



Newsflash

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December provided a degree of respite for investors as volatility fell; however, equity markets were left lacking direction reflecting a continuing shortage of investor consensus. The second half of 2007 will be remembered as a time when the borrowing of sub-prime debtors caused far reaching consequences. The inability of many of this class of borrower to repay their mortgages was reasonably significant, but the main cause for concern was the nature in which many of these investments were sold throughout the global marketplace. Investment banks have enjoyed the benefits of securitising higher-risk loans with combinations of other classes of debt into structured products. Tranches of these structures were then sold on with a credit rating which may have been attractive in comparison to some of their underlying holdings. The repackaging of the sub-prime debt was a major cause of concern as many investors could not easily discern what they actually owned within a securitised wrapper.

Perhaps even more pertinently, the inability to discern what was held on other institutions' balance sheets resulted in operators in the debt markets becoming extremely reluctant to lend to each other as they found themselves less confident in their assessment of the risk posed by their counterparties. This resulted in the credit crunch: the increasing viscosity of the money markets was caused by investors requiring higher yields to justify making loans. The credit crunch has had many effects including the intervention of major central banks who attempted to increase the level of liquidity in the system to encourage lending and avert economic slowdown. Leveraged asset classes such as property

and some private equity deals also became less appealing as the cost of debt had increased substantially. As news of the credit crunch percolated through to make headlines in all media, the level of investor anxiousness increased, causing a decline in equity markets and a government bond rally, the latter causing spreads to widen further as government debt yields shrunk.

By the end of 2007 many banks had taken the sub-prime related losses back onto their balance sheets causing write downs in the region of USD 80 billion. In order to do this many banks have sold new stock, often to Asian and Middle Eastern sovereign investment funds. The extent of losses has resulted in some senior resignations from financial companies, and even a run on the British bank Northern Rock. The market goes, therefore, into 2008 with a degree of caution, although the fact that some losses have been recognised is a positive first step toward greater certainty. Please see Focus: Global Outlook and Themes for 2008 on page 4 for more thoughts on the year ahead.

In December, global equity markets exposed investors to less volatility than they had been accustomed to of late. With the exception of Japan, the overall monthly return of the major markets was broadly flat with a slight bias to the downside. US equities returned -0.7%, Continental European equities fell -0.9% and Japanese equities lost -3.6% in local currency terms. The UK was a slight exception, returning 0.3% in December. Over the course of the year Japan provided negative returns, down -11.1%, whereas the US, UK and Europe produced positive returns of 4.9%, 5.3% and 5.2%, respectively, in local currency terms. Global equities returned -1.3% in US dollar terms in December and, for the year, returned 9.0%. This performance is a testament both to the strength of the markets in the first half of the year and to the resilience of the markets in the second half. The markets had less direction during the latter period, and indeed had periods of weakness, but they did not fall precipitously and the major markets, with the exception of Japan, recovered to finish the year at their late June levels.

Throughout much of 2007 Global Emerging Markets Equities have comfortably out performed their developed market counterparts. In December GEM equities returned 0.4% in US dollar terms, bringing the fourth quarter return to 3.6%. This is a reasonable return but it is dwarfed by the 2007 return of 39.4% for the asset class. This is a significant return and probably in excess of most investors' forecasts at the start of the year. This strong positive return also

serves to highlight the levels of volatility which can be present in the emerging markets and in other less efficient asset classes. This volatility when it is positively skewed provides investors with an opportunity to out perform the developed markets. The opposite is also true on the downside, this is why we advocate a diversified and cautious approach to emerging market investing, which may lag slightly the strong bull runs, but which aims to reduce the drawdowns experienced in less buoyant times.

Global government bonds were flat in local currency terms as investors priced in different interest rate scenarios for different global regions. US Treasuries returned 0.1% in local currency, Japanese government bonds returned 0.2% and UK gilts returned 1.3% in December. European government bonds returned -0.3% demonstrating a significant divergence in interest rate outlook. Broad Investment Grade bonds under performed the pure government exposure, returning -0.3% in December. Emerging Market debt spreads widened over the course of 2007 after a period of tightening to historically low levels. The spread increased by 100 basis points (bp) over sovereign debt as investors sought lower risk assets, to finish the year at a spread of 240 bp. High yield debt plotted a similar path, with spreads more than doubling from the lows in February to end the year yielding almost 350 bp over sovereign debt.

Global currency traders decided to turn their attention from the US dollar to sterling in December with the British currency performing poorly against all other majors. The yen and the euro also lost value against the dollar returning -0.7% and -0.4%, respectively, as the greenback enjoyed the benefits of more positive investor sentiment, however, these both outperformed sterling, which returned -3.2%. This weakness reflects investors' reappraisal of the UK's interest rate outlook. In contrast, as the oil price gained to the end of the month, it provided a fillip to some of the so called 'commodity currencies', such as the Norwegian krone (up 2.0%), the Brazilian real (up 1.0%) and the New Zealand dollar (up 0.2%). The US dollar overall has experienced a difficult year with the trade weighted US dollar index returning -8.3%. This reflected a variety of factors including the impact of 75 basis points of interest rate cuts in the second half of the year. Yet the decline has been consistent throughout the year, suggesting sentiment towards the US dollar had already been bearish.

Global property experienced an unusually high degree of correlation within the asset class in December. The fundamentals

of global property are still not universally negative, but the sentiment in the short term seems to be. There are certainly regions that are overpriced at present, for example direct UK property investments are yet to experience much of the downturn predicted by the listed property market. In the UK the levels of investor withdrawals from funds, coupled with the illiquidity of the asset class, has meant that many funds are now without their liquidity 'buffer' of equities and cash. The result of this is that if withdrawals continue, funds will have to contemplate selling physical properties into a thin market. Yet areas where the fundamentals do not appear so clearly negative, such as Asia, also experienced negative returns in December. In fact, Asian property underperformed the other regions in December, returning -6.0% in US dollar terms. Despite a relatively poor end to the year, Asia still outperformed other regions in 2007, returning 14.8%. The US REIT's market performed similarly in December, returning -5.2%. There is, however, a strong performance differential between the US and Asia over the year, with the US returning -16.8%, giving Asia a relative outperformance of over 30%. Europe and the UK

returned -3.9% and -2.5%, respectively, in December, and have returned -36.7% and -23.4% in local currency terms through 2007.

Global commodities experienced a strong month returning 5.8% in US dollar terms. Gold gained 6.6% in the month, to end 2007 up by 31.5%, as investors sought diversification and inflation hedges in their portfolio. Gold is often considered by investors to have inflation-influenced value and therefore exposure to gold is often sought when inflation appears possible. Inflation is considered a risk factor by some investors as a result of continued commodity price strength. Oil, for example, has rallied throughout 2007, finishing the year up 55%. In December platinum, palladium and silver all returned over 5%. Agricultural commodities performed well in December, returning 6.0% in US dollar terms. Strong returns were posted by corn and soybean meal, both of which returned over 13%. Lumber fell -7.2% on continued concerns over the US housing market and the impact that will have on construction going forward.

Asset Class Performances

Asset Class Performance (%)	Dec 2007	Q4 2007	2007
US Equities \$	-0.7	-3.5	4.9
UK Equities £	0.3	-0.4	5.3
Cont. European Equities €	-0.9	-2.3	5.2
Japanese Equities Yen	-3.6	-8.6	-11.1
Global Equities \$	-1.3	-2.4	9.0
Global Emerging Markets Equities \$	0.4	3.6	39.4
US Bonds \$	0.0	4.2	9.1
European Bonds €	-0.3	1.1	1.8
Japanese Bonds Yen	0.2	1.4	2.6
Global Bonds \$	-0.3	3.5	9.8
US REITs (property) \$	-5.2	-13.2	-16.8
FTSE Real Estate £	-2.5	-15.1	-36.7
FTSE EPRA Real Estate ex UK €	-3.9	-12.5	-23.4
FTSE EPRA Real Estate Asia \$	-6.0	-6.9	14.8
Euro vs. US Dollar	-0.4	2.8	10.9
Sterling vs. US Dollar	-3.2	-2.3	1.7
Yen vs. US Dollar	-0.7	3.0	6.7
Rand vs. US Dollar	-0.5	0.9	3.2
Commodities \$	5.8	11.6	32.7
Agricultural Commodities \$	6.0	4.6	20.6
Oil \$	3.9	20.4	55.4
Gold \$	6.6	12.4	31.5

* Source: Bloomberg, Lipper

Focus: Global Outlook and Themes for 2008

The year 2007 has shown a transformation in investor sentiment from perennially bullish to rather more unsure, with the performance of asset classes to match. In the first half of 2007, with the exception of late February, equity markets continued their strong run. In the summer, as the news of worsening conditions in the US sub-prime market began surfacing, perception of risk increased significantly, causing equity markets to fall, bonds to rally and money market rates to spike up as investors became willing to 'pay up' for apparently lower-risk asset classes. The final quarter of 2007 has been characterised by investor uncertainty, and, despite attempts by central banks to provide support, 2007 looks likely to close with little direction or consistency in market sentiment.

Figure 1, below, plots the spread of US LIBOR over the Fed Funds Rate against the VIX Volatility Index. The relationship between equity volatility (a sign of investor uncertainty) as implied by VIX and the 'expensiveness' of borrowing represented by the spread of LIBOR over the Fed Funds rate throughout 2007 is clear. This shows VIX rising sharply from a particularly low level, reflecting increasing investor uncertainty in the equity market, and the spread of US dollar LIBOR moving out from 10 basis points (bp) over the Fed Funds rate to nearly 100 bp. The move in spread is also a symptom of investor nervousness as banks require more compensation (yield) to loan to other banks.



Figure 1: Spread of USD 3m LIBOR over Fed Funds rate VIX Index

As a result of the above, investors have spent the second half of 2007 exposed to rather more uncertainty than they have become accustomed to. As the extent of the damage to the financial sector globally caused by the credit crunch has become increasingly apparent, the big question now on investors' minds

is the scale of the knock-on effects on the real economy and hence on corporate earnings. Below we look at some themes that we believe may feature in this challenging environment in 2008.

Interest rates in developed markets increased at a measured pace through 2006 and early 2007. Now the most likely course for the developed markets' interest rates will be flat or biased to the downside. Indeed the US and UK central banks have already given a strong signal of intent by cutting interest rates by 100 and 25 basis points, respectively; whilst doing so, central banks are reminding investors that they do not have a free hand to cut rates as they remain alert to inflation risks. One likely result of these rate cuts should be to fuel capital gains for government bonds as their yields move down in concert with the government target rates. Also, as shorter dated yields drop, yield curves should stay 'normally' shaped due to lower yields on shorter term debt. The central banks are hoping that by cutting interest rates they will stimulate business and consumer spending, as saving is less attractive and borrowing becomes cheaper. The danger of cutting interest rates at this point is that it may result in the desired increase in spending, but the effect of this is merely price inflation without concurrent improvements in global growth rates. The potential for stagflation, as it became known in the 1970s, may be the main reason why the European Central Bank is so far reluctant to signal a dovish stance. In this environment, investors will seek relatively safe haven investments among equities, favouring defensive sectors such as pharmaceuticals (which have been out of favour for years), utilities, tobacco and telecoms. Cyclical, consumer-oriented sectors are likely to suffer as credit and spending are curtailed.

When the risks of inflation are increased, investors tend to look to invest in 'inflation hedges': assets whose performance is positively correlated with inflation. An obvious source of inflation hedges is commodities as commodity prices are themselves components of inflation. Commodities generally have undergone a strong run for a decade (see Figure 2 below) with prices presently close to their highs. If the global economy does stagnate, demand for these should drop, especially given their high nominal price levels, and commodity and resource related shares, which have been the stock market darlings of

recent years, are likely to suffer. Agricultural commodities, however, could continue to perform well. Demand for food may prove resilient as the Emerging Markets' burgeoning middle class improve their current diets, whilst capacity constraints and producer efficiency levels provide a limiting factor to supply. Furthermore, with the increasing governmental emphasis on alternative, crop-based fuels, demand for agriculture appears likely to remain high in 2008.



Figure 2

Figure 2 also demonstrates that, thus far, agriculture has been left behind by the recent 'commodity boom', suggesting that there may be 'headroom' for prices. Indeed it is the only constituent of Figure 2 to have lost value since 1997.

Inflation-linked bonds are another source of inflation protection. The principal value of these securities is usually linked to a domestic price index and these securities could benefit in absolute terms from both reduced interest rates and their inflation protection qualities. Other sources of inflation hedges include gold (a commodity, but with arguably different fundamentals as a long term store of value) and property with inflation-linked rent reviews.

The major equity markets have all been affected by the recent events concerning the sub-prime market and resulting illiquidity of credit markets. The full effect of these are probably yet to be experienced by corporate balance sheets, but so far financials have written down approximately USD 70 billion in earnings as a result of sub prime, the 'credit crunch' and their related effects. This will impact company valuations as price is often viewed as a function of forecast earnings. However, despite reduced earnings

expectations equity markets do not look inherently expensive and, if earnings hold up better than expected, equities could begin to look cheap on a price to earnings basis. One extremely important issue for 2008 is therefore corporate earnings, especially in the developed markets. In quarter three 2007, US earnings growth subsided quite abruptly and the most likely cause for this was large financial companies accommodating losses from sub-prime related issues. Also it is likely that equity market volatility will not return to the low levels seen in early 2007, as a heightened level of volatility becomes typical due to less certainty in the marketplace. The sub-prime worries will continue and speculation over the width and depth of the problems can be replaced with fact. Equity markets are expected to remain nervous while the extent of the credit crisis unfolds, but valuation support suggests that further sustained weakness will represent a good buying opportunity.

The US dollar has experienced weakness of late, driven by several factors including the cutting of interest rates and re-appraisal of the US economic outlook. The present weakness appears to be more of a concern for the US's trading partners rather than for the Fed. In fact, the weakness of the US dollar may have had some beneficial effects on the US economy. For example, as the US dollar becomes cheaper the buying power of 'foreigners' in the US increases. This US dollar weakness has in fact led to positive net exports from the US for the first time in c.15 years. In the short term this contribution to GDP has taken up the slack from the weakening housing market. Factors such as these suggest that the US economy may not perform as poorly as many anticipate in 2008. Furthermore, it is possible that the US dollar will gain as other countries begin to cut their rates to stimulate their economies. Also if other countries begin to cut their interest rates then the present yield differential between the US and other countries will narrow, which would likely result in a degree of US dollar appreciation.

Within property markets it is clear that the developed markets have not been able to retain their lustre in 2007 following on from a number of above trend years. Globally, as the cost of debt increases, buyers and sellers have to adjust to a new base scenario where higher interest rates necessitate higher rental yields, which is likely to result in lower capital values.



Fig 3: UK Property Returns vs. UK Equities (rebased)



Fig 4: European Property Returns vs. German Equities (rebased)

The recent performance of listed property can be viewed as a leading indicator of direct property prices, as they are priced prospectively rather than retrospectively. It is clear from Figures 3 and 4 above that during the bull run from 2002 property returns were consistent with the broader equity market index. In 2007 this changed dramatically and property has underperformed equity markets markedly. In the direct property markets, this is yet to be fully reflected (and it may never be if direct investors think equities have gone too far), but it is clear that there is reduced transaction activity and the beginnings of lower pricing. One cause of the current illiquidity is that despite the message from the equity market, adjustments to expectations are yet to take place: buyers are looking for lower prices, while sellers are reluctant to drop prices. Direct property participants will eventually calibrate to the new conditions and the market will open up again. Despite current sentiment, real estate may still be an attractive proposition in 2008 for investors, but regional allocation will be a paramount consideration. Despite the relatively localised concerns in the UK and US, other economies are benefiting from good supply and demand fundamentals, even at present. Asian property has proved resilient in 2007, and we expect this to continue into 2008. Furthermore, investors

must seek skilled property managers that are able to use active management to wring value out of their holdings. Property should always be viewed as a steady income-generating investment and this will still be possible in 2008. Furthermore, as mentioned above, property has an inflation hedging character, as rents in regions such as Europe are inflation indexed. The market will be timid until a number of large and fairly priced deals provide some comfort.

One much maligned economy, Japan, has been out of favour recently and its recent performance has been somewhat underwhelming. Japan's investors are cautious after years of deflation and painful memories of previous mistakes, but the economy could surprise on the upside. The financial sector appears reasonably healthy, having less exposure to structured products and sub-prime debt than their western counterparts; property occupation is high and asset values are supported. Interest rates remain close to zero at the short end and are unlikely to change significantly in the year ahead. For corporations more generally, the potential for externally driven growth is reasonable as Japan's trading partners are increasingly its Asian cousins rather than a strong reliance on the US. This final factor may provide a degree of dislocation were the US economy to tip into a recession.

From a currency perspective, the long-term mean reverting nature of currencies suggests that investors should be exposed to a range of currencies in their portfolios. Within that, however, investors can discriminate whilst remaining diversified. Sterling has been strong against the US dollar, fuelled by a growing interest rate differential. This differential is likely to reverse into 2008, and sterling may weaken as a result. The UK's problems in terms of high levels of indebtedness and a vulnerable housing market are not dissimilar to those in the US, but sterling to date has been highly resilient; this might well change in coming months as the UK economy slows sharply. Equally, the euro may have a similar experience if the ECB moves to a looser monetary policy. At the same time, the US dollar, which is currently low on a trade-weighted basis, could surprise on the upside if the US economy proves resilient. Whatever the outcome among the major currencies, the outlook for Asian currencies is strong; most are undervalued and have been kept artificially low to support a strong trade performance. With rising inflationary concerns in some of these countries and increasing pressure from trading

partners, it is likely that there will be a gradual long term appreciation of Asian currencies.

Entering 2008, with notable uncertainty amongst investors, corporations and possibly even central banks, investors may wish to take a conservative asset allocation whilst the market adjusts to the reality of a global credit crunch and its highly uncertain impact on economic activity. Barring a global

recession, as 2008 progresses there should be opportunities for investors to position their portfolios higher up the risk curve and, if the present negative sentiment continues in the short term, investors should be presented with appealing valuations. 2007 has demonstrated that genuinely diversified asset allocations can mitigate risks and provide higher risk-adjusted returns. This benefit of diversification is likely to be a key mantra for 2008.

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