

*“Three disparate catalysts have triggered the present correction: Chinese monetary policy, US bank reforms and Greek fiscal concerns. Although risks have risen, we believe that each of these individual events will most likely turn out to be manageable and, in themselves, will not derail the global economic recovery.”*

*Nick Nelson, Strategist, UBS*

## 1. MARKETS

- After a strong rebound in 2009, January 2010 proved a weak month for equities with most markets declining by around 4%. This weak trend has followed through into February. Sentiment was adversely affected by concerns regarding the extent and timing of the unwinding of the strong monetary and fiscal strategies employed by Western and Chinese Governments, the uncertainty regarding the threatened break-up of Western banks' proprietary businesses, and the large and unsustainable budgetary deficits in the Southern Euro Zone. Each should be contained, but **uncertainty is the enemy of markets**. Bonds were duly stronger as a result, as safe havens were sought, and the dollar rebounded. Gold continued its decline and commodities also suffered due to concerns about lower Chinese economic growth.
- In equity markets, the S&P 500 index lost 3.7%, the worst monthly decline since February 2009. The FTSE 100 lost 4.1%, and the Global MSCI All World \$ also lost ground, falling 3.7%.
- In the US specifically, large cap shares fell 3.5%, the Dow Jones 30 Index falling to 10 067, with the Russell 2000 Index falling marginally more, by 3.7%.
- Bonds, both sovereign and corporate, had a good month, especially at the long end of the yield curve. There remains an unprecedented gap in yields between 2 and 10 year sovereign bonds, implying that the market is unnaturally suppressed at the short end, where the Government monetary stimulus remains. There is as yet no indication that the Developed Countries are ready to raise short-term interest rates, which are still close to zero, offering investors virtually nil returns. Pan-Asian bonds remained strong, with yields declining. Greek, Spanish, Portuguese and Italian bonds had a bad month as these countries' economies were seen to be vulnerable to debt downgrades. China and India have pre-empted inflationary tendencies by increasing reserve requirements for their banks.
- After the strong rise of the gold price over most of 2009, a further fall in the gold price occurred, weakening to \$1 078 per ounce, a loss of 8.5% in two months. The gold price has, however, risen in every year over the past 9 years.

- Against the euro, the dollar appreciated by nearly 4%, the latter being affected by poor sentiment due to the financial problems in the Southern Euro Zone.

## 2. INVESTMENT MANAGERS' REPORTS.

### 2.1 VAM Funds (Lux) equity funds (Driehaus Capital Management)

- Growth shares still not achieving historical premium over value shares, offering opportunities when normal relationship is re-established. **Investors should have some growth shares as part of their portfolio to benefit when this occurs.**
- Good companies now starting to be rewarded with higher valuations.
- Earnings season in US good for bottom line growth and some revenue growth now coming through. Some signs of wage growth in the US supporting consumption.
- Concerns re Chinese monetary tightening similar to 2003/4 after which stock market values rebounded. Same expected to happen this time. China is "fine".
- Concerns re Euro Zone reinforce the view that the **US is relatively attractive.**
- Belief that Emerging Markets may underperform against the US in first half. This may change in second half but then the focus will change in the US towards materials and energy to pick up on this.
- Staying away from areas which are the subject of US Government interference.
- Overweight in tech shares (spec. LED lighting technology), biotechs and some consumer shares. Equal weight in healthcare. Likes natural gas as long-term secular bet, companies in short term recruitment, and some regional banks.
- Dollar might pause in strength but seen to be a better bet short term than Euro.
- Developed Markets in Europe still fragile.
- Gold attractive as a long-term play, but have exited temporarily. Would reconsider if the world economy stagnates. Likes iron ore, not aluminium and titanium.
- **Overall, a lot to be encouraged about. Important to be patient after the strong run up in share values in 2009.**

### 2.2 VAM Multi Asset Strategy Fund (Valu-Trac Investment Management)

- **Equity market** increasingly vulnerable - **reduced intrinsic value** and future share gains depend on continued strong earnings growth.
- **Global equities are in danger of a renew bear phase. More cautious than before. Manager putting higher allocation into short dated sovereign bonds (Australia, Canada and Japan) and commodities, although equities still largest single component. If earnings disappoint, bond and**

**commodities will have higher allocation.** This bear stage in equities can be avoided, however, if global corporate earnings increase substantially.

- **Corporate bonds, however, still favoured against sovereign bonds.**
- Global economies in unstable equilibrium. Extent and duration of government fiscal and monetary support causing concern for either excessive inflation or deflation down the road - both negative for overvalued equities and longer dated sovereign bonds.
- For equities, buy signals are coming from Finland, Greece, Austria, Ireland, Italy, New Zealand, Portugal, Singapore, Asia ex Japan and Australia, and Europe ex the UK.
- Asset allocation between equities and bonds still favours equities against bonds but by a reduced margin.
- **Growing attractiveness of commodities other than gold. Gold is presently unlikely to continue its remorseless rise but is good for the longer term.** In process of selling wheat and staying in aluminium, and nickel. Zinc looks good.
- **Overall stance is one of caution, awaiting developments in corporate earnings.**

### 2.3 VAM Property Fund (Fleming Family and Partners)

- **The unlisted property market is now showing good returns** as increases in valuations lag the listed market which showed good growth over the past 9 months. Capital values for some unlisted properties have been revised upwards which gives the potential for capital gains as well as attractive income yields.
- More corporate activity in property market evident as value emerges. Liberty International now to release value by spinning off its Retail Division.
- Broader stabilisation of property market experienced. British Land has just announced very positive results with a more bullish tone, underpinning the sector.
- **Income yields for prime property at 6 to 7% becoming compelling for longer term investors.** These yields continue to compare favourably with longer dated Government stock. Many conventional assessments of the value of property investments are compared to long term bond yields.
- Greater geographical spread of property investment now obtained.
- UK property market being the first to enter the recession is now leading it out.
- Although returns are lower, UK and European property markets seen as less volatile and hence less risky than their Asian counterparts.
- **Property remains a long term, risk adjusted, income and capital gain play.**
- **Property cycle is different to that of equities and could offer stabilisation at a time of equity market turbulence.**

## 2.4 VAM Asia Fixed Income Fund

- Some bearishness appeared in the month although the Fund fared well. Concerns developed regarding monetary tightening in China and the bankruptcy of Japanese Airlines (JAL).
- Asian yields still present superior yields versus developed country counterparts.
- VAM Asia Fixed Income Fund remains an excellent alternative to low yielding cash deposits. Low interest rate environment seems here to stay for some time.
- Fund components have changed with Singapore bonds now 16% of the portfolio. Australian bond exposure has been reduced from 22% to 15%, reflecting Australian monetary tightening. Most other exposures broadly unchanged.
- Average maturities marginally increased to 6.1 years. Lower exposure to shorter maturities. Industry breakdown shows a marginally higher proportion invested in the financial sector.

## 3. SUMMARY

- February has seen lower international equity markets in the first half as risk aversion increases and concerns mount in the Euro Zone. The Far East has fallen further than the Western Markets as they correct from higher levels.
- Investors currently face a **“wall of worry”** with concerns being transferred from companies and individuals to Governments. Many have unsustainable budgetary deficits and need austerity budgets to retain their credit ratings and debt raising capacity to finance these deficits. Current victims of this trend have been Portugal, Italy, Greece and Spain. Ireland has already put in place remedial action. How this situation unfolds will in part depend on the willingness of the Northern EU countries, and especially Germany and France, to bankroll a rescue for the worst affected members of the EU. In the meantime, the dollar has increased as a “safe haven” currency, and US Treasuries have gained.
- **Analyst consensus is, however, that 2010 will be positive for equities** and returns should beat those of other asset classes, especially bonds and cash. The steepness of the upward trend in share prices will depend importantly on the extent and duration of corporate earnings growth. This will soon have to come from volume growth and pricing power, rather than corporate rationalisation.
- **More caution than before in the markets is evident.**
- Short-term interest rates in the developed world remain on hold at unusually low levels for the time being, which continues to weigh on the sovereign debt yield curve. Returns on longer-term sovereign bonds unattractive.
- In Emerging Markets, some tightening in China, India and Brazil. Chinese growth at 10% per annum continues to surprise and lends support to commodities.

- When general monetary tightening occurs in 2010, this should have the impact of increasing interest rates, especially at the shorter end, causing losses in some sovereign bonds. Sovereign downgrades are a negative influence on those markets.
- Property fundamentals remain attractive as an income play and eventual inflation hedge. Property prospects seen to be good for the next year as yields are presently superior to those for bonds. Interest spreading out to unlisted sector as well. The catalyst for further gains would include an increase in bank lending to the sector.
- The gold price has fallen but remains in a long-term bull trend as fears of inflation remain. Some of the weakness has been due to dollar strength (last month it was the opposite) but also reflects investor speculation.

\*\*\*\*\*