



Market and Portfolio Review

Summary

- Green shoots continue to show signs of economic improvement
- Most asset classes continue to grow and equities provide the greatest returns
- Rotation of portfolios for a change in the economic cycle

Review and Outlook

This quarter has continued to provide strong returns, with UK and global equities returning c. 22%¹.

Economic indicators have continued to show signs of improvement and some of the major European economies have posted a positive quarter of economic growth.

Although unemployment has continued to rise, the rate of job losses has moderated. It is likely that where possible, companies will continue to reduce their workforce to reduce costs and that an improvement in employment numbers will lag the recovery in the next phase as confidence grows. Therefore, whilst rising unemployment still represents a risk, it may not be a good leading indicator of a recovery and the moderation of job losses should be seen as positive.

To date the recovery has followed a classic pattern, with bonds followed by high risk bonds followed by equities recovering in turn.

This has benefitted Clarion portfolios, where the manager has rotated through bonds to equities over the course of the cycle.

Corporate bonds have also provided strong returns for investors as the spread (premium required for corporate bonds over risk-free government debt) has narrowed considerably over the quarter.

Although spreads have narrowed, they remain elevated offering opportunity for further narrowing and capital gains to investors. However, the team is concerned that the huge levels of stimulus being injected into the economy could cause inflation expectations to increase.

Normally, central banks use interest rates to either stimulate or suppress an economy. After reducing interest rates to 0.5% during the credit crisis, the Bank of England has embarked on a new policy called Quantitative Easing.

Quantitative Easing (QE) is printing money to buy assets. QE serves two purposes. The first is that it puts cash into the system, which is then multiplied as it travels around the economy. The second is that the cash is used by the central bank to buy gilts and bonds. To date, the Bank of England has purchased £155Bn of gilts and £1.1Bn of corporate bonds. It is likely that this scheme will be extended further.

When individuals take out loans or mortgages the cost of the loan is linked to the yield curve, which illustrates the yield received when buying gilts of different lengths of time. The Bank of England has been a huge, price-insensitive buyer of gilts, purchasing 25% of gilts issued. This has the effect of pushing down yields and flattening the yield curve, making it cheaper for borrowers to take out loans.

The huge level of stimulus applied to markets appears to be working. Whilst consumers may not yet be changing their spending habits, individuals with a job and a variable rate mortgage are likely to be enjoying much higher levels of disposable income than they

¹ FTSE All Share TR & FTSE All World TR – 30 Jun 2009 to 30 Sept 2009. Source: Lipper Hindsight

are used to. During a recession this money is often saved as a precautionary measure, however as confidence grows consumption should increase. In the UK we have seen a significant increase in the savings rate and also consumption has remained relatively resilient.

As well as inflation, the risk to bond holders is that when the QE policy is reversed, pressure will build for the yield curve to steepen. This will create capital losses for bond holders, however it is likely that the central bank will be extremely wary of a steepening yield curve as it could potentially damage the recovery. Therefore, to be prudent, we have reduced the bond exposure to an underweight position and have no gilt exposure.

The UK stock market has increased by c. 50% since the lows in March². Whilst this is a significant increase in a short period of time, it remains around the historic average P/E valuation. Given a moderate increase in earnings, equities could still be seen as relatively inexpensive. In addition, the FTSE 100 is still well below its peak in the last cycle and is at the same level as it was 12 years ago.

We therefore remain neutral to overweight in equities and are likely to increase positions as positive economic data builds or short term fluctuations create opportunities.

In our opinion, the credit crisis was the end of an era of cheap and excessive debt. During this period the West has been financed by the East, which has become the world's manufacturing base. The side effect of this era of cheap money has been a bubble in property which burst in 2007, plunging the main global economies into recession.

We feel that the next period will look very different to the last period. Given the unprecedented stimulus by governments, which are

building unsustainable deficits and the extremely loose monetary policy aimed at getting consumers/businesses to borrow more, it is likely that inflation will be more volatile and the global economy harder to manage. Over the long term there needs to be a shift to higher levels of consumption in the *developing* world and higher savings in the *developed* world.

This change will take a long period of time, as social security in developing economies is required to give consumers the confidence to reduce their precautionary savings. However, if China wishes to continue its climb to a global super power it will need to address the current global imbalance and build social security into its plans.

The emergence of the developing economies is likely to be the main economic driver of global consumption in the foreseeable future. In addition, the higher level of savings and government surpluses in economies like China provides a greater ability to stimulate, whilst the developed markets address their debts.

Therefore, where appropriate the team will steer investments to areas that have a high exposure to Asia and other Emerging regions, where savings rates are high.

We are in a period of uncertainty where loose central policy needs to turn into private/real demand. Whilst we feel that this process will happen as the large amounts of cash in the system are put to work, the team have been careful not to make rapid changes into areas that have already recovered strongly and present lower future returns.

We expect the markets to remain volatile and look for further opportunities.

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² FTSE All Share TR 3 Mar 2009 to 30 Sept 2009. Source: Lipper Hindsight