

Alan Boswell & Company Ltd



Market Update – 10 August 2009

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Outlook

This month's update is clouded by the curse of August. That is to say, very thin trading volumes that do not always justify the market moves and of course mean that volatility in prices can be magnified by such small bargain sizes. The market adage of 'sell in May and go away, stay away until St.Leger's day' could well be taking effect in markets this year.

The effect has been to continue consolidating share price gains at the expense of limited new market information on the economy and individual companies. Banks have been the only really heavyweight news item of note, and more due to the bonuses issue again, rather than the fact that healthy banking profits are often a precursor for more stable credit conditions. Perhaps this period will be a defining moment when we look back and say that was the point that lending activity began to stabilise and return to some level intermediate level, even if lower than previous periods. The contradiction however remains the lagging indicator that is unemployment. This could yet prove the straw that breaks the camel's back in market confidence terms so investors would do well to bear that in mind when choosing markets to invest in.

Personalities dominate the news from the last few weeks of this overview, given that Bill Clinton has been involved in releasing North Korean prisoners for the US administration (who knows if any kind of nuclear deal was discussed), the Iranian Prime Minister continues to suffer difficulties with the general populace (who continue to protest) and the country remains one of the most significant global geo-political issues, whilst the UK parliament is still suffering from the expenses row backlash and their seeming inability to manage the economic expectations of the UK public.

Market participants have remained fully divided on returns and forecasts for economic activity both in the UK and overseas, and we remain committed to our diversified stance on investing wherever possible for our clients. No doubt bond investors would prefer to see continued low interest rates (it can increase bond values) to justify the higher income possible at this time, whereas equity investors may well prefer to see some inherent inflation levels to accelerate the effect of earnings on their share prices.

Inflation

Recent news from the Bank of England suggested that CPI (the government's preferred inflation measure) has fallen to 1.8%¹. This means a letter from Mervyn King to the Treasury to explain why it is below the target level of 2%. Given that including mortgage interest payments the RPI rate is -1.6% for data released on 14 July² the public could be confused, after all food costs and the like hardly seemed to have fallen in comparison.

The Bank of England retained the base rate at 0.5% for its latest meeting on 6 August³, with a commitment to continue with the asset purchase program it has undertaken in an attempt to increase credit availability and liquidity in corporate debt such as bonds. The commitment is now up to £175bn from the original £125bn which is almost allocated now. With pay growth and spare capacity in the UK economy the BoE noted that future inflation has become quite difficult to forecast but that they were likely to maintain the base rate in the near future.

Investors have noted that at some point, gilt yields will need to reflect the fact that printing this much new money will inevitably increase the risk to the UK sovereign debt (gilts). If investors begin to fear this happening, a sell off in government bonds could occur. Whilst higher gilt yields are good news for annuity purchasers, anyone holding merely this asset class is substantially exposed to capital loss in future, and if sterling were to weaken against a basket of currencies, it could store up some significant fiscal and monetary policy problems for any future UK government trying to balance its books.

We continue to see fund managers rotating towards the higher yield/risk end of the bond spectrum as they see returns beginning to appear. Some bonds have equity like exposure to any good news and in some instances have returned significant amounts in recent months. Whilst markets may get ahead of themselves, this higher risk assumption by bond fund managers may well mean a turning point is being reached in financial markets. Index linked bonds remain expensive because of their inflation protection but for some may well be the only game they wish to play at this time if inflation levels in future reach the level of some analyst predictions. Those multi asset funds

¹ <http://newsvote.bbc.co.uk/1/hi/business/8149227.stm>

² <http://www.statistics.gov.uk/instantfigures.asp>

³ <http://www.bankofengland.co.uk/publications/news/2009/063.htm>

that we recommend are still likely to be using derivative structures that can be liquidated at will to gain access to these assets (the so called credit default swap) rather than owning the rather less liquid bonds that exist underneath. It is a more efficient method of running such a portfolio and allows instant/cost effective trading if required.

Commodities

Continued movement in recent oil and gold prices have presented a bit of an issue for investors. On the one hand higher oil prices would suggest tentative recovery prospects whilst the rise in the gold price is anticipating the potential for more economic pain. Is either point of view correct? We remain unsure about the situation generally but do recommend portfolio exposure to diversify your investments. Some miners and oil majors have fallen perhaps unduly and fund managers may consider value exists long term so perhaps indirect investment rather than holding the physical asset is right at this point in the cycle. Both could still be considered opportunities for you to invest in.

The recent tropical storms and typhoon affecting areas of South East Asia and Japan indicate once again how potentially exposed some basic foodstuffs can be in the face of unpredictable natural phenomena. If you consider how important rice, coffee, rubber and the like are to both consumers and exporters in these areas, it serves to highlight not only how exposure to these areas can be important for investors as a diversifier but also as a potential capital growth tool. The supply/demand dynamics rarely fall away quickly and considering the global population is still rising we should be mindful of how useful these exposures can be.

Global Assets

In our research we came across a strange word recently: autarky. It is the supposed self sufficiency of an economy/community without the need for outside support. Why include it here? Merely to illustrate that in the joined up world we now live in we suggest that investors should consider whether holding UK assets for the bulk of their portfolio is still the only game in town, especially given possible UK economic difficulties in future.

However, as many of our clients will already know, for those with the appetite, and sufficiently long outlook, there should be an allocation to assets in a different geography, currency or asset class to diversify away from home markets. Not all global businesses trade heavily in the UK and vice-versa so areas like South East Asia (which has strong regional trade patterns) could be a booster for flagging portfolios in future.

Many foreign companies have begun to recognise the importance of dividends so again this need not be a reason to avoid global assets. European and Global Income funds are beginning to find favour and do mean you spread your risk across another groups of companies and countries, along with their underlying currencies. Invariably buying global or resource based funds will imply you have an international outlook for your investment exposure and we can help you to understand the risks involved and if appropriate recommend a suitable course of action to you.

With asset rotation again beginning to support certain assets and markets, using one of the selection of multi manager/asset funds that we recommend to clients could assist with this investment quandary, particularly as some managers have a much higher overseas bias than their home UK market. The ability of these managers to buy some very successful closed funds for retail investors should not be underestimated at this time.

Summary

As we have noted before in our summaries, we will continue to favour using managers with long term track records who can demonstrate the necessary performance for our clients. Overseas exposure should be considered part of the mainstream investment process for clients, and we would look to have some for all but the most defensive investors. All clients should be mindful of the time frame for their investments.

A medium to long term (5yr+) investor should be prepared to accept prices moving against them whilst holding their investments for some future expenditure. For those with lower levels of risk tolerance we may be able to utilise the latest generations of structured products (particularly for income generation) where the risks/returns are fixed at the outset of any investment.

Please feel free to contact your financial advisor if this or any point mentioned here could add value to your own portfolio, or if you feel a review would be useful at this time.