

### Summary

- Equity Market Growth
- Double dip fears remain
- Deflationary bond markets
- Data Relief

### Review and Outlook

The quarter has been positive for most investors with equity markets recovering. The FTSE All Share (UK) has returned c.13.5% and the FTSE World has returned c.9% over the period<sup>1</sup>.

Whilst double dip fears have remained the *hot* topic on investors' minds, the economic data has continued to support recovery, creating some relief.

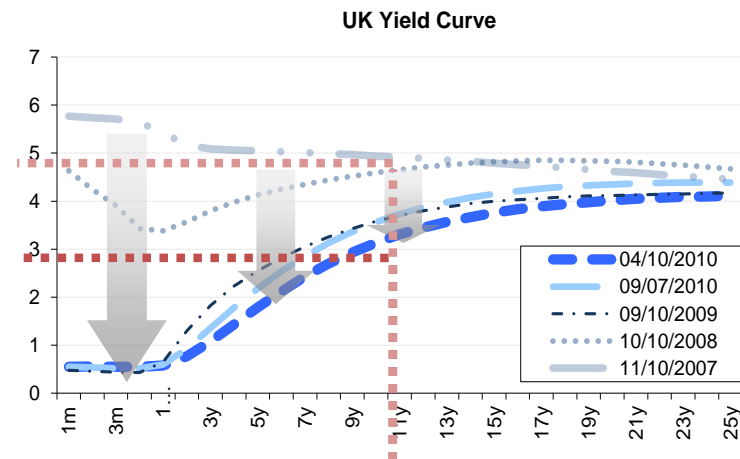
Following comments last period that most developed economies are now embarking on a gradual tightening of fiscal (government) policy, which had tested investors' nerves and created a sharp correction in equity markets in the last quarter, expectations have fallen to more realistic levels.

Data from the developing areas of the world, such as China, has generally exceeded expectations in the period, supporting a recovery. In addition, policy tightening, which had previously been imposed to stop the economy overheating, has been relaxed a little.

Data from developed economies continues to be fairly volatile but generally positive. Although the figures are mostly lower than the first quarter, we would become concerned if they were not. A quick recovery could mean that the global economy was not addressing the previous imbalances that caused the credit crisis.

<sup>1</sup> FTSE All Share TR, FTSE World TR – 1 July 2010 to 30 September 2010. Source: Thomson Reuters Lipper

The bond market continues to provide strong returns despite record low yields. The UK government in particular has benefitted from fractures in the EU. Whilst all G20 governments agreed that budget deficits should be tackled, halving the rate of growth in debt by 2013, the UK is one of the leading countries to actually put changes into force. Exceptions are the countries that risked immediate crisis if they did not act, i.e. the P.I.I.G.S discussed in the last quarter, which have been forced to cut more drastically. The main EU partners have not been able to agree on how to tackle their deficits causing investors to look for perceived safety in the UK.



Source: Thomson Reuters Datastream

Each blue line in the chart above shows the cost to the UK government of borrowing money for different lengths of time at different dates. i.e. the current rate of interest for the UK government to borrow money for ten years is c.3% (represented by the red dotted line). The blue lines, which represent the yield curve at different dates has been falling. i.e. the rate at which the Government borrows money has fallen. Three years ago it would have cost the UK Government c. 5% to borrow for ten years (pink line).

Inflation in the UK is running at 3.1%<sup>2</sup>, which is above the targeted 2% inflation target managed by the Bank of England. The inflation rate has continued to remain higher than the target for much longer

<sup>2</sup> Thomson Reuters Datastream as at 15 September 2010.

than the Bank of England estimated. The Monetary Policy Committee, which sets bank base rates, believe that there is a 75% chance that the rate will remain above the target in a year's time and a 50% chance that it will continue to be above their target in two and three years.

The interest on government debt currently has a zero real yield, i.e. investors in government debt are happy to just preserve the value of their investment over the next ten years compared to a historic real yield of c.2%.

It would also seem counter intuitive that investors are willing to lend money to the government at lower rates now, when the government deficit is c.65% of GDP and rising by c. 10% a year, compared to 36% of GDP three years ago.

The conclusion that must be drawn from the bond market is that investors expect lower inflation / deflation, which will lead to even lower interest rates in the future and a positive real yield. This would be akin to the Japanese economy, which despite efforts to reflate the economy following a property bust and banking crisis in the 1990s has suffered continued deflation and ever increasing government deficits.

Whilst there are some parallels between the crisis in Japan in the 1990s and the credit crisis suffered in the Western economies in 2008, there also significant differences.

Ben Bernanke, the current Federal Reserve Chairman (US Central Bank), is a leading expert on the Great Depression of the 1930s and the Japanese financial crisis. Bernanke has been clear that following the crisis, countries affected need to reflate their economies quickly. The Bank of England has followed this example and was the first country to embark on its pioneering Quantitative Easing (QE) programme in 2009. QE effectively prints money and places it into the economy by purchasing government debt from investors, mainly banks. This switch of fast money for slow money is designed to provide a boost to the economy, but the risk is higher inflation.

In one sense QE was not as successful as planned, the cash injected into the system was used by banks to bolster their balance sheets and was not passed to businesses and consumers. However, QE did stop an overall sharp contraction in the money

supply and halted a more severe recession. In addition, the main benefit of QE has been to reduce interest rates. The Bank of England purchased roughly 25% of all UK government debt in issue during 2009. As a huge price insensitive buyer it has pushed yields down. In the bank's Inflation report in May it stated that the effect of the QE program was to reduce/flatten the yield curve by 1%.

The Clarion investment team believe that the current yield curve represents irrational behaviour by bond investors on almost all economic scenarios short of another great depression. Our view is that the global economy will continue to mend, but it will be through a protracted recovery. This view is supported by the current economic data.

Despite strong returns from equities since March 2009 they remain below their historic valuation on price to earnings or price to book ratios. Given our view of a protracted recovery, it is likely that equities are around fair value and therefore expectations for the future are more average stock market returns over the medium term.

From 2000, a significant number of businesses started to repair their balance sheets, building cash reserves. This trend was slightly reversed in the lead up to the credit crisis, however many firms have record levels of cash and strong balance sheets. Although the next part of the economic cycle will remain challenging, we believe that many companies will be in a strong position to succeed, and when confidence returns, will invest. We have already started to see consolidation in many industries and believe that equities are a lower risk investment relative to other asset classes.

Our strategy continues to favour equities in larger cash generative businesses and we remain underweight in bonds. Cash is being used to balance the risk profile of investor portfolios

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