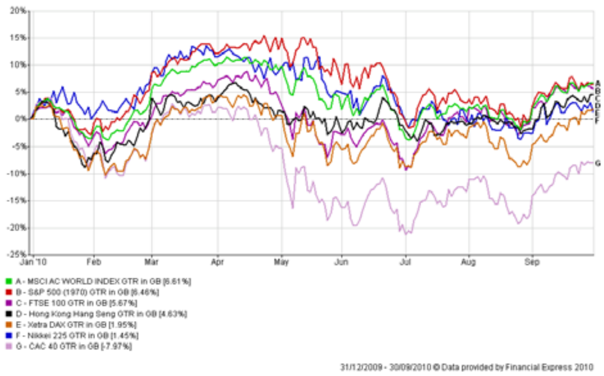
Investment Outlook & Review - Autumn 2010

JLT INVESTMENT MANAGEMENT



Across the summer months we have seen the same volatility in both bond and equity markets around the world as has been prevalent throughout 2010. Influenced on almost a daily basis by economic statistics, government forecasts and corporate announcements – both positive and negative – markets have found it difficult to make much headway.

However, despite all the short-term fluctuations the overall trend has been slightly positive. As described below there are many actual and potential problems that can influence investors – but they are already known (and possibly discounted). It is the unexpected nasty surprise that investors fear (an unexpected pleasant surprise – whilst not impossible – seems unlikely at this stage.)

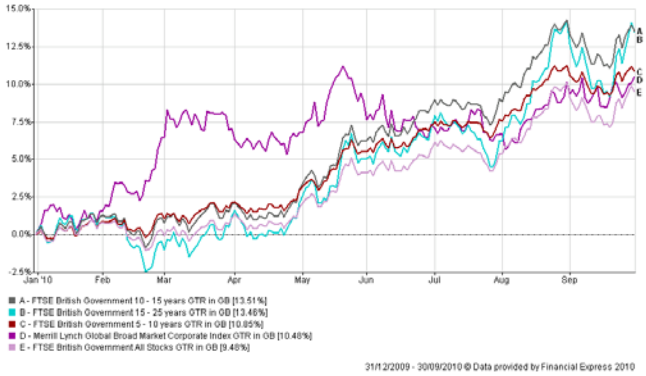
The possibility that there are still some major skeletons to be uncovered seems to be the biggest constraint on investors' desire to be net purchasers (and for indices to rise). Cash remains (and whilst interest rates stay near zero, will continue to remain) an unattractive alternative.

Property – especially commercial – has its own set of individual, separate, problems to overcome. So for the time being bonds, equities (and gold) remain the preferred home for surplus funds.

Despite the short-term volatility it has paid investors to stay in equity and bond markets during 2010 – albeit marginally. Income generated has made up the largest part of the total return in many areas, and we expect this to continue for some time to come, especially if the negatives mentioned in this note become more accentuated.

It will also become clear from the sections below on the various markets that stock-picking remains the key. Certainly in all the developed equity markets there are marked differences between the performance of sectors and individual stocks within sectors. This, of course, is normal, but in current circumstances is being exacerbated by government policies around the world which are producing winners and losers to a greater extent than heretofore. Concentrating investments on good managers is currently giving the best returns.

Fixed Income



Given the low yields available, the heavy levels of supply and the likelihood that interest rates will rise at some stage to dampen any actual (or perceived) inflation threat, government bonds would appear to be a most unattractive option.

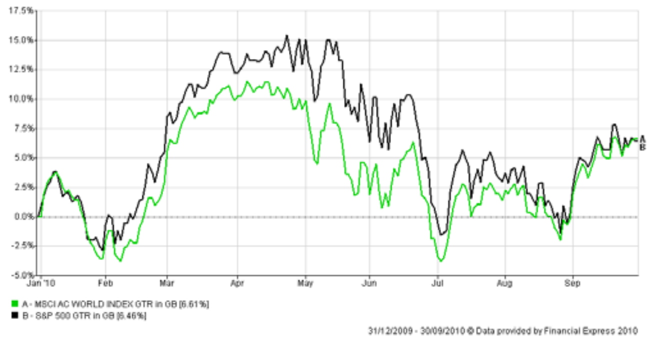
However, somewhat surprisingly, they are being considered a safe haven and investors have been willing to accept lower and lower returns to gain this safety.

At some stage this will change and yields will rise (thus capital values will fall) – possibly quite significantly. The catalyst – maybe some unexpectedly strong economic growth figures – seems unlikely to occur in the short-term, so for the time being yields in the developed world could fall even further.

Our preference for high quality corporate bonds is unchanged, and has been for some time. Valuations still remain attractive relative to government bonds as despite the predominantly good corporate profits background markets are still pricing in unlikely levels of company defaults.

Whilst cash provides an unattractive home for investors, corporate bonds continue to give a real return, with apparently more safety than was forecast during 2008 and 2009.

U.S.A.



As elsewhere corporate profit growth has been surprisingly strong. Many companies are awash with cash and there has been an upsurge in corporate takeover activity (it is cheaper to buy another company than build a business from scratch). Inflation remains low and interest rates seem unlikely to rise significantly in the foreseeable future.

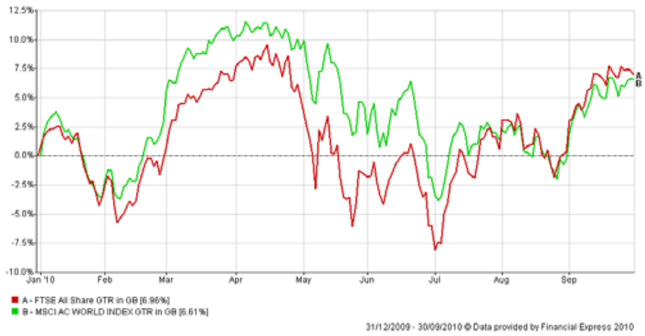
Under normal circumstances this should provide a positive background to the market, but circumstances are not normal. Economic statistics, especially on unemployment, housing and the budget deficit, remain stubbornly weaker than should be the case at this stage of a recovery – if such a recovery is in place. (Since the end of the quarter under review there are strong signs from the US authorities that further Quantitative Easing might be needed as the recovery is proving so anaemic).

In addition, the mid-term elections to be held in November could lead to a result that will limit the administration's ability to change policy going forward.

So despite the positive corporate news investors have largely stayed on the sidelines over the summer, being more concerned with economic numbers (the possibility of a 'double-dip' recession) than company figures. Perhaps the upcoming third-quarter profits figures might provide some more encouragement.

Until there is more confidence in the overall economy's prospects this sideways movement could continue. However, as always, the US remains such a vast market that good investors can make positive returns whatever the general trend. We remain neutral, but acknowledge that any positive news could lead to a rapid rise in indices.

United Kingdom



The companies that make up 'UK plc' have, largely, proved much more resilient than expected over the last eighteen months. Corporate profits, aided by the weakness in sterling over the period, have held up considerably better than original forecasts and 2011 is expected to continue this trend in many areas (unless world economic growth falters).

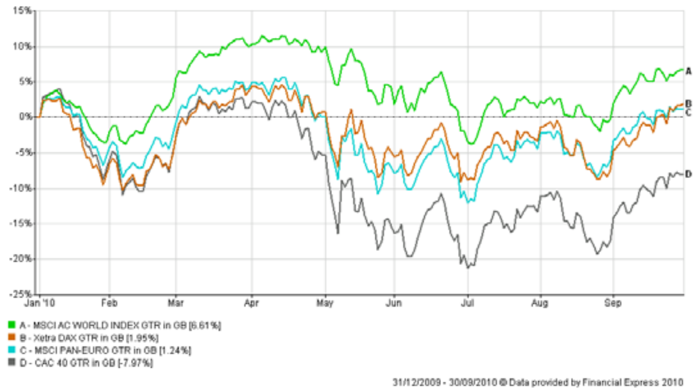
However it is unclear how the cuts in government spending due to be announced towards the end of October will effect overall growth or individual company's prospects. We have seen one example – Connaught – of how quickly circumstances can deteriorate (though in this case not just due to government cutbacks).

Government cuts should also have a negative effect on consumer confidence, which has remained surprisingly positive. The fear of higher unemployment following cuts in the public sector seems likely to dampen, if not reverse, any domestic growth now being seen.

The FTSE, however, as we have mentioned often before, could continue to outperform the rest of the UK indices. Its composition, overwhelmingly biased to overseas earnings, world trade and global commodity prices, means it will follow a different path to the 'UK plc' described above.

We remain neutral on the UK market generally, preferring opportunities elsewhere. Whilst corporate profits growth in some areas will provide a prop for some prices, we believe the overall background will prove negative in the short to medium term, and a good stock picking manager is needed to gain the most benefit from any upward movements.

Continental Europe



The news appears to have been unceasingly bad. For months all eyes have been focussed on the well-known problems of the peripheral countries in the eurozone (Greece, Spain, Italy, Ireland etc) and the austerity measures being put in place in those areas.

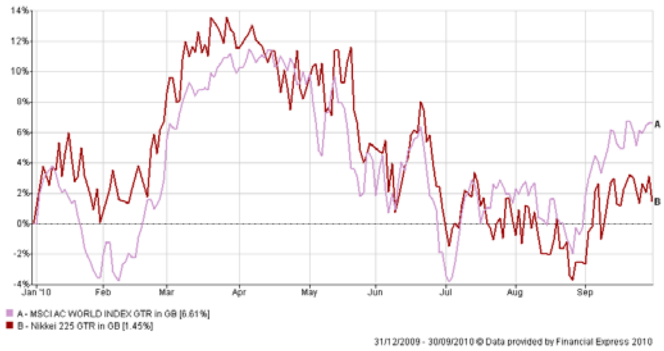
Elsewhere there is also continued concern that many Continental European banks have still to fully account for losses on their balance sheets – major problems still potentially to be resolved by further fund raising, reorganisation (forced or voluntary), and possibly even bankruptcy.

Finally domestic growth in many areas is being constrained by high unemployment, and its effect on consumer confidence.

But this seemingly highly negative background conceals some major positives. Aided by cost-cutting and reorganisation during the recession, manufacturing across the region is rebounding and exporters are benefiting from the weaker euro. Coupled with continuing low interest rates corporate profits are showing surprisingly robust growth in many countries and share prices are selectively responding.

It seems impossible, given the circumstances, to be bullish on eurozone markets but given the number of countries involved, and their different stages of economic recovery, it is wrong to ignore the area completely. Whilst profits continue to surprise on the upside there will be opportunities available to fund managers to make good returns.

Japan



The economy is slowly recovering from the recession, the more rapid pick-up elsewhere in Asia is a benefit and equities in many sectors look very cheap historically.

But – nobody cares.

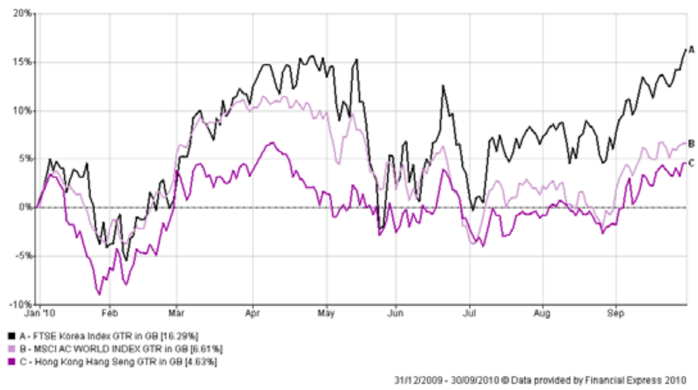
The negatives – the strong yen impacting exports, high government debt, an ageing population and, not least, deflation – have all kept both domestic and, more importantly, foreign investors sitting on their hands.

The key is probably the level of the yen (particularly against the US dollar). This has been said many times before but it is now viewed as the talisman against which all other policy decisions are measured. The Japanese government is desperate to lower the yen's value against all currencies but especially the dollar, and is willing to try anything to facilitate this. So far all attempts to reverse the upward trend have proved futile.

Eventually – for whatever reason – the yen will weaken and revert to a more 'normal' level. At this time investors should return to a market that looks fundamentally cheap. But there have been so many false dawns over the last few years that even this tentative forecast could prove as misplaced as all the others.

Patience is required!

Asian Ex Japan

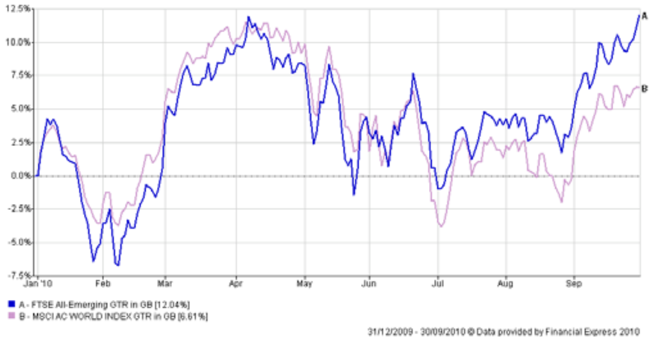


The long term story of growth in Asia, led by China, continues unchanged. Inter-regional trade is growing apace and, as forecast, is slowly decoupling from the rest of the world. Economies throughout the region are mostly in a far better position financially than in the developed world. The banking system seems more stable than elsewhere, largely unaffected by the travails in the west (however some Australian financial institutions could have more to disclose).

However in the short term there are some clouds on the horizon, mainly attributable to China, and specifically to the value of the renmimbi. In China the value of the currency is far more a political decision than an economic one and as such is leading to heightened trade tensions with the US. Rhetoric in the US Senate has been increasing and could worsen in the run-up to the elections in November. A full scale trade war would benefit nobody in the long run, but would have a severe short-term impact on markets worldwide – and particularly in Asia.

We remain very positive on the region on anything but a short-term time scale. Events in China need watching closely, as always, as the psychological effect on investors of policy decisions often far outweighs the real economic effects. We would add to positions in clients' portfolios on any major setback.

Emerging Markets



Emerging Market indices have largely outperformed their developed counterparts as investors have realised their financial institutions seem more stable, growth is more solid (especially in Asia and Latin America) and the pick-up in commodity prices is of direct benefit to many emerging economies. Many institutions in developed countries have also been trying to build up weightings from historically low levels.

All of this has led to significant cash inflows to some markets, to such an extent that some countries (for example Brazil) have seen their currencies appreciate by far more than is desired in the short term. Coupled with the weakness in the euro, exports from emerging markets could suffer.

As mentioned above the longer term positive story on emerging markets worldwide (versus developed markets) is unchanged but in the short-term – given recent performance – any change in investor sentiment could lead to a disproportionately sharp setback as 'hot' money leaves the bigger emerging markets as quickly as it has been invested.

As in Asia, we would add to positions on any significant fall in prices.

Conclusion

We have made no changes to our policy over the summer quarter. Known problems have either continued in Europe or arisen in Asia and the USA. The outlook is still cloudy, with economic statistics in many countries at best ambiguous and often contradictory. Equity markets have been nervous and volatile, but with a slight positive bias.

As before we favour bonds, especially investment grade corporate, where we continue to believe the total return this year (yield plus a small capital gain) will compare favourably with other asset classes. At some stage it must be right to sell government bond holdings – but not whilst they are viewed as a safe haven for investors worldwide.

Within equities our longer-term strategic view remains that developing markets of all types should be preferred to those of the developed world. However, in the short term, it would be wrong to ignore the value around in Europe and the US. Also as in previous quarterlies, we believe equities / funds with a yield, are likely to continue to outperform as long as interest rates remain at current levels.

Finally a word on gold. It is unusual, to say the least, that in recent weeks bonds, equities, commodities and gold have all been rising in price simultaneously. This does not augur well for the future! At least one of these asset classes needs to reverse its price trend to allow a 'normal' relationship to return. It may not happen in the short term, but at some stage something will have to give!