VIEWPOINT

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Newsflash

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July began with a continuation of June's losses. These falls, however, had come to an end by mid month and in fact risk assets staged something of a rally to end the month. Despite the final performance numbers, overall July provided a continuation of the classic risk-aversion scenario that investors have become accustomed to over the last year. Once again investors experienced government debt appreciation, while spread sectors and equities softened. The monthly return numbers, however, mask another month of high volatility which saw the equity market fall in the order of 5.5% before the recovery.

The most important news, and the turning point for investor sentiment, centred on Fannie Mae and Freddie Mac, the two US Government Sponsored Entities (GSEs). Early in the month there was significant rumour and intrigue regarding the liquidity of these, the largest mortgage lenders in the US. In a manner similar to Bear Stearns there were calls for government intervention and the possibility of nationalisation was raised. By mid-month these fears had been allayed with Treasury sponsored support measures and thus the rumoured liquidity crisis did not grow into a genuine solvency crisis. A second significant theme must be the reduction of the price of oil. At the end of June a barrel of oil cost over USD140 per barrel, but by month end it had fallen to USD124 (see Fig. 1). Whilst this is still materially higher than the price of even a year ago, it highlights the fact that inflation concerns could moderate reasonably quickly if global growth slows and demand for commodities abates. Indeed inflation expectations for the next year have fallen by close to 1%.

Most of the global equity markets ended July in negative territory. The index began by continuing June's downward trend at the start of the month as concern grew regarding the state of the US mortgage lenders Fannie Mae and Freddie Mac following the collapse of IndyMac and the impact that would have on the economy. The past year has been difficult for equity investors; indeed the Global Equity index has fallen in eight out of twelve months. In July, the global equity market returned -2.4%, bringing its year to date return to -12.8% in US Dollar terms. Amongst the major indices, the US was reasonably resilient, returning -0.9% in USD. Japanese and European equities performed in a similar fashion, returning -1.2% and -1.3% in local currency terms, whilst the UK underperformed these, returning -3.6% in Sterling terms. Although this served to continue the recent decline in equity markets, at least the late rally in July showed that the equity market remains alert and responsive to better news.

In global emerging markets, the continued investor uncertainty led to a decline of -3.8% in US Dollar terms in July, bringing the year to date return to -15.1%. Despite the negative returns overall, there were some pockets of strong performance in July. India, for example, returned 12.0% in local currency terms providing some respite for investors in a difficult market, whilst Turkey gained 21.0%. This was mitigated by markets such as Russia and Brazil which returned -14.4% and -12.8% respectively in local currency terms. Performance differentials such as these highlight why we continue to advocate a diversified approach to emerging markets, rather than focussing on country or regionally specific funds.

Global bonds were able to provide investors some stability, if not any meaningful returns, as the market gained 0.1% over the month. Year to date bonds have returned 4.2% in US Dollar terms, as investors have sought 'safe haven' assets. The yield available on the 10 year US Treasury ended the month below 4%, which appears fully priced, despite being above the mid-March low of 3.3%. Despite the fact that inflation is at present a much cited concern for market participants, the inflation protected bond market's implied inflation level is moderate in the developed markets. Breakeven inflation in the major markets is forecast to be between 0.2% in Japan and 3.5% in the UK. This suggests that the bond market is reasonably sanguine about inflation at present. This will provide some comfort to central banks, whose ability to mitigate slowing global growth was curtailed by the presence of inflationary pressures. Overall bonds have provided a welcome degree of stability to portfolios over the past nine months, providing positive returns when investors needed them most.

Within the non-government fixed income universe in July, overall, lower-quality debt underperformed the higher-quality, further underlining the markets' preference for 'safe havens' last month. Global High Yield corporate bonds retreated -1.8%. This may represent a small underperformance when compared to sovereign debt, but these bonds have outperformed equities over the same period. Hard currency denominated emerging markets debt returned 1.6%.

Within the currency markets, the South African Rand saw a resurgence following a poor start to 2008 as the prospect of a more hawkish monetary policy in South Africa provided a fillip to the currency. Year to date, however, the Rand is still in negative territory against the greenback returning -6.4%. The other major currencies were weak as the US Dollar staged something of a rally in the month. The Zimbabwean Dollar continues to be in a torrid state, returning -83.6% in July alone as inflation ravages the economy.

The global property markets experienced a slight relief from their recent drift downwards. Global property returned 0.8% in US Dollar terms, following a return of -13.2% in June. The latter explains the majority of the year to date return of -13.0%. Within the various property regions, the UK and US performed well, returning 3.2% and 2.7% respectively in local currency terms. The

Source: Lipper Hindsight, Bloomberg, Citigroup, Lehman Brothers, August 2008

US and the UK were the first property markets to come off their highs last year, and the US in particular has been providing a degree of support for the global index as other regions continue to experience weakness. Asian and European property stocks weighed on the index, returning -0.3% and -2.5% respectively. July serves to reinforce our belief that investors should take a diversified approach to global property securities, using regional allocation decisions to exploit the performance differentials that exist between them. As the listed market is a leading indicator for the direct market we would expect further declines in the direct market.

Following strong returns in June, one source of respite in July was the falls in the commodities markets. Gold fell slightly, returning -1.3% in the month, but oil experienced a material drawdown to end the month -12.4% lower. This was particularly significant as oil has been a much-cited contributor to the recent inflationary pressures. The oil price fell as investors become more confident about the supply side, whilst demand is falling as consumers change their habits in light of spiralling fuel costs. Silver was in fact the only precious metal that provided positive returns (2.0%), as platinum and palladium fell -14.9% and -17.5% respectively. The soft commodities market also had a difficult month, returning much of their June gains. Overall the market returned -8.8%, with few futures in positive territory. A number of large index constituents performed poorly, such as wheat which fell by -8.2%. In the commodities markets generally investors should expect volatility, especially where futures are held, but we expect, over the longer term, that the returns available from selected elements within this asset class will compensate for this heightened risk. Also, from a portfolio perspective, as these commodities are lowly or negatively correlated with other asset classes, a prudent allocation to agriculture could actually serve to reduce overall portfolio risk.

Asset Class Performances

Asset Class Performance (%)	July 2008	2008 YTD
US Equities $	-0.9	-13.0
UK Equities £	-3.6	-14.4
Cont. European Equities €	-1.3	-20.3
Japanese Equities Yen	-1.2	-10.7
Global Equities $	-2.4	-12.8
Global Emerging Markets Equities $	-3.8	-15.1
US Bonds $	0.5	3.1
European Bonds €	2.1	1.4
Japanese Bonds Yen	0.4	0.4
Global Bonds $	0.1	4.2
US REITs (property) $	3.2	-0.4
FTSE Real Estate £	3.0	-18.8
FTSE EPRA Real Estate ex UK €	-1.6	-13.6
FTSE EPRA Real Estate Asia $	-0.3	-23.0
Euro vs. US Dollar	-1.0	6.7
Sterling vs. US Dollar	-0.5	-0.5
Yen vs. US Dollar	-1.9	3.4
Rand vs. US Dollar	7.2	-6.4
Commodities $	-9.3	17.2
Agricultural Commodities $	-8.8	2.3
Oil $	-12.4	30.0
Gold $	-1.3	9.9

Source: Bloomberg, Lipper, Citigroup, August 2008.

FOCUS: The Credit Crunch One Year On

On 9 August 2007 the European Central Bank (ECB) acted to pump liquidity into the banking system, following a leap in interbank interest rates. This instance has since been heralded by many as the opening chapter of what became known as the 'credit crunch', a phenomenon which, twelve months on, has yet to conclude. If 9 August 2007 was the first chapter, the preface had been long and complex, with a number of different elements coming together to cause the liquidity in the money markets to dry up. Later the causes of the seizure of the credit markets will be assessed, but first a brief reminder of the course of events over the year.

Just a month after the ECB's first actions, on 13 September 2007, Northern Rock sought emergency funding from the Bank of England (BoE), resulting in a run on its deposits as account holders became anxious about the bank's solvency. This represented the first run on a UK bank since Victorian times and did little to bolster faith in the oversight and regulation of the UK financial markets. Next, throughout the autumn of 2007, banks began to report the first bout of losses related to the subprime mortgage crisis, emanating from the US. In early December the world's major central banks embarked on a concerted effort to further inject billions of dollars of liquidity to the banking system, temporarily lowering the interbank rate. Into the New Year equity markets were weak and on 21 January 2008 the global markets had their largest one day fall since the terrorist attacks on the World Trade Center in 2001. The Federal Reserve (the Fed) reacted by undertaking an emergency interest rate cut to help to reduce the viscosity. In mid March, America's fifth largest investment bank, Bear Stearns experienced a liquidity crisis that came perilously close to a solvency crisis as clients left in droves. The bank was swiftly and clinically saved by JP Morgan acting in concert with the Fed. The most recent news relates to the US Government Sponsored Entities Fannie and Freddie whose liquidity was called into question this month, following the collapse of IndyMac.

The years leading up to August 2007 provide the background for the last 12 months. The money markets were brought to a standstill by the bursting of a bubble in the credit markets. The bubble had resulted from the benign market and economic conditions of the past decade which resulted in reductions in default risk and a compression of credit spreads globally. This led to a search for yield and investment banks looked to low grade home buyers as a source of this. As a result, the investment banks developed an insatiable appetite for sub prime mortgages which they could securitise and sell on to other investors. Mortgage brokers, who would negotiate these loans and then sell them on to the banks, were naturally eager to oblige and additionally, an emboldened, but financially poorly consumer was enticed by teaser rates and low deposits to take to the property ladder.

The investment banks put the sub prime debt through any one of a number of processes, with the ultimate aim of diversification of risk between holdings. Investors were theoretically protected by the diversity of the underlying borrowers (the individual homeowners). This debt was often repackaged by the use of structured products such as CDOs, a financial tool that through diversification and concentration of risk with a minority of investors in lower tranches, purported to reduce the risk for investors in the 'debt' tranches. CDOs were hardly a regular topic of conversation for the average punter a year ago, but today their import, if not their mechanics, are becoming understood by Joe Bloggs, John Doe and Mrs Watanabe. As a result of the tranche methodology, a collection of bonds that included a proportion of subprime loans ended up being sold on as AAA credit. Thus, simply put, a subprime bond could be mixed with other loans, sliced, diced and repackaged, and sold as part of a tranche of high quality, low risk debt.

A large proportion of this debt was in fact held by investment banks and in isolation looked safe, but the value of many of these holdings fell spectacularly as questions about the robustness of assumptions used in structured products surfaced. As these losses were either marked to market or actually realised, banks experienced significant write downs. According to the most recent Bloomberg data, the level of these write downs has hit USD501 billion. This resulted in a bout of capital raising for the banks of USD353 billion as they sought to buttress their balance sheets.

Source: Lipper Hindsight, Bloomberg, The Economist, August 2008

Since the ECB's first steps a year ago a number of central banks have acted with varying degrees of aggression to add liquidity to their markets. The most obvious protagonist is the US, who cut their interest rates by 3.25 percentage points from 5.25% to 2.0%. This task has been made additionally complex by the fact that the recent swelling of commodity prices has fanned the flames of inflation. The traditional monetary policy tools used to combat slowing economic growth or boost liquidity tend to also increase inflationary risks. Now, with global growth slowing, but inflationary pressures still high, central banks will find their role more difficult than of late.

The conditions now for borrowers represent a logical continuation of the conditions that were first experienced one year ago. The money markets remain viscous, despite repeated attempts to add liquidity to the system. Effectively lenders wish to ensure that any loans they make have a good chance of being repaid. As a result the interest cost charged on these loans remains high, which has the dual benefit of increasing revenues for the bank (making potential losses more bearable) whilst making debt more expensive for the borrower (which prices many out of the market). Additionally in many instances where a loan is collateralised, lenders will now require a higher loan to value (LTV) ratio, meaning that the

Fig 2:
US LIBOR (%)
Fed Funds Rate (%)
Source: Bloomberg, Aug 2008

Fig 3:
Spread between US LIBOR and Fed Funds Rate
Source: Bloomberg, Aug 2008

value of a loan available on collateral of a particular size has fallen. Figures 2 and 3 show that despite a reduction in the nominal level of the interbank lending rate (LIBOR), the spread over the Fed Funds rate has increased making loans more expensive from a relative perspective compared to recent years. A recent survey from The Federal Reserve's Senior Loan Officer Opinion Survey (SLOOS) for Q3 also suggests the constriction has continued through the summer with over 57% of respondents of the survey indicating tightening terms in Q3 on commercial and industrial loans. This is a slightly higher pace than in Q2, which in itself was the third highest tally since 1990.

The increased costs of borrowing have undoubtedly contributed to the significant falls in residential and commercial property, especially in markets where the consumer balance sheet has been overstretched by years of cheap and freely available credit such as the UK and USA. Figure 4 shows the relationship

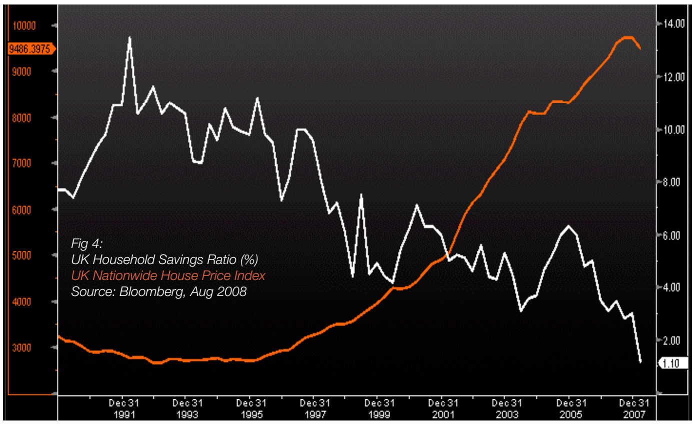

Fig 4:
UK Household Savings Ratio (%)
UK Nationwide House Price Index
Source: Bloomberg, Aug 2008

between the recent increase in housing prices in the UK and the reduction in consumer savings. Of late consumers have stretched themselves to buy houses that they could barely afford. This had the effect of driving the residential property market higher. This in turn made consumers feel richer through the 'wealth effect'. Furthermore, as investors were able to extract cash through renegotiating mortgages with banks, they were able to use their house to generate cash. This relies on a rising housing market and a supply of willing lenders, neither of which are commonplace now. Furthermore the fact that consumers could use their houses as a source of capital meant they could be less scrupulous with the other areas of their personal finances. Now that their homes have proven to be a less certain store of value, and certainly not a device with which to print money, individuals have curbed their discretionary spending, which is having repercussions on the high street.

Source: Lipper Hindsight, Bloomberg, The Economist, August 2008

The past year has provided conditions that few would have predicted in early 2007. The degree of adjustment required from both the largest investment banks through to small consumers globally has been marked. In 12 months the market has moved from a credit bubble which aided the growth in real asset prices to a slump in the value of the same real assets as the money markets dried up. But, although shaky at present, the financial sector is now working on ways to re-invigorate itself. It is clear that the structured credit side of many an investment bank will not generate so much revenue in the short term at least as investors will remain wary of such investments, but the simple steepening of the yield curve and the spread that banks are charging for debt over their base rates will provide a source of revenue. Also, if one makes the assumption that banks have been upfront and reactive about recognising sub-prime related losses, then the last year's recapitalisation may mean that they are in a reasonable shape financially. Furthermore, as it has become more difficult to borrow, the individuals, investment market and businesses have had to de-lever and learn to become less reliant on debt, which is no bad thing for the US and UK consumer. Also cash rich investors such as Asia and the Middle East have been able to put their significant reserves to work, resulting in capital inflows to 'Western' markets. What next for the markets? Last autumn the market was greeted with the initial announcements of losses in financial institutions. Perhaps this autumn, when the markets have had well over a full year of reports post the beginning of the credit crunch the picture will become clearer and the market will become more comfortable in its ability to prospectively value companies again. In the past year a lot of bad news has been priced into the markets, and equities may remain range bound and in the doldrums until analysts and traders feel they have a better perspective. One positive is that a reduction of global growth should provide some respite from the growing inflationary pressures provided by energy and food. It is unlikely that commodities such as energy and materials will continue to experience significant gains if global growth cools. If inflation reduces at least the central banks will only have to worry about maintaining global growth rather than fighting inflation at the same time.

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