TEE FINANCIAL PLC

Independent Financial Advice, Investment & Asset Management

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Outlook 2010

As 2010 starts interest rates are being held at historically low levels and economic growth prospects and credit markets have improved. Instead of negative global growth we are now looking at positive return projections. This has been reflected in a sharp broadly based global rally in equity, commodity and corporate debt markets and more stable to rising property values since the lows experienced in March 2009.

Cash and Conventional Gilt holders have been left on the sidelines as sentiment has turned sharply in favour of higher risk assets helped by a weakening dollar and better than expected corporate results. The rally is now 10 months old with little consolidation and with those who missed out looking to buy in on dips. The easy money has now been made with the market pricing in a higher level of expectations and currently ignoring any negatives. The market movement suggests the global economy has entered the recovery phase of the cycle. The current volatility is coming from investors trying to validate the current position from economic statistics and more importantly worrying that corporate earnings are on track to justify the higher price or valuation levels.

The basis for the current global rally is that investors currently perceive that emerging/developing countries despite stimulus packages have decoupled from the more developed nations and have better relative economic prospects in terms of growth and corporate profitability going forward and also have potential for currency appreciation as a natural result of superior growth levels. Hence investors are increasing weightings towards these regions or are looking for themes relating to or connected to this perception. Any continued strength in these regions on a recovery in world trade will also be of benefit to the more developed countries.

In addition, the more developed countries (where the dragging effects of credit constraints, high unemployment and debt levels are currently being counteracted by low interest rates, restocking and stimulus packages) are starting to recover lost output but at a slower rate than the developing economies. The better predicted growth returns are in the USA followed by the Eurozone and then the UK. Investors rationale here is that interest rates can continue to be held at low levels for longer than is currently anticipated without increasing inflation expectations to dangerous levels and this will give the economies time to recover to a point where they can stand on their own feet without a need for further stimulus packages. This transition when it occurs, most likely in 2010, will be the most critical. If the stimulus is removed too quickly when there is not sufficient demand to replace it we could see growth levels dip and deflationary expectations return, which would be negative and is what governments are currently intent on avoiding. If it is removed too late it may be difficult to contain increased inflationary expectations without a sharp rise in rates, which would also be a negative.

There are many risks associated with the above views and hence why in 2010 I would advise a strategy of broad based asset diversification rather than becoming too concentrated, emphasising higher quality and transparent asset types and a combination of a passive and active fund style.

With regards to cash, interest rates are likely to remain low so the reason for holding is to take advantage of investment opportunities or set backs during the year.

Gilts are currently out of favour with yields having risen recently on a) worries that interest rates will have to rise on improved global economic prospects b) the threat to AAA UK credit rating from higher debt levels if conditions do not improve c) a need for the UK Government to increase the Gilt supply to fund its budget deficit d) fear that foreign investors may withdraw support if the currency falls sharply e) the timing of an exit from the government programme of buying gilts which has artificially suppressed yields since its incorporation. Currently the pace of buy backs has slowed and finally f) steadily rising equity markets.

Some of the reasons for holding this asset class would be a) to cover an income requirement b) using them as a method of reducing risk within a diversified portfolio and c) protection against a double dip recession or deflation. Given our current view is more towards the inflationary camp as the Government tries to reflate the economy it seems sensible to keep any conventional gilt holdings held on average relatively short dated and look to add/mix Index Linked Gilts if appropriate to guard against any unexpected inflation.

Corporate Bonds (both investment grade and high yield) have benefited from a sharp rally over the last year as the credit market started to open up and demand increased for income. There is still a good yield gap over gilts and cash for income investors but less scope for capital gains especially with regards to the investment graded bonds although bond managers point to the lower end of the investment grade spectrum as to the best value. As sentiment has improved investors have been buying into the higher yield area, which has the highest risk characteristics in term of potential corporate defaults. This again is another demonstration of how the risk appetite has improved.

We have become more positive on commercial property given the fall back over the last two years and the higher rental yields available compared to gilts. As an asset class it is also a good diversifier relative to equities and also offers the scope for both income and capital gains although returns could be more subdued due to the current lack of credit. The main options here are equity based property funds or ‘pure bricks and mortar type funds’. Strategically a mix of both offers a diversified platform.

We view both domestic and global equity markets as the better asset class relative to Cash and Bonds in terms of adding value going forward especially taking account of the poor returns over the last decade. Given the extreme rally recently in markets investors may become selective at current levels.

We are fortunate in the UK to have such an open economy with a good % of larger companies with overseas earnings (not heavily dependent on the UK market) and therefore I would anticipate a bias towards the larger capitalised UK companies (mainly FTSE 100). If economic recovery expectations become more pronounced then we can take a more balanced approach across the medium and smaller sized companies which tend to have a more domestic earnings profile. This area usually performs well in the recovery part of the cycle.

Investors may also be looking to build overseas equity weightings for a) diversification benefits b) to take advantage of higher growth markets (e.g. Emerging, BRIC, Pacific ex Japan, South East Asia) c) to invest in more specialist sectors (e.g. technology, environmental/ethical, commodity, single markets) and d) also to benefit directly from any weakness in £ (e.g. this year we could see further weakness from a perceived lack of willingness for the government to take decisive action over the deficit and the follow on loss of confidence from overseas investors in terms of supporting it, political risk from say a hung parliament, downgrade to UK credit status etc). The currency is already relatively weak after a sell off against $ and Euro in 2008 from higher levels and this should be taken into account in terms of currency risk versus the potentially higher overseas asset returns.

The equity rally has been led by cyclical sectors (earnings which are very sensitive to the economy) like for example Mining, Basic Materials, Leisure, Engineering, Transport and Technology. We may therefore see some sector rotation into other sectors, which have lagged in terms of the rally for example Utilities, Telecoms, Pharmaceuticals and Tobacco.

In addition the investment trust sector is interesting in terms of being able to take advantage of gearing and some heavy discounts in terms of prices to asset values and offers both domestic, global and specialist sectors.

UK equity income funds which offer above average yields also look attractive relative to some of the growth orientated funds both domestically and globally.

In summary markets will always offer investors opportunities and I expect like 2009 this will reoccur in terms of markets and / or sectors. Given the numerous risks (e.g. exit from quantitative easing programmes) and scepticism over the strength and sustainability of the recovery I would expect another year of high volatility.

Prices can fall as well as rise, yields are not fixed and can vary, hold for the longer term and do not rely on past performance.

Dominic Sheehan
Investment Director

Annual Statistical Market Returns

Indices	31/12/2008	31/12/2009	% Capital Change (£)
Global Equities			
FTSE 100	4434.20	5412.90	22.07
FTSE 250	6360.85	9306.90	46.30
Dow Jones	8776.39	10428.00	7.64
Dax 30	4810.20	5957.43	14.60
Hang Seng	14387.48	21872.50	41.30
Nikkei 225	8859.56	10546.44	5.00
Shanghai Composite (China)	1820.81	3277.14	62.80
UK Bonds			
UK Govt All Stocks	160.83	152.13	-5.40
Index Linked All Stocks	342.36	357.48	4.40
Currencies			
£/$	1.4647	1.6168	10.40
£/Euro	1.0437	1.1279	8.10
£/Yen	132.64	150.38	13.30
£/HK$	11.78	12.67	7.60
£/Yuan	9.98	11.03	10.50
Commodities			
Oil	42.29	78.51	68.20
Gold	880.15	1096.35	12.80