



Investment Outlook & Review

Summer 2009

ON A YEAR TO DATE BASIS THE IIMIA DISCRETIONARY MANAGEMENT MODEL ASSET ALLOCATION HAS ADDED VALUE RELATIVE TO THE APCIMS PRIVATE INVESTOR INDICES; WHEN COMBINED WITH STRONG FUND SELECTION THIS HAS RESULTED IN CONSIDERABLE OUTPERFORMANCE RELATIVE TO THE INDICES. SIGNIFICANT CONTRIBUTORS INCLUDE:

- DIVERSIFIED FIXED INTEREST EXPOSURE: RELATIVE TO APCIMS THE PORTFOLIOS ARE UNDER WEIGHT GILTS AND OVER WEIGHT CORPORATE BONDS.
- DIVERSIFIED EQUITY EXPOSURE: RELATIVE TO APCIMS THE PORTFOLIOS ARE UNDERWEIGHT UK EQUITIES AND OVER WEIGHT INTERNATIONAL EQUITIES, IN PARTICULAR ASIAN AND EMERGING MARKET EQUITIES.
- STRONG STOCK SELECTION INCLUDING IMPRESSIVE OUTPERFORMANCE BY OUR CHOSEN FIXED INTEREST, JAPANESE EQUITY AND US EQUITY FUNDS.

OUR CONTINUED BELIEF THAT LONG-TERM UK INVESTORS WILL BENEFIT FROM PORTFOLIOS WHICH ARE WELL DIVERSIFIED BY GEOGRAPHY AND ASSET CLASS HAS STOOD US IN GOOD STEAD SO FAR THIS YEAR, THE FOLLOWING REVIEW AND OUTLOOK GIVES AN INDICATION AS TO WHERE WE BELIEVE PORTFOLIOS SHOULD BE POSITIONED IN ORDER TO BENEFIT FROM A RECOVERY IN THE GLOBAL ECONOMY.

As we went into the second quarter, it looked like financial markets around the globe had started to rally in earnest from their March lows and shake themselves free from the panic-fuelled collapse which preceded them. On the policy front, it seemed at last that the colossal efforts by central authorities to halt the declines in economic activity were beginning to have a real effect and the various fiscal stimuli, such as near-zero interest rates and quantitative easing, were working. The concern was that this would be a temporary market rebound propelled by the speculators and companies offloading inventory, belying the continuing significant difficulties for economies and their policy makers. The outcome so far has been a combination of fortunes which saw markets stage an impressive recovery through April and May, only for the momentum to fade during June as conflicting data on the state of the global economy spoilt the party. Nevertheless, markets have remained above their lows and an increasing number of commentators are suggesting that we will not re-test them. As to whether these are the green shoots of recovery, one has to look to the detail both on a macro as well as a corporate level.

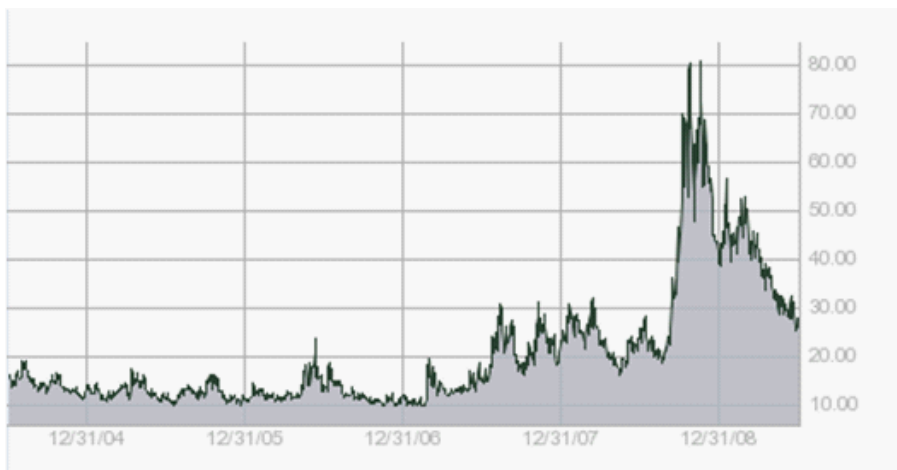
Global equities recorded one of their strongest quarters, and many markets enjoyed double-digit returns – Hong Kong's Hang Seng index was up 35.4%, Germany's DAX up 17.7% and the

Dow Jones Industrial Average in the US up 11%. It was only weak US consumer data released at the end of the period that brought the fireworks to an end with a bit of a damp squib.

However, at the halfway point in 2009, markets are in fact no further advanced than they were prior to the Lehman collapse, showing just how oversold the markets had become in the near-Armageddon meltdown of the credit crunch. In the UK, for example, the FTSE All Share index is still down 1.7% year to date and similarly in the US the Dow is -3.8% YTD. For the long term investor, the gains made in the recovery of the last quarter will only go part way to easing the pain of earlier losses. The notable difference in markets compared with six months ago is their reduced volatility, together with a narrowing of corporate bond spreads over recent weeks, suggesting that appetite for risk is improving, and that this might be a more sustained upward trend.

A useful indicator is the Chicago Board Options Exchange Volatility Index (VIX), often seen as the "investor fear gauge" - the higher the reading, the greater the fear. The VIX chart on the next page shows clearly that the extreme negative moods at the end of 2008 have subsided, although the index is still at an elevated level on a historical basis.





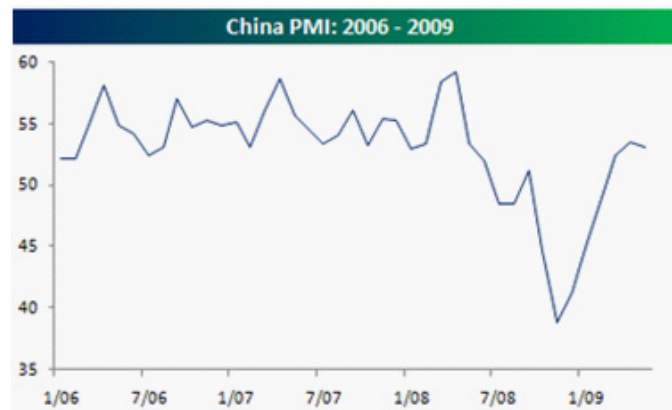
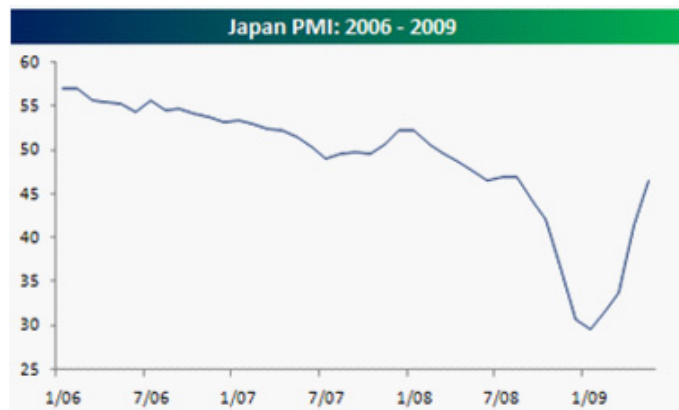
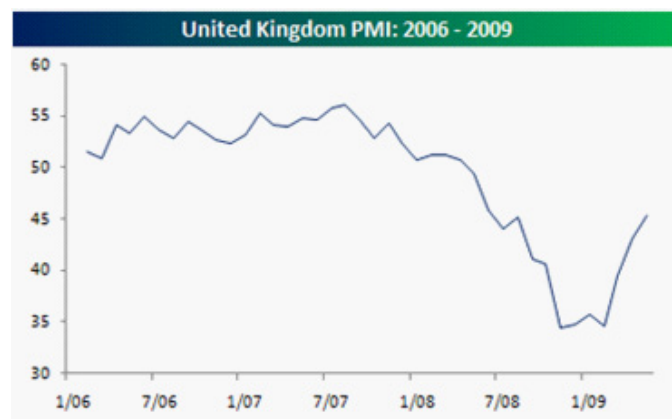
Source: CBOE

As markets run ahead of the wider economy, we can view this as a forecast of the markets' expectations of a recovery to come. In the context of the macro picture, it might suggest that the effects of the fiscal policies are ensuring that we have avoided a repeat of the Great Depression. At a corporate level, the picture is less positive - credit spreads are still implying high levels of defaults by companies on their debts, the financial sector is addressing its problems but profit warnings abound elsewhere. Whilst financial appetites appear to be improving, the evidence implies that caution is still needed as filling up too quickly on risk assets could result in further bouts of indigestion in the form of cut dividends, earnings downgrades or cancellation of debt paper. Indeed, the latter part of June saw the rally levelling off amid mixed economic forecasts and clearly a full economic recovery looks likely to be a slow and sluggish process. For companies, the Purchasing Managers Indices, which we have mentioned in previous notes, are a good signal of corporate intent. These are now indicating manufacturing expansion globally, with China leading the way by some margin.

However, a reading below 50 indicates a contracting economy and with the exception of China, all major economies are still in contraction.

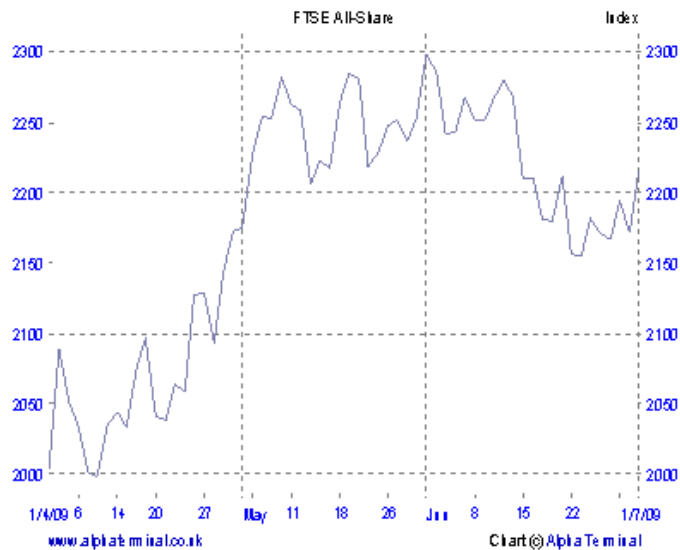
Clearly, worldwide trade has been to the edge of an abyss and the significance of the US consumer, who accounts for more than 20% of global GDP, should not be underestimated. Over the past decade, consumers in the West have geared up more and more, driving the global economy to an unsustainable level. It was therefore inevitable that as retail spending dwindled and unemployment soared, capital would be sucked out of the wider global economy, and widespread contractions would be encountered.

The obvious route out of this is a change in spending patterns and a reduction in the levels of indebtedness. Therefore, consumer growth in the coming years is likely to come from the emerging economies, and it will be investment and government spending that is most likely to lead growth in the West, not the consumer.



Source: Bespoke Investment Group

FTSE All Share 1/4/09 – 1/7/09



United Kingdom

As with all major global stock markets, the UK had a positive quarter, returning around 11.5% (although June took the shine off the earlier two months). The main drivers of the market rally were those sectors and businesses that had been sold off most aggressively in earlier periods, notably financials, cyclical stocks, mining and resources companies.

This doesn't disguise the fact that many companies are still struggling with the effects of the credit crisis and doing everything to repair their devastated balance sheets, especially the banks. It is therefore inevitable that in the coming months unemployment will continue to rise, rights issues will be offered and dividends will be cut. However, with asset prices still at cheap levels, there is support for the better run businesses to refinance and there is an argument that since the traditional banks are still reluctant to lend, at least at reasonable rates of interest, the market is acting as its own bank.

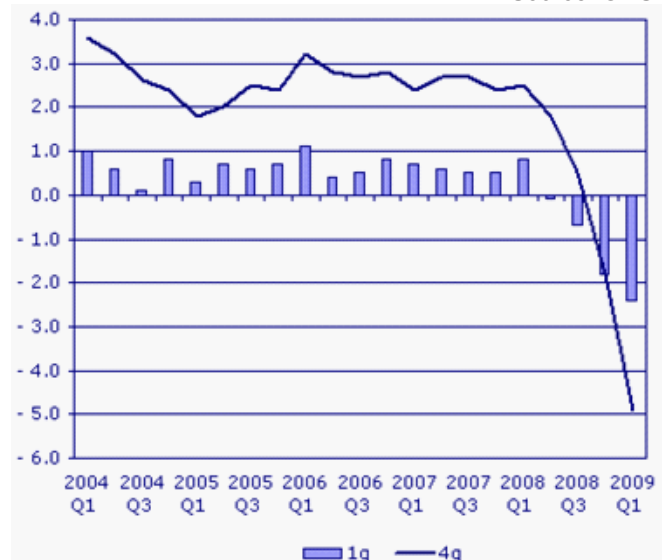
Furthermore, the greater flexibility of the UK labour market has allowed businesses to cut wage costs very quickly – this gives an immediate boost to cash flow and balance sheet strength. It therefore looks like the 'official' recession could be approaching an end and GDP will start to grow again in the latter half of the year. The most likely headwind will be in the public sector where the budget deficit of 12% of GDP is likely to play a crucial part in political positioning ahead of the elections next year. Whoever wins that election will have to deal with the poisoned chalice of introducing public spending cuts, tax increases and other measures that will dampen economic recovery. It is unlikely to be a consumer-led recovery but one driven by investment and export, although a strengthening pound will make this difficult. We remain cautious on the UK market and gain exposure via selected opportunities.

United States

The Fed's strategy of low interest rates and quantitative easing to create liquidity, together with corporate earnings figures that came in ahead of expectations, allowed the US market to participate in the strong second quarter rally, but it still managed to lag the rest of the world. The market is also off its peak of last Autumn, having been so oversold in the panic to reduce its debt, and the question is whether it is likely to recover further or if it has reached the level it should have reached on the way down. Again, the Devil is in the detail of, amongst other things, the effectiveness of fiscal policy, how companies are addressing their debts and whether profits are stable.

UK GDP Growth

Source: ONS



It would certainly appear that financial markets in the US are starting to respond to the policy actions as the Fed has enabled the private sector to tackle its debt problems and encouraged a return to risk assets. On a corporate level, the inventory cycle appears to be at the bottom with the PMI indicating that new orders are on the rise, which will force companies to increase stock levels again. In contrast, job losses have been massive, wage growth is at zero and corporate revenues are still in decline. Nonetheless, productivity is still achievable under these conditions and therefore profit margins can be maintained, whilst the cost saving of a lower wage bill is quick to find its way to the balance sheet. It will be interesting to see how the figures look as we enter the second quarter reporting season.

The fly in the ointment is the US consumer, who now accounts for a whopping 72% of US GDP. With the numbers of unemployed increasing with every month's data, there is simply nowhere else for spending to go but down. This will occur despite the support from the Fed to keep household borrowing costs low, and retailers will no doubt bear the brunt. The obvious outcome is that consumption will fall, savings rates will rise and economic growth will be anaemic. The US housing market is also likely to have an impact on the rate of economic recovery, not least in part because financing of mortgages is linked to the 30-year Treasury rates. As the yields of these fell, refinancing of old, costlier mortgages became cheaper and in turn led to increased disposable income. No matter how affordable property has now become, the recent upswing in Treasury yields has put paid to this benefit for the time being. We seek selective opportunities via the right managers whilst remaining neutral on the region.

Continental Europe

The problems in the Eurozone are quite different to those in the Anglo Saxon economies as they don't have the same level of household debt (with the exception of Ireland and Spain). As we highlighted in our previous update, the problems have been ones of contagion from the reduction in global demand as export orders and investment has tumbled, not helped by the inertia of the ECB over fiscal policy. Whilst there have been some big deals during the period, such as Fiat taking on Chrysler, profit warnings have also been in increasing evidence and unemployment continues to rise.

Employers also don't have the same level of flexibility over their workforce overheads and this is likely to put pressure on companies' profit margins. A depreciation of the currency will be supportive of export growth as the global economy begins to recover, although those countries that participated in the West's



debt boom will not benefit. Given the region's greater reliance on trade beyond its borders, equities continue to look vulnerable and we maintain our neutral stance in portfolios.

Japan

Japan's stock market has had a remarkable quarter, turning in a positive return of 22.8%, but then it really had to, having all but closed for business in Q1 and reminding us that Japan's economy has displayed considerable seasonality in recent years. As we remarked last time, this poor performance highlighted Japan's utter reliance on the export of goods and services to the rest of the world. The problem was exacerbated by the strength of the Yen making the cost of goods too expensive to the global marketplace. Naturally then, as the rest of the world rebounded, so too did Japan. The Bank of Japan's financial package seems to have had some traction, certainly in terms of improving sentiment as much as anything else, with the Tankan survey reporting a modest bounce in business confidence since the dire April figures. The same survey, however, reported a fall in corporate profit expectations to a new low, and it is clear that a sustainable recovery is still very much connected to a revival in exports. Coupled with this is a very poor labour market, where unemployment is rising and stands at more than 5% today, whilst the ratio of vacancies to applicants has reached a new low. This will inevitably result in a drop in consumer spending, making a domestically driven recovery improbable. The difficulties will therefore be made all the more challenging if the Yen doesn't weaken. We remain neutral on the market as a whole but recognise that there are investment opportunities in certain good businesses, particularly on the small cap market, so we look for selective exposure via the right managers.

Asia Ex Japan

Being underweight in so many markets means, unless you hold cash, you have to allocate money somewhere, but where is the best place to be investing? For some time now, we have been more bullish on the prospects for the Far Eastern economies, particularly the Chinese recovery opportunity. When the Chinese authorities marshal a strategy, they mobilise all agencies and the effect is quick and effective. The government is loosening the monetary policy and putting vast amounts of resources into infrastructure and development. China is also realigning its economy away from a reliance on the US as exports level off and imports rise and is likely to emerge more quickly from recession as a consequence, if it hasn't already done so. Indeed, the World Bank has revised its outlook for growth in China to +7.2% from

+6.5% against a global figure that is negative and was revised downwards.

Conclusion

With governments pumping vast amounts of resources into their economies and spending their way out of the slump, it is taking huge effort to halt the economic decline, and recovery is going to be a long, laborious process. In the UK and US, some housing statistics are suggesting the worst is over and this is key to both consumer confidence and – probably – the future course of government measures and interest rates. Confidence has also been boosted by a perceived improvement in the rate of change of the employment numbers, but here again the evidence is patchy and might only be a sign that the pace of decline is slowing. We might yet experience further down turns in the data. Indeed, until recently, there was also considerable debate about a return to inflation. Industrial capacity utilisation in the West (eg factories lying idle) is at low levels and still falling such that we are likely to see continuing restructuring and rising unemployment as businesses look to reduce their output costs. Therefore, inflation is very much something to worry about further down the road when economies are firmly on the recovery path. The risk for Western economies is that complacency returns in the belief that things are now alright and consumers as well as companies allow themselves to drift back into the bad old habits of borrowing and spending.

On the financial markets, sentiment is much improved, as bad news does not seem to unsettle them nearly as badly as it would have done at the end of 2008; on the day when GM finally went bankrupt earlier this year, the markets actually rose. There is much to be confident about but we have also been ominously close to the brink of disaster and there is still a lot of bad news around. This has not been a 'normal' recession so it is overly optimistic to assume we will have a 'normal' recovery – be it 'V' shaped, 'W' shaped or bowl-shaped, with a prolonged period of bumping along the bottom before a real recovery is seen. However, none of the above precludes the possibility of making money in both fixed income and equities on a selective basis worldwide. Returning to the question mentioned at the start of this note, there is no denying that the ubiquitous "green shoots" do exist, both here in the UK and overseas but their hardiness is suspect. We believe that there are many opportunities for investors with anything other than a very short-term investment horizon, and take a cautious and secular view of markets.

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