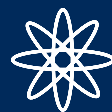

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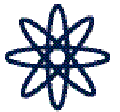
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

A steady final quarter in international equity markets has cemented the gains shown in the previous two quarters to provide a satisfactory offset to the decline in equities in 2008. On the other hand, with investors' anxieties about the banking system and world economy somewhat allayed, the poor fundamentals for bonds have started to catch up with their yields and a disappointing final quarter has rounded off a disappointing year for high quality bonds.

The tables below detail relevant movements in markets:

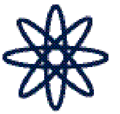
International Equities 30.09.09–31.12.09

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+3.0	+3.9	+4.9	+6.9
Finland	-2.1	-4.8	-3.9	-2.1
France	+3.4	+0.6	+1.5	+3.4
Germany	+4.0	+1.1	+2.1	+4.0
Hong Kong, China	+7.4	+6.4	+7.4	+9.4
Italy	-0.7	-3.5	-2.6	-0.7
Japan	+0.8	-4.0	-3.1	-1.3
Netherlands	+8.2	+5.2	+6.2	+8.2
Spain	+2.9	N/C	+1.0	+2.9
Switzerland	+3.5	+2.9	+3.9	+5.8
UK	+6.1	+6.1	+7.2	+9.2
USA	+6.0	+5.0	+6.0	+8.0
Europe ex UK	+3.0	+0.6	+1.5	+3.4
Asia Pacific ex Japan	+4.5	+4.6	+5.7	+7.6
Asia Pacific	+2.7	+0.4	+1.4	+3.3
Latin America	+9.4	+11.1	+12.1	+14.3
All World All Emerging	+7.3	+7.8	+8.9	+10.9
The World	+4.8	+3.5	+4.5	+6.5

Source FTSE World Indices
FT Government Securities Index All Stocks (total return): -2.0%

International Bonds—Benchmark Ten Year Government Bond Yields (%)

Currency	30.09.09	31.12.09
Sterling	3.59	4.01
US Dollar	3.31	3.84
Yen	1.30	1.29
Germany (Euro)	3.23	3.40



Sterling's performance during the quarter ending 31.12.09 (%)

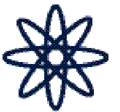
Currency	Quarter Ending 31.12.09
US Dollar	+1.0
Canadian Dollar	-1.6
Yen	+5.0
Euro	+3.0
Swiss Franc	+0.7
Australian dollar	-0.8

Other currency movements during the quarter ending 31.12.09 (%)

Other Currency	Quarter Ending 31.12.09
US Dollar/Canadian Dollar	-2.6
US Dollar/Yen	+4.0
US Dollar/Euro	+2.0
Swiss Franc/Euro	+2.3
Euro/Yen	+2.0

Significant Commodities (US dollar terms) 30.09.09–31.12.09 (%)

Significant Commodities	30.09.09–31.12.09
Oil	+10.5
Gold	+10.0



Performance During 2009

International Equities 31.12.08 - 31.12.09 Total Return Performances (%)

	Local Currency	£	US$	€
Australia	+36.9	+57.2	+76.5	+71.0
Finland	+10.1	+1.2	+13.7	+10.1
France	+27.7	+17.3	+31.8	+27.7
Germany	+24.0	+13.9	+28.0	+24.0
Hong Kong, China	+63.2	+45.3	+63.1	+58.1
Italy	+21.8	+11.9	+25.7	+21.8
Japan	+8.7	-5.8	+5.8	+2.5
Netherlands	+45.0	+33.2	+49.7	+45.0
Spain	+36.2	+25.2	+40.6	+36.2
Switzerland	+23.8	+13.5	+27.5	+23.6
UK	+28.0	+28.0	+43.7	+39.2
USA	+27.2	+13.2	+27.2	+23.2
Europe ex UK	+29.9	+20.1	+34.9	+30.7
Asia Pacific ex Japan	+54.8	+53.8	+72.8	+67.4
Asia Pacific	+28.8	+19.6	+34.3	+30.1
Latin America	+63.7	+82.2	+104.7	+98.3
All World All Emerging	+65.9	+62.5	+82.6	+76.9
The World	+28.9	+19.6	+34.4	+30.2

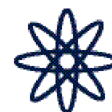
Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -1.2%

International Bonds—Benchmark Ten Year Government Bond Yields (%)

	31.12.08	31.12.09
Sterling	3.02	4.01
US Dollar	2.22	3.84
Yen	1.18	1.29
Germany (Euro)	2.95	3.40

Sterling's performance during the year ending 31.12.09 (%)	
US Dollar	+10.8
Canadian Dollar	-4.8
Yen	+13.7
Euro	+7.9
Swiss Franc	+0.9
Australian Dollar	-13.0



Other currency movements during the year ending 31.12.09 (%)	
US Dollar/Canadian Dollar	-14.1
US Dollar/Yen	+2.6
US Dollar/Euro	-2.6
Swiss Franc/Euro	+0.6
Euro/Yen	+5.4

Significant Commodities (US dollar terms) 31.12.08 - 31.12.09 (%)	
Oil	+71.1
Gold	+27.1

Markets

For international equity markets, the final quarter of 2009 was one of consolidation. The strong upward movement in share prices, noted in the second and third quarters of the year, was preserved. In total return terms, the local currency return on the FTSE World Index in the final quarter was 4.8%, in sterling terms 3.5%, in US dollar terms 4.5% and in euro terms 6.5%. In local currency terms, there were particularly strong performances, as so often recently, from the FTSE Latin American Index (+9.4%) and the FTSE All World All Emerging Markets Index (+7.3%).

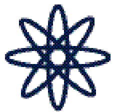
Elsewhere, the FTSE UK and FTSE USA Indices performed well, returning 6.1% and 6.0% respectively. The FTSE Asia Pacific ex Japan Index returned 4.5% and the FTSE Europe ex UK Index returned 3.0%. Japan had a difficult quarter with the FTSE Japanese Index returning just 0.8%. If we look at the sterling adjusted returns in a quarter where, against most currencies, sterling trended higher, there were still enhanced returns from the FTSE Latin American Index (+11.1%), the FTSE All World All Emerging Markets Index (+7.8%) and the FTSE Asia Pacific ex Japan Index (+4.6%). Elsewhere, the total return in sterling terms on the FTSE USA Index was reduced to +5.1% and to +0.6% for the FTSE Europe ex UK Index. Weakness in the yen caused the FTSE Japanese Index to move into negative territory with a return of -4.0%. Australia maintained its consistently good performance with a local currency return in the FTSE Australia Index of +3.0% and, in sterling terms, +3.9%.

International bond markets, as measured by ten year government bonds, with the exception of Japan, endured a weak quarter. For sterling bonds, the gross redemption yield rose by 42 basis points to 4.0%, on US dollar bonds it rose by 53 basis points to 3.84% and on German government bonds by 17 basis points to 3.40%. The yield on the ten year Japanese government bond fell by 1 basis point to 1.29%.

In the currency markets, sterling advanced by 1.0% against the US dollar, by 5.0% against the yen, by 3.0% against the euro and by 0.7% against the Swiss franc. Against the Canadian dollar it fell by 1.6% and against the Australian dollar by 0.8%.

In the commodity markets, oil and gold both performed strongly rising by 10.5% and 10.0% respectively.

If we look back at the year, the overall returns reflected a very poor opening period of just over two months, followed by very strong share price rises over the rest of the year. In local currency terms, the FTSE World Index returned 28.9%, in sterling terms 19.6%, in US dollar terms 34.4% and in euro terms 30.2%. Looking at individual countries and regions, as measured by the relevant total return FTSE World Index in local currency terms, the outstanding performances were from Emerging Markets (+65.9%), Latin America (+63.7%), Hong Kong, China (+63.2%), Asia Pacific ex Japan (+54.8%) and Australia (+36.9%). The most disappointing performance came from the FTSE Japanese Index (+8.7%). If we look at the sterling adjusted total returns from the relevant FTSE indices, the figures change quite dramatically in some cases. The Latin America return rises to +82.2% and the Australian return to +57.2%. On the other hand, the Hong Kong, China return reduces to



a still very spectacular +45.3%. For the USA, the local currency return of +27.2% falls to +13.2% in sterling terms, the Europe ex UK return falls from +29.9% to +20.1%, whilst the Japanese return moves into negative territory at -5.8%. The return on the FTSE UK Index was above average at +28.0%.

International bond markets, as measured by high quality ten year government bond yields, had a very poor year, although some lower grade issues produced good returns but obviously with higher risk. The gross redemption yield on the ten year sterling government bond rose by 99 basis points from 3.02% to 4.01%, on US dollar bonds by 162 basis points from 2.22% to 3.84% and on German government euro denominated bonds by 45 basis points from 2.95% to 3.40%. The rise on Japanese government bonds was less spectacular at 11 basis points from 1.18% to 1.29%.

In currency markets, after its substantial fall in 2008, sterling made a partial recovery but not against all currencies. Against the US dollar, it rose by 10.8%, against the yen by 13.7%, against the euro by 7.9% and against the Swiss franc by 0.9%. On the other hand, it fell by 4.8% against the Canadian dollar and by 13.0% against the Australian dollar.

In the commodity markets, after its roller coaster ride in 2008, oil recovered by 71.1% and gold rose by 27.1%.

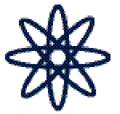
Economics

To look at international equity markets over the year one might think that the world economy was performing well as shares, after an initial weak period in January, February and early March, powered ahead. However, the reality is very different. Whilst there have certainly been some signs of encouragement, particularly in the east and emerging markets, there remain areas with some very serious problems. Into this category fall countries such as the UK, the USA (to some extent) and parts of the eurozone, notably, Greece, Spain, Portugal, Ireland and Italy. There remain many serious problems in the financial system so in no way should the strength of the international equity markets lead to a feeling that the world economy has emerged from the crisis. However, this does not mean that the performance of equities has been an aberration. Far from it. Equities have been our preferred asset class, for reasons which we have articulated in previous reviews and which we will go over again in this review. As far as the performance of high quality government bonds is concerned, this has been poor and this, apart from short dated maturities, is a class of asset which we continue to avoid as we believe it carries great risks, particularly in the bond markets of those countries mentioned above. Commodities have generally performed well on the back of fears about a return of inflation and the Chinese growth story.

After a very poor start to the year, the major economies, with the exception of the UK, returned to growth in the third quarter and the expectations are that 2010 overall will be a year of modest growth for the world economy. This is as a result of the enormous monetary and fiscal stimulus given to the world economy by governments throughout the world aimed at averting a recession from becoming a depression. But such a stimulus, achieved through orthodox and unorthodox methods, has come at a heavy cost for many countries, the consequences of which will be apparent for a long time. These consequences will have to be borne in mind by investors as they shape their investment policy in the future. Insofar as these policies have resulted in a resumption of economic growth and therefore improved the outlook for corporate earnings, the rise in share prices is justified and shares, in our view, still do not look dear. But we think there is also a further reason, which is that in those countries with very serious economic problems, shares could be the best shelter from any economic crisis which may develop. Again, we will come back to this later, expanding on our thinking on this point.

At this point, we should reflect on the costs, for some countries, of this massive economic stimulus which has been given to the world economy. Whilst the stimulus has been justified in the short term, we need to reflect on what it will mean for the economies where the stimulus has been greatest.

It will be recalled that, side by side with the objective of preventing a recession becoming a depression, a further and related issue was to avoid deflation taking a grip. This would see a prolonged period of falling prices, not just odd quarters of falling prices. The dangers of deflation would revolve around the vicious circle of falling prices

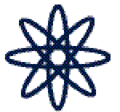


causing consumers and businesses to postpone discretionary purchases thus exacerbating the economic downturn and leading to depression. We have never thought that this was a likely result, but many people did at the time. It now seems to be much less of an issue in view of the inflationary forces which are appearing in some countries and which we think may become relevant again, something which used to be the case in the past. So we should now review the measures which were taken by many countries to stimulate their economies, starting with monetary measures.

These took two forms, but not every country took both. Where all major countries followed the same course was on interest rates. They were cut dramatically, in some cases effectively to zero, the aim here being to stimulate economic activity by reducing the cost of borrowing and relieving the pressure on companies' and individuals' cash flows. Of course, this policy also resulted in losers. For instance, in the UK, it is estimated that there are six or seven times more savers than borrowers. Negligible interest rates were also used to boost asset values in order to generate a positive wealth effect, or "feel good" factor, which may encourage more spending in an economy. The second unorthodox method, used in countries such as the UK and USA, was quantitative easing, carried out in different ways, effectively the modern day version of printing money. This, too, was targeted at economic expansion, the idea being that central bank purchases of private sector assets in exchange for newly created money would stimulate an economy. This would be done by banks lending their money more freely although that has not readily happened so far. However, as mentioned above, there has been a leakage into various assets such as shares, bonds and, perhaps, property. The UK has been the most aggressive exponent of quantitative easing. In fact, the upper limit of quantitative easing in the UK is £200 billion, roughly what the government expected to issue by way of new government stock to finance the budget deficit. In a roundabout way, the newly printed money has financed this year's expected budget deficit.

Whilst it may be argued that one, or both, of these aspects of monetary policy was justified in view of the grave economic and financial position facing the world economy, they both carry very high risks, mainly in the timing of the exit from these policies, particularly quantitative easing where used. It is self evident that printing money is very dangerous. If governments or central banks could create money to finance their deficits, the consequences would be debasement of the currency and raging inflation as increased quantities of money chased a finite amount of goods and services. The real challenge for this high risk policy is to exit it at the right time. Exit too early and any economic recovery might be aborted, exit too late and it may be impossible to contain inflation. In our view, the risk attached to the latter is much greater than to the former. However it is exited, it poses a threat to medium and long term interest rates. If we take the UK as the most extreme example, we see a country which has followed the most aggressive quantitative easing policy at the same time as having one of the worst current budget deficits. If the Bank of England were to sell back the gilts which it has purchased from the private sector at the same time as it has to issue substantial quantities of new government stock to finance the budget deficit, the collision of the two activities seems bound to lead to much higher interest rates. The mood is already starting to turn ugly in the government bond markets and higher interest rates on government debt raises funding costs and makes the borrowing situation even worse.

The dangers of ultra low interest rates revolve around the distortion they cause to financial markets. As touched upon above, we believe that is already starting to happen in the bond markets where the absence of any meaningful interest rate on deposits is pushing investors into other types of asset which offer a better yield. Shares have benefited and we would argue that, notwithstanding their rise in 2009, they still do not look expensive. The same cannot be said for bonds. Although government bonds have not performed well in 2009, we believe the distortions caused by ultra low short term interest rates and quantitative easing have meant that bond yields are well below what they should be, given the headwinds which they face. Signs of life in parts of the property market may also be a function of this distortion.



The problem with distortions in financial markets is that the bursting of bubbles, which they are liable to create, can leave very nasty side effects in financial markets and individuals' wealth with unpleasant effects for financial institutions with knock on effects for economies as a whole. The negative wealth effect can cause economic recessions. We will return to the issues in the bond markets later.

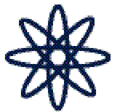
The measures taken on the fiscal front have also been extreme. Various combinations have been used such as tax cuts, increased public spending or just a passive reaction to the widening public deficits which, in a number of countries such as the USA and UK, have reached levels which one would never previously have contemplated. Budget deficits come in two varieties, cyclical and structural. Cyclical deficits arise when, in a recession, tax revenues are reduced and government spending raised, say on social security. These are the automatic stabilisers of an economy and, if not countered by government action to raise taxes or cut spending, will provide an offsetting stimulus to an economy. However, in good times, it is important that governments do not spend the extra money arising from an increased tax take or reduced government spending but, rather, keep it in hand for bad times. This is what the government of Australia did in the good times and, so, has been able to stimulate the economy which, in fact, never went into recession. On the other hand, countries like the USA, UK and some eurozone countries failed to observe this basic rule and now find themselves in a serious economic and financial position. These and other countries have serious structural deficits. This occurs when, whatever the conditions, budgets are unbalanced because government expenditure is right out of line with income. This is the serious part of the deficit since it means that the overall level of debt, as a percentage of GDP, will continue to rise, making normal assumptions about interest rates. This leaves two dangers, firstly that debt servicing costs will continually rise and, secondly, that a country's creditworthiness will be called into doubt. This phenomenon is now evident and we will discuss it later.

For those countries running significant structural deficits, and there are a lot of them, the financial imperative for them will be to address the issue as soon as they feel that they safely can. Whilst they will not want to reverse the stimulus until economic recovery is established, they cannot afford to leave it too late for much the same reasons as we mentioned for the exit from the current extreme monetary policy being followed.

The creditors of countries with high levels of public debt in relation to GDP, combined with large current budget deficits, will not tolerate inaction on addressing these issues so governments will have no option but to act. The actions of Ireland in addressing its very serious budgetary problems where, amongst other measures, many in the public sector will have to take pay cuts, is a precursor for further action elsewhere. Whatever action is taken to tackle budget deficits, whether it be public spending cuts or tax increases or, more likely, a combination of the two, this will weigh on a country's economic growth. The countries with the weakest finances and, therefore, in need of remedial action, will find growth hard to come by. They may be helped out by export markets but domestic demand is bound to be subdued as the measures to improve finances bear down on it.

In general economic terms, one can envisage a situation where international economic growth will be two paced. Those countries with the strongest financial positions, such as in the Asia Pacific region, parts of the Middle East and Brazil, should outpace those countries with poor finances, such as some western countries and Japan. This is obviously a generalisation but it is self evident that those countries which are going to have to take action to address their fiscal problems will be at a disadvantage to those where the fiscal position is stronger. In our September 2009 review, we noted on page 9 the estimated structural deficits of the G7 countries as outlined by the International Monetary Fund in its October 2009 World Economic Review. Particularly serious were the 2010 estimated structural deficits for the USA at 5.3%, France at 4.1%, Italy at 3.8%, Japan at 8.0% and the UK at 9.6%. The overall deficits were much higher because of the cyclical component on top of that.

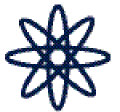
Whilst attention was focused on the banking crisis towards the end of 2008, and rightly so, the extent of the likely deterioration in various countries' fiscal positions rather took a back seat but, now, that is no longer the case and the eyes of the bond markets and rating agencies are firmly focused on those countries with weak financial conditions.



If governments, for whatever reason, pull back from addressing their fiscal problems, creditors and the foreign exchange markets (except those countries which are in the euro) will not be slow in blowing the whistle on them. Some time ago, we noted that strains were building up in the eurozone as a result of diverging economic performances. Of course, it was never meant to be like this. The economies of the eurozone were meant to converge. But the euro was a political initiative and, with the eurozone not being an optimal currency area, problems were bound to occur at some stage because "the one size fits all" interest rate and the inability of any country to devalue (or revalue, for that matter) was a completely unrealistic situation as time went on.

Divergences, as we mentioned in previous reviews, were building up but, now, with the financial and economic crisis afflicting the world economy, they are causing very serious problems. The main problems arose from the inability of any eurozone member to set its own interest rates and diverging rates of inflation. Examples of the former are Ireland and Spain, both with significant problems at present. They both experienced out of control property booms. In normal circumstances, an independent central bank would have raised interest rates to control the boom but this tool of control was given up when Ireland and Spain entered the euro. These economies experienced boom and bust and are now in a very difficult position, particularly Ireland. If we take another country, Italy, as a result of higher wage inflation than Germany, it is estimated to have lost 30% of its competitiveness against Germany over the last decade. Although building up trouble for the future, the traditional short term remedy would have been devaluation. That option is, of course, no longer available. This means that, over time, economic problems will get worse, ending up with some sort of crisis that could put a country's creditworthiness in doubt. We have now reached that position with Greece's long term sovereign debt which carries a BBB+ rating from Standard & Poors and Fitch and an A2 from Moody's. In order to restore competitiveness, in the absence of an ability to devalue, real wages would have to be cut dramatically. As mentioned earlier, this is happening in Ireland and has, of course, caused unrest, but this is as nothing compared with what would probably occur in other eurozone countries, Greece probably being a case in point. One just cannot see it happening voluntarily, nor most governments having the courage or stomach to do so. But the markets will force something to happen in the eurozone. It is instructive to look at ten year eurozone government bond yields against the benchmark German government bond, Germany being the eurozone's best credit. At the time of writing, the ten year German bond has a gross redemption yield of 3.36%. Taking some other eurozone credits, in ascending order of premium, measured in basis points over the German bond yield, the Dutch government bond premium is 16 basis points, Finland 19 basis points, France 21 basis points, Belgium 36 basis points, Austria 49 basis points, Spain 60 basis points, Italy 70 basis points, Ireland 145 basis points and Greece 238 basis points. These differences in yields do not reflect those of an optimal currency zone.

If one has to make forecasts of financial and economic issues which may arise in 2010, the strains and financial problems within the eurozone are likely to feature. Following the shocks in the banking and credit markets in 2008, investors will be very wary of other problems which may emerge. One of these, we think, will be sovereign debt and, within the eurozone, some of the weaker countries may have their resolve tested. What could happen in the eurozone? So much political capital has been invested in the project that eurozone governments will be very reluctant to allow the it to fray at the edges. If a debt default by one or more countries looks likely will other countries rally round? For example, would Germany help? One feels that, whatever the German government may want to do, the general public would be very unhappy to see the German taxpayer propping up another country. The German public was unhappy to see the Deutschemark disappear, partly because it was suspicious of the financial and economic resolve of other countries. One feels that, possibly with the exception of Ireland, the resolve or ability of the weaker eurozone countries to take the necessary steps to address their fiscal problems and restore competitiveness may not be there. There, therefore, arises the possibility that some of the weaker members may leave the eurozone. This would be extremely difficult. Reverting to their former currencies would mean a devaluation against the euro which would exacerbate their debt repayment problems and servicing problems and probably lead to default. But staying in would be equally difficult if governments found it impossible to take the



necessary measures. What is certain is that things cannot go on as they are. Something has to give and 2010 will be an important one for the eurozone and the concept of monetary union.

If sovereign debt issues arise in the eurozone, they arise elsewhere, too. Looking at the table to which we referred, the UK looks the most vulnerable with the vast size of the structural deficit showing the magnitude of the task facing whichever party forms the next government. It is the UK which gives us most concern amongst the major economies and it is difficult to overstate the gravity of the state of the UK's public finances. Because most of our clients are sterling based, it is worth spending some time discussing possible outcomes of this problem.

The immediate point to mention is that our client portfolios are well diversified geographically. We have always believed that geographical diversification is prudent even when the UK economy did not have the problems which it has now. Most countries have economic problems but some are worse than others and into this category we place the UK. For that reason alone, geographical diversification is important. We saw this, for example, in 2008 when the pound fell heavily. Overseas, unhedged overseas exposure reduced considerably the pain of a very bad year for stock markets.

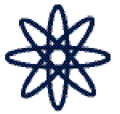
Bedevilling the situation in the UK is the imminence of the General Election which is causing politicians to go into denial about the gravity of the economic situation. The Pre Budget Report failed to give clear guidelines as to how the problem is going to be addressed. A bill in the Queen's Speech to specify debt reduction targets is merely a meaningless wish if not backed up by a clear action plan. All the political parties have to be up front about what needs to be done, otherwise, when the inevitable unpleasant medicine has to be administered, there will be public anger that the politicians had not prepared them for what has got to happen. The measures just announced in Ireland are a precursor of what will have to happen in the UK.

It has been assumed, although we think it is a dangerous assumption, that markets are giving the UK time to have its election and that whichever party emerges victorious will then be expected to announce drastic measures to address the situation. The worst outcome would be a hung parliament because, given the unusually high level of antipathy between the UK's political parties, it is difficult to see them agreeing on anything. It is likely that markets would react very badly to this outcome.

As we say, we do not accept this assumption. The deterioration in the situation in Greece, exacerbated by the new government's disclosure that public finances were in a far worse state than previously indicated, has alarmed markets which are looking at further candidates for potential credit rating downgrades. As this is written, the pound is falling against the US dollar and some other currencies, although the euro has weakened almost certainly as a result of worry about the Greek position. Sterling government bond yields are also rising and the ten year government bond yield has risen above 4.0%. With a chronic current account deficit and a very large budget deficit, the weak fundamentals could catch up with the UK at any time. The contrast between decisive action in Ireland and lack of clarity in the UK's approach to debt reduction is stark.

What are the possible outcomes of the present position in the UK? Dealing firstly with the optimistic scenario. This will see the present government or next government of whatever complexion taking decisive action on public expenditure with as little reliance as possible on tax increases, which will have greater long term negative effects, to put the UK's public finances on a sustainable path to deficit reduction. As mentioned earlier, these measures will depress domestic demand so economic growth will be slow. They are also likely to depress sterling which should give the UK some competitive advantage although, with the decline of manufacturing in the UK, this benefit should not be overstated. Even the best case scenario means a long haul to sound finances for the UK but at least a convincing policy should mean that markets will give the UK the benefit of the doubt.

That is not likely to be the case if the markets are not convinced by government policies to address the problem and this could mean a very unpleasant situation for the UK. The credit rating agencies have already marked the UK's card, indicating that they expect decisive action to address the deficit. If the UK loses its top credit rating, it



will have to pay a relatively higher interest rate, making debt servicing costs more expensive. It is estimated that about a third of the gilt market is held by overseas investors. Should they take fright and sell, bond yields could rise very sharply. Within the eurozone, we have seen what has happened to Greek bond yields and, already, UK government ten year government bond yields are nearly at Italian levels and Italy has a lower credit rating than the UK. In the worst case, a collapse of confidence in the UK government bond market could cause a major problem in financing the deficit with fears that it could be monetised. A view that serious efforts were not being made to address the deficit problem could undermine sterling. The stakes are very high with potentially very serious consequences for the UK if the debt issue is not addressed properly.

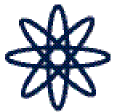
Whilst we have spent some time addressing the particular issues with the UK, high levels of borrowing are an issue nearly everywhere, and the large sums which have to be borrowed by governments are likely to exert an upward pressure on bond yields. When investors were extremely risk averse, government bonds seemed to be a safe haven but now that investors feel more confident about the security of bank deposits and the ability of the authorities to deal with the banking situation, they have been prepared to consider other assets away from government bonds, hence the rise in yields over the year as our table at the beginning of this review shows. Where quantitative easing has been applied, the reversal of this process, as mentioned earlier, will present an additional issue for bond markets and yields.

If we return to the IMF's table of General Government Fiscal Balances as a percentage of GDP contained in our September review, we also note the high overall imbalance in the USA. There is no doubt with the Administration's future spending plans on top of the present level of spending that the USA faces serious public debt problems. However, it has one advantage over the UK which is that, with the US dollar being the world's largest reserve currency, it is not in such an exposed position as the UK. Foreign investors do not take such a risk selling sterling as they would US dollars because the much greater value of the latter in their reserves would render such a policy detrimental to the value of their remaining holdings of US dollars. This is not a reason for fiscal profligacy but it does give the USA an advantage in terms of a breathing space to correct its imbalances. Whether or not it takes it is at the mercy of a political system which does not make control of public expenditure easy.

Also, on page 11 of September's review we quoted examples from the IMF's World Economic Outlook table of the G7 countries' expected level of net debt as a percentage of GDP. Apart from Canada, the figures make for ugly reading. Italy has a chronic problem and is one of the weak links in the eurozone's financial disciplines but the one which stands out most of all is Japan. Japan has been helped by very low interest rates which have contained its servicing costs but its problems are severe, more so as a declining personal savings ratio has been apparent in Japan for some years.

The recession resulted from the financial sector crisis and, as we look back on a year which has seen a recovery in equity market prices, it is easy to forget the wall of worry which so unnerved investors towards the end of 2008 and in the early part of 2009. Fears about the safety of bank deposits drove investors into secure investments like government bonds and Treasury Bills. We can now see that the authorities' action around the world to reassure depositors removed perhaps investors' greatest fear and led to the recovery which started in March. Investors dislike uncertainty and the removal of that particularly worrying concern was certainly instrumental in improving investor sentiment. Added to which was the effect on asset values of quantitative easing, where applied, and ultra low interest rates which drove some investors to other assets providing a yield. We discussed the effects of these factors earlier in this review.

Whilst the problems of certain financial institutions have moved somewhat into the background, a number are still relying on governments and central banks for their day to day existence. Recession or weak economic growth call into question the value of loans advanced when things seemed so much better. All these issues have to be worked out. As always, those companies (financial institutions in this case) which have weathered the storm best will be able to strengthen their position. We see this in the results of the strongest banks. One has the impression



the governments and central banks have found ways of handling problems in the financial sector, albeit at great cost and that is a positive development for markets for it has removed a major worry.

What does 2010 hold for investors and the world economy? Most forecasters expect a return to growth, albeit at a low rate following economic contraction in most economies in 2009. If we take the forecasts of the IMF and OECD for 2010 (2009 estimated figures in brackets), the IMF forecasts US growth at 1.5% (-2.7%) and the OECD 2.5% (-2.5%). For the eurozone, the IMF forecast 0.3% (-4.2%) and the OECD 0.9% (-4.0%). For Japan, the IMF forecasts 1.7% (-5.4%) and the OECD 1.8% (-5.3%). For the United Kingdom, the IMF forecasts 0.9% (-4.4%) and the OECD 1.2% (-4.7%). The IMF expects China to grow by 9.0% (8.5%) in 2010 and the OECD expects it to grow by 10.2% (8.3%) in 2010. Respective figures for India from the IMF are 6.4% (5.4%) and the OECD 7.3% (6.1%). Other parts of Asia are expected to exceed western rates of growth. The IMF expects the Newly Industrialised Asian Economies to grow by 3.6% (-2.4%) in 2010. These figures are evidence of the magnitude of the shift of power from western economies and Japan to the east, not to mention countries like Brazil where, after zero growth this year, the OECD expects growth of 4.8% in 2010. So, one forecast, of which we can be almost certain, is that, in 2010, the disparity in performance of these economies will continue, with their effect being to provide the catalyst for some growth in the world economy overall.

Another forecast is that there will be further growth in protectionist sentiment. This is a trend which needs watching carefully for, if allowed to grow unchecked, it could be a serious threat to world economic growth. It is a cheap shot for politicians to advocate protectionist measures to support home industries without considering the wider damage which it can do. They distort trade patterns and leave most people worse off. A full scale trade war would be damaging for stock markets because it would slow down economic growth. This is something to watch for in 2010.

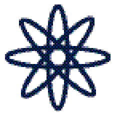
The financial sector is very unpopular because of the taxpayer support which many companies have needed when they go into trouble. This is understandable. However tempting it is for populist politicians to attack the sector, it is a question of being careful what you wish for. Unwise attacks, either through tax impositions or hostile rhetoric, can end up costing a country dear. The UK is obviously a case in point. The financial sector has required enormous support but the sector is one at which the UK excels. Other countries would be delighted to attract some of the business. If the current populist outcry permanently damages the economy's tax base, the situation will be difficult to recover. Investors need to be aware of this trend because of its longer term effects.

In 2010, markets could be unnerved by problems in the sovereign debt market. We have talked about this earlier on, suffice it to say that this would be a particular issue for bond investors. We expect investors to place great emphasis on quality. Bond rating agencies are bound to downgrade some sovereign credits.

We would tie this issue in with the eurozone, the problems of which we described earlier. There are likely to be more downgrades during the year and worries about defaults. How the eurozone governments and the ECB tackle this will be interesting given the huge political capital invested in the project. The build up of problems will come to a head sometime in 2010, we think, because the economic pressures on weaker eurozone economies will become unbearable.

We have discussed quantitative easing earlier in this review and touched upon the difficulties in calculating the right time to reverse it. It must be reversed, otherwise the newly created money, if it is not withdrawn from the economy, will create inflation. Because different asset markets have been buoyed by quantitative easing, it is logical to argue that its reversal could cause the opposite effect as it could lead to higher interest rates. It was a high risk policy, where used, but it was introduced in an unprecedented situation. If not handled carefully, it could cause a problem in some markets where it has been introduced as a policy measure. This, too, will probably be an issue in 2010.

2010 will certainly see some brutal economic retrenchment in countries whose public finances are in a serious condition. How will markets react to the measures? One would put it no higher than to say that it is possible for



stock markets to perform positively notwithstanding restrictive economic measures, however tough they are. Why must this be the case? If investors feel that the correct economic policies have been laid down, it may give them more confidence to invest in a country because it lowers the risks of investing there. Secondly, a point which is highly relevant to the UK, is that many companies are highly international in their businesses so that they can diversify the risk away from their home country. Thirdly, if a country takes measures which show that it is serious about tackling its deficit problems, that may improve the interest rate outlook, something which should benefit shares. In the case of Ireland, if the market is impressed with the measures taken, it may lower the relative cost of money. As we saw earlier, in the eurozone, this can be measured by the relevant country's bond yield premium over the current best credit, Germany.

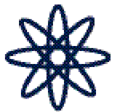
Currency volatility may be expected to be a feature of 2010. If serious problems emerge within the eurozone in the way we discussed earlier, that could adversely affect the currency. We have noted that, since the Greek problems developed in such a dramatic way, the euro has been weak against the US dollar. If there is a crisis within the eurozone in 2010 because of the financial problems of one or more members of the monetary union, one's intuition is that it will not be helpful for the currency. These are the early indications from the fallout from Greece's problems.

Sterling is the currency most at risk, we believe. We have dwelt at some length on the issues surrounding UK public debt. Sterling is highly vulnerable to any suspicion that the government of the day is not serious about tackling the UK's public debt problem. So poor are the UK's fundamentals that the issue could blow up at any time.

It is fashionable to believe that the US dollar is vulnerable because of the imbalances in the US economy. In fact, the current account deficit has approximately halved since its peak in 2006. Its domestic public debt situation, as the earlier IMF table shows, is serious. But currency movements are a zero sum game. Even if all the major economies with freely floating currencies are in trouble, not all currencies can go down against each other. Therefore, given the problems that other countries and currency unions have, the potential relative weakness of the US dollar is not a foregone conclusion. As the level of Japanese debt shows, Japan also has serious debt problems. Of course, as we mentioned earlier, the US dollar, although declining in importance in the composition of world foreign currency reserves, is still the most important reserve currency, which gives it an advantage over smaller currencies like sterling.

As the forecasts from the IMF and OECD show, overall economic growth is expected to resume in 2010 in those countries which have been mired in recession in 2009, whilst countries like China, many parts of Asia, India and countries such as Brazil will grow much faster. This should assist a recovery in corporate earnings which is necessary to validate part of the rise in share prices in 2009. In many cases, where earnings have increased in 2009, it has been the result of cost cutting rather than top line revenue growth. Modest economic growth should give some help to top line growth and those companies exposed to parts of the world which are growing rapidly should particularly benefit. As a consequence of this, dividends, which have been adversely affected by the recession, should show some growth in 2010, helpful at a time when bond yields have started to rise.

As we look back twelve months to the review we wrote at that time, we indicated that we expected the equity market to anticipate better times even though economic recovery would be slow. We also said that we thought much of the bad news was already in share prices. We indicated that we thought, in the context of top quality bonds, that medium and long dated issues everywhere looked very exposed. For the first two months of 2009 and a bit of March, equity investors had to endure a torrid time before the dramatic recovery started in March. What we did not know was the extent of quantitative easing which, where applied, has given rather a low quality boost to share prices. The UK is a case in point and we discussed this phenomenon earlier. The year, therefore, turned out broadly as anticipated, though perhaps we were surprised at the rate at which share prices advanced. We are, however, in such unusual circumstances, with so many additional issues to consider, that forecasting is not easy.



With that caveat in mind, we would make broadly the same forecast for 2010. Bonds, for the reasons mentioned earlier, remain very unattractive in our view. The sheer size of governments' borrowing requirements, the risks of inflation developing as a result of quantitative easing, where applied, or the effect on interest rates where it is reversed, not to mention the risks of further sovereign credit risk downgrades or, possibly, defaults, make current yields look most inadequate. We therefore expect high quality bonds to experience a poor year in 2010 and would only hold short dated issues. Although bonds are often thought of as safe investments which can dampen down volatility in investment portfolios, they can be highly risky investments if bought on the wrong yield basis and can take a long time to recover. If the choice were between bonds and cash, the latter, although yielding very little, looks safer, and gives the opportunity, afforded by its flexibility, to re-enter bond markets at a more realistic level. However, to us, that does not seem a near term prospect. So, for various reasons, on the information currently available, we expect shares to outperform bonds and cash in 2010. Positive reasons are expectations of modest international economic growth in 2010 and ratings and dividend yields which do not look unreasonable. We do not think that there is an asset bubble in equities, unlike bonds. If we look at economies at the high end of the risk spectrum, such as the UK, equities may provide the best protection. Having exposure to real assets through ownership of shares in an international economy which is growing may give the best protection because those companies exposed to the international economy may flourish in a way which purely domestically orientated businesses might not be able to do. If an economic crisis leads to severe currency weakness then this would provide an additional insurance policy. In these circumstances, shares could be the default asset. What is certain is that 2010 will bring surprises which we cannot presently anticipate and investment policy has to be adjusted, if necessary. However, this how we see things at present.

December 2009

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