



Newsflash

A new month and the twenty third issue of Viewpoint from FP.

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In May, the volatility that investors had to weather earlier in the year became somewhat more subdued. The reduction in the VIX index since its peak in mid March has been reasonably consistent and this growing perceived dependability of the markets has provided a fillip to higher-risk assets. Equities performed well on the back of this and global bonds sold off slightly. The reasonably benign market performance, coupled with fewer market-related headlines in the popular press, might cause May to appear almost a 'non event' given the tumultuous backdrop that the first four months of 2008 painted. Despite this, as is investigated in the Focus section below, some of the events of May 2008 could have very significant consequences going forward. Commodities came to the fore as a combination of factors drove the oil price to fresh highs in nominal terms. This, coupled with continued concern regarding the increases of food prices, has increased headline inflation globally and therefore uncertainty remains regarding possible interest rate paths. As we will explore below, whilst this inflation will prove to be an inconvenience in the developed world, and probably an impediment to economic growth, in the developing world, where food and fuel account for a significant part of the consumption basket, these price increases, which are large in isolation, are of severe import when taken together.

Global equities had a reasonable May returning 1.5% in US Dollar terms. The UK equity market lagged the global majors, returning -0.2%. The US, in contrast, was reasonably strong returning 1.2%, matching Europe which returned 1.1%.

Japanese equities out performed all of these by providing 3.6% in local currency terms, which was diminished slightly for dollar based investors due to a degree of Yen weakness in the month. In the year to date, Japan has also posted relatively strong returns in local currency terms, returning -3.6%. This compares favourably to UK equities which have returned -4.4%, the US which has returned -4.1% and Continental Europe, which returned -9.2% in local currency terms. Amongst the sectors of the global equity markets there was a strong commodity influence in the returns. Energy and materials, which returned 5.3% and 5.1% respectively were amongst the leading sectors, whilst the financial sector continued to underperform, returning -4.0%. In May, the financials were the only sector of the MSCI World in negative territory, demonstrating the continued negativity towards this sector. Given the inflation concerns, the underperformance of consumer related sectors could be expected, but these were still in positive territory, with the consumer discretionary sector's return of 1.1% actually outperforming the staples' return of 0.7%.

Emerging Markets equities had a mixed month with Argentina and Russia both returning 16% in US Dollar terms, whilst India fell by -10.3%. Overall the positive returns outweighed the negative, as the global index returned 1.9%. Pakistan was the worst performing market, returning -23.5% in US Dollar terms. Perhaps May should be viewed in light of the strong index returns in April, which saw the index return over 8%. At times such as these to expect a second month of strong returns may have been somewhat optimistic. The divergence of returns evident between the emerging markets in May again highlights why we suggest a broadly diversified approach to investing in this asset class rather than focusing on specific regions. Doing so should reduce the volatility, whilst the asset class as a whole should outperform developed equities on the upside. The fact that Emerging Markets are providing reasonable returns at present does demonstrate that on balance investors remain moderately positive with respect to these economies.

The bond market told a similar story to equities. Fixed income securities sold off mildly to post a return of -1.2% in US Dollar terms. This appears due to a number of factors, all of which pull in broadly the same direction. Firstly, it is due to reduced demand as investors were less inclined to purchase bonds compared to earlier in the year. Essentially investors are now less willing to pay a pretty full price for the bonds' status as a safe haven. Secondly, in light of deteriorating inflation trends, central bank rhetoric has become less dovish of late, and there are even instances of some hawkishness, especially amongst those with an inflation-based mandate. This has tended to shift the expectation of the bond market and has reintroduced the possibility that interest rates, in some pockets of the global economy at least, could increase this year. The primary justification for this is the continuing inflation fears which are undoubtedly keeping many a central bank on a finely balanced course. The traditional monetary policy response to increased inflation is to increase interest rates, in an attempt to incentivise saving rather than spending, thus providing a degree of friction to the flow of money. This is the opposite tactic that central banks employ to stimulate a faltering economy (which we arguably have in much of the developed world). It is the necessity to balance these conflicting demands which is causing concern for central bankers.

In the currency markets the US Dollar managed to find some support and post some small gains against several major currencies. As previously mentioned, the Yen lost value against the US Dollar, returning -1.0% in a month, bringing its year to date return to 5.8%. Other majors which depreciated include the euro and Sterling both of which returned -0.2%. The South African Rand returned -1.2%, bringing the year to date loss to -10.5%. The strongest currency performers were the Latin American pair of the Brazilian Real (up 2.2%) and the Mexican Peso (up 1.6%). The performance of the Dollar overall suggests that investors feel further rate cuts in the US are unlikely. From this perspective, the slight weakening of the euro is surprising, given many market participants are pricing in interest rate increases in the euro zone.

In May global property returned -2.5%. Europe and North America posted the strongest returns, however even these regions were moderate at best. The US returned 0.1% and Europe ex UK -1.4% in local currency terms. The regional property indices have continued to provide broad performance differentials year to date, with the US proving resilient as investors have become nervous. Surprisingly, given the many similarities between the US and the UK, the UK has borne the brunt of investor negativity, whilst the US is relatively unscathed. This is due in part to the fact that the UK's listed property market entered 2007 in a rather frothy state, and some degree of correction was likely even before the credit crunch struck. Year to date US REITs have returned 8.4% in US Dollar terms, whereas the UK returned -11.8% over the same period.

No review of May 2008 would be complete without an analysis of the oil price. West Texas Intermediate crude ended the month priced USD127.4 per barrel, having touched USD132.6 during the month. The factors behind this seem to be lower than expected global inventories and a fast-approaching

US storm season which often results in disruption to the process of oil extraction and distillation. In addition to this, the growing tensions throughout the African continent with both South Africa and Zimbabwe in the headlines last month, and supply disruptions in the key producer Nigeria will cause some anxiety about the supply of African crude, on top of the existing geopolitical tensions in the Middle East. The result of the increased cost of oil has been protests across Europe as a variety of fuel users are impacted by the cost to their businesses. Oil returned 12.3% in the month, bringing its year to date return to 35.8%. The commodity markets overall have been the best performing asset class thus far in 2008, returning 3.9% in the month and 19% since the end of 2007. The agricultural commodities market underperformed in May with wheat prices continuing to suffer from an expected bumper global crop this season, while the corn market declined due to a lack of fresh fundamental news and a recovery in the planting pace in the cornbelt. Over the month the agricultural futures returned -2.4%, but they remain in positive territory year to date, up 1.1%.

Asset Class Performances

Asset Class Performance (%)	May 2008	2008 YTD
US Equities \$	1.2	-4.1
UK Equities £	-0.2	-4.4
Cont. European Equities €	1.1	-9.2
Japanese Equities Yen	3.6	-3.6
Global Equities \$	1.5	-2.8
Global Emerging Markets Equities \$	1.9	-2.0
US Bonds \$	-1.4	1.3
European Bonds €	-1.3	0.3
Japanese Bonds Yen	-0.8	-1.1
Global Bonds \$	-1.2	3.8
US REITs (property) \$	0.1	8.4
FTSE Real Estate £	-8.7	-11.8
FTSE EPRA Real Estate ex UK €	-1.4	0.7
FTSE EPRA Real Estate Asia \$	-4.6	-10.9
Euro vs. US Dollar	-0.2	6.3
Sterling vs. US Dollar	-0.2	-0.7
Yen vs. US Dollar	-1.0	5.8
Rand vs. US Dollar	-1.2	-10.5
Commodities \$	3.9	19.0
Agricultural Commodities \$	-2.4	1.1
Oil \$	12.3	35.8
Gold \$	1.7	6.0

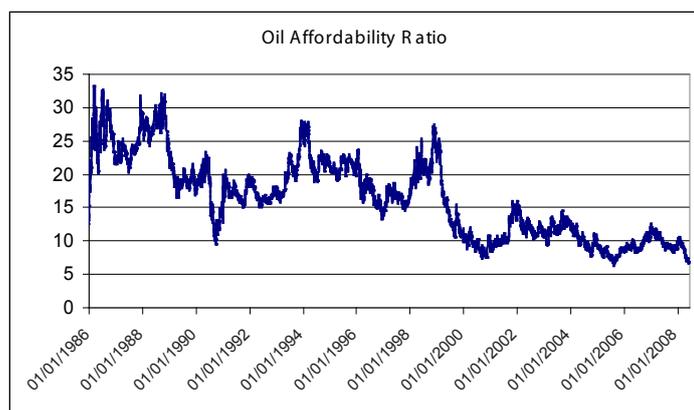
Source: Bloomberg, Lipper, Citigroup, April 2008.

FOCUS: Inflation: The Emerging Markets' most popular export?

The majority of the last decade has been characterised by relatively low inflation in the developed economies. This has been aided by apparently successful monetary policy and the 'export' of deflationary pressures from volume producers such as China. This was possible in part due to the continuing improvements in production techniques which have allowed the prices of produce to drop. As the developed markets imported ever-cheapening goods from the developing world, that element of their consumption basket provided downward pressure on the overall level of inflation. This, when coupled with benign energy, food and labour costs provided a stable inflationary environment, which meant interest rates could remain moderate, reducing the impediments to economic growth.

In May, official figures suggest that on average global headline inflation has risen to 5.5%, the highest level since 1999. The main causes of this are the dual forces of increased prices for food and fuel. In the developed world headline inflation rates are increasing,

but the core inflation measures remain subdued suggesting limited flow through so far of higher food and fuel prices into the broader economy. However commentators are becoming increasingly concerned that core inflation will also rise significantly in the coming months. In 2006 commentators on the oil price began murmuring of increases in the price of oil which may prove to be less transitory, indeed through the course of that year the price of oil rarely fell below USD60 per barrel, but it did not cross the threshold to USD80 territory. That event took place in 2007, where the nominal price of oil grew with reasonable consistency throughout the year. 2008 has seen a continuation of this theme, with oil hitting new nominal highs. The oil affordability ratio graph below prices oil in terms of gold, that is the number of barrels of oil that could be purchased with one ounce of gold. From this rough relative perspective the cost of oil has increased to almost five times the cost of 1986/87. Over the last decade the gold price has increased significantly, but this was clearly out paced by oil, which was as low as USD10.8 per barrel as recently as 10 years ago.



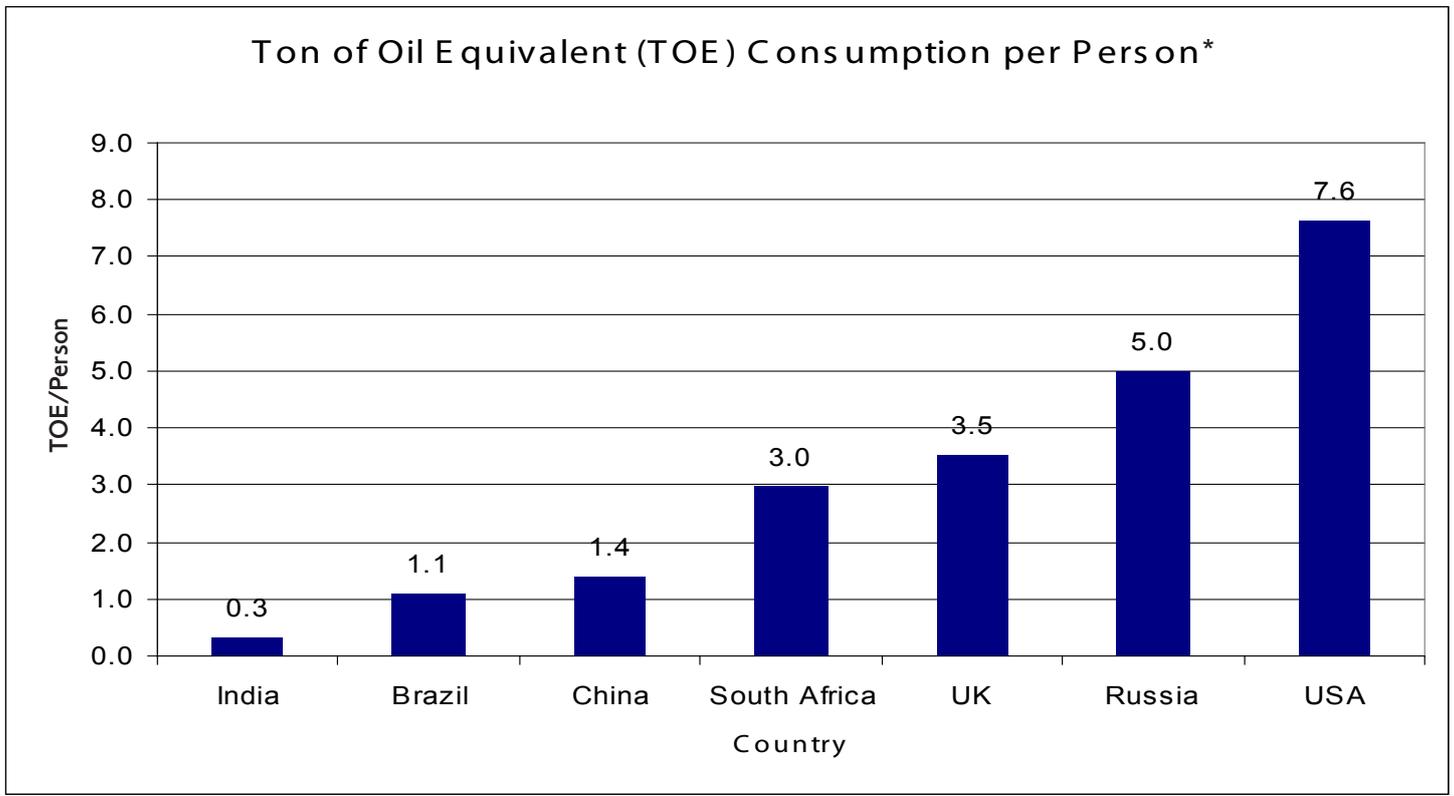
Source: Bloomberg, RMB Asset Management

It is easy to forget in these benign conditions the perils of inflation. Many a government has lost its grip as a result of the intolerable pressures that rising prices have on both individuals and businesses. Indeed the current picture in the emerging markets is notably more negative than the developed markets.



Source: Bloomberg

For a start, the cost of food and fuel is a more significant proportion of their consumption basket. Oil consumption is an extremely important component of inflation at present, and again the more impoverished have less capacity within their personal consumption basket to absorb these costs.



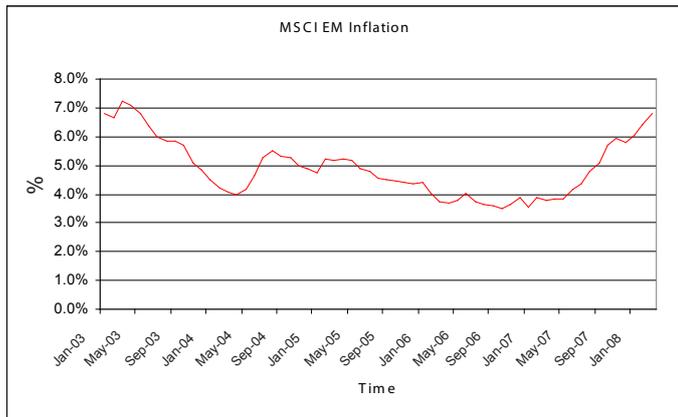
Source: RMB Asset Management, BP Statistics Review, US Census Bureau

The above graph demonstrates that regions where current demand growth is high, such as China and India, are still 'under-using' oil when compared to Western norms. Were even the Indian population to increase its consumption to Chinese levels, the effect would likely be significant. Equally, the fact that inflation is high in these regions despite their lowly per capita use of costly fuel should be of concern.

With the US courting a recession and with much of the developed world slowing down, the ability of central banks to combat inflation is somewhat stymied. The most effective method of reducing inflation would be an increase of interest rates in those areas affected. However, the fact that the US has made swingeing interest rate cuts to stave off more

economic hardship has resulted in the interest rate also falling in countries where the local currency is pegged to the Dollar. This involuntary loosening of monetary policy in these regions results in fewer restraints to inflation. This is a strong reason why inflation is a concern for these regions. The effects of this phenomenon are clear from the graphs depicting inflation and real interest rates in the major constituents of the MSCI Emerging Markets Index. Although weighted averages of inflation numbers are not a perfect reflection of inflation in these areas, it serves as a guide. What can be discerned from recent price movements is that inflation has risen significantly in recent months. Headline inflation includes the effects of food and fuel prices, making it especially pertinent at present.

* The tonne of oil equivalent (TOE) is a unit of energy: the amount of energy released by burning one tonne of crude oil, approximately 42 Giga Joules
Source: Bloomberg, The Economist, Schroders

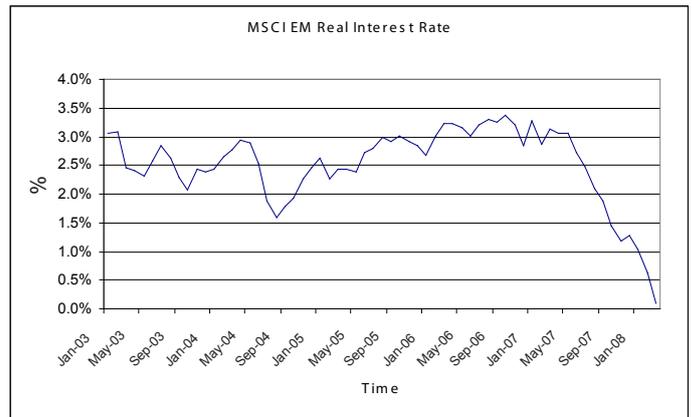


Source: RMB Asset Management, Bloomberg

Although there is room for debate about the quality of some official data, UBS believe that in Asia ex-Japan the real interest rates are in negative territory and averaging -1.7%, whilst Goldman Sachs suggest that Singapore and China have real interest rates of -5% or more. Information such as this suggests that Asian policy makers need to take a firmer stance on inflation. In many of these countries this will mean increasing interest rates, moving away from a monetary system that is too loose for their economies at present. The effect of this would be local currency appreciation against the Dollar, which would make their dollar denominated imports such as oil and other commodities cheaper in local terms, however their local currency exports would be more expensive to US consumers. It would appear that whilst still reticent, some of Asia is beginning to accept the notion that in the short term at least, growth may have to be sacrificed for the purpose of deflating asset price and inflation bubbles.

Despite these concerns there is a definite risk that the central banks of these regions that are at risk of greatest inflation will not act for the longer-term good. They are likely to impose trade restrictions or tariffs on commodities which they want to manipulate. Indeed there is an argument that much of the recent food price inflation has been caused by government intervention in the form of subsidies for bio-fuel production, which has distorted supply and demand fundamentals globally. The end result of these government methods tends either to be an overstretched government purse (in the case of subsidies) or an out of pocket consumer (in the case of tariffs). Furthermore, many governments will suggest that as only headline inflation is especially problematic at present, and this tends to be transitory in nature anyway, any

Source: Bloomberg, The Economist, Schroders, BBC



Source: RMB Asset Management, Bloomberg

sustained monetary policy tightening may be misguided. Current food and fuel prices do contain a degree of supply shocks and speculation at present, feeding to headline inflation, and they might expect prices to ease later in the year as higher prices naturally spurs on supply. However the focus on core inflation was a mistake made by the developing markets in the 1970s and today there are a number of economies on the cusp of repeating those mistakes. By succumbing to political pressure to keep rates low to boost employment and economic growth as well as maintaining the artificial Dollar peg, they could be fuelling the negative real interest rates which will further boost demand, which, if coupled with increased wage demands could cause an inflationary spiral.

Ultimately, the effect of increases in food and fuel costs will have the most dramatic impact in the emerging markets as the consumption baskets of their domestic consumers are heavily weighted towards food and fuel. When one's income is small, subsistence spend is incredibly important and an increase of the cost of a food item will have a direct and significant effect on consumption baskets. If corn doubles in the UK, people would either not notice this or find substitutes. In Mexico, for example where 40 million people live on USD5 a day or less, the cost of feeding the poor will increase almost linearly with the price of the raw material and therefore will have a significant effect on consumption. Additionally if prices continue to rise in these exporting countries, this is likely to feed through into the core CPI of net importers in the developed world. It may be that the US decision to cut interest rates prevented problems in the short term, but by indirectly fuelling price growth in Asia, there may still be hardship to come for the US consumer in the form of higher inflation.

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