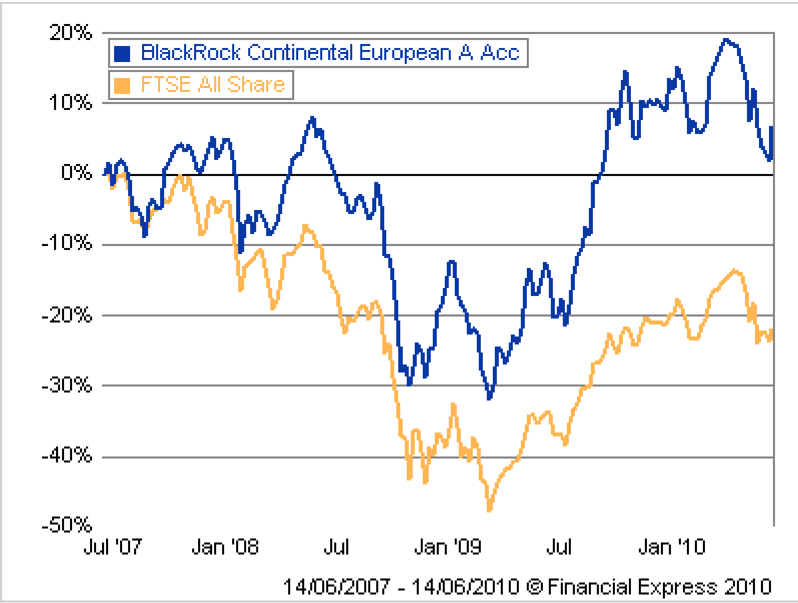
Investment View – June 2010

Economic uncertainty has increased over recent weeks as a result of the growing euro crisis. On the other hand global corporate default rates recorded a sharp month-on-month fall in May, reflecting the generally improving economic outlook and better credit conditions in the wider sphere. Industrial production in the eurozone grew for an 11th consecutive month in April, although with ever widening divergences between the main and peripheral states.

These contrasting signals have triggered a significant rise in volatility over recent weeks with falls in equity markets and rising government bond prices producing lower yields. Although market risks have increased as a result of the many commentators view that as the type of correction that had been widely expected following the strong rally of the previous 12 months.

One result has been valuations of equities compared to sovereign bonds falling back to exceptionally attractive levels. In both the UK and the euro area equity dividend yields have risen above the levels of 10 year government bond yields. This is a remarkable and very rare event.

The good news is that when it last happened in March 2003, which was the first time in over 40 years, it marked the end of the last bear market. Set against the backcloth of continuing upgrades to forecasts for corporate earnings from analysts, the next 12 months will be interesting, to say the least.



Our recent policy of maintaining an increased weighting towards Europe and against the UK has proved especially beneficial over the last 12 to 18 months as the chart shows. However, given the rising fears of the sovereign credit crisis spreading to other nations such as Spain and Portugal this policy will be reassessed carefully over the next few months.

In terms of global economic activity like everyone else we expect only modest growth, which in turn is likely to result in keeping inflation down, and we therefore do not expect any rises in official interest rates in the major developed economies for the foreseeable future.

In the UK the new coalition government having a sizeable majority has supported the rally in gilt prices. Aggressive cut backs in public spending should help to stabilise the deficit, although it will remain at uncomfortably high levels for some time to come. There will be obvious implications for economic growth as public sector cuts will surely raise unemployment and keep wage growth subdued elsewhere.

Inflation fell to 3.4 per cent in May providing support for the Bank of England's view that the current rise is a short term spike reflecting the rise in VAT and the fall in sterling which has pushed up the costs of imports. Many commentators expect interest rates to now remain on hold for another 12 to 18 months. This increase in inflation has had the apparently benign effect of reducing the national debt as a proportion of GDP. While quantitative easing has clearly helped to achieve this the big question is whether the government can keep the lid on the cost of living without raising the cost of borrowing.

In contrast with the developed economies we expect upward pressure on interest rates in some of the faster growing emerging economies such as China at least in the short term. Chinese inflation rose in May above the 3% target set by the government for the year, at a time when wage pressures in the economy were also rising. But other indicators suggested that growth in the Chinese economy was lower than expected. Industrial production dropped to a year-on-year increase of 16.5% in May, against 17.8% the month before, suggesting that some of the government's tightening measures, including a clampdown on property speculation, are beginning to work through the system.

The institutional property market in the UK has inevitably paused for a breath following some spectacular gains over the last year, some funds achieving 20% increases in unit price year on year. The rapid rebound in capital pricing in the second half of 2009 was clearly not sustainable and as was predicted. The capital element of the return on the IPD Monthly Index, which reflects a wide range of pooled property funds, has reduced in recent months, with the 0.8% rise in April representing the lowest gain since the recovery began last August.

The inflows to property over the past year were not driven by fundamentals but the wall of cash created by quantitative easing and the low levels of income available from government bonds. We now expect a period of consolidation where rental yields remain attractive relative to cash deposits but little growth in valuations. Vacancy rates are drifting lower and there are signs of a stabilisation in rental values. Income is re-establishing itself as the main driver of long-term returns, with active asset management also growing in importance. Valuations remain reasonably attractive, with property offering a healthy yield premium compared to most other asset classes.

The IPD Monthly Index still yields 2.7% more than the 10-year benchmark gilt, 1.3% more than sterling investment grade corporate bonds, 3.4% more than UK equities and 6.1% more than cash. In most cases these yield differentials are wider than the historical norm, suggesting that even if inflows have abated in recent months, we are not about to enter a period of outflows from commercial property.

However, we expect to see positive rental value growth resume in the coming months and, meanwhile, the long leases and upward-only rent reviews that characterise UK commercial property have helped to insulate the actual rents received by investors from the effects of the downturn.

In the corporate bond sector we have seen mixed results with conflicting influences affecting market sentiment and the demand for yield that has helped the sector stage such a massive recovery. Credit markets rallied strongly at the start of the quarter however gains were pared back towards the end of the month on renewed sovereign debt concerns.

Despite this weakness towards the month end, the credit market outperformed UK Gilts by 0.2%. The yield premium on sterling investment grade credit fell from 1.58% at the start of the month to 1.56% at the end of April. In the high yield sector there are still signs of scope for healthy yields on risk adjusted measures, and strategic bond funds will help portfolios to take advantage of these opportunities.

Asset backed securities (ABS) are presently considered the most attractive section of the corporate bond market, these bonds have suffered fewer defaults than expected and offer plenty of scope for price appreciation.

We therefore remain generally positive on the corporate bond sector both in the UK and overseas markets, although short term volatility will continue as we have witnessed in other key asset classes.

Steve Patterson - Investment Director