VIEWPOINT

www.financial-partners.biz | Vol. 20 | March 2008

Newsflash

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

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Table of Contents

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February's performance numbers demonstrate several themes, but overall they reflect the fact that the most dominant returns were available for commodity centric investors. February saw oil close at over USD100 per barrel for the first time in history as perceived supply and demand imbalances combined with a weak dollar to push prices higher. The gold spot price, traditionally an inflation hedge, closed the month just short of the much vaunted USD1,000 per ounce. The continued commodity run is impressive given the already nominal high levels that the hard commodities in particular have reached in 2007. This strength also paints an interesting picture for global growth. Effectively the commodity markets are suggesting that global growth will continue to manifest itself in the form of high demand for commodities. Indeed it seems that much of the demand at present comes from speculators rather than genuine consumers. Despite this, global bonds also rallied in February, a move which suggests that bond investors perceive a somewhat bleaker global economic outlook. Couple this with a relatively mixed message from equity markets and a largely negative property market and the picture becomes somewhat blurred. February, therefore, may have provided some ambiguous messages for investors, and certainly the market is yet to calm their nerves. As we progress into 2008, the picture should become clearer as more companies report their full year profits and the full extent of the credit crunch will be more certain.

Equity markets produced more heat than light in February, with most indices taking a meandering path to end the month broadly where they began. Overall global equity returned -0.6% in the month, bringing the year to date return to -8.2%. The poorest performer amongst the majors was the US, which returned -3.3%. The UK finished the month in positive territory, returning 0.8%. Europe performed in line with the global index, returning -0.4% whilst Japan underperformed, returning -1.6% over the month. Investors with a positive mentality will take some comfort from the fact that markets appeared to find a comfort level after a torrid January. Yet there is ample scope for bearish sentiment with many investors expecting company reports from 2007 and into 2008 to demonstrate a drop in earnings and further losses related to the viscous credit market.

Global Emerging Markets demonstrated a strong return to form after posting poor results in January. In February the emerging markets returned 7.4%, bringing their year to date loss to -6.0%. Notable performers included Brazil and China, returning 12.1% and 11.7% respectively. These returns were amongst the highest in the universe and the large weight of these in the index will have aided performance overall. The poor performance last month will be quickly forgotten by advocates of a 'decoupled' emerging market. Proponents of this suggest that the emerging markets are adequately self sufficient to weather a 'western' slowdown better than other regions. This is despite the fact that a popular topic for the last decade has been the globalisation theme. Investors should bear in mind that despite the good performance of the emerging markets, globalisation is likely to work both ways, and if EM benefited during the periods of strong performance, they are also likely to suffer in more taxing times. We saw in January that even if Asia has successfully decoupled in an economic sense, its financial markets are yet to. Despite this emerging markets appear to be in reasonable shape. Their national finances are strong, the consumer is less indebted than their western counterparts and overall the financials in these regions seem less directly affected by the credit crunch.

The fixed income markets continued to benefit from the dual influences of their safe haven status in times of uncertainty, combined with the markets' continual downward reappraisal of interest rate expectations. Overall global bonds returned 1.8% in US dollar terms, with the US again providing leading returns as the US Treasury is considered the safest haven and the Fed appears to have the most dovish monetary policy in the world. US Treasuries sold off for most of the month, but a rally in the final few days caused the yield to approach 3.5% for the ten year note. Government bonds are undoubtedly providing a degree of dependability and safe haven status for investors, but with yields at their present levels, new investments into the asset class are not enticing.

The main story within the currency markets in February mirrors the characteristics of the bond markets. Overall it appears that investors believe that interest rates in the US will continue to drop and that this will occur at a faster rate than in other regions, moving the yield differential to the detriment of the US currency. The Dollar's weakness was manifested through the strength of most currencies including the Euro, which gained 2.5% against the greenback and the Japanese Yen, which gained 2.1%. The flat performance of sterling against its American counterpart suggests that the currency markets are equally negative towards the UK, pricing in similar levels of interest rate cuts going forward. The South African Rand experienced continued weakness versus other currencies. In February the Rand returned -3.4% against the US Dollar and -6.9% against the euro. The strongest currencies were again the commodity currencies such as the Brazilian Real, Australian Dollar and the Norwegian Krone, all of which gained over 8% against the US currency in a month.

Within the property markets, February, like January, demonstrated strong regional performance differentials. During the month, in aggregate, global listed real estate returned -1.8%. In February, European listed property provided the strongest returns of 5.1%, whilst over the same period the UK and USA were in negative territory, returning -1.5% and -3.8% respectively. Like January, the Asian component lagged again, returning -5.5% in the month. Investors should be buoyed by the performance of European property which was strongly positive and the fact that the UK market retained most of its January returns to remain in positive territory year to date. If the equity markets are leading indicators of the direct property markets, we may yet see further declines from bricks and mortar investments in these regions, but within a few months they too should have found a floor.

Thus far in 2008 Agriculture is proving to be the most consistently performing asset class. The Agricultural Commodities Index returned 13.6% over the month in US dollar terms, closely followed by the broader commodity market, which returned 12.5%. This performance reflects a number of factors including a belief that inflation may be allowed to go somewhat unchecked while the US continues to cut rates to buttress the economy. Also the demand from the emerging markets continues to be strong, adding to demand pressures and this couples with supply constraints to give upward impetus to prices both in agriculture and general commodities. One final tail wind to commodity performance is the weakness of the US Dollar. Purchasers of the commodities who are based outside of the US may be willing to pay slightly more for these assets as they fall in local currency terms and furthermore, commodity producers with an international footprint will wish to increase the nominal USD selling price. Year to date agriculture has returned 18.7% in US dollar terms, which is an extremely good return against a backdrop of extremely tough credit conditions and sharply weaker equity markets.

Asset Class Performances

Asset Class Performance (%)	Feb 2008
US Equities $	-3.3
UK Equities £	0.8
Cont. European Equities €	-0.4
Japanese Equities Yen	-1.6
Global Equities $	-0.6
Global Emerging Markets Equities $	7.4
US Bonds $	1.0
European Bonds €	0.5
Japanese Bonds Yen	0.5
Global Bonds $	1.8
US REITs (property) $	-3.8
FTSE Real Estate £	-1.5
FTSE EPRA Real Estate ex UK €	5.1
FTSE EPRA Real Estate Asia $	-5.5
Euro vs. US Dollar	2.5
Sterling vs. US Dollar	0.1
Yen vs. US Dollar	2.1
Rand vs. US Dollar	-3.4
Commodities $	12.5
Agricultural Commodities $	13.6
Oil $	7.6
Gold $	5.2

Source: *Bloomberg, Lipper*

FOCUS: Japanese Equities

Japan has performed below our expectations throughout 2007. Through the year Japanese equities returned -11.1% in local currency terms. Japan is itself an interesting economy, with a number of conflicting messages. Overall, the economy appears to be facing some long term uncertainties, but offers some attractive investment and valuation opportunities which we investigate below.

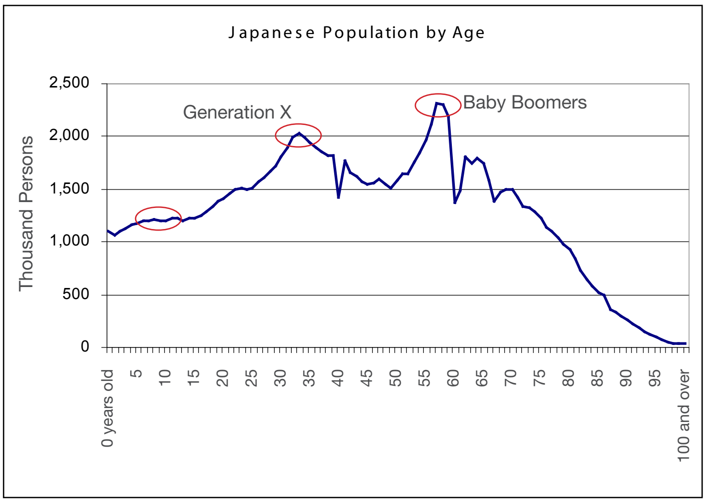

Fig. 1 • Source: Japanese Statistics Bureau

There are three important topics relating to Japan for investors at the moment. The first issue and a possible cause for concern is the population. The Japanese population is both shrinking and ageing. As can be seen in Fig.1, left, the highest concentration of ages in the populous is the baby boomer generation, an economically powerful, but conservative group. Their children, generation X, also represents a spike. Worryingly for the long term demographic trend, where we would expect to see a final spike for the children of generation X, we see declining population. The present population of Japan is 128 million , but there seems little impetus for population growth. The average Japanese lady only has one child. Furthermore, Japan is renowned for very low levels of immigration. If neither this nor the birth rate pick up, the population will continue to shrink.

Another facet of the population issue is the amount of internal migration throughout Japan. The only area experiencing net internal migration is into Tokyo and its environs, putting significant pressure on infrastructure in that area. There are areas of the countryside that are becoming largely deserted of people of working age, leaving a significant bias to the elderly.

A second important issue for Japan is the global perception of its economy. Presently it seems that many investors have a negative impression but this is not necessarily the reality. Firstly, Japan is experiencing a healthy export market at the moment, with growth of exports leading Germany, the UK and the US. Not only has the volume of exports increased, but also the quality of the mix of counterparties has also improved. Japan's export partners have diversified significantly, resulting in a lesser reliance on any one major partner. This alone should provide a greater degree of export security going forward, especially if the now much discussed global slowdown turns into pockets of recession.

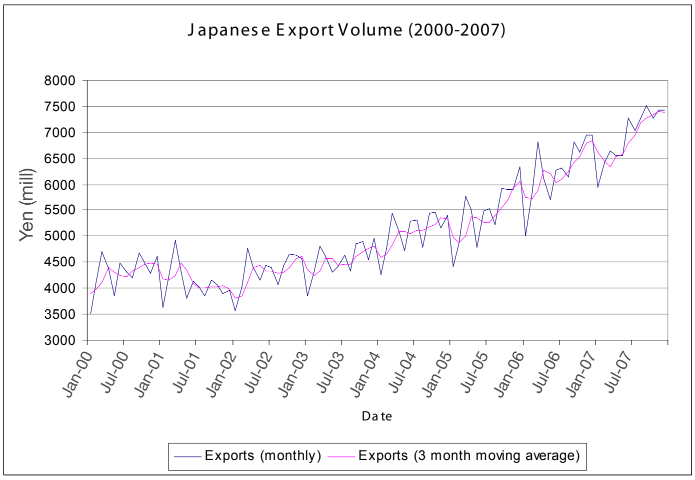

Fig. 2 • Source: IMF

The Japanese current account is also related to the performance of exporters. The current account is in positive territory, and continues to rise, a phenomenon that is impressive given the terms of trade under which Japan operates. Japan is a natural importer of commodities, so to continue to improve the current account despite this headwind demonstrates the strength of their exports. Figure 3 demonstrates that this improvement of current account as a percentage of GDP has come about despite worsening situations in countries such as the US and UK.

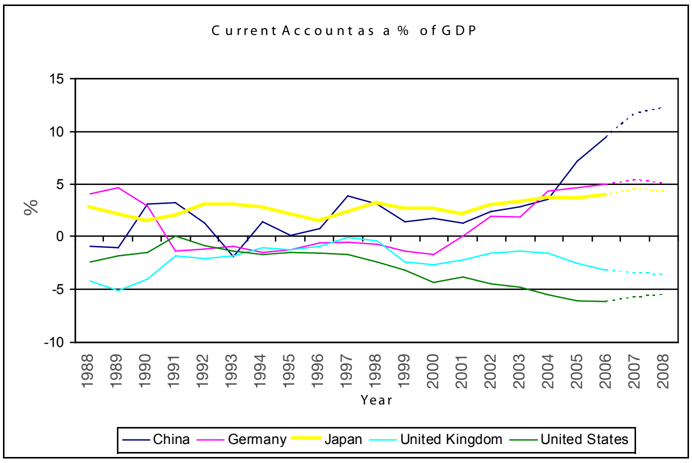

***Fig. 3 • Source:** IMF*

The third issue is important for prospective equity investors. This is that despite the mixed message economically and demographically, the Japanese equity market appears cheap. Market commentators recently have focused on the supposed relationship between the equity market dividend yield and the Japanese Government 10 year bond yield. There does seem to be a degree of substance to this, but perhaps it is based more on convenience than first principles. Given the perpetual nature of equities a more appropriate proxy would seem to be the yield on the 30 year bond, which at 2.4% is still well above the dividend yield of 1.8%. Despite this the dividend yield is now at a level which historically tends to precede a period of strong performance for Japanese equities.

For businesses there are reasons to be positive. The direct effects of the credit crunch have been felt in the Anglo Saxon world, with Asian banks left relatively unscathed from the first round of losses. The fact that interest rates are so low in Japan has been a source of criticism in recent years, but now cheap capital will benefit industry, especially if companies need to dip into short term funding to ease any pressure building up. The falls in equity values have resulted in price to book values averaging 1.4 times, the lowest level since 2003. Furthermore the last time the dividend yield hit 1.8% in Japan, the bond yield was 8%, a rate differential that was highly favourable for bond investment. Dividends overall bottomed in 2002, and since then they have grown at a strong pace. The dividend yield is strong for two reasons, firstly profits are solid and Japanese companies are paying out more dividends to shareholders, but secondly as the market falls the dividend grows as a percentage of share price. Now the yield is at a level that should be more attractive to both global and domestic investors.

Japanese investors are still in a cautious frame of mind after the losses experienced in the last crash. The majority of their investments are biased towards safety and a dividend yield only about 1% above the rate available in savings accounts does not appeal to local investors. However, where securities are offering a decent yield, the public do seem willing to move away from cash holdings. An example of this is the popularity of J-REITs and the propensity for ‘Mrs Watanabe’ to buy foreign bonds such as the Uridashi issues sold to retail investors. Going forward, Japanese investors could favour higher yielding equities as their age necessitates more income focused investments. Now as Japanese investors repatriate their foreign holdings, closing their carry trade positions, there may be more domestically sourced impetus for the stock market as this cash is put to work locally.

As a result of this Japanese equity investments are appealing at present. We have been overweight Japan for a while, and despite this underperforming, our view has not changed materially. In fact as Japan has fallen further than other markets, the valuation argument that appeared pertinent during 2007 is now even more compelling. Japan provides a relative safe haven from the credit crunch engulfing the US and Europe and also offers the prospect of a strong currency. This combined with low price to book values, reasonable Price/Earnings ratios and historically high dividend yields, suggests the market should outperform in 2008.

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