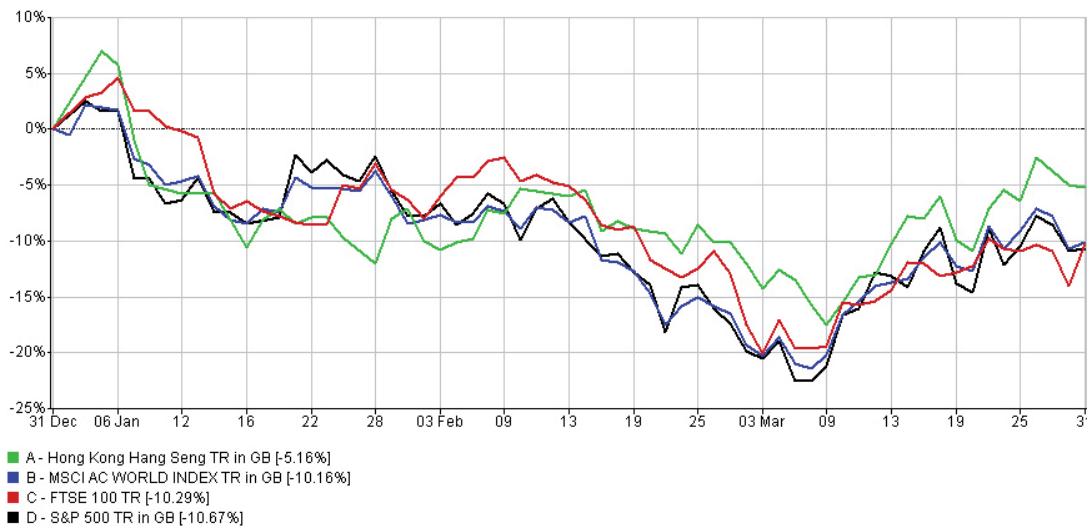




## Investment Outlook & Review

### Spring 2009

ONCE AGAIN THIS HAS BEEN A VERY VOLATILE QUARTER IN EQUITY AND FIXED INCOME MARKETS WORLDWIDE WITH PRICES STARTING STRONGLY IN JANUARY AND FEBRUARY AND THEN COLLAPSING, ONLY TO BE FOLLOWED BY A SHARP RALLY IN MARCH. A SUCCESSION OF ITEMS PERCEIVED BY INVESTORS TO BE 'GOOD' NEWS, LED TO SHORT COVERING (HEDGE FUNDS AND OTHERS BUYING BACK SHARES THEY HAD SOLD HOPING THAT PRICES WOULD FALL) IN TECHNICALLY OVERSOLD MARKETS AND THE QUARTER ENDED ON A POSITIVE NOTE.



31/12/2008 - 31/03/2009 © Data provided by Financial Express 2009

Policymakers around the world remain very active in trying to restore confidence in the global banking system and enable it to regain a certain level of normalcy. Measures taken in recent months, whilst yet to show any concrete results, have at least led to signs of moving in the right direction, with the hope that more positive indications of recovery will be seen later in the year.

In the USA, the Public-Private Investment Program (PPIP) is providing a way of allowing banks to remove some of the toxic assets from their balance sheets. This plan in itself led to a 7% single day rise in US equity prices. In the UK, the Bank of England's first attempt at quantitative easing may be a shot in the dark, with longer term results uncertain, but in the short term has led to a sharp fall in yields in medium to long-dated gilts. Even in Continental Europe there are signs that the severity of the situation has been finally acknowledged, with interest rates falling to record levels, and (despite recent disagreements at the G20 Summit in London) a greater willingness to consider stimulative measures.

### United Kingdom

Over the quarter, economic data continued to deteriorate, to such an extent that the Government's room for manoeuvre in the forthcoming budget has been severely constrained. Initially equity prices reacted poorly to all bad news, culminating in early March when Aviva, despite holding its dividend, fell 30% in one day after announcing its results.

Investors' appetite for risk appeared to be at rock bottom. Yet there have been signs that all is not what it seems. The largest rights issue in UK corporate history – HSBC – proceeded without a hitch and after the quarter end was completed successfully. It is becoming evident that good quality companies can raise money with rights issues (or even in the corporate bond market) despite the overall market background. However, the reverse is also true – companies trying to raise money to repair ravaged balance sheets are still having difficulty, needing to give very generous terms to tempt shareholders to subscribe.

Some dividends have been cut and there will be more. But none, to date, have been unexpected and perhaps investors have been too pessimistic in their forecasts.





Figure 1.  
1st Quarter  
Source: Capital  
Economics

The key has been, and will continue to be, earnings. Anecdotal evidence has suggested that business conditions (for UK plc) have worsened since the start of the year. Many of the FTSE constituents are benefiting from the fall in sterling boosting their overseas earnings but domestic companies are suffering from a rise in the costs of imports and a fall in demand. As can be seen from the chart on the following page, the UK consumers are, for the first time in many years, increasing their savings (despite interest rates falling so far that the return on these savings is negligible).

There is no question that the recession in the UK will be the most severe since the 70s, if not before, with the Treasury constantly having to revise its forecasts downwards. The problem for markets is not so much its severity as its length. If all the measures that have been taken lead to some signs of recovery in the latter part of the year, as a few commentators suggest, then prices should at least stabilise at these lower levels. If, however, it becomes obvious that the downturn will continue well into 2010 (or even beyond) then earnings, dividends and prices will remain highly vulnerable. It is still too early to tell, but the omens do not look promising.

Government bonds have continued to perform well as interest rates have fallen. There has been some short-term volatility (for example when a recent gilt auction was under-subscribed – not unknown, but rare – showing what might happen further down the road if gilt issuance leads to a buyers strike), but the trend has been lower yields and rising prices. The key is the deflation / inflation argument. Analysts are sharply divided on the future course of inflation in the UK (and elsewhere) with many fearing a repeat of the Japanese experience of the last ten years (the 'lost decade').

Many believe the most recent inflation figures to be anomalous, hiding a downward trend into deflation that will become apparent in the coming months. If this happens, markets are expected to react badly (although the long end of the gilt market will then look attractive).

Corporate bonds have also been volatile over the quarter, due to the continuing difficulties of finding the 'right' price for individual issues. However, in recent weeks some companies have successfully raised new money in the UK

and Continental Europe and there are signs that investors are more comfortable with current price levels (and of course the yields available are very tempting). The implied default rates are still very high – higher than during the Depression – but these are being perceived as an aberration far more than a foretaste of things to come. Even the bonds issued by banks and insurance companies – a large part of the overall market – have become more attractive to investors as confidence returns.

The sudden withdrawal of credit by the banks in mid 2007 was the main reason for property values falling in 2007 and it was a continuation of that plus the onset of recession and forced selling that were the key attributes for the major falls in 2008. Property fund managers are now beginning to say that opportunities are appearing but only in top quality assets and locations with attractive yields. Forecasts of a further 15% fall in capital values in 2009 are not uncommon, and no recovery is expected until at least next year. Thenceforward yield will regain the importance it used to have, with maximum annual returns of 5-10% likely rather than the significantly higher figures seen in the boom years.

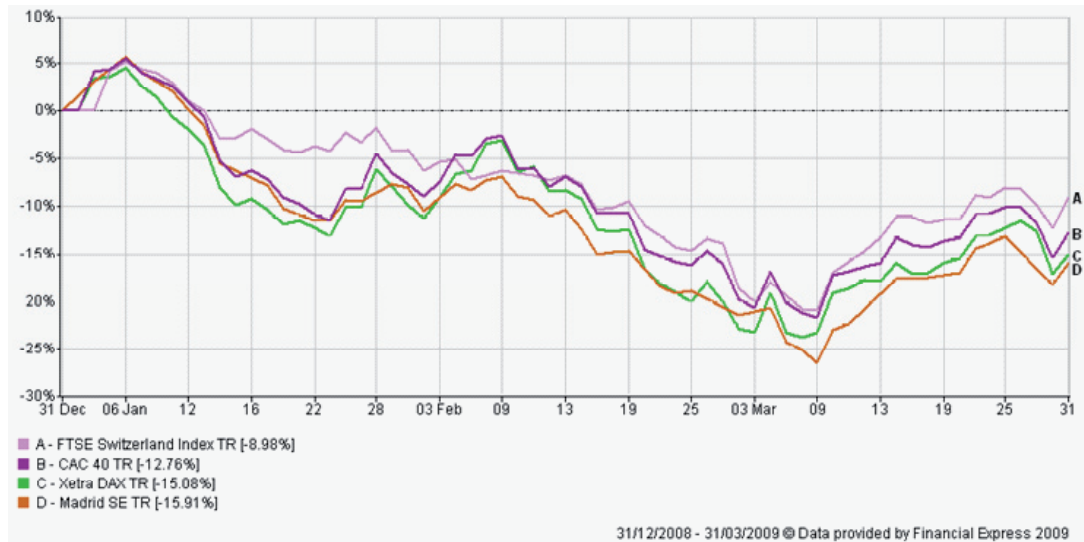
In summary, gilts are beginning to look expensive (unless one believes prices will fall, Japanese style, to give a yield of almost zero) due to the supply / demand equation; corporate bonds look cheap but may not recover in capital terms until the economic outlook is clearer; and the key to equity valuations remains earnings. We believe the outlook for UK plc is relatively poor against other economies around the world, with the result that earnings will be more depressed, and take longer to recover, than elsewhere. As a consequence the UK should be underweighted in a global equity portfolio.

### Continental Europe

Gross domestic product in the euro area contracted 1.6% in the fourth quarter of 2008 (worse than previously reported). This was the deepest ever quarterly fall, brought on by a collapse in external trade, but many analysts and economists believe the first quarter 2009 will deteriorate further with no economic statistics yet showing any signs of stabilisation.

The euro zone remains boxed in by an arguably overvalued currency, interest rates that, although reduced, the rest of the world believe to be still too high, and a hawkish ECB. Countries such as Ireland, Spain and Italy are all suffering from the inability to devalue their currencies to ease the existing





problems of overvalued real assets and France and Germany, especially the latter, have seen their export sectors collapse. Protectionism, either overt or covert, is beginning to appear, and a 'beggar my neighbour' policy becoming more evident.

In addition the major banks in the euro zone (and Switzerland) are heavily exposed to the outstanding debts of the emerging economies of Eastern Europe. A Europe-wide solution to this crisis needs to be resolved soon, if UK-style measures on re-liquifying financial companies is to be avoided.

The prospects for European stock markets do not look favourable. However, there are still many companies across the region continuing to thrive, and a neutral position is recommended in portfolios.

#### U.S.A.

Wall Street has been as volatile as elsewhere as the US Treasury Department, the Federal Reserve and President Obama's own team of policymakers have tried to restore some stability to the banking system.

The PPIP previously mentioned is designed to provide the means by which the banks can remove some of the toxic assets from their balance sheets. This goes further than previous suggested packages and, in theory, will be easier to manage (as it will be a continuous operation, rather than a fire-sale after a bank fails). But as in all previous attempts at a similar solution, the key issue remains how the price of individual assets will be determined – and thus how attractive they might be to potential buyers.

In addition to the PPIP, the regulators will be applying 'stress-testing' to the banks to confirm their stability (a moot point is why this hasn't been done before!). How this will be done is questionable but if it increases confidence in the sector, it will be deemed a success.

Finally there has been the much publicised (and discussed) \$800 billion fiscal stimulus passed recently by Congress. Unlike the Japanese plan mentioned below, this emphasises longer term reforms and financing at the expense of a short term boost to demand. As a result, its impact might take

longer to have any noticeable effect than politicians (and investors) might wish. Coupled with the recent Federal Reserve announcement of its willingness to purchase up to \$1 trillion of mortgage-backed and Treasury securities, the US government is being acknowledged as doing all it can to relieve the situation.

Will all of this, plus an element of quantitative easing to ward off any deflationary threat, lead to a recovery sooner rather than later? Rising confidence in the banking sector and growth in the supply of credit are pre-requisites (as elsewhere, especially in the UK). The measures above should help to achieve this (if they don't, all bets are off!).

The wider economy has seen a few – a very few – signs that some sectors are nearing or at the bottom of their cycle (housing starts, the trade deficit and retail sales), leading to the hope that the worst of the fall in activity may be over.

Corporate profit announcements over the next few weeks will give the first indication if this is the case. Should the results season pass without too many unexpected disasters, investors might start to discount a recovery, however anaemic, in the late autumn or first quarter of 2010. Wall Street always leads a recovery and if this more optimistic scenario pans out, it will soon be time to overweight equity positions in the region.

#### Japan

Economic news has been almost universally bad. The economy shrank at its fastest rate in nearly 35 years in the 4Q of 2008, exports continued to plunge and factory output was falling at a record pace. Wholesale prices also declined for the first time in many years and as a result, fears of returning deflation led to the market falling to a 26 year low during the quarter.

The crisis has exposed the extreme export dependence of the economy with the collapse in external demand leading to both reduced capital investment within Japan and lowering consumer sentiment. Demand from China in recent years helped improve Japan's economic prospects and the (temporary?) disappearance of that demand has exacerbated the downturn in Japan itself. (China overtook the US as Japan's largest trading partner during 2008).

A series of measures have been announced to try and turn round the economy including purchases by the Bank of



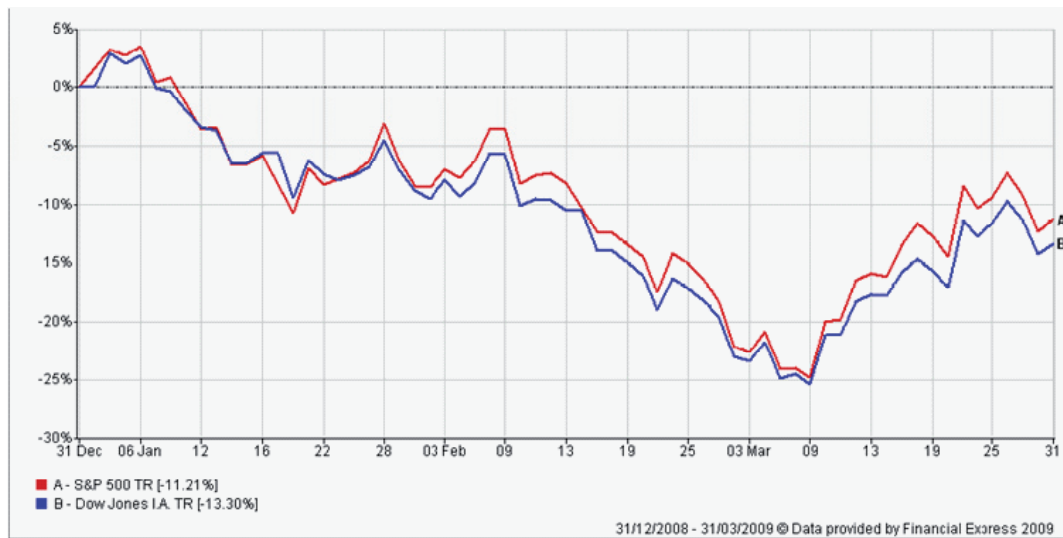


Figure 4.  
U.S.A

Japan of Y1 trillion of stocks to stabilise the financial sector and Y1 trillion of corporate bonds to help companies with balance sheet problems. This has culminated, early in the 2Q, in a bigger-than-expected spending package of Y15.4 trillion (3% of GDP), received favourably by the market, despite some criticism of its short-term emphasis (with the longer-term fiscal burden increasing as a result).

Despite all the negative economic news the stock market has rallied along with the rest of the world. Share prices are extremely cheap by any traditional method of measurement but foreign investors remain net sellers and until some catalyst causes this to reverse (a pick-up in exports perhaps), the market will remain lacklustre.

#### Asia Ex-Japan

Asian equity markets have led the rebound in March, outperforming other world markets. Despite the grim economic news elsewhere announcements from China have been more positive. The widely reported Purchasing Managers Index has now improved for four months in a row (which indicates expansion rather than contraction). Bank lending is picking up as is consumer confidence. Even the property sector (except the very top levels) has shown some signs of recovery. The export sector, however, remains in the doldrums and the resulting unemployment still could lead to social unrest if the authorities do not act further to alleviate the problem.

However, many investors in the region still expect equity prices, after the bounce, to return to previous low levels. There are very large cash reserves waiting to be put to use, and like elsewhere, it is noticeable that in recent weeks stocks now seem extremely resilient to bad news over profits and are often rising after profit downgrades. This is not unusual towards the end of a bear market, and with markets down 60% in eighteen months, it is too late to sell on anything but a short term trading view.

The rest of the region has viewed the apparent recovery (or at least no further deterioration) in China as positive and markets have reacted accordingly. Going forward we believe that Asian (ex Japan) stock markets will continue to outperform their

Western counterparts as economic prospects improve, and overweight positions are recommended.

#### Conclusion

Markets generally are at critical levels. We have seen a sharp rally from technically oversold positions. Is this a dead cat bounce before indices fall back to new lows or have we seen the worst?

New lows are still a possibility, but their probability has perhaps fallen in the last few weeks. The economic crises affecting Japan, parts of Europe and elsewhere have many months to run and could lead to unforeseen consequences. The banking system globally has still many problems to sort out and nationalisation remains a threat in several of the G7 countries. Some commentators in the US in particular believe the numbers from major banks will be so bad that this is a probability, not a possibility.

But as mentioned above it has been very noticeable in recent weeks that bad news has had far less effect on prices than previously, even if unexpected. Markets appear to have discounted all but disaster (which could of course still happen). So we could see a rising trend, albeit with higher volatility and several false dawns (Japan is a salutary precedent in this respect).

It is far too early to declare a new bull market. As one commentator said recently 'the light at the end of the tunnel could be an oncoming train'. Economic data will not improve for several months at the earliest, corporate news will stay dire. But a lot of this is known already, markets are a discounting mechanism and there have been many indications of more rational behaviour amongst investors. Finally, and in the long run probably most importantly, there are huge amounts of cash sitting on the sidelines, earning nothing, waiting to be invested somewhere.

At the moment we remain defensive with significant investments in fixed income. But cash levels have been reduced somewhat from the extreme levels seen at the end of last year in case the rally has a longer life than many investors expect.

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