



Newsflash

A new month and the 45th issue of Viewpoint from FP.

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Table of Contents

1. June 2010 Review	1 – 5
2. Focus	6 – 9
3. Important Notice	11

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June 2010 heralded the FIFA World Cup's debut on African soil, and acting in tandem market sentiment mirrored the erratic emotions of many a team's followers as goals were scored and conceded on the soccer pitches of South Africa and across trading desks around the globe. As will be the case with the soccer (or football if you like) some stalwart asset classes kept on delivering, whilst young stars failed to rise to the occasion. And may we take this opportunity to commiserate with the Black Stars from Ghana – as John Maynard Keynes put it: “markets can remain irrational far longer than you or I can remain solvent.”

During the last couple of weeks more central banks raised their interest rates with Sweden and Brazil following in the footsteps of Australia which started to tighten monetary policy as early as October 2009. Inflation seems to be much more of a near future phenomenon in emerging markets, and on the back of this outlook more interest rate increases could be on the cards in certain developing countries. Some central banks outside of developed markets may however continue to mimic the approach of the US Federal Reserve, Bank of Japan, Bank of England and the European Central Bank by keeping rates lower for longer. On 1 June the Central Bank of the Russian Federation lowered their refinancing rate for the 14th time since April 2009, which shows that they are clearly not concerned with inflation (yet...). During this year it became more and more obvious that the four major central banks will not only keep monetary policy loose for



a considerable amount of time, but would also be prepared to continue with quantitative easing to a higher degree than what market perhaps anticipated. This is of course required to offset the effect of an era of fiscal austerity, which we cover in depth in this month's FOCUS section.

In last month's Viewpoint we referred to the graph alongside which shows the generic US 10-year Treasury yield against the index level of the S&P500. At the start of the month equities seemed to break away from the trend as markets went up but bond yields continued to decline. From the start of April holders of government bonds have made handsome capital gains (circa 6.5% on the 10-year Treasury), whilst the S&P 500 has shed around 12.5%. In our view this has pushed government bonds, not only in the United States but also in Europe and the United Kingdom, into valuation levels that could be described as expensive. The caveat to this view is of course a "double-dip" scenario which leads to deflation, in which case current yields on government bonds would retrospectively be described as extremely attractive.

Following significant underperformance when compared to other regions, European equities had a particularly strong month as it gained 0.2% in euros, and remained flat in USD

terms. Compared to the main American bourses (S&P 500 down 5.3%) the Europeans have bounced back strongly as investors started to distinguish between inherent risk contained in the weak peripheral European governments and the strength of the European corporate sector (excluding some of the banks). Emerging market equities were somewhat stronger than broad developed markets as the MSCI World Emerging Markets delivered -0.7% versus a -3.4% return posted by the MSCI World index.

Similar to Germany which tends to be a solid performer during most World Cups, bonds continued to deliver positive returns during June. With the exception of European government and high yield bonds all other major pure bond asset classes delivered positive returns during the month. US Treasuries were particularly strong as the yield on the 10-year bond fell from 3.26% mid month to 2.93% on 30 June. Investment grade corporate bonds kept up with its government counterparts in the US (+2.1%) and UK (1.1%) underpinning the relative value to be found in corporate credit versus governments. On the back of relatively healthier economic outlooks and receding yields emerging market bonds issued in hard currency also rallied and added 2% in total return, taking the year to date performance up to over 5%. As was the case with Germany

during the semi-finals government bonds may now get to the end of its good run, as a positive result from the European banks' stress tests could certainly favour more flamboyant (read volatile) asset classes.

In a turnaround from the first five months of the year the Pound Sterling reacted very well to the election of a new government as well as the new chancellor's announcement of the UK's fiscal austerity package. The British currency gained around 3% against the greenback and euro, and remained stable against a strong Japanese yen. Based on our general outlook on GDP growth expectations our investment thesis is still that emerging market currencies could continue to strengthen against the major developed currencies, in spite of lower inflation and interest rates in the major economic regions. The much discussed slowdown in the rate of Chinese economic growth all but erased the gains commodity indices made in the first half of the month. In the end broad commodities were flat for the month, but gold managed to add another 3% which takes it up to over 10% for the year to date.

From an investment point of view the big unknown for the year ahead is the influence that authorities will have over the path of the economy and indeed the markets. This is clearly illustrated as market participants eagerly await the results of European banks' stress tests (mentioned above). France's finance minister (Christine Lagarde) was quoted as saying that the stress tests will show European banks are "solid and healthy". The official results are expected to be released on the 23rd of July but some news around the outcome is sure to leak beforehand. As was the case with a similar test applied to US banks in the first quarter of 2009, rigorous test criteria and a workable action plan to assist weaker banks may underpin markets and could be the catalyst for stronger returns in risk assets. It is sobering to note that increased taxes, reduced fiscal spending and high levels of unemployment may prove to be a drag to such returns, but this is no reason for investors running for the hills. An investment strategy which favours income generating securities with yields in excess of cash or government bond rates may just turn out to be the recipe for portfolio management success in 2010.

Asset Class Performances

Asset Class/Region	Index	Currency	Jun 2010	YTD 2010
Equities				
United States	S&P 500 NR	USD	-5.3	-6.9
United Kingdom	FTSE All Share TR	GBP	-4.6	-6.2
Continental Europe	MSCI Europe ex UK NR	EUR	0.2	-3.7
Japan	Topix TR	JPY	-4.3	-6.4
Australia	S&P/ASX 300 TR	AUD	-2.7	-10.1
Global	MSCI World NR	USD	-3.4	-9.8
Global Emerging Markets	MSCI World Emerging Markets TR	USD	-0.7	-6.2
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	1.9	6.0
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	1.4	4.4
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	2.1	5.8
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	1.2	4.5
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	1.6	5.9
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	1.1	6.0
Euro Government Bonds	Citigroup EMU GBI TR	EUR	-0.8	2.2
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.2	3.5
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	-0.2	5.5
Australian Government	JP Morgan Japan Government Bond Index TR	AUD	1.2	2.2
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	1.7	5.1
Global Government Bonds	JP Morgan Global GBI	USD	2.1	0.4
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	1.5	-0.9
Global Convertible Bonds	UBS Global Convertible Bond	USD	-0.8	-4.6
Global Emerging Market Bonds	JP Morgan Global EMBI+	USD	2.0	5.1

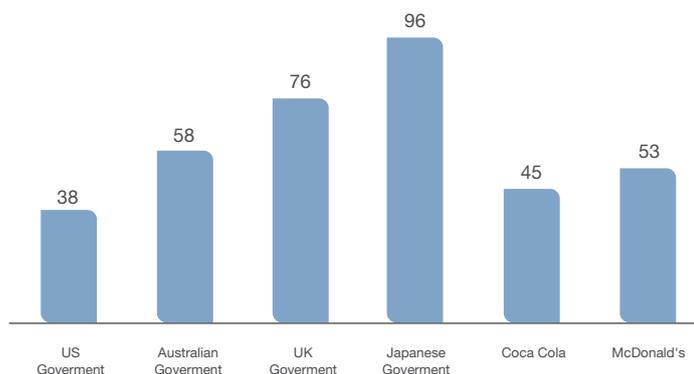
Asset Class/Region	Index	Currency	Jun 2010	YTD 2010
Property				
US Property securities	MSCI US REIT TR	USD	-5.3	5.1
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	-4.6	-13.3
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	3.5	-1.5
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	0.3	-7.8
Australian Property securities	FTSE EPRA/NAREIT Australia TR	AUD	-0.4	-8.4
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	-2.4	-6.3
Currencies				
Euro		USD	-0.2	-14.6
Sterling		USD	3.0	-7.4
Yen		USD	2.9	5.2
Australian Dollar		USD	0.7	-6.1
Rand		USD	0.3	-3.9
Commodities				
Commodities	RICI TR	USD	0.0	-9.9
Agricultural Commodities	RICI Agriculture TR	USD	1.2	-11.4
Oil	ICE Crude Oil CR	USD	1.2	-2.8
Gold	Gold index	USD	3.0	10.6
Interest rates				
	Last meeting		Current rate	Change at meeting
United States	28 April 2010	USD	0.25%	No change
United Kingdom	10 May 2010	GBP	0.50%	No change
Eurozone	6 May 2010	EUR	1.00%	No change
Japan	30 April 2010	JPY	0.10%	No change
Australia	1 June 2010	AUD	4.50%	No change
South Africa	13 May 2010	ZAR	6.50%	No change

Source: Lipper Hindsight, July 2010

FOCUS - The dangers of fiscal austerity

While corporates spent 2009 bolstering their balance sheets through equity and debt issuance, governments around the world introduced vast fiscal stimulus packages. This happened at a time when tax receipts were plunging, in an attempt to boost their economies out of recession. The measures have worked to an extent and continue to have a positive effect in many areas, although the recovery has been far more tentative than most would have hoped for. The upshot of this though is that credit risks have now shifted substantially from the corporate sector to the government sector. This can clearly be seen in the graph alongside where we compare the costs of credit default swaps (CDS) which provide insurance against a default by the debtor. While modern portfolio theory relies heavily upon the presence of a risk free asset, which has traditionally been US government debt, this graph clearly shows that the market does not view US Government obligations as being without risk any more. The CDS market is implying that the risk of default attached to the debt obligations of Coca Cola is not much greater than that of the US government, and is considerably less than that of various other developed nations! The UK government, and indeed many other G-20 countries (particularly in Europe), are viewed as being considerably less credit worthy than many of these blue chip corporates.

Five year credit default swap rates (basis points)



The reason for this unusual situation is that the market believes governments are running out of options. This means that the range of possible outcomes a few years down the line are slipping out of their control, and investors are therefore demanding a higher risk premium on sovereign debt. Further stimulus packages are mostly out of the question and interest rates in nearly all of the developed

world can go no lower so policy makers have largely exhausted their firepower. Many nations should recover with the passage of time, as economies grow and consumption recovers, enabling governments to reduce debt levels. However, if markets do not choose to give these nations time or if the policy balance required to restore fiscal consolidation is mis-judged then this could potentially lead to currency devaluations and/or debt restructurings.

The main factor determining whether markets provide governments with the required time to heal are the size of budget deficits and the level of debt compared to GDP. In the short to medium term there is very little that governments can do to address the latter, beyond laying down a solid budgetary framework for the future; budget deficits, however, can and are being addressed. The sheer scale of budget deficits across many developed nations is a serious cause for concern for both governments and investors alike. Although sovereign debt outside of the eurozone countries is generally attracting low yields, thus suggesting that national finances are not a cause for immediate concern, governments are inclined to bring their finances under control in order to avert a situation like that of Greece. However, another reason for low bond yields is that economic activity remains fragile, and therefore fiscal restraint could yet force a double dip-recession. Indeed there are arguments against an overreaction to current deficits on the basis that deficits are likely to fall regardless of whether governments impose austerity measures, in response to the economic recovery and as one-off stimulus measures fall out of the calculation. If this weren't to happen due to the economic recovery stalling then the case for budgetary restraint would only be further diminished. Therein lies the critical policy dilemma facing many nations: fiscal austerity now to restore financial health and avoid a possible debt downgrade or restructure, albeit at the risk of a double dip recession or social upheaval; or continue to spend to try to sustain growth but face the risk of loss of confidence in debt, a possible downgrade, or worse default and resultant economic and social upheaval.

One option open to governments is to do nothing; maintain the fiscal deficit and bear the potential consequences in the

expectation that growth will recover to close the gap between government income and expenditure. The US is the most obvious proponent of this approach at the moment as it sees a continued need for stimulus to boost growth. This is also the path that Japan chose to go down a couple of decades ago, but a key difference is that Japan was able to borrow from its own households who had accumulated significant savings. Today the US is not in a position to borrow from its households, which are savings deficient; the US is dependent on foreign flows to finance its deficit and China is among the largest US creditors. China clearly has very different interests compared to the US, making this a distinctly different situation to Japan where government and household interests were more aligned. A significant advantage for the US though is the continued status of its debt as the world's most credible reserve currency and asset. This enables the world's largest economy to maintain a \$1.6 trillion budget deficit, the largest ever, without policymakers feeling pressured to address this problem until they have achieved their goal of getting growth back on track. In the near term this lack of fiscal tightening in the US, combined with continued loose monetary policy, would suggest better growth prospects relative to other developed countries. There are not many countries that can pursue this option though without running the risk of bond markets pouncing and forcing an immediate response.

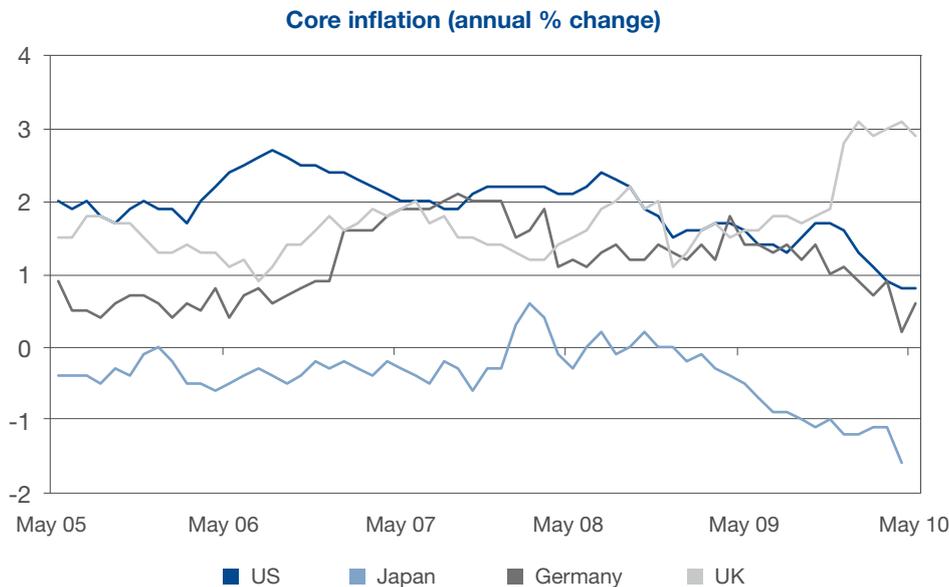
The clear alternative to doing nothing is to tighten fiscal policy now rather than wait for markets to potentially force such action. A consensus is forming that believes this to be the correct approach, and this was mostly reinforced at the recent G20 meeting in Toronto, with many countries around the developed world having announced measures in recent weeks to rein in budget deficits and mounting public debt levels. Under this fiscal retrenchment scenario governments have been imposing a variety of austerity measures that reduce expenditure and boost income, including cutting the size of the public sector and reducing welfare payments or, on the other side of the ledger, boosting revenue through higher taxes and new banking levies. The hope is that consumers and businesses continue to recover despite austerity measures so as to compensate for lower public sector demand, but it is generally accepted that monetary policy must remain accommodative in order to support

consumption and asset prices. Importantly, fiscal consolidation needs to be targeted at spending cuts rather than tax rises and be accompanied by measures to promote competitiveness. The earliest adopter of this approach was Ireland, where the economy suffered more than most during the global financial crisis, and which was among the first to impose significant austerity measures in 2009. More recently the UK followed them down the same path with a budget that emphasized the need to rebalance the economy away from debt and government consumption. Meanwhile Germany remain firmly committed to fiscal austerity and recently announced over €80bn of spending cuts as well as up to 15,000 public sector job cuts to complement new taxes including an agreed banking levy.

The risks arising from fiscal tightening are that the private sector may not compensate sufficiently and thus the country slips back into recession or perhaps even deflation. This double-dip scenario is not well supported by history though – once an upturn has begun it usually continues unless there is a major new negative economic shock. Indeed over the last 125 years and 38 recessions only 3 could be described as double-dip; they have usually occurred when the initial recession was mild and are less likely when there is a large output gap in the economy. Nonetheless, at this early stage markets remain somewhat undecided over whether to reward countries for bold spending cuts or punish them for fear of a double-dip recession.

Another factor that is being taken into consideration by markets is the chance that social unrest may reduce political will to make any serious attempt at austerity. Although the populations of the UK, Ireland and Japan have all been relatively understanding so far of the need for fiscal retrenchment and resulting unemployment, this is in sharp contrast to scenes across Europe, and particularly Greece, where workers have taken to the streets to place pressure on their governments due to job losses and falling living standards.

The economic recovery across the developed world remains in its formative stages and some data suggests it is becoming increasingly fragile. If policy makers were to pursue aggressive fiscal tightening then they must recognise that deflation is a risk



and so should ensure effective monetary policy offsets are in place. Monetarist economists would argue that there are already significant inflation risks due to the scale of quantitative easing measures employed, but the evidence shows that broad money supply growth has actually been very low. Although central banks realised the need to print money they could do nothing to prevent banks from hoarding it on their balance sheets. Indeed the reality is that core inflation is trending down in most regions and deflation appears to be a greater near term threat (see chart below). A deflationary scenario would increase the real value of debt thus increasing overall debt burdens which would inevitably lead to a significant reduction in the growth outlook. Adequate monetary policy offsets may however be difficult to deliver today, particularly in the eurozone where policy must fit a diverse group of economies.

Peripheral eurozone countries such as Greece and Portugal are facing huge challenges, and for now this is where the market is focusing its attention. Their public finances have suffered significantly and largely as a result of euro strength having caused them to lose competitiveness. Normally the best way out of this situation would be to generate a strong improvement in net exports outside of the eurozone - other countries that have historically endured debt crises have achieved this through a considerably weaker exchange rate. However, while the euro has weakened somewhat in recent months the bulk

of peripheral eurozone members trade is conducted within the eurozone, thus eliminating much of the exchange rate benefit, and it is likely that prices and costs must fall in order to boost demand. In recent weeks yields on Greek government debt have risen to levels higher than they were prior to the announcement of the €750 billion support package by the EU/IMF, in part due to the forced selling of their debt by index trackers after they dropped out of several developed market indices. The plight of Greece is further highlighted by the fact that it is likely to see its debt to GDP ratio rise next year even if it does everything pledged under the IMF program, making a debt restructuring within the next few years look likely. Creditors are aware of these risks and are therefore demanding higher interest rates to compensate. There is however potential for a vicious cycle whereby the higher financing costs demanded further increase the chance of default, therefore justifying higher yields and so on. It has become increasingly clear that the eurozone is in need of a greater degree of fiscal union across its members to complement its currency and political union. As ever it takes a crisis to accelerate a need such as this to the top of the agenda, and more has been done towards achieving this goal in the past few months than in the past ten years. In the meantime however, something must be done and most countries are now pursuing budgetary restraint to reduce the path of long term deficits, but despite this investors still fear that debt restructuring in some nations is inevitable.

It is likely that most developed nations will go through some degree of fiscal restraint in the next few years to bring today's budgetary problems under control. The downside economic risks are clearly higher now as the dangers of premature fiscal tightening are equally as great as those from delayed tightening, and the challenge is to pursue measures that improve the long term outlook without denting near-term growth prospects. This balancing act has been successfully achieved by numerous governments over the years, but in most cases the problems were not so globally synchronised; thus the rest of the world was capable of absorbing excess domestic supply. However, if Europe and the US were to fall back into recession now then even the rest of the developed world and BRIC (Brazil, Russia, India, China) economies are unlikely to be able to absorb the resulting supply. Europe and many other developed countries could potentially end up in a beggar-my-neighbour situation towards an increasingly fiscally stretched US.

For now investors are clearly troubled by this lack of clarity on the economic and financial outlook. We have identified several reasons for concern and no doubt there are plenty of potential

pitfalls lying ahead. However, the most likely outcome, albeit clouded by significant tail risks, is that the fragile economic recovery will be sustained, while monetary policy remains highly accommodative to offset the negative effects of fiscal tightening. Despite the difficulties governments are facing the private sector remains in relatively good shape and businesses are gradually increasing spending. Equity valuations are not particularly challenging at their current levels and corporate bonds offer good opportunities for fixed income investors, especially compared to the low yields on government bonds. As one market commentator put it, to be a seller of equities at current levels, you have to back the double-dip thesis.

On a final note though, it should be remembered that regardless of the path of the global economy or government budgetary decisions, the structural trend for deficits in developed countries remains a serious concern. Debt to GDP ratios are likely to rise substantially in the coming decades due to unfavourable demographics and the resulting pension and healthcare costs. At that point today's budget deficits could be a fond and distant memory...

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