

# **Market Commentary**

**September 2007**

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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 September 2007. 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 Commentary

After a strong start to the year, global equity markets became increasingly volatile and suffered substantial weakness in July and August. In the month to mid-August equities fell by more than 11%, losing all of their gains for the year. Subsequently, equity markets regained a degree of calm and recovered about half of their losses.

The cause of the setback in equity markets is to be found in the financial markets themselves rather than in any immediate change in the macroeconomic outlook. Prior to the market turmoil, central banks were already gently bringing the era of easy credit and accommodative monetary policy to an end. This was being achieved by gradual increases in interest rates. However, rapidly growing concern about the inherent risks and potential impact of some new highly geared financial instruments, most notably in the credit markets, has finally brought the easy credit environment to an abrupt close. Such has been the turnaround in market sentiment that central banks have considered it appropriate to inject liquidity into money markets and make emergency funds available to ensure that they continue to function.

Turning to the outlook, one key risk that is now being carefully weighed by investors is whether the fallout from the crisis in credit markets might seriously weaken the entire financial sector or even undermine global economic growth. Our view is that this seems unlikely. Central banks in the US and Europe are likely to ease interest rates if much slower growth looks a genuine possibility, even though, at present, economic growth remains robust in most areas of the world including developing markets such as China and India. These areas are largely unconnected with the credit market issues and their continuing strong expansion should support growth elsewhere.

Considering the outlook for equity markets we remain of the view that valuation levels are very supportive with many markets continuing to trade at price/earnings ratios close to their long term averages. On balance therefore, we are maintaining our positive view on equities for the present while monitoring developments closely, particularly in the structured credit markets.

The FTSE World index has provided a total return of +4.34% over the last six months and +12.28% over the last year in sterling terms.

## 2. Equities

### 2.1. UK Equities

The UK economy continues to perform strongly. In the year to the end of July, GDP increased at an annualised rate of 3.0%. However, with credit markets in turmoil, as discussed above interest rate increases are no longer on the agenda. Instead, the Bank of England is likely to wait for clear indications that the economy is slowing in response to problems in the financial markets. If there are indications that these financial problems may lead to a material slowdown in growth, interest rates are likely to be reduced.

Strong economic growth, together with the return of a degree of pricing power for the corporate sector, has resulted in excellent earnings growth for companies. This, coupled with strong dividend growth, has continued to support UK equities. Strong corporate profits growth has meant that UK equities do not look expensive in terms of price/earnings ratios, despite share prices having risen sharply over the past four years.

We are mindful, however, that the outlook for equities was already becoming less favourable as a result of rising interest rates and that this is likely to be magnified by recent financial market developments. We are also aware of the valuation anomalies now apparent within the UK equity market, with mid. and small sized stock looking more expensive. Our recent reweighting of portfolios towards larger companies addressed this.

The FTSE All Share index has provided a total return of +4.16% over the last six months and +11.84% over the last year in sterling terms.

## 2.2. European (excluding UK) Equities

Despite excellent performance in recent years, Continental Europe continues to be our favoured destination for overseas equity investment. Valuations remain reasonable and earnings are supported by economic growth – particularly in Germany which is benefiting from strong export growth and increasing consumer confidence. Growth in Europe is also underpinned by the gradual structural improvements being made at the corporate level in areas such as capital efficiency and labour costs.

While European equity markets have benefited from improved consumer confidence and stronger growth, the European Central Bank (“ECB”) has been raising rates to head off the threat of rising inflation. Interest rates have now doubled since the ECB began its monetary tightening cycle in December 2005. The ECB remains vigilant on inflation but is now likely to pause in its rate tightening cycle to take stock of the impact of financial market volatility.

We are retaining our current overweight position in European equities.

The FTSE Europe (ex. UK) index provided, in euro terms, a total return of +6.54% over the last six months (+6.83% sterling adjusted) and +18.29% over the last year (+18.81% sterling adjusted).

### 2.3. North American Equities

The US economy continues to grow quite strongly. This, aided by the very weak US dollar, has led to strong corporate earnings growth and helped US equity markets make reasonable gains over the last year. However, the weak currency has impacted returns for sterling based investors which, as a result, have been relatively disappointing.

The US is at the centre of the current financial market turmoil with many of the low grade mortgages, which have been repackaged into the now troubled credit instruments, originating in the US. A slowdown in the US housing market has triggered the failure of some of these credit instruments and it is now likely that tighter credit conditions will further aggravate housing market weakness.

Turning to the positives, high levels of employment should mean that the economy will not slow too sharply, although this will require close monitoring. Comfort can also be taken from the fact that, with the inflation threat now receding, the US central bank, the Federal Reserve, has room to cut interest rates should weakness in the housing market spread further into the economy.

Given the prolonged underperformance of US equities, which has left them looking more reasonably valued relative to other markets, we are now recommending portfolios contain small allocations to US equities.

The S&P 500 index provided, in US dollar terms, a total return of +5.70% over the last six months (2.69% sterling adjusted) and +15.13% over the last year (+8.58% sterling adjusted).

## 2.4. Japanese Equities

Japan's economy is growing quite strongly due to demand for its exports, but remains troubled by weak domestic consumption and very low inflation. Low interest rates and a weak currency have kept the worst of the deflationary forces at bay but the stronger economy has not, so far, resulted in stronger demand for Japanese assets.

Earlier this year the Bank of Japan ("BoJ") took its second step towards bringing interest rates back into line with international levels with a 0.25% increase. At only 0.50%, however, interest rates are still low by international standards and the caution with which the BoJ is increasing rates has been a factor in keeping the Japanese yen very weak. This weakness has undermined returns to international investors who bought into Japanese equities to participate in the long awaited economic recovery.

We remain of the view that Japan's gradual economic restructuring will eventually bear fruit, resulting in stronger equity market returns and a stronger yen. We are therefore recommending that, despite disappointing performance in recent months, allocations to Japanese equities are maintained.

The FTSE Japan index provided, in yen terms, a total return of -7.41% over the last six months (-8.05% sterling adjusted) and +0.33% over the last year (-4.27% sterling adjusted).

## 2.5. Asia Pacific (excluding Japanese) Equities

The economies of the Asia Pacific (excluding Japan) region continue to look relatively attractive from the perspective of an international investor. Decreasing reliance on western export markets and sizeable foreign currency reserves mean that the periodic crises of the past are unlikely to be repeated. Additionally, strong economic growth and current account surpluses make it likely that Asian currencies will appreciate over the medium term.

Large speculative capital flows mean that the Asia Pacific equity markets remain among the most volatile in the world. We believe, however, that investors with a longer time horizon will earn excellent returns as the 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 +15.15% over the last six months and +30.90% over the last year (for sterling based investors).

## 2.6. Emerging Markets Equities

Emerging market equities have risen strongly over the four year equity bull market, driven in part by strengthening economic fundamentals. These improving fundamentals remain in place; strong growth has driven up employment and income, thereby creating a virtuous circle of consumer demand and further strong growth. The equity markets no longer offer the bargain valuations of 2003 but, with the long term growth story looking as strong as ever, we believe allocations to equities within the emerging regions should be maintained.

The FTSE All-World Emerging index provided a total return of +19.77% over the last six months and +35.89% over the last year (for sterling based investors).

### 3. Fixed Interest

Fixed interest investments have not fared particularly well over the past year as stronger economic growth has driven interest rates higher. Yields are now more attractive and the value of government bonds as a portfolio diversifier has been fully demonstrated in the recent financial market turmoil.

Within the various classes of fixed interest instruments we have long 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 wholly inadequate. We have therefore advised clients to focus allocations to fixed interest entirely on UK government bonds. This view has been vindicated by the recent credit market problems which have seen spreads widen very sharply. Meanwhile government bonds have benefited from stronger demand for very low risk investments.

The ABI UK Pension Fixed Interest sector provided a total return of -1.72% over the last six months and +0.39% over the last year (for sterling based investors).

#### 4. Property

Investments in commercial property in the UK have provided very strong returns over the last five years. However, rising capital values have not been supported by commensurate increases in rent, leaving yield based valuations looking stretched. With rising interest rates making the returns available on cash deposits and bonds more attractive, commercial property prices have stopped rising and in some areas started to retreat. Indeed, UK commercial property, as measured by the ABI Pension Property index, recorded a loss in the second quarter of 2007 - its first quarterly loss since 2001.

We continue to recommend reduced allocations to this asset class.

The ABI UK Pension Property index provided a total return of -3.96% over the last six months and +4.53% over the last year (for sterling based investors).

#### 5. Cash

Cash deposits earning approximately 5.75% p.a. at present with no (nominal) capital risk are attractive from a defensive perspective and we continue to regard them as an important component of portfolios. Where appropriate, advantage should be taken of 'cash plus' products that offer an enhancement through tax shelters.

N.B. Unless otherwise noted, all performance figures are total returns (including income re-invested) for the six month period from 28 February 2007 to 31 August 2007 and the twelve month period from 31 August 2006 to 31 August 2007 (source: Lipper Hindsight).