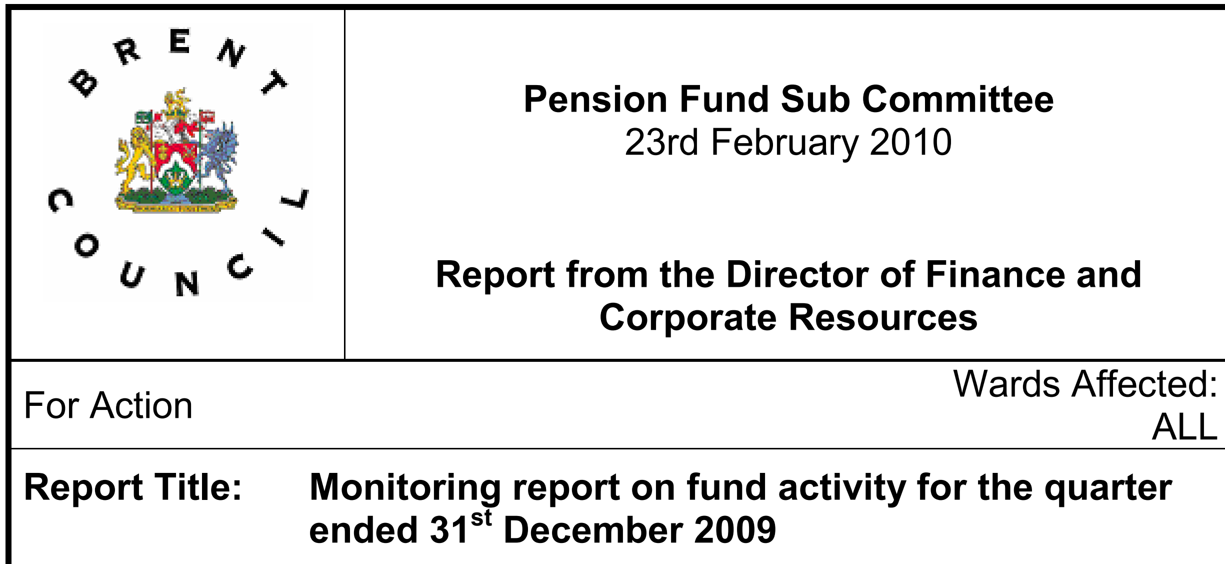

Pension Fund Sub Committee
23rd February 2010

Report from the Director of Finance and Corporate Resources

For Action	Wards Affected: ALL

Report Title: **Monitoring report on fund activity for the quarter ended 31st December 2009**

1. SUMMARY

This report provides a summary of fund activity during the quarter ended 31st December 2009. It examines the actions taken, the economic and market background, and investment performance, as well as commenting on events in the quarter. The main points arising are:

a) Equity and credit markets rose during the quarter. Equity markets fell during January.

b) The Fund has grown in value from £418m to £431m, and has outperformed its benchmark over the quarter (0.4%) mainly as a result of improved performance in equities, fixed interest and hedge funds. The Fund underperformed the average local authority fund (-0.1%), as a result of lower exposure to equities. Over one year, the Fund has underperformed its benchmark (-1.1%) mainly as a result of poor returns in private equity offset by good stock selection, and underperformed the average fund (-2.1%) as a result of lower exposure to equities.

2. RECOMMENDATIONS

Members are asked to note this report.

3 DETAIL

ECONOMIC AND MARKET BACKGROUND - QUARTER ENDED 31ST DECEMBER 2009

3.1 All equity markets, rose during the quarter following the end of the the recession. The UK rose by 5%, USA 5%, Germany 2%, HongKong 4% and Japan by 4%, but the emerging markets 'led the charge – Russia 14%, Brazil 11% and China 18%. The UK economic background was:

- UK base rates remained at 0.5%. Medium and long-term interest rates rose during the quarter. Credit markets have improved – LIBOR and LIBID have

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moved closer to bank rate. The Quantitative Easing programme is to continue until February 2010, but at a reduced rate.

- Headline inflation (RPI) rose by 2.4% in the year to December (-1.4% September), and the Index of Consumer Prices (CPI) rose by 2.9% (1.1% September), as the fall out of the VAT reduction and rising fuel costs increased inflationary pressures. The re-introduction of VAT at 17.5% may increase the rate to around 3.5% in January before inflation falls in the first half of 2010 as spare capacity and low pay increases bear down on prices..
- Average earnings growth (including bonuses) was 1.9% p.a. in November (1.6% August), well below the Bank of England's 'danger level' (4.5%). Unemployment has begun to fall, but the number of full time jobs has fallen, and the overall number of unemployed may rise as the government cuts public expenditure.
- The UK economy has been in recession (GDP falling by 4.8% in 2009), but grew by 0.1% in Q4 2009 and is expected to grow by 1% / 2% in 2010 (and 1.5% in 2011).
- It has been anticipated that consumer spending will fall, though retail sales were up 3.1% in the year to November. A number of retailers have issued profit warnings or entered administration. The squeeze on incomes, and the decline in equity withdrawal from the housing market as prices fall, may further depress demand. House prices have risen over one year (3.6%). Mortgage approvals are only 60% of their level two years ago. Capital Economics still expects house prices to fall by a further 10% / 15%.

In summary,the recession may have ended but interest rates are expected to remain low. The government is using both fiscal and monetary policy to combat the downturn. The recovery is expected to be slow with occasional setbacks, but sentiment has improved considerably.

3.2 Central banks have co-ordinated activity to supply liquidity to markets so that credit is available to support economic activity. It is expected that USA economic growth will decline by around -2.5% in 2009, though the economy has grown in the second half of the year. The Fed has reduced rates to 0% - 0.25% and introduced a major programme of quantitative easing, as a response to rising unemployment (10.2%) and slow growth. There is evidence that the USA housing market is starting to form a base, and that the USA economy may grow by 3% in 2010 (but only 1.5% in 2011). The ECB has reduced rates to 1% and taken measures to improve banks' liquidity, but it is expected that Eurozone GDP growth will shrink by -4% in 2009 and only grow by 1.5% in 2010. Growth in China and India will be around 9% and 8% respectively in 2009, but accelerate in 2010 to around 10% and 8% respectively. The world economy is expected to shrink by -3% in 2009, grow by 4% in 2010, but only expand by 2% in 2011.

3.3 A paper on market events and future prospects, written by the Independent Adviser, is attached.

3.4 Table 1 below shows the changes in asset allocation, how asset allocation compares with the benchmark and with the average fund (WM Local Authority average), and how the change in the market value during the quarter is allocated across asset classes. Items marked (*) in columns 4 and 8 cannot be separately

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analysed, but are included elsewhere. The WM Local Authority average asset allocation indicates little change apart from market movements.

Table 1: Asset Allocation as at 31st December 2009 compared to the Benchmark

Market (1)	Market Value 30.09.09 £M (2)	Market Value 30.09.09 % (3)	WM LA Average 30.09.09 % (4)	Fund Benchmark 30.09.09 % (5)	Market Value 31.12.09 £M (6)	Market Value 31.12.09 % (7)	WM LA Average 31.12.09 % (8)
Fixed Interest							
UK Gilts	17.6	4.2	9.9	4.5	15.7	3.6	10.2
Corp.Bonds	24.3	5.8	*	4.5	23.0	5.5	*
IL Gilts	-	-	5.4	-	-	-	5.3
Overseas	-	-	2.6	-	-	-	2.6
Emerg. Market	3.3	0.8	-	-	4.3	1.0	-
Infrastructure	0.7	0.2	-	0.5	0.7	0.2	-
Secured loans	19.7	4.7	-	5.5	17.4	4.0	-
Credit Opps.	12.7	3.0	-	2	13.1	3.0	-
Credit Alpha	5.6	1.3	-	1	7.9	1.8	-
Equities							
UK FTSE350	114.8	27.5	33.6	18.5	115.1	26.7	33.6
UK Smaller co's	15.5	3.8	*	4.0	15.2	3.5	*
Overseas	94.5	22.7	33.6	26.5	103.2	24.0	33.3
USA	41.8	10.0	9.8	-	45.8	11.1	9.3
Europe	28.6	6.9	9.9	-	28.5	6.2	9.0
Japan	4.0	1.0	3.8	-	4.7	1.1	3.8
Pacific	8.6	2.1	4.2	-	10.1	3.6	3.7
Other	11.5	2.7	5.9	-	14.1	1.9	6.1
Other							
Property – UK	18.0	4.1	5.3	8.0	19.2	4.4	5.6
Property – Eu.	7.4	1.8	*	*	6.8	1.6	*
Hedge funds	40.7	9.8	1.1	10.0	41.3	9.5	1.6
Private Equity	26.8	6.4	3.0	8.0	33.7	7.9	2.4
GTAA	10.1	2.4	-	4.0	10.5	2.4	*
Infrastructure	5.4	1.3		2.0	5.0	1.2	*
Cash	0.5	0.2	4.2	1.0	-1.0	-0.3	4.1
Total	**417.6**	**100.0**	**100.0**	**100.0**	**430.9**	**100.0**	**100.0**

3.5 The main changes have occurred as a result of market movements and increased exposure to private equity. During the quarter, £7.6m was invested in private equity and £0.5m in UK property. It has been agreed that £0.75m should be returned from the fixed interest portfolio each month (until March), and £1.25m per month invested in global equities. Since the end of the quarter there has also been further investment in private equity (£1.1m) and infrastructure (£0.6m), and sales of UK

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equities (£5.2m). The Fund is currently overweight in UK equities and underweight in overseas equities and property, but steps are being taken to correct these imbalances.

Performance of the Fund

3.6 The independent WM Company measures the returns on the Brent Pension Fund. Table 2 sets out returns for the quarter to 31st December 2009.

Table 2: Investment Returns in Individual Markets

Investment Category	RETURNS						Benchmark/ Index Description
	Quarter Ending 31.12.09			Year Ended 31.12.09			
	Fund %	Benchmark %	WM Local Auth %	Fund %	Benchmark %	WM Local Auth %	
UK Equities			4.9			29.7	
UK Equities	6.0	5.7		31.5	29.7		FTSE 350
UK Small Caps	-2.4	-7.7		61.9	57.7		FTSE Smallcap ex IT
Global Equities	4.7	4.5	3.9	28.0	28.2	26.4	FTSE World 75% Hedge
North America	3.6	5.6	5.2	11.2	23.9	17.1	FTSE USA
Europe	0.9	2.7	1.8	28.6	30.0	20.5	FTSE Eu Ex UK
UK	2.0	5.7	4.9	17.3	30.4	29.7	FTSE All Share
Japan	6.2	-0.9	-3.2	16.4	4.5	-4.4	FTSE Japan
Pacific (ex Jap)	0.4	5.0	4.6	61.5	59.2	48.8	FTSE Pac. Ex Jap
Emerging	15.0	6.1	7.2	71.0	27.6	54.3	FTSE World (Other)
Fixed Interest							
Total Bonds	1.0	-0.5	0.3	15.5	3.6	7.6	Brent benchmark
UK Bonds	-1.8	-2.0	-0.2	0.5	-1.2	8.3	FTSE UK over 15 years
Index Linked UK	-	-	1.4	-	-	6.9	-
Corp Bonds	0.0	0.5	-	11.6	10.8	-	iBoxx Sterling Non-gilt
Secured Loans	5.2	0.9		52.0	4.7		3 month LIBOR +3%
Credit Opportunities fund	2.6	1.4		28.4	5.7		3 month LIBOR+5%
Other							
UK Property FOF	10.1	9.4	6.5	-	2.2	-5.3	IPD Pooled index
Eu Property FOF	-7.7	9.4		-	2.2		IPD All properties
Hedge Funds	1.4	1.1	1.9	13.3	5.1	8.3	3 month LIBID+4%
Private equity	-0.2	0.1	1.1	-21.3	1.2	-15.5	LIBID 7 Day
Infrastructure	-1.4	1.1	-	-	-	-	3 Month LIBID +4%
GTAA	3.9	6.2		57.9	27.3		FTSE 100
Cash	-0.5	0.1	0.2	n/a	2.4	0.9	GPB 7 DAY LIBID
Total	**3.2**	**3.1**	**3.3**	**15.6**	**16.7**	**17.7**	

3.7 Details of individual managers' performance tables are attached in Table 3, which shows three month, one year and longer-term information. Returns for the quarter were positive, outperforming the benchmark by 0.4%. The main stock selection factors were:-

a) UK small companies. The fund outperformed as the manager overweighted smaller AIM stocks that did not fall in value as rapidly as their larger FTSE counterparts.

b) Fixed interest. Once again there was outperformance in government and corporate bonds as the manager overweighted fast recovering corporate

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bonds. Secured loans and the Credit Opportunities Fund also recovered in improving credit markets. The manager has reweighted the fund to increase exposure to the Credit Opportunities and Credit Alpha funds, to take profits in secured loans, and to increase the weighting in the core fund.

c) Hedge fund of funds outperformed as multiple strategy and equity related strategies continued to be successful.

d) GTAA. The manager underperformed as previously successful strategies lost value. In particular, the short on Japanese bonds and the long on the Japanese yen reduced returns.

e) Global equities outperformed the benchmark as stock selection, particularly in the ‘value’ portfolio’, and currency added value.

f) Property. The UK fund of funds underperformed as a result of additional cash holdings and the reticence of some funds to resume paying dividends.

3.8 Over one year, the Fund underperformed the benchmark by 1.1%. Asset allocation – lower exposure to UK Small companies, higher exposure to bonds - has been negative. The main stock selection factors were that private equity underperformed sharply, but that other stock selection was positive – equities, bonds, GTAA and hedge funds.

3.9 The relative underperformance of the Brent fund against the WM Local Authority average in Q4 arises as a result of the asset allocation followed by the Brent Fund (lower exposure to equities), offset in part by gains in stock selection and exposure to secured loans and credit.

3.10 The Brent fund has underperformed the average local authority fund by 2.1% over one year, mainly because it has had a lower exposure to equities (higher exposure to alternatives) in a period when equities have performed very strongly.

Actions taken by the Brent In-House UK Equity Manager during the Quarter

3.11 There has been some purchases and sales during this quarter to invest dividends (£0.7m) improve tracking error, rebalance the Fund towards global equities, and invest in private equity .

Purchases

a) Took up rights issues.

Sales

a) Sold stocks to ensure more accurate index tracking or as they left the index (such as Mouchel and Headlam Group).

b) Sold stocks to fund investment elsewhere.

Future Strategy for the UK FTSE350 Index tracking fund

3.12 The strategy is that of tracking the FTSE 350 within 0.5% over the year. Activity during January included selling stocks (£5.2m) to fund increased exposure to global equities and private equity.

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NEW DEVELOPMENTS AND FUTURE INVESTMENT OUTLOOK FOR THE BRENT FUND

3.13 Equity markets have fallen marginally during January following the sharp rise since March. UK gilts have also lost value as markets anticipate rising interest rates to fund the government deficit and to control inflation.

3.14 As expected, investment analysts are becoming more confident about the future progress of markets. It is felt that the world economy will grow in 2010. However, it is anticipated that growth will be slow, and that hopes of sharply rising profits may prove over optimistic.

4. FINANCIAL IMPLICATIONS

These are contained within the body of the report.

5. STAFFING IMPLICATIONS

None directly.

6 DIVERSITY IMPLICATIONS

The proposals in this report have been subject to screening and officers believe that there are no diversity implications arising from it.

7 LEGAL IMPLICATIONS

There are no legal implications arising from the report.

8. BACKGROUND INFORMATION

AllianceBernstein – December 2009 quarter report.

Henderson Investors – December 2009 quarter report
Persons wishing to discuss the above should contact the Exchequer and Investment Section, Finance and Corporate Resources, 020 8937 1472/1473 at Brent Town Hall.

DUNCAN McLEOD
Director of Finance & CR

MARTIN SPRIGGS
Head of Exchequer and Investment

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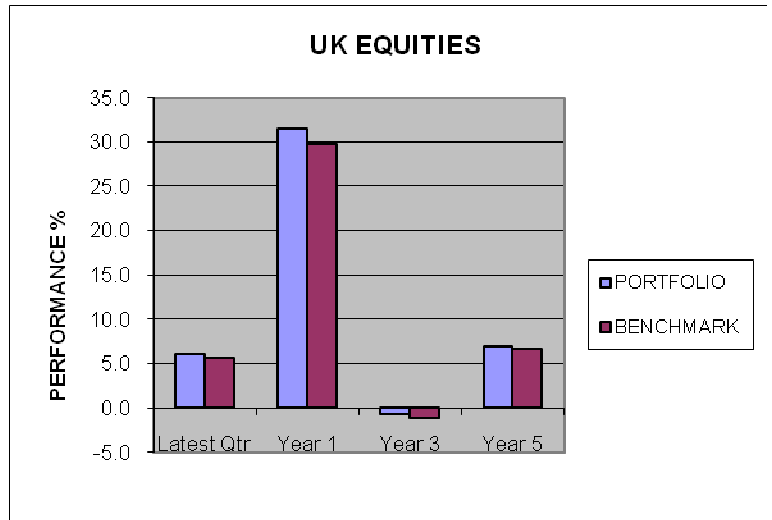
PERFORMANCE FOR INDIVIDUAL PORTFOLIOS 31st December 2009

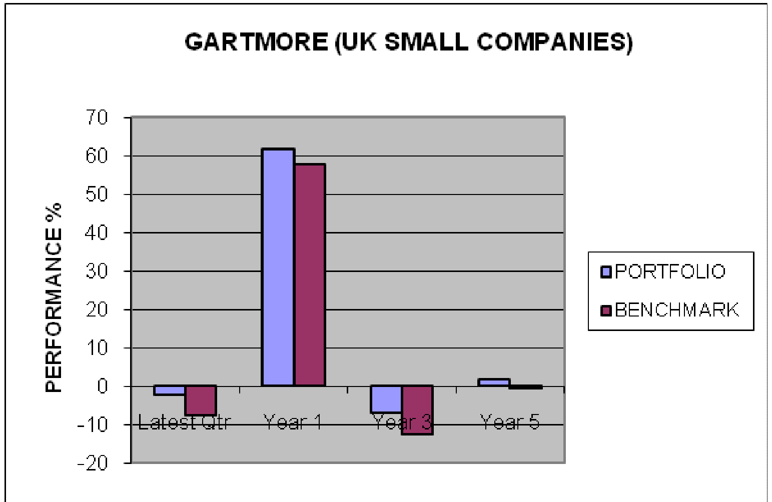
UK EQUITIES

	PORTFOLIO	BENCHMARK
Latest Qtr	6.0	5.7
Year 1	31.5	29.7
Year 3	-0.7	-1.1
Year 5	7.0	6.6



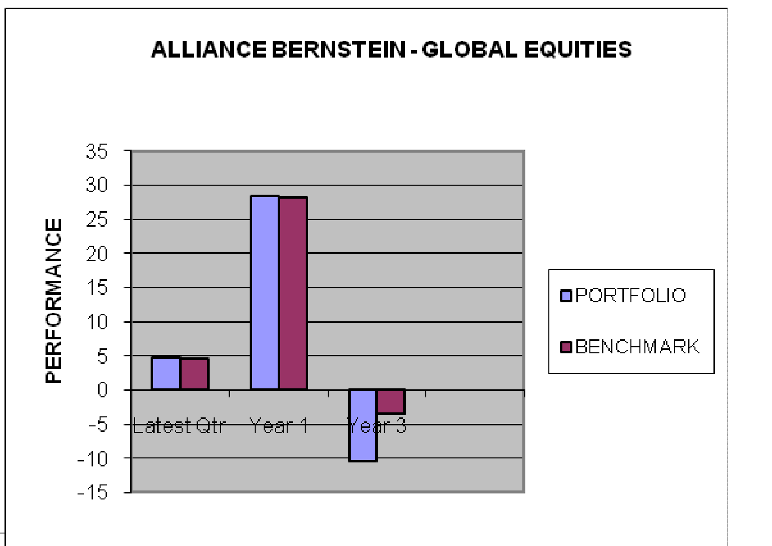
GARTMORE (UK SMALL COMPANIES)

	PORTFOLIO	BENCHMARK
Latest Qtr	-2.4	-7.7
Year 1	61.9	57.7
Year 3	-6.9	-12.5
Year 5	1.6	-0.5



ALLIANCE BERNSTEIN - GLOBAL EQUITIES

	PORTFOLIO	BENCHMARK
Latest Qtr	4.8	4.5
Year 1	28.3	28.2
Year 3	-10.4	-3.4



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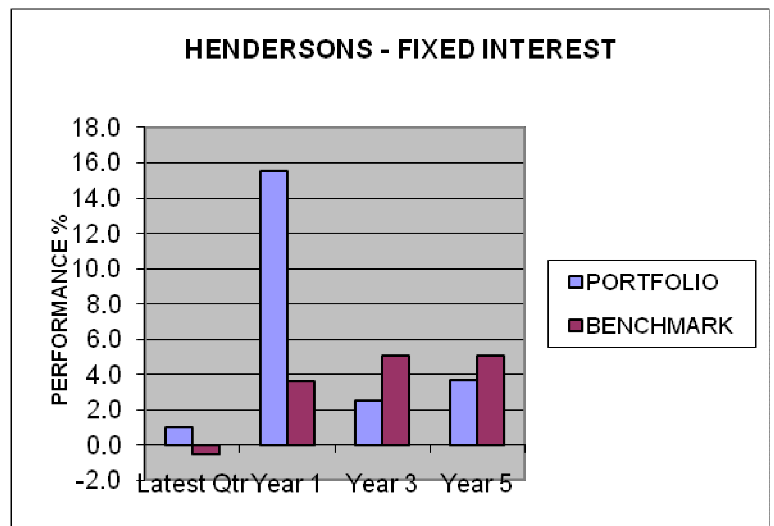
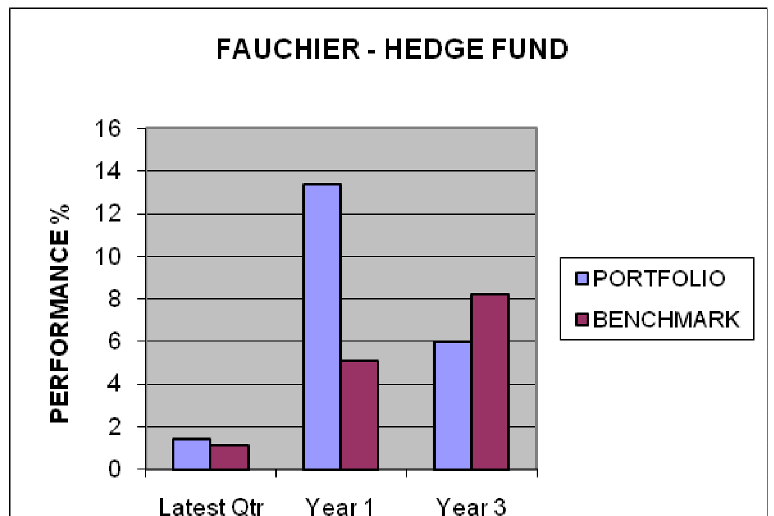
HENDERSONS - FIXED INTEREST

	PORTFOLIO	BENCHMARK
Latest Qtr	1.0	-0.5
Year 1	15.5	3.6
Year 3	2.5	5.1
Year 5	3.7	5.1



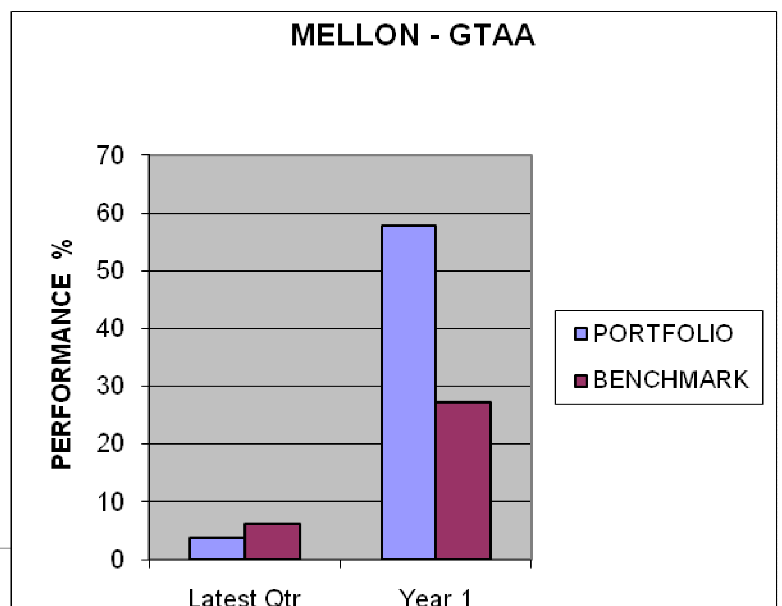
FAUCHIER - HEDGE FUND

	PORTFOLIO	BENCHMARK
Latest Qtr	1.4	1.1
Year 1	13.4	5.1
Year 3	6.0	8.2



MELLON - GTAA

	PORTFOLIO	BENCHMARK
Latest Qtr	3.9	6.2
Year 1	57.9	27.3



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Report from the Independent Adviser

Investment Report for the Quarter ended 31st December 2009

Market Commentary

The index returns and currency movements both for the quarter and year ended 31st December 2009 are shown in the tables below.

Index returns expressed in sterling

		Q/e 31.12.09
		%
Equities		
Emerging Markets	MSCI Emerging Markets Free	7.5
UK	FTSE All Share	5.5
North America	FTSE North America	4.8
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	4.1
Europe	FTSE Developed Europe (ex UK)	0.5
Japan	FTSE Developed Japan	-4.0
Fixed Interest		
UK ILGs	FTSE British Government IL Over 5 years	1.5
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	0.1
UK Gilts	FTSE British Government All Stocks	-2.0
Property	IDP	N/A
Cash	Merrill Lynch LIBOR 3 Month	0.1

Currency Movements for quarter ended 31st December 2009

Currency	30th September 2009	31st December 2009	Change %
USD/GBP	1.599	1.615	+0.1
EUR/GBP	1.094	1.126	+2.9
USD/EUR	1.462	1.435	-1.8
Yen/USD	89.535	93.095	+4.0

Index returns expressed in sterling

		Year ended 31.12.09
		%
Equities		
Emerging Markets	MSCI Emerging Markets Free	59.4
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	51.2
UK	FTSE All Share	30.1
Europe	FTSE Developed Europe (ex UK)	19.9
North America	FTSE North America	14.8
Japan	FTSE Developed Japan	-5.8
Fixed Interest		
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	10.7
UK ILGs	FTSE British Government IL Over 5 years	5.6
UK Gilts	FTSE British Government All Stocks	-1.2
Property	IDP	N/A
Cash	Merrill Lynch LIBOR 3 Month	1.7

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Currency Movements for year ended 31st December 2009

Currency	31st December 2008	31st December 2009	Change %
USD/GBP	1.438	1.615	+12.3
EUR/GBP	1.034	1.126	+8.8
USD/EUR	1.390	1.435	+3.2
Yen/USD	90.650	93.095	+2.7

At the start of 2009 who could have envisaged the extremely robust returns shown in the table above for the year ended 31st December 2009, In particular, the rise of 30.1% in the FTSE All share Index? This rise is all the more remarkable as it represents an increase of 54.0% from the 3rd March low point. At the head of the leader board for 2009 was the emerging markets sector (+59.4%) as investors came to recognise the stronger rates of GDP growth in those regions compared with the nations of the Western Hemisphere. This perception was also behind the 51.2% returns from Asia. The back marker by far was Japan showing the only negative return in the table of -5.8%. It has become increasingly evident that Japan is mired in deflation and likely to remain so for quite some time despite the election of the Democratic Party. The other principal feature of the return table from a UK point of view was the rise of the pound against the US dollar of 12.3%, and against the Euro at 8.8%. This strength was a surprise given the rapidly deteriorating British economy as epitomised by the enormous fiscal deficit, but it reflected a recovery from an oversold position in 2008 when the pound declined by 27.3% against the dollar and 24% against the euro.

Within the fixed interest sector corporate bonds were a clear winner advancing 10.7%, with investors attracted by the high yields thereon. Index linked advanced by 5.6% as investors sought some protection from inflation. Government gilts, on the other hand, returned a negative 1.2% due to the rapidly worsening state of the British economy.

With regard to the market returns for the final quarter of 2009, these were very resilient considering the volatile background and the activities of governments and central banks who were in the complex process of steering their economies out of recession and back to growth. Some countries were starting the process of dismantling their emergency measures which had proved so vital in the previous two years. Other countries, particularly in the Eastern Hemisphere and Emerging Markets, did not have to face these problems as their economies were sufficiently robust i.e. China and India. This is reflected in the above table. The UK returned a heartening 5.5% despite its undoubted problems, but this was really because its market had been oversold in the first quarter of the year. The European return of only 0.5% was unexpectedly low whilst the negative return of 4.0% from Japan was no surprise in view of the nation's continuing deflation troubles and the rudderless new Democratic government. Fixed interest returns were disappointing especially gilts (-2.0%). Index linked gilts continued to hold their own, up 1.5%. Corporate bonds marked time having been very strong earlier in the year.

UK

Positive Influences

- In the 3 months to October unemployment advanced by 21,000 to 2.49M which was better than generally expected

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- The British Retail Consortium reported that December retail sales returns were +6.0% p.a. demonstrating increased consumer confidence.
- Chancellor Darling promised to halve the UK's deficit by 2014.
- The Bank of England estimates that GDP will grow by 2.2% in 2010 which is appreciably higher than the Treasury's estimate or the economists' consensus. For 2011 the Bank estimates a 4.1% increase.
- The FT house price index advanced by 0.7% in October to levels last seen in September 2006.
- The manufacturing activity index increased to 53.7 in October (September 49.9).

Negative Influences

- The last decade recorded the lowest rate of economic growth for the post war period with GDP averaging 1.7% p.a.
- The Confederation of British Industry (CBI) expects the UK to face a "slow anaemic recovery". It estimates GDP increases of 1.2% for 2010 and 2.5% for 2011. It adds "there is no sign of a clear driver of strong economic growth". The CBI is very critical of government plans to tackle the £178B deficit saying "the government has not yet set out a credible pathway back to financial stability".
- The Office for National Statistics recorded that in November retail sales returns receded by 0.3%, but were up by 3.1% year on year.
- It is becoming increasingly questionable that London will be able to maintain its status as the world's principal financial centre.
- The UK is the only G20 country still officially in recession.
- The third quarter estimate of GDP growth was marginally revised to -0.3% from -0.4%; appreciably below consensus economists' estimates.
- CPI in October rose by 1.5% p.a. (September +1.1% p.a.) due to volatile petrol prices.
- Public debt grew by a substantial £11.4B in October amd £84.7B for the first 7 months of the fiscal year 2009, equating to the total level for the previous year.
- Mervyn King, the governor of the Bank of England, stated "the UK is facing a prolonged period of balance sheet adjustment".
- The leading rating agency Fitch says the UK is at greater risk of losing its sovereign debt AAA credit rating than any other major economy.
- The National Institute of Economic and Social Research said that, in the quarter ended 31st October, the economy shrank by 0.4%.
- On 5th November, the Bank of England injected a further £25B into the economy via its quantitative easing programme bringing the total to £200B. Quantitative easing is printing money by any other name and highly likely to result in increased inflation.
- In his pre-budget report Chancellor Darling was expected to clearly state how the Government was going to tackle the massive and rapidly growing budget deficit. Disappointingly, the necessary radical action appears to have been postponed until after the forthcoming election. However, the Chancellor did indicate that taxes on middle income earners would rise and that national insurance would increase. He also announced a 50% supertax on bonus payments by banks. The reality is that there can be no short term wonder cure. To reduce the deficit and recessionary forces will take several years as markedly increased taxes and

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severe cutbacks in spending grind through the economic system. In his report the Chancellor made the following forecasts of GDP growth:-

2010/11	1 to 1 ½%
2011/12	3.5%
2012/13	3.5%

The Chancellor also forecast that government borrowing would halve over the next four years.

USA

Positive Influences

- The Conference Board's index of consumer confidence increased to 52.9 in December (November 50.6).
- Canada's third quarter rate of GDP increased by 0.4% boosted by strong domestic spending.
- October retail sales increased by 1.4% thanks to a rebound in car sales.
- As a demonstration of his long term faith in the American economy Warren Buffett announced a takeover of the Burlington Northern & Santa Fe Railway, one of the largest US railroad operators.
- The Institute for Supply Management's non manufacturing index grew to 50.1 in December from 48.7 in November. The Institute's manufacturing index rose to 55.9 in December, its highest level since April 2006.

Negative Influences

- New jobs fell by 85,000 in December versus a generally expected small rise. The unemployment rate was unchanged at 10.0%, and could peak at 10.5%. For as long as unemployment remains high and the housing market continues in a weak state this is likely to stay the hand of the FED in tightening interest rates.
- Housing starts dipped by 10.6% in October. The Commerce Department reported that new home sales in November slumped by 11.3% versus an expected rise. At the end of the third quarter 1 in 7 borrowers were behind on their mortgage payments or facing foreclosure.
- Ben Bernanke at the Federal Reserve Board stated "though we have begun to see some improvement in economic activity we still have some way to go before we can be assured that the recovery will be self sustaining".
- Durable goods orders in October decreased by 0.6%.
- The third quarter estimate of GDP was revised down to 2.8%.
- The Commerce Department stated that construction spending fell for the seventh consecutive month in November, to the lowest level in 6 years.

Europe

Positive Influences

- The European Central Bank gave notice that it intends to start the process of unwinding its emergency financial support measures.

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- German production levels rose by 3.5% in Q3. This was the strongest quarterly rise since the reunification of West and East Germany. German industrial orders increased by 0.2% in November (October -1.9%), less than expected.
- Rises in third quarter GDP were as follows:-

	%	
Eurozone	+0.4	(against a contraction in the previous 5 quarters)
Germany	+0.7	
Italy	+0.6	
France	+0.3	

- The European Commission's economic sentiment indicator increased for the ninth consecutive month jumping in December by 2.5 to 91.3 for the Eurozone countries, the highest level since September 2008.

Negative Influences

- Eurozone unemployment in November advanced to 10.0%, the highest for 10 years.
- Eurostat reported that Eurozone retail sales fell 1.2% in November.
- The Greek prime minister Papandreou admits the country suffers from "systemic corruption". Greek sovereign debt was downgraded to BBB by Fitch.
- German inflation in November increased by +0.4% (October -0.1%).

Japan

Positive Influences

- The Bank of Japan reported that exports rose 0.6% in November, the eighth consecutive monthly rise. This was directly attributable to strong demand for Japanese goods from Asia.
- The Bank of Japan vowed that it would "not tolerate deflation" signalling that it would continue to keep interest rates low. On 1st December the Bank of Japan injected a further $114B of liquidity into the banking system.
- The government announced that its estimate of GDP growth in the third quarter rose by a much stronger 4.8% p.a. rate than expected. Two thirds of this rise was attributed to the powerful expansion in domestic demand.
- Haoto Kan, Japan's new finance minister, stated that he favoured a weaker Yen policy in order to boost exporting companies.

Negative Influences

- Yukio Hatoyama of the Democratic Party, the newly elected prime minister has appeared to struggle in his first 100 days in office.

Asia/Pacific

Positive Influences

- The purchasing managers' index in China for December was 56.1 (November 55.7) whilst that of India was 55.6 against 53.0 for the same periods.

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- Chinese exports grew by a substantial 17.7% in December which was much higher than expected. Exports to the US rose 15.9% whilst those to the European Union were up 10.2%.

Negative Influences

- On 1st December the Reserve Bank of Australia increased interest rates by ¼% to 3 ¾ %.
- China's inflation rate for November grew by 0.6% (0.1% October).
- Dubai World, a state holding company for property development, suspended repayments on a $3.5B bond due in mid December. It announced an emergency restructuring programme and requested a debt stand still. This caused concern for a domino effect within Dubai together with a run on the banks there and contagion in other heavily indebted countries. Within days Abu Dhabi, the financial powerhouse of the United Arab Emirates, came to the rescue, but it imposed severe conditional terms. It is quite clear that the whole of Dubai is under a severe financial cloud which is unlikely to lift for quite some time, calling into question of the viability of the many property developments there sated, with very high levels of bloated debt. Dubai's ruler, Sheikh Mohammed Bin Rashid Al-Maktoum has much to do to restore his reputation.
  Singapore's fourth quarter GDP rate was markedly lower at -7.0% (quarter 3 +15.0%).

Conclusion

As usual, particularly at the start of a year, in order to predict the likely course of markets and asset classes it is necessary to attach an appropriate weight to all the various enhancing and detracting factors which effect an appropriate investment strategy. Taking a view to the end of 2010, the principal influential factors are as follows:-

Detracting:-

- The difficulty for governments and central banks in executing an efficient exit programme to dismantle the raft of emergency measures which were enacted over the last two years as a result of the global financial crisis. This will be particularly relevant for the UK and USA.
- The likelihood that inflation will pick up as economies begin to recover from recession and negative rates of GDP growth.
- Several European countries have vast fiscal deficits namely Greece, Ireland, Portugal and UK. In these cases the rating agencies are likely to down grade the ratings of the respective countries' sovereign debt. If the UK was to lose its triple AAA sovereign rating then interest rates may rise in order to attract overseas purchases at gilt auctions. This could also cause further sterling weakness.

Enhancing:-

- Many institutional and private investors overreacted early in 2009 as they attempted to de-risk their portfolios in the light of the most worrisome economic

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outlook and the appalling conditions in the international financial arena. Now it is clear that Armageddon has been avoided and that most economies are in the course of recovery, albeit anaemically in some cases, then investors with still considerable levels of cash are likely to invest back into the equity markets, particularly in the more defensive and safer stocks. Indeed, there is still good long term value to be found in these types of stocks.

- Many corporations perceived to be "defensive" are reporting better than expected earnings and, due to past conservative policies, are able to make worthwhile dividend increases.
- There is little doubt that the economies of emerging markets are most clearly outperforming the economic growth of the traditional industrialised countries. For this reason institutional investors have been increasingly prepared to invest in such areas. It is interesting to note that over the last decade the BRIC (Brazil, Russia, India & China) stock markets have been the strongest global performers by a large margin.
- As countries, particularly those in the Western Hemisphere, begin to recover from recession then it is quite possible that central banks will increase interest rates from the historically low levels which they currently stand namely:-

	%
Bank of England	0.50
European Central Bank	1.0
Swiss National Bank	0 – 0.75
Federal Reserve Board	0 – 0.25
Bank of Japan	0.10

If interest rates rise then it runs the risk of impacting consumer spending, raising mortgage rates and, for corporations, increasing the rates at which they borrow in the corporate bond market in order to maintain necessary levels of capital expenditure and spending on research and development.

- The UK economy in particular will suffer from the increase in VAT in January, rising unemployment and flat or lower wage levels. These three items will be harmful to retail spending.
- On the political front, President Obama has come tolerably well through his honeymoon year, considering the plethora of difficulties that he inherited from the Bush regime. In Germany, Angela Merkel received a stronger mandate for her chancellorship and appears to be coping well. In Japan, the recently elected Democratic Party are struggling under the weight of many years of ineptitude and weak policies inherited from the old Liberal Democratic Party. However, in political terms, the most worrying country by far is the UK where the economy is in extremely poor shape under the £178B deficit. With a general election due, probably in May, there will now be five months of the usual political wrangling and point scoring. Nevertheless, at the end of this time most commentators seem to agree that we have reached one of those points in history when the electorate simply wants a change. It therefore seems highly likely that a Conservative government will be returned. It remains to be seen whether it will be a majority government, or a "hung parliament" which would not be well received either by the stock markets or the currency markets.

So, what is the net effect likely to be both for stock markets and asset classes? The general perception would seem to be that equity markets have recovered a long way from plumbing the depths of despair in March. It seems likely that there could now be a

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pause in the markets' momentum in order to assess whether respective nations are making genuine progress in a return to normality and laying the ground for worthwhile rates of GDP growth later in 2010. It will also be important to see the extent to which asset classes are being re-hydrated. In that regard it does seem that, due to better liquidity, private equity, property, hedge funds and infrastructure will be able to return to growth and, importantly take advantage of the large number of attractive valuations in their respective spheres of operation. Better levels of liquidity should also result in more mergers and acquisitions together with an increased number of initial public offerings. Fixed interest as an asset class finds itself in a difficult situation. Gilt edged could suffer further if interest rates rise and sterling depreciates. Corporate bonds have been the sector's best performers, but here again, if interest rates rise, their returns to an investor may flatten. However, index linked stocks could stand to benefit if inflation rates were to rise.

In sum, in the first half of 2010, equities may mark time, but later in the year if there is a general global economic improvement, equities could achieve an annual return in, say, the high single figure vicinity. However, as mentioned, in the BRIC/emerging markets area returns could be more worthwhile. It is disappointing to conclude that the UK equity market could prove to be one of 2010's back markers due to the state of the economy and the country's finances which will take the government, of whatever political persuasion many years to sort. Do not expect equity returns to be as strong as those of 2009.

Valentine Furniss
12th January 2010

Investment Report for the month of January 2010

After the robust recovery of equity returns both for 2009 as a whole and also for the final quarter of that year it is scarcely surprising that in January 2010 there should be a pause whilst market strategists and economists sought to assess the future course of markets both in the short term and for the year as a whole. In that regard of increasing concern has been both the extent and size of record breaking fiscal deficits and the length of time that it would take the principal industrialised nations to reduce these to manageable levels. These worries against a generally nervous background, resulted in equity returns being negative in all regions with the exception of Japan which achieved a positive return of 2.7 a small improvement from its falls of 4.0% for the quarter ended 31st December 2009 and 5.8% for 2009 as a whole. Europe was the most laggard equity market retreating 5.8%. Fixed interest returns on the other hand were positive with corporate bonds advancing 2.3% and gilts 0.7%. However, index linked gilts merely marked time with an unchanged return. Another adverse factor for most markets was the increasing number of investors, both institutional and private, who decided to lock in some of the worthwhile profits they had made in 2009.

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Index returns expressed in sterling for the month of January 2010

		Month ended 31st January 2010
		%
Equities		
Japan	FTSE Developed Japan	2.7
North America	FTSE North America	-2.9
UK	FTSE All Share	-3.6
Emerging Markets	MSCI Emerging Markets Free	-4.8
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	-5.5
Europe	FTSE Developed Europe (ex UK)	-5.8
Fixed Interest		
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	2.3
UK Gilts	FTSE British Government All Stocks	0.7
UK ILGs	FTSE British Government IL Over 5 years	0.0
Property	IPD	n/a
Cash	Merrill Lynch LIBOR 3 Month	0.0

Currency Movements for month ended 31st January 2010

Currency	31st December 2009	31st January 2010	Change %
USD/GBP	1.615	1.602	-0.8
EUR/GBP	1.126	1.153	+2.4
USD/EUR	1.435	1.390	-3.1
Yen/USD	93.095	90.655	-2.6

Macro economic data and events from the regions were:-

UK

- GDP growth for the final quarter of 2009 was a minuscule and disappointing 0.1% versus a consensus expectation of 0.4%. Nevertheless, Chancellor Darling is sticking to his growth forecast for 2010 of 1 to 1 ½%.
- For the 3 months ended 30th November the total number of people classed as "economically inactive" rose to a record level of 8m or 21.2% of the working age population. This was driven by a sharp rise in students not seeking work. These figures do indeed underline the parlous state of the UK's employment market.
- The UK manufacturing index rose to 56.7 in January, the highest level for 15 years. British exporting companies benefited from the combination of inventory rebuilding, a recovering global economy and the weakness of sterling.
- The National Pension Service of South Korea is to increase its stake in Gatwick Airport to 12.0%.
- Following Kraft of America's take over of Cadbury, merger and acquisition activity could increase further as companies seek synergistic advantages. Weak sterling also makes the UK's companies more vulnerable to being taken over by foreign concerns.
- The Confederation of British Industry forecasts GDP growth of 1.2% in 2010 and 2.5% in 2011.

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- CPI in December was 2.9% (November 1.9%). This is the largest increase on record. Mervyn King of the Bank of England said this rise was “temporary” and “did not constitute a continuing source of inflation”. This smacks of wishful thinking and is probably in part caused by the vast amounts of money that the government has been printing under the guise of quantitative easing.
- According to the McKinsey company, the country with the biggest jump in debt relative to GDP over the past decade was the UK.
- On 7th January, unsurprisingly, the Bank of England held interest rates at ½% and voted to continue with its quantitative easing programme.
- The purchasing managers’ index for services dropped to 54.5 in January from 56.8 in December due in part to heavy snow falls.

USA

- January export orders rose for a seventh consecutive month.
- The Institute of Supply Management’s index increased in January to 58.4 (December 54.9), the highest level since August 2009.
- Bernanke was confirmed by the Senate for another 4 year term as Chairman of the Federal Reserve Board.
- On 27th January the FED kept interest rates on hold pledging to keep rates “exceptionally low” for “an extended period”.
- Moody’s, the rating agency, warned that the sovereign credit rating of the USA could come under increasing pressure unless stronger measures were taken to reduce the US budget deficit and unless economic growth improved.
- Large corporations have made understandably cautious statements about the outlook even though they have been experiencing signs of recovery.
- The Conference Board’s consumer confidence index reached 55.9 in January, its highest level since September 2008.
- Existing home sales collapsed by 16.7% in December compared with a 7.4% rise in November.
- On 21st January Obama, aided and abetted by Paul Volcker (an ex Chairman of the FED) announced the most far reaching overhaul of Wall Street since the 1930s as a direct reply to the public dissatisfaction with the banks. Obama underlined his commitment by stating “never again will the American taxpayer be held hostage by a bank that is too big to fail”. Banks are to be forbidden to run trading desks or “owning, investing in or sponsoring” hedge funds or private equity groups. These moves are similar to the Glass-Steagall Act (rescinded in 1999) which separated commercial and investment banking. Obama also plans a levy on big financial institutions in order to recoup some of the costs of the financial crisis.
- On the first year anniversary of Obama’s presidency the Democratic Party lost to the Republicans the hitherto safe seat of Massachusetts. Part of this loss was a reflection that during Obama’s term of office the unemployment rate in the USA has increased from 7.7% to 10.0%.
- There was an unexpected 0.3% drop in retail sales in December.
- Unemployment in January fell to a 5 month low of 9.7% (December 10.0%), but 20,000 jobs were lost, although this was an improvement on December’s 150,000 lost jobs.

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Europe

- Eurozone governments borrowed a record €110B in January with the unfortunate affect of increasing costs for countries with the weakest public finances.
- Spain's economy (four times that of Greece) is in dire straights with a deficit which is forecast to equate to 12% of GDP in 2010.
- In January, the Spanish unemployment rate was estimated to be 18.8% of the work force. This is by far the highest rate in the main Eurozone economies.
- Greece's ability to finance its voluminous debt levels continues to cause acute concerns.
- Germany's IFO business confidence index improved in January for the tenth consecutive month and reached a 17 month high.
- The German government estimates a GDP growth rate of 1.5% in 2010, up from its previous estimate of 1.2%.
- German industrial production fell by 2.6% in December (November +0.7%).
- The Eurozone's corporate purchasing managers' index for January was 53.6, down from December's 54.0.
- The French government estimates that GDP growth will be +1.4% in 2010 against its previous estimate of only +0.75%.

Japan

- New machinery orders fell by 11.3% in December.
- In December wages decreased by 6.1% p.a. constituting the nineteenth monthly fall. This clearly adds to deflationary fears.

Asia

- The People's Bank of China is acting more aggressively to curb demand for credit which had risen to unacceptable levels.
- China's GDP for the fourth quarter of 2009 grew by a powerful 10.7% p.a. and by 8.7% for the year as a whole. This compares with China's economic growth target of 8.0%.
- China's inflation rate in December was 1.9% p.a. (November 0.6% p.a.).
- China's industrial output in December was a most substantial 18.5% p.a. (November 19.2% p.a.).
- China's regulators have ordered certain banks to temporarily halt lending in order to rein in the growth of credit.

Conclusion

Macro economic data in January supported the view that the economies of the principal industrialised nations, with the exception of the UK, are recovering GDP at a pace that could not possibly have been envisaged a year ago. Corporate earnings have generally been appreciably better than expected. To an extent these factors have gone some way to dispelling the fear that countries could suffer from a double dip recession. However, realism dictates that, against these more optimistic factors, many countries, especially in the western hemisphere, are continuing to be bedevilled by the truly horrendous size of their fiscal deficits boosted by continuing

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quantitative easing programmes, e.g. European governments borrowed a record €110B in January alone, thus increasing borrowing costs of those countries in an extremely weak state namely Greece, Ireland, Portugal and Spain. Markets should be constantly aware just how long it will take such economies to repair their national balance sheets. Such recoveries should be measured in years rather than in months, especially in the most worrisome case of the UK. The worst affected countries will inevitably suffer erosion of their currencies, especially sterling. However, the corollary of this is the boost to their vital exporting corporations. Other factors on investors and economists watch lists will continue to be the real possibility that interest rates will have to rise, that inflation may re-emerge and that rates of unemployment may continue for longer than expected. In a most sobering assessment, the International Monetary Fund warned that the industrialised world could face 10 years of spending cuts and tax rises and that public finances could experience a decade of contraction.

It will take time before the net effect of the above conflicting influences can be gauged with a sufficient degree of confidence to make firmer market forecasts. Certainly for investors of a worrying disposition there is much to worry about. That is why the cautious conclusion reached in the earlier quarterly report still stands.

Valentine Furniss
8th February 2010

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