Market Commentary for the year to 30th June 2009

- **Markets end on a positive note as investors are encouraged by "less bad" news**
- **Credit crisis morphs into global economic recession**
- **Aggressive central bank easing by US and UK appears to gain traction**
- **US Fed and Bank of England embark on government debt purchases to bring yields down**
- **"Green shoots" of economic recovery emerge from March**
- **Financials helped by "good news" from banks, hopes for US Treasury plan for toxic assets**
- **Riskier assets outperformed from March, but not enough to erase earlier losses**

Stock and bond markets rallied in the final quarter of the 12 month review period, erasing a large chunk of the heavy losses chalked up through to the March lows. Yet, as a whole, most asset classes still suffered heavy losses over the year. Corporate and consumer lending ground to a virtual halt and what began as a credit crisis morphed into a global recession. From March onward, however, stocks and non-government bonds surged as investors, spurred on by a slew of improving economic indicators, looked beyond negative headlines and positioned themselves for a global economic recovery.

The stocks and bonds of financial companies were at the epicentre of the meltdown in financial markets for much of the year. They also led the rally in global financial markets, as some major banks noted improvement in their operating profits and investors also reacted enthusiastically to expanded plans by the US Treasury for dealing with the banks' loss-making, or "toxic", assets. Investors were also encouraged by aggressive bond buying by the US and UK central banks, which was aimed at pushing yields lower and encouraging lending to consumers and businesses.

The MSCI AC World Index ended the 12 month period down 14.59% (in sterling), but would have been much worse if not for a steep drop in sterling against most other world currencies. In dollar terms, the index was down 29.32%. The Barclays Capital Global Aggregate Index (sterling hedged) of world bond markets fell 2.76%, with demand for the perceived safety of government debt and shunning of all types of risk being the main drivers of returns prior to March. Gains in the index from March onward were attributed to surging appetite for sectors of the bond markets perceived to be riskier.

Stocks

For much of the year, sector performance in the MSCI AC World Index reflected a clear preference among investors for defensive positioning and avoidance of areas that are more sensitive to economic cycles. Utilities, Healthcare and Consumer Staples were therefore among the best-performing sectors. However, equity sector performance shifted dramatically in the final three months of the review year, and sectors that are sensitive to changes in the economic cycle came roaring back as recovery hopes came alive.

Financials remained the worst performing sector for the period as a whole, despite leading the rally from March onward.

The VIX Index, a measure of implied volatility in the S&P 500 Index that is also known as the "fear index," dropped back to levels not seen since before the collapse of Lehman Brothers last September, and ended June at 26.35. That was more than two thirds less than its record 80.86 reached on 20 November 2008, at the height of the panic in the markets. However, it remained well above its long term historical average.

Bonds

US recession was officially confirmed in December 2008, with the National Bureau of Economic Research (NBER) determining that it had begun one year earlier, in December 2007. In a departure from its usual practice, the NBER didn't wait for corroborating evidence such as two consecutive quarters of falling gross domestic product (GDP). The US Federal Reserve (Fed) showed its deep concern over the economy by slashing interest rates to virtually zero in December and following that up with outright purchases of bonds in an effort to drive yields lower. Other global central banks also contributed to aggressive easing.

With official interest rates near zero, the Fed announced a $300 billion bond purchase program in March to try to lower bond yields and thus bring down corporate and consumer lending rates. This followed a similar £75 billion ($110 bn) move by the Bank of England (BoE) earlier in the month, which included plans to buy both government and corporate debt. After an initial positive reaction to the moves, bond yields in general (which move inversely to prices) were pushed higher again into the end of the review period as investors became wary of the substantial debt governments had to take on in their efforts to bail out entire industries and stimulate their economies.

Longer-dated government bonds sold off in particular amid these concerns. Yields on US 10 year Treasuries rose to just shy of 4.0% and to their highest levels since the demise of Lehman Brothers, on concerns that the Fed's program of buying government bonds (known as "quantitative easing") would not be enough to meet the increase in supply.

Although they fell over the year as a whole, commercial mortgage-backed securities (CMBS) were among the leaders as markets surged ahead from March, an example of the positive impact that US government programs were having on investor sentiment. This rally was fuelled in large part by the announcement in May that legacy (previously issued) CMBS would be included in the expansion of the US Term Asset-Backed Securities Loan Facility (TALF) program.

Emerging-market debt (EMD), also perceived to be among the riskiest sectors of the fixed-income markets, posted strong returns towards the end of the annual review period as well. However, gains for high-yield bonds, CMBS and EMD were all pared as investors turned somewhat jittery again into the end of June.

The Economy

Economic news was generally bleak around the globe for much of the period, before turning the corner into generally "less bad" indicators from around March onward. More forward-looking indicators, such as consumer and business confidence and purchasing managers surveys on manufacturing and services activity, showed improving trends across major developed economies over the course of the last three months of the review year.

The US housing market continued to deteriorate, as rising mortgage rates combined with a continued steady rise in unemployment fed an accelerating pace of delinquent payments and foreclosures. However, weekly jobless claims and the number of jobs being shed showed signs of levelling off in April and May. US and UK retail sales made gains around this same time, only to reverse them as the quarter wore on, casting doubt on recovery in the consumer sector.

Recession in Europe was worse than previously estimated in the first quarter of 2009, with an official EU estimate showing GDP in the 16-nation Eurozone contracted by a record 2.5%. Sharp falls were also registered in Eastern Europe. The dour sentiment was echoed in the UK, with the BoE labelling the economic outlook as "extraordinarily difficult."

Oil and many other commodity prices started the review year near record highs, and then quickly plunged from their heights amid deepening economic gloom. WTI Cushing crude oil prices fell as low as $31.41 on 22 December 2008, before more than doubling from that low to finish the review period just shy of $70 per barrel. Still, they were less than half the record price of $145.29 reached in July 2008. In the currency markets, mounting recovery hopes meant that the dollar lost some of its earlier appeal as a "safe haven" in times of global turmoil. Still, it ended the 12-month period up about 17% at $1.65 against sterling while rising roughly 11% against the euro to end the period near $1.40. It fell by 9% to about 96 yen, as investors who had borrowed money in Japan at ultra-low interest rates scrambled for yen to repay those loans as markets tumbled.

Summary

In our view, while risks to the outlook for global financial markets remain historically high with confidence still shaky and the health of global banks uncertain, the worst of the recession is probably behind us. We believe credit conditions should continue to improve over the second half of this year, as the coordinated government and central bank response to the global credit crisis and recession it triggered really does appear to be gaining traction.

If "less bad" news turns into "more good" news, investors would likely continue their move into riskier assets. However, setbacks are inevitable and will correspond with investors' perceptions regarding the outlook for economic activity and corporate profitability.

We believe the environment for equity markets should improve in the latter half of the year as the global economy strengthens. However, the extreme levels of government and central bank stimulus will eventually need to be removed, and this could limit the growth potential of the global economy and corporate profits once they enter into a sustainable recovery.

Equity markets may continue to struggle with setbacks as they attempt to climb a wall of worry and are constrained by still-declining earnings and tight conditions in the credit markets.

We believe non-government bond markets continue to offer better risk-adjusted opportunities for returns compared with government bonds. While defaults will certainly rise as the global recession continues, we believe investors continue to be amply compensated by the spreads offered in both high-yield and investment-grade corporate bonds, as well as mortgage-backed bonds and other structured securities (debt instruments made up of smaller loans packaged into a single security).

Past performance should not be used as a guide to the future

Do not act on this information alone!

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