



Alan Boswell & Company Ltd
Market Update – 27 July 2010

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Outlook

The period since the last update continued to provide significant levels of volatility in market indices. The FTSE100 index moved down nearly 5% between 25 June and 1 July only to bounce back by 11% or so from 1 July to date¹. Market indices including the S&P 500 and MSCI World Index fared at least as badly over the same period reflecting another bout of profit taking and reduction in risk levels caused by a variety of factors.

At the time of writing, sovereign debt issues remain top of the investor agenda, although geo-political realities are beginning to bite a little more ferociously. The European regulators completed their 'stress' tests on 91 European banking groups and released their findings over the week ending 23rd July: preliminary reports suggested only 7 (Spanish) banks would not stand up to the 'stress' in reality, but investors may still feel that issues exist for those groups in terms of hidden debts.

A recently released IMF report quoted in the international press suggested that in the 3rd & 4th quarters of 2010 as much as \$4trn or £2.7trn of international debt (US, UK and Japan especially) needs to be refinanced, hence investors remaining wary of banks generally and certainly European banks in particular. It is easy therefore to see why investors continue to have panic and euphoria attacks in equal measure, such refinancing could have an impact on financial markets and leave equity investors with short term losses in some instances. The effect of a Moody's downgrade on 20 July to Irish government debt from Aa1 to Aa2 has been muted at the moment, but if another EU country were to suffer a similar change in the near future, then a certain contagion effect could occur. The result could be a further round of quantitative easing by central banks and the attendant inflation threat that may cause.

Further afield, issues surrounding the sinking of a South Korean ship (allegedly by North Korea) have left the region in some state of tension due to a current military readiness exercise jointly between the US and South Korea. It has left North Korea declaring a potential 'sacred' war against them, and any political tension could cause shares to move dramatically in both directions. At the same time, the US continues to posture against BP for the Macondo oil spill by not only preventing drilling rights, but also using political pressure to purchase BP assets in the Middle East for other US competitors.

Notwithstanding all of this, many market commentators continue to make the point that many large companies are trading at average valuations given their diverse business models, ability to soak up smaller competitors and of course their overseas earnings. Many are arguing that BP is now one such company with inherent value despite the threat of US political pressure and the removal of Tony Hayward from the head of the firm.

As an example, Rentokil recently bid £2.5bn for the SSL International group of businesses. Clearly there are businesses that remain in the ascendancy, and with cash to purchase companies, and identifying those winners may provide handsome rewards for investors. All this despite tight credit markets for many, just proving that if businesses are viable capital will always be available from creditors.

Inflation

The Greek debt bubble and the sister issues in countries such as Spain and Portugal continue to dog markets. Clearly one option to resolve this is to inflate away the debt but with a currency bloc in force that isn't possible. The euro has therefore been under pressure to some extent due to this effect with consideration of a two tier arrangement of central euro members under the German euro whilst the remainder have some type of floating euro or return to their own currency again.

The UK coalition announced plans for some fiscal and monetary austerity with their emergency budget during July but many of these measures (including vat increases) do not take immediate effect. The initial reaction of the financial markets was broadly positive although the usual detailed analysis will be required to see if the plans can work to reduce the deficit sufficiently. Recently the UK (£) has been recovering some ground against the US (\$) whilst holding it's own against the euro. However, a basket of currencies in areas such as Asia or those with a strong fiscal position have been much the stronger. For example, Australian (\$) values have increased along with local interest rates as inflation has risen there in recent months.

As we mentioned last month, exporting countries with a commodity exposure have been raising interest rates and this has attracted international capital flows (the so called carry trade).

¹ Source: Financial Express 27 July 2010 - FTSE100 TR in GBP 25 June to 26 July inclusive

We continue to see high inflation numbers, although they fell back slightly last month and presumably Mervyn King must be running out of printer ink for the number of letters he will have written to explain to the Treasury. For the period to June 2010 figures for CPI were 3.2%² (down from 3.4%) and RPI 5% (down from 5.1%). The unemployment rate increased to 7.8% (from 7.5%) as it would appear some slight structural changes are taking place in the job market. For the time being the Bank of England governor and the board seem happy to pursue a policy of cheap money (still 0.5% base rate) and are hoping that their view of inflation is still correct: that is it will fall back later this year and be below trend into 2011.

One important number that looks likely to change is that in future public and private sector pensions may well see their increases based on the CPI inflation rate and not the RPI inflation rate. This potentially means a lower pension for all but only time will tell. The basket of goods for CPI is markedly different to the RPI, and indeed includes quite a few items that do not relate directly to a UK consumer. Clients should be mindful of any changes that they see in their pension and index linked investments given this change which is due in future.

Commodities & Property – Alternatives to investing in them

We mentioned the continued strong gold price (in US\$) last month along with opportunities that may still be available in property assets.

This month it seems appropriate to highlight some alternative assets clients may have read about elsewhere. TLPs and Lilocs may be unknown to most but a surprising number of investors hold these assets in their multi asset funds. These structures buy into the (predominantly US) market for life settlements. These are insurance arrangements which are often traded by those in ill health later in life when perhaps the cash is more useful than the insurance policy. The investments can often act with little or no correlation (relationship) to stock markets and can provide some useful diversification of risk for investors.

A TLP is a traded life policy: literally a second hand insurance policy on which the investor continues to pay the premiums and benefits on the death of the policyholder before the maturity of the policy (after having paid the life assured a sum for the plan in the first place). A Liloc is a 'Life Insurance line of Credit': essentially a cash advance against the value of the insurance policy now in return for the value of the plan on the death of the life assured. Perhaps you may view the asset class as a moral judgement but returns can be favourable in the right portfolio and certainly if the underwriters do a sufficiently rigorous job, the risks can be considered as reasonable. The market in the US is huge with literally billions of dollars of insurance out there to choose to invest in. One of the major names clients may have seen in their portfolio is that of EEA Life Settlements. They are not without their own risks however, and we would urge caution before investing, to make sure the full risks are known by clients investing directly.

Summary

We continue to monitor news on the changes to the UK tax situation for investors, savers and spenders. Tight credit conditions remain for even the best borrowers so haste will be needed when a suitable deal appears. Witness the withdrawal of all savings certificates by National Savings recently due to their popularity. Use of the available tax wrappers remains a top priority for us as your advisors.

With our preference for a multi asset approach to client investments, and the close contact we have maintained with our preferred managers, we hope our clients have been able to see through the volatility and understand the positioning these managers have used to protect or enhance client portfolios where possible. With cash offering so little in terms of return it will unfortunately be necessary to accept some risk is required to make a return approaching inflation or above in the present climate.

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

² <http://www.statistics.gov.uk/instantfigures.asp> - 27 July 2010