



International Investment Panel - House View November 2008

Global Outlook

The outlook for the global economy is dire.

The bursting of the credit and housing bubbles has left markets reeling and the world facing severe recession. Global government reactions have been unprecedented, including the direct guaranteeing of bank deposits and the large cuts in government interest rates. The total cost of these reactionary measures is estimated at \$3.5 trillion and rising.

Some thawing of the frozen credit markets has been evidenced through a moderate narrowing of spreads (the price paid by companies to borrow from the market over government borrowing) but overall, the various governments remain very much the only real avenue for credit with the usual money markets remaining shut. Liquidity still attracts a massive premium across nearly all asset classes.

The crisis in the larger financial institutions seems to have passed, the major national or clearing banks appear to have weathered the storm, albeit at a major cost to shareholders and future profits.

As is now becoming apparent, nearly all major economies are de facto in recession or will be within months if not weeks. There is very little transparency as to the trajectory of the future growth path: suffice to say that real GDP growth seems unlikely to resume until 2010 and we are likely to experience a much deeper recession in the intervening period than any in recent history. Evidence is pointing towards a collapse in consumer demand across the globe.

After massive forced de-leveraging cutting a swathe across the financial and investment sectors, the consumer is now starting to feel the pinch as credit availability dries up and debts are being called in. The reduced consumer spending and subsequent turndown in corporate earnings has begun and will accelerate from this point. A massive stimulus package from China has only served to provide further evidence that the juggernaut of Chinese demand is in danger of slowing to a relatively tepid pace. Newsflow is awful and set to get worse.

On the positive side, there is some good news. Commodity prices are in free fall, inflation is dead for the time being and rate cuts have been generous. More will follow. However, the impact will take time to filter through into the real economy, with a meaningful recovery seemingly a long way off.

Structurally, the US and Japan seem best placed to emerge first on the other side of this perfect storm. Europe faces headwinds in terms of infighting and a lack of action. Exposure to developing markets also remains a risk, especially for those countries more closely aligned to Eastern Europe.



In terms of monetary policy, the UK has already surprised with a massive 1.5% rate cut and it seems likely that more is to come. Perhaps reflecting a political appetite to embrace radical action, Britain will probably be a leader in enabling direct fiscal stimulus through tax cuts. The ECB has been late to the party but as the Eurozone dips into recession, it is unlikely to want to remain behind the curve for long. The US is also likely to cut rates further, forcing global rates to very low levels. Cash as an asset class will fast lose its yield and deposits will start to lose their attraction, which may force investors seeking income to take on more risk.

Currencies are reflecting both the crisis in markets and economic reality. Massive asset selling and global risk aversion have forced a significant dollar rally, not only against emerging currencies but against sterling and the euro. The pound has been hard hit by poor fundamentals but also the aggressive policy reaction by authorities. However, there is a view that the dollar's rise against sterling is now looking overdone and there is some scope for the pound to rally in the short-term, although the dollar seems likely to remain the currency of choice for some time to come.

As investors continue to express negative opinion in the equity markets, this has forced bond prices up (and yields lower). This is unlikely to unwind soon, although it might be expected that any rally in equity markets could lead to some retracement in bond prices. Fears over the expected massive government bond issue being ignored by investors will probably be market specific and unlikely to have a major impact on the broader bond market, as inflation fears disappear.

Investment Implications

Equity

The International Investment Panel has not changed its cautious stance on equities, and has reduced its overall exposure to reflect the ongoing market correction. Although it is felt that equity prices probably made their lows for this bear market during October, consensus is that we are likely to trade sideways in a volatile manner for at least the next six months. There may be substantial and tradable rallies within this period. Valuations do appear attractive; yield differentials with competing asset classes have turned in favour of equities while sentiment remains very oversold. However, there has been limited conviction in any rally to date, there remains no visibility on corporate earnings and the risk of disappointment remains high.

Fixed Income

Bonds are favoured over equities and cash. Short to medium-dated government bonds still offer value (over cash) as inflation concerns abate, short rates come off and growth concerns escalate. Interest rates are expected to continue to fall and yield curves steepen further. A re-pricing of investment grade corporate credit appears to offer better value than direct equity at this stage. Default and liquidity premiums are at extreme levels, reflected in the falling yields and continued wide spreads.



Property and Alternative Strategies

As the economic downturn continues, we expect consumer confidence will fall. Subsequently, consumer spending is expected to fall further as precautionary saving increases (despite falling interest rates). Leading indicators and surveys suggest both consumer and business confidence are low. This will place increased downward pressure on house prices as house buyers leave the market. Added to this, any borrowing will have more stringent lending terms attached. ***The panel cannot make a case for buying property at this stage*** and currently advocate a zero exposure to this asset class.

It is recognised that extraordinary performance and liquidation pressures are having an abnormal impact on the hedge fund industry. Equity forced selling, whilst strengthening the Dollar, is having a negative effect on Hedge Fund valuations. Aligned with a lack of liquidity and falling investor confidence (in the sector that promises absolute returns yet delivering double digit negative returns), the increasing number of investor redemptions continues. While opportunity will present itself to those managers who can adapt to the changing environment, further consolidation and rationalization of the sector is expected. ***The Panel has reduced exposure to this asset class.***

Currency

The anticipated reduction in current interest rate differentials and better growth prospects support the panel's ***bullish view on the US Dollar over the medium-term.*** However, in the short-term, we expect a rally in GBP as the current correction has been overdone.

Regional allocation

The panel's macro view still predicates a bias towards the US but feels that European and Asian valuations are increasingly attractive. The panel retains a cautious view on emerging markets. We remain near full weight in Japan.

Conclusion

Market focus has shifted from the financial sector to the real economy, where the news is dismal. As such, the panel view is that ***it would be imprudent to take on additional risk at this stage.*** However, conditions could near a point within the next few months where the purchase of riskier assets may become more attractive for the nimble investor.

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