

## H2 Investment Manager Commentary 2007

The second half of 2007 was the point when reality finally hit equity markets; apart from a small correction in February, which had been more than made up by Easter, the problems of sub prime mortgages had been comprehensively ignored. Indeed, some Investment Banks went as far as setting up new vulture funds to invest in this asset class, pausing only briefly to take on 10 times gearing, before ploughing on. The collapse of two such funds in July was the start of the "Credit Crunch". Thus what started as a small regional problem in America has come to dominate the global economy.

The abundant supply of cheap money which had fuelled the rise in most asset classes, bar equities, very quickly dried up. Banks, looking to repair their balance sheets, stopped lending to each other, and curtailed third party advances whilst increasing margins. Both the Fed and the ECB acted quickly to pump liquidity in to the system, and in the case of America, to start cutting interest rates. Meanwhile, the authorities in the UK did nothing, citing moral hazard, thus causing the first run on a bank since Victorian times. Nowhere else in the developed world has this occurred. By the end of the year, the Northern Rock problem remained unresolved, but the negative effect on consumer confidence was to take an increasing toll.

Merger and Acquisition activity, which had been a major supportive prop for markets, dried up virtually overnight. This had been a key driver for mid 250 companies in the UK, and led to the widest valuation differential between that index and the FTSE 100 seen in recent times. Given that smaller capitalization companies tend to be more domestically focused, it was little surprise that these indices had plummeted by year end, and are probably in to a full blown bear market. Large caps were not spared either; banks, retailers and house builders, amongst others, saw their share prices decimated.

Some of the new found liquidity was destined for the growth areas of the Far East; the Chinese market rose by 50% between mid August and the end of November, before correcting. The feeling amongst investors was that these high growth areas could decouple from the rest of the world, and would not be affected by any consumer downturn. European markets also produced strong returns, whilst the S&P 500 index hit an all time high in mid October. This coincided with oil at \$96 a barrel, and somehow it seemed wrong that both these things were happening at the same time. As Autumn became Winter, banks began to reveal the extent of losses from sub prime, and investors started to adopt a more sober view of the economic outlook. All markets fell in the fourth quarter. Interestingly, those banks needing to raise fresh capital chose to do so from investors in the Middle and Far East, often through Sovereign Wealth Funds; the beginning of the transfer of economic power from western markets was underway.

The traditional safe havens of Gold and Sovereign Debt produced attractive returns.

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