

Global Investment Review

Second Quarter 2010

Introduction

One of our expectations for the current year was that volatility would increase as the markets grapple with a number of major uncertainties, in particular the speed and magnitude with which the unprecedented global stimulus is withdrawn and the longer term outlook for economic growth. The opening months of 2010 have indeed seen some sharp swings in prices across most of the major asset classes as investors moved quickly between the 'risk on' and 'risk off' trade.

Key Global Market Indicators

Asset Class Performance	YTD
USD 3m LIBOR cash returns	0.15%
MSCI World Equity (USD)	-2.8%
Citigroup World Global Bond Index (USD)	0.2%
Commodities (RICI TR index)	-2.90%
GBP/USD	-5.70%
EUR/USD	-4.90%
USD/JPY	4.80%

*Data source: Lipper as at 28 February 2010

In the equity markets, the New Year started cautiously and by early February share prices had corrected by between 5% and 10% almost across the board. This downturn proved short-lived, however, with markets continuing to make new post-crash highs and at time of writing back in positive territory for the year to date. But while sentiment indicators show a relatively high level of bullishness, there is certainly no euphoria. There still seems to be a high level of scepticism and distrust among investors on markets, economic growth and policy responses.

Investors have tended to focus on negatives whilst ignoring the positives. The January correction was driven by a number of factors, including President Obama's scathing regulatory attack on banks and also a surprisingly negative reaction to the Chinese authorities' moves to cool what appeared to be a rapidly overheating economy.

The China story was quickly overtaken by events in Greece. Serious concerns emerged surrounding the Greek fiscal budget deficit, which stood at almost 13% of GDP following years of profligate spending. The position appeared unsustainable and without EU support or the capacity to take the needed adjustment through its currency, a Greek default looked assured. Greece contributes only a small part to European GDP, however, the main concern was the threat of contagion. The threat of default spread through other Southern European countries with massive debt to income imbalances, Portugal, Italy, Spain, Ireland and even the UK. With Germany and France reflecting a popular reluctance to finance the bailout of Greece, the credibility of the European Union was brought into question.

These events have illustrated the fundamental flaw in a single European Union; it is virtually impossible to run a multi-state region with a single currency (and therefore a single interest rate mandate) and yet not have a single fiscal mandate. Greece was able to borrow at the

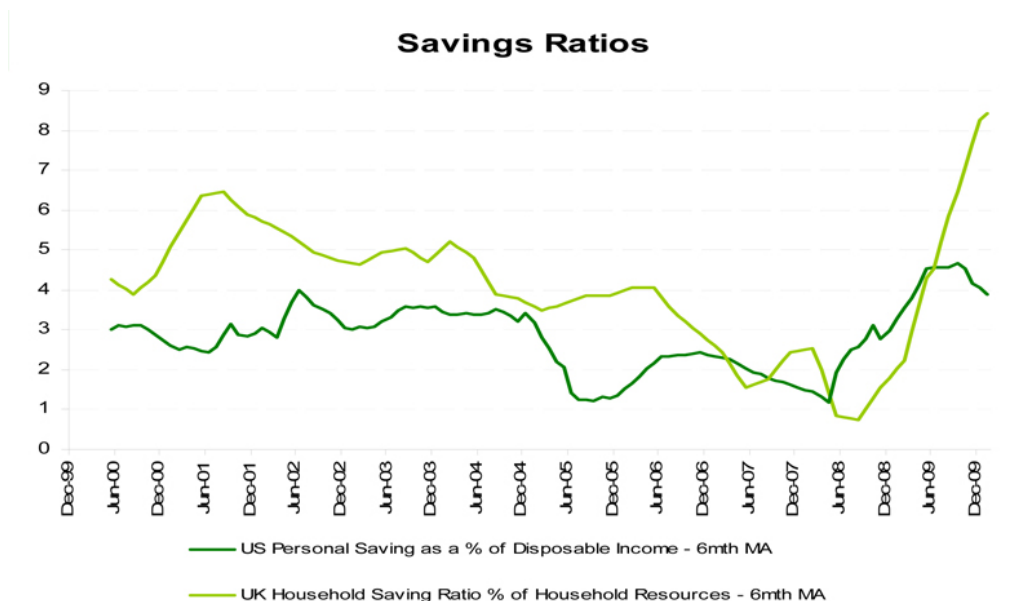
same rate as Germany, yet has nowhere near the same capacity to pay it back.

In 2010, it seems markets have become much more sensitive to negative shocks. The risks to longer-term growth and market stability have undoubtedly increased. It should be recognised that any future exogenous shocks are likely to deal a more telling blow (than usual) due to the impaired effectiveness of any counter-cyclical fiscal policy that could be employed by so many debt laden economies.

However, the problems described above should be placed into context and that they relate primarily to Europe. There is a high probability that economic growth, particularly in the US and the developing countries, will surprise on the upside. As the recovery gains momentum the number of doubters should gradually reduce and be supportive of equity markets.

The two countries that will provide the main impetus for the world to recover from the financial and economic crisis are America and China. What appears to be emerging from the US is a profits-led recovery which will fuel capital expenditure, a better employment outlook and a more buoyant consumer. Corporate profits are on track to make a new high this year four years after they peaked in 2006. To put this in perspective it took twelve years for profits to hit a new high in the 1930's and 16 years in Japan's lost decades.

Recent data flows in the US have shown provided some room for optimism. There has been a large increase in manufacturing output (a leading indicator) and more recently, indications that the household savings ratios (see chart on next page) now appear to be topping out. In the absence of government support, this latter point is crucial to a sustained recovery and may suggest, albeit tentatively, the return of the consumer.



Source: Bloomberg

Consensus is that China is running too hot and creating a huge property bubble and the eventual bursting of the bubble will have devastating economic, political and financial consequences, both domestically and internationally. Although there are obvious concerns we feel this bearish view is significantly overdone and that the Chinese authorities are very much in control of an economy that is in much better shape than most other countries.

The International Investment Panel

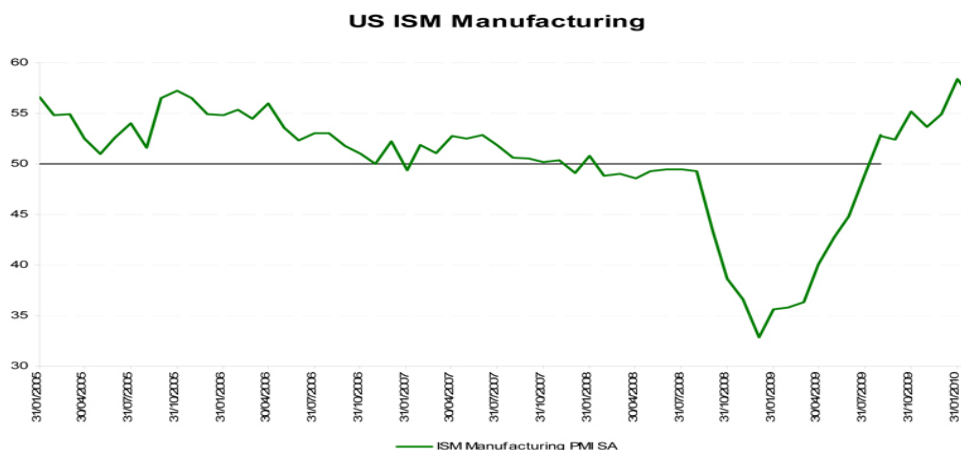
Equity Market Outlook

The broader macro view of the International Investment Panel maintains a positive outlook on equities, which retain the title of preferred asset class on a relative value basis. This in part is due to improving fundamentals for equities and a likely continuation of loose monetary policy. This relative attraction is assisted by the fact other asset classes have appreciated to fair or overvalued positions, with risks building up commensurately.

This broadly bullish view of equities is tempered slightly by the possible risks from an increase in volatility (throughout 2010) and that potential shocks from stressed debt markets could spill over to equity markets. Accordingly, the panel has adopted a balanced view and reduced the overweight position in equities by 5% from to 55% (50% being at weight), partly reflecting current portfolio positions.

The Panel suggests that an actively managed approach will be required. Increasingly, more emphasis will need to be placed on geographic allocation as developing markets are no longer the clear bet they appeared to be last year.

- A recovery in corporate profitability and strong economic growth fundamentals particularly in the USA have improved confidence in the sustainability of the recovery. The Panel has adopted a more positive direction on this region.



Source: Bloomberg

- Europe appears to be the perennial laggard in terms of global growth. Restrictive fiscal problems and political wrangling needs to be resolved. An unpopular sustained period of austerity is also likely to cause significant social unrest in affected economies. The view of the Panel is to maintain an underweight position in European equity weightings.
- With some emerging markets having gained over 160% from their Dec 08 lows, valuations are now starting to look stretched. As a consequence, the Panel advocates reducing risk in the short-term. However, the Panel maintained a unanimous long-term positive view of Asia and emerging market, whilst acknowledging the risks associated with recent monetary tightening in China.

- Unloved Japan was identified as a possible contrarian position. Certainly, it appears to offer defensive qualities in volatile market conditions.

Fixed Interest Outlook

The Panel has maintained its previous negative position on developed country sovereign bond markets. The deterioration of government balance sheets may continue to cause significant problems and excessive debt levels pose a structural impediment to longer-term growth prospects. This quarter saw the announcement of the end (or temporary cessation) of quantitative easing policies which will remove a support for bond prices. With positive signs in the equity markets continuing, as stated previously, it would take an unforeseen event of significant magnitude to see any meaningful flows back into sovereign debt.

The outlook for inflation on a short-to-medium term outlook remains benign, given the large output gaps and slow recovery in of the job markets. However, there is a risk that markets do begin to anticipate the emergence of an inflation problem down the line. In this context, governments do face the problem of neutralising the excess liquidity they have created through support for the financial system.

The Panel therefore continues to underweight this asset class in favour of equities. Fixed income credit exposure is favoured. To some extent this is a correlated play on equity markets.

- The Panel see some value in investment grade corporate credit, however, with strong return's in 2009 under the belt, bonds appears to be at or near fair value, consequently the panel view this more as a yield play ex-growth (income rather than growth).
- A proportionate exposure to high yield bonds appears attractive, where the risk premia suggests there could be further gains to be made.
- Some exposure to convertible debt, which provides some optionality on equity movements, was also agreed.

Currency Outlook

On balance, the Panel's views on currency remains negative toward the major currencies, particularly the Euro, in favour of emerging market currencies.

- However, improving leading indicators in the US and general risk aversion suggest the Dollar may continue to strengthen against the under siege Euro.
- Concerns over a possible hung parliament ahead of May 6 elections and government debt levels could result further short-term weakness in Sterling. However, the pound is likely to outperform the Euro, given the tools at the disposal of the UK authorities, a state with both independent fiscal and monetary policy. .
- Outside of the developed currencies the panel sees value in a basket of emerging market and Asia Pacific currencies, in particular the Indian Rupee, Australian Dollar and Korean Won. The Japanese yen appears vulnerable to correction.

Alternative Assets

The Panel has maintained its weighting in this asset class. Split across three sub classes, the panel view is as follows.

- The Panel continues to see hedge funds as a viable portfolio diversifier in a multi-asset portfolio. There are also benefits as a hedge to any further market corrections, therefore justifying the 15% weight. The view is that the sector is an increasingly less crowded trade and liquidity continues to improve.
- There is no change on the Panel's view on property. There is no exposure currently in the tactical model. While the asset class is seen primarily as a yield play with between 7 - 8% yields, timing of entry to the sector and choice of an appropriate vehicle warrants further investigation due to a continuation of continued tight credit conditions and sector specific risks such as increasing supply.
- The Panel's outlook on commodities remains moderately favourable, with global demand remaining fairly strong. However, the panel recognises risks in a stronger Dollar and tighter economic controls as evidenced in China recently, which serves to moderate the view slightly.

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Please direct any questions or comments to:

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