Market Bulletin

MONDAY 25TH FEBRUARY 2008

This weekly Briefing Note aims to pick out some of the key financial and economic issues touched on in the press over recent days and from time to time includes the views of some of our independent fund managers.

Markets Meander

Global financial markets continued to vacillate last week as investors cogitated about the possibility of the US economy going into recession later in the year. Credit markets suffered particular turmoil, as **The Financial Times** noted, as investors unwound positions in structured products, with the situation exacerbated by news of Credit Suisse unveiling a $2.8bn write-down on asset-backed investments. As a result, credit spreads in both Europe and the US widened to record levels before steadying towards the end of the week. Over in the equity markets, unsettling economic data in the form of worsening US manufacturing activity drove prices lower, although by the end of the week Wall Street ended little changed. In London the mood was much brighter, with better than expected earnings news from Lloyds TSB and Barclays giving sentiment a welcome fillip. As a result, the banking sector rose smartly with rumours of a possible takeover by Lloyds TSB of one of its weaker rivals – Alliance & Leicester was named as a possible candidate – so by close of business the FTSE100 notched a 100 point gain on the week.

Sky's the Limit

Away from the financial markets all eyes were on commodity prices where prices roared ahead, giving the sector a record-breaking week, with the strong advances fuelled by speculative money, according to **The Financial Times**. Inflationary worries boosted gold which put in a sparkling performance, enabling prices to close at a record high of $943 per ounce – up almost 50% since a year ago. Oil prices also headed up, with the price of US crude hitting a record high of $101.32 per barrel before easing back. The continued upward trend of commodity prices – caused by a combination of high demand and increasing speculation by traders – is a concern for global investors as they try to assess the effects on inflation which is now rising inexorably. Continued strong growth in the developing economies such as China and India is creating a dichotomy – continued growth is good for the global economy, but it is also fuelling higher inflation.

Last week, Asian steel makers raised prices sharply in response to a surge in the cost of raw materials – the price rises, ranging from around 30% to 71% for higher-quality supplies, will force carmakers, shipbuilders and the like to charge more for their products. Prices are likely to increase further following comments from Rio Tinto who said it would continue to "obtain a freight premium" that reflects the proximity of its Australian mines to major Asian steel makers. And it's not just metal and energy prices that are rising, soft commodities too have risen sharply and even tea prices are likely to jump it seems, as a result of production problems in Kenya, the world's largest exporter of black tea. So unsurprisingly this inflationary backdrop is causing increasing concern for investors and Central Banks alike as they mull over the problem.

High Wire

The issue of rising inflation against a backdrop of a slowing US economy is the source of much discussion by economists. In **The Sunday Telegraph**, Liam Halligan focused on the poor economic news emanating from the US and specifically the minutes of the last Federal Reserve meeting. The Fed is predicting that US growth will slow to 1.5% this year, which whilst not consistent with 'recession' – two successive quarters of negative growth, is less than its previous forecast of 2.2%. It also raised its forecast of 'core' inflation: this is of real concern because it excludes food and energy (two key expenses for any consumer) hence Halligan's scepticism, but also fears that the Fed is actually grappling with 'stagflation' - an unpleasant combination of stagnating growth but rising price pressures. Fed Chairman Ben Bernanke has made it clear that interest rates will be cut aggressively to avoid recession, but on the flip side, this will merely fuel inflation. Halligan concluded that Bernanke is walking a tightrope and he is not alone - both the European Central Bank and the Bank of England are in a similar dilemma.

Over in the US economist Irwin Stelzer, writing in **The Sunday Times**, admitted that a few storm clouds are gathering but that there are some rays of sunshine too. He agreed that inflation is becoming a bigger issue and that other problems exist: falling consumer confidence, a weakening jobs market, confirmed by comments from the Fed's own report that "recent data indicated that consumer spending had decelerated considerably". He went on to say that higher energy costs are worrying, with no signs of any increase in supply – the likes of the oil cartel Opec are refusing to lift production and many producing nations continue to resist opening their oil fields to exploration and development by Western firms. But it's not all bad news – down at grass roots level, businesses are still making money. Recent surveys show that whilst businessmen are concerned about what might lie around the corner, they continue to report healthy sales and satisfactory profits.

Rocky Times

News that the government is after all going to nationalise the stricken bank Northern Rock drew a predictable barrage of criticism from shareholders and economists alike. Writing in **The Times,** Anatole Kaletsky described Alistair Darling's announcement as "unbelievable" and, although agreeing that state-ownership was the only remaining credible option, had doubts whether it would ultimately achieve its objective: to recoup £100bn of taxpayers money as quickly as possible. **The Independent** reported that, in order to head off legal action by Northern Rock investors, the Treasury announced that it intends using an independent valuer to assess the worth of the bank's shares. Investors in the bank fear that the decision to nationalise could leave them with little or nothing in return for their stakes – the bank's shares were de-listed on Monday after closing at 90p the previous week.

Away from this thorny issue, comments from one of the Bank of England's advisers, Timothy Besley (an external member of the Bank's MPC) who has a record of voting against interest rate cuts, implied that with credit conditions tightening, there was a strong possibility of a more aggressive programme of rate cuts. Notwithstanding the Bank's caution and belief that inflation will overshoot its target, the view is that there is a real chance of cheaper borrowing in the months ahead. One key beneficiary would be the UK housing market which is showing signs of slowing, according to **The Times** - even though asking prices jumped a surprising 3.2% in the last four weeks, according to a survey by Rightmove. Commentators were quick to point out that it is eventual sales prices that count and that another boom is not underway, rather it seems that February is the time eager estate agents want to get fresh properties on their books and are giving ambitious valuations to win business.

Watch the Stars

The ability of fund managers to outperform is tested in falling markets, but in recent months a handful of names appear to be able to buck the trend. This point was highlighted by both **The Financial Times** and **The Sunday Telegraph** who looked at which managers had continued to do well in the recent difficult times as well as over the longer term – concurring on a few. The papers picked out Neil Woodford of Invesco Perpetual who, whilst being pessimistic on the outlook, has also been very defensively placed for some time now. This more cautious approach has nevertheless yielded strong returns for investors. Over in the Asia Pacific sector, Hugh Young of Aberdeen was singled out for his excellent track record going back 20 years with his more cautious approach, buying quality companies with strong balance sheets and holding long term, with experts describing him as a safe pair of hands.

Another cautious area is the Corporate Bond sector where managers invest in fixed-interest instruments issued by companies to raise capital which are similar to gilts, but without a government guarantee. Here, **The Sunday Telegraph** favoured Paul Causer and Paul Read of Invesco Perpetual who, whilst generally preferring the more cautious end of the market, are prepared to invest in more adventurous high-yield bonds from time to time to enhance performance. Experts have described them as the dynamic duo of the fixed-interest world, with their understanding of the credit cycle second to none. Having been bearish of credit markets for three years, they now see good value appearing and a resurgence of performance. Both Neil Woodford and Hugh Young currently manage funds for St. James's Place, whilst Paul Causer and Paul Read have recently been selected by our Investment Committee to manage our own Corporate Bond Fund a little later in the year.

Eye of the Storm

One fund manager who remains quietly optimistic is Richard Peirson who manages the St. James's Place range of AXA Framlington Managed Funds and he explains why the worst may well be over following extreme volatility in global financial markets. "The last year has been very eventful and I cannot remember any time when markets have been quite as volatile and unsettling. The latter part of last year saw bonds recover as the sub-prime crisis unfolded and equities becoming increasingly nervous, leading to full blown panic in January of this year. In response, investors' risk appetite diminished and we saw a flight from small cap stocks to large cap. This was rather a headwind for me, as small and medium size companies are my area of expertise. Nevertheless, we managed to avoid the worst by increasing levels of cash up to 10% and only holding government bonds – I prefer eurobonds as I believe the ECB's inflation fighting credentials to be better. Recently we've been buying equities on the dips, which volatility allows you to do. Over the last few months we've increased exposure to emerging markets and whilst we reduced our Japanese holdings after being too optimistic too soon, I think now is a good time to be going back in.

We sold property stocks in late 2006, but we have been trading the sector more, buying back in and then selling – making a 20% profit. We've been underweight banks generally, but actively trading Standard Charter and this has been profitable too. Small caps are showing signs of life and there is some real value emerging in the likes of Speedyhire, which we own. In the mining sector we took profits in Rio Tinto and BHP Billiton late 2007, but have added again on recent weakness. So whilst recent volatility is unsettling for a fund manager it does create opportunity. As to outlook, it's not as clear as I would like it to be, but current valuations take into account of lot of economic uncertainty and I am able to find companies that generate growth and likely to enjoy a re-rating".