

Review of Markets

Though markets have not always seemed to appreciate it, 2010 will be, and has already been to date, a difficult year - if only because of the unprecedented events experienced in the years that preceded it. We do, though, believe, that positive returns can be achieved if the economic recovery that began in 2008 can be sustained.

It is a year in which we know there will be hurdles ahead with the journey being, to use an analogy, akin to the Grand National. Furthering this, we see the UK General Election on 6th May as having been the 'Beacher's Brook' of the fences to be crossed, the pending reversal of quantitative easing as being the wider but no less daunting 'Chair' and any increase in interest rates being the 'Canal Turn' on the course to be run, though we are now anticipating not having to negotiate the latter until 2011. In between these, there will be other fences to be jumped.

As happens in the Grand National, the political 'runners and riders' ran into each other at the 'Beacher's Brook' that was the General Election. A hung parliament with a Conservative/Liberal Democrat coalition has ensued. This has not occurred since the Second World War and, as a bold but untried form of government in the modern era, there are, as we see it, a trio of possible outcomes, 'the good, the bad and the ugly'. Within the 'good' scenario, the cementing of the Liberal Democrats within the Government with Nick Clegg as Deputy Prime Minister and other members of the same party being in the Cabinet should lead to greater solidity than just the looser voting arrangement would have given and could prove to be a wise move on Prime Minister, David Cameron's part with pragmatism rather than dogma being at the heart of policymaking. The 'bad' scenario would be a swift breakdown in the coalition, in which, like the Grand National, we have to go round again and face 'Beacher's Brook' and another General Election for a second time in a short space of time. The 'ugly' outcome is that a legislative malaise occurs in which legislation is watered down or deferred for the sake of stability rather than progress and issues are not dealt with in a robust manner. All in all, though the coalition is more solid than may have otherwise been expected, stability has not truly been achieved. We may, and hope to, be pleasantly surprised but there is much that can go wrong.

There does, though, appear to be agreement in dealing with the most urgent issue, 'the elephant in the room' of economic policy, that of reducing the budget deficit. Following the new coalition Government's budget, it is intended that the majority, some 80%, of the deficit reduction is to come from spending cuts, which is more supportive of sustaining economic growth, rather than predominantly through tax increases, which is not. The deficit reduction is, however, a process and not an event and will take a number of years with the proposed cuts being broader and deeper than previously expected.

As to other fences to be crossed, more have emerged since the year end than were anticipated, with the collapse in confidence in the Euro being the most obvious, and against all the odds placed at the start of the year, UK Sterling has been stronger than was anticipated and UK gilts have been perceived as being a (relative) safe haven! The markets' behaviour during the 'inter-regnum' between the General Election and the Coalition Government being formed was interesting to observe. Essentially, the markets eyes were on other external, non-domestic matters in the form of Greece's debt problems and the stability of the Euro. This is symptomatic of the now global nature of markets and the UK's limited influence within them.

Meanwhile, the economic recovery in the UK, as the last of the major western economies to emerge from recession, is still tentative with estimated growth of just 0.2% in the first quarter of 2010 and 0.4% in the fourth quarter of 2009 signalling the end of the most pernicious economic downturn for more than a

generation. As we see it, the biggest risk to markets and the UK economy is the untimely unwinding of that which enabled the stabilisation of the capital markets and the economy in 2009 - quantitative easing.

With the purchase of gilts by the Bank of England having come to an end, the questions are when will these be sold back into the market, how the UK government can fund its budget deficit and who will buy the excess supply of gilts in the absence of the Bank of England's buying. There are, however, two candidates to 'soak up' the excess, being the banks, who will need to buy gilts when new capital reserve requirements are enforced, and pension funds, who, under the FRS17 rules, must buy long-dated gilts to match their long-term liabilities. Over £100 billion could be taken up by these two categories of forced buyers alone. This will, though, leave a substantial amount still to be raised, which will depend on the UK retaining its AAA credit rating.

The budget deficit reduction is potentially both deflationary and recessionary with the reduction in public expenditure, and ensuing job losses in the public sector, together with tax rises, further dampening already fragile consumer confidence and spending. This will inevitably constrain economic growth, which is likely to be muted anyway. In the long-term, it can be argued that sub-trend economic growth will be no bad thing. Together with higher taxes and lower spending, it is a necessary medicine in order to restore the UK economy to health. In differing degrees, we will all have to take some form of the medicine, that is except the bankers, who seem to be morally impervious to the economic necessities that the rest of us are having to deal with.

Otherwise, we are in a period in which headline inflation in the UK has risen. This, though, has largely been driven by higher oil prices, to which has been added the VAT increase, but does not mean that it will continue to rise. Within the headline rate, core inflation, which excludes 'duty heavy' items, such as fuel, alcohol and tobacco, appears to be under control and the 'output gap', so favoured as an indicator by Mervyn King of the Bank of England, still has to be closed. This should limit the risk of wage-driven inflation, which should to a degree offset the potentially inflationary impact of quantitative easing. However, whilst the broad definition of money supply has exploded as a result of quantitative easing, the narrower definition, as in the money circulating within the economy, has not grown significantly. As such, the argument between inflation and deflation continues to be debated with the key question being when quantitative easing, having now come to an end, is reversed and the gilts held by the Bank of England are released into the market. We suspect that the latter will not happen immediately but occur over a number of years. We are also of the view that monetary policy will defer to fiscal policy, and lag this, so as not to curtail the economic recovery that now seems to be underway. We, therefore, do not anticipate interest rate rises in the UK until, at the earliest, well into 2011.

We see a similar situation to the UK's elsewhere in the major developed economies, in differing degrees, with fiscal stimulus packages, extremely low interest rates and quantitative easing having to be reversed. This has already begun in the likes of Australia, China and Korea.

Meanwhile, if 2008 was the year of the 'perfect storm', the 'annus horribilis' for investors in all markets and asset classes, including those previously perceived as being defensive in nature, in 2009 'less bad news became the new good news'. In what we describe as having been a classic counter-reaction to the previous over-reaction, markets reacted positively to this and rallied accordingly. This was to the extent that, whereas equity and non-government bond markets were cheap in March 2009, such good value as was apparent then is less so now. There are, however, pockets of value available within various asset classes.

We believe that UK equities, in a broader sense, are currently attractively priced and that stable, non-cyclical, cash generative, dividend paying companies with strong balance sheets are even more so. This follows the so-called 'dash for trash', in which lower quality companies, which were previously priced for



oblivion, were re-priced for survival, leaving behind the aforementioned better managed, higher quality, less cyclical, more defensive and better financed stocks. Therefore, whilst for the patient investor, we do see a long-term opportunity in equities in both the UK and other developed markets overseas, we currently favour UK equity income funds, which have the added advantages of, by offering good dividend yields, being less reliant on capital growth to generate a positive return in what may turn out to be a sideways moving market and of having a high degree of non-UK revenues and earnings. We are still generally advocating the phasing in of monies into equities over a period of time.

In a similar vein, the attractive risk/reward pay-off in the investment grade corporate bond market that was apparent in March 2009 has been diminished following the very rapid recovery in the asset class that followed. With the yield 'spread' over government bonds having narrowed, making for what were equity-like returns in 2009, investment grade corporate bonds are now 'fair value'. However, whilst Government bonds are unattractive in an environment of exceptionally low interest rates, that can only rise in due course, and the exceptionally high budget deficits that are having to be funded, we perceive that there is value to be had further down the credit quality scale and are, thus, currently favouring strategic bond funds that have the flexibility to invest in high yield corporate bonds.

Looking overseas, we continue to believe that it will be beneficial to have a meaningful exposure to Asia Pacific and emerging markets. In this, we see the likes of China, India and Russia continuing to grow at a faster rate than the already developed countries over the long-term, albeit at a lower rate for a time than was previously the case. That said, emerging markets do not look cheap in the short-term and again phasing of investment into this area looks to be a better strategy than investing a lump sum straight away.

We are warming to UK commercial property, if only as the yield available has risen to historically attractive levels, which has been attracting investors, particularly, with the pound having fallen, from overseas. However, on the ground, vacancies are still rising, whilst rental income is falling, and, in 2010, likely to fall further as leases are renegotiated, with the tenant having the upper hand over the landlord. As a result, and, in particular, given the illiquid nature of the asset class, we are, for the time being, only really 'dipping a toe in the water' and are currently wary of committing too much to the asset class until such time as we see a sustained improvement in the economic environment, just in case there is another 'big freeze'. We are monitoring the asset class's 'temperature' closely but are being deliberately patient in light of its illiquidity. Whilst the asset class is, at this point in time, arguably appropriate for higher risk investors, we do not believe that it is yet for more cautious clients.

It is said that the 'most daunting view in the world' is being a jockey approaching the aforementioned 'Becher's Brook' on the Grand National course at Aintree. Fearful as it is, forty jockeys face it each year, as forty did this year, the year before and will do next year.

For investors, taking the risk in jumping such hurdles is necessary to earning a return this year, last year, next year and/or has been the case in previous years. Unfortunately, taking such risk led to heavy losses in 2008, which generally have yet to be recovered. However, in 2009 taking the 100-1 'long shot' paid off in both the Grand National and in investment markets.

To win the Grand National, means having to go around the course not just once but twice - with having to jump the same fences for a second time. It needs longer term thinking than most races. However, whilst just going around the fences, instead of over them, gains you nothing in the investment race, excessive risk taking will lead to an inevitable fall. For this year's investment race, we are preferring caution over unnecessary risk and are not betting everything on one horse, and certainly not one with long odds, but, instead, are spreading our bets across a number of horses, preferring those with experience that have run the course before. We are certainly not expecting a 100-1 bet paying off for a second consecutive year! Our aim



for our clients is, though, for them to complete the course very much still in the saddle and, hopefully, with a few extra pounds in their pockets without having taken undue risk. The hope is that we do not have to face 'Beacher's Brook' again in the near future.

Emery Little Cresswell Cadenhead Investment Department – 12th July 2010

PS. The opinions expressed here represent the views of Emery Little Cresswell Cadenhead at the time of preparation and should not be interpreted as investment advice. If a review meeting has not been arranged and you wish to have a meeting or a conference call, please contact our office to arrange a mutually convenient time.

Performance Data

World stockmarkets	% change			
	1 Month	3 Months	Year to Date	1 Year
UK (FTSE All-Share)	-4.85	-12.60	-7.87	17.10
USA (S&P Composite)	-8.12	-10.64	-0.23	23.41
Europe (FTSE Europe ex UK)	-3.25	-16.38	-13.38	12.01
Japan (Nikkei 225)	-4.04	-9.42	1.02	13.08
Asia Pacific (FTSE Asia Pacific ex Japan)	-3.14	-10.63	-3.61	28.62
Emerging Markets (MSCI Emerging Markets Free)	-3.77	-7.88	0.14	32.73
World (FTSE World)	-6.18	-12.03	-3.89	19.84

Source: Lipper Hindsight, capital return only, UK Sterling adjusted, mid market prices to end June 2010

MARKET DATA

World stockmarkets	Index	P/E Ratio	Div Yield %
UK (FTSE All-Share)	2,543.47	13.1	3.3
USA (S&P Composite)	1,030.71	16.0	2.1
Japan (Nikkei 225)	9,382.64	19.9	1.9
Germany (DAX 30)	3,497.52	15.3	2.8
France (CAC 40)	3,442.89	16.1	3.9
Hong Kong (Hang Seng)	20,129.00	14.5	2.8

Index source: Lipper Hindsight, data relates to indices in brackets, capital return only, in local currency, mid market prices as at end June 2010. PE Ratios and Dividend Yields source: Financial Times. Non-UK PEs and Yields relate to a sample of stocks that cover at least 75% of each market's capitalisation and not to the indices in brackets. UK PE and Yield are for FTSE All-Share index.

UK indices	Index	P/E Ratio	Div Yield %
FTSE 100	4,916.87	12.39	3.47
FTSE Mid 250	9,366.12	16.74	2.59
FTSE 350	2,598.19	12.83	3.35
FTSE Small Cap	2,690.90	NA	3.01
FTSE All-Share	2,543.47	13.10	3.34

Index data source: Lipper Hindsight, capital return only, in UK Sterling, mid market prices as at end June 2010. PE Ratios and Dividend Yields source: Financial Times.

ECONOMIC DATA

	Interest Rate	Inflation Rate	GDP Growth	
			2010 Latest	2010 F'cast
UK *	0.50%	3.2%	-0.2%	1.2%
USA	0.00 - 0.25%	2.0%	2.4%	3.1%
Eurozone	1.00%	1.4%	0.6%	1.1%
Japan	0.10%	-0.9%	4.6%	3.1%

* Inflation as shown is the Harmonised Index of Consumer Prices, Retail Prices index - 5.0%

Source: The Economist