

# Alan Boswell & Company Ltd



## Market Update – 27 January 2009

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## Outlook

Over the festive period it would appear that the issues affecting the capital markets have finally started to produce a serious impact on the real economy, both in the UK and globally. The media has been filled with stories of gloom in a way not seen for some time. Some pundits are predicting a 1930's style period of depression, with even those more optimistic about capital markets seeming to believe that a deflationary period may be no longer a possibility but a probability.

Confidence has been knocked badly, of that there can be little doubt, but as consumers change their outlook on expenditure, certain styles of companies have shunned the norm by posting good sales over the festive period. For example, both Aldi and Primark increased their sales by over 20% compared to the same period last year. There has of course been the highly publicised victims as well, the final closure of Woolworths, a high street stalwart for decades, Zavvi, Whittards and others in administration, JCB laying off staff and Honda closing their Swindon factory for an extended period which might be several months. Even the normally stable world of consulting and accountancy has seen KPMG announce to its staff that it would offer the option to take three months of leave on a reduced income of 30% of their normal salary.

This process is, in fact, natural in both business and market cycles but has been exacerbated by the lack of clarity over the valuation of the so-called 'toxic debt' issued by lenders relating to mortgage backed securities. As governments continue to plough billions of local currency into these securities, and most recently the UK government announced plans to purchase corporate bonds (a form of asset backed debt) to attempt to create liquidity in traded corporate debt, the taxpayer continues to provide a currently uncertain level of support that will need to be paid for in future.

Clients may be aware of the term 'quantitative easing'. A noble sounding ideal but in principle it is merely the ability of a central bank to print more money. It has important implications because in theory it is the final act after any monetary policy ceases to be effective. Whilst interest rates remain so low in real terms, that is after inflation, the effect of such loose policy over a long time could have serious inflationary effects during the next market/business cycle. Commentators have suggested that this is the final act after which no-one has any idea of how to proceed. Whether it is quite that serious however, no-one actually knows. With luck, this is mere conjecture, rather than an economic reality.

With the new President firmly ensconced in office in the US, most economies will be looking for a strong lead and direction to provide some stability and perhaps lift some of the gloom that is so pervasive at present. The new President is keen to embark on long term investment into infrastructure spending and with any positive job creation it could have a ripple effect to many global businesses. China too is looking to invest enormous sums of money to try and support its rapidly expanding populace who are now becoming more urbanised. In short, there will be opportunities to make money in alternative areas compared to the normal US, UK and European markets with a knock effect being the support of the global economy in some measure. Against this background, the dollar remains a de facto currency whilst sterling and the euro have begun to fall against both the dollar and the yen heavily. Traders are betting on the UK being a weaker economy in future.

However, one cannot escape the market sentiment and it will appear scary for some time. Whilst it remains so clients and investors should continue to monitor their own circumstances and consider if their portfolios still match their aspirations. In our opinion, at this point it appears more gloomy, investment opportunities could abound in the months ahead for those investors with the right appetite and time frame.

## Inflation

The recent news is of a fall in inflation levels to 3.1% for December 2008<sup>1</sup> figures. This is the CPI rate (consumer prices index). That was a monthly drop of 0.4% so clearly lower input costs in terms of raw materials and oil/energy are beginning to take effect. Of course some will be down to discounted prices in some goods such as clothes so perhaps the figure should be treated with a little caution. The RPI (retail prices index, excluding mortgage interest) rate is currently 2.8%<sup>2</sup> and again this is likely to fall further in line with economic retrenchment. Given the reduction in interest rates to an almost unbelievable (and never seen in the history of the Bank of England) 1.5% during January 2009<sup>3</sup>, it is possible that inflation will fall much faster over the next few months when mortgage interest payments and the like fall in value. Inter-bank lending rates remain slightly higher but have fallen dramatically from their much wider pricing over the base rate in recent months suggesting liquidity is returning to some areas of the banking industry, even if only at a slow rate. The cost of debt servicing in real terms remains high and investors should remain wary of the need to reduce this exposure wherever possible whilst investing in assets offering above inflation return opportunities.

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<sup>1</sup> Statistics.gov.uk – December 2008 inflation release

<sup>2</sup> As above

<sup>3</sup> bankofengland.co.uk – January MPC minutes

## Commodities and Property

Investors exposed to natural resources and energy (either general or alternatives) might think an ill wind is blowing through their portfolios but there can be no doubt that oil has been the dominant feature of equity and resources portfolios over the last 12 months. The price has an effect on virtually every investor and business to some degree and part of the pricing mechanism has seen the speculators first bid up the price to then record highs of \$140+ per barrel down to the current \$41 per barrel<sup>4</sup>. Both prices are clearly not going to stick for long and consumption remains within the production capabilities of the primary oil producers. What might happen though is that (as with Russia and Ukraine recently) investors and energy users may be held more to account by producers. This political edge could change the global energy business with winners and losers on both sides. Until alternative sources of power are capable of delivering, clients should have some exposure to the energy and commodities story because supply is only likely to get tighter so those companies with businesses in the sector could stand to benefit strongly in future.

So it is with precious and base metals. Although an economic slowdown may seem to affect pricing, materials will continue to be consumed, particularly by China and India in their pursuit of economic performance and infrastructure spending. Many countries need to replace vital roads, railways and power grids which still require base materials and whilst cash continues to offer low rates of real return, precious and semi precious metals and stones will hold their place as a store of value. Indeed, some commentary has suggested the the real price of gold should be above \$2,000 per troy ounce in the near future, currently approximately \$900 per troy ounce . Perhaps this is unlikely but for those clients with an appetite to hold such commodities, a diversified exposure can be offered through various fund management groups or as part of a discretionary portfolio.

Property remains the only real area of concern in this particular scenario. Land is still a valuable commodity but with little current trade no true basis of fact can be established for commercial property. Banking and liquidity are the main drivers here so we will continue to see suspensions of withdrawals and re-capitalising of investors who hold such assets. They do still provide good levels of support in the form of the rents received by tenants so should be no means be excluded from portfolios of long term investors. It is an asset that requires patience as much as skill to reap the returns.

### Index Linked

Whilst inflation may fall in the near term as noted above, there is every possibility that by literally printing more cash, the Bank of England and the UK government may be storing up problems for a future economic recovery. Arguably, the only option is to flood the market with liquidity when confidence is low but this could mean much higher rates of inflation and thus interest rates in future when all this money has to find a home. Invariably, people start to invest more and expect higher returns and create the next market cycle. Easy liquidity and monetary conditions may have been part of the reason for the problems that the global economy is presently facing and some restriction on this liquidity injection would, in the medium term, be a sensible if painful option to take by the current government and its agencies.

Retention of some inflation protecting assets is therefore still suitable for clients, and if inflation rises in the period running up to the 2012 London Olympics investors may well reap the benefit of a patient holding in the asset class. Of course, alongside this they should be considering other assets, and corporate bonds remain the flavour of the month with many fund managers. Skill in credit markets is in short supply so any exposure should be limited to quality managers with suitable experience and a large team of analysts to back them up. The corporate bond market remains illiquid due to the fact that no bond provider is offering suitable quotes, a term called 'mark to market' and there can be wild price swings between different market makers of this type of debt instrument. Nonetheless, they can offer high yields at the moment and if you are an income taker this may be of interest. Any return to normal pricing will see an immediate uplift in the value of these investment funds.

### Summary

Today people who hold cash equivalents feel comfortable, but they should not. They have opted for a terrible long term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed, the policies that government will follow in its efforts to alleviate the current crisis will probably prove inflationary and therefore accelerate declines in the real value of cash accounts.

Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice "I skate to where the puck is going to be, not to where it has been".<sup>5</sup>

We will continue to favour the approach of risk taking by a spread of assets across different economies and normally this would be via a suitable discretionary manager or multi asset/manager fund arrangement given the necessary risk profile for the investor. It is an approach best discussed through your adviser and you may already have insured funds (say in a pension plan) that perform the same function. The dampening of volatility and consistency of returns is what we are looking to achieve for most clients over the medium to long term and this style can be very suited to that purpose. Please contact your adviser for further details.

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<sup>4</sup> [bbc.co.uk](http://bbc.co.uk) (market data chart – Brent Crude Oil \$/barrel) 22 January 2009

<sup>5</sup> The New York Times – Warren E. Buffett – 17 October 2008