

## Investment Market Update – 6 July 2009

We are currently at a major crossroads for investment markets:

- Many investment managers are now convinced that we have a V-shaped recovery developing which will lead to the economy and asset values climbing almost as steeply as they fell. In which case, the current equity rally will largely continue upwards and unabated. The argument is that the rate of collapse is slowing and the fiscal stimuli of the massive global bailouts will free up capital markets further supporting the recovery. Those investors, who have so far stayed on the sidelines, will be forced to buy equities for fear of missing out on the rally, thereby driving prices higher still.
- A small number remain, including the Bank of England and the IMF, who believe that tougher times are ahead and that we may not recover until 2011/2012. The problem is the amount of bad debt held within banks but not yet written off. This debt will have to be addressed, further reducing the liquidity that banks have to support their lending. This in turn will suppress economic growth, increasing unemployment and damaging property prices and business confidence. This scenario indicates an L-shaped 'recovery' where the economy just doesn't pick up for years.

We don't believe this recession is like those seen over the last 30-40 years. Instead, we think it is a major financial dislocation of a magnitude not seen since the 1930s, but not mirroring that collapse exactly. The 1930s also saw strong share rallies that ultimately collapsed back into new lows until the final low was reached in 1932. History shows that major asset bubbles decline around 75%-90% from their valuation peaks, this means a possible target of 1,675, possibly as low as 670 for the FTSE 100 (currently around 4,200).

The long-term downtrend in the UK FTSE 100 and US S&P 500 equity indexes continues; the medium term downtrend is also still intact; however, the short-term trends for both markets are now strongly up but this could be changing.

### What Happens Next?

Historically, major seismic collapses follow a general pattern:

1. An initial collapse, the scale of which horrifies everyone.
2. Some sort of recovery, and everyone talks of things getting back to normal, but really all that has happened is that the rate of collapse has lessened.
3. The reality that there is no recovery hits home and asset values plummet with dire consequences.
4. There are several more 'false hope' rallies.
5. A final rally occurs that no one believes in, thinking it to be just another dead end rally, but in fact it is the start of the major recovery in asset values.

We believe we are currently completing stage 2, and we are sure that further falls in equity values will happen shortly because there isn't a recovery taking place just a

slowing in the economic slump. When investors realise that the rise in shares is not supported by the economy then prices are likely to fall.

In conclusion, we think the recent rally is nothing more than a bear market rally – destined to fail. What we have learned is that there is a risk that if we are too cautious then our recommended portfolio is going to lose out if equities keep rising – we definitely do not want to be buying back into equities when the FTSE is around 5,500, having missed out on 2,000 points of recovery.

We have to remain open to the possibility that all the money pumped into the economy by World Governments might work and mean that we avoid stages 3 & 4 and go straight to stage 5 - the full recovery.

Government securities (UK and Overseas) have been struggling as investors becoming more and more worried about how much debt Governments are weighed down by. Money is flooding out of the UK, which is seen as very sickly by foreign investors. In order to get money back into the UK, interest rates as reflected by Gilt income yields, will have to rise pushing Gilt capital values sharply lower.

The Current Portfolio (that most clients hold)

UK Equities	10%
Pharmaceuticals & Health Equities	10%
Gold Equities	5%
Overseas Bonds	15%
UK Gilts	35%
Corporate Bonds	15%
UK Index-Linked Gilts	5%
Cash	5%
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	100%
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General Comments on the Current Portfolio

- UK Gilts have suffered in the last few weeks but are oversold and due a ‘bounce’. We think the long-term prospects are not good given the amount of Government debt and the prospect of rising interest rates. So we are looking for the opportunity to exit the Gilt holdings.
- Sterling has strengthened against the Euro in recent weeks but this movement may now be over. We think European global bonds will suffer a similar fate to UK Gilts so we wish to sell the holdings in this asset class too. Instead, we are recommending a 5% holding in a new Global Bond fund, which invests predominantly in the Far East and Emerging Markets.

- The 25% weighting in equities is too low in the medium term but we think UK and US markets will struggle to rise much above their current levels until a full recovery is under way.
- There is no exposure to the Far East and emerging markets, which is where we believe the main recovery is going to occur in the future.

### **Portfolio Changes:**

If equities fall over the summer then this presents an opportunity to increase the portfolio weighting in equities but at lower prices. We would still be holding a sizeable proportion of the portfolio in non-equity investments. If markets fall further then we can increase the weighting in equities further, buying at lower prices again. The aim is to be fully invested by the time we reach the bottom of this cycle.

### **Our Proposed Portfolio:**

	Current	Proposed
UK Equities	10%	10%
Japan/Far Eastern Equities	0%	5%
Emerging Market Equities	0%	5%
Pharmaceuticals & Health Equities	10%	10%
Gold Equities	5%	5%
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	25%	35%
Overseas Bonds	15%	5%
UK Gilts	35%	35% **
Corporate Bonds	15%	15%
UK Index-Linked Gilts	5%	5%
Cash	5%	5%
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	100%	100%
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\*\* We will greatly reduce the UK Gilts as soon as they rebound from current low levels, with the proceeds being held in cash funds ready for further equity investment.

### **Way Forward**

We are not proposing immediate implementation of this portfolio, merely introducing the concept of increasing the equity exposure shortly. You need do nothing at this stage. We will contact you when we feel the time is right to make the portfolio changes.

Should you have queries then please contact us immediately to discuss them.