Market Commentary

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Saunderson House Limited
1 Long Lane
London EC1A 9HF

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

SAUNDERSON HOUSE

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1. Economic Outlook

Optimism about the strength of the global economic recovery began to falter in the second quarter of the year, and by late summer had almost entirely evaporated. The likely catalysts for this fall in confidence include rising concerns about the sustainability of sovereign debt burdens, weaker business confidence surveys and disappointing employment data, in both the US and Europe. All these data suggested that the developed world could experience its second recession in three years.

A resumption of recessionary conditions could be brought about by Greece (or perhaps even Italy) defaulting on its sovereign debt and setting off a chain of events similar to those seen in 2008's financial crisis. That crisis was triggered by a collapse in confidence in the banking system, which undermined credit markets and came close to bringing down the global financial system. While not impossible, we regard another full-blown crisis as unlikely. Central banks and governments today have the tools to address the issues, as we have seen with the European Central Bank's (ECB) ongoing purchases of peripheral eurozone sovereign debt, and with October's plan by eurozone member states to write down Greek debt and recapitalise banks.

Thus, it remains our central case that developed economies can avoid a slide back into financial crisis and recession, enduring instead an extended period of uneven and lacklustre growth. Our conviction in this view is bolstered by the support from robust growth in the emerging market economies, which provides demand for Western goods and services. This, combined with the maintenance of interest rates at exceptionally low levels and further monetary policy action in the developed world, should counteract the recessionary forces of a deleveraging consumer and macroeconomic rebalancing.

The challenging economic conditions faced by the developed world have their origin in the accession of China and India to the free market part of the global economy, causing a shock to the market for goods and services on a scale never before seen. We doubt the adjustments to this shock are likely to be completed within a timescale of a few years.

Selected Index Performance to 31 October 2011

	6mth Return (£)	1yr Return (£)	6mth Return (LC)	1yr Return (LC)
FTSE All Share (UK)	-7.76	0.63	-7.76	0.63
FTSE Europe ex. UK	-19.06	-9.31	-16.69	-8.76
S&P 500 (US)	-4.01	7.06	-7.11	8.09
TOPIX (Japan)	-2.46	-1.30	-9.29	-3.54
FTSE All World Asia Pacific ex. Japan	-10.73	-4.75	-11.14	-5.61
FTSE All World Emerging Markets	-12.49	-9.60	-15.31	-8.73
FTSE UK Gilts 5-15 Years	10.35	9.76	10.35	9.76
FTSE UK Index Linked Gilts 5-15 Years	8.57	12.50	8.57	12.50
BarCap World Government Inflation Linked	4.99	6.76	4.99	6.76
BofA Merrill Lynch Sterling Corporate Bond	2.25	3.52	2.25	3.52
BofA Merrill Lynch Sterling Broad Market	8.09	8.66	8.09	8.66

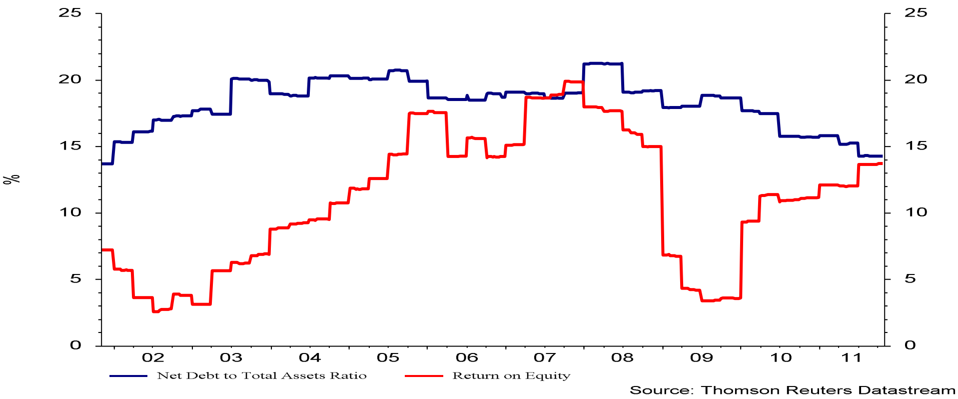
The following sections discuss the outlook for selected markets and asset classes.

2. Equities

2.1. UK Equities

The sharp fall in UK equity prices since early July highlights the sensitivity of quoted company valuations to global economic and political factors, regardless of their underlying profitability. While austerity measures and debt overhangs are likely to weigh on US and European economic growth (as we have seen in the UK over the past year), the extent to which this will undermine UK corporate profits is less clear. Having substantially reduced their costs during the recession, company managers have been reluctant to put costs back in before seeing stronger end demand. This has left many companies lean and generating healthy profits, allowing them to strengthen their balance sheets (see Fig. 1). As a result, the corporate sector is now better placed to weather the challenging economic environment.

Fig. 1 UK corporate leverage falling and profitability rising

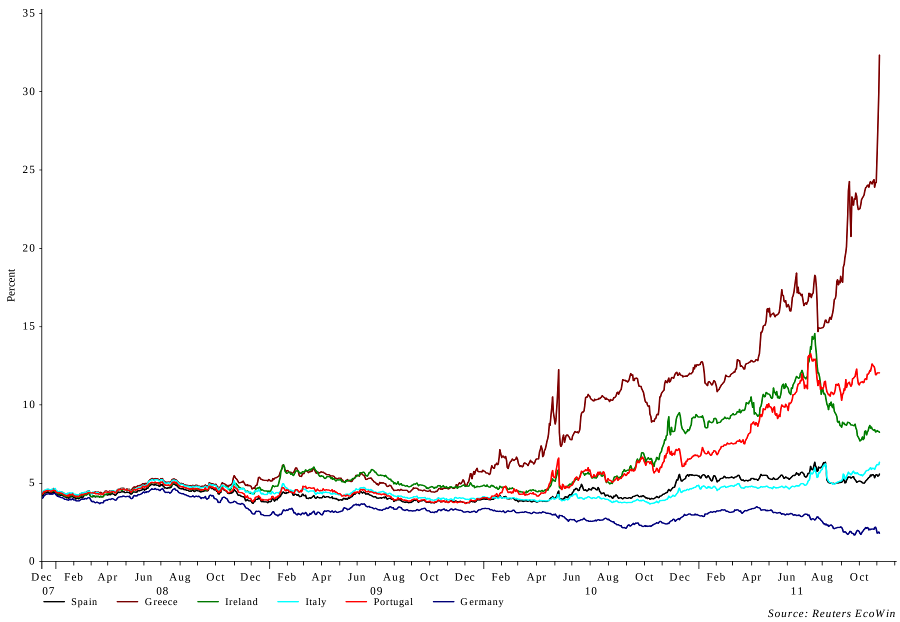


The UK market is currently trading on a forward price-to-earnings (PE) ratio of c10 times. This is attractive when compared to a long term average PE of c14 times. In addition, dividends are high compared to yields on other asset classes, particularly cash and gilts. Equities, therefore, appear to offer a reasonable margin of safety; Standard Life Investments estimates that the market is currently discounting a c30% drop in earnings. To put this into context, earnings only fell c25% during the last recession. While such a decline in profitability is not impossible, we consider it unlikely. Companies overall are less leveraged than in 2008-09 and corporate failures during that period have removed some excess capacity. Aggressive austerity by Western governments and consumers resulting in a sharp fall in global trade and growth could, however, trigger such an earnings fall. In this scenario, less economically sensitive companies should perform best, as they have done over the summer, but our central expectation is for consumers to gradually repair their balance sheets. Mindful of the risks of this scenario, however, we recommend that some defensive UK equity funds are retained, though we believe that, with the assumption of weak growth now priced in, funds of more cyclically exposed companies offer the potential for stronger returns. We therefore recommend that UK equity allocations are maintained, with a tilt towards value funds.

2.2. European (excluding UK) Equities

The eurozone sovereign debt crisis has continued to dominate headlines in recent months. The latest plan to halt contagion from Greece to the wider financial system and avoid triggering another banking crisis includes leveraging of the European Financial Stability Facility (EFSF) from the current €440bn to €1trn, a 50% write down of Greek sovereign debt, and a recapitalisation of European banks. While this latest effort at addressing the crisis is encouraging, and was initially taken well by markets, the exact details of the plan remain vague, particularly on how to stimulate growth in peripheral eurozone economies. It is likely that further intervention will be required in order to convince investors that a full-blown crisis has been avoided, and until a long term feasible solution is unveiled by the EU/IMF/ECB "troika", we are likely to see further pressure on peripheral eurozone sovereign debt (see Fig. 2) and continued high levels of volatility in European equity markets.

Fig. 2 European 10-year Government Bond Yields

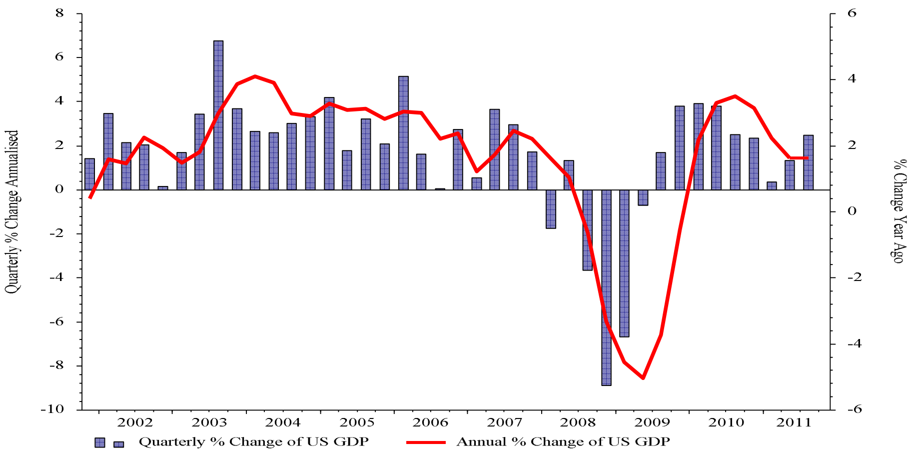


Despite the elevated political risks in the region, the majority of European companies are in good financial shape, with strong balance sheets, good cash generation and robust business models able to act as a buffer to economic headwinds. The core eurozone region hosts many quality franchises generating a significant proportion of their revenues overseas, such as Volkswagen, SAP and LVMH. Investors have sold these indiscriminately in recent months, leaving valuations looking increasingly attractive relative to history and other asset classes. This presents an opportunity to increase allocations to an unloved and seemingly oversold asset class. However, for now, we recommend that current allocations to the region are maintained until a more comprehensive solution to the debt crisis has been found.

2.3. North American Equities

Optimism regarding the outlook for the US economy at the beginning of the year has largely failed to materialise, with the jobs market and housing market both disappointing. The sharp declines seen in the equity market, however, discount a much bleaker economic backdrop. Investors have been quick to price in the risks of poor budgetary discipline in the US and the failure to reach a resolution to the debt problems in the eurozone, but have been less willing to merit strong corporate earnings and the positive economic data that there has been. US GDP growth, for example, was recorded at an annualised 2.5% for the third quarter (see Fig. 3), driven by a 2.4% p.a. increase in consumer spending and a 16.3% p.a. improvement in business spending.

Fig. 3 US GDP Growth



Source: Thomson Reuters Datastream

Cognisant of the slow progress made by the economy, the Federal Reserve (Fed) and US government have announced a raft of stimulus measures to support growth. The Fed has stated its intention to keep benchmark interest rates "exceptionally low" until at least mid-2013, while it has also disclosed a new monetary policy programme dubbed 'Operation Twist', designed to lower the cost of long-term funding. President Barack Obama's proposed $447bn finance bill known as the 'American Jobs Act', meanwhile, has failed to win support, though its intent is apparent and alternative plans are being looked at.

Turning to the corporate environment, US companies continue to report forecast-beating earnings, which at current prices support already attractive valuations. Standard & Poor's predicts earnings for the S&P 500 will reach a new peak of $98 per share by the year-end, giving the index a forecasted PE ratio, based on current prices, of 12.7 times, which is more than 20% below its post-war average. Earnings for 2012, meanwhile, are forecast to grow by c10% to $109 per share. With the market some c20% below its 2007 peak and earnings forecast to reach new highs this year, we believe US equities are well placed to make progress. However, mindful of the headwinds facing the economy, we recommend that current allocations are maintained.

2.4. Japanese Equities

Japan's stock market has been weak over 2011 to date, largely due to the effects of the major earthquake and subsequent tsunami in March. The second half of the year has also been highly volatile, with investors swinging between hope and fear as the unfolding eurozone debt crisis threatened to engulf larger economies such as Italy and Spain. Since the start of the year, the benchmark Nikkei 225 index has fallen c13% in local currency terms (and 8% in sterling terms), underperforming the MSCI World index of global equities, which has fallen c3%.

The latest Bank of Japan Tankan survey, released on 3 October, revealed that business sentiment among large manufacturers recovered somewhat in the third quarter of 2011, with firms planning to increase capital expenditure by 3% on average in the fiscal year to March 2012. However, the survey also noted that management optimism was generally tempered by concerns over a strong yen and the ongoing eurozone debt crisis.

Fig. 4 USD/JPY Exchange Rate, Year to Date

Macroeconomic uncertainty and market volatility has driven demand for perceived "safe haven investments", including the Japanese currency. As a result, the yen has remained very strong relative to Japan's major trading partners (refer to Fig. 4), averaging about the 76.0¥/$ level over the month of October. This is significantly stronger than the median 81.1¥/$ level budgeted for by major industrial companies, as reported in the recent Tankan survey. However, on 31 October, the Bank of Japan intervened in foreign exchange markets, acting on orders from the Ministry of Finance, after the yen hit a post-war high against the US dollar of 75.35¥/$. The yen/dollar exchange rate has averaged about the 78.0¥/$ level since the intervention.

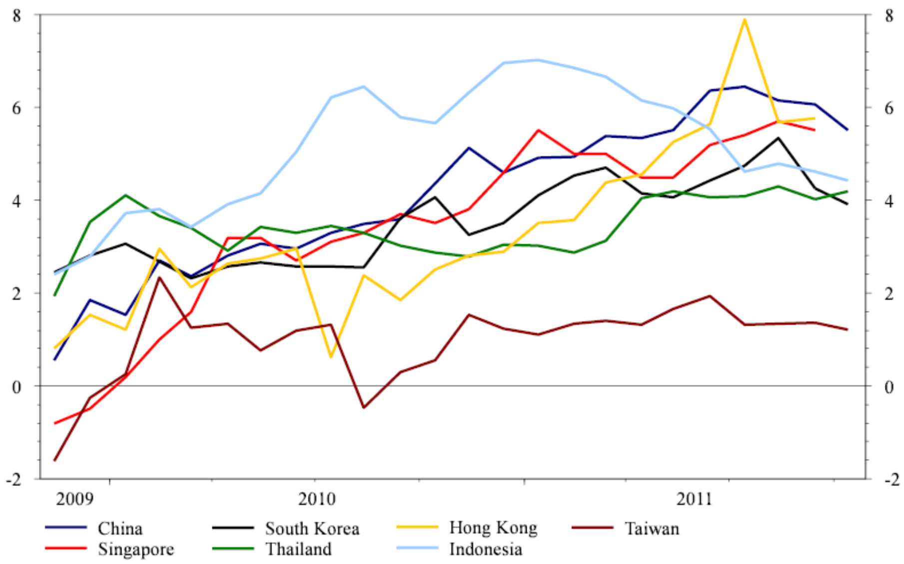
Japanese equities continue to trade on relatively low valuations compared to their international peers, though this is reflective of the headwinds faced by the Japanese economy. Recent events have not fundamentally altered our view on the investment prospects for Japan and we are not, therefore, recommending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

2.5. Asia Pacific (excluding Japanese) Equities

Over the course of this year, the MSCI Asia Pacific ex. Japan index has fallen c9%, underperforming global equity markets, as represented by the MSCI World index, which have fallen by c3%. Regional equities have fallen as expectations of a worldwide double-dip recession have risen. Negative sentiment has been fuelled, in large part, by the inability of EU leaders to forge a credible solution to the eurozone debt crisis, and to put a floor under this issue. While economic growth in Asia remains strong, doubts are beginning to surface. For example, China's PMI manufacturing index – a leading indicator of economic activity – unexpectedly fell to 50.4 in October from 51.2 in September. China's Q3 GDP also grew by a less than expected rate of 9.1% yoy, adding to concerns that the Chinese economy, a major driver of global growth, may be starting to falter.

Asian policymakers have been in monetary tightening mode for much of this year, attempting to rein in the cost of living by targeting food and house price inflation. However, recent moves by the Indonesian and Australian central banks to cut interest rates suggest that we may have reached an inflexion point in the region's monetary policy cycle. Official data suggests that inflation is slowing, or has stopped rising, in a number of Asian economies, most importantly China (see Fig. 5).

<u>Fig. 5 Asian Consumer Price Inflation</u>



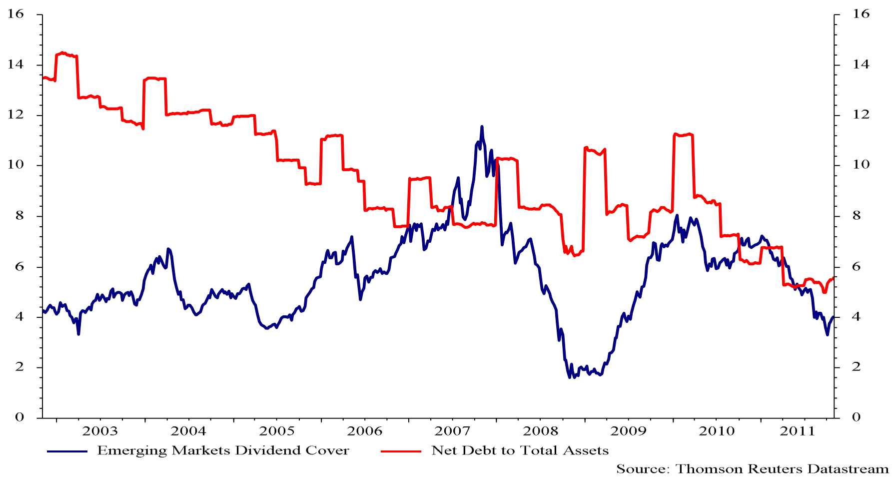
We are conscious that the risk of further market corrections exists as, despite signs that regional inflation may be peaking, interest rates still have room to rise and market volatility remains elevated. In addition, the weak outlook for global growth and the risk of policy error in China remain key concerns. However, we would balance these risks against the fact that the Asia Pacific ex. Japan region is still supported by sound, longer-term economic fundamentals and structural growth factors (e.g. a rising middle class consumer). We recommend that current allocations to the region are maintained.

2.6. Emerging Markets Equities

Emerging market equities, as measured by the MSCI Emerging Markets index*, have fallen sharply over the course of the last twelve months. Geopolitical tensions in the Middle East and North Africa, and concerns over rising inflation and interest rates featured prominently in the first half of 2011. More recently, the eurozone debt crisis and concerns that global growth may be slowing has taken centre stage. While there is no disputing the favourable economic fundamentals of, and long-term growth prospects for, the developing world, investors have tended to ignore these and focus instead on short-term uncertainty.

While emerging market economies continue to show strength in the uncertain global environment, recent data has begun to disappoint. Third quarter growth and manufacturing data releases in China both came in below analyst estimates, reinforcing concerns that the world's second largest economy may be slowing. Emerging market corporates, meanwhile, have started to come under pressure, with profit margins falling due to rising input costs (driven by higher commodity prices) and a slowing of revenue growth. However, in an attempt to strengthen their balance sheets, companies have been reducing debt and maintaining high levels of cash (see Fig. 6). This indicates that companies should be well positioned to cope with any short-term pressures as a result of renewed economic weakness.

Fig. 6 Dividend Cover and Net Debt to Total Assets



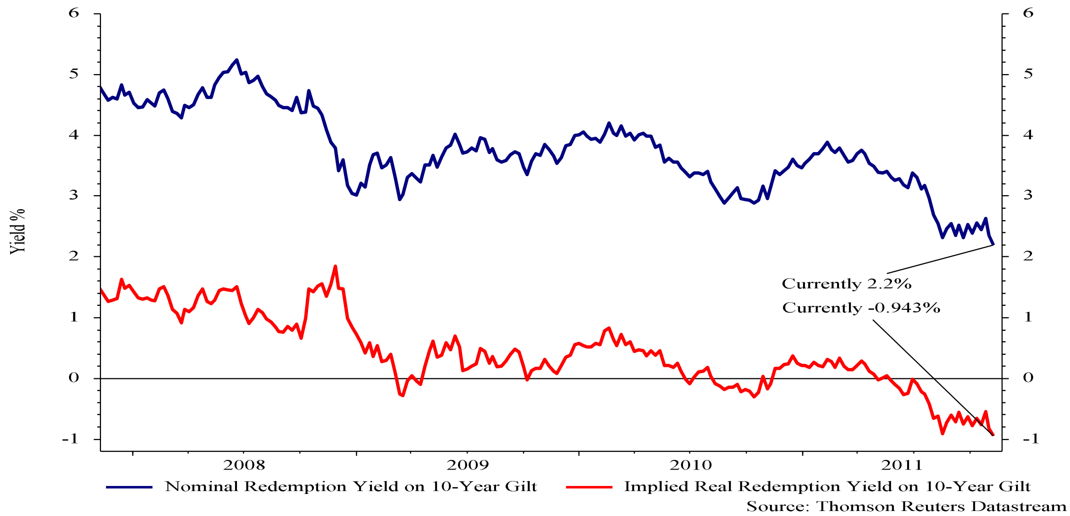
The recent weakness in emerging market equities has caused valuations to fall to attractive levels. The dividend yield is currently 2.9% (versus a 10-year average of c2.5%), while the PE ratio is below 12 times (versus a 5-year average of c14 times). Although we believe that valuations are now offering good value, we are cautious of increasing allocations until global macroeconomic uncertainties ease. We therefore recommend that current allocations are maintained.

* The MSCI Emerging Markets index 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

The weakening of global economic data, combined with political inertia in the US and eurozone, has triggered a flight to quality within fixed interest markets. One beneficiary of this has been the UK gilt market, where the yield on the 10-year benchmark issue fell to a low of 2.20% in mid-September. Yields have since risen from and fallen back to this level (refer to Fig. 7). At c2.20%, adjusting for anticipated inflation (derived from the 10-year inflation swap rate), the real yield on the 10-year benchmark gilt is -0.94%. US and German government bonds have also benefited from 'safe haven' status, despite the former's credit rating downgrade by S&P to AA+ in August, and the 10-year issues of both countries now also trade on negative real yields.

Fig. 7 Nominal and Real Yields on the 10-Year Gilt

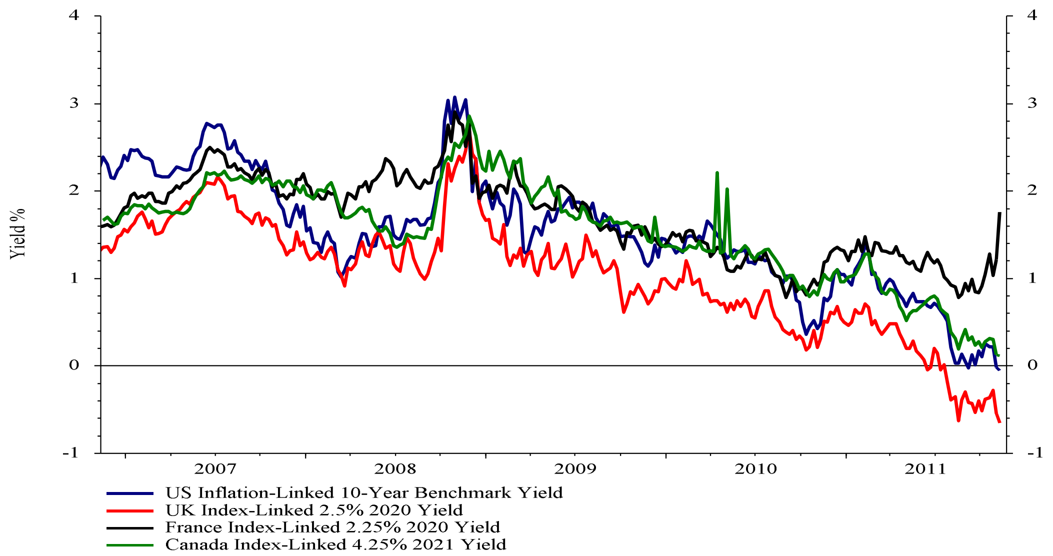


On such low yields, these bonds are only attractive if the economic picture deteriorates further and inflation expectations fall sharply. Given extremely accommodative monetary policy in the developed world, with a second round of quantitative easing (QE) announced last month by the Bank of England, and the Fed open to further QE in the US, we believe that such a severe deterioration is likely to be avoided. If economies manage to "muddle through", or endure only a modest contraction in growth, we believe that core Western government bonds could perform poorly as investors regain their appetite for risk. We therefore continue to recommend zero allocations to conventional government bonds.

Where we do still see an opportunity in government bonds is via inflation-linked issues. Although the real yields on UK index-linked gilts (ILGs) are all currently below 0.5%, with some in negative territory, we consider it plausible that inflation in the Western world, particularly the UK, could continue to surprise on the upside in the medium term. This view is driven by the exceptionally low level of interest rates, in conjunction with the use of QE, to increase the quantity of money in circulation. These actions, combined with the fact that a dose of higher inflation would be helpful for governments that need to bring their debt to GDP ratios down, lead us to believe that inflation-linked bonds still merit a place in portfolios, despite their low real yields.

We also believe that, with UK ILGs currently offering particularly low yields, (thanks in large part to strong institutional demand), investors should hold some of their inflation-linked allocations in funds of overseas government bonds. Fig. 8 shows the additional yield available on US, French and Canadian inflation-linked bonds of similar maturity relative to their UK counterparts. In addition to this yield pick-up, the managers of these funds can exploit duration and relative-value opportunities. 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.

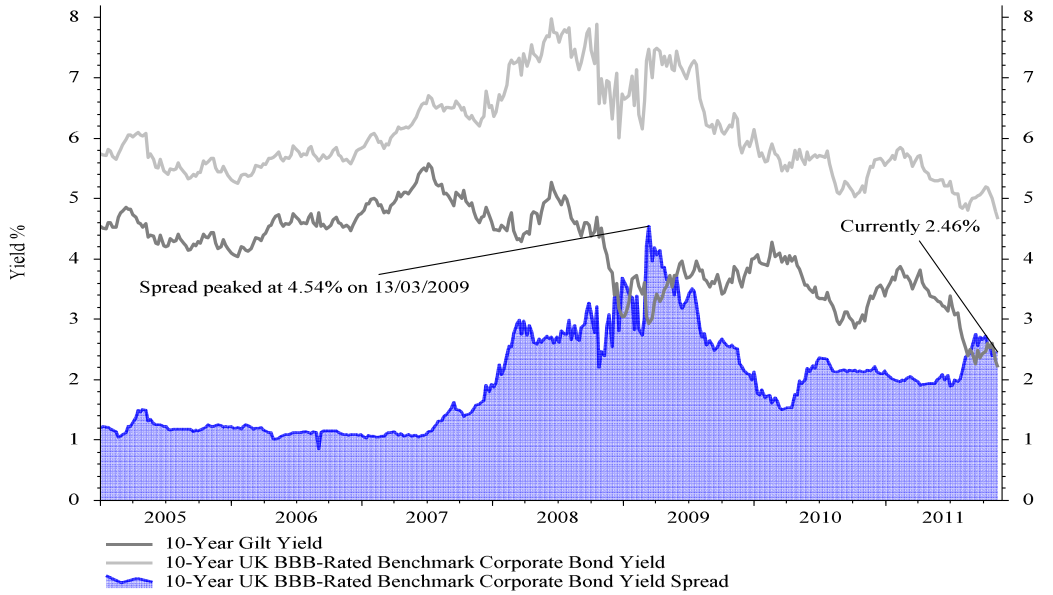
Fig. 8 Global Inflation-Linked Government Bond Yields



Source: Thomson Reuters Datastream

Turning to corporate bonds, yields have remained relatively stable during the recent period of risk aversion. However, the yield spread on corporate bonds relative to the equivalent government bonds widened substantially over the summer as government bond yields fell (Fig. 9).

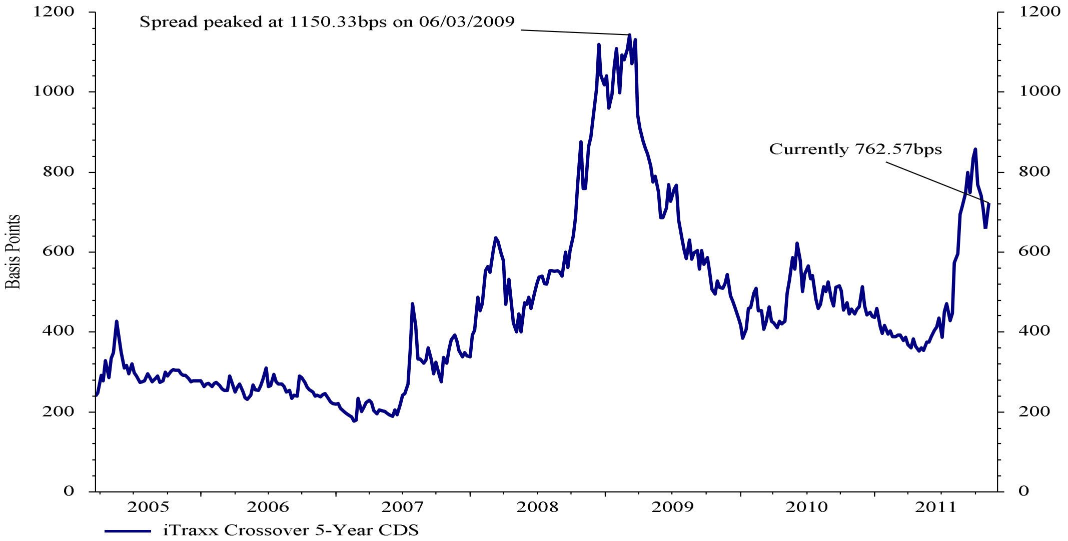
Fig. 9 The BBB-Rated Corporate Bond and 10-Year Gilt Yields (Gap = Spread)



Source: Thomson Reuters Datastream

Although credit spreads remain considerably tighter than at the height of the financial crisis in March 2009, they appear to now be discounting a fairly bleak environment for corporates. According to F&C Thames River, the investment grade bond market is currently pricing in the failure of one-in-eight European and one-in-ten US blue chip companies in the next five years. This picture is mirrored in the sub-investment grade market, where credit default swap spreads on the iTraxx Crossover index of liquid European bonds rated BB or B have risen to c7.6% (Fig. 10).

Fig. 10 The Credit Spread on High Yield Corporate Bonds



Source: Thomson Reuters Datastream

While this is considerably lower than after the collapse of Lehman Brothers, it implies that between one third and a half of all sub-investment grade companies will default within five years. Our view is that, outside an economic depression, these implied default rates are much too high and yield spreads should therefore contract over time. This belief is supported by the extent to which companies have strengthened their balance sheets and cut costs since the last recession. Corporate cash levels are now much higher than in 2008, meaning that a withdrawal of liquidity by banks, as occurred following the collapse of Lehman Brothers, would be less likely to lead to a sharp rise in bankruptcies. Companies have also used the low borrowing rates of the past three years to refinance much of their existing debt prior to maturity. As a consequence, most investment grade and sub-investment grade companies should be able to get through to 2014 without the need to refinance large amounts of maturing debt.

However, we are mindful that risks remain, particularly in terms of the impact of a disorderly default by Greece or a funding problem for Italy on the European financial system. Until there is greater clarity on peripheral Europe, we believe that higher volatility will continue to be a feature of bond markets. As such, we prefer corporate bond allocations to be invested in more strategic funds, whose managers have the flexibility to adjust both their credit and interest rate risk exposure to fit economic and market conditions as they evolve.

4. Property

UK commercial property remains a two-tiered market. The South East, particularly London, is relatively insulated from the weakness of the broader UK economy, instead being influenced more by global growth. Prime quality retail and office space in the capital enjoys both robust tenant demand, allowing landlords to increase rents, and strong interest from UK institutions and overseas investors. With little development in recent years, the pool of prime assets in good locations is limited, and investor demand has resulted in yields being pushed down as low as 4% in the West End of London.

In contrast, secondary quality assets in regions with high unemployment and a dependence on the public sector for jobs (such as Middlesbrough and Liverpool), have been impacted by weaker tenant demand, limiting the scope for rental increases and making vacant space hard to let. As a consequence, investor demand for these properties continues to be weak, despite initial yields often in excess of 10%. A further weight on this side of the market is the overhang of lower quality assets held on bank balance sheets, with research from De Montfort University showing that, as at the end of 2010, major UK lenders had £207bn of outstanding debt secured against property. This is 9.4% lower than in 2009, as banks have now assessed what they hold and are gradually disposing of their more institutional grade assets. However, this leaves them with progressively less saleable portfolios that they will have to work through over an extended period.

In the near term, we see little scope for rental growth outside the strongest locations, due to the historical link between rents and GDP. However, the investment market appears to be supported by the second round of QE, which will help to reduce discount rates, as well as continued demand for quality assets. We therefore believe that our recommended funds of prime and near-prime properties, whose managers can add value through refurbishments and re-lettings, can provide reasonable returns over the coming years.

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 was 5.0% year on year in October, while retail price inflation was recorded at 5.4%. 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 15 November 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 April 2011 to 31 October 2011 and the twelve month period from 31 October 2010 to 31 October 2011 (source: Lipper). LC = Return in Local Currency.