Year End, 2008

Much has been written about the worst year in living memory for equity investors, the second worst year ever. In terms of numbers, the World Index fell 45%, America 41%, UK 33%, Japan 43% and Emerging Markets 55%. At the very extremes, Tunisia was the only market showing a positive return, plus 10%, (don't ask), whilst Iceland imploded, falling 94%. A flight to quality produced a gain of 12% for Global Sovereign Bonds whilst currencies have been extremely volatile, with Sterling a major loser.

In the UK, equity markets ended their five year bull run in January, suffering an 800 point fall, to be followed by the nationalisation of Northern Rock in February, and the rescue of Bear Stearns in March. Government ministers were confident that Northern Rock would be a "profitable investment" for taxpayers; oh for the return of such innocent times. By mid May, the index had recovered to 6400, where it started the year……… truly a trap for the unwary.

It was left to the autumn before the real damage set in; Lehman Brothers collapsed on September 15th, taking both shareholders and bondholders with it. This will surely rank as the biggest policy mistake of this downturn; everything thereafter changed, with credit markets completely seized. But it also marked the point at which Central Banks started to realize the scale of the problem. UK interest rates have fallen from 5% to 1.5% in three months, and much the same rapid decline has been seen in America and Europe. Thereafter, a fire hose of liquidity was unleashed, averting a complete collapse of the banking system in early October, but with just hours to spare. Billions here, trillions there, it is very difficult, now, to know how this will pan out, but there are indicators to watch. We will explore these later.

All of this financial mayhem finally hit home with the consumer; many developed markets are very dependant on discretionary spending for GDP growth. In both the UK, and the USA, it accounts for some two thirds of the economy; add in "Capex", and it is nearer 80%. The savings rate is negligible, so when confidence is lost, the effects are very quickly felt in the real economy.

From that point, it all begins to unravel, and as we have seen, at great speed. Lower demand produces job loses at every point in the supply chain and our trading partners are in no better shape, given that this is a global recession. That is how the year ended, and the new one started.

Outlook

The speed and severity of the downturn leads us to believe that a quick return to more normal economic conditions is unlikely any time soon. Indeed, given the almost total destruction of the banking system, the loss of consumer confidence and the resultant increase in unemployment, growth may prove illusionary for some time.

Investment Manager Commentary

However, at some point, the vast amount of stimulus will have an effect. The signs we are looking for include a bottoming out in US house prices, which is where this whole problem started, and an improvement in demand for credit, and mortgages. Confidence indicators will also be important, not necessarily to indicate that things are getting better, just that they have stopped declining.

We will also be watching inflation very carefully; at the moment, the big worry is deflation, and rightly so, but whenever liquidity has been pumped in to the system before, inflation has been the end result.

Our investment stance remains one of caution.

David Oakes

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