Commodities – a proper secular uptrend

The real momentum trade during the past year and again in the first quarter of 2006 has involved exposure to commodities. There have been some extraordinary rises in both base and precious metals, which in turn have propelled mining stocks to very high levels. Apart from speculative investment buying, prices are being squeezed upwards by continued demand and supply imbalances: Asian economies, particularly China, have had a relentless appetite for basic raw materials as they develop their infrastructure, whilst mining companies have struggled to raise production levels.

"Long term growth investors with the appetite for commodity-related risk should be well rewarded."

There have also been supply disruptions in certain areas. Some commentators have likened the current state of the commodities market to the technology bubble in 1999, and point to an imminent crash. We would point out, however, that the technology boom was, in many cases, fuelled by pure speculation and investors' willingness to pay high prices for profits which would arrive far in the future or possibly not at all. With mining companies, however, there are real profits and dividends being generated today.

We believe that we are in the midst of a secular uptrend in commodity prices, brought about by the longer term demographic and economic shifts emanating principally from Asia. Long term growth investors with the appetite for commodity-related risk should be well rewarded, but we would also caution that the road will not be a smooth one and that price spikes and bouts of extreme volatility will not be uncommon.

The USA

Rising US interest rates appear at last to be having a tangible impact on the US consumer. At 4.75%, rates have now climbed above those in the UK, and US consumers have seen a jump from 1% in just two years. House prices are still rising, but the pace of growth has slowed. Demand for bank loans and mortgages also seems to be easing, a signal that tighter monetary conditions are beginning to bite. New home sales in the US fell by more than 10% in February and the stock of unsold homes has risen sharply.

The consumer is also feeling the pinch at the petrol station, with US gasoline prices heading back towards the peak reached during the immediate aftermath of hurricane Katrina. But employment and consumer confidence figures, which are closely interlinked, paint a different picture about the US economy's current health: the unemployment rate has fallen to 4.7%, its lowest level for 4½ years, and the March index of consumer confidence rose to its highest level for four years.

All this points to a difficult phase for Ben Bernanke, the Fed's new chairman, particularly given the unknown waiting period before interest rate policy has any meaningful impact. What we do know is that if he takes the brakes off too quickly he risks pushing up inflation; if he applies them too firmly there is the danger of stalling consumption and sending the economy into a downward spiral.

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investment update

2nd quarter 2006

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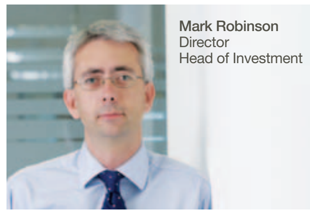

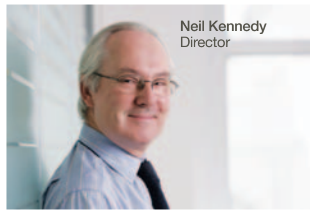

A garden for all seasons

The past three years have seen very good levels of return from global stockmarkets. We have, of course, been recovering from a low base, so whilst in isolation the strength of the bounce back seems quite extraordinary, reminding ourselves of the very difficult period beforehand puts these gains into some form of perspective.

On the whole we remain reasonably optimistic about the prospects for equity markets this year. Corporate profits have largely met or exceeded expectations and allowed market valuations to retreat to more acceptable levels. We still prefer larger companies to smaller companies on valuation grounds, and are also attracted by investments which offer a good level of income, even for portfolios where the generation of income is not the primary objective. European stockmarkets, for example, offer some increasingly attractive dividend yields and generally trade at a lower valuation to most other international markets.

An important, but quite difficult, discipline when markets continue to defy gravity is to keep a firm eye on the level of stockmarket exposure in portfolios and to keep risk under control. It is human nature to want to increase risk when everything and everyone around appears to be doing so well. However, like a well-tended garden, constant pruning and weeding is required to keep portfolios in good shape for whatever the next season brings.

Jamie Berry
April 2006

A powerful start to the new year

Breaking through 6,000 points on the FTSE 100 Index, a level which we last saw on the way down during March 2001, is certainly a milestone, although we are yet to reach the heady heights seen at the end of 1999 when this index reached an all-time high of 6,935.

However, the shape of this mainstream barometer of UK market activity is very different today than it was in 1999, when the so-called TMT trinity of telecom, media and technology companies had such a big influence. Today, energy and resource companies feature much more heavily, as do financials. The top 10 UK companies are valued at over £750bn, or 45% of the entire UK equity market – a heady statistic if ever there was one. A big move in any one of these companies, or indeed the sectors they represent, therefore has a big influence on the market as a whole.

"…we continue to populate the portfolios we manage with equity funds where the managers do not have their hands tied behind their backs…"

We *will* return to the heights seen at the end of 1999, but when we do it will be for very different reasons and through the success of a totally different selection of companies. Being in and out of the right companies and sectors, rather than slavishly following benchmarks, is as important as ever, and this is why we continue to populate the portfolios we manage with equity funds where the managers do not have their hands tied behind their backs by index constraints. The clever managers over the past year have found excellent investment opportunities below the top-tier companies, but many are now reining in some of their bets in favour of the relative safety of larger companies, where valuations are not so excessive.

The UK Budget

There were no major economic surprises in the UK Budget, as most of the government's predictions for economic growth, spending and borrowing had been well flagged beforehand. It is disappointing that the Chancellor did nothing to improve relations with professional advisers and the City. Having been forced to back-track on rules for property eligibility in pension funds, it seems that trusts have become the latest casualty of hasty legislative change.

On the one hand the government acknowledges the important role that trusts play in society, but on the other it seems to have completely underestimated the impact that some of its proposed changes will have on everyday, legitimate planning. Hopefully the government will listen to the representations currently being made by professional bodies and clarify its intentions.

"The government's predictions had been well flagged beforehand."

The Chancellor also took the opportunity to provide an update on the government's plans for the introduction of Real Estate Investment Trusts (REITs), allowing for the conversion of many property companies into more efficient vehicles, which in turn should allow a wider audience of investors to gain access to commercial and residential property. The REIT market is well-established in the US and is expanding in Europe. The demand for investment in UK REITs, when they are introduced from January 2007, will therefore depend on the relative attraction of income yields and capital growth prospects at that time. We are already looking at ways of diversifying our property exposure into other markets, but also see the development of REITs in the UK market as a positive step.

"…a wider audience of investors to gain access to commercial and residential property."