

Alan Boswell & Company Ltd



Market Update – 15 January 2010

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Outlook

Since we last updated clients on the view from financial markets it is fair to say that investors have done pretty well since early March 2009 lows. Anyone who held on to their portfolio after the Lehman's default in October 2008 will doubtless have seen a significant recovery of their values.

What drives this behaviour in markets? Mostly irrationality and over exuberance (some call it the 'random walk theory') married to some degree of realisation that there is fundamental value to be found. As with a natural disaster, markets can make and lose value very rapidly (and when least expected) after having been benign or dormant for long periods.

The momentum effect of such a large wall of money coming from cash deposits earning little will probably see investors witness continuing strength in commodity shares and the commodities themselves (clients will surely have noted petrol prices well above 110p a litre in places) whilst defensive shares such as pharmaceutical and utilities have not participated heavily in price increases. Ironically, the area most beaten up (bank shares) has been some of the best performers in the market. Whether justified or not, any investors holding such assets have seen amazing returns on little new market information.

China has continued to dominate news flow in financial affairs particularly and with its seemingly endless appetite for base metals and commodities like oil, and the never ending suggestion that growth will continue at something like 6-10% per annum indefinitely, some commentators are suggesting China is the biggest bubble ever. Clients may have noticed that those resource rich nations who can export competitively have fared better economically than many consumer led developed nations. It has been in the press that Australia has already chosen to begin interest increases to prevent inflationary forces and China also sought to change the capital reserve ratio for domestic banks to slow down the money supply a fraction.

Some of our most respected fund management partners are suggesting a two part year where returns continue to gain momentum and then fade towards the start of the 3rd quarter. Some of this is based on government borrowing and tax receipts and some on forecasts for company earnings and employment prospects. Doubtless, volatility will persist at times and clients would be wise to avoid listening to market noise, instead taking a step backwards and being more measured in their outlook.

Finally, clients may have noted that the disparity between the depositor and investor protection schemes has been removed recently. Please ask for clarification on this point from your adviser.¹

Inflation

Whilst the numbers have remained benign, at least compared to previous periods of measurement, there is a belief that at some point all the QE (quantitative easing) being conducted by the UK government could produce a higher level of inflation. Along with planned tax rises (note VAT back up to 17.5% on 1 January) to try and rebalance the budget deficit which will suck money out of the economy, the Bank of England will have to exercise careful control of interest rates. Given that we have never seen this in modern times, no one is sure what will happen.

The European Central Bank kept interest rates at 1% for the eight month in a row² and the Bank of England kept them at 0.5%³ whilst maintaining total QE at £200bn. As noted above, Australia and China have started reversing this process to some degree. This differential could last for some time, and lead to sterling along with the dollar remaining relatively weak in currency purchasing terms. Clients should therefore maintain broad exposure to overseas markets to suit their risk appetites because the currency translation can aid portfolio performance.

Where government deficits are seen to be unsustainable and perhaps even uncontrollable, investors may take a view that sovereign debt such as gilts should warrant a higher yield (income) for the risk of investing.

¹ http://www.fscs.org.uk/consumer/latest_news/2009/dec/new_compensation_limits/

² bbc.co.uk – 14/1/2010

³ [bank of England](http://bankofengland.gov.uk) 7/1/2010

In parallel with this, the local currency is likely to be sold by investors as well (as it will be deemed to be weaker). A double whammy of sorts that could result in the falling capital value of gilts and some type of currency run that could lead to a concerted effort to increase interest rates to support it, and then an even softer economic recovery.

According to the Office of National Statistics data CPI (the government's preferred inflation measure) has risen from 1.5% to 1.9% in November 2009⁴. Mervyn King has been noted in the press as suggesting that this figure is likely to yo-yo around based on underlying seasonal and economic variations to the basket of goods measured. What is clear is that with RPI (which includes mortgage repayments) rising to a positive 0.3% as well, inflationary pressures may just be beginning to be felt within the system. With a cold spell of weather and heavy consumption of oil and gas for power and heat purposes, the next numbers could surprise further on the upside.

The appetite for bond issuance from investors had seen heavy buying of retail funds from managers such as M&G and Invesco where inflows now mean many of their fixed interest funds are over the £2bn mark. However, the market continues to swallow the issuance due to the fixed nature of the income received by the investor. With returns so low on cash, this may well continue but clients should be mindful of the fixed interest assets they own and look to review anything they feel is not continuing to match their requirements. Strategic bond funds could find favour for most as they are more flexible and can use hedging techniques to protect income yields from falling too far.

Commodities

The story of the last few months has been the continued rise of gold to around \$1200 per ounce on trading screens. With oil rising in tandem, these two market exposures would have seen your portfolio rising handsomely from very low levels but you would have needed 20/20 vision to have maintained a large exposure to the two areas last March. Nevertheless, gold miners and oil support services companies have done exceptionally well in some cases and many fund managers don't hold lots of the physical assets, preferring the companies themselves.

With the US dollar having weakened against a basket of currencies, there should be no surprise that the price of gold has risen so quickly. It is, after all, priced in US dollars for standard measures. There is often an inverse relationship between the currency and the asset, but as the US government seems keen to keep the dollar weak to aid exports somewhat, gold may well stay in vogue as a store of value against future inflation. Sadly, no income is paid from the gold itself, which can make the price move erratically at times. With commodities particularly, looking at the companies operating in the arena rather than just the physical commodity is worthwhile when discussing investing with your adviser.

Global Assets

Although it may seem to be flavour of the month, we have always tried to persist with a more expansive investment approach from our clients. It is no coincidence that most of the FTSE100 listed companies make a significant proportion of their earnings in another currency and therefore many distribution and income funds are really global funds. Global funds have some added advantages: specifically they diversify you across many countries without needing to own lots of stock and they can encapsulate various investment themes for even small sums of capital invested.

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.

With continued interaction between different markets and regions of the globe, diversification remains our goal within client portfolios, both to mitigate risk levels and also to offer opportunities to participate in gains in value. Regular reviews can assist in this regard.

Please feel free to contact your financial adviser 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.

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