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Independent Investment Management

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The first quarter of the year has been yet another challenging period for investment in all asset classes. Cash returns have become the latest victim of the widespread monetary stimuli designed to reflate the global economy, with interest rates now close to zero. It is still too early to judge the success or otherwise of quantitative easing, but it does mark a new, and hopefully final, phase in this current downturn.

To some extent it does not feel as though we have moved on much from the conditions prevalent at the end of the year, although behind the scenes an awful lot is being done to repair the financial system's balance sheet. The recent G20 summit has reinforced the message that there is a united front determined to tackle the world's financial problems: the US$1 trillion package of measures announced, designed to get banks lending again, was initially welcomed by markets. However, the next phase of signing agreements and checking the small print is understandably causing the financial worry machine to kick into action again, and it will be some time before we can assess the real success or failure of the summit's conclusions.

Conflicting economic data continues to make it difficult to identify trends and any threads of optimism for markets to grasp. A more optimistic housing or consumer survey can quickly be followed up by unexpected inflation numbers or manufacturing output, so there are certainly ample statistics to cause markets to remain jumpy. Only when we get a few more months under our belt are we likely to know whether any of the 'unexpected' results of recent economic data and surveys are 'blips' or something which warrants greater attention.

For brief moments since the start of the year there have been some quite strong rebounds in world equity markets, but as soon as these have gathered some momentum the rallies have tended to peter out. Fundamentally, it has been good to see the FTSE 100 Index back above 4,000 points from time to time, possibly reflecting buying at what is considered by some to be very attractive long term value. But sustaining new territory continues to be challenging given continued conflicting economic news and varying reaction to government initiatives. Our instincts tell us that we will probably retest the low points again.

Having said that, predicting the 'bottom' of the market is an impossible task, but something nonetheless that investors tend to search for, particularly after declines of the magnitude that we have seen over the past year. The economic scene has changed so much, and the damage done to the financial system has been so great, that applying traditional valuation measures is unlikely to give us any meaningful clues as to when markets will fundamentally turn for the better. The investment world is unquestionably a very different place now than it was not only just a few years ago but also when compared to previous major economic downturns. Making comparisons with, and trying to draw sensible conclusions from, what we know about previous downturns may give us some pointers, but these will not take into account the very unique set of economic and market variables that we are facing right now, so it is important

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not to read too much into what the history books tell us. That said, it is worth noting a couple of indicators which have subsequently signalled the low points of the four major bear market 'bottoms' of the last century and which are likely to play an important part in determining whether we see a rejuvenation in market sentiment sometime soon. First, corporate bonds have historically led a recovery in equity markets and second, an end to the decline in commodity markets has also signalled a buying opportunity.

In the case of corporate bonds, where we have significant commitments, we have yet to see any meaningful move in prices, although some stability is appearing at the higher quality end of the credit spectrum. Quantitative easing has been extended from the buying of government bonds to corporate debt and there are also signs that the Bank of England's Asset Purchase Facility is starting to improve liquidity. However, yields remain extraordinarily high both in investment grade and lower-rated debt, and still imply quite unprecedented levels of corporate failure. It is still early days, but several bond managers are now indicating that they can see some light at the end of the tunnel rather than the lights of another train coming towards them. As the history books tell us, and as we have noted before, a broad and sustained equity market recovery cannot really be expected until after the corporate debt markets have first seen some rebound.

As far as commodity prices are concerned, these remain a key leading indicator of global demand and potential future inflation. One broad indicator for the demand in global commodities is the Baltic Dry Index, which measures the cost of moving raw materials by sea around the globe. At its peak last May, the Index stood at almost 12,000 points, but by early December it had fallen by around 95% to below 700 points. The price of copper and iron ore, two bellwethers of economic activity, are around 50% below their peaks of last year. Looking at very recent figures, however, both the Baltic Dry Index and certain commodity prices are off their lows, which could signal that demand is starting to rise again. Alternatively, it could signal that commodity prices tumbled too far last year and are merely showing a modest rebound that is more representative of fundamental activity. Either way, the slight upward trend in the Baltic Dry Index is encouraging, as is the recent rise in the price of copper, which has historically always preceded a rebound in equities.

We are well aware of the challenges which face us in the coming year, during which the long hard battle to restore lost values will commence. At present, we are taking note of some of the peripheral market indicators which historically have proven to be the buying signals. We know that if we wait for an earnings revival we will have missed the 'bottom', but that is currently of less concern to us than increasing exposure to equity markets too early and reacting to what could still be false dawns. However, whilst there are still many longer term issues for economies to deal with, not least the debt burden that is now upon them, there are increasing signs that we are now through some of the worst of the financial system's difficulties. Reducing current high levels of cash, particularly now that returns are so low, is therefore becoming an increasingly attractive shorter-term tactical proposition, even if the much longer term prognosis for equity markets still remains uncertain.