investment update

WINTER 2009

ANNUS HORRIBILIS

Is it over?

THE SPEED OF CHANGE

Too quick for most

THE KEY DRIVERS FOR 2009

This year's economic drivers

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A slow burn

DEFLATION – THE BIGGEST THREAT

A global solution needed for a global issue

BERRY

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2008 has been a dreadful year for the world's financial markets. Seemingly impregnable institutions have fallen, and the reputations of many other global institutions have been severely tarnished, many probably beyond repair. A year ago, indicators pointed towards a mild recession in some areas, but with growth in the global economy expected to continue, supported by the seemingly unstoppable Chinese growth train.

How things have changed. There are not enough column inches here to list the catalogue of business failures, government bail-outs, policy moves and rapid shifts in economic statistics, particularly in the latter half of 2008, but who would have thought a year ago that global interest rates would rapidly be approaching zero percent and that collectively governments would have committed themselves to raising around $3 trillion of new debt? As we start a new year it is difficult to find some seasonal cheer after a period of quite extraordinary, and in many cases unprecedented, market and economic events, but what follows is an attempt that tries to put things in perspective.

January 2009

THE SPEED OF CHANGE

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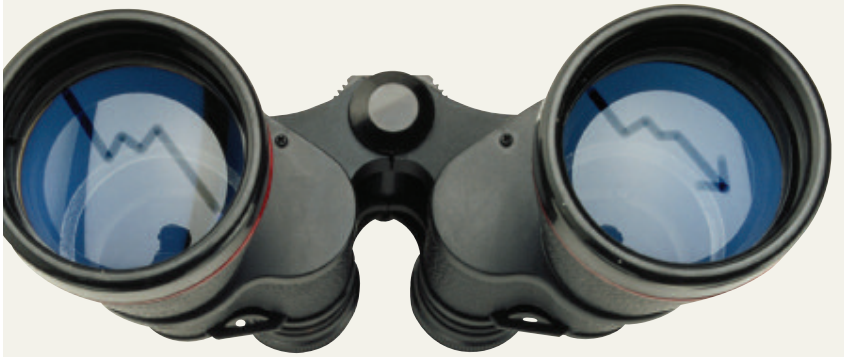

The extent to which the economic scene changed so quickly in 2008, and the genesis of the recession that is now upon us, can be seen in the predictions of many economic forecasters just one year ago.

Virtually all significantly underestimated the speed and scale of the downturn, with the general consensus expecting interest rates in the UK to settle at around 5% by the end of 2008 rather than the 1.5% that we have now. Many were forecasting still quite acceptable economic growth of over 2% rather than the very modest or negative growth we have now. This rapid shift in economic variables made it extraordinarily difficult to set a durable investment strategy for the whole year; these characteristics are unlikely to disappear quickly, so the determination of a strategy for 2009 can be expected to be equally challenging and impacted by many moving parts. Trying to provide sensible market level forecasts for the end of 2009 is almost impossible, but instead it is worth examining some of the economic influences which are likely to shape the next twelve months and guide our thinking.

THE KEY DRIVERS FOR 2009


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Director

Interest rates are likely to fall further and then remain low for some time. Ultimately, this significant monetary action should provide a stimulus to both business and consumers.

Inflation is expected to fall further as slowing demand for raw materials, particularly from China, brings down the price of many commodities: the oil price has already fallen by around 70% from its peak in July and this reduction is now feeding through to lower transport and heating costs; both low and relatively stable interest rates, combined with falling inflation, should provide a strong backdrop for government bond markets, notwithstanding the large amount of additional debt that governments need to issue in order to fund their huge bail-out commitments; corporate bonds, which currently offer compelling income yields relative to cash and government bonds, should also perform better against this interest rate and inflation outlook.

With the UK economy in particular trouble, sterling is likely to remain weak against both the euro and dollar, suggesting that overseas exposure for our sterling-based clients will continue to be rewarded on a relative basis. We should also expect the number of corporate casualties to rise, either as a result of reduced consumer spending or because of over-indebted businesses caught up in the domino effect of the seizure in lending – some sectors will do better than others, so investing in funds with flexible styles will be as important as ever. Finally, we should not expect to see any immediate significant improvement in lending conditions, whether it is between banks or at the consumer level – progress on this front will be slow and will take time.

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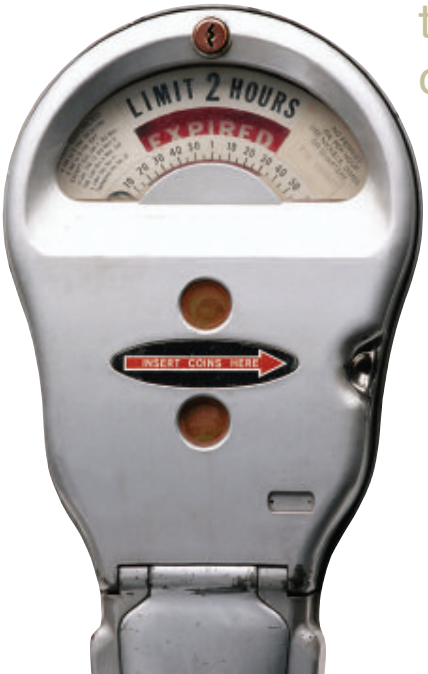

CONFIDENCE – THE CRUCIAL INGREDIENT



One thing that we can be fairly certain of is that sustained confidence – as opposed to short periods of hope - will not be restored in a hurry.

Confidence can be lost very quickly, but nearly always takes time to rebuild. A strong rally in equity markets, which is still quite possible, and widely predicted in the new year financial press, could provide a catalyst for some renewed optimism, but it needs to be backed up with hard evidence that the global economy can turn the corner. It is still far too early to be talking about the green shoots of recovery that will come as a result of the monetary and fiscal stimuli that are currently being put in place around the world, but those green shoots will come eventually.

In the first half of 2009, markets are likely to continue to be influenced by current news rather than anything further afield. For this reason the volatility and 'mis-pricing' of various assets such as some structured products that we have experienced in the past twelve months is unlikely to disappear in the near term. However, we should not forget that markets and economic fundamentals are rarely aligned and a recovery in the former can (and normally does) occur well before any recovery in the latter. Like using a good barometer, it is important to look at today's reading but also to remember to tap the glass to see what lies ahead. What we see at present from an economic perspective is not particularly encouraging, but the valuations of various asset classes are becoming increasingly more attractive, particularly as returns on cash deposits collapse: the income yield on the UK equity market, assuming dividends are not cut significantly, does look quite appealing at over 4%, whilst yields of more than 7% on investment grade corporate bonds look equally enticing, and imply quite unimaginable levels of default and no hope of eventual recovery. If there is talk from some corners of the investment community of a big bear market rally in equities, inspired by attractive yields and valuation, then it is illogical not also to have a big rally in corporate bonds.

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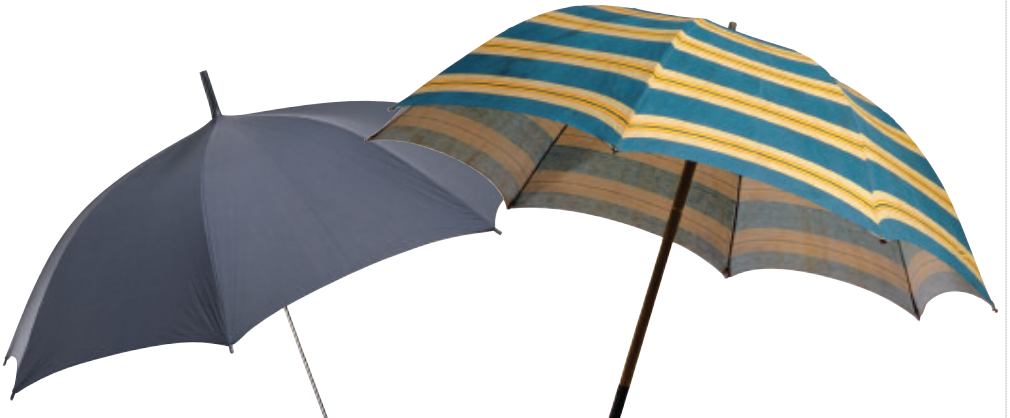

DEFLATION – THE BIGGEST THREAT

The biggest danger in this current downturn is that as inflation falls, employment conditions deteriorate and confidence generally remains weak, consumers start to postpone expenditure in the belief that tomorrow's price will be even cheaper, whether it is a house, a car or a new pair of shoes.

This trap, akin to the deflationary spiral witnessed in Japan over many years, is not an easy one from which any economy can extricate itself. The media will undoubtedly also play their part in this recession in a way which was not possible in previous downturns – information via email and the internet is immediate and widely dispersed, so the hardest task will be to turn this current supertanker of negative sentiment onto a course which sends a more positive message and gives greater confidence to consumers. This can really only come when consumers feel more positive about their employment situation, see less pressure on their debt position and when they generally feel they have more disposable income in their pockets. Governments are helping in this regard by reducing interest rates, through tax cuts and by announcing large public spending initiatives, but it does still require some considerable understanding by consumers that they are, to a large extent, in control of their own destiny. However, the one key difference between our current troubles and those experienced during Japan's deflationary era, for example, is the fact that this is a global problem which is being tackled on a global scale - international policy makers are all pulling in the same direction to achieve a common goal that should, ultimately, deliver a global solution to the problems which have their origins in the early part of this millennium. This solution will not manifest overnight, and the early part of 2009 could see some further challenging periods of market and asset price instability, but the foundations are now being laid for a longer term recovery which should become a little clearer as the year unfolds.

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