



MARKET COMMENTARY - SECOND QUARTER 2010

MARKET OUTLOOK

Autumn 2010

INVESTMENT REVIEW

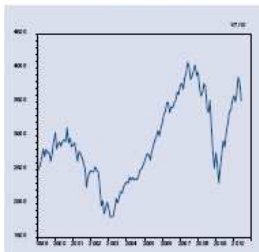
We have reviewed the market data and economic conditions resulting in an amendment to our asset allocation models. Our **Strategic Portfolio Service** which has now been running for 18-months provides an active quarterly fund review; please let us know if you would like more information on this. Our quarterly market outlook provide our views on market and economic factors that influence our investment strategy.

EXECUTIVE SUMMARY

- Evidence of a peak in global growth is gathering with a moderation in the pace of recovery.
- Leading indicators of economic activity are turning down. In this scenario, stocks tend to underperform bonds until indicators trough, and this is unlikely to happen before late 2010.
- Global unemployment rates are stabilising, but at high levels, suggesting GDP growth is just about in line with the moderate pace of recovery.

ECONOMIC OVERVIEW

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Although the Authority's response to the credit crunch provided liquidity to markets by swapping debt from the private to public sector, it failed to address the global structural imbalances between the debt-ridden developed and cash-rich emerging economies. After the initial optimism – fuelled by the prospect of economic recovery and rising corporate profits – the reality is now belt-tightening and debt repayment against the backdrop of potential sovereign debt defaults in the peripheral eurozone economies. World growth rates are predicted at 2.4% for the developed world and 6.7% for emerging economies. However, there is a greater risk of policy error occurring, which is either caused by governments under-estimating tax revenues or over-estimating their ability to reign in expenditure.

It is potentially alarming to see significant degrees of fiscal tightening being announced at a time when a number of lead indicators are turning down.

At present, US manufacturing appears to be stalling whilst unemployment figures are disappointing, and coupled with falling export orders this suggests that the woes in the eurozone are finally beginning to have an impact on the US. These numbers add to the picture of an economy losing momentum, although various technical data would suggest this newsflow is heralding a slower growth and not recessionary scenario. We feel the fears of a double recession are probably misplaced as the economy has a large output gap and monetary policy is likely to remain accommodative for a significant period of time. However, in the short term it raises the risk that the US economy could slow by more than is factored into markets.

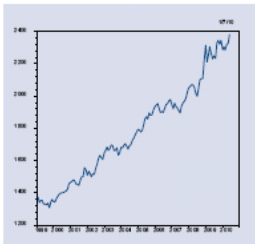
Risk aversion has returned as government bonds have strengthened. Concern now seems to be centred on solvency rather than liquidity as budget deficits rise to their highest levels ever seen during peacetime. Markets have begun to question the sustainability of government support. Fiscal tightening in the UK has become the order of the day, although in the US this seems to be less of a priority. History suggests that belt tightening and inflation achieve greater success than attempting to grow an economy out of debt. The main question now is whether private sector stimulus is sufficient to make up for government expenditure cuts.

There are indeed other threats to growth, namely China, where the authorities are attempting to cool activity in order to bring property speculation under control and prevent a damaging rise in inflation. The recent announcement by the People's Bank of China suggests action will include revaluation of the currency. We suspect that this action will be delayed or inadequate and will still result in an uncomfortable period for the US whilst currencies remain unbalanced.

We still believe the world economy is on a sustainable recovery path with fears of a moderation not being without foundation, there is evidence that the initial phase of the recovery is drawing to a close.

INTEREST RATES & FIXED INTEREST

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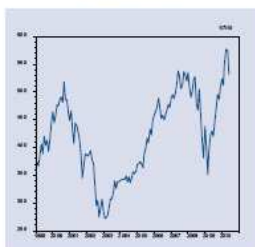


Headline CPI rates have risen rapidly over the last year, but oil prices and core inflation are relatively steady. The announcement of VAT rises next January to 20% will keep inflation temporarily higher. The Bank of England in these circumstances is unlikely to conduct further quantitative easing operations although we would expect them to keep interest rates at a low level for some considerable time to come. One forecaster is even predicting rates to remain below 1% for the next 4 years! We certainly believe that the inflation problem people seem to fear is still 2-3 years away, with current deflationary influences winning out.

George Osborne's emergency Budget set out to deal decisively with Britain's record government debt, accelerating the reduction of the structural deficit. The comment by Moody's that the Budget was supportive of the UK's AAA rating is undoubtedly good for confidence. It was a Budget for the gilt markets and not particularly the stock market. We continue to believe quality corporate bonds to be better value than government debt, with the sweet spot being in quality high yielding debt being the most valuable.

EQUITY MARKETS

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Effectively, markets are behaving as if we have gone back into recession, a move consistent with fears about growth and a double dip. Whilst we see such concerns as overdone, the loss of growth momentum may mean that it will take some time for sentiment to change. On a valuation basis, equity markets look relatively attractive. Prospective price to earnings valuations are still well below historical averages and risk appetite has fallen to near panic levels already according to a renowned Credit Suisse measure. We remain structurally positive on equities and risk assets but are tactically cautious whilst markets fret about growth and sovereign debt. In practice, this means moving underweight in risky assets as we feel the growth cycle is peaking. There is certainly a cooling off in global growth rates and by moderating our stance in US equities and commodities, we feel there will be an opportunity to buy back into these risky assets later in the year.

COMMERCIAL PROPERTY

Commercial property is still an attractive asset class to hold with its strong non-correlation to equities and fixed interest. Availability of good quality stock is currently low, but yields in the prime end of the market are attractive. There are concerns that banks will need to continue their unwinding of loan books and restructure finances. However, retail funds are still experiencing positive inflows although they have come down from the highs of last year. Central London rents appear to be improving and sentiment is polarising markets towards good quality investments whilst marking down secondary property. Quality retail funds such as those we are currently using have credible current yields with further growth on capital value expected.

ASSET ALLOCATION

Recent history suggests that when bond and equity markets disagree over the prospect for markets, it is the fixed income investors who prove to be correct. We are removing a further few degrees of risk off the portfolios by topping up fixed interest investments and are taking risk off equity markets and utilising further our exposure to alternative strategies. As cyclical companies struggle under market conditions, we favour funds that focus on companies with secure dividends and have strong cash positions. This means weightings in pharmaceuticals, utilities, tobaccos, telecoms and supermarkets remain strong as they are relatively unaffected by the slow pace of domestic economic growth. We believe this is not a time to be in higher risk assets and that many investors will lose their nerve in the face of talk of a double dip, and is likely to create an opportunity to buy back into risky assets at lower levels.

Source: Datastream