

# **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 3 March 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

Concerns that the US economy might be heading into recession continued to build through the early months of 2008. Closely watched indicators of sentiment, such as the ISM survey, have fallen to levels not seen since 2001 and employment data are also weakening.

The housing market is at the heart of the problems for the US. House prices, according to the Case-Shiller Home Price index, were almost 9% lower in the final quarter of 2007 compared to the previous year. With the number of repossessions rising and volumes in both new and existing home sales continuing to fall, there is little indication that price declines are nearing an end.

The crisis in financial markets is closely related to the woes of the housing market. Investors have lost confidence in synthetic bonds that have interest payments secured on mortgages (known as mortgage-backed securities). This has led to sharp price declines and the loss of liquidity in markets for such securities. Write-offs and major provisions against future losses at banks have followed, together with failures at hedge funds, such as Peloton, which employed leverage to gear up returns from portfolios of mortgage-backed securities.

The Federal Reserve (the Fed) is clearly concerned about the outlook for the US economy. Since August it has cut interest rates by 2.25%, including a dramatic 1.25% reduction in January alone. US interest rates now stand at 3.00% (compared to 5.25% in August 2007) and the likelihood remains that there will be further interest rate reductions in the coming months. Unlike the recession in the early years of the decade, however, Fed interest rate reductions are not easing the financial burden on heavily indebted US homeowners. This is because many US mortgages are fixed to 10-year bond yields, rather than short term interest rates. These bond yields have not fallen to the same extent as short term interest rates because bond investors have become concerned about the inflationary threat of rising commodity prices and a rapidly weakening US dollar.

Another factor making the job of central bankers more difficult at present is the contraction of credit availability. Bank asset write-offs and provisions, together with investors' loss of confidence in many types of non-government securities, mean that financing – so readily available until recently – is now harder to find. Banks are preserving liquidity in order to rebuild damaged reserve ratios, while access to financing from bond markets is being denied to all but the most credit-worthy borrowers. These factors are combining to undermine, at least to some degree, the impact of interest rate reductions.

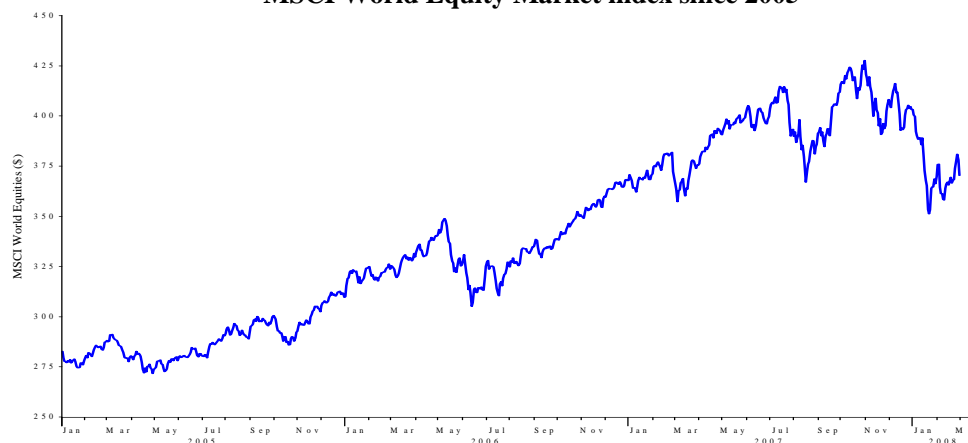
The dislocation in credit markets has its roots in the excessive use of leverage to gear the returns from investments generating stable cash flows, such as property and corporate bonds. The result has been that valuations on commercial property, non-government fixed income securities and many other assets were driven to unsustainable levels by leveraged investors. By contrast, equity valuations (based on price to earnings ratios), have not moved far above their long term average. However, equities are clearly impacted by (a) losses at financial institutions and (b) slower company earnings growth as the pace of economic expansion declines - hence the late, but substantial, correction in equity prices. Since the recent peak at the end of October, equities, as measured by the MSCI World Equity Market index, had fallen by 18% by late January. A partial recovery left equities down just over 13% by the end of February. In monetary terms, this amounts to some \$5,000bn being wiped off the value of global equity markets in just four months.

Equities now join commercial property and high-yield corporate bonds on investors' list of 'least favoured' asset classes. This situation is not new; we reached the same point in the last business cycle in 2002. Investors are now focusing on the defensive qualities of cash and government bonds and the protection offered by absolute return funds. Such an investment landscape will offer opportunities for value-orientated investors in 2008.

With December's reduction in European equity allocations, client portfolios now have high 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 through 2008.

The MSCI World Equity Market index has provided a total return of -4.63% over the last six months and -1.51% over the last year.

**MSCI World Equity Market index since 2005**



## 2. Equities

### 2.1. UK Equities

The pace of UK economic growth is slowing rapidly. This is evident in falling house prices, declining consumer confidence and weakening retail sales. To mitigate the impact of the slowdown, the Bank of England (the BoE) has reduced interest rates by 0.50% to 5.25%.

The full effects of the dislocation in financial markets on credit availability is not yet fully clear, but reports of tighter lending standards and more stringent credit scoring by the banks are already apparent. Tighter credit terms for both businesses and consumers fully justify further interest rate reductions by the BoE. However, its scope to implement further rate cuts will depend, at least in part, on the path of inflation. Data for January showed the consumer price inflation (CPI) at 2.2%, marginally above the BoE's target rate of 2.0%. Retail prices inflation, the measure used for inflation-linked bonds, is nearly double CPI, at 4.1%. This upward pressure on prices stems from higher energy and food prices, which have been driven by international factors such as rapid growth in emerging economies. It is vital for UK economic growth that inflation subsides over the course of the year, freeing the hand of the BoE to deliver interest rate cuts as necessary. While inflationary pressures should ease as declining global economic growth acts to slow demand for resources, strong demand for commodities from the Asia Pacific region, together with an element of speculation, have so far kept prices high. This is unhelpful for the BoE, and may act to hold interest rates higher than otherwise necessary, causing a longer, or steeper economic slowdown.

Turning to equities, strong returns until mid-2007 were driven by supportive economic growth conditions, and the return of a degree of pricing power to companies. 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, UK equities did not become expensive in terms of price to earnings ratios. After the recent falls, UK equities are, on first inspection, more attractively valued than they have been for several years. However, we are mindful that with growth slowing and the credit markets impaired, the earnings outlook for companies is becoming less favourable. Our view is, therefore, that there will be better opportunities to add to holdings in the coming months. In the meantime, we recommend that current allocations to UK equities are maintained.

The FTSE All Share index has provided a total return of -6.55% over the last six months and -2.66% over the last year.

## 2.2. European (excluding UK) Equities

Continental Europe has been our favoured destination for international equity allocations since 2004. This has proved very profitable, with European (ex UK) equities outperforming those of the US, UK and Japan over the last three years.

Many of the factors that have 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. As a result, we recommended a reduction in allocations to European equities at the end of last year.

One of the main reasons for this change of view was the recent strength of the 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 cause of this euro strength is the European Central Bank's reputation for taking no risks with inflation by holding interest rates higher than might otherwise be the case. With rates falling in the US and UK, delays in rate cuts in Europe risk driving the euro higher still, making any slowdown in the European economy more acute.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -13.16% over the last six months (-1.94% sterling adjusted) and -7.48% over the last year (+4.75% sterling adjusted).

### 2.3. North American Equities

The US is at the epicentre of the current economic turmoil. After years of strongly rising prices, the US housing market is now weakening rapidly as the easy access to mortgage finance, which fuelled much of the boom, is withdrawn. The economy was already slowing in response to the monetary tightening that took interest rates from 1.00% to 5.25% in the two years to mid-2006. Declining house prices and reduced access to credit have only exacerbated this slowdown.

Interest rates have already been pared back by a full 2.25% since August, demonstrating that the Fed is ready to take aggressive action to avert a recession. Whether it succeeds or not will depend on several factors, including how deeply rooted the sub-prime related issues are, the resilience of the job market, the impact of falling house prices on consumer behaviour and the extent to which economic activity outside the US remains healthy.

Our recommended portfolios hold only small allocations to US equities. We believe that these should be maintained for the present.

The S&P 500 index provided, in US dollar terms, a total return of -8.79% over the last six months (-7.52% sterling adjusted) and -3.60% over the last year (-5.03% sterling adjusted).

## 2.4. Japanese Equities

The performance of both the Japanese economy and stock market continues to disappoint. While overall growth has been fairly steady, domestic consumption remains weak, and stubbornly low inflation continues to frustrate the Bank of Japan's policy aim of gradually increasing interest rates. However, the crisis in credit markets has brought about a sea-change 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. The reduced availability of speculative capital, together with 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 yen has appreciated by 10.29% against the dollar and by 11.60% against sterling over the last six months.

While an appreciating yen is beneficial for sterling based holders of Japanese assets, it is not helpful for the export-orientated Japanese economy. Slowing world growth is also an unwelcome development for Japan's export sector. These factors mean that the long-awaited strong performance from Japanese equities may, yet again, be delayed. However, Japanese companies have almost no exposure to the credit-related problems besetting other economies and Japanese equities are looking very good value, relative to other markets, historical valuations and Japanese government bonds. We therefore recommend current allocations to Japanese equities are maintained.

The FTSE Japan index provided, in yen terms, a total return of -16.79% over the last six months (-6.05% sterling adjusted) and -22.95% over the last year (-13.61% sterling adjusted).

## 2.5. Asia Pacific (excluding Japanese) Equities

The performance of the economies of the Asia Pacific (ex Japan) region remains impressive. The economies of South Korea, Hong Kong and Taiwan are all estimated to have grown by close to 5% in 2007 while Singapore is expanding even faster, with a growth rate of approaching 8%. 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. Additionally, 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. Large speculative capital flows, however, mean that the Asia Pacific equity markets remain among the most volatile in the world and, after strong upward moves, these markets are no longer cheap. It also remains to be seen whether the economies of the region will continue to be unaffected by the slowdown in the west.

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 +3.13% over the last six months and +18.75% over the last year (for sterling based investors).

## 2.6. Emerging Markets Equities

Emerging markets equities rose very strongly through the four-year global equity bull market, driven, at least in part, by strong economic growth and rising domestic consumption. These improving fundamentals remain in place; expanding economies have driven up employment and income, thereby creating a virtuous circle of consumer demand and further strong growth.

Investors are currently favouring the markets of the 'BRIC' economies: Brazil, Russia, India and China. While these economies are exhibiting very strong growth, we are concerned that investor appetite, particularly for Indian and Chinese shares, is taking on speculative proportions. Valuations look quite high and we are cautious about recommending further allocations to BRIC funds at present. Elsewhere within emerging markets, we are maintaining current allocations, while remaining mindful that the current pace of appreciation in equity prices is unlikely to be sustained.

The FTSE All-World Emerging index provided a total return of +10.02% over the last six months and +31.77% over the last year (for sterling based investors).

### 3. Fixed Interest

Fixed interest investments did not fare particularly well in the early part of 2007 as strong economic growth drove interest rates higher. Since that time, however, government bond yields have fallen back in anticipation of slowing economic growth, and therefore lower interest rates. Government bonds have also benefited from 'safe haven' status amid the turbulence in credit markets and have fully demonstrated their value to investors as the most effective portfolio risk diversifier. In contrast, corporate and non-investment grade bonds have suffered from decreasing risk appetite amongst fixed interest investors.

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 UK government bonds. This view has been fully vindicated by recent developments, which have seen spreads widen very rapidly. We are closely monitoring corporate and non-investment grade bond yields relative to those available on government bonds, with the view to increasing allocations to the non-government sector when valuations become compelling.

The ABI UK Pension Gilt sector provided a total return of +3.76% over the last six months and +3.06% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +6.82% over the last six months and +7.63% over the last year.

#### 4. Property

After several years of strong returns, investors in UK commercial property have suffered a major setback. In recent years, bank borrowing has been increasingly used to fund property purchases. However, the availability, at low cost, of abundant debt financing had driven prices up to levels where yield-based valuations looked extremely stretched. Mid-2007 saw an abrupt reduction in the willingness of banks to lend at low rates against property purchases, which, together with reduced appetites for risk among investors, has served to undermine commercial property valuations.

Our Investment Bulletin of October 2006 set out our view that commercial property prices could suffer a period of consolidation as yields were forced back up 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 and 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 turning more positive towards commercial property at some point in 2008.

The ABI UK Pension Direct Property index provided a total return of -11.86% over the last six months and -15.34% over the last year.

#### 5. Cash

Sterling cash deposits, earning approximately 5.25% p.a. at present, are attractive relative to the yields currently available on fixed interest or commercial property. While UK interest rates will probably continue to fall in 2008, we still 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). They also bring flexibility to portfolios, enabling investors to take advantage of opportunities in other asset classes as and when they arise.

## 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 also areas where we believe investors should demand more clarity.

The much publicised demise of the London-based hedge fund group, Peloton, 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 last month. 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.

For completeness, we have quoted below performance figures for hedge funds using the widely followed HFRX Global Hedge Fund Index. We are, as might be expected, somewhat sceptical about the integrity of these figures. 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 continue to submit numbers for inclusion in the index.

The HFRX Global Hedge Fund GBP index provided a total return in sterling of +1.65% over the last six months and +3.18% over the last year.

N. B. Unless otherwise noted, all performance figures are total returns (including income re-invested) for the six month period from 31 August 2007 to 29 February 2008 and the twelve month period from 28 February 2007 to 29 February 2008 (source: Lipper Hindsight).