

Alan Boswell & Company Ltd



Market Update – 9 June 2009

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Outlook

We make no apology for the review this month, given that the average person (including most investors) surely cannot be sure how the world is moving forward after the credit crunch exposed the leverage most private and public enterprises had on their balance sheets. Measured by the FTSE All Share and 100 indices, the rise in market values has been over 20% from early March lows¹. Everyone seems to have forgotten the potential of the Mexican swine flu outbreak now that UK news has been dominated by Labour ministers resigning after a Daily Telegraph expose on parliamentary expenses and the European/local council elections where the incumbent Labour administrations performed poorly. You will no doubt have read or heard the news on GM filing for Chapter 11 bankruptcy protection in the US and now LDV vans in the UK filing for administration as well. This just goes to show that despite market sentiment recovering, the real (personal) lives of thousands of people are being affected away from the public gaze. This has important implications for future spending/savings patterns, state benefits/taxation levels and also the inflation/deflation argument.

Market commentary suggests that recent bank stress tests have been designed to minimise the risk of large capital raising both in the UK and abroad, but with Blackrock Merrill Lynch suggested as a potential buyer of Barclays Global Investors for approximately \$13bn, and many banks looking to cut the support packages offered by the governments in the UK and US, perhaps there is reason for some cautious optimism that lending levels will revive.

Standard & Poors, the rating agency, has recently publicly downgraded its outlook on the UK debt situation with reports suggesting that by 2013 they expect public debt as a proportion of GDP to be 100%, with a 37% risk of the UK debt being downgraded from the much cherished AAA rating given to G7 economies. They have recently just cut the Irish rating to AA from AA+² as well indicating the overheated nature of Irish housing markets particularly.

A BBC report from 2 June suggests that European Union unemployment data has moved to a 10 year high, with Spain at around 18% unemployment in April 2009 much the highest³. It is possible that although this figure could rise, utilisation of the capacity that is building up globally might restrain higher prices generally and keep inflation levels low. Whether this will herald a return to more normalised growth in time now depends on the ability of central banks and governments to produce suitable policy measures.

Inflation

The latest data released by the National Statistics office revealed that CPI inflation has fallen to 2.3% at the end of April 2009, and the RPI measure has fallen negative (-1.2%)⁴. Sterling continues to be under pressure due to potential gilt issuance by the UK. The budget deficit and potential gilt issuance continues to weigh on UK gilts and to some extent sterling as well. The Bank of England announced that they will be extending their repurchase of gilts (via the use of newly printed money) to a further £50bn on top of the initial £75bn committed. The government has a maximum limit of £150bn at present for this quantitative easing policy. A sustained rise in gilt yields from their current low levels would make the safety of government debt more tenuous but given the safety aspect many investors remain holders of the stock.

Energy costs (wholesale) continue to fall as global demand eases but the price of short term oil and gas would appear to be suffering another bout of investor enthusiasm. Stock levels are noted by market commentators as higher than for some time, whilst utilisation levels continue to fall. Perhaps this is just another case of market participants trying to force the markets higher to make a profit on their own account via the traded derivatives market.

The CPI target remains 2% and on that basis the Bank of England continues to hold base rates at 0.5%⁵, given the downside risks for undershooting this target. The Eurozone continues to occupy the middle ground and may be expected to increase monetary support over the medium term if economic woes persist, particularly in Germany and France with the ECB continuing to adjust base rates accordingly.

¹ Financial Express 1/1/09 to 9/6/09

² <http://newsvote.bbc.co.uk/1/hi/business/8089307.stm>

³ <http://newsvote.bbc.co.uk/1/hi/business/8078655.stm>

⁴ <http://www.statistics.gov.uk/cci/nugget.asp?id=19> 9 June 2009

⁵ <http://www.bankofengland.co.uk/publications/news/2009/044.htm> 4 June 2009

Commodities and Property

Some assets continue to show relative recent strength (given their 2008 highs) from our last update, with oil and gold continuing to benefit investors to some degree. Other assets like base metals have lacked the same strength given global economic doubts. Markets continue to react favourably to any forward movement from emerging consumers such as China reflecting generally higher prices in anticipation of higher consumption.

Soft assets, such as coffee and rice grains, will continue to suffer from weather related issues alongside the demand changes being seen in global markets. The expectation that many emerging economies will become serious consumers have perhaps eased short term but there is no doubt that exposure to companies benefitting from the increase in agricultural produce required globally will find their holding likely to rise in value over time.

Oil has recently traded above \$68⁶ per barrel but given earlier comment, how sustainable this figure is could be open to question. Many investors may have bought into the asset class again and long term it remains a serious investment proposition. The short term may still be dominated by futures traders rather than underlying economics. However, if re-stocking has been achieved at low cost, the price could fall in the near term and then rise sharply on any recovery globally. Investors should consider exposure to the asset as part of their portfolios. Any poor weather could see a rise in the prices of the main indices.

The recent re-rating of risk assets has given property REIT shares a boost. This is the benefit of owning property company shares rather than underlying fixed asset itself. Prices do fall equally as rapidly though, so retail investors should consider if this volatile structure would be better included in their portfolio as part of a more flexible fund mandate. Far Eastern markets remain a major target for the funds involved, but low stock turnover remains the problem for pricing of the properties. Income therefore remains a key element of the overall return and investors may well see this aspect hold up better than some areas of the market.

Index Linked & Gilts

The general public should by now be aware of the size of the budget deficit, even if not understanding the implications. With huge supply expectations weighing on market sentiment in the near term many investors are looking at the risk of holding normal gilts (of any duration) against the potential for Index Linked gilts/bonds to outperform in future. Prices have remained broadly constant given the safety aspect of the asset class, but it is likely that much of the comment in the weekend press will begin to consider the possibilities for index linking over the medium term. If the liquidity programme being undertaken by the central banks of the G7 and other nations works, no-one has experience of the results and it may need an equally rapid restriction of liquidity (via interest rates primarily for the public) to prevent a wild swing to inflationary policy. An exposure to both assets ought to be a consideration for investors as we have said before. Again a managed exposure is favoured to get the best out of the asset class.

Summary

With the recent budget reflecting increased taxation on higher earners, it is clear that clients should take advice not only on savings but also on spending patterns. We suggest those who are sure to be affected (those making large pension contributions, trustees, etc) should discuss the matter with their advisor and accountant in tandem to maximise other areas of tax efficiency in their planning.

In future it may be that clients (including trustees) will need to focus more of their intentions on capital values increasing rather than income generation and therefore keep their marginal taxation lower overall. This could involve a change in risk attitudes that will need careful understanding and management as well as longer term objectives.

We are not certain that all the budget aspects can be easily policed and there is considerable room for misunderstanding so please make sure that you discuss any circumstances with your adviser before investing further funds or releasing capital.

There are solutions available that will suit many points of view and we would welcome the chance to discuss them with you. We would only ask you to retain an open mind to alternatives that you may previously have not considered to be suitable to your circumstances.

⁶ http://newsvote.bbc.co.uk/1/shared/fds/hi/business/market_data/commodities/default.stm 9 June 2009