Investment Report for the Quarter ended 31st March 2010

Market Commentary

The index returns and currency movements for the quarter ended 31st March 2010 are shown in the tables below.

Index returns expressed in sterling

		Quarter ended 31st March 2010
		%
Equities		
Japan	FTSE Developed Japan	15.4
North America	FTSE North America	12.5
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	9.8
Emerging Markets	MSCI Emerging Markets Free	9.1
UK	FTSE All Share	6.4
Europe	FTSE Developed Europe (ex UK)	3.9
Fixed Interest		
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	4.0
UK Index Linked Gilts	FTSE British Government Index Linked Over 5 years	2.0
UK Gilts	FTSE British Government All Stocks	1.1
Property	IPD	Not available
Cash	Merrill Lynch LIBOR 3 Month	0.1

Currency Movements for quarter ended 31st March 2010

Currency	31st December 2009	31st March 2010	Change %
USD/GBP	1.615	1.517	-6.1
EUR/GBP	1.126	1.121	-0.4
USD/EUR	1.435	1.353	-5.7
Yen/USD	93.095	93.440	+0.4

Head of the leader board was Japan (+15.4%). Whilst this performance reflected an improvement in the country's economy it was to an extent a catch up move from the very poor relative return experienced in 2009 when fears over deflationary conditions were paramount. Next came the USA (+12.5%) reflecting a more encouraging economic outlook, especially with regard to the recovery in productivity. The 9.8% rise for Asia Pacific reflected the continuance of strong growth and export prospects across the region, particularly in China, as is so often the case. Emerging markets again put up a robust performance in returning 9.1%, thus building on the excellent returns from this area for last year. The FTSE all share index returned 6.4%, a very creditable achievement against a background of a high fiscal deficit together with political uncertainty ahead of a General Election. The laggard on the leader board was Europe returning 3.9% despite the financial problems of Greece which

in turn fuelled concerns over other weak Eurozone countries namely Portugal, Ireland and Spain.

Within Fixed Interest, the clear first runner was corporate bonds which returned 4.0% due to the fact that it was one of the highest yielding sub sectors and not prone to sovereign debt problems. Investors also became less worried about the default risk in corporate bonds. Index linked gilts returned 2.0% due to greater fears that inflation was likely to re-emerge. UK gilts returned a subdued 1.1%, largely due to their relatively lower yields within the Fixed Interest sector and also worries over the sovereign debt problems referred to above. Another market apprehension within the gilt market was the likelihood that sterling would continue to be a weak currency. LIBOR 3 month cash returned a minuscule 0.1%. Small wonder that investors were switching out of very low yield deposits into other higher yielding asset classes, particularly equities.

The currency exchange rate table highlights the weakness of sterling over the quarter, down 6.1% against the US dollar. This weakness reflects investor nervousness in holding a currency with one of the largest global fiscal deficits expressed as a percentage of GDP

As can be clearly seen from the returns table, the resilience of equity markets experienced in 2009 has continued into the first quarter of 2010 although all markets suffered a dose of realism in January with negative returns for that month. Such resilience for the quarter has stemmed from the fact that, in most equity markets, the underlying positive influences have far outweighed the negative influences. The principal positive influences which have driven markets are as follows:-

- The still substantial levels of liquidity held in historically very low yielding deposits which have driven investors both institutional and private to switch into safe haven high quality equities on more attractive yields with strongly financed balance sheets.
- Corporate earnings and dividends have been appreciably better than expected, often accompanied by relatively optimistic trading statements.
- Inflation rates have generally been contained.
- Central banks have continued to hold interest rates at extremely low historic levels to the obvious advantage of highly leveraged companies and consumers.
- The continuing radical measures and stimuli by governments and central banks to provide essential life blood liquidity to their respective financial systems.
- The rebuilding of corporate inventories at a greater pace than expected.
- An export boost, particularly to those countries with weak currencies.
- The expectation by the IMF that world trade will make a meaningful recovery in 2010.

The principal negative and corrosive influences have been the obvious ones. That is to say, very anaemic increases in economic growth, particularly in the case of the UK and Europe. And the dramatic ballooning of fiscal deficits which is also especially marked in the UK and currently stands at a massive £178B.

Global politics have also played a part in the direction of respective equity markets and indeed other asset classes. These are highlighted below:-

In the UK

Such is the preoccupation of the three main political parties ahead of the General Election on 6th May, that any major legislation will necessarily be postponed. It goes without saying that, whichever party is elected, it will face the mammoth task of reducing the gargantuan fiscal deficit. Then expect acute cutting of public costs and severe taxation increases. In reality this process could grind on for at least 3 to 4 years. Of great concern to stock markets is the possibility of a hung parliament which could result in a weak political mandate with which to address all the country's current problems. In the meantime the Government and the Bank of England are grappling with a programme to dismantle the emergency measures created during the financial crisis not the least of which is the exit from quantitative easing (printing money) which runs the risk of re-igniting inflation.

In the USA

President Obama, after a rocky start, struggled to enact the promises for change he so eloquently extolled at the hustings. However, he has since done well, under stiff opposition from the Republican Party, to wrestle through Congress the very emotive Health Reform Bill. This is indeed a feather in his cap and has considerably enhanced his presidential status both within the USA and also on the world stage.

In Europe

The acute indebtedness of Greece has posed a problem. Angela Merkel of Germany and Nicolas Sarkozy of France would have liked to effect a totally Eurozone rescue plan to the apprehension of Trichet, head of the European Central Bank. In the event, the solution has been a joint support programme by the International Monetary Fund and the Eurozone. This should serve to protect the current Eurozone structure with its single currency.

In Japan

The newly elected Democratic Party have made a slow and disappointing start to extracting the economy from the mire of 10 years of deflation. A much more powerful economic policy needs to be urgently enacted.

In Asia

Many countries have produced worthwhile rates of GDP growth together with increasing levels of exports in strict contrast to most of the economies of their Western Hemisphere counterparts. In particular, the Politburo of China together with the Peoples Bank of China have combined to flex their mighty international muscle in many ways:- effecting deals with some of the world's largest mineral and other extractive companies in order to secure adequate future supplies for their steel, oil and gas industries and of course for increasing the future supply of water in a nation where current levels are very low. There are also signs that China is at last starting to respond to international calls for a fairer system of managing its currency, the renminbi. Indeed, high level meetings are currently taking place between the USA and China in that regard.

Regional Influences

UK

Positive Influences

- In the fourth quarter of 2009 the Office for National Statistics revised up its GDP growth estimate to 0.4% from its original estimate of 0.1%.

- In the Budget the government estimated GDP growth of 1% to 1 ½% in 2010 rising to 3% to 3 ½% in 2011.

- CPI inflation in February fell to 3.0% from 3.1% in January.

- Dividend payouts to shareholders are estimated to rise by 18% for the FTSE 100 companies.

- The Office for National Statistics reported that the trade deficit in February was £6.2B down from £8.1B in January.   This was below the consensus estimate of £7.3B and the smallest deficit since June 2006.

- Remarkably the Organisation for Economic Co-operation and Development predicts that in the first half of 2010, the UK will have the fastest rate of economic expansion of any of the World's large industrialised countries.   The UK "Think Tank" forecasts that output will increase by 2.0% in the first quarter of 2010 and by 3.1% in the second quarter of 2010.

- Ernst & Young say that corporate profit warnings dropped to a 10 year low in the first quarter of 2010.

<u>Negative Influences</u>

- In the Budget public spending is estimated to be £167B in 2010 which is £11B less than the estimate made in December, but still a shocking level.   The government estimates that the deficit will fall to £163B in 2011 and to £74B in 2014/15.

- In the fourth quarter of 2009, whilst public sector employment rose 7,000, private sector employment fell 61,000.

- The Budget, with the General Election close at hand (6th May) turned out to be an unsurprising damp squib.

- The increasing demands of our ageing population.

- Bankruptcies are at an all time high.

<u>US</u>

<u>Positive Influences</u>

- The Labour Department reported that new claims for jobless benefits fell by 14,000 to 442,000 for the week ending 19th March.   This was the lowest level since December 2008.

- In March 162,000 new jobs were created, the best performance for 3 years.   The unemployment rate remained unchanged at 9.7%.

- Larry Summers, the senior economic adviser to Obama, stated "there is the sense that the country's long term problems – healthcare, energy, education and long run fiscal deficits are being addressed.   All of these should increase a generalised sense of confidence and, this will be a source of stimulus to the economy".

- The Conference Board's consumer confidence index for March showed a strong increase for March to 52.5 from 46.4 in February.

- The US Institute for Supply Management's manufacturing index for March grew to 59.6 (February 56.5). This is the highest level since July 2004 and is in part due to a rebound in inventories.

- On 16th March the Federal Reserve Board kept its interest rate on hold saying economic conditions were likely to warrant "exceptionally low" interest rates for an extended period". Inflation is likely to remain subdued "for sometime".

- The Commerce Department stated that consumer spending in February grew by 0.3% (January +0.4%), its fifth consecutive monthly rise.

Negative Influences

- Although February new orders for durable goods advanced 0.5% this was below consensus estimates of 1.0%.

- Sales of new houses fell to 308,000 in February, the lowest level since records began in 1963.

- The National Association of Realtors reported that sales of existing houses in February decreased by 0.6%, the third consecutive monthly drop, but nevertheless an increase of 7.0% on an annualised basis.

- The Labour Department reported that the February producer price index dropped 0.6% which was worse than expected, but 4.4% higher for the year.

- The Commerce Department reduced its estimate of GDP for the fourth quarter of 2009 from 5.9% to 5.6%.

- February housing starts fell by 5.9% partly blamed on severe winter storms.

Europe

Positive Influences

- The Eurozone corporate purchasing managers' index (includes both manufacturing and services) advanced in March to 55.9 (February 53.7), it eighth consecutive month of growth and the fastest rate since August 2007.

- The European Commission reported that industrial production in the Eurozone rose 0.9% in February which was faster than expected.

Negative Influences

- Irish GDP shrank by 2.3% in the fourth quarter of 2009 partly due to devastating floods there.

- The leading rating agency Fitch downgraded Portugal's credit rating to AA- from AA stating "significant budgeting under performance in 2009" and "the structured weakness in the country's economy".

- In France the mid term election results augured particularly badly for Nicolas Sarkozy's UMP party which was trounced by the socialists.

- On 31st March Moody's, the rating agency, downgraded 5 leading Greek banks. Indeed, Greek banks have had to seek more aid as savers have withdrawn deposits due to the obvious threat over a further escalation of the current debt crisis.

- Eurostat reported that, in the fourth quarter of 2009, GDP was unchanged due in part to the phasing out of the government's emergency measures within the financial system.

During the quarter there was, unusually, a distinct paucity of macro economic data from both the Asia/Pacific region and also Japan. The principal influences are shown below:-

Asia/Pacific

Positive Influences

- China's rate of GDP surged a remarkable 11.9% in the first quarter of 2010.

- The World Bank predicts that the Chinese economy will expand by 9.5% in 2010. This represents an increase on their previous estimate of 8.7%.

- There was a surge in merger and acquisition activity in Asia.

- Singapore's GDP in the first quarter of 2010 was extremely strong and rose +13.1%.

Japan

Negative Influence

- February machine orders fell by a marked 5.4%

Conclusion

So, in conclusion, what is the principal combination of factors needed for equity returns to make further meaningful progress between now and the end of 2010 and to build on the surprisingly robust returns already achieved in the first quarter of the year? The answer is that the required factors are very much the same as those that have been needed for quite some time. They are as follows:-

- Evidence that the crisis in the international banking system is largely overcome with no further major incidents or casualties.

- That governments and central banks will be able to successfully exit from the plethora of stimuli, rescue programmes and emergency measures that they applied in 2008 and 2009; particularly with regard to quantitative easing. In exiting it will be important to ensure that the respective financial systems continue to remain adequately hydrated.

- That the main industrialised nations are able to demonstrate that their economies are healing and once again showing worthwhile underlying rates of GDP growth. In other words that these countries are climbing out of their respective recessionary conditions and thereby decreasing the oft mentioned fear that economies might relapse into double dip recessions.

- Whilst it is becoming generally accepted that, later in 2010 interest rates will increasingly have to rise, it is vital that this will not impact or snuff out a return to economic growth which in certain cases could be somewhat anaemic.

- That corporations will continue to improve productivity, rebuild inventories, strengthen their balance sheets and provide consistently rising earnings and dividends.

- That investors, both institutional and private, will continue to regain their confidence and feel good factor and make further switches out of cash into still attractive high yielding equities.

- That inflation remains under control. In that regard the finite reserves of minerals, oil and gas are concerning. OPEC estimates that the price of oil could average $80 a barrel between now and the year end. It is, of course, inevitable that inflation will pick up as economies recover.

- That fiscal deficits will be seen to reduce, especially in the UK and USA. It will also be important that, within the Eurozone, the "intensive care" economies of Greece, Ireland, Portugal and Spain are kept closely under the monitoring radar. In the case of the UK, were it to lose its triple A credit rating, then there would be acute difficulty with future gilt auctions and sterling would most surely endure further suffering. It is a current worry that, at this time in the UK, there does not appear to be a creditable policy to reduce its bloated level of structured debt.

- That there will be a distinct improvement in consumer morale due in part to an increase in employment levels together with better job security.

- It is desirable that merger and acquisition activity picks up to include IPOs (initial public offerings).

- That there is evidence that World trade is making a genuine recovery.

- That in the UK it is imperative that further globalisation takes place. However, in that regard, let it not be forgotten that Britain has very substantial international investments with almost half of the FTSE 100 company earnings coming from overseas. Not to mention their ownership of very substantial global assets.

If most of the prerequisites contained in the above wish list come to pass, and it is a big "if", then these favourable factors should be reflected in improved equity levels, particularly in emerging markets, but nothing like to the same extent as the returns achieved in 2009. In sum and at best, equity returns for the year as a whole could be in the mid to high single digit area. But, because of the strong returns already achieved in the first quarter of 2010, the implication is that the best of respective returns have already been seen for the year with quieter markets to be expected between now and the year end. Financially secure corporate balance sheets and rising earnings levels will be at a premium. Stocks with these attributes will continue to provide a sanctuary for investors, particularly those with relatively high yields. This applies to stocks both within the UK and globally. As always, foreign exchange rates will have to be most carefully watched. Particularly sterling which has been one of the worst casualties of the World recession.

With regard to other asset classes:

- Fixed Interest returns will probably be somewhat flat, particularly with regard to sovereign debt, especially UK gilts which are still under the cloud of a possible downgrade by the rating authorities. Index linked stocks could make further progress as they offer a protection against inflation which is generally expected to

increase. Corporate bonds could also make further advances, but only to a small extent after their strong returns in 2009.

- Property should continue with its gradual recovery from its most severe down cycle. There are certainly strong signs of investor interest returning to the sector to take advantage of many attractive valuations; even with regard to large trophy offices.

- Private Equity stands likely to benefit due to a greater availability of liquidity and also a distinct improvement in the IPO market. The secondary market in private equity pooled funds has current attractive offerings as it is a way of circumventing the "j" curve effect.

- Hedge Fund of Funds should continue to take advantage of current attractive opportunities. They should also continue to prove their worth as a form of portfolio insurance which is normally uncorrelated to other asset classes.

- Global Tactical Asset Allocation (GTAA) should find better opportunities than in 2009 and should benefit from lower market volatility. Also currency positioning should prove a better source of profits than in the past.

- Infrastructure should be able to further enhance its attraction as an asset class due to the many good value investments that abound, especially in the USA and China whose economies are both so dependent on an efficient national infrastructure. This continues to be an excellent long term asset class for a pension fund.

On the economic front it should be re-emphasised that strong rates of GDP growth are continuing to be achieved in China, India and Brazil. It is significant that, over the last decade, the stock markets of those countries, including Russia have outperformed the traditional industrialised countries' stock markets by an extremely substantial amount. Is this a pointer for the future? Emphatically yes. In the longer term globalisation in all asset classes should prove beneficial to pension fund performances.

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15th April 2010