical average. We view this valuation as fair and believe that emerging markets should continue to benefit from strong growth prospects and economic fundamentals, including favourable demographics. We therefore recommend that current allocations are maintained.

* MSCI includes 21 countries in its emerging markets index: Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

3. Fixed Interest

In the developed world, anaemic economic growth and relatively high inflation are sending conflicting signals to bond markets. The result is a high degree of volatility, as evidenced by movements in the benchmark 10-year gilt yield over the past year (Fig. 7). We believe that this volatility could continue for some time, though the historically low levels of government bond yields suggests that, over the longer term, the direction of yields will be upwards.

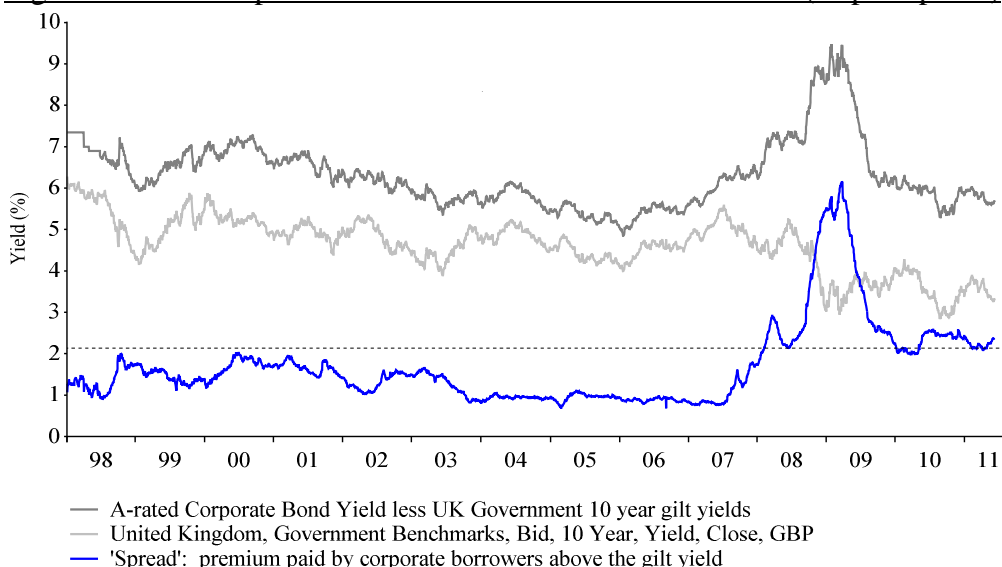
Fig. 7 Volatility in the 10-Year Gilt Yield



Source: Reuters EcoWin

We do not, therefore, recommend holding conventional gilts or bond funds that, through long duration (a measure of sensitivity to yield movements), are closely correlated to gilts. This includes investment grade corporate bonds, which had been our preferred area of the fixed income universe since January 2009. Fig. 8 shows that corporate bond yields are now close to the average level they have traded at over the past decade. However, this yield can be separated into two components: i) the underlying government bond yield and ii) the credit spread. The latter reflects the additional yield paid to compensate investors for the risk of default and the illiquidity of the bonds.

Fig. 8 A-Grade Corporate Bond Yield and 10-Year Gilt Yield (Gap = Spread)

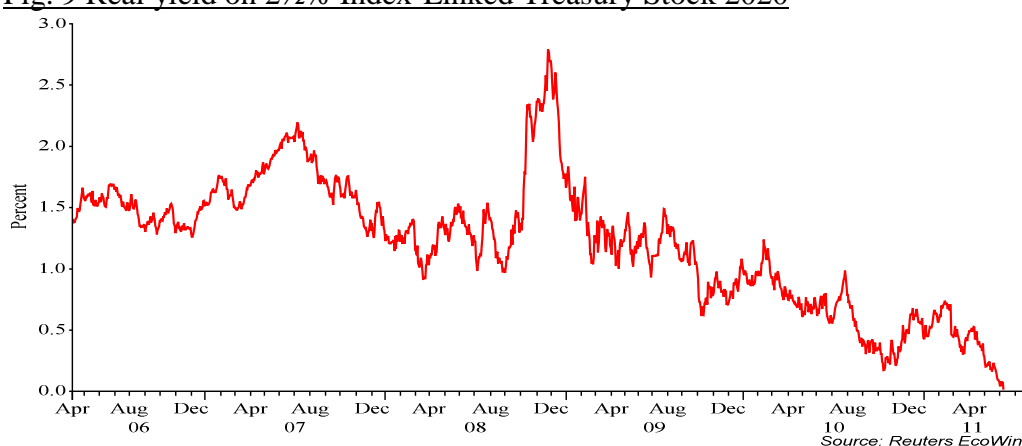


Source: Reuters EcoWin

Considering the above, the underlying gilt yield is unattractively low, but the credit spread remains wide relative to history. This leads us to favour “strategic” bond funds whose managers have the scope to separate these two sources of risk and return from portfolios of bonds, and capture the opportunities that they deem most attractive. At times of positive sentiment towards risk assets, this may be the credit spread on corporate bonds, though their flexible mandates also allow them to profit from falling government bond yields in times of risk aversion.

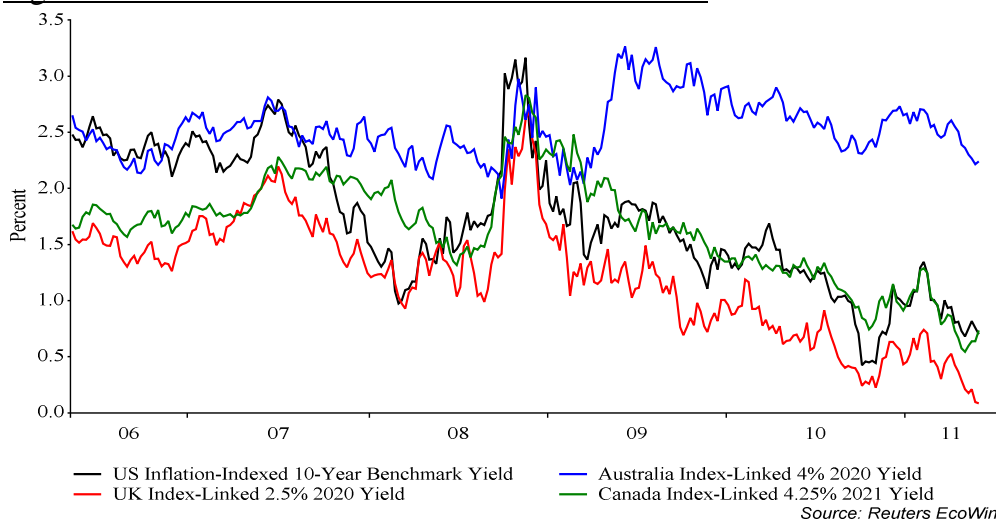
Another area of bond markets that we favour is index-linked bonds, where coupons and capital values are linked to measures of inflation. Historically, we have preferred index-linked gilts (ILGs), though now consider them to be trading at fair value. Fig. 9 shows that the real yield on the 2½% Index-Linked Treasury Stock 2020 is low relative to its own history.

Fig. 9 Real yield on 2½% Index-Linked Treasury Stock 2020



While real yields on ILGs remain low, we continue to recommend that, where appropriate, investors obtain inflation protection through sterling-hedged funds of global index-linked bonds. These provide access to bonds with significantly higher real yields than on their UK counterparts (see Fig. 10), and their managers may exploit duration and relative-value opportunities to add further value. Our view is that such funds will offer a degree of protection if real yields on ILGs revert to the levels at which they have traded in the past.

Fig. 10 Global Index-Linked Government Bond Yields



4. Property

The yield on the UK commercial property market has been virtually static at c6.5% since May 2010, reflecting limited capital growth and broadly flat rental values. In our view, this situation looks likely to persist for the remainder of 2011, with the occupational market outside central London remaining weak. The capital is much more integrated into the global economy than the rest of the UK, and is seeing strong occupier demand and rental growth, despite spending cuts and the recent weakness of the domestic economy. Outside London, and particularly in regions with high unemployment and a dependence on the public sector for jobs (such as Liverpool and Middlesbrough), the occupier market remains sluggish, with falling rents and high vacancy rates.

Turning to the investment market, the supply of prime quality assets popular with institutional and overseas investors remains limited. This is providing some support to current valuations. However, bank lending is still heavily rationed, particularly for properties in poorer locations and those with short leases, limiting the scope for leveraged buyers to enter the market and bid prices up. Banks (notably Lloyds, RBS and Irish “bad bank” NAMA) also hold a substantial number of property assets on their balance sheets that they are now starting to dispose of. However, while this may weigh on prices, the impact it would have on banks’ balance sheets gives us confidence that disposal programmes will be extended and orderly.

As long as the above concerns and uncertainties persist, we believe it remains appropriate for property allocations to be invested in funds of prime and near-prime UK commercial properties, whose managers can add value through refurbishments and relettings. Such asset management initiatives should help to provide stability of income and the potential for some capital growth over the medium term.

5. Cash

Sterling deposits and monies held in AAA-rated liquidity funds currently earn returns broadly in line with the BoE Bank Rate of 0.50% p.a. In comparison, consumer price inflation (CPI) reached 4.5% in April, while retail price inflation was recorded at 5.2% (RPI). Given the low real yields available on cash, we have recommended clients reduce the proportion held in portfolios in order to access higher yielding investments, primarily through increasing exposure to strategic bond funds.

The above commentaries reflect our views as at 10 June 2011. 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 November 2010 to 31 May 2011 and the twelve month period from 31 May 2010 to 31 May 2011 (source: Lipper Hindsight). LC = Return in Local Currency.