

# **Market Commentary**

**October 2009**

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### Risk Warnings

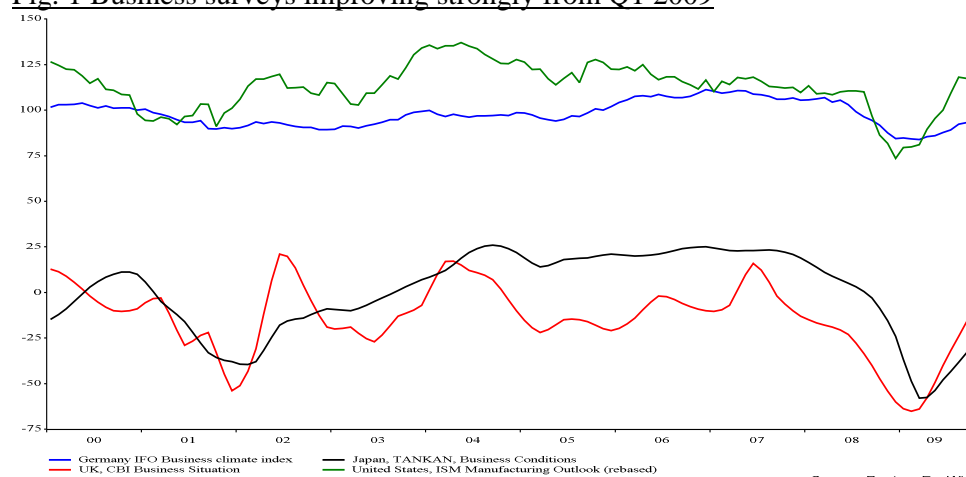
This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 9 October 2009. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments 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

Recently released data, together with forward-looking surveys of business and consumer sentiment, are indicating a more robust global recovery than many observers dared hope for only a few months ago. Concerns that the world economy might suffer a multi-year depression, reminiscent of the 1930s, or would remain mired in recession for a prolonged period have eased, and the discussion among policymakers and economists is now centred on the shape and durability of the recovery. In illustration of the degree of change in expectations, the Paris-based research body, the Organisation of Economic Co-operation and Development, last month upgraded its forecast for output from the G7 in 2009 to -3.7%, only three months after downgrading to -4.1%.

Recognition for the rapid improvement in the economic outlook, as exemplified by the turnaround in business surveys (see Fig. 1), is, in large part, attributable to the speedy and aggressive response to the credit crisis from both monetary authorities and governments. Ignoring warnings about the cost or inflationary consequences of their actions, central banks have moved decisively to take official interest rates down to the lowest levels ever recorded, while governments have launched fiscal packages to support demand in their economies. A wide array of other policy measures are now in place to ease credit market conditions, support mortgage holders and extend loans to key businesses, such as the car manufacturers and container shipping. As a result, financial markets have stabilised, consumer sentiment has recovered somewhat, and businesses have begun to rebuild inventories.

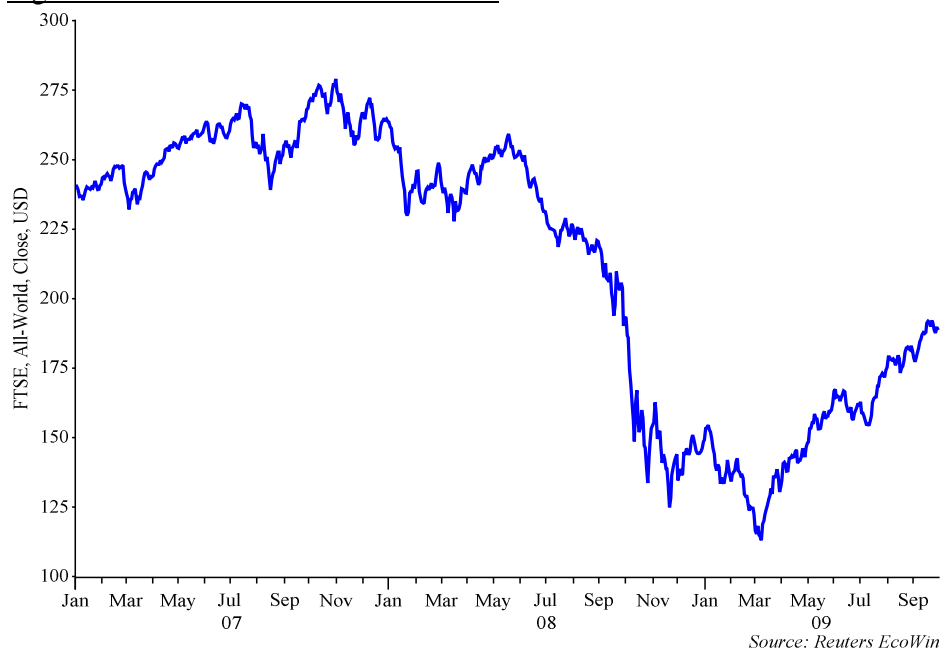
**Fig. 1 Business surveys improving strongly from Q1 2009**



Looking forward to 2010, we believe that the key debates will centre on the extent to which recovery becomes self-sustaining and the degree to which policy support can be withdrawn without a relapse in growth.

As would be expected, the improved economic outlook has resulted in a rapid bounce in equity markets from the depressed levels of March (see Fig. 2). The recovery in share prices has been supported by company results statements which have, in the main, met or exceeded analysts' forecasts over the past few months. The drivers of better corporate earnings include the inventory rebuild mentioned above, as well as benefits on costs, as companies have reaped the rewards of the aggressive overhead reductions made in late 2008 and the early part of this year. Cost pressures have also been alleviated by reduced raw materials prices, compared to last year.

Fig. 2 FTSE All World Index since 2007



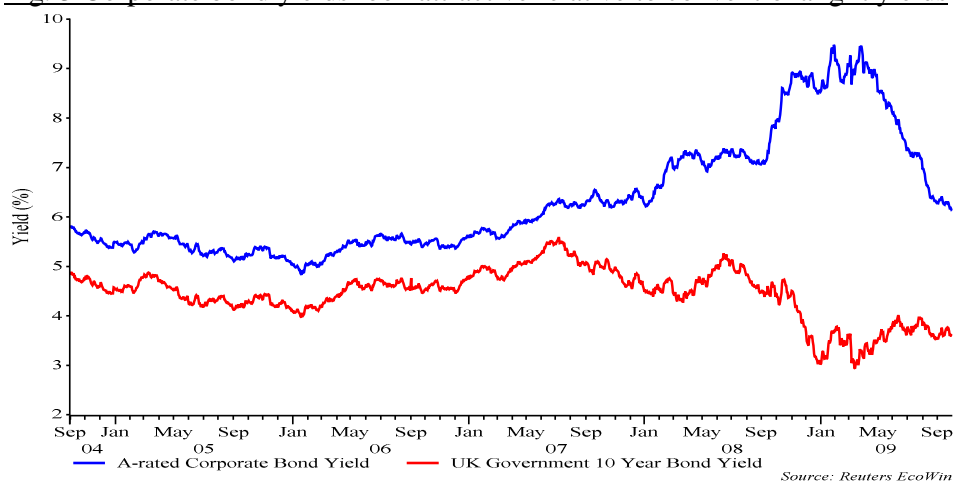
The path of economic growth and therefore corporate profits and dividends will be the key determinant of equity market returns in 2010 and beyond. Considering valuation, the extreme weakness in equity markets in late 2008 and early 2009 saw dividend yields in most major equity markets move above their respective government bond yields. This was a clear indication of investors' extremely bearish expectations for both the sustainability of existing dividends and the prospects for dividend growth. The rally over the past six months has brought equity yields down once more but, unless earnings and dividend growth remain very subdued for a prolonged period, equities remain attractively valued relative to both government bonds and cash deposits.

The MSCI World Equity Market index has provided a total return of +27.54% in sterling terms over the last six months and +9.63% over the last year.

Turning to other key asset classes, government bonds, which were the asset class of choice for investors in the final quarter of 2008, have struggled to make further progress. The downward pressure on sovereign bond prices resulting from the high levels of issuance appears, for now at least, to have been balanced by government policies designed to expand money supplies, including the direct purchases of government bonds. Commercial banks, which have access to low cost short-term funds, are also purchasers of government bonds at present.

In stark contrast to government bonds, corporate bond yields were driven to exceptionally high levels in late 2008 both by concerns about falling corporate earnings and forced selling by leveraged investors. The increase in the yield premium on corporate bonds versus government bonds was even more pronounced than the rise in the absolute level of corporate credit yields (see Fig. 3). This situation began to correct in the first quarter of 2009 in response to the policy initiatives outlined above, since when corporate bond prices have made a rapid recovery. In our view, however, corporate bonds still present opportunities for investors given the attractive yield available in comparison to both government bonds and cash on deposit.

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



Considering commercial property, the five-year property bull market came to an end in mid-2007 when prices eventually began to weaken under the pressure of credit market dislocation. Property values continued to decline until the middle of this year as tighter credit market conditions removed an important source of funding for commercial property buyers, and the deteriorating economy undermined tenant demand. While commercial property values have now begun to stabilise, rents may have further to fall. However, yields now stand at appealing levels, both in absolute terms and relative to other assets. We are therefore recommending additional allocations to this asset class.

The following sections consider our monitored asset classes, including hedge funds and cash, in more detail.

## 2. Equities

### 2.1. UK Equities

The recession in the UK is showing signs of levelling out, with GDP in the second quarter declining 0.6% compared to an average drop of 2% in each of the two previous quarters. The improvement can be seen in the housing market, where, on figures produced by Nationwide, house prices have now risen for five consecutive months, and also in consumer confidence, which according to polls by GfK NOP, has risen to its highest level since the beginning of the year. A key driver behind the stabilisation of the economy has been the adoption of ultra-accommodating monetary policy by the Bank of England. In March, the Bank rate was reduced to an all time low of 0.50% and a £125bn program of quantitative easing was introduced. This was extended by a further £50bn in August.

Despite the aggressive policy responses, the upturn in the UK may not prove as robust as in other developed economies. Regardless of who wins next year's general election, the new government will have to address the country's budget deficit through a combination of tax increases and spending cuts. Households are unlikely to be able to drive economic growth, with their over-extended balance sheets requiring further saving and less spending. Also, the financial services sector, which in the previous economic cycle was a major contributor to growth (contributing £500bn to the economy in 2007, according to the British Bankers' Association), looks likely to be hamstrung by increased regulation to reduce the risk of a repeat of the financial crisis.

While the UK's economic recovery may not be the strongest in the developed world, we are recommending that current weightings to UK equities are maintained at present. UK equities have attractions on valuation grounds and sterling's depreciation since the onset of the credit crisis should aid UK-based businesses to both increase exports and displace imports with domestically produced goods. It is noteworthy that, in aggregate, major UK-listed companies generate a substantial proportion of their revenues from overseas (c60% according to HSBC). These should be able to grow their profits at a faster rate than the domestic economy and also benefit from faster profits growth as foreign earnings are translated to sterling.

The FTSE All-Share index has provided a total return of +35.69% over the last six months and +10.80% over the last year.

## 2.2. European (excluding UK) Equities

Eurozone GDP was 0.2% lower in the second quarter of 2009 following a 2.5% fall in the first quarter, with the improvement aided by both France and Germany unexpectedly returning to growth. The 16-country region continues to experience deflation, with consumer prices down 0.3% year-on-year in September. The European Central Bank (ECB) has been less willing than its Anglo-Saxon counterparts to reduce interest rates and its official rate now stands at 1.00% – higher than base rates in the UK, US and Japan. Although this has prompted criticism that the ECB is not being sufficiently aggressive, the central bank's injection of €442bn of one-year funds into the eurozone banking system in June, at an interest rate of just 1.00%, shows that it has taken supportive action. European banks now have access to effectively unlimited low cost liquidity until the summer of 2010 at least. As a consequence, the ECB's balance sheet is now bigger as a proportion of eurozone GDP than that of the Federal Reserve relative to US GDP.

Unemployment in the eurozone, which rose to 9.6% in August, has not prompted aggressive fiscal policy responses from European governments. Due to their more generous welfare systems, headline-making policies to support the jobs market, similar to those in the US, have been judged less crucial. These social safety nets, plus lower consumer indebtedness, should mean that European consumers can cope with higher levels of unemployment and continue to spend. However, domestic consumer spending is a less important driver of GDP in Europe than it is in the US and the UK. Continental Europe is instead more reliant on exports and it is here that the strength of the euro in 2008 and the sharp fall in world trade have been particularly painful. The euro has now weakened somewhat and economic data are indicating a degree of recovery. However, this is likely to be fragile and it should take some time before export-orientated European companies see any significant growth in demand. Having advised a reduction in weightings to European equities at the end of 2007, we recommend that remaining allocations are retained where appropriate.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +44.17% over the last six months and +0.44% over the last year. In sterling-adjusted terms, the returns are +42.24% over the last six months and +16.48% over the year.

### 2.3. North American Equities

The response of the US authorities to the credit crisis and subsequent economic downturn has been impressive. Under the chairmanship of Ben Bernanke, an expert on depression-era economics, the Federal Reserve (the Fed) reduced interest rates extremely quickly. From 5.25% in September 2007, policy rates are now effectively zero, although official policy statements declare that the target for interest rates is “between zero and 0.25%”.

Interest rate reductions have been accompanied by a policy akin to the quantitative easing undertaken in the UK. However, rather than buying government issued bonds, the US authorities are buying up to \$1,450bn of mortgage backed securities from the two government sponsored housing enterprises, Freddie Mac and Fannie Mae. The aims are similar to the UK’s quantitative easing, to force additional liquidity into the economy and drive market interest rates down towards the official interest rates. These monetary measures have been accompanied by a Keynesian-style \$700bn fiscal stimulus package, the Troubled Asset Relief Program.

These measures appear to be having their desired effect with economic output in the second quarter contracting by a less-than-projected 0.7% p.a., a marked improvement on the 6.4% annualised contraction in the first quarter. Stabilising consumer demand is prompting companies to rebuild inventories, triggering growth in production and orders, and raising hopes of a strong rebound in corporate earnings in the fourth quarter of 2009 and into 2010.

Consumer demand, however, remains fragile. Headline retail sales data have been buoyed by the impact of the ‘cash-for-clunkers’ scheme, unemployment has continued to rise, albeit at a slowing pace, and a return to the credit-fuelled consumption patterns of previous years is doubtful. Consumer credit continues to contract as the household sector deleverages, and the need for US consumers to rebuild their savings is likely to create a meaningful headwind for demand.

Turning to the stock market, six months ago, US equities had fallen to levels that could be considered inexpensive relative to historical valuations. However, aided by the loose monetary and fiscal conditions, the recent rally has taken them back, in our view, to broadly fair value. We therefore 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 +34.02% over the last six months and -6.91% over the last year. The fluctuating value of the dollar means that, when translated into sterling, the returns are +20.11% over the last six months and +3.75% over the year.

## 2.4. Japanese Equities

With GDP having contracted at an annualised rate of 14.2% in the first quarter of 2009, the recession in Japan was the most severe in its post-war period. It was also sharper and deeper than those seen in the other major developed economies. Though acute, the contraction proved relatively short-lived as the economy returned to growth in the second quarter of the year. Export volumes, industrial production international trade, and measures of consumer confidence, among others, have turned upwards, prompting the Bank of Japan (BoJ) to suggest that the worst of the economic downturn has now passed.

Despite the economic revival, the Democratic Party of Japan (DPJ), elected in an historic landslide victory on 30 August, faces significant challenges. Demographic trends, particularly the ageing of the population, are creating significant obstacles to economic growth. Expectations of deflation appear embedded and therefore, to a degree, self-fulfilling. Furthermore, with little scope to effect further monetary or fiscal stimuli, the DPJ is likely to resort to cutting infrastructure expenditure to fund attempts to stimulate consumer spending in a population that has, with good reason, developed a profoundly cautious attitude.

At the corporate level, the outlook is somewhat more positive. As a major exporter of manufactured goods, the Japanese corporate sector proved highly sensitive to the weakness of the global economy. However, aggressive cost cutting measures have been undertaken and, together with lower raw materials input costs, Japanese companies should now be in a relatively strong position to benefit from any recovery in global demand. In addition, balance sheets that were strengthened in response to Japan's own banking crisis in the early 1990s are increasingly being put to use to acquire rival companies, both domestically and overseas.

Despite having appeared attractively valued versus both their own history and their international counterparts for some time, Japanese equities remain deeply out of favour with international investors. The economic outlook is highly uncertain and consequently we believe it is too early to increase recommended allocations. However, current allocations should be maintained, where appropriate.

The FTSE Japan index provided, in yen terms, a total return of +18.35% over the last six months and -16.15% over the last year. The strength of the yen in the six months to 31 March means that, when translated into sterling, the returns are +17.01% over the last six months and +10.81% over the year.

## 2.5. Asia Pacific (excluding Japanese) Equities

The global crisis affected the Asia Pacific region not through banking or finance channels, but through the sharp contraction in international trade that resulted from the collapse in trade finance and the steep falls in consumer demand in the west. As export volumes declined, industrial production fell, economic growth estimates were revised lower and unemployment increased. The failure of the Asia Pacific economies to ‘decouple’ and thereby avoid the problems of the developed world, together with much higher risk aversion among investors, caused the region’s equity markets to underperform in 2008. However, as policy measures have delivered a better economic outlook, and risk appetite has improved, Asia Pacific equities have recovered strongly (see Fig. 4).

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



With high savings ratios, cheap labour and strong public sector finances, many Asia Pacific economies have the potential to achieve rapid economic growth. Having benefited from strong export-led growth over the past decades, Asian policy makers are now making a decided effort to stimulate domestic demand which, with increasing levels of prosperity, should stimulate further economic growth over the long-term. However, more immediately, Asian growth is likely to remain closely linked to the health of the global economy.

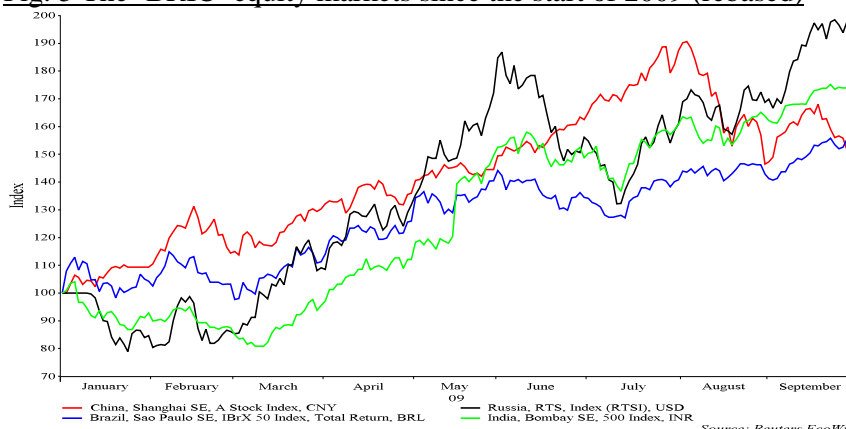
Such has been the strength of the equity market rally in Asia that valuation measures are now above their long-term averages despite the remaining uncertainties about the global economic outlook. Though we recognise the region’s long term potential, we do not currently recommend increasing allocations.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +48.71% over the last six months and +23.47% over the last year. In sterling-adjusted terms, the returns are +47.64% over the last six months and +41.01% over the year.

## 2.6. Emerging Markets Equities

After the steep losses recorded in 2008, emerging equity markets\* have thus far enjoyed a strong 2009 (see Fig. 5). Performance has been closely tied to the perceived health, or otherwise, of the developed economies. Though many emerging economies (with the notable exclusion of those in Eastern Europe) were largely free of the debt issues that plagued their western counterparts, investors sold emerging market equities aggressively on concerns about knock-on effects on emerging markets. Investors judged, correctly, that the prospect of a protracted decline in western consumption would undermine, at least temporarily, the export driven growth models of the emerging economies. The recent improvement in economic data has encouraged a renewed optimism to which emerging markets equities have responded strongly.

**Fig. 5 The 'BRIC' equity markets since the start of 2009 (rebased)**



Developments in China merit special mention. Fuelled by continuing robust economic data, Chinese equities had, prior to August, risen strongly in spite of concerns that the government's stimulus package would provoke indiscriminate and ultimately unprofitable loan growth. However, the introduction of government measures to dampen credit creation led to a sharp sell-off in August.

Though we believe the long-term outlook is positive, emerging equity markets valuations appear to reflect hopes of a quick and strong global recovery – an outcome that is, as yet, far from certain. We therefore do not recommend adding to allocations for the present.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +65.53% over the last six months and +20.25% over the last year. In sterling-adjusted terms, the returns are +48.35% over the last six months and +34.02% over the year.

\* MSCI includes 22 countries in its emerging markets index: 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

The UK Debt Management Office, on behalf of HM Treasury, is set to issue £241bn of UK debt securities in the current fiscal year. This is almost £100bn more than the 2008/9 issuance, which was itself far higher than earlier years. Simultaneously, the Bank of England has, via the Asset Purchase Facility, purchased £145bn of gilts from non-public holders as part of its £175bn remit. In the US, debt issuance will be approximately \$2tn, though American repurchases are being focused on the debt of the mortgage agencies as well as on US treasury bonds. The aims of these seemingly conflicting policies are clear: to fund government borrowing requirements and force additional liquidity into the financial system. However, the presence of the authorities as both the issuer of government bonds and buyer of substantial portion thereof, is almost certain to result in price distortion. In the UK, the 10-year conventional gilt yielded 3.36% at the end of September. This yield, in our view is insufficient given the medium term threat of higher inflation and the fact that repurchases, which are clearly supporting prices, will end long before issuance levels fall back to pre-crisis levels.

In contrast to conventional government bonds, index-linked gilts remain an asset class we currently favour. While investor interest in these waned late last year, due to concerns over the possibility of a long period of deflation, our view is that inflation risks are likely to rise in the medium term. The current economic weakness makes near term inflation unlikely, but, in our view, the monetary policies being employed by the BoE significantly raise the risk of higher inflation over the next decade. We believe that a ten-year inflation rate of 2.59% (for RPI) as implied by the gilt market may be underestimating this risk.

We are also still favouring funds of corporate bonds. Since late January, when we recommended increasing allocations to investment grade bonds, this sector has rallied strongly. With all but distressed bonds trading close to their par value, we expect that returns will now come increasingly from income rather than capital appreciation. Mindful that official interest rates must rise in the medium term, we have latterly been recommending that new allocations go to strategic bond funds, where managers can hedge out interest rate risk and allocate assets to wherever they see value within the asset class.

The ABI UK Pension Gilt sector provided a total return of +2.78% over the last six months and +11.36% over the last year. The ABI Pension Sterling Corporate Bond sector provided a total return of +25.08% and +11.15% over the same periods. The ABI UK Pension Index-Linked Gilt sector provided a total return of +6.14% over the last six months and +2.93% over the last year.

#### 4. Property

In slightly over two years, UK commercial property prices have fallen by 44%, according to figures compiled by Investment Property Databank (IPD). This correction far exceeds the previous sharpest fall recorded, which was 27% in the three years to mid-1992. In the property bull market that ran until mid-2007, the asset class was a major beneficiary of the easy credit environment that induced asset price bubbles in several asset classes. Property deals were often structured with high levels of low cost debt financing, though, the availability of such financing disappeared at the onset of the credit crisis and with it went a key prop for commercial property prices. This effect was exacerbated by the deteriorating economy, which further undermined property values by putting downward pressure on rents.

The extent to which prices have fallen over the past two years together with the accompanying rise in yields means that commercial property is once again looking attractive to value focused investors. Key risks include the extent of the ongoing, downward pressure on rental values and occupancy rates, arising from the weak economic environment, as well as the additional supply from developments now approaching completion. However, yields of c7.8% (according to IPD) appear attractive relative to other asset classes and offer, in our view, sufficient compensation for the risks. We are therefore recommending increases to commercial property allocations.

One factor complicating the outlook for commercial property is the c£230bn of outstanding loans backing UK commercial properties held by banks. Much of this will need to be either refinanced or repaid over the next five years. So far, banks have generally been willing to extend or refinance loans in return for higher coupons and undertakings by borrowers to inject more capital into deal structures. However, there remains some risk that lenders will be less flexible in future and force the sale of properties, thereby increasing supply and depressing prices further. To mitigate this risk, we are recommending that increased allocations are focused on established funds holding predominantly prime and ungeared, or lowly geared, property portfolios.

The ABI UK Pension Direct Property index provided a total return of +0.72% over the last six months and -17.12% over the last year.

#### 5. Cash

Sterling deposits and monies held in AAA-rated liquidity funds can presently earn returns broadly in line with the BoE Bank Rate of 0.50% p.a. Despite low rates, cash still has attractions and we continue to favour small overweight positions in the asset class, particularly where attractive rates from government-backed or good quality institutions can be secured. Cash, whether on instant access 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 +0.25% over the last six months and +1.35% 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.

Almost one in ten hedge funds closed in 2008, according to Chicago-based research group Hedge Fund Research. Losses for the calendar year, as measured by the group's HFRX Global Hedge fund index (in sterling) were almost 23%, the biggest annual decline since data tracking began in 1990. Investor expectations of positive, uncorrelated returns from hedge funds have clearly been disappointed. Despite a partial recovery over 2009 to date, the industry's ability to justify high charges and performance fees remains, in our view, questionable.

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. London-based Tosca, at peak an \$8bn fund, fell by more than 60%. Others employing high levels of gearing have found themselves even more severely impacted. As credit availability decreased through 2008, geared hedge funds had little choice but to sell their underlying assets at whatever prices were available in the market. This forced selling intensified in the fourth quarter of 2008 as hedge fund investors continued to file significant redemption requests.

We expect the hedge fund 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 validity 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 +9.53% over the last six months and -5.04% over the last year.

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**The above commentaries reflect our views as at 9 October 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 31 March 2009 to 30 September 2009 and the twelve month period from 30 September 2008 to 30 September 2009 (source: Lipper Hindsight).**