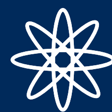

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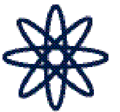
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

A quarter of consolidation has seen the maintenance of earlier gains in equities and some downward pressure on bond yields. Both of these asset classes have benefited from very loose monetary policy and exceptional measures taken to prevent economies sliding into depression. This rather complex situation is discussed in our review.

The tables below detail relevant movements in markets:

International Equities 31.07.09–30.10.09

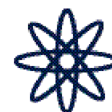
Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+11.1	+21.4	+20.7	+16.0
Finland	+0.1	+4.7	+4.1	+0.1
France	+6.1	+11.0	+10.4	+6.1
Germany	+2.0	+6.8	+6.2	+2.0
Hong Kong, China	+3.7	+4.3	+3.7	-0.4
Italy	+7.1	+12.1	+11.5	+7.1
Japan	-5.6	-0.2	-0.7	-4.6
Netherlands	+5.5	+10.4	+9.8	+5.5
Spain	+5.8	+10.8	+10.2	+5.8
Switzerland	+5.7	+11.7	+11.1	+6.7
UK	+10.3	+10.3	+9.7	+5.4
USA	+5.5	+6.1	+5.5	+1.3
Europe ex UK	+5.8	+10.9	+10.3	+6.0
Asia Pacific ex Japan	+5.3	+10.6	+9.9	+5.6
Asia Pacific	-0.2	+5.2	+4.6	+0.6
Latin America	+10.8	+17.4	+16.8	+12.2
All World All Emerging	+8.1	+11.2	+10.6	+6.3
The World	+4.8	+7.4	+6.8	+2.6

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +3.6%

International Bonds—Benchmark Ten Year Government Bond Yields (%)

Currency	31.07.09	30.10.09
Sterling	3.80	3.63
US Dollar	3.51	3.40
Yen	1.42	1.42
Germany (Euro)	3.78	3.22



Sterling's performance during the quarter ending 30.10.09 (%)

Currency	Quarter Ending 30.10.09
US Dollar	-0.6
Canadian Dollar	-0.9
Yen	-5.5
Euro	-4.5
Swiss Franc	-5.4
Australian dollar	-8.9

Other currency movements during the quarter ending 30.10.09 (%)

Other Currency	Quarter Ending 30.10.09
US Dollar/Canadian Dollar	-0.4
US Dollar/Yen	-4.9
US Dollar/Euro	-3.9
Swiss Franc/Euro	+1.0
Euro/Yen	-1.0

Significant Commodities (US dollar terms) 31.07.09—30.10.09 (%)

Significant Commodities	31.07.09—30.10.09
Oil	+4.9
Gold	+11.3

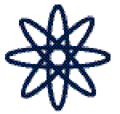
Markets

Over the quarter, the recovery noted in our last review has continued with the gains from last March's low point being consolidated. In total return terms, the FTSE World Index returned 4.8% in local currency terms, 7.4% in sterling terms, 6.8% in US dollar terms and 2.6% in euro terms. Looking at local currency returns, the FTSE Japanese Index produced the only negative return at -5.6%. Elsewhere, the best performers in local currency terms were Australia (11.1%), Latin America (10.8%) and the UK (10.3%), all measured by the relevant FTSE index. Elsewhere, The FTSE All World All Emerging Markets index returned 8.1%, the FTSE Europe ex UK Index returned 5.8%, the FTSE USA Index 5.5% and the FTSE Asia Pacific ex Japan Index 5.3%. However, because of the weakness in sterling during the quarter, the results were rather different in sterling terms. Japan still remained negative but only just at -0.2% but Australia, because of the Australian dollar's extreme strength, returned 21.4% whilst the FTSE Latin American Index returned 17.4%, the FTSE All World All Emerging Markets Index returned 11.2%, the FTSE Europe ex UK Index 10.9% and the FTSE Asia Pacific ex Japan Index 10.6%, all ahead of the return on the FTSE UK Index.

Bond yields, as measured by ten year government bonds, declined over the quarter. The gross redemption yields on sterling government bonds declined by 17 basis points to 3.63%, on US government bonds by 11 basis points to 3.4% and on German government bonds by 6 basis points to 3.22%. There was no change in the yield on Japanese government bonds at 1.42%.

In currency markets, sterling weakened against all the major currencies, although only slightly against the US and Canadian dollars with falls of 0.6% and 0.9% respectively. The main weakness was against the Australian dollar (-8.9%) but there was also notable weakness against the yen (-5.5%), the Swiss franc (-5.4%) and the euro (-4.5%).

In commodity markets, oil rose by 4.9% and gold by 11.3%.

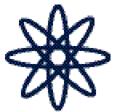


Economics

Although the world economy remains in a very serious state, stock market levels are well above this year's low point last March. That does not reflect a sea change in the world's economic position but, rather, a combination of factors. One is that investors are not as fearful as they were. Fear of the unknown is an important driver of markets. Last autumn, especially, but also in the early part of this year, there was genuine fear. Would banks collapse and depositors lose their money? It cannot get much worse than that. Now, it feels fairly safe to say that depositors do not fear for their money because governments, central banks and regulators have worked out a way of dealing with the issues of unstable banks, albeit at great cost. Investors expect stocks and shares to move up and down but they do not expect to fear for the safety of their deposits. The removal of that fear eliminated a major negative from markets. The first quarter of this year represented a dire time for the world economy with GDP falling sharply almost everywhere, reflecting the fact that the world economy "stopped" in the final quarter of last year as the banking crisis unfolded. The Madoff scandal broke last December and the ramifications were enormous. Hedge funds, as a generality, were already experiencing a difficult time as, in some cases, strategies unravelled. The Madoff scandal added to the problems of the industry by reducing trust. The result was a further round of redemptions and more forced sales of securities in the world's stock markets. It was, as they say, a "perfect storm".

However, stock market cycles are different to economic cycles and this often puzzles people. Why, when individuals and companies are experiencing very difficult conditions, should shares be rising? If, with hindsight, we can say that last March probably represented the low point of this stock market cycle, what has caused shares to rise since then? One reason is the removal of fear about the banking system. This is not to be misunderstood. Many banks were and still are in a very poor state but the authorities had worked out ways of dealing with the issues. The other reasons surrounded policy responses. On the fiscal side, budget deficits were allowed to increase dramatically as economies' automatic stabilisers came into play. Automatic stabilisers represent counter cyclical variations in governments' finances caused by recessions and booms. In the former case, a deterioration in governments' finances, caused by reduced tax revenues and higher social security spending on unemployment benefits is not counteracted by raising taxes or cutting public expenditure. In the latter case, rising tax revenues and, perhaps, lower social security spending, allow governments' finances to move into surplus to provide for a deterioration in public finances in bad times. Thus, in bad times, a cyclical deficit may be run and, in good times, a cyclical surplus may be run. However, it is not as straightforward as this because many economies are running large structural deficits which are undesirable and unsustainable and we will come on to this issue later. In the short term, however, very loose fiscal policy is providing some support for the international economy even though dangers lurk later on if the deficits are not addressed in a timely manner.

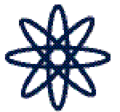
If fiscal policy has loosened by default, positive action has been taken to keep monetary policy as loose as one can remember. In its most traditional form, interest rates have been moved towards zero in all the main currencies. The intention is obvious. It is to reduce the cost of borrowing to improve the cash flows of individuals and businesses, thereby improving economic activity to above the level it would otherwise have been. There are losers, however. There are many more savers than borrowers and these individuals' incomes are being badly squeezed to the detriment of their spending power. The unorthodox method is quantitative easing ("QE") which is shorthand for printing money. In the UK, the QE programme has been authorised up to £175 billion. Under the UK version, the Bank of England buys bonds (nearly all gilts) from the private sector paying for them by the electronic creation of deposits for the sellers. The aim of this is to drive down bond yields thereby helping potential borrowers and to get the money created moving around the economy to create activity, ward off deflation and to raise asset prices. This last point is interesting. Only recently has a member of the Bank of England's Monetary Policy Committee said this, but we have been making this point for a while in the context of the rising stock market. Rising asset values create a "feel good" factor, again encouraging more economic activity. Central banks have been providing liquidity to markets in a number of ways to free up the banking system and get lending moving again. At the worst point in the crisis, banks were fearful of lending to each other and a seizing up of the banking system posed a serious threat to the world economy for if the supply of credit dries up so does economic activity.



So we now move to a situation where liquidity is plentiful and interbank rates have moved to more normal levels relative to official rates instead of being elevated, as they were last year. At the moment, the banks have parked a lot of it at central banks. Indeed, there was talk in the UK of the Bank of England imposing negative interest rates on banks' deposits with it to try to get lending moving. Put at its simplest, if money is being printed and there is a finite amount of assets available, the price will rise. This very general and simplistic point makes the argument. In conjunction with this, the lack of yield on bank deposits is forcing some investors to look at alternative assets for yield. Shares, bonds and property are obvious examples where yields are significantly higher than on cash deposits. Very low interest rates on bank deposits are distorting the asset markets and money pushed elsewhere, for what might be termed artificial purposes to obtain yield, risks causing an asset bubble. Although shares have risen since March, they do not look dear but bonds, to us, look to be in a bubble and very expensive.

Earlier in the year, there was much talk of deflation, rather less now. We do not believe the deflation story. We need to define what we are talking about now. By deflation, we do not mean the odd quarter or two of falling prices but a prolonged series of negative readings on price levels. Very loose monetary policy plus quantitative easing, or variations thereof, threaten inflation later on and it will be difficult to put the inflationary genie back into the bottle. Those who put forward the deflation, or lack of significant inflation, argument, home in on the output gap, the difference between actual and potential output. Of course, as a result of the recession, it is quite wide in many countries now. However, as a result of the shock engendered by last year's financial crisis and the ensuing recession, capital investment has been limited, so capacity expansion has been restrained and recovery might bring economies up against capacity constraints sooner than expected. If that does happen, inflation could soon return. Looking at the price of oil and gold, both of which have been rising, admittedly in terms of a weak US dollar, it is difficult to accept the deflation argument. Intuitively, the creation of money and very loose monetary policy are likely to cause inflationary problems in the future. The weaker the economy, the more difficult it will be to exit from these exceptional measures because of other difficulties an exit will create. Already, two of the world's stronger economies, Australia and Norway, have started to raise interest rates in a move towards restoring normality, although it is only the beginning. Their position contrasts with that of a very weak economy such as that of the UK where the exit from the current highly abnormal monetary measures will be particularly difficult. The size of the fiscal deficit is alarming and it will have to be addressed as a matter of urgency. This is likely to mean that, absent severe downward pressure on sterling which is always a possibility given the UK's poor fundamentals, monetary policy is likely to remain very loose with the move towards restoring some semblance of normality in interest rate levels likely to be delayed. The longer it is, the more likely it is that inflation will become a problem but the collision between a reversal of the QE measures which would mean, amongst other things, the Bank of England selling bonds back to the private sector, a move which would be likely to put upward pressure on bond yields, and the need for the Bank of England to sell vast quantities of new government stock to finance the budget deficit, would put further upward pressure on interest rates. A move towards the premature removal of QE could exacerbate economic weakness whilst a delay could cause serious inflationary problems later on. But this is too simplistic an exposition of the issues. One needs to talk about the UK in this context because it is in a particularly weak situation. If a country is in a very weak position, the flexibility of policy options can be taken out of its hands by creditors, buyers of government debt and the foreign exchange markets. That is why those countries which are in a particularly weak position have to take credible action to rectify their finances. A practical example of this is Ireland, where the weak position of government finances has forced and will continue to force drastic action, a foretaste of what may be to come in the UK and other countries with severe budgetary problems.

It is a zero sum game. Nearly every country has financial problems arising from the recession but some are in a relatively good position and others in a relatively bad position. Not all exchange rates can go down at the same time and those countries which are in a relatively weak position are vulnerable to the actions of their creditors and the foreign exchange markets. The exception is the group of countries within the eurozone which are facing very difficult conditions, such as Ireland, Greece, Spain, Portugal and Italy. They cannot devalue their way out of



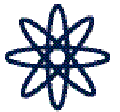
economic trouble so have to take other measures, which will have to be brutal, to restore their competitiveness. As we have often mentioned before in these reviews, countries within the eurozone are seeing their economies' performance diverge rather than converge which was the original idea. The eurozone is far from an optimal currency area and no one should be fooled by the euro's current strength. This is exacerbating the problems of the weaker economies and the severe nature of the adjustments needed to converge with a country like Germany, for example, will involve policy changes and financial adjustments which many of the respective populations will find unacceptable. Notwithstanding the difficulties of leaving the eurozone, we still believe it likely that some countries will not be able to bear the pain of the adjustment needed to remain within it. The Stability and Growth Pact's economic disciplines have gone out of the window and, if it were to be enforced, it is not difficult to see social unrest in some of the affected countries. So, whilst it is not the topic of much speculation at present, we think the eurozone could face monetary union difficulties from those of its members which are suffering some particularly severe economic weakness at present.

However, one of the reasons for the recent upward movement in share prices, besides the liquidity reason and the search for yield which cash deposits currently do not give, is that the economic news has become less bad or even better and, of course, markets look forward. The huge monetary and fiscal stimulus given to the world economy has generally had the desired effect of arresting the decline in the world economy. This is reflected in IMF's World Economic Outlook, excerpts from which are given below:

Real GDP Growth (%)

	2008	**2009** (estimate)	**2010** (estimate)
Advanced economies	0.6	(3.4)	1.3
USA	0.4	(2.7)	1.5
Eurozone	0.7	(4.2)	0.3
Germany	1.2	(5.3)	0.3
France	0.3	(2.4)	0.9
Italy	(1.0)	(5.1)	0.2
Japan	(0.7)	(5.4)	1.7
UK	0.7	(4.4)	0.9
Newly Industrialised Asian economies	1.5	(2.4)	3.6
China	9.0	8.5	9.0
India	7.3	5.4	6.4

Source: International Monetary Fund - World Economic Outlook - October 2009 (excerpt)



Consumer Prices (%)

	2008	2009 (estimate)	2010 (estimate)
Advanced economies	3.4	0.1	1.1
USA	3.8	(0.4)	1.7
Eurozone	3.3	0.3	0.8
Germany	2.8	0.1	0.2
France	3.2	0.3	1.1
Italy	3.5	0.7	0.9
Japan	1.4	(1.1)	(0.8)
UK	3.6	1.9	1.5
Newly Industrialised Asian economies	4.5	1.0	1.9
China	5.9	(0.1)	0.6
India	8.3	8.7	8.4

Source: International Monetary Fund - World Economic Outlook - October 2009 (excerpt)

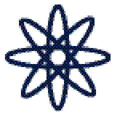
General Government Fiscal Balances as a % of GDP - G7 countries

		2008	2009 (estimate)	2010 (estimate)
USA	actual balance	(5.9)	(12.5)	(10.0)
	structural balance	(3.4)	(5.1)	(5.3)
Germany	actual balance	(0.1)	(4.2)	(4.6)
	structural balance	(0.6)	(2.2)	(2.7)
France	actual balance	(3.4)	(7.0)	(7.1)
	structural balance	(3.3)	(4.0)	(4.1)
Italy	actual balance	(2.7)	(5.6)	(5.6)
	structural balance	(2.7)	(3.7)	(3.8)
Japan	actual balance	(5.8)	(10.5)	(10.2)
	structural balance	(5.2)	(7.6)	(8.0)
UK	actual balance	(5.1)	(11.6)	(13.2)
	structural balance	(5.5)	(9.0)	(9.6)
Canada	actual balance	0.1	(4.9)	(4.1)
	structural balance	0.4	(2.2)	(1.6)

Source: International Monetary Fund - World Economic Outlook - October 2009 (excerpt)

In a further update on Asia issued at the end of October, the IMF upgraded its forecasts for Asian growth to 2.8% for this year and 5.8% for 2010. This compares with its forecasts, made last May, of growth of 1.2% and 4.3% respectively.

So, the change in direction of the world economy for 2010 as evidenced by the IMF's latest forecasts and the effect on asset prices of cheap money, plentiful liquidity and the search for yield is the driving force behind bond



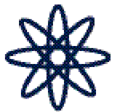
and equity markets at present. As stated before, we regard bonds as being in a bubble with yields on offer, for example, in high quality bonds, as shown in the table at the beginning of this review, completely inadequate in the light of government financing requirements, potential inflationary risks and the withdrawal, at some stage, of the exceptional measures taken to prevent an economic recession leading to an economic depression. The prospective price/earnings ratio of shares look reasonable on the basis of some economic recovery next year and dividend yields, in the current very low interest rate environment, still look attractive with some increase in dividend payments likely next year.

What are the problems which markets will have to consider in the future? The wretched state of many countries' finances, as shown in the second table above, means there will be a strong headwind for growth to face. Measures which will have to be taken to restore countries' public finances will weigh down on growth. A combination of cuts in public expenditure and rises in taxation will make economic growth harder as purchasing power is withdrawn from economies. This is likely to mean that, for many western economies and Japan, economic growth will be sluggish for the foreseeable future. The withdrawal of the exceptional measures such as QE means the threat of higher bond yields, for the reason given earlier, will also prove unhelpful. These are issues which investors will have to consider carefully in their investment policy. Fortunately, however, this is not a uniform problem. As we mention above, Asia is doing relatively well, as are other countries like Brazil and Australia. The benefits of superior growth in these areas will be of indirect help to those western countries and Japan where the going is tough. The strong recent relative stock market performance of many of these countries reflects their superior current and potential performance.

As many of our clients' portfolios are sterling based, we should expand further on the UK's prospects. We have referred to these indirectly in earlier narrative and they do not look good. A major real adjustment in policy is becoming an urgent necessity and creditors, domestic and foreign, will want to see evidence of this. The general election, due, at the latest, by the beginning of next June, is complicating matters because no party apparently wants to set out the real scale of the adjustment which has to take place for fear of frightening the electorate. But it is not a minor adjustment which has to be made. The level of the current and prospective budget deficit (we use this expression as shorthand), as well as the trend in the level of overall public debt in relation to GDP, is frightening. Tinkering at the edges is no good in such a dire situation. The level of adjustment, which will have to be made, is something not many of us will ever have experienced. So, in a way, we are in a rather unreal position at present with the sea of liquidity giving rather a pleasant feeling for investors, quite the opposite of the concerns of this time last year, but knowing that some major measures are going to be introduced to put public finances on the path to some sort of order. It may be that markets will take matters out of the authorities' hands and force action to make a start on restoring public finances. Sterling has made a modest recovery after the collapse last year and this is surprising given the economic outlook for the UK but it should not give rise to any complacency since sentiment can change at any time.

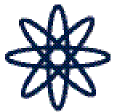
Where sterling based investors can take some comfort is that holdings in foreign shares provide some insurance against the dangers inherent in the UK economy. Most economies are in better shape or less bad than that of the UK where the first estimate of third quarter GDP performance was surprisingly bad, showing that the UK economy was still in recession in contrast to elsewhere. The figures may, of course, be revised but the 0.4% fall in GDP between the second and third quarters was not expected. However, from an investment perspective, UK investors in, say, FTSE 100 companies, can derive comfort that a substantial part of their business comes from overseas directly or indirectly and that these companies provide some hedge against very difficult times for many purely domestic companies or in the event that sterling comes under pressure. So, directly or indirectly, the importance of exposure to less risky economies is vital. The paradox is, therefore, that investment in UK shares, as part of a diversified international portfolio, makes sense even in an economic environment as difficult as this.

As we have been doing so far this year, when the balance of economic news has been bad, we have highlighted



some of the indicators showing that things are becoming less bad, stable, or even improving, as a way of focusing attention on the issues which the stock market could be looking forward to and which might have contributed to the recovery from March's low point. For the market to continue to rise, it will need an increasing flow of good news showing that the cycle really has turned and providing support for the IMF's more optimistic view of next year's international prospects.

Starting with the USA, we have had two pieces of news on GDP. At the beginning of October, the estimate for the contraction in second quarter GDP was reduced to 0.7% compared with the previous estimate of 1.0%. At the end of October, we had the first estimate of third quarter GDP which showed an increase to an annual rate of 3.5%, which was better than expected. The ISM's index for non manufacturing businesses rose to 50.9 in September from 48.4 in August, signalling very modest expansion. There was an improvement in the US trade deficit in August with an improvement in exports and decline in imports with the goods and services trade gap falling by 3.6% to US$30.7 billion. The Commerce Department reported a fall in inventories of 1.5% in August. This is good news since it means that production is likely to rise over the next few months to restore inventories against the background of a better economy. The Federal Reserve's Beige Book reported that the US economy is slowly recovering but pointing to serious problem areas in banking and commercial property. In September, existing home sales rose by 9.4%. The National Association of Realtors said that sales of previously owned homes rose to an annual rate of 5.57 million, well ahead of expectations. This was probably tax driven because of the impending expiry of the tax credit for first time buyers. Also in the housing market, the Standard & Poors/Case Shiller home price index for twenty American cities rose in August by 1% from July. New orders for long lasting US goods rose by 1% in September, compared with the 2.6% decline in August. There were also some better items of news from the eurozone. The headline purchasing managers index for the manufacturing sector rose to 49.3 in September from 48.2 in August. Whilst still signalling contraction, it is at a lower rate and moving towards the expansionary figure at over 50. The figure for the services sector expanded to 50.9 in September from 49.9 in August. Industrial output in the eurozone rose by 0.9% in August, the fourth consecutive monthly increase. Markit's eurozone flash services purchasing managers index for October showed its first reading at 52.3 compared with 50.9 in September which is its highest level since February 2008. Capacity utilisation in the eurozone rose to 70.7 in the third quarter from 69.6 in the second quarter. Within the eurozone, in Germany, the headline purchasing managers index for German manufacturing rose to 49.6 in September from 49.2 in August. While still signalling contraction, it was at the highest level since August 2008. The Ifo Economic Research Institute said its business climate index rose to 91.9 in October from 91.3 in September, the highest level since September 2008. In France, the Bank of France's business sentiment indicator for the manufacturing sector rose to 92 in September from 89 in August, a fifteen month high. Official data for French business confidence showed that the index rose to 89 in October from 86 in September which was the highest level for one year. In China, economic growth in the third quarter rose to an annual rate of 8.9% compared with 7.9% in the second quarter. In the UK, there are some signs of life in the housing market. Halifax reported that house prices in September rose by 1.6%. The Council of Mortgage Lenders reported that UK banks approved 29% more loans to buy homes in August than a year earlier. The RICS said that the number of surveyors and property agents reporting price rises in September exceeded those reporting declines by 22 percentage points which is the highest proportion since May 2007. Official figures reported a 0.5% rise in house prices in August, reducing the rate of annual fall to 5.6% from 8.3% in July. The Land Registry reported that house prices in England and Wales rose by 0.9% in September to give average property prices a level 5.6% lower than a year earlier. The Bank of England reported that mortgage approvals climbed to their highest level for eighteen months in September to 56,215 compared with 52,970 in August. The Council of Mortgage Lenders said that home loans moved up by 2% during September. £12.5 billion was advanced, the second highest figure this year, but 27% down on September 2008. According to the British Bankers Association, the number of home purchase loans approved by British banks in September was 76.8% higher than this time last year.



We have tried to explain in this review the disconnect between what has happened to stock markets since March and the situation in the world economy. The reasons for the recovery are not necessarily of high quality, as we have explained. There are some very tough and unpleasant decisions to be made in many countries, including the UK, parts of the eurozone and, eventually, the USA. However, we have made the point that not all countries are in such a bad position as those mentioned above, and exposure to these countries' stock markets, plus the benefits that their relatively thriving economies bring to companies in the badly placed countries, which have exposure to these markets, provides some insurance policy. Of the main asset classes, we think shares have the fewest problems. However, we cannot expect the same rate of appreciation such as we have seen since March and it is likely that they will become more volatile, simply because of the extent of the recovery. We will also have to consider how stock markets will respond to the gradual removal of the economic stimulus described in this review. We reiterate our serious concern about the inadequate level of bond yields, except at the short end of the market.

October 2009

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