



Newsflash

A new month and the 46th issue of Viewpoint from FP.

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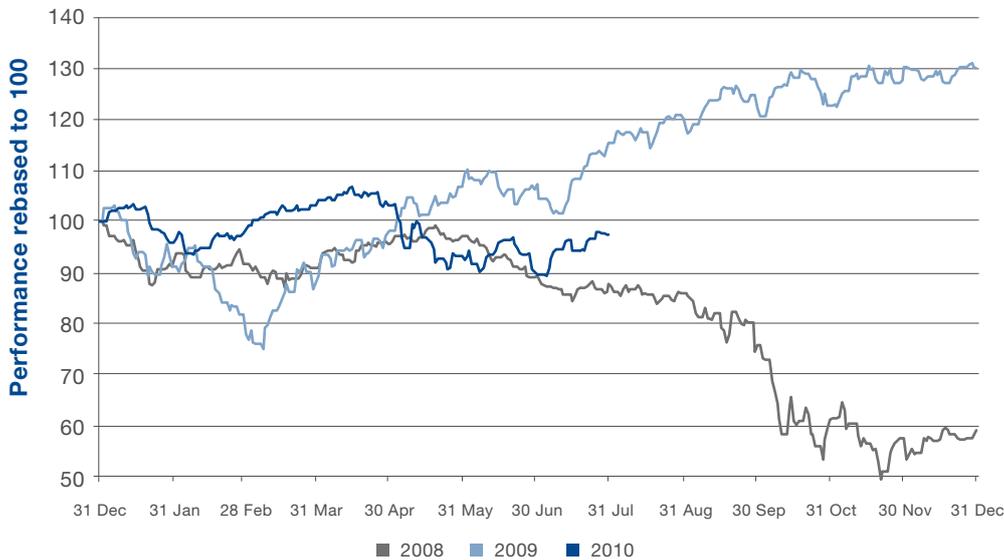
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The second half of 2010 has begun with rather a better tempo than the first half finished. Although markets were flat in very early July, the majority of the month was a positive time for risk assets. Market participants clearly felt in need of returns reminiscent of merely a year before, finding the positive in all but the gloomiest of news stories and company reports. The influence of positive sentiment is noticeable as the marginal data and news flow which probably would have resulted in a negative day in June, kept the market buoyant in July. Despite having been positive on equity market valuations for some time, we do think that July's rally might prove a little too sharp and as a result, to expect a continuation of this magnitude of returns may be overly optimistic. On page 2 is a chart of the MSCI World for the past two and a half years. This shows the divergence of returns between 2009 and 2008 and how year to date 2010 has performed in comparison. It is interesting to note how poorly all three years began. It is also interesting to note that the drawdown that occurred in April through June 2010 is amongst the biggest index falls during the 'credit crunch' period. This occurred despite positive commentary from the private sector, continued expansionary interest rate policies and relatively benign inflation. The concerns that have emanated from the markets year to date are premised more on the imbalance in government budgets and the impacts that any austerity measures may have on the consumer.

MSCI TR (net) in USD Rebased



Source: Bloomberg

Given the concerns regarding government finances, it is somewhat paradoxical to see government paper continuing to rally and with sovereigns such as the US (which has by no means the strongest fiscal position of all nations) yielding sub 3% over ten years. The reason behind this is that ultimately cash looking for a 'safe haven' has nowhere else to go. This positive feedback loop is presently resulting in any strongly negative views on the market resulting in a flight to quality. This is keeping government bond yields down, benefitting governments as they are able to issue debt cheaply. This scenario is also positive for high quality corporates as the cost of their debt is benchmarked off government rates plus a spread and although the spread is out a little, many corporates have been taking this opportunity to refinance cheaply.

The other important news story for the month centred on Europe as the banking sector stress tests. The markets' response to the outcome has been fairly muted and this is perhaps unsurprising as the stress tests turned out to be something of a damp squib. The conclusions were fairly positive, but the study appeared to leave some stones unturned in the process. The Committee of European Banking Supervisors (CEBS) suggested that seven of 91 EU banks failed to achieve a tier one capital ratio of 6% under a series of macroeconomic scenarios. Furthermore, the panel concluded

that only EUR3.5 billion was required to put the European banks in a stable position. The tests were also subject to some criticism as the committee effectively provided a 0% probability to defaults of sovereign holdings. Whether this is correct or not, it is clear that the markets remain concerned about the potential for default in the second tier European sovereigns as the spreads remain elevated.

Turning to the markets specifically, all of the major equity markets posted positive returns in July. The poorest performing major market in the month in local currency terms was Japan, which gained 1.0%. The strongest region was the US, which gained 7.0% in US dollar terms. The global equity index outperformed this, however, when stated in dollars as the greenback fell against all major currencies, providing a tail wind to foreign returns when translated into dollar terms. The chart on page 3 demonstrates the dollar's weakness over July. Investors in Europe who hid euros under their mattress, taking absolutely no investment risk in their local currency, would still have made 6.4% in US dollar terms in the space of a month, such was the volatility in the currency markets. The MSCI World Index returned 8.1% in US dollar terms in July and the emerging markets returned 8.3%. Year to date, the developed markets are still in negative territory with returns of -2.5%.



July currency returns vs. USD. Source: Bloomberg

The fixed income markets were reasonably strong too, with most government paper posting positive returns in local currency terms. UK gilts were the worst performers of the sovereign markets, returning -0.3% in sterling terms. Overall global government bonds returned 3.4% in US dollars, again aided by the weakening reporting currency. The broad investment grade index, which includes government paper, agencies and investment grade corporates, moved in lock-step with returns of 3.3%. High yield debt was the stand out debt class for the month, which is a function of the risk rally that occurred across all markets. US high yield returned 3.5% in local currency terms, whilst the European high yield markets gained 4.5% in euros. Year to date these asset classes have experienced significant positive gains and their returns exceed both investment grade debt and equities.

Property equities also rallied alongside other risk assets and the returns of this sector were in excess of the broader equity markets. The US posted the strongest returns in local currency terms of 9.7% and year to date this sector has gained 15.2%. In July all of the regions provided congruous returns with gains in the order of 7-8% and the Global Property Security Index returned 9.5% in US dollars again with the currency markets aiding returns. Year to date, the UK Property Security Index has underperformed, with returns of -7.0% in sterling terms. The Global Property Securities Index has outperformed the broader equity markets year to date, with a return of 2.5% compared to -2.5% in US dollar terms.

The commodities markets had an interesting month with both agricultural and broad based indices performing well. Gold performed poorly, returning -6.0%, with some selling pressure likely coming from investors whom had been using the commodity as a safe haven. As sentiment turned to embrace risk, gold holdings may have been used to fund forays into the equity markets. Oil was muted, with a return of 0.3% in July doing little to affect the year to date return of -2.5% in US dollar terms. Despite these returns from major index constituents, the broad commodity index gained 7.9% in July. Year to date the returns from this asset class remain in negative territory, with returns of -2.7%. Agricultural commodities posted strong returns, with gains of 13.7% in July and this sector will also have provided impetus to the broad index as Agriculture accounts for over a quarter of that. Notable specific returns for futures within the index include major index constituents such as: wheat (+37.0%), corn (+8.9%) and soy oil (+9.1%).

Asset Class Performances

Asset Class/Region	Index	Currency	Jul 2010	YTD 2010
Equities				
United States	S&P 500 NR	USD	7.0	-0.4
United Kingdom	FTSE All Share TR	GBP	6.9	0.3
Continental Europe	MSCI Europe ex UK NR	EUR	4.7	0.8
Japan	Topix TR	JPY	1.0	-5.5
Australia	S&P/ASX 300 TR	AUD	4.5	-6.1
Global	MSCI World NR	USD	8.1	-2.5
Global Emerging Markets	MSCI World Emerging Markets TR	USD	8.3	1.7
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	0.7	6.8
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.1	4.6
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	2.0	7.9
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	3.5	8.1
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-0.3	5.7
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	0.9	6.9
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.9	3.2
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	1.2	4.8
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	4.5	10.3
Australian Government	JP Morgan Japan Government Bond Index TR	AUD	0.4	2.6
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.0	5.1
Global Government Bonds	JP Morgan Global GBI	USD	3.4	3.8
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	3.3	2.4
Global Convertible Bonds	UBS Global Convertible Bond	USD	6.0	1.2
Global Emerging Market Bonds	JP Morgan Global EMBI+	USD	4.4	9.7

Asset Class/Region	Index	Currency	Jul 2010	YTD 2010
Property				
US Property securities	MSCI US REIT TR	USD	9.7	15.2
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	7.3	-7.0
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	7.9	6.2
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	8.0	-0.4
Australian Property securities	FTSE EPRA/NAREIT Australia TR	AUD	8.2	-0.8
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	9.5	2.5
Currencies				
Euro		USD	6.4	-9.2
Sterling		USD	4.7	-3.0
Yen		USD	2.1	7.4
Australian Dollar		USD	7.2	0.7
Rand		USD	5.0	0.8
Commodities				
Commodities	RICI TR	USD	7.9	-2.7
Agricultural Commodities	RICI Agriculture TR	USD	13.7	0.7
Oil	ICE Crude Oil CR	USD	0.3	-2.5
Gold	Gold index	USD	-6.0	3.9
Interest rates				
	Last meeting		Current rate	Change at meeting
United States	23 June 2010	USD	0.25%	No change
United Kingdom	5 August 2010	GBP	0.50%	No change
Eurozone	5 August 2010	EUR	1.00%	No change
Japan	14 July 2010	JPY	0.10%	No change

Source: Lipper Hindsight, August 2010

FOCUS - The credit crisis: after-shocks or permanent structural damage?

The credit crisis which first surfaced three years ago is far from over. The initial shock produced an economic earthquake and an unprecedented fiscal and monetary response. The damage continues, especially now in the government sector with unsustainable public sector debt levels in many countries. Are these after shocks that we are now seeing or is the landscape again changing permanently? Are the underlying fault lines still with us? Uncertainty levels are extremely high and are getting no clearer. In this thick fog of concerns, what do we know with certainty?

First, substantial damage has been wrought to western economies. Economic activity fell by up to 10%, wealth declined materially and some productive capacity has been permanently lost. Yet emerging economies came through largely unscathed. New realities of global power are in evidence with the rise not just of China but other developing countries as leading global players. We no longer talk about the G7 or G8 but it is now the G20.

Second, the era of easy credit in the West, much backed by housing, is over.

Third, fiscal conservatism is here to stay for the foreseeable future; the transfer of private sector debt to the public sector since the crisis started, the irresponsible behaviour of some governments in the past decade, and the inevitability of ageing populations and resultant drain on public sector resources leaves public debt in many countries at unsustainable levels: debt must be reined in. Many countries are being forced down the austerity route to avoid a debt collapse.

Fourth, global rebalancing-higher consumption in surplus countries, more savings in deficit nations-is essential to establish lasting stability.

Fifth, monetary policy in the West is likely to focus on short term deflationary risks rather than any long term inflationary concerns. The threat of deflation is imminent, that of inflation a somewhat distant and uncertain possibility. Evidence of

previous financial crises and economic cycles illustrates how difficult it is to break out of a deflationary spiral, possibly because of behavioural patterns; whatever the cause most central bankers understand how important it is to avoid getting into that spiral in the first place. Interest rates are set to remain low for a very long time and there is a strong chance that quantitative easing will be resumed in due course.

While so much is clear, we need to understand the implications of these far reaching developments and also take into account the huge uncertainties which are making investment policy decisions immensely difficult.

Central banks and governments face tough choices. The risk of policy error is huge. Do central banks ease policy further to counter deflationary forces? What longer term risks with inflation are they prepared to take? What signals will they look for to tighten policy? The record of central banks over many years suggests that they are unlikely to be ahead of the curve in spotting changes in trend. They are much more likely (especially in the US and UK) to take a longer term risk on inflation than risk deflation.

Governments are faced with a choice between financial solvency which means considerable short term pain and potentially a double dip recession and even social unrest, or continuation with fiscal stimulus and risk a debt funding crisis, default, resultant recession and potentially social unrest. In reality, probably only the US has the luxury of this choice, since it remains the world's most powerful economy and reserve currency, with the invaluable ability to fund its debts exclusively in its own currency. But even in the case of the US the markets will not tolerate high debt levels indefinitely; sooner or later reality will return, as it already has among the US States where there is a fierce spending squeeze at the moment. As we saw with Greece, other countries simply do not have the choice, they have to live within their means; their inability to fund in the markets at sustainable levels means that they are forced to reduce spending, raise taxes and cut debt. The age of austerity is upon us.

Companies across many industries face structural over capacity; banking and autos are obvious examples. Although these issues are being aggressively addressed and balance sheet health of the corporate sector has been rapidly rebuilt, companies cannot continue to grow by cutting their cost base. Where will growth come from in a low growth environment? Expect to see many more mergers and acquisitions and continuing expansion into the emerging world.

At the moment there appears to be a disconnect between the message being delivered by bond and by equity markets, and between macro and micro predictions of economic activity. Bond yields have fallen sharply in recent months as investors have become much more concerned about the ability of economies to continue to grow in the face of severe public sector cuts and the ongoing deleveraging process in the private sector. Yet equity markets, while nervous, are still well up on the levels of early 2009. Macro predictions of economic growth are being revised down across the board yet companies continue to give a positive view on profitability and their outlook.

Worryingly, despite the massive injections of liquidity by central banks globally over the past two years, real broad money growth across the developed world is showing no growth. Banks are continuing to hoard cash to restore financial health and build a much bigger liquidity buffer to protect against future shocks.

What does all of this mean and what are the implications for investors?

First, asset allocation should blend caution, diversification and opportunism. This is not a time for aggressive positioning of portfolios with large biases to any particular asset class, the uncertainties are just too high. The focus should be on end outcomes and liability matching rather than the asset class. Diversification across uncorrelated asset classes is the prudent and sensible approach. But we are undoubtedly in a highly volatile environment with markets very sensitive to shifts in the balance of expectations, and we need to remain

alert to the opportunities this creates; buying undervalued equities at moments of market panic makes a lot of sense to us.

Second, liquidity and capital protection will remain paramount. The risk of permanent loss of capital should be uppermost in our minds, not simply the outperformance of a particular index; absolute returns in a low growth, low return environment will be vital. After the shocks of the past three years, liquidity will remain a critical consideration for investors. Similarly, leverage and complex overlays are off the agenda for the foreseeable future.

Third, there will be continuing separation of alpha and beta. Beta can be increasingly sourced at very low cost especially in the most efficient markets of the world, such as the US and UK, whereas investors should be seeking out the alpha opportunities in the high growth and less efficient markets of the emerging world. Growth, wherever it can be found (most probably in or sourced from the emerging world) will sell at a premium; we will need to get used to paying a higher valuation for emerging market stocks than those in the West.

Fourth, interest in 'exotic beta', accessed through the growing array of ETFs in different markets and sectors, will expand in pursuit of broader diversification and increasingly scarce growth opportunities. By implication, investment choices are likely to become more varied, again confirming the need for diversification and opportunism.

The huge uncertainties mean high tail risks for investors. Some insurance against the extremes of risk should be maintained. Although government bonds appear to be expensive, they offer the ultimate safe haven in the event of a double dip or market dislocation. But not all governments are equal; there is a critical need to buy insurance that pays out when the worst happens. Sovereign risks remain one of the biggest risks for investors in the next couple of years. On the other side of the spectrum, while inflation is not today's problem in the West the end game of the credit crisis (and perhaps the ultimate solution to the excess levels of debt) could be

inflation. Some inflation protection such as inflation linked bonds or commodities will have merit.

Equity styles should be increasingly considered in the construction of portfolios. Equity markets have moved sideways now for almost a year, albeit with some large swings on the way. During that time corporate earnings have increased by 20-30%, so the valuation of equities has fallen to historically attractive levels. But given the risks to the economy and the selective impact of spending cuts on the way, great care needs to be taken with the type of investment, by sector, style and company. Defensive, quality stocks with strong cash generation, robust balance sheets,

powerful franchises and high predictability of earnings should be the winners in coming years. These companies are trading at low valuations at the moment, having underperformed during the big surge in markets last year. Those companies which can combine these qualities with safe and attractive dividends look particularly interesting during the low income years ahead.

Finally, the environment we foresee is not a multi-year bull market but rather sideways trading markets for some time to come, moving in a wide and sometimes worrying range but creating excellent opportunities for dynamic asset allocation across a wide range of asset classes.

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