

Alan Boswell & Company Ltd



Market Update – 8th May 2009

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Outlook

As clients will know, the UK budget statement was much later than usual and more on that later in this missive. To juxtapose; the news has been dominated by a (potentially) virulent flu virus from Mexico that thankfully has failed currently to live up to all the media 'pandemic' hyperbole. May it not reach any further than it has.

What it does show is the effect that the media can have on investor confidence and the way in which investors react to such instances. Remember SARS in 2003 when Chinese markets got battered? It took a while for some companies to recover and the media would be wise to be careful with their head line stories at this sensitive time for investors generally.

A recent stress test by the US Treasury has revealed some details about those US banks where further capital raising is necessary and only today the media has been speculating on the need for around \$75bn in extra fund raising from investors. Time will tell if this is accurate or indeed enough (as some have suggested it isn't).

Against these stories, there have been moves in some areas of the market with either companies meeting analyst earnings expectations or at least not falling short by as much as some feared. Alongside this some US pharmaceutical companies have agreed terms to merge and resilience is still evident in food retailers such as Tesco and Sainsbury in the UK. Despite the market turmoil, there has been a rise in recent weeks in most of the major indices although the jury remains out on whether this is a sentimental rally or something more substantial. Clients should be prepared for equally precipitous drops along the way. Key to any improvements will be the market index low points getting steadily higher (on the performance charts that is).

Much data, particularly on employment/property is a lagging indicator so the real economy may be much worse than it appears when the data is released publicly. Clients should be aware that markets discount future growth much further out than any finance minister or government forecast when making investment decisions.

Inflation

The latest data released by the National Statistics office revealed that CPI inflation has fallen to 2.9% at the end of March 2009, and for the first time since 1960 the RPI measure has fallen negative (-0.4%)¹. The government has confirmed that those who receive such benefits marked to the RPI index will continue to receive at least a 2.5% uplift in those benefits but we cannot tell if this is sustainable. As we have stated before, pensioners could struggle as the state scheme is linked to RPI (which was over 4.5% last September) when the pension was revalued for this year but is now negative, whilst most pensioner costs continue to rise (eg: food and heating). The next revaluation is now key to this.

Sterling continues to be under pressure due to potential gilt issuance by the UK. The latest budget surprised only in terms of the size of the issuance potential, due to an estimated budget deficit of £175bn this financial year. Market commentators speculate that this may not mean the end of the issuance and they are starting to sell sterling on the basis that the currency is not as valuable and the debt level is unsustainable. It's not uncertain if this means a sustained rise in gilt yields from their current low levels. There is an argument that government debt remains a safe haven for investors but an inflection point is clearly being reached where the market could move either way decisively.

Energy costs (wholesale) are falling rapidly to reflect the lower level of global demand and along with the associated reduction in base material costs, CPI and therefore RPI expectations continue to suggest a period of deflation. To counter this, there is a valid expectation that issuing so much debt and new money into an economy can only increase the risk of much higher inflation as a price to pay for some stability in asset prices such as housing. What the markets are trying to surmise now is the extent to which the over leveraged UK taxpayer will have to pay in increased taxes to fund this huge gap in public finances and the effect on spending patterns.

¹ <http://www.statistics.gov.uk/pdfdir/cpinr0409.pdf> - 8 May 2009

The CPI target remains 2% and given that Bank of England held base rates at 0.5%² this week, they clearly feel a risk in undershooting this figure exists at the present time. In parallel, the ECB announced a cut in base rate to 1%³, as well as extra monetary measures for the European Union to help stimulate some growth in the Eurozone so even the normally staid ECB realises the risks remain on the downside at this point for the economy

Commodities and Property

Some assets have shown relative recent strength (given their 2008 highs) 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. Any positive news from emerging consumers such as China will therefore reflect in higher prices. Poor weather will undoubtedly aid any price strength this year in agricultural markets, but staples such as soya beans and coffee remain victim to the weather and underlying demand. Any increase in 'green' industry as advocated by President Obama may well move these markets heavily.

Oil has held above \$50⁴ per barrel and this would appear to be a reasonable floor. Some of the price support could be re-stocking of supply but the price is often a reasonable indicator of future expectations. Many investors now appear to be backing long term oil prices rather than shorting the sector according to reports. Anything above \$60 will likely mean the assumption of some economic growth appearing on the radar of investor expectations in the medium term.

Some fund managers are now favouring the property REIT area based on the dual effect of the equity like upside and the base of real assets underlying the fund/stock. The target areas for those managers investing remains the Far East but with some reservations on US and UK assets. Liquidity is improving but there is little anecdotal evidence of increased turnover with many manager keen to improve the performance of existing holdings first rather than selling at any price. 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

As mentioned earlier, the UK need to issue a huge supply to the markets to fund debt in the near term. Gilt yields initially slid a little, but remain firm as the asset has the aura of safety in turbulent times. A recent Index Linked issue was oversubscribed but a normal gilt issue was not, perhaps reflecting the need for inflation protection in future periods for investors. The 'bubble' effect may or may not exist in the asset class, but it is likely prices will remain firm for a while yet, particularly as the ECB and UK will continue to purchase quality government and corporate debt to maintain liquidity. Overexposure is to be avoided but the asset retains a diversification balance in most portfolios. Further out (2 to 3yrs), it is clear that Index Linked assets will also have value, either via gilt funds or through National Savings Products and investors should look closely at the asset class to see if it suits their requirements.

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 increases 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.

² <http://news.bbc.co.uk/1/hi/business/8037685.stm> - 8 May 2009

³ <http://news.bbc.co.uk/1/hi/business/8037523.stm> - 8 May 2009

⁴ http://newsvote.bbc.co.uk/1/shared/fds/hi/business/market_data/commodities/default.stm - 8 May 2009