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Newsflash

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

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As we write Viewpoint September 2008, a number of significant events have taken place in September, which it would be remiss not to mention. Into the second week of September storm clouds began to gather threateningly over Lehman Brothers. On 14 and 15 September it became apparent that Lehman was not deemed ‘too big to fail’ and the company filed for Chapter 11 bankruptcy. The two banks that had appeared to be running a slide rule over Lehman and weighing up a bid, Barclays and Bank of America (BofA), both abandoned their courtship and to add insult to injury, BofA sought to acquire Merrill Lynch in an all-stock deal and Barclays now stands poised to pick the meat from the Lehman carcass. Later in the week, AIG, once America’s largest insurer by market cap was saved by a USD85 billion loan for 79.9% of their equity. This loan from the Treasury is at the eye watering rate of Libor plus 850 basis points and this loan will be superior to AIG’s other outstanding debt which is concerning for AIG’s debt holders. It is too early to properly assess the repercussions of these events, but it is clear that the Bear Stearns rescue is not the all encompassing ‘line in the sand’ that many had thought it to be. The Fed will stand by and watch major banks fall into bankruptcy, thus reducing accusations that it was perpetuating the ‘moral hazard’ which many thought afflicted a ‘bankruptcy immune’ Wall Street. Perhaps Bear was merely lucky that it burned through its capital quicker than everyone else.

This is clearly significant news for the market and the response from all asset classes has been material. The US Treasury’s bills (short term debt) have actually been trading at a value above par, which is unusual for a discount security, showing investors are more interested in maintaining capital than any yield generation. These times of extreme pessimism provide opportunities. We have long espoused the view that when markets feel at their worst and optimism is all but gone that valuation can be most exploitable. For example on 18 September the UK stock market gave investors a key buy signal as the dividend yield available on stock surpassed that available on the 10 year gilt (see Fig 1). This signal has historically been an indication that valuations

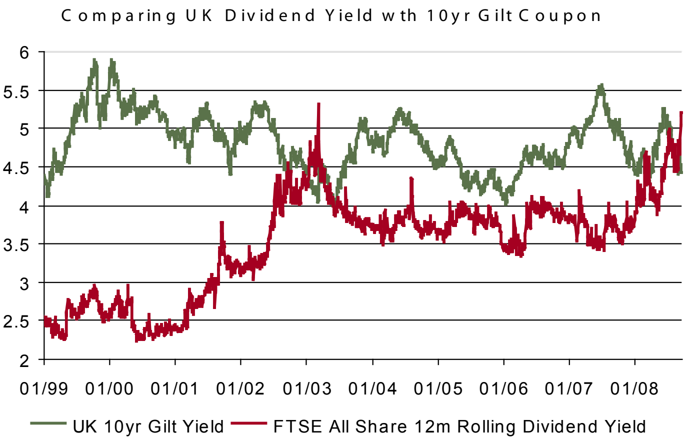

Fig. 1
Source: Bloomberg, September 2008

are close to their floor. This is the first time that this technical signal has been seen since March 2003, the nadir of the last bear market. The dividend yield of stocks is a function of the dividend and the price of the market. As the value of the index has fallen recently, but without a notable reduction in the level of the divided, the yield has increased. Contrastingly, as the value of the fixed income security rises due to investor demand for low risk assets, the yield has fallen. On 18 September short selling of financial securities was banned by the FSA in the UK and this has provided a fillip to markets. It is actions such as these and the concerted, coordinated effort globally by central banks to becalm the markets that suggest the market could be at a turning point. We continue to hold credit in diversified portfolios as a means of experiencing most of this equity upswing, but credit should have a greater floor to valuation than equity, thus reducing the downside volatility for investors.

Let us now turn our attention to August. Equity markets remained reasonably buoyant following the positive performance in the second half of July. Although the markets appeared to lose some impetus towards the end of the month, the equity returns were certainly more stable than in recent months. In local currency terms equity posted small gains, but the strength of the US

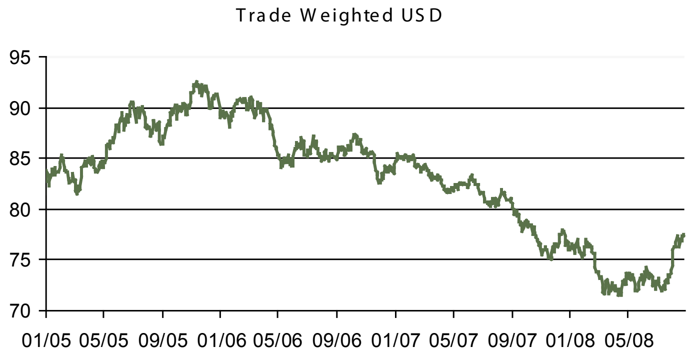

Fig. 2
Source: Bloomberg, September 2008

Dollar (see Fig 2) mitigated these returns somewhat. Additionally, bonds gained some ground in local currency terms but, again, the move of the dollar meant these returns when translated to US dollars were negative. In other markets commodities continued their recent poor form as investors reappraised their view on the demand for these assets going forward. We will discuss the recent currency moves in some depth in the Focus section below, but first we will endeavour to provide some insight into the recent asset class performance.

Global equity markets returned -1.4% in US Dollar terms in August, despite moderate gains in most major markets over the period. In local currency terms, the index was up 1.2% demonstrating the power of a strong reporting currency to deflate the apparent return of local currency holdings. Volatility was reasonably stable throughout the month as investors let themselves relax slightly from their recent 'high alert', which provided an increased sensitivity to almost any economic datum, announcement or story. Despite this, market volatility is still significantly higher than in 2006 and early 2007. Amongst the major markets, the UK performed well returning 5.0% in local currency terms, comfortably outperforming the US and Europe which returned 1.4% and 1.5% in their respective local currencies. Global emerging markets equities underperformed relative to global developed markets again in August. This is understandable given the change in sentiment of investors from

Source: Bloomberg and Lipper Hindsight, September 2008

the exuberance and hubris of early 2007 to a more grim-faced disposition of late. Emerging markets equities returned -8.0% in August, bringing their year to date return to -21.9%.

The fixed income markets also suffered as a result of the US Dollar's strength against most global currencies. In local currency terms, government bonds gained 1.2%, whereas in US Dollar terms, the strength of the greenback provided a headwind to performance and the index returned -2.0%. Global investment grade bonds narrowly outperformed their government counterparts as spreads narrowed somewhat, returning -1.6% in US Dollar terms. Most of the regions performed in an analogous fashion, demonstrating the effect of currency on the global index returns. US bonds ended the month in positive territory, returning 1.1%, whilst European bonds returned 1.2% in local currency terms and Japanese bonds returned 0.9% in Yen terms. High Yield and Emerging Markets Debt spreads were both reasonably subdued in August. High yield spreads moved out by 28 basis points (bp) to end the month at 778bp, whilst Emerging Market Debt spread widened by 16bp to end the month at 299bp.

The global listed property market underperformed the global equity markets slightly, returning -2.1% in US Dollar terms. The UK Property market performed well in local currency terms, returning 5.6%, but the -7.9% decline in sterling over the same period results in a negative return in a dollar reporting currency. Asian property continued to post poor returns, losing -6.0% in August. The moves in the UK are strong, but come on the back of a number of poor months. Year to date the UK has returned -14.2% in local currency terms, Europe -13.0% and Asia -27.7%.

In comparison, the US has returned 1.9% year to date, the market believing that the quick actions by the Fed in cutting rates may provide a better floor to property valuations in United States.

The major theme in the currency markets has been mentioned several times in Viewpoint already. The value of the US Dollar has slid down on a trade weighted basis for a number of years and looked long overdue a correction (see Fig.2). In the focus topic overleaf, we will discuss further some possible causes of this move, but at this juncture, the magnitude of the move may be of interest. It has already been noted that the move was adequate to negate many a positive local currency return to make global indices reported in US Dollar terms to appear to have suffered in August. The Yen performed well against the Dollar, returning -0.4% to bring the year to date figure to 2.9%. The euro lost -5.6% in August and Sterling fell -7.9% against the greenback.

Following a significant reduction in the oil price in July, and a broader commodities sell off, the sector remained out of sorts in August. This sell off is likely to be due to a number of factors including a drop in forecast demand going forward and a reduction of speculative positions. One result which is clear is that a number of the major components of the consumption basket, though still high from a nominal perspective, are now providing less impetus to inflation. Overall commodities fell -6.9% in August, but their strength earlier in the year means they are still up 9.1% in 2008. Agricultural commodities have also suffered of late and in August they returned -3.7% to outperform the broader commodities index.

Asset Class Performances

Asset Class Performance (%)	August 2008	YTD August	Sept to Date*	Year to Date*
US Equities $	1.4	-11.8	-5.9	-16.9
UK Equities £	5.0	-10.1	-12.8	-21.6
Cont. European Equities €	1.5	-19.1	-10.7	-27.8
Japanese Equities Yen	-3.7	-14.1	-12.5	-24.8
Global Equities $	-1.4	-14.0	-9.4	-22.1
Global Emerging Markets Equities $	-8.0	-21.9	-19.5	-37.1
US Bonds $	1.1	4.2	2.0	6.3
European Bonds €	1.2	2.6	0.3	2.8
Japanese Bonds Yen	0.9	1.3	-0.5	0.8
Global Bonds $	-1.6	2.6	-0.2	2.4
US REITs (property) $	2.3	1.9	4.4	6.4
FTSE Real Estate £	5.6	-14.2	-5.6	-19.0
FTSE EPRA Real Estate ex UK €	0.7	-13.0	-5.8	-18.0
FTSE EPRA Real Estate Asia $	-6.0	-27.7	-13.5	-37.4
Euro vs. US Dollar	-5.6	0.7	-2.4	-1.7
Sterling vs. US Dollar	-7.9	-8.4	-0.3	-8.6
Yen vs. US Dollar	-0.4	2.9	3.5	6.5
Rand vs. US Dollar	-5.0	-11.1	-6.4	-16.8
Commodities $	-6.9	9.1	-12.5	-4.5
Agricultural Commodities $	-3.7	-1.5	-11.4	-12.7
Oil $	-5.8	22.5	-21.0	-3.2
Gold $	-9.3	-0.3	3.6	3.3

Source: Bloomberg, Lipper, Citigroup, September 2008.

* Performance up to and including 18th September 2008.

FOCUS: The Strengthening US Dollar

Predicting currencies is often said to be something of a folly. There are a couple of strong reasons for this. The first is that currencies can stubbornly ignore fundamentals, remaining under or over valued from a fundamental perspective for surprising periods. A second characteristic of currency markets is that they can be extremely volatile. The reason for this volatility is the fact that in order to buy a currency, one has to sell another. As a result, the factors driving the supply and demand for any currency are strongly interwoven with the supply and demand drivers for the other currencies it is valued against. August's volatility demonstrates these two phenomena well. Firstly, on a trade weighted basis the US Dollar has been becoming progressively cheaper since July 2001, losing almost 40% to the trough earlier this year. After a couple of months of stability, the Dollar has now rallied on a trade weighted basis by around 7% in little over a month (see Fig.2).

Dollar strength sounds like a positive phenomenon for global investors and it is so long as you wish to sell your dollar assets and buy assets denominated in another currency. The difficulty comes when investors try to understand the impact that a strong dollar will have on their globally diversified portfolio. The main effect is one of perception. Asset market gains or losses occur independently of any currency moves. As a result, as we have seen in the global equity and bond markets this month, a gain in local currency terms can become negative as a gain in the dollar has diminished the purchasing power of these foreign currency denominated assets in terms of dollar assets. But they may have appreciated against other currencies so reporting currency, and its effect on performance, is something of a lottery. As a result investors should stick to the currency that they genuinely think in – i.e. where they are likely to have assets and liabilities when choosing the reporting currency of their fund, rather than trying to tactically choose another.

One issue which has affected the Dollar more recently versus other global currencies has been the negative interest rate differential which has grown versus both the euro and Sterling. This lower yield on cash held in the Dollar meant that holding dollars in place of the other two currencies became relatively unattractive. As a result, investors could sell USD and buy EUR or GBP and receive a better yield on the currency. This increased buy side pressures for the European currencies whilst correspondingly increasing the sell side pressures for the USD. However, the interest rate cycle has moved on and it appears more likely that the UK and Europe will have to embark on a programme of interest rate cuts, whilst the US is more likely to re-enter a hawkish phase (see Fig.3). As a result of these changes, the prospective interest rate differential has shifted in favour of USD. Essentially, the US was

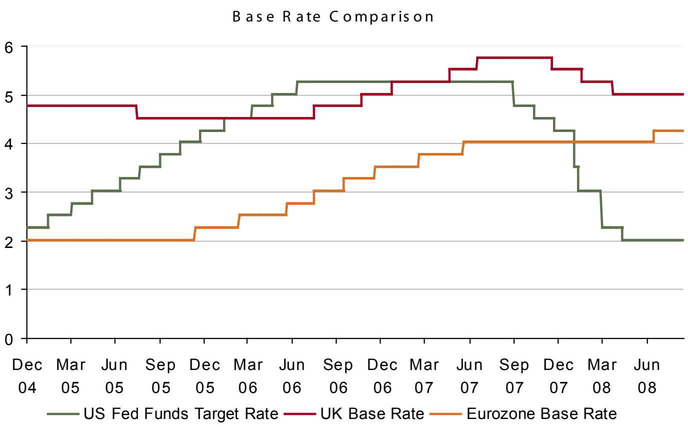

Fig. 3
Source: Bloomberg, September 2008

the first country to be hit by the credit crunch, the first to react to it, and now the market believes, likely to be the first economy to lead the world back out. Historically the US has proven adept at reinventing itself and cutting out the deadwood in the economy. This would tend to suggest that the US will lead the rest of the world out of the present malaise. A risk factor to this thesis is that the US falls into a full-scale recession. The direct implication of this would likely be a cut in the US interest rate, which would undermine the interest rate differential argument. The impact that a US recession would have on other currencies is difficult to predict, but the likelihood is that if the US suffered a full-scale recession, the implications for other world economies, in aggregate, would not be especially positive.

The recent years' USD weakness has actually had a positive effect on the US economy. The weakening of the greenback

Source: Bloomberg and Lipper Hindsight, September 2008

from a global perspective has meant that foreigners' purchasing power in USD terms has increased. This has had the effect of making US goods and services cheaper. As a result, the level of US exports has actually increased (see Fig.4) and this has

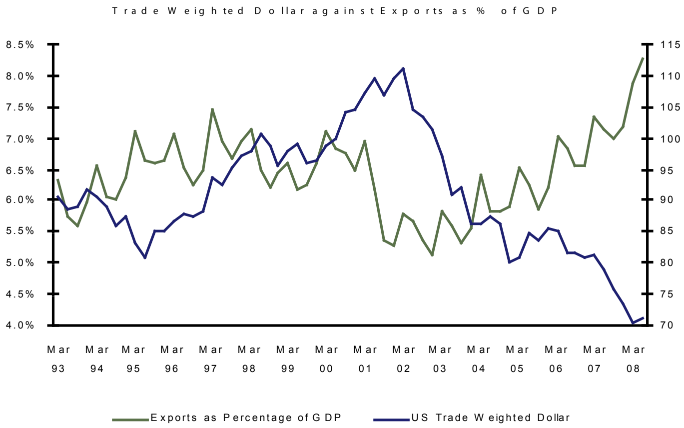

Fig.4
Source: Bloomberg, September 2008

benefitted the US current account (see Fig.5), which although still in negative territory, is moving slowly towards positive territory. Despite this, there are still plenty of reasons to be

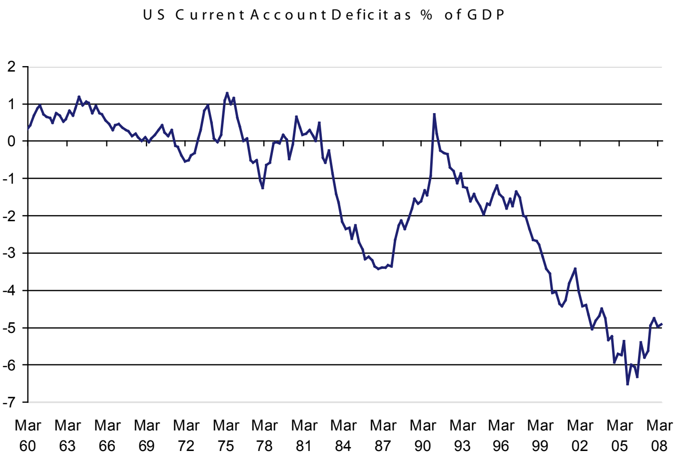

Fig. 5
Source: Bloomberg, September 2008

negative about the present state of the US current account as a proportion of GDP. The deficit has moved to approximately -5% of the GDP, which is still a significant deficit. The current account will improve at times where the value of investments and trade going into an economy exceed those being spent by the members of that economy abroad. What we can learn from this uptick in the current account as a percentage of GDP is quite intuitive, namely that as a country's currency devalues, it makes exports more attractive to foreigners and makes importing for domestic consumers more expensive. Therefore there are net capital inflows to the economy.

One benefit for the global economy, which might be only remotely linked to the price of the US Dollar is the fact that while the Dollar was weak, oil producers who wished to increase their purchasing power in world currencies had to keep the nominal (dollar) price of oil high to provide strong purchasing power in global terms. Now the US Dollar's strength versus international counterparts means that the nominal price of oil can fall. Figure 6 depicts the influence that reporting currency can have on perceptions of returns. In dollar terms the price of oil has fallen of late. However, as oil is priced in USD, foreign currencies have to be sold, to buy Dollars which can be used to buy oil. This means that the appreciation of the US Dollar has offset, to some extent, the falls in the oil price in euro or Sterling terms.

Overall, the strong rally in the US Dollar is something that we have frequently suggested was long overdue. The fundamentals in the US are improving, although there are still some elements

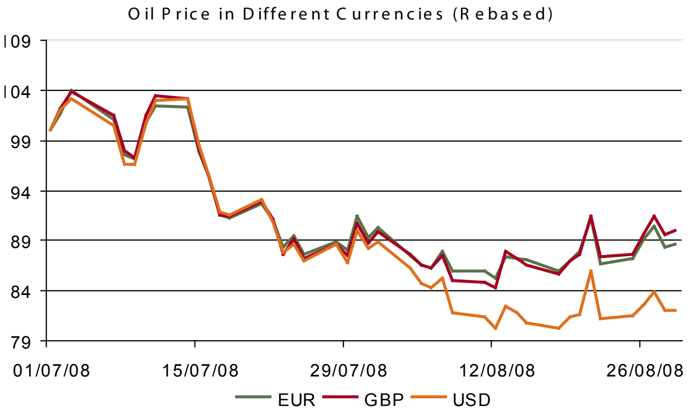

Fig. 6
Source: Bloomberg, September 2008

of concern, especially relating to the current account deficit and the budget deficit, but the US is not in an exceptionally poor state in comparison to parts of Europe – the UK being an obvious example. Add to this the likely improvements in the interest rate differential which will favour the greenback against other major currencies and it appears likely that the Dollar may have further

Source: Bloomberg and Lipper Hindsight, September 2008

appreciation ahead. This is unlikely to be an orderly process and there will be instances where the US Dollar suffers in the short term against its counterparts, but overall we expect the trend to be positive. This is why we suggest a diversified currency allocation within multi-asset funds, but investors should keep a large chunk of assets – usually at least two thirds of a portfolio – in their base currency. This serves to prevent overreliance on a single currency were it to lose purchasing power over a prolonged period, as did the USD up until recently, whilst providing some diversification and the ability to share in the upside of a basket of international currencies, whilst limiting the risk to any one position outside of the base currency.

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