



## Newsflash

A new month and the eighteenth issue of Viewpoint from FP.

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## Table of Contents

- |                                      |       |
|--------------------------------------|-------|
| 1. <b>January 2008 Review</b>        | 1 – 3 |
| 2. <b>FOCUS: A Turbulent January</b> | 4 – 8 |
| 3. <b>Important Notes</b>            | 9     |

Following on from 2007's somewhat damp ending, global markets did not enter 2008 bursting with optimism. This, together with the spreading impact of the credit crisis, set the scene for a run of successive daily losses accompanied by negative news stories. Indeed some equity markets performed worse in the first three weeks of January than they had begun any other year. Add into this volatile mix Jérôme Kerviel, SocGen's rogue trader, who caused losses several times larger than the infamous Nick Leeson and mid-month the equity market appeared close to melt-down. The Fed then intervened twice in January, using its emergency powers for the first time since the aftermath of the 2001 terrorist attacks in New York. The total Fed rate cuts in January were 125 basis points, bringing the US interest rate to 3.0%. The effect of these cuts was to settle investor nerves, partially reversing some significant intra-month price falls in risk assets. The Fed's emergency rate cut came after a day of torrid trading in Europe. With hindsight it appears that this particularly poor day may have been caused at least in part by trading out of positions held by Kerviel at SocGen. Regardless of the rate cuts the levels of equity market volatility rose throughout January, peaking at the highs seen in November and August 2007, and only beginning to stabilise towards month end.

From the start of the month to the date of the Fed's emergency cut, major markets had lost between 10 and 20%, but the emergency 75 basis point rate cut, followed by a scheduled 50 basis points soon after, resulted in an equity market rally to month end. The size of the rally was significant and served

to hide the severity of January's first half losses. The month closed with global equities down -7.6% in US Dollar terms. The strongest major market was the US, which returned -6.1%. Continental European equities were the worst major, returning -12.2%. These poor returns and the sharp move down in equity prices seems to price a large amount of negative news into the market. Towards the end of the month a greater degree of confidence was apparent as volatility fell, and the markets stabilised.

In recent months, there has been a great volume of print dedicated to the 'decoupling' of the emerging markets (EM) from the developed markets. This is not a view that we have held and the ability of these economies to resist the negative performance in the developed world came under severe pressure in January. Indeed EM equity returned -12.5% in January to underperform their developed counterparts. Returns such as these serve to highlight the fact that these markets are not immune from sentiment, asset values and economic activity in the developed markets. They also highlight the fact that investors in emerging markets equity need to be aware of the potential for volatility in this region. As we have advocated before, exposure to this region should be through conservative managers to ensure that, whilst missing some of the upside, investors should aim to the worst of the downside at times of negative performance.

Global bonds benefitted on two fronts in January as the poor equity market performance sparked a flight to quality and global interest rate forecasts were revised down. The Fed's total of 125bp cut in interest rates dragged global bond yields lower stimulating the bond market leading to capital gains. The 10 year US Treasury ended January yielding under 3.6%. In total return terms US Treasuries provided 2.6%, Japanese Government bonds 0.5%, European Government bonds 2.4% and UK gilts 0.9%. Recently global bonds have provided investors a degree of insulation from the volatility in risk assets; this underlines the merit of bonds as a diversifier of risk in multi-asset portfolios. In January global bonds overall returned 3.0% in US Dollar terms. Despite the market volatility, Emerging Markets Debt spreads did not change greatly through the month, with these bonds yielding c.230 basis points over the US Treasury at month end.

In global currency markets the Fed's rate cuts were reflected in further US Dollar weakness. The top performing major currencies were the Japanese Yen and Swiss Franc. These appreciated by 5.1% and 4.8% respectively against the US Dollar. In 2007 the Yen benefitted at times of volatility as this caused 'carry traders', borrowers in low yielding currencies such as the Yen, to close their positions by buying Yen, causing Yen strength. The Swiss Franc often benefits at times of market anxiety for the same reason, although the Franc is a less popular choice for the carry trade. Additionally the Swiss currency is seen by the market as a defensive holding, making it attractive during volatile market periods. Other currencies that benefitted over the period were the relatively high-yielding Australian and New Zealand Dollars, the widening of the interest rate differential versus the US Dollar over this period aiding returns. A notable underperformer in January was the South African Rand, which returned -8.9% against the US Dollar. Moves of this magnitude underline why it is prudent to have diversified currency components within multi asset portfolios.

Commodities continued to perform well in January, returning 2.7% to investors. The metals performed well with gold up 10.5%, silver up 14.3% and platinum returning 13.9%. Oil, on the other hand, provided negative performance in the month, returning -2.7%. Agricultural commodities continued to provide strong performance, outperforming commodities in general, returning 4.5%. Notable performers in the soft commodities included cocoa, up 15.5% and canola, up 13.1%. Throughout January commodities in general have provided returns which are lowly correlated with the equity markets. In the medium term we believe that the combination of supply and demand factors, coupled with global political initiatives make agricultural commodities an appealing portfolio diversifier. In January this may have contributed to the out performance of agricultural commodities compared to the broader commodity index.

Global listed property markets again proved the benefit to investors of tactical, regional allocation decisions. The fact that regional property's supply and demand fundamentals vary significantly between geographical areas is a topic that has been covered regularly in Viewpoint. Global listed

property returned -5.5% in January, with the UK providing the strongest returns of 4.8%. All the other major regions were in negative territory, with the US returning -0.4% and Europe -2.1%. Asia returned -9.4% to underperform the other regions. The strength of the UK performance was due to a number of factors including a slight change in sentiment

generally among the market to a more positive stance, several property companies reporting better than expected results and, in light of the other two points, the impression that the UK listed property sector may have sold off a little too far in the second half of 2007.

## Asset Class Performances

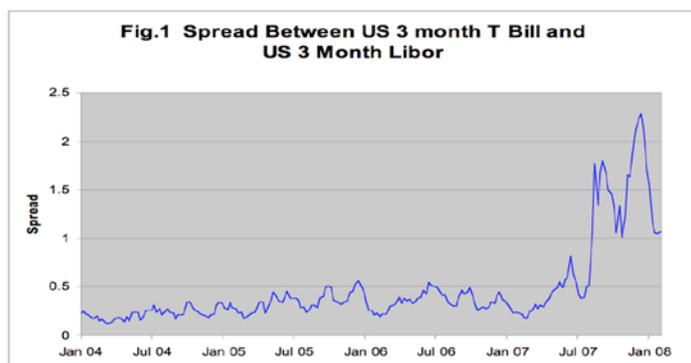
Asset Class Performance (%)	Jan 2008
US Equities \$	-6.1
UK Equities £	-8.7
Cont. European Equities €	-12.2
Japanese Equities Yen	-8.8
Global Equities \$	-7.6
Global Emerging Markets Equities \$	-12.5
US Bonds \$	2.7
European Bonds €	2.4
Japanese Bonds Yen	0.5
Global Bonds \$	3.0
US REITs (property) \$	-0.4
FTSE Real Estate £	4.8
FTSE EPRA Real Estate ex UK €	-2.1
FTSE EPRA Real Estate Asia \$	-9.4
Euro vs. US Dollar	1.3
Sterling vs. US Dollar	-0.1
Yen vs. US Dollar	5.1
Rand vs. US Dollar	-8.9
Commodities \$	2.7
Agricultural Commodities \$	4.5
Oil \$	-2.7
Gold \$	10.5

Source: Bloomberg, Lipper

## FOCUS: A Turbulent January

January was truly a terrible month in equity markets across the board. Markets have been coming to terms with the possible effects of the sub-prime crisis in the US and the resulting credit crunch since last June when it first became a major issue. However these issues finally caught up with the equity market and in the first half of January markets plummeted.

When the first murmurings of the sub-prime crisis came to light last June it appeared that any fallout would only be felt in the fixed income markets. Fig 1. shows the spread between the 3 Month US T bill and the 3 Month US LIBOR. Essentially LIBOR is the rate that banks use to lend to each other, from January 2004 until May 2007 the highest that this spread reached was 56bps and the average spread was just 30bps.



Source: Bloomberg

Normally LIBOR rates are one of the most boring parts of financial markets with investors only using it to place money they want to be super safe. It was only important for banks that used it to fund short term liquidity to finance their day to day operations. A major user of this short term funding was Northern Rock Bank in the UK.

Of course this incredibly dull part of the market suddenly became interesting last year. As major banks began to realise that they would have to take on huge losses owing to their sub-prime exposures they wanted to hold on to their capital. This meant that normal interbank lending came to a halt. The spread between the 3 Month T Bill and LIBOR leapt to 228bps at one point and has averaged 125bps since last June. In simple terms it meant that banks were now paying a lot more to finance themselves. This led directly to the problems at Northern Rock as they could not fund their liabilities and had to seek funding from the Bank of England as lenders of last resort for support.

It was not just Northern Rock which had problems; a lot of major banks, with their access to funding coming under pressure, found it hard to keep their capital adequacy ratios at high enough levels. For a bank, preserving their capital adequacy ratio at a high enough level is critical. If it falls too far they would lose their credit worthiness and come under severe pressure. It was through the banking system that the 'sub-prime crisis' turned into the 'credit crunch' and transferred to the equity markets.

The easiest way for a bank to ensure it does not break its capital adequacy ratio is to stop lending, thus preserving cash. This has not happened totally but banks started to restrict their lending and charged a lot more to make loans. Consumers and companies that were used to easy credit are finding they are paying a lot more to borrow money.

This is what scared equity investors; if lending in an economy is reduced this will lead to lower growth. If there is lower growth in an economy then equity valuations suddenly do not look so attractive. In January these worries came to the fore and equity markets capitulated. Fig. 2 shows the falls in equity markets from the start of January to just before the Federal Reserve cut rates on the 22nd of January.

**Fig. 2**

Region	Stock Market	Percentage Fall
<b>Americas</b>	S&P 500 Index	-9.8%
	NASDAQ Composite Index	-11.8%
	S&P/TSX Composite Index	-12.3%
	Brazil BOVESPA Stock Index	-15.9%
<b>Europe</b>	FTSE 100 Index	-13.6%
	DJ EURO STOXX 50 = Pr	-15.8%
	Swiss Market Index	-14.1%
	CAD 40 Index	-15.5%
	DAX Index	-15.8%
<b>Asia*</b>	TOPIX Index (Tokyo)	-17.3%
	Hang Seng Index	-21.8%
	S&P/ASX 200 Index	-18.2%
	Shanghai SE A Shere Index	-13.3%
	Taiwan TAIEX Index	-10.9%
	NSE S&P CNX Nifty Index	-20.2%

Source: Bloomberg

\* Prices to Close of Business 22<sup>nd</sup> January

With concerns over the availability of credit in the real economy driving the market lower there was an easy solution. This was for the Federal Reserve to cut interest rates, thus making it much cheaper to borrow money whilst still allowing banks to make a handsome profit on what they lend out. On January 22<sup>nd</sup> before the US stock markets

opened this is what the Federal Reserve did; in a surprise move they cut rates by 75bps. This was then followed by a further 50bp cut at their scheduled meeting on the 30<sup>th</sup>. The effects of this on the markets can be seen in Fig. 3 which shows how markets performed from the time the rate cut was announced until the end of the month.

**Fig. 3**

Region	Stock Market	Percentage Move
<b>Americas</b>	S&P 500 Index	4.0%
	NASDAQ Composite Index	2.1%
	S&P/TSX Composite Index	8.4%
	Brazil BOVESPA Stock Index	10.8%
<b>Europe</b>	FTSE 100 Index	5.4%
	DJ EURO STOXX 50 = Pr	2.4%
	Swiss Market Index	5.3%
	CAD 40 Index	2.6%
	DAX Index	0.9%
<b>Asia*</b>	TOPIX Index (Tokyo)	10.4%
	Hang Seng Index	7.8%
	S&P/ASX 200 Index	8.9%
	Shanghai SE A Shere Index	-3.9%
	Taiwan TAIEX Index	-0.8%
	NSE S&P CNX Nifty Index	4.9%

**Source:** Bloomberg

The key question now is what will happen going forward? Investors are left with a dilemma. In the short term growth will undoubtedly be weak and it is well known that interest rate cuts take time to feed through the economy. Will markets fall further; reacting to current bad news or will they rally in the knowledge that lower interest rates will boost the economy over the medium term?

Our current view is that the latter will happen and that as 2008 progresses equities will begin to show improved

performance. However there will be a lot of short term volatility as the effects of the credit crunch continue to work their way through the economy and uncertainty levels regarding the depth of the earnings and declines in many sectors remain very high. We have reduced our equity exposure over the last few months and are comfortable to remain where we are in the short term. As the economic outlook becomes clearer and as monetary policy is eased further we envisage increasing this equity weight over the second or third quarter of 2008.

**Fig. 4**

Region	Stock Market	Percentage Move
<b>Americas</b>	S&P 500 Index	-6.1%
	NASDAQ Composite Index	-9.9%
	S&P/TSX Composite Index	-4.9%
	Brazil BOVESPA Stock Index	-6.9%
<b>Europe</b>	FTSE 100 Index	-8.9%
	DJ EURO STOXX 50 = Pr	-13.8%
	Swiss Market Index	-9.6%
	CAD 40 Index	-13.3%
	DAX Index	-15.1%
<b>Asia*</b>	TOPIX Index (Tokyo)	-8.8%
	Hang Seng Index	-15.7%
	S&P/ASX 200 Index	-10.9%
	Shanghai SE A Shere Index	-16.7%
	Taiwan TAIEX Index	-11.6%
	NSE S&P CNX Nifty Index	-16.3%

*Source: Bloomberg*

The initial cut stopped the freefall in markets and led to a sharp rally in equity prices in all markets with the notable exceptions of Taiwan and the Shanghai index in China. The month still ended down as Fig.4 shows, but the rate cuts restored some confidence to markets.

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