

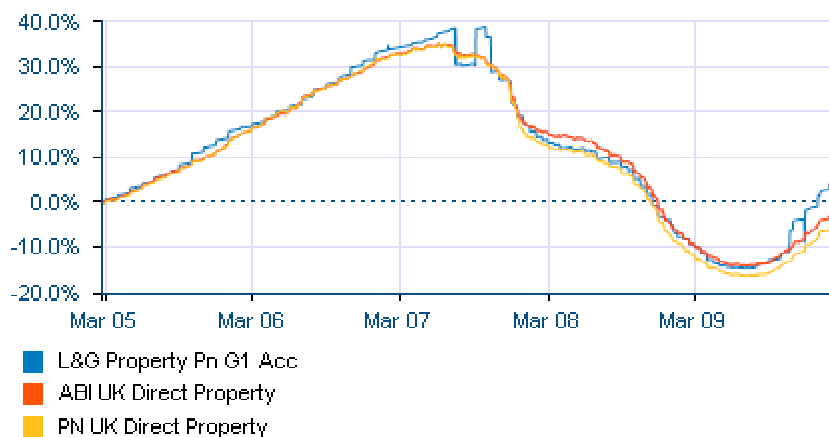
Investment View – February 2010

Last month we reported on the sharp upturn in corporate bonds which has benefitted many clients. The UK commercial property market has also turned the corner and in December the IPD Monthly Index produced the biggest monthly gain in its 23-year history. Clients who bought extra property fund units to take advantage of the depressed values are now reaping the rewards. The turnaround has been marked but what should investors expect from now on?



The recovery has been driven by significant capital inflows on the back of very attractive valuations that had pushed property yields to 15-year highs. With interest rates at an all-time low the gap between the rental yield on property and the cost of borrowing had by mid 2009 reached levels not seen since IPD data began – a buyers' market!

According to several fund managers the demand/supply balance in London looks set to improve



18/02/2005 - 18/02/2010 © Financial Express Holdings 2010

further over the coming quarters. London is typically a lead indicator for the rest of the country. We therefore anticipate a further narrowing of the yield gap between bonds and commercial property which implies capital values should continue to improve, however the trajectory of increase may be less steep than we have seen in recent months.

Bank of England data showed lending to UK businesses contracted by £4.3bn in December after showing signs of stability in November. Bank lending slumped across all sectors of the economy increasing concerns of a 'double-dip' recession - not helped by a drop in January retail sales. But it is the UK's huge public sector deficit that is the real concern. More than 60 leading economists have backed Alistair Darling's decision to delay spending cuts until 2011, creating a split within the profession on the crucial election issue of how to tackle the UK's huge public debt.

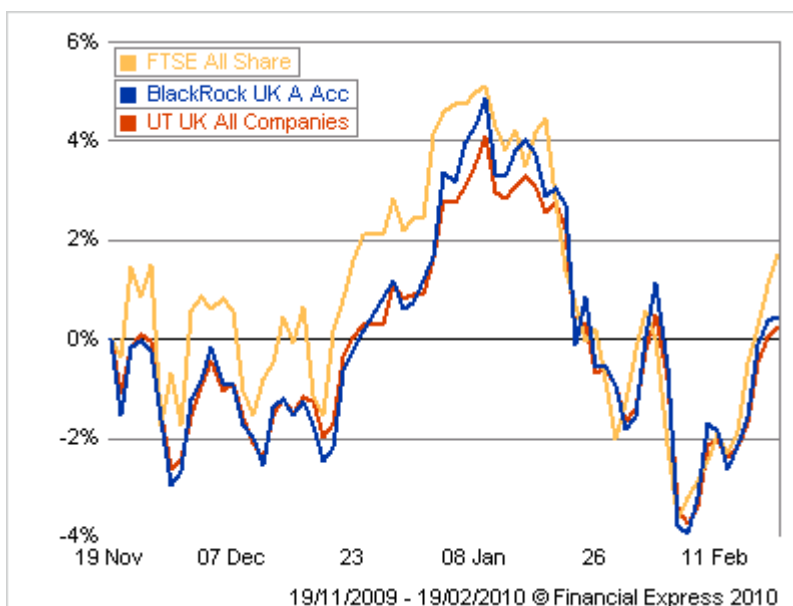
These economists warn of the risks of damaging Britain's fragile recovery by early cuts but their views run contrary to those of the 20 economists who wrote to the Sunday Times last weekend supporting the Conservative party's argument that fiscal tightening should start this year to reassure the markets and head off the risk of Britain losing its triple A credit rating. If the UK's credit rating is reduced this will raise the likelihood of an aggressive UK government bond sell off and will create a real risk of a run on Sterling.

UK interest rates have been at the record low level of 0.5% for 11 consecutive months. Inflation rose to 3.5% in January - the fastest annual pace for 14 months - from 2.9% the month before. The Bank of England had warned inflation could rise to 3.5% this year but predicts it will fall back below the 2% target later in 2010. However the Bank of England has decided against further quantitative easing (QE), the policy designed to stimulate growth in the UK economy. The Bank has pumped £200bn of new money into the economy by buying assets such as government bonds, as a way to boost lending by commercial banks.

The mix of economic data has meant equity markets have been on a mini 'roller-coaster' ride since our last Investment View went to press. The UK stock market was heading for a drop of around 10 per cent from its early January high, but has now recovered some of that lost ground.

It is too early to say whether this was a true 'market correction', or just a bout of profit taking. I expect that volatility will continue for the next few months, as markets become ever more sensitive to new economic data, having reached what might be considered 'fair value'.

This is to be expected and may provide the opportunity for consolidating gains from the last 12 months. We remain generally positive on equity markets, and expect the continuation of a gradual recovery in economic activity, with improving earnings providing scope for further gains. However, the general forecast for western economies remains modest with recovery constrained by ongoing deleveraging of debt at both national and household levels.



European worries over the state of Greek finances increased as the country battles with a spiralling debt crisis and strikes. The Greeks are going to attempt a multi-billion euro bond issue, in what will be a test of the country's credibility in financial markets, with doubts over whether it will be fully subscribed. It is not just the Greeks who have financial credibility worries. UK gilts fell as evidence emerged that Britain's public finances had deteriorated, with very disappointing employment figures is adding to the nervousness. The UK government borrowed £4.3bn in January which is normally a month in which tax revenues would be expected to permit a reduction in national debt. It is the first time the government has borrowed money in January since records began in 1993 and suggests the scale of the shortfall could rise this year above £180bn which at 12.8 per cent of GDP, would be even greater than the shortfall in Greece!

For the Eurozone as with the UK we are concerned by evidence of economic deceleration. It is difficult to see strong domestic demand emerging in either the UK or Europe during 2010 as unemployment increases and all countries are fighting large deficits. Nevertheless I do not see any need to change our strategy at this stage, as the relative risks may be even greater here in the UK than among our European neighbours. Markets are also digesting news from the Federal Reserve, which raised its discount rate by 25 basis points to 0.75%. Speculation has risen that the move signals the start of a withdrawal for emergency liquidity measures from the economy, which has shown some signs of life in recent months.

Emerging markets have continued to demonstrate impressive levels of growth but cannot be immune from the effects of what is taking place in the rest of the world. We have recommended clients take some profits to consolidate their portfolios and this will continue for the foreseeable future. (More on emerging markets in next month's Investment View).

Stock selection will continue to be a key driver of performance this year and we will maintain our leaning towards actively managed funds.

Steve Patterson

Investment Director