

Global Investment Review

Third Quarter 2009

Introduction

Equities continued to rally through the summer, with gains now at 60% from the March lows but still significantly off their 2007 peak. Both government and corporate debt spreads have narrowed. Risk premiums on risky assets, previously at extreme levels following fears of financial collapse, have begun to normalise and prices of these asset classes have rallied.

This behaviour has not been confined to financial markets. The decision by households and businesses to cut spending at the end of 2008 led to an outright stall in economic activity. However, following aggressive monetary and fiscal stimulus policies and the gradual normalisation of credit markets, the global economy now appears to be exiting recession. Along with the revision of corporate earnings expectations from overly depressed levels, this has lent further support to the equity and credit rally.

Key Global Market Indicators - September 2009

Asset Class Performance	YTD
USD 3m LIBOR cash returns	0.28%
MSCI World Equity (local currency terms)	14.65%
Citigroup World Global Bond Index (local currency terms)	0.71%
CRB Commodity Index	10.52%
GBP/USD	11.61%
EUR/USD	2.59%
USD/JPY	2.73%

*Data Source: Bloomberg as at 30 September 2009

Far from the mad dash for cash which characterised last year's trading patterns, the reverse is now in effect. Although cash levels remain high, there is some evidence that momentum in the financial markets is being sustained by a wall of liquidity. Yield, or more correctly an absence of yield on safe assets, is playing an important role in driving investor behaviour. The willingness to adopt increased risk is reflected not only in the surge in credit prices but also a continued flow of money to emerging markets and currencies.

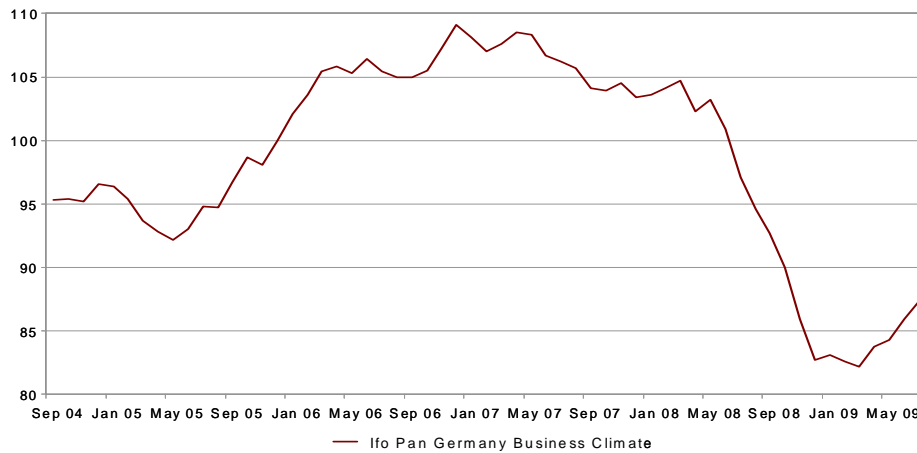
Current investor sentiment is clearly divided. The optimists, who continue to attract converts to their cause, believe the economic rebound will remain intact, inflation may resurface but will not be a problem, interest rates will remain low for the foreseeable future, valuations are not extreme and therefore continued exposure to risk assets is warranted. The pessimists concentrate their arguments around the likelihood of the current inventory-led economic rebound will be short-lived and are more inclined to the deflation argument and a significant pullback in asset prices.

The International Investment Panel is firmly in the bullish camp. Although it is recognised that markets have run hard and it is sensible to expect some kind of pullback, there is no doubt that price momentum and investor sentiment remain largely positive. The risk of the monetary authorities' tightening policy too early seems remote, given the lessons learnt in the 1930's. We are not concerned about any immediate threat of inflation since capacity will remain underutilised for some time. We expect emerging economies to decouple from the lower growth trajectories of developed nations.

Global Economic Outlook

As noted previously, the September quarter has generally been a story of increasing optimism. Leading indicators such as the German IFO Business Climate Index (see chart below) showed that European business confidence is rebounding. A similar picture can be found across developed economies.

German IFO Business Climate Index

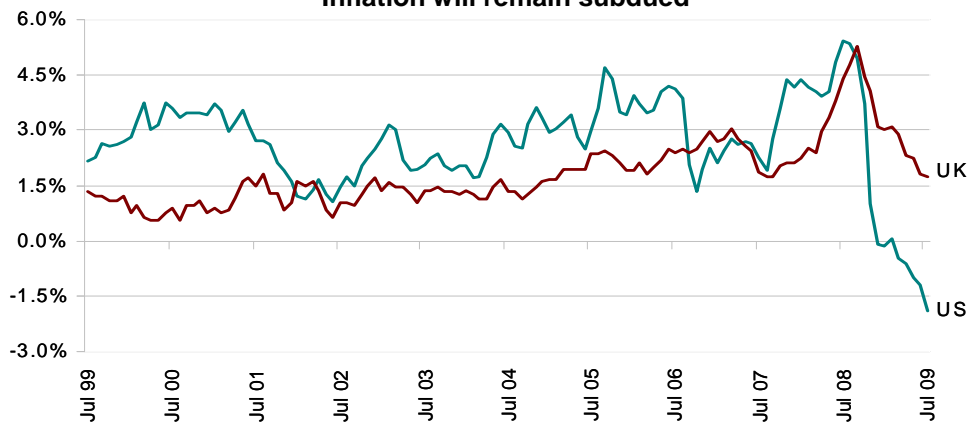


(Source: Bloomberg September 2009)

It seems appropriate to comment on the much talked about unwinding of liquidity support packages, specifically quantitative easing. The concern is that, following a period of higher asset prices and resumption in bank lending, the resultant additional increase in money supply will spur inflationary pressures. There is an additional perceived risk that central banks will keep these stimulative policies in place too long (for fear of thwarting the recovery), and thus increase the risk of inflation down the line

However, current inflationary expectations in the market remain low and stable. There is no real evidence of bank lending resuming in any meaningful way. The Bank of England has extended its quantitative easing programme recently which suggests this risk is muted. Australia has recently raised interest rates, the first to do so, thus reinforcing both a positive view on growth and a proactive stance towards managing inflationary expectations.

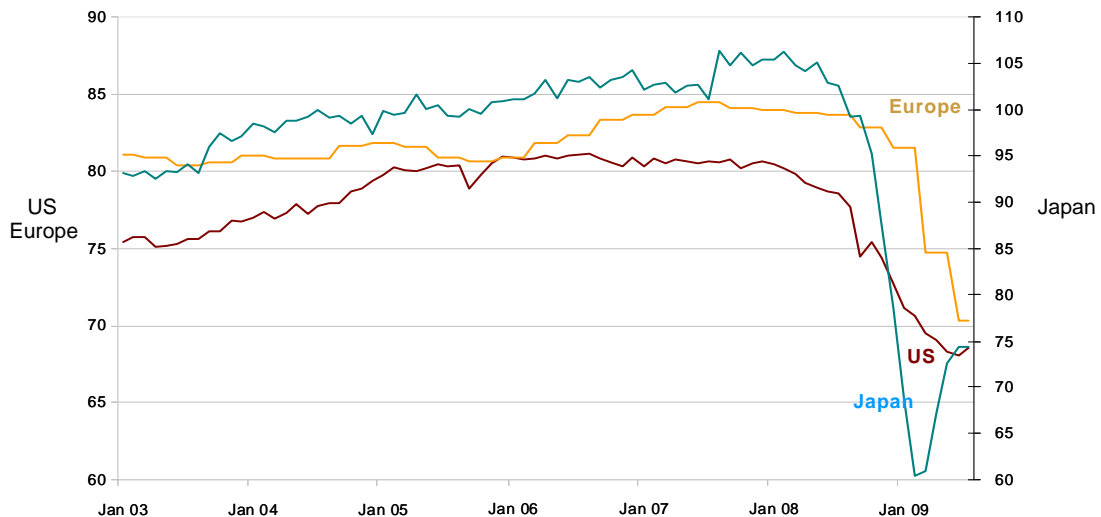
Inflation will remain subdued



(Source: Bloomberg September 2009)

- As we have mentioned, there remains a significant amount of over-capacity in the global economy. It is noted that the US unemployment market has shown little sign of stabilising. It should be noted that this is typically a lagging indicator of economic performance. Nonetheless, utilisation remains at extreme lows (see chart below) and suggests that developed growth rates will remain relatively weak, compared to emerging nations.

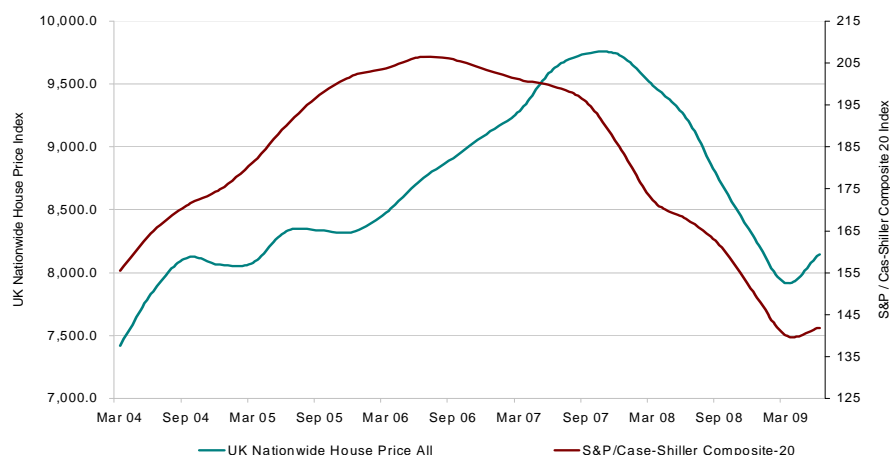
Capacity utilisation



(Source: Bloomberg September 2009)

- US and UK house prices have shown some signs of stabilisation in recent months as evidenced from the Case Shiller and Nationwide House price indices (see chart overleaf). UK regional data shows house price increases are now being observed, particularly in the South and London, perhaps reflecting growing optimism in the city. Broader price support is likely to be attributable to an improvement in credit availability evidenced from a recent rise in mortgage approvals and the ongoing shortage of house supply.

US & UK house prices



(Source: Bloomberg September 2009)

- Deleveraging continues in both households and businesses alike. Households are

continuing to save, or rather, pay down debt. Both businesses and households are now strong net savers. However, regardless of this structural impediment to growth in the longer-term, the rebound from the severe economic contraction experienced towards the end of 2008 and the beginning of 2009 should allow for reasonable growth rates over the next twelve months.

- Emerging markets and, in particular, Asian countries do not suffer from over-leveraged consumers, impaired banking systems or any rapid deterioration in government finances as witnessed in developed nations. In fact the contrary is true. The attraction of this region as a investment destination requires little amplification. It is no surprise that Asian markets have enjoyed the largest gains year to date.

Global Equity Market Outlook

As we have suggested already, the views of the International Investment Panel towards equities can best be summed as strategically bullish but tactically cautious. In other words, we recommend a meaningful exposure to international equities over the long-term but recognise both the capacity for a short-term correction and the opportunity it might present to increase weightings again. Participants on the Panel have recently reduced equity exposure to reduce risk exposure and lock in gains but remain actively engaged in seeking opportunities to re-establish these positions.

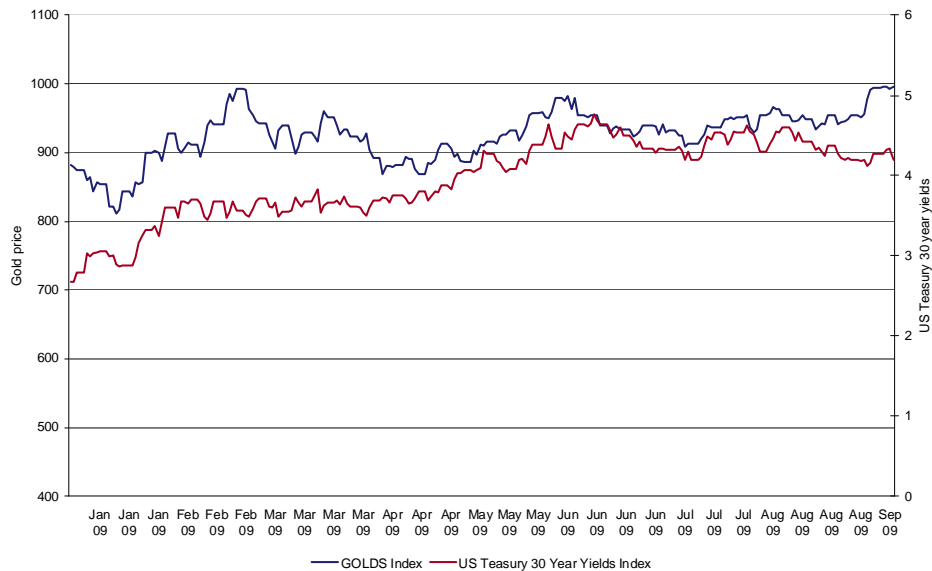
- The view remains that stock selection and active asset allocation from a top-down perspective will continue to pay dividends in these markets. Passive management is not an appropriate strategy in these markets.
- It is worth reiterating that investors can increase risk exposures within portfolios by purchasing investment grade corporate debt. Arguably, this provides similar exposure to the equity with more asset protection. However, it should be noted that investment grade debt yields have come in considerably and the investment is now less compelling on a risk-adjusted basis.
- In terms of regional exposure, valuations in Asia are now looking relatively expensive. Given that the US and UK economies are likely to emerge fastest from the economic slump amongst developing nations, valuations look fair. Some rebalancing of exposures within these areas has taken place (refer table on page 7) but it should be stressed that the Panel retains its strategic preference for emerging countries.
- Other than its fairly high export exposure to China, Europe continues to display poor fundamentals and is underweighted in portfolios.

Fixed Interest Outlook

Bond markets have continued to rally following the short-term sell off in June, albeit at a slower pace, and now appear to be settling into a sideways trading range. Spreads have continued to narrow and CDS prices (cost of default insurance) have fallen as investors became less nervous.

- However, the rally in the developed government bond markets appears to be overdone and driven more by bank buying and a search for low risk yield than fundamentals. This view is certainly supported by the curious rise in the gold price (see chart below) which is probably driven more by liquidity pressures and some inflation hedging than anything else. The Panel suggest there is risk of a sell-off in

government bonds but would view this as an opportunity to increase longer-dated weightings.



(Source: Bloomberg September 2009)

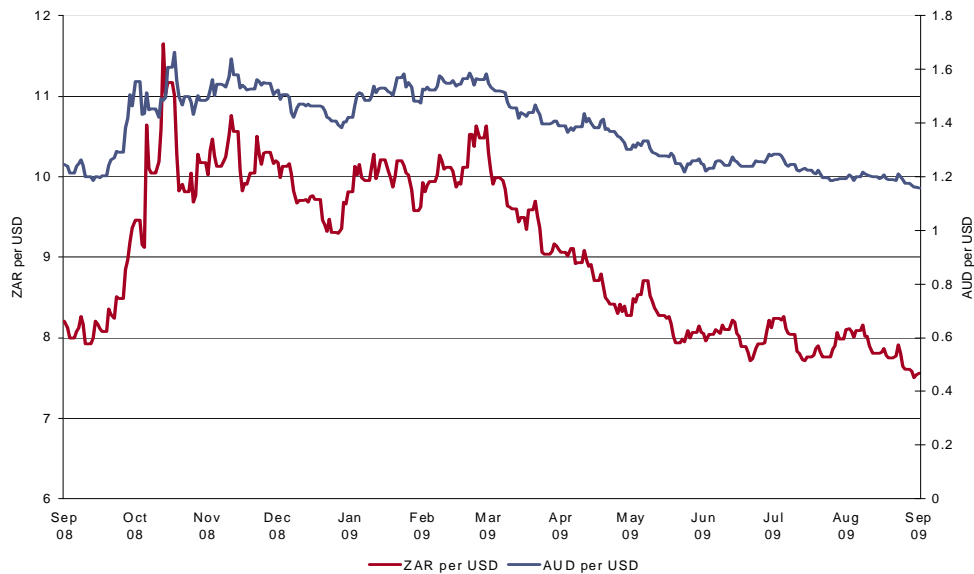
- Corporate credit has rallied strongly in 2009 with equity like returns, rising from the panic induced selling witnessed in 2008. Spreads have since narrowed considerably and yields on a risk-adjusted basis are normalising relative to government paper. The Panel recognises this as a legitimate avenue for investment but advocates restricting exposure to investment grade paper.
- The Panel has highlighted Australian country debt as a value opportunity given its strong commodity backing, proximity to China and the country being the first to raise official interest rates.

Currency Outlook

Unsurprisingly, the view on currencies is somewhat mixed other than those supported by clear economic fundamentals. Other than a low conviction bias to the US dollar and Sterling (a deeply undervalued position and excessive pessimism on the UK economy), there remains no clear favourite amongst the currency majors.

- The dollar remains generally unloved and continues to generate expressions of disloyalty from its many trading partners and reserve holders. China and other emerging economies have been vocal. However, there seems to be a long way to go before another viable alternative will emerge as the world's reserve currency. Given reasonable fundamentals and a contrarian view, there is some risk that the dollar may surprise investors on the upside. It should also be noted that it remains the preferred hedge against market risk.
- The Euro is most unloved based on fundamentals, although it may be benefiting disproportionately from excess dollar pessimism.
- The Panel continues to favour emerging market currencies as well as commodity and

yield plays. This pattern is already being played out across numerous markets with the South African Rand and Australian dollar obvious beneficiaries (See chart below)



(Source: Bloomberg September 2009)

Alternative Assets

The Panel has softened its views on this broad asset class. Specifically, the direction is set as follows:

- The Panel has recommended a small increase in exposure to hedge fund of funds, noting that this asset class should continue to benefit from current market inefficiencies and volatility. It remains a viable alternative to limited returns on cash.
- Noting the poor returns available on cash, the Panel undertook to review the opportunities available in the Property sector. It should be stressed that the Panel remains wary of high debt levels, refinancing issues and supply/demand aspects. An interim recommendation is to follow.
- The Panel recommends that exposure to the commodity sector be taken indirectly through emerging and commodity market investments. Predicting individual sector and metal price movements is beyond the remit of this Committee in this environment.
- Gold is seen as a potential hedge against higher inflation and as an alternative to equities. Recent press coverage linking gold to an energy currency seems speculative. However, at current prices this would be a low conviction call and would not necessarily warrant inclusion in portfolios.

Strategic and Tactical Allocation

Asset Class	Strategic Weight	Tactical Weight	Directional Move	Comment
Equities	50	50	↓	Tactically underweight
	USA		↑	Upweight at Asia's expense
	UK		→	Unchanged
	Europe		→	Unchanged
	Japan		→	Unchanged
	Emerging markets		↓ ↓	Reduced back towards weight
Bonds	25	20	↓	Reduce duration – explore credit opportunity
Cash	25	20	→	Waiting opportunity to reduce further
Alternatives		10	↑	
(Taken from cash)	Hedge Funds	10	↑	Increased weight
	Property	0	→	Too early to buy
	Commodities	0	→	Exposure via emerging markets
Total		100		

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