Investment Report for the Quarter ended 30th June 2010

Market Commentary

The course of equities during the quarter proved to be highly volatile as markets both in the UK and globally were pushed hither and thither by a combination of rapidly moving and often highly conflicting influences. By the end of the quarter the especially adverse headwinds overwhelmed the fewer positive tailwinds and, as the return table below clearly shows, all the principal equity markets suffered without exception. By contrast, it was heartening that fixed interest returns were broadly positive as investors sort the haven of less risky assets which provided a measure of succour to the battered portfolios both of institutions and private shareholders.

Index returns expressed in sterling

	Indices	Quarter ended 30th June 2010
		%
Equities		
Emerging Markets	MSCI Emerging Markets Free	-7.0
Japan	FTSE Developed Japan	-8.7
North America	FTSE North America	-10.3
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	-10.4
UK	FTSE All Share	-11.8
Europe	FTSE Developed Europe (ex UK)	-14.3
Fixed Interest		
UK Gilts	FTSE British Government All Stocks	4.5
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	2.0
UK Index Linked Gilts	FTSE British Government Index Linked Over 5 years	1.6
Property	IPD	4.8*
Cash	Merrill Lynch LIBOR 3 Month	0.1

* Return for 3 months to 31st May 2010 (latest available)

Currency Movements for quarter ended 30th June 2010

Currency	31st March 2010	30th June 2010	Change %
USD/GBP	1.517	1.496	-1.4
EUR/GBP	1.121	1.221	9.0
USD/EUR	1.353	1.225	-9.5
Yen/USD	93.440	88.490	-5.3

Within the return table it is scarcely surprising that Europe (-14.3%) was the obvious laggard, principally due to concerns over the very future of the Eurozone and the much publicised fiscal deficits of some of the smaller European countries, especially Greece. UK (-11.8%) continued to be bedevilled by debt problems at all levels. Political worries also abounded in the run up to the General Election. Asia/Pacific (-10.4%) was troubled by the possibility that the pivotal economy of China might be slowing down at last. Japan (-8.7%) continued to be worried about the ability of its new Democratic Party to take sufficiently imaginative steps to

begin to solve the long term deflation situation which has almost become an endemic condition in Japan. Even the return for Emerging Markets fell 7.0%, but that was really because they were infected by the thought that even their robustly growing economies would be affected by a lower global demand for their exports on which they are still quite reliant.

Overall returns in the Fixed Interest sub sectors were helped by their presumed attraction as a form of insurance and sanctuary in the most turbulent and volatile background that affected other asset classes. Property continued to recover from its pronounced down cycle, especially in the UK. Advantage began to be taken of increasingly attractive prime quality valuations.

Within the currency world it was the strength of sterling against the Euro (+9.0%) that was so marked and also the recovery of the US dollar (+9.5%) against the Euro. Movements directly attributable to the Eurozone's well publicised fiscal deficit and economic woes.

This was a particularly eventful quarter when equities and other asset classes had to contend with a combination of especially adverse factors. The principal negative factors which continued to inflict damage on the markets were those that have existed for some time namely:-

- Not a day went by without further detracting news and adverse comment regarding the most worrisome fiscal indebtedness of the Eurozone nations together with their respective financial structures. The worst situations were clearly in the south of the Eurozone namely in Greece, Portugal and Spain who all suffered from weak GDP growth and high rates of unemployment. The better placed Eurozone members continued to be France, Germany and the Nordic region.

- Within the UK, the event of greatest influence was of course the General Election on 6th May and the run up period to that day. A real political fever prevailed with the media taking full advantage and predicting a wide spectrum of likely outcomes. In the event, the return of a coalition government has proved to be a calming influence. So far, the early honeymoon period of the coalition has gone surprisingly well with no apparent major disagreements.

- In the period leading up the UK's general election it was a well known fact that the country's fiscal deficit was proportionally the second highest in the European Union. At one time it was estimated to be a staggering £168B. All parties, of whichever political hue, acknowledged this fact and that, post the election, this appalling deficit could only be reduced by a programme of tax increases and most severe cutbacks in public expenditure. In reality the time for this emergency process is now and already the new coalition government has unveiled its plans in that regard. One thing is an absolute certainty and that is no person or household will be unscathed by this process as the harsh remedial medicine contained in the Emergency Budget takes grip. The bottom line is quite clear. It will take at least a three year grind to meaningfully reduce the deficit. It will indeed be a period of great collective austerity to pay for the past years of profligacy.

- The apprehension that the weaker economies with high fiscal deficits would suffer a double dip recession.

- External market influences included the intransigent situation in Afghanistan, the seemingly never ending Israeli/Palestinian deadlock and the worrisome regime in Iran with its nuclear threat Although most of these confrontational factors have over time, become discounted in the market place, they are capable of flaring up at any time and therefore have to be most carefully watched.

- It is an undeniable fact that governments and central bankers of the most indebted nations, particularly in the Western Hemisphere, are constantly wrestling with their respective debt problems. However, the proverbial silver cloud against this worrying background has undoubtedly been the continuing low level of interest rates which it has become vital to maintain in order not to snuff out fragile rates of economic growth as nations continue to struggle to recover from the malign effect of the sub prime disaster which plumbed its depth in the 2007/2008 era. It is worth recording just how low interest rate levels still are, vide:-

	%
Bank of England	0.5
European Central Bank	1.0
Switzerland	Zero to 0.75
Federal Reserve Board	Zero to 0.25
Japan	0.10

The maintenance of such low interest rates should help both consumers and corporations.

- The BP oil spill saga will most likely run and run just as the Exxon Valdez incident did back in 1989. Certainly the aggressive rhetoric of President Obama and Congress has not helped. It seems clear that they are both politicking ahead of the mid term elections in November. Of immediate impact is the suspension by BP of its dividend for 2010 and the $20B subscription to a fund specifically to pay for the spillage and all the litigious claims which will inevitably come. The dividend suspension will have a marked effect as it is generally estimated that the BP dividend accounts for some one sixth of the UK's total dividend income. It therefore follows that both private and institutional investors will be severely disadvantaged, particularly pension funds.

  - Despite the world's financial problems it is encouraging that the Organisation for Economic Co-operation and Development (OECD) has lifted its estimate of global growth for 2010 to 4.6% from 3.4% and for 2011 to 4.5% from 3.7%. A major contribution to this of course comes from the stronger growing economies of the Eastern Hemisphere. The OECD sounds a warning that growing deflation provides a risk.

  - Stock markets are anxiously waiting to see how the world banking system is to be reorganised in order to protect nations from the financial mayhem of the last three years. Apart from special taxes on banks it does seem likely that, over time, banking activities may be split between investment banking and retail banking, similar to the laws that used to prevail in the USA under the Glass Stiegel Act. Certainly the activities of banks are going to be most stringently monitored and regulated from hereon. Stress testing is just a start. It is encouraging that, within the UK, responsibility for the banking system is now entirely that of the Bank of England. That is how it should be. Thus avoiding the tripartite system (Treasury, Government and Bank of England) that proved so slow and inept at the time of the financial crisis. The changes will take time to unfold, but the result will surely be a more highly regulated, transparent and safer financial system with much lower levels of leverage and also improved liquidity.

UK

Positive Influences

- The mood from the factory floor and the manufacturing industry is, on the whole, more optimistic than the seemingly constant economists' gloom.
- There is to be a new budgeting watchdog called the Office for Budget Responsibility "to provide independent economic and borrowing forecasts for the Government".
- On 19th May the Bank of England held interest rates.
- In the quarter to 30th April 2010, 31,038 new houses were registered, a substantial 74.0% increase on a year ago.
- New car registrations were 11.5% p.a. higher in April.
- Unemployment fell by 34,000 to 2.47M people in the quarter to 31st May. For the month of May the unemployment rate inched lower to 7.8% from 7.9% in April.
- There is no shortage of international companies wishing to get close to the embattled BP, not the least of which is Petro China, that country's largest oil and gas producer.
- Within the Emergency Budget of 22nd June, the Office for Budget Responsibility forecast that GDP would grow 1.2% in 2010, 2.3% in 2011, 2.8% in 2012 and 2.9% in 2013. The Budget also estimated that CPI would fall to 2.7% by the end of 2010. Additionally, it forecast that the percentage of unemployed people would fall from 8.0% in 2010 to 6.1% in 2015/16. It was also announced that there would be a levy on bank balance sheets by January 2011, that corporation tax would be cut by 1% over the next 4 years taking it down to 24% by 2014/15, that VAT would increase to 20% from the current 17 ½% from 4th January 2011 and that the rate of CGT would rise from 18% to 28%.
- The Office for National Savings reported that public sector net borrowing was £16.0B in May versus consensus estimates of £18B.
- The Chancellor George Osborne announced that the FSA would be abolished with a commensurably sweeping increase in the powers of the Bank of England. The principal new remit for the Bank of England is to prevent a build up of risk in the financial system in addition to the Bank's monetary policy roll.
- Retail sales in June advanced by a resilient 1.0%, the strongest increase for a year.

Negative Influences

- The British Bankers' Association said that lending to financial companies in April fell by £1.1B.
- The fiscal budget now stands at a mammoth £156B.
- On 1st June such was the concern over the leakage from BP's Macendo deep water oil well in the Gulf of Mexico and its damage to the eco system that the company's shares traded 13% lower on the day. It was feared that BP might default on its debts. Additionally, the Obama administration was pressurising BP not to pay

shareholders a dividend before the total cost of the oil spill clean up could be estimated.

- On 10th June the Bank of England left interest rates unchanged.

- Whilst the purchasing managers index increased fractionally in May to 55.4 from the 55.3 level of April, this was a lesser figure than the market had been expecting.

- In the first quarter of 2010 the deficit in goods and services reached £9.7B from the £8.7B in the previous quarter. The principal excuse for this deterioration was the weakness in demand from the Eurozone, the UK's biggest trading partner.

- CPI inflation in June was 3.2%. This compares with the government's target of 2.0%. Inflation was affected both by the high price of oil and also January's VAT rise from 15% to 17.5%. A year ago Mervyn King (the Governor of the Bank of England) had been forecasting inflation of only +0.7%!

- In the first quarter of 2010 there were a record 35,680 insolvencies.

- The overly aggressive rhetoric being used against BP by President Obama is no doubt spurred by November's mid term elections. His recent hostile attitude is scarcely likely to improve Anglo American relationships at this critical time. Perhaps Obama should recall that the sub prime and consequent financial banking disaster was spawned in the USA. Two can play the international blame game!

- The International Monetary Fund estimates that the UK GDP growth rate will be 1.2% in 2010 and 2.1% in 2011 versus the government's estimate of 2.3%.

- The National Institute of Economic and Social Research estimates that GDP grew by 0.7% in the second quarter of the year.

- The new Office for Budget Responsibility (OBR) forecasts that the overall fiscal deficit for 2010/11 will be £155B down from original estimates of £163B.

- The Fitch rating authority reduced its BP credit rating from AA to BBB.

- BP announced, in the aftermath of the oil spill and pressure from the US government, that it would suspend its dividend this year and pay $20B into a ring fenced account to be phased over 4 years specifically to clean up the damage as a result of the spill.

- Industrial production receded 0.4% in May against estimates of +0.4%.

- The Government decision to switch from using RPI to CPI when updating the value of private pension payments has caused a stir in the fixed interest markets where the prices of index linked bonds fell.

North America

Positive Influences

- Construction spending grew by 2.7% in April.

- On 1st June the Bank of Canada raised interest rates by a ¼% to ½%, the first rate increase since July 2007.

- The Commerce Department reported that retail sales advanced by 0.4% in April. This was twice the economists' consensus estimate.

- The unemployment rate for June eased back to 9.5% from May's 9.7%.

- Headline inflation decreased to 3.2% p.a. in June (May 3.4%).

- On 23rd June the Federal Reserve Board (FED) kept interest rates unchanged.

Negative Influences

- The trade deficit in May was $40B, little changed from April and March.

- President Obama ordered all 33 deep water oil rigs in the Gulf of Mexico to halt drilling. Indeed, he proposed a 6 month moratorium on offshore drilling. This will certainly impact both economic growth and also job creation. Ready access to energy has always been so vital to the US economy and has been considered somewhat of a divine right by the population.

- The Commerce Department revised the first quarter 2010 GDP growth rate from 3.2% to 3.0%. This compares with economists' estimates of 3.4%.

- Existing home sales dropped by 2.2% in May whilst new home sales fell by 32.7%, the lowest level since records started in 1963.

- The FED reduced its estimate of GDP growth in 2010 to 3.0 – 3.5% from its previous April estimate of 3.2 – 3.7%.

- June retail sales fell a further 0.5% from May's slide of 1.1%. This was worse than forecast.

- The Institute of Supply Management's index of non manufacturing business decreased to 53.8 in June (May 55.4).

- The Conference Board's confidence index fell dramatically to 52.9 in June from 62.7 in May. This was a much steeper fall than expected due to the state of the economy and the labour market.

- The National Association of Realtors announced that pending house sales collapsed by 30.0% in May against economists' estimates of a 12.5% fall.

- The Institute of Supply Management's manufacturing index declined to 56.2 in June against May's 59.7, a much larger drop than expected.

- The US labour force shrank by 652,000 in June, the second largest monthly fall since 1995.

- Durable goods sales fell by 1.1% in May.

- Housing starts fell by 5.0% in June.

Europe

Positive Influences

- On 10th May the European Union and the International Monetary Fund announced a €750B rescue plan to help the most indebted nations within the Eurozone.
- On 13th May Portugal introduced an emergency tax on wages and profits to help tackle the nation's budget problem.
- On 27th May the Spanish parliament passed an austerity package. Not before time.
- On 10th June the European Central Bank (ECB) left interest rates unchanged. The ECB's governor announced unlimited 3 month loans to last to the end of 2010 in an attempt to encourage banks to meet their customer financing needs.
- On the whole, corporations in Sweden, Finland and Norway have exhibited robust earnings growth, outperforming most other European countries.
- Several Eurozone countries have now imposed a ban on short selling programmes. These bans were initiated by Germany, especially in regard to Eurozone government bonds.
- There are now, at last, some signs that Portugal and Spain are introducing emergency measures to improve their finances.
- In a great austerity drive Spain cut civil service pay by 5% to help reduce the country's budget deficit.
- China's State Administration for Foreign Exchange, which manages the country's currency reserves, stated "Europe has been, and will be, one of the major markets for investing China's exchange reserves". Similar backing for the Euro was also stated by the Kuwait Investment Authority and South Korea.
- The Eurozone is conducting stringent stress tests on 91 banks focusing upon balance sheet strength.
- Trichet, head of the ECB, stated "a double dip recession is not at all what we are observing".
- Angela Merkel, the German Chancellor, announced an additional €80B of public spending cuts.
- German industrial production increased by 2.6% in May in part due to strong demand from China.
- German exports expanded by a marked 9.2% in May.
- German engineering orders in May advanced by a prodigious 61.0%.
- At the EU Summit meeting on 17th June there was a call to impose a general levy on European banks to ensure that they contribute to the cost of overcoming the financial crisis.

- Spain is to reform its rigid labour market and is to publish stress test results on its banks. At last a step in the right direction.
- France is to increase its retirement age from 60 to 62.

Negative Influences

- Hungary's economic condition became increasingly weak with the previous government having manipulated the official macro economic data. Rather like the Greek government.
- The Cajasur savings bank failed and its control was passed to the Bank of Spain. There are 45 such banks most of which are involved in Spain's ailing property market.
- Eurozone banks have become increasingly reluctant to lend to each other for fear of the counter party risk. As a result there has been a relentless rise in 3 month EURIBOR, the rate at which European banks charge each other for lending in Euros.
- France's purchasing managers' index for May eased back to 55.8 against 56.6 for April.
- On 31st May the ECB stated the Eurozone financial sector and economy are facing "hazardous contagion" from the region's debt crisis and forecast €195B in bank write downs this year and next.
- The Fitch rating agency down graded Spanish debt from AAA to AA+.
- Germany's ZEW index of investor confidence slumped to 45.8 in May (April 53.0).
- To underline the seriousness of the Eurozone situation the German Chancellor, Angela Merkel, said "what is at stake is no more and no less than the future of Europe, and with it the future of Germany in Europe". This statement was made in the Bundestag regarding support for Greece's drastic 3 year austerity programme.
- There are clear signs that the German Chancellor Angela Merkel's coalition government is showing further weakness.
- On 26th May a German 5 year bond auction failed, clearly demonstrating investor apprehension.
- German industrial orders in May fell by 0.5%, in marked contrast to the rise of 3.2% in April.
- German unemployment rose to 7.7% in June from 7.5% a year earlier.
- Eurozone unemployment fell by 6,000 in April, the first drop for 2 years.
- Angela Merkel, Nicolas Sarkozy and Silvio Berlusconi find themselves in an increasingly parlous state with their respective electorates. This is partly due to the harsh measures they have been enacting to bolster their economies.

Japan

Positive Influences

- The annualised rate of GDP growth for the first quarter of 2010 was revised up to 5.0% p.a. from 4.9% p.a.

- On 4th June Naoto Kan was elected the new leader of the Democratic Party after the resignation of Yukio Hatoyama as prime minister who had failed to live up to the electorate's high hopes for him. Mr Kan's leadership style is allegedly more dynamic than his predecessor. It is to be hoped that he and his party will be able to enact the essential strong measures which are so urgently needed to address Japan's economic woes.

- On 16th July the Yen surged to its highest level of the year against the US dollar.

- Exports fell by 1.2% in May (April +2.3%)

Asia/Pacific

Positive Influences

- The Chinese government hinted that, through its State council, property taxes would be reformed in order to cool down the developing property bubble.

- China has agreed to spend £16B building oil refineries and other petroleum related infra structure in Nigeria in order to boost its reserves of crude oil.

- China's exports at +48.5% in May were much higher than estimated.

- China's trade surplus in May was $19.5B compared with only $1.7B in April

- On 19th June China announced it planned to introduce more flexibility into its exchange rate. It therefore seems likely that the currency peg between the renminbi and the US dollar will be broken. This announcement was cleverly timed, a week ahead of the G20 summit meeting.

- Singapore's first half 2010 GDP growth rate was a stupendous 18.1% p.a.

- The Australian economy added 45,900 jobs in June well ahead of estimates of 15,000.

- On 11th June the New Zealand central bank raised interest rates by ¼% to 2 ¾%.

- On 27th June the Reserve Bank of India raised interest rates by ¼% to counter rising inflation (10.2% in May).

- In the first quarter of 2010 India's GDP grew by 8.6%.

Negative Influences

- Australia announced plans to impose a 40% tax on the profits of resource companies. Subsequently this proved to be a contributing factor in the replacement of the hitherto popular prime minister, Mr. Rudd.
- In China the purchasing managers' index of the Chinese Federation of Logistics and Purchasing fell to 53.9 in May from 55.7 in April, reflecting lacklustre demand from domestic and foreign markets.
- China's rate of GDP for the second quarter of 2010 fell to +10.3% (first quarter +11.9%).
- China's industrial production in June was 13.7% p.a. down from 16.5% p.a. in May.
- The purchasing managers' index in Korea for June decreased to 53.3 (May 54.6) whilst that of India receded to 57.3 in June from 59.0 in May. China's purchasing managers' index for June fell to 52.1, down from 53.9 in May.
- India's industrial output in May increased by 11.5% p.a. compared with the April rise of 16.5% p.a.
- Tensions between North and South Korea were further inflamed when the North Korean navy torpedoed a South Korean ship.

Conclusion

To an extent the dismal returns of the reported quarter to 30th June 2010 go some way to discounting all the many uncertainties which currently prevail in the market place, and it goes without saying that it is investor uncertainty, both institutional and private, that is continuing to negatively influence most asset classes. So when will the clouds of gloom part to produce a better market background in which equities, in particular, can recover their losses and once again make worthwhile advances? The answer appears relatively simple. That is to say the following will need to happen:-

- Banks to be restored to a measure of health with genuine stress tested stronger balance sheets. No more debt ridden skeletons should fall out of financial cupboards. This will be especially pertinent within the weaker Eurozone countries like Greece, Spain, Portugal and Ireland.
- Corporate earnings statements will need to reassure shareholders that their respective dividend streams will be maintained and preferably increased. They will also need to reassure that earnings will not be too badly impacted by the current recessionary background and that dividend levels can be maintained or even increased.
- It will be important for governments and central banks to demonstrate that they are enacting the remedial medicine so badly needed, in the Western Hemisphere especially, to resuscitate economic growth and to thereby improve the morale of banks, industrial companies and consumers. Most vitally, it will be essential for banks to be more prepared to lend to those companies and individuals whose spending is an essential stimulus to national economic growth.

- That governments are seen to take proactive measures both to stimulate current levels of economic growth and, at the same time, to ensure that inflation rates will be kept under control. This will be a difficult tight rope walking test which will probably result in pre-emptive increases in interest rates from the present record low historic levels. Such interest rate increases are likely to be incremental and modest.

- The most critical ingredient of all will be that it can be clearly seen that at last the current horrendous levels of fiscal deficits are being meaningfully reduced by timely actions by respective governments and central banks.

- It will be necessary for sufficient liquidity to continue to be injected into the financial system to provide the essential life blood on which consumers, economies, corporations and most asset classes are so reliant.

- And finally, that the threat of a double dip recession in the principal industrial economies can be removed to the relief and comfort of all investors. Rather than a double dip, it seems more likely that economic growth in the Western Hemisphere will be positive, but somewhat anaemic. On the other hand the economies of the Eastern Hemisphere should continue to demonstrate strong growth, but at a lesser pace than in 2009.

If sufficient progress can be made to achieve the above supportive conditions then, and only then, will equity markets breathe a collective sigh of relief and start to make up for so much lost ground. Fixed Interest markets will, as they usually do, continue to focus manically on the rates of national inflation, central bank action and other macro economic data. For this reason, fixed interest returns between now and the year end could be somewhat lacklustre, despite the attraction of this investment class as a safe haven. In general, central bank interest rates are likely to remain very low especially in the UK and USA. Only in the Asia/Pacific region could they increase to any extent. It therefore follows that returns on deposit cash will likely continue to be miserably low.

With regard to other asset classes; Hedge Fund of Funds, Global Tactical Asset Allocation and Currencies are likely to continue to struggle due to the common problem that there is still too much correlation amongst most asset classes. Therefore there are less anomalies of which to take advantage. However, opportunities exist within private equities as liquidity improves and the secondary markets appear increasingly attractive. Infrastructure also benefits from better liquidity and growing demand for its wide spread of underlying sectors such as:- road and bridge tolls, airports, utilities (especially water management), airports, prisons, hospitals and oil terminals. Opportunities also exist within commodities, but because this is a relatively volatile asset class a longer term view is necessary. It is worth re-emphasising that, in the longer term, alternative asset classes have a real role to play in a pension fund and an amalgam of these classes should serve to reduce the portfolio's long term risk. The caveat is that their performance attribution has to be most carefully monitored. Certainly to a much greater degree than the classic asset classes of equities, fixed interest and property.

In sum, despite the current collective gloom, it seems reasonable to suggest that for 2010 as a whole equity returns could be in the high single digit area. If that is achieved it would come as a relief to many and a distinct surprise to some of the current doomsayers and overly pessimistic media and financial journalists.

Valentine Furniss
25th July 2010