FP FINANCIAL PARTNERS

VIEWPOINT

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Newsflash

A new month and the 49th issue of Viewpoint from FP.

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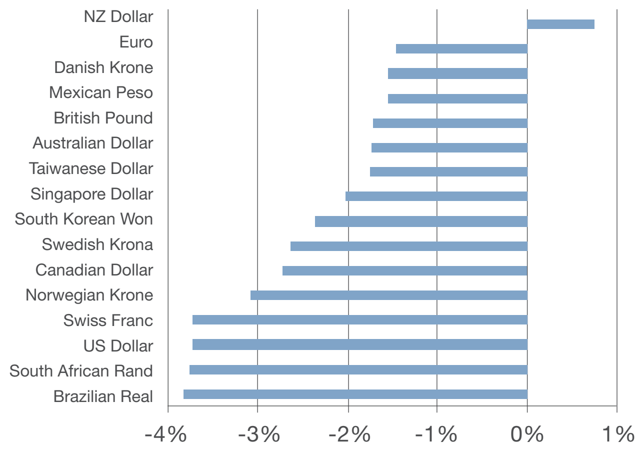
Table of Contents

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

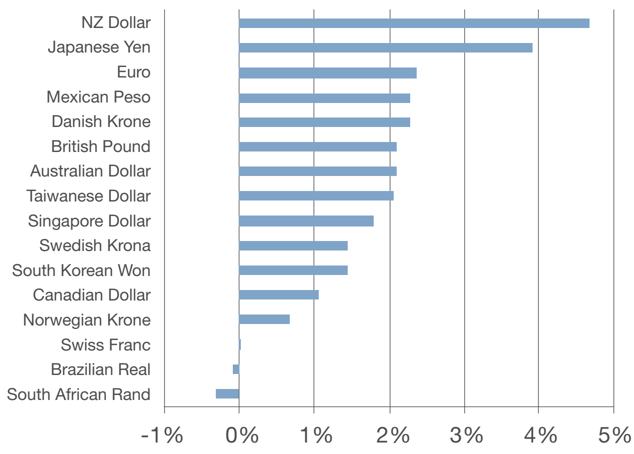
October, as a month, was perhaps a little short of defining features, as markets caught their breath following a strong September and looked forward to the Fed's announcement on Quantitative Easing in November. This slightly bland landscape allowed the previous month's momentum to spill over and this, as much as anything else, seemed to keep bourses edging higher. October did, however, see the Bank of Japan (BoJ) announce that in order to further enhance monetary easing a tripartite scheme would be pursued, the most important of which was the "Establishment of an Asset Purchase Program". The BoJ may as a temporary measure, purchase various financial assets, i.e. engage in Quantitative Easing (QE). The yen rallied on the back of this throughout the majority of October: the graphs overleaf demonstrate the breadth of both JPY strength and USD weakness in the month.

Looking forward, November is set to bring a number of newsworthy events. As Viewpoint comes to print, the US mid term elections have taken place and the result is a weakening of Obama's mandate, with the Republicans seizing the House of Representatives, the lower house of the US legislature. This immediately stymies Obama's ability to pass laws and this is likely to mean that the President's more controversial social policy reforms, such as 'Obamacare', will not come to fruition. Many reasons have been suggested for why Obama, a man elected on a tide of optimism that bordered on euphoria, could allow his halo to slip despite no particular personal

Currency Returns in JPY terms



Currency Returns in USD terms



mishaps. An obvious major issue is the financial state of the nation that he inherited and this presidency, like the Prime Ministership for David Cameron in the UK, may through the lens of history come to be seen as a poisoned chalice. How president Obama reacts to a public chastisement remains to be seen, but his decision to defer making strident and painful moves to address the US economy's imbalances when he had a strong mandate, may prove to be a crucial mistake. Looking forward, therefore, a potential positive is that the US legislature could focus more on the key economic issues rather than pet projects and the fulfilment of partisan election manifesto pledges that may have been a distraction up until now.

Another major event in the US was the FOMC meeting which took place on 3 November. It is highly unlikely that the Fed will alter interest rate policy for some time to come as the economic recovery remains frail and inflation is not at a level that is likely to concern policymakers. There has been a growing expectation throughout the markets in recent months that the Fed will re-instate Quantitative Easing in what has been dubbed 'QE2'. The Fed did not disappoint the market and in fact surpassed the consensus of a second round totalling USD 500bn in the first instance, with the announcement of USD 600m, with the potential to add to this should circumstances require.

Turning to the markets in October, global equities, as represented by the MSCI World index, gained 3.7% in US Dollar terms to bring the year to date returns to 6.4%. Japan's currency gains did not translate into positive local currency returns in the stock market, as the Topix fell by -2.2%. The export-centric elements of this economy will see their international competitiveness reduced by the prolonged yen strength. Year to date, Japanese equities are also the laggard, with returns of -9.0% in yen terms, whilst the currency has gained 15.6% against the US Dollar, demonstrating the same overall theme. In October, the other developed markets posted positive returns, led by the US, with the S&P 500 gaining 3.8%. Despite providing returns that are more than double that of the developed markets year to date, the emerging markets underperformed slightly in October, with a print of 2.9%.

The high quality end of the fixed income market has remained resolute despite positive moves from the equity markets. October saw fixed income market participants ready themselves for further QE, an announcement on which is expected in early November. This 'countdown to QE2', as PIMCO refers to it, has resulted in US Treasury short term rates hitting new lows in October. The market has alighted on a starting figure of USD 500bn for QE2. This is the value that the NY Fed president Dudley suggested should provide

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. November 2010. Past performance is not indicative of future returns.

stimulus equivalent to a 50-75bps fed funds rate cut. In local currency terms most major government bond indices drifted off over the month, with UK gilts returning -1.4%. The weakness of the US Dollar over the month provided a tailwind to foreign currency returns when expressed in greenback terms, with the JP Morgan Global Government Bond Index gaining 1.3%. On the whole, corporate paper was buffered by its spread over benchmark rates, and this index returned 1.2% in US dollar terms, with the enhanced capital returns offset by a lower weight to Japanese Yen in this index compared to the GBI. Global emerging markets bonds outperformed their developed peers with a return of 1.8% in October.

The two main stories in the currency markets have been discussed already in this edition of Viewpoint, namely the US Dollar's general weakness and the Japanese yen's general strength. The euro appreciated by 1.8% against the US Dollar, but remains down by -3.1% year to date. Sterling, similarly, gained 1.5% over the month, but remains 1.0% behind year to date. Commodity currencies such as the Australian Dollar and South African Rand are up 9.0% and 5.9% respectively against the greenback year to date, but this is well behind the yen, which has gained 15.6%.

In commodity markets, gold and oil both posted positive returns to compliment the behaviour of other risk assets. Year to date, agricultural commodities have now outperformed other commodity types, aided by the occasional supply-side shock and continued murmurings relating to the secular changes in the emerging markets' burgeoning middle class's appetite. Throughout 2010 this section of the commodities market has gained 23.5%, whereas the broader index (which also contains an agriculture subset) returned 7.5%, which is in line with oil's return for the same period. Gold returned 3.0% in October, but year to date the precious metal has gained 19.7% predominantly due to safe haven / store of value trades.

The global property sector performed broadly in line with the broader global equity market in October with a return of 4.0% in US Dollar terms. The UK listed property sector posted the strongest regional gains in the month, with the FTSE EPRA/NAREIT UK index gaining 5.8%. Year to date, the UK has returned 3.2%; the return for global securities for the same period is 14.5% and the US is 24.2%. With the exception of the UK, in local currency terms there appear to be two distinct groups of year to date returns. Australia and Asian property securities have returned 10.4% and 10.8% respectively, whilst Europe ex UK and the US have gained 21.2% and 24.2% respectively.

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. November 2010. Past performance is not indicative of future returns.

Asset Class Performances

Asset Class/Region	Index	Currency	Oct 2010	YTD 2010
Equities				
United States	S&P 500 NR	USD	3.8	7.3
United Kingdom	FTSE All Share TR	GBP	2.5	9.4
Continental Europe	MSCI Europe ex UK NR	EUR	2.7	5.7
Japan	Topix TR	JPY	-2.2	-9.0
Australia	S&P/ASX 300 TR	AUD	1.8	-0.8
Global	MSCI World NR	USD	3.7	6.4
Global Emerging Markets	MSCI World Emerging Markets TR	USD	2.9	14.0
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-0.2	8.8
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	2.7	9.9
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	0.1	10.9
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	2.6	14.2
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-1.4	8.3
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	-0.4	10.7
Euro Government Bonds	Citigroup EMU GBI TR	EUR	-0.5	4.1
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-0.1	6.4
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	2.0	17.2
Australian Government	JP Morgan Japan Government Bond Index TR	AUD	-0.4	3.0
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	-0.4	5.8
Global Government Bonds	JP Morgan Global GBI	USD	1.3	9.8
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	1.2	7.4
Global Convertible Bonds	UBS Global Convertible Bond	USD	3.5	9.5
Global Emerging Market Bonds		USD	1.8	16.5

Asset Class/Region	Index	Currency	Oct 2010	YTD 2010
Property				
US Property securities	MSCI US REIT TR	USD	4.7	24.2
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	5.8	3.2
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	2.7	21.2
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	3.0	10.8
Australian Property securities	FTSE EPRA/NAREIT Australia TR	AUD	1.0	10.4
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	4.0	14.5
Currencies				
Euro		USD	1.8	-3.1
Sterling		USD	1.5	-1.0
Yen		USD	3.7	15.6
Australian Dollar		USD	1.2	9.0
Rand		USD	0.3	5.9
Commodities				
Commodities	RICI TR	USD	4.7	7.5
Agricultural Commodities	RICI Agriculture TR	USD	10.9	23.5
Oil	ICE Crude Oil CR	USD	6.8	7.4
Gold	Gold index	USD	3.0	19.7
Interest rates	**Last meeting**		**Current rate**	**Change at meeting**
United States	03 November 2010	USD	0.25%	No change
United Kingdom	04 November 2010	GBP	0.50%	No change
Eurozone	04 November 2010	EUR	1.00%	No change
Japan	04 November 2010	JPY	0.10%	No change
Australia	02 November 2010	AUD	4.75%	+25bps
South Africa	19 November 2010	ZAR	5.50%	-50bps

Source: Lipper Hindsight, October 2010

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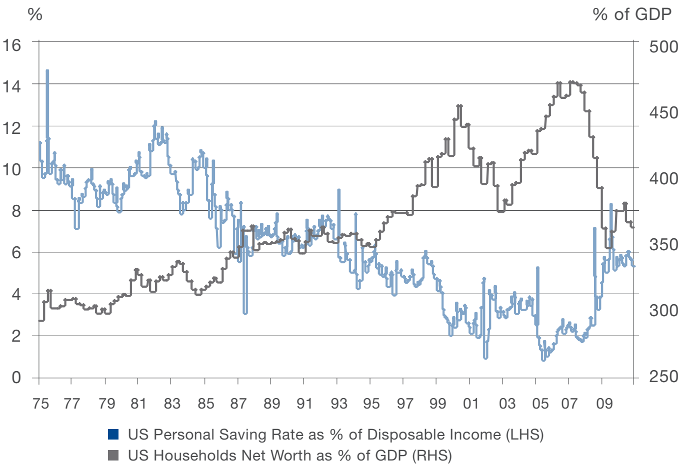
Focus – The outlook for inflation

With 2010 now nearing its end, and before we embark on what promises to be another roller-coaster year for financial markets, Viewpoint would like to pause for a moment to address the topic of quantitative easing (QE) and in particular its potential effects on inflation. Although most measures of core inflation globally do not suggest any cause for concern, at least with regards to inflation, there is a chance that monetary stimulus in developed markets will start feeding in to higher prices, particularly in the emerging world. We feel that this may well be a topic receiving significant attention by the end of 2011.



Market participants have been given countless excuses for adopting a cautious view of the world this year, but despite this equity markets continue to discount a moderate growth outlook. Indeed, in recent months the global economy seems to have emerged on the other side of a 'soft patch' precipitated by fear of euro zone sovereign defaults, renewed weakness in the US housing market, policy tightening in China, fiscal retrenchment in the West and a slow down in macro data after the strong rebounds in 2009. In spite of these headwinds, markets have climbed the proverbial 'wall of worry' with most equity indices now at higher levels than at the start of the year.

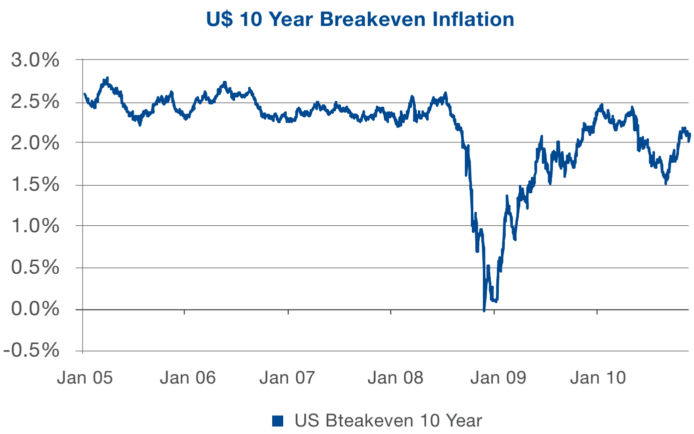
However, this view of the year is skewed by the effects of recent events in the US, where Fed (Federal Reserve) policy has been practically the only significant driver of investment returns in recent weeks. Asset prices have staged an impressive recovery from the year's lows following the announcement of a second round of quantitative easing (QE II). The genesis of this was a weaker than expected recovery in growth and employment in the world's largest economy, where despite the largest ever peacetime stimulus package the economic recovery has failed to gain traction. With unemployment at 9.6% and core inflation stubbornly low – at 0.6% year on year in October representing at least a 50 year low – the Fed felt the need to announce a further USD 600m of asset purchases in order to fulfil its dual mandate of high employment and low inflation.

With the Fed unable to reduce nominal interest rates any further, QE II offers an opportunity to lift inflation expectations and, with short term rates expected to remain low for some time to come, reduce real interest rates. Conversely, if the Fed had taken no action then the risks of outright deflation would have been greater, which would have had the opposite effect of raising real interest rates and thus reducing spending and putting the economy's recovery at risk.

With borrowing costs already at extremely low levels however, it's unlikely that the cost of credit is a real obstacle to growth, thus causing many to question how impactful this round of asset purchases will be. Instead, the Chairman of the Fed, Ben Bernanke, has made it clear that one of the key objectives of their monetary policy is to boost stock prices in order to increase the net worth of consumers at a time when house prices remain depressed. The chart above provides support for the Fed's approach by showing that increased household net worth tends to result in a lower savings rate (higher spending rate).

The other side to the Fed's policy is that they are trying as hard as they possible can to avoid outright deflation. The inflation rate has fallen to extremely low levels and there is a tangible threat of deflation in the coming year, given the fragile economy, weak property market and large amounts of slack in labour and goods markets. For example, high levels of production in last quarter's ISM survey have

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. November 2010. Past performance is not indicative of future returns.



contributed to economic growth recently, but the level has been in excess of new orders, resulting in inventory growth. A reversal of this trend has the potential to drag the economy back into recession which would undoubtedly cause inflation expectations to fall yet further. With these risks in mind the Fed has all but stated that they are targeting higher inflation. Justification for this comes from the observation that authorities are mostly well versed at dealing with high inflation but have little experience of addressing deflation. Therefore, rather than targeting the normal long run inflation level they seem to be erring on the side of caution by aiming slightly higher, since the consequences of inflation down the line are far more acceptable and easier to address.

Since Ben Bernanke first alluded to QE II on 27th August 2010 at the Jackson Hole Economic Symposium, almost all asset classes have enjoyed strong gains whilst the dollar has followed a downward trend. US monetary policy has caused the dollar to drop by over 10% in the past five months, with falls being broad based against most trading partners. The overriding message from the market seems to be “don’t fight the Fed”.

In addition to this, other developed economies have had their hands on, or near to, the printing press in recent months, including Japan and the UK. The Bank of England has since thought better of conducting further QE, given that inflation is currently running above target as a result of increased VAT and the ongoing effects of Sterling devaluation, but that is not to say that it may not be on the cards again in the future if current growth trends persist. Meanwhile Japan continues to try and dig itself out of the very same deflationary trap that other developed markets are now battling to avoid.

Such balance sheet expansion globally clearly poses inflationary risks in years to come, but for the time being a sustained inflationary outburst looks unlikely given the degree of spare capacity in the economy. If economies were to recover sharply, along with increased velocity of money and credit growth, then the inflationary risk may be brought forward somewhat, but for the time being such a shock appears unlikely.

Viewpoint believes that key inflationary risks instead lie in emerging markets where growth remains very strong and monetary conditions are generally far too accommodative. With many emerging market currencies pegged to the US dollar, countries are inadvertently importing US monetary policy which is wholly inappropriate for their booming economies. For example, short rates in emerging markets have averaged below 5% over the last 12 months, whilst GDP growth has exceeded 10%. Such a huge gap between growth and borrowing costs can overexcite asset prices, stimulate profits and eventually stoke inflation. Countries such as China are experiencing negative real interest rates thus providing incentives for individuals, corporations and government institutions to spend their money in order to avoid ceding purchasing power to inflation. This is a problem not just for today but potentially for some years to come as US interest rates are likely to remain low.

The more immediate outcome of this situation is likely to be enhanced growth in these regions along with booming asset prices, as has been well publicised in the case of the Hong Kong property market for example. Indeed emerging markets are already growing at a fair clip, with retail sales up by over 20% year on year in countries including India and Indonesia. Eventually these economies are likely to overheat though, as wage rises increasingly come through and inflation takes a grip. Recent data out of China showed consumer price inflation coming in higher than the market expected in October, surging to 4.4% year on year, driven by increased food and commodity prices. Although China has monetary policy tools

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. November 2010. Past performance is not indicative of future returns.

at itsdisposal, such as loan quotas and reserve requirements, these are unlikely to be sufficient to offset the effects of a continued stream of stimulus in the Western world.

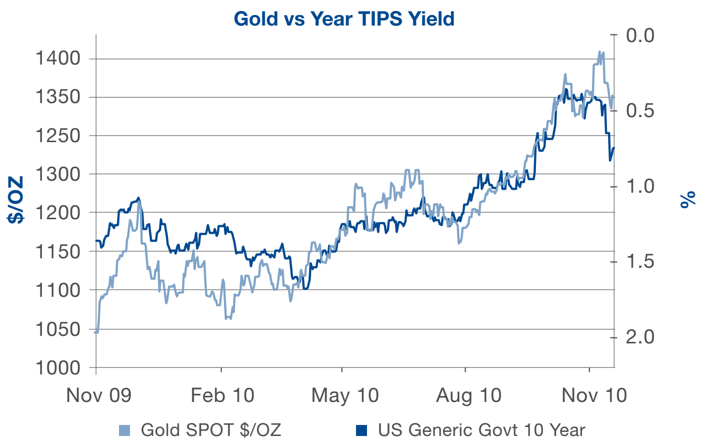
The excess stimulus could be neutralised if domestic currencies were allowed to appreciate significantly, but most countries are reluctant to take this approach as, in the short to medium term, it would make their economies less competitive in export markets – particularly versus China – so instead they continue to accumulate current account surpluses. Those emerging market currencies that are not pegged have seen their currencies appreciate significantly versus the greenback in recent months, prompting comments such as those of Brazil's Minister of Finance who described the situation as a "currency war". The pressure for emerging currencies to appreciate is likely to continue though and is largely justified by growth rates.

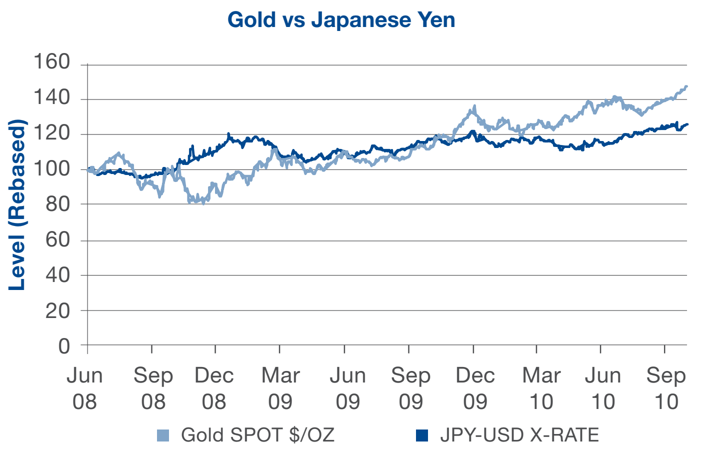
Although the risk of deflation clearly remains non-zero, Viewpoint is of the opinion that price rises are a greater risk at this stage, possibly even in the West where there remains sufficient economic slack to keep inflation benign. Although we do not expect rampant inflation in the next year or so, the extent of efforts to reflate asset prices could well lead to inflation problems down the line and such pressures are likely to rear their heads in emerging markets first.

For the time being the inflation picture remains benign across the emerging market universe and this should enable the asset class to continue to provide good returns. Many emerging market currencies remain attractive and emerging market equities have the potential to deliver further gains despite valuations being high compared to historical norms. Continued stimulus from the developed world will result in excess liquidity chasing higher return assets in emerging markets and it would take a significant and unexpected event to halt this trend.

As things stand there are few asset classes that currently offer obvious value as longer term insurance against the risks of inflation, with the exception perhaps of high quality developed market equities.

The fixed claim represented by bonds amounts to very little at current levels: Coca Cola recently issued three year bonds with a coupon of 0.75% and here the slightest sniff of a price rise would wipe out any real return for investors. The sub-3% yield on a 10 year US Treasury provides greater compensation for less credit risk but greater duration, but clearly there is real potential for the outlook for inflation to change substantially over 10 years. The risk / reward balance seems rather skewed in this instance, with lots of downside and not a lot of upside.





If one were to assume unchanged inflation expectations then perhaps investing at a 3% yield is justifiable, but then why not invest in equities where yields are higher across all developed market regions? Indeed investing in the stock of Coca Cola would provide a dividend yield of 2.7%, the prospect for capital growth and pricing power to protect against any inflation in the future. Equities aren't always able to provide

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. November 2010. Past performance is not indicative of future returns.

inflation protection but as a general rule they do manage to in low or moderate inflation environments.

Real assets such as commodities and property are further alternatives that can provide a degree of insurance. Property markets do not appear to offer compelling value at current levels though, at least on a relative basis compared to equity markets, and there is a significant degree of idiosyncratic risk present. Over the long term this market should provide good protection given the ability to provide greater cash flows when inflation increases, but the increased protection generally comes at the expense of liquidity. Commodities meanwhile are richly priced on the back of a weak US Dollar and expected demand from the rapidly expanding emerging world, and China in particular. This is a market that is particularly vulnerable to the whims of shorter term supply and demand and as such returns can be exceptionally volatile. These two asset classes have substantial merits and in the event of an inflationary shock they would likely provide the best protection to investors. Downside risks prevail for the time being though.

Precious metals and particularly gold are often viewed as assets that can hedge against the risk of inflation, but they suffer from the problem of being difficult to value given a lack of cash flows. Although gold may continue to reach new highs in the months to come, the charts alongside show how highly the yellow metal's price seems to correlate with other assets that either provide inflation protection (TIPS) or that are viewed as a safe haven (Japanese Yen).

Viewpoint remains of the opinion that high quality equities benefiting from pricing power and stable cash flows currently represent some of the best long term investments at current valuations.

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. November 2010. Past performance is not indicative of future returns.

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