

Global Investment Review

Third Quarter 2010

Introduction

At the halfway point of 2010, our observations of a continuing global recovery punctuated by bouts of investor unease and fear continue to prevail. The recovery is gaining momentum in the US and continued growth in China and the Asia Pacific regions provide continued optimism. Europe is lagging in the recovery phase and is the main source of unease despite now accounting for a very small portion of global growth (about 1% of global GDP growth). However, fears continue to emanate from Europe, increasing volatility in risky assets.

The fear factor would appear to be back, as illustrated in recent moves in the VIX index. The VIX is an index that tracks the cost of market insurance (a proxy for investor comfort/discomfort) which began to rise again in mid-April, having steadily fallen from the highs of October 2008 to levels well below average. Although not the alarmist reaction that we saw in 2008, the markets are certainly displaying a heightened degree of nervousness.

Markets appear to be at a tipping point. As global fundamentals continue to improve, investors remain wary of the risks of a double-dip recession. Developed countries and their governments are acutely aware of this fear. Whilst not wishing to impair the recovery, they must also begin fiscal tightening to address their large budget deficits.

Key Global Market Indicators

Asset Class Performance	YTD
USD 3m LIBOR cash returns	0.53%
MSCI World Equity (USD)	-6.6%
Citigroup World Global Bond Index (USD)	-2.3%
Commodities (RICI TR index)	-9.9%
GBP/USD	-10.0%
EUR/USD	-14.5%
USD/JPY	2.3%

*Data source: Lipper as at 31 May 2010

The spectre of a double-dip recession is being fuelled by an array of concerns:

- Contagion from the European sovereign debt crisis, driving a fresh liquidity crisis in the region's banking system and the effects it might have on global growth
- Continued fears of a Chinese property bubble
- Increasing financial regulation
- Recently escalating political tensions between North and South Korea.

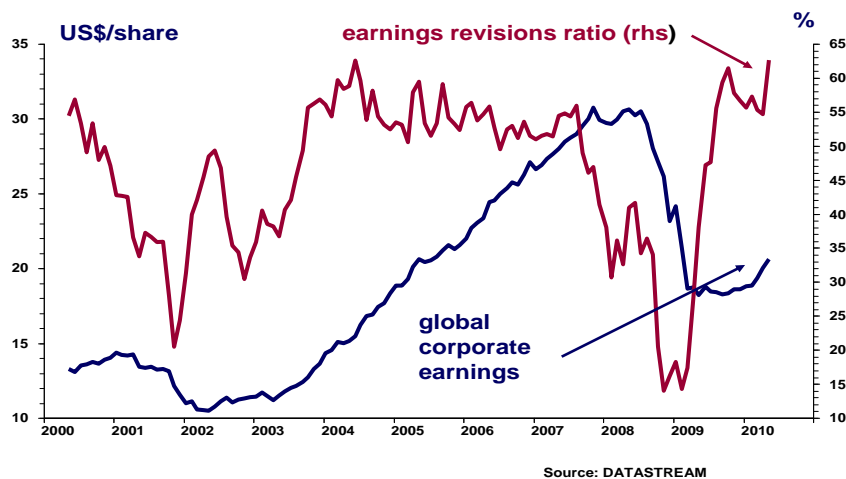
In the short-term Europe remains the greatest concern to holders of global risky assets. Leadership from Germany is badly needed if stability is to be found and maintained. The unilateral decision by the German government to introduce a short selling ban on European Sovereign debt securities, as well as on ten large German financial institutions, was not encouraging.

In 2010, politicians have become increasingly instrumental, by design or not, in the instability of regional and global markets and should be considered a significant risk. Austerity

packages will be painful, yet arguably made worse by politicians pointing the finger of blame at one another in what are already distressed markets. Hungary's incoming government recently demonstrated this lack of foresight when announcing that the economy was in a much worse state than they thought (whilst pointing the finger directly at the outgoing incumbent). The subsequent widening of spreads on Hungarian Sovereign debt was such that immediate back-tracking was needed to avoid a run on Hungarian paper. Point scoring politics have perhaps never been less welcome.

However, in our view recent market weakness is an overreaction that will prove to be temporary. In developed markets it is unlikely that central banks will remove the accommodating monetary policy anytime soon. Further, a rescue package (€750bn) to bail out the indebted peripheral European nations is now in place. A robust outlook for corporate earnings (see chart), attractive valuations and evidence of extremely negative sentiment are, we believe, additional reasons to maintain a positive view of prospective equity returns.

Corporate earnings globally are recovering and analysts are revising up their earnings estimates.



The International Investment Panel

Equity Market Outlook

Despite recent volatility and losses in global equity markets, the International Investment Panel (the "Panel") supports the view that the recovery is still intact. In turn, this broad consensus supports our continued overweight position in Equities. The recent market correction is seen as an opportunity to build positions in anticipation of a bounce in the short-term and continuing out-performance of other asset classes in the medium to longer-term.

- The risk to equities from tighter monetary policy, in the US and China in particular, has lessened as a consequence of the European crisis and recent financial turmoil. This removes one of the risks to equity markets that we identified at the start of the year and at the margin it is supportive of short-term global growth prospects.
- Europe continues to be a laggard in terms of growth. In valuation terms however,

Europe is now starting to look cheap vis-à-vis the US and China and a weakening Euro could provide an export-led stimulus to growth. Nevertheless, the Panel acknowledges that the risk in European markets remains significant, preventing any meaningful tactical increase to allocation at this time.

- Coincident fundamentals in the US are improving. Corporate earnings are now being driven by increasing revenues as opposed to cost cutting, with upward revisions to earnings now greater than downward revisions. Despite continued high unemployment with marginal signs of improvement, other leading indicators are improving. The US housing market in particular now appears to be stabilising.
- Short positions in Europe have been huge but are now unwinding, which could trigger a bounce and sustained rally in the short to medium-term.
- To summarise: tensions between S. Korea and N. Korea, European austerity measures, a Chinese housing bubble and political interference are all considered as credible concerns to the pace of recovery in equity markets but not yet sufficient to derail the positive outlook.

Fixed Interest Outlook

The Panel maintains its negative view on developed country sovereign bond markets, but sees some improving conditions. On balance, the risks are considered too great for any increase in allocation.

Austerity measures being announced in Europe and the drag on growth associated with such packages will continue to remain a significant risk to European sovereign debt. The US, inherently stronger, has more tools to deal with its budget deficit than Europe. However, it too, will be restructuring huge amounts of debt in the coming years. Relatively, the bulk of UK debt is structured on much longer terms. With debt maturing further out, the additional breathing space is viewed as a positive for the country.

It is recognised that there may be short-term flows back into US and UK government bonds which are predominantly based on fears of a double-dip recession and the risk-off trade. However, this does not justify an increase in weight at present.

The Panel has not changed its outlook on inflation in the short to medium-term. That is, high unemployment and large output gaps remain and input prices from subdued commodity markets and low oil prices continue to support a fairly benign inflationary environment. With numerous global anti-deflationary packages in place and further government intervention expected, the Panel expects inflationary forces to return longer-term.

- Although now stabilising, the Panel remains negative on European sovereign debt. Consequently, the potentially negative impact on credit markets is significant and with excess returns in corporate debt now appearing to be played out, the Panel is reducing its weight to investment grade corporate paper.
- LIBOR rates have risen on fears of banks exposure to the troubled European sovereign debt markets. European banks in particular are increasingly likely to turn to government funding promoting a self-fulfilled liquidity squeeze.
- The overweight position to High Yield debt remains. With manufacturing and industrial output improving and with a recovery in corporate earnings, the Panel

continues to support a preference for high yield debt.

- Sovereign debt stability measures are now in place in Europe. The fear of contagion into other regions has subsequently fallen. Currently underweight, the panel sees some value at yields of 3.75 to 4% in UK treasuries (see chart below).

UK 10 year yield change – Crisis 08 to Current Crisis



Source: Bloomberg

Currency Outlook

The Panel maintains a negative view on the Euro, albeit at a lower conviction, favouring the Dollar and emerging market currencies in the medium to longer term.

- With the European sovereign debt rescue package now in place there could be a short term rally in the Euro from over sold positions. A reduced growth outlook however will present a significant headwind in the medium to longer term.
- Due to the UK's more effective fiscal and monetary controls to that of its European neighbours, and taking into account attractive valuations, the Panel believes the currency is oversold at these levels.
- It is felt that some of the Scandinavian countries, notably Norway and Sweden, with stronger fiscal positions than their EU neighbours may see a strengthening of their currencies.
- Emerging markets currencies remain a strategically longer term play. The Korean Won and Indian Rupee are two currencies favoured by the Panel.

Alternative Assets

The Panel has maintained its positive view on this asset class. Split across three sub classes, the Panel's view is as follows.

- Hedge funds are a useful asset class diversifier and the shake-out in the sector will have removed most underperforming and rogue elements. Liquidity concerns remain, demanding a cautiously selective approach.
- Residential Property inflation in the UK is currently at 10% year on year, a consequence of constrained supply and some moderation in mortgage markets. Yields on commercial property are now approx 6%, falling from over 8% this time last year.
- The panel remains at a zero weight in Property due to significant concerns in the sustainability of the Property recovery at this point.
- The Panel's positive view on Commodities remains intact. Short term concerns on global growth could restrain upside potential.

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