

A Year of Specific Opportunities

“Bull Markets climb walls of worry but we must not ignore the obstacles still ahead.”

-Phillip Hadley, IOAM Managing Director



Indian Ocean Outlook for 2010

We believe that 2010 will offer strong opportunities for those able to navigate the obstacles ahead and has the potential to be another rewarding year for investors.

Financial markets, across the board, have recovered from their severely oversold levels seen in the first quarter of 2009, but we feel still offer further upside potential for prudent and strategic investment. Although 2010 may witness periods of consolidation and changing market leadership, many current trends will continue to dominate the investment scene. In summary, we expect the following:-

- **Equity Markets:** will be less turbulent than in 2009 and end 2010 higher again. Stronger company fundamentals will take precedence over the fashionable 2009 higher-beta stocks. Attractive returns will be available from non-UK domestic investments. ***Overweight.***
- **Fixed Income Markets:** the withdrawal of Central Bank support and fragile public finances create a negative environment for government debt principally, but with a knock-on effect into the corporate debt area. ***Underweight.***
- **Property Markets:** A growing opportunity in certain areas - Commercial over Residential. ***Begin reinvestment.***
- **Commodity Markets:** will continue to be supported by the global recovery; especially energy. ***Overweight.***
- **Absolute Return:** will provide on-going opportunity for solid risk-adjusted returns. ***Reduce to Market weight***



What Happened Last Year – Back from the Brink?

The story of 2009 would not make the bestsellers list. It did have a beginning, a middle and an end but during the first few months we were plumbing the depths of despair. Half-way through the year, we were in the midst of one of the strongest post-war rallies ever, and, as the year drew to a close, we entered a period of stabilisation and consolidation.

January to Mid-March - Plumbing the Depths. The year started very badly as, the brief respite we enjoyed over the previous New Year period, quickly evaporated as the financial crisis deepened. Equity markets plumbed new lows (the UK stock market fell over 20% and the US over 25%). Fixed Income markets remained attractive as investors sought the perceived safety of Government Bonds, whilst initially shunning the more credit-sensitive Corporate Bond market, regardless of falling interest rates. Despite predictions to the contrary, investors sought sanctuary in US Dollar-based assets, boosting the currency to multi-year highs and resulting in speculation in Dollar-based commodities, such as gold.

Mid-March to October - A Period of Recovery. In March, the US (and subsequently every other Government and Central Bank) embarked on the largest concerted support effort ever witnessed. Quantitative easing (QE) developed into a buzz word. Government commitment to pump massive liquidity into the financial system, via the Central Banks, prevented a potential collapse of the entire financial system. The global economy was, therefore, saved from slipping into a prolonged and catastrophic recession. As the UK Bank of England committed to plough £200 billion into UK markets, (the US Federal Reserve committed many times that figure) investors, still licking their wounds from the recent stockmarket capitulations, failed to make best of the sharp and aggressive rally from the March lows. Later, as many realised that the impact of the QE was having a positive effect, many returned to Equity (and other financial) markets. Between mid-March and October, global Equity markets produced one of their strongest performances on record, with the UK recording a gain of over 49% and the US 62%. (bottom to top). We were well and truly back from the brink!

October to Year End - A Period of Consolidation. Markets paused for breath in October and a period of consolidation began which constrained Equity markets into a comparatively narrow trading range, particularly after the volatility of the first six months. Those of a more positive persuasion (like IOAM), felt the huge level of stimulus that had been injected into financial markets would sustain economic growth. The negative element feared the inflation and higher interest rates that would ensue. Traders taking profits were at odds with Institutions beginning to commit longer term money. Worries that quantitative easing would end, sooner rather than later, in the New Year pushed markets towards the bottom of their range, whilst news that many of the world's developed economies (the UK the most notable exception), had emerged from official recession, propelled them higher. The latter prevailed and Equity markets finished the year with a flurry, closing up over 22% (in the UK) and 23% in the US for the year as a whole.



Has the Fear of Global Recession Now Passed? What of the UK?

The UK will quickly follow the US and Europe out of recession, but remain the laggard.

It should not have been such a surprise, to even the most casual of observer, that the UK is (and will be) the last major developed economy to emerge from official recession (i.e. two or more quarters of economic decline). The UK's dependence on services, in particular the financial sector, along with its over-indebtedness on home owners and consumers alike, helped push the country closest to the brink during this financial crisis. These factors, and the slowness with which the Bank of England initially reacted to the deteriorating economic situation, pushed the UK to the back of the queue for recovery. However, the improvement in economic growth now witnessed across the globe is being replicated in the UK and **GDP will certainly move into positive territory in the first quarter of the year if it did not do so (as we expect) in the final quarter of last year. We will, however, be and remain, the laggard - following, rather than leading.**



A sense of restraint has swept the globe and, in particular, the UK. Home owners (and potential buyers) have begun to realise that their home is no longer an automatic substitute for a pension and will not continue to represent the collateral needed to finance their excessive consumption. Indeed, this, and the more realistic lending criteria from financial institutions, has led to muted house price increases, even as we return to more normal economic conditions. This sense of restraint has also caused many to review their personal finances. Many households have attempted to pay down their outstanding debts (taking advantage of the low level of interest rates) and to boost their savings. Indeed, the savings rate in the UK has rapidly expanded to near 9%, its highest level in eleven years.

It should be noted that, any trends expected to ultimately reduce consumer spending, which generally represent two thirds of GDP, are considered negative for economic growth. However, in this environment we believe that the opposite may be true. Expectations are already lower and many remain fearful over the sustainability of any economic recovery and job security (we discuss this further below). **In such an environment, investors are looking for stability and a sense of confidence that the foundations are once again secure and we can confidently rebuild the economy and personal wealth.** Such confidence, if it materialises provides the potential for a very conducive environment for wealth creation.

Many risks remain that could derail a positive outlook and further economic recovery.

In the UK, unemployment is still an on-going problem, public finances are unsustainable and the uncertainty a General Election causes, all need to be addressed. The VAT increase in January and, to a lesser extent, the suspension of the car “buy-back” scheme, will certainly affect consumers this year. Most worryingly, the eventual withdrawal of Central Bank support through the suspension of quantitative easing, needs to be reviewed carefully. If not handled correctly, this could present a major stumbling block this year (please see the section on Government Securities below). Unfortunately, much like last year, but thankfully not to anywhere near the same scale, we expect a number of stumbling blocks and worries to present themselves before we reach our final predicted positive outcome.

A Decade Lost? But what of the Next?

Many describe the last ten years as the ‘lost financial asset decade’, given that the major economies’ Equity markets are at the same level now as they were in 1999. Whether we subscribe to this view or not, it certainly highlights the case that, financial assets have lagged the spectacular returns generated by physical assets (such as Property and Commodities) and even, surprisingly, Fixed Income instruments.

We would, therefore, postulate that, with economic growth now forecast to be positive but not spectacular, the loss of some confidence in the security of the property markets, and the emergence of a whole new consumer society from the emerging markets, that this may be the decade when financial assets, especially Equities, out-perform spectacularly.



How Do We View the Various Asset Classes in 2010?

EQUITY MARKETS, in our opinion, will remain turbulent but less volatile than 2009. We anticipate this will offer above-trend return and we remain positive for the 2010 outlook for Equities.

Overall, we anticipate Equity markets in developed economies, to be at least 10% to 15% higher by year-end. A decent year is in prospect! Unfortunately, we do not feel that this will be reflected in constant monthly returns, rather one in which we will witness periods of jubilation and periods of fear. Having entered a phase of consolidation in the final quarter of 2009, markets have shown their potential to surprise in early 2010, with the upward trending markets followed by a swift setback. However, the many headwinds we are now facing will lead to some notable periods of negative performance. As discussed above, the withdrawal of quantitative easing and the fragility of consumer demand, may present us with a number of surprises during the year.

We anticipate further rotation from the higher-beta, riskier sectors of the market (including smaller caps for example) which performed so spectacularly last year, into more “boring” Blue-Chip companies with solid fundamentals and clarity of earnings. We perceive those offering higher, more secure earnings will be demanded by yield hungry investors in the current low-interest rate environment.

Despite emerging from recession, we expect economic activity in the UK to remain behind that of many other countries during the course of the year. We, therefore, expect we will see more exciting opportunities in both overseas developed, and emerging, economies alike. **We will be strongly recommending, and reflecting for discretionary clients, an increased international allocation within all portfolios this year.**

From an international perspective, we see excellent opportunities, particularly in the developing and emerging economies of the world, with Asia and Latin American countries leading the way. Both areas have “side-stepped” the worst of the debt-fueled recession the West is emerging from and will be prime beneficiaries of any economic recovery. We would overweight these areas in Equity portfolios.

Of the developed economies, we believe that the UK Equity market does have the positive influence that insulates it, to a degree, from the struggling UK economy. Two-thirds of market earnings in the UK are generated overseas or from International companies. However, given the many issues that are UK specific this year we believe that UK Equity performance will be towards the bottom of our performance range for global equity markets and necessitate the international diversification, suggested above, to take advantage of global financial market strength. This is in contrast to the US equity market, where we expect to perform towards the top of our forecast range this year. We fully expect a turn-around in the US economy and, with its historic ability to rebound with force, we suggest a sustainable economic recovery will undoubtedly transfer into higher Equity valuations, specifically in the US. Additionally, the much anticipated demise of the US Dollar has not materialised and we forecast an appreciation this year as fiscal tightening takes hold during the summer, making US investments attractive to non-dollar denominated investors. We, therefore, believe that, exposure to US Equities, will give us a currency gain also during the year.

We are more concerned with regard to Europe, given the seemingly insurmountable structural challenges the region faces and would remain, at best, only normally-weighted, being more country focused as the circumstances unfold.



Conclusion and Action for Equities in 2010

Generally, we do not believe that 2010 will be a year for an Equity index tracking strategy!! We believe this is specifically a time when individual themes, sector or country opportunities present themselves and is an environment far more suited to an active discretionary investment strategy, unlike 2008-2009 where strategy was much more generic in flavor. It will be fine to “buy and hold” but this will not make the most of the specific positives unfolding from economic recovery. We will, therefore, seek to follow an opportunistic Equity investment mandate, which may result in a more focused investment strategy than has been the case over the past 2-3 years.

FIXED INCOME markets will face significant challenges throughout the year. We witnessed strong polarisation within the Fixed Income markets from mid-March to the end of last year. Unlike 2008, 2009 was dominated by Corporate Bonds that prospered right through to year end with Sovereign Debt, “Gilts” in the UK, and “Treasuries” in the US suffering. During the first quarter of last year, credit spreads in the Corporate Bond market had widened to historically high levels as fear of default and institutional collapse reached its nadir. However, as markets unfolded, some rationality returned to the financial valuations and as thoughts of economic recovery began, these historically wide spreads quickly contracted, offering the potential for significant gains. Investors seeking higher-yielding investments in a low-interest rate environment swarmed in to the corporate bond market, making it one of the most favoured sectors for allocation in 2009. Our portfolios typically benefited from our overweight allocation to the sector, but, by the end of the year, we had begun to consolidate some of the strong gains generated from the higher-credit quality investments allowing us to move into the higher-yielding low-credit quality opportunities which were the last to react to the positive upswing.

However, the above-trend gains that were generated by the sector in 2009 will not be repeated this year. Credit spreads are now more normalised and our forecasted higher interest rate environment, which we believe will unfold in the final quarter of 2010, will not be conducive to the sector. We are, therefore, reducing a significant portion of Corporate Bond exposure and only retaining exposure to the higher-yielding opportunities for the time being, until this trade is played out further. Sovereign Debts continued to perform well in the first quarter of 2009 as interest rates fell and investors were drawn to their perceived safety. This soon changed and, as the year wore on and credit fears began to subside as investor risk appetite increased, Sovereign Debt become increasingly unattractive. Interestingly, the quantitative easing programmes initiated across the globe supported valuations as Central Banks bought billions of pounds worth of bonds issued by their respective governments. Fearing that valuations could not be supported indefinitely, we began to exit our Sovereign Bond positions in the second half of the year.

Conclusion and Action for Bonds in 2010

Sovereign Debt now faces significant risks during 2010. The withdrawal of Central Bank buy-back programmes, record levels of Government Bond issuance, the underlying potential for a moderate rise in inflation and the ensuing increase in interest rates, will certainly undermine valuations. A wider recognition that public finances are in a perilous state, particularly in the UK and US, further increases the danger of a Government Bond sell-off as the year progresses. We, therefore, do not expect to have any exposure to the Government Bond markets in the UK and US (the Euro zone is less susceptible to the aforementioned risks) except where we can gain short-exposure to the market and benefit, should valuations fall. We will be underweight Government Debt – if not with no allocation in 2010.



PROPERTY MARKETS may surprise us and are now offering an interesting opportunity.

Over indebtedness, fuelled by a confidence that property prices would continue their meteoric rise unabated, certainly was a prime contributor to the recent severe economic recession. Property markets in developed countries around the world collapsed as credit availability was curtailed and personal debt mounted. A contracting labour market added additional pressure to property valuations, leading to the worst decline in prices for over a decade. Whilst we certainly did not forecast the magnitude of problems that befell the sector, we issued many a cautionary note to property investors over the years. Indeed, we began our withdrawal from the property sector in 2007, completed it in early 2008 and remained on the side-lines throughout last year. **The time for change is upon us.**

However, for 2010, we see property (or Real Estate for our American brethren) as an asset class that will offer an attractive yield and potential for some capital appreciation. It should be noted that this outlook is not to be applied to the broader markets, but more focused sectors with more compelling supply/demand characteristics. In the UK, for instance, higher-value homes, with long leases, in prime areas, such as the South East of England and London, will continue to attract high-net worth and overseas investors alike, especially with the weakness of sterling. Additionally, with interest rates remaining low, demand from institutional investors looking for higher yielding investments and prices, should under-pin the sector for some time to come. **We will also be evaluating commercial property, again in prime areas.** Improving confidence among financial institutions and a lack of supply, given most new developments were put on hold over the last two years, should reinvigorate the office rental market in London, for example.

Conclusion and Action for Property in 2010

As a final comment, we are, however, not so confident on the broader market outlook. Although residential property prices in the UK actually appreciated for more months than they fell in 2009, resulting in a near 6% increase, according to Nationwide, we are sceptical for such average growth this year. Many of the factors which buoyed prices last year, are running their course i.e. record low interest rates, a smaller than feared increase in unemployment, together with recent stabilisation in the Banking sector and signs of an economic recovery. The pent-up demand, particularly from cash-buyers, has also normalised. Should interest rates rise faster than expected and the employment landscape not improve as quickly as forecast, house sales may stagnate? We do, however, feel that both the yield and capital levels give us some up-side potential for the first time in over 3 years.



ABSOLUTE RETURN focused investments will remain a source of lower-volatility gains.

Our allocation to Absolute Return Funds during 2008, and the early stage of 2009, helped our portfolios to retain their composure during the worst of the market declines. Whilst remaining positive contributors during the 9 month market rally, their performance during this time notably lagged the other high-beta and more directional exposures we held. Although we have reduced our overall Absolute Return exposure in the second half of 2009, we will retain a meaningful exposure to the sector during 2010, particularly for more risk averse clients. Given the potential ebb and flow we expect from the Equity markets and our downbeat outlook for the Fixed Income sector, we believe that less-correlated investments will help maintain a lower volatility of return within our portfolios. Secondly, there has been significant development within the sector in terms of objectives and strategies. We are now no longer constrained to focusing only on low-volatility investments but can now select investments that offer higher-betas and exposure to specific markets, once not available to us.

We do not expect significant forays into the Hedge Fund, or Hedge Fund of Funds arena, this year.

Although there are some compelling opportunities now on offer, we remain concerned that much of the sector is still battling to deal with the aftermath of the liquidity crisis which hit many strategies particularly hard. We are, however, looking for strategies that will allow us to increase the liquidity of any such investments we wish to make.

Again, we will not be recommending the “defined return” sector this year. Whilst the sector has attracted many advocates over the years, we do not believe in strategies with poor liquidity and transparency. Given the distress caused to investors by several defined Return Funds this year (e.g. Keydata), we believe that this view is vindicated.

One area in which we will retain an investment interest is the Liquid Structured Products that are still trading below their guaranteed return level in many instances. These products, providing they are underwritten by institutions of appropriate credit worthiness, now offer an almost guaranteed capital appreciation until maturity – or an easily calculable yield to maturity for longer term investors.

COMMODITY MARKETS are set for further significant gains. The Commodity Markets have provided notable themes over the last two years. In 2008, crude oil made the headlines by surging over 51% to reach the giddy heights of \$145 a barrel. Its spectacular falls, as we entered the recession, offered us a compelling investment opportunity which we capitalised on last year through our allocation to the energy sector which, subsequently, rallied 78% through the year. However, last year it was the price of gold that made all the headlines. Precious metals rose 25%, hitting an all-time high of \$1,200 an ounce as investors sought the security of the physical commodity during uncertain times, then as a hedge against future global inflation and against a falling dollar. Indeed, the weakness of the US Dollar (most commodities are denominated in dollars) contributed to many of the gains we witnessed last year.

This year we expect Commodity prices to appreciate further; improvement in global economic growth and the accommodative monetary conditions we are now enjoying will be extremely supportive to the Commodity space as a whole. Indeed, the International Monetary Fund (IMF) supported this view in its 2010 Outlook when it said that the prices of many Commodities are likely to increase further



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because of strong demand and global economic expansion moving at a faster pace. We believe that Energy-related Commodities will be the biggest beneficiary in 2010 and will seek to exploit this. However, higher energy prices may not be directly as beneficial to companies operating in the energy sector, given the current level of under-capacity present in the sector; expanding capacity to meet increased demand may increase costs in the medium term to the detriment of profits. We will, therefore, focus on developing exposure to the underlying commodities towards the later part of the year, in preference to the energy-related companies. This will be achieved predominantly through the purchase of Equity Unit Trusts and or OEICs.

Agricultural Commodities may also surprise us again this year. Although not as headline grabbing as other asset classes, we cannot ignore the demographic shifts and increased spending power emanating from the emerging markets. India, for example, is now the world's largest consumer of sugar, a commodity that gained over 120% on fears that demand will outstrip supply following poor crop forecast in areas such as Brazil. We will look for such opportunities when constructing our Commodity allocation during the year.

CASH DEPOSIT may become more attractive as interest rates rise – but that is not just yet! We witnessed a diminishing return on cash deposits in both 2008 and 2009. With interest rates now at historically low levels across the globe, interest rates offered to savers are generally unattractive. However, in line with our view of rising interest rates later in the year, this situation will gradually change and thus latterly provide us with an alternative that will yield something. We may have to wait until the 4th Quarter, but we feel some more specific cash opportunities may develop early than that.

In the early part of 2009, we favoured substituting Government Securities for any cash balances held within portfolios. However, as we increased our overall exposure, these cash balances were reduced. Unless market volatility increases dramatically over the coming months, we expect to maintain minimal cash balances within portfolio.



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