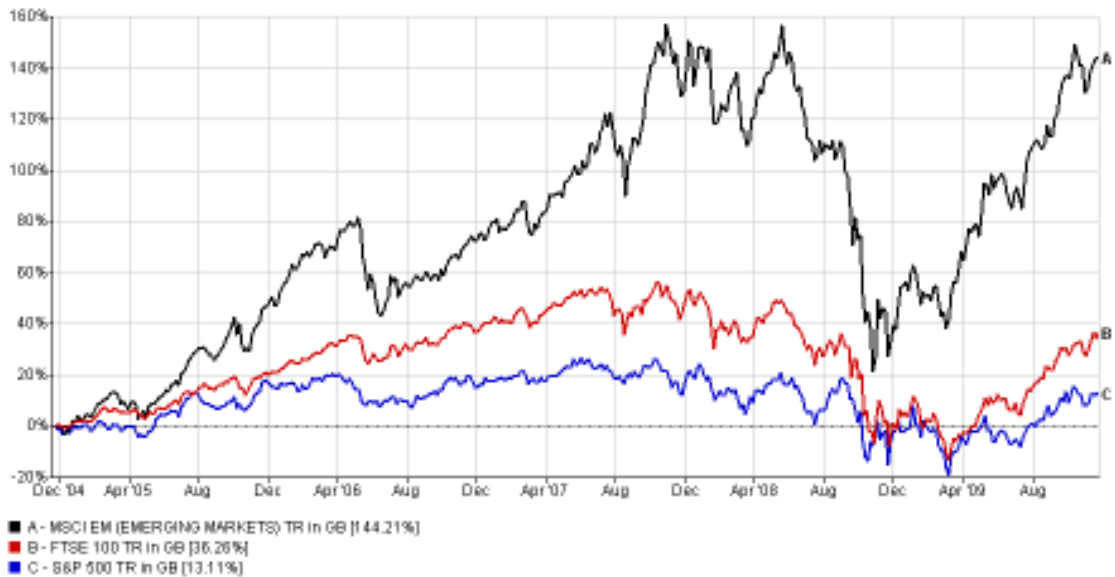


## Christmas Newsletter 2009

I am pleased to report that 2009 has been a much better vintage for investment markets and your portfolios than the “annus horribilis” for investors of 2008, although caution remains the watchword. The root causes of the overly leveraged global banking system’s near collapse seem to have been excessive risk taking in the residential subprime market in the US, and the use of expensive, overcomplicated derivative-based structured product solutions, which it turned out that no-one understood at all. When price declines in the US housing market led to losses on mortgage asset-backed securities, the more heavily indebted banks and hedge funds were forced to sell, which set in motion a vicious debt-deflation spiral.

However, investment markets experienced strong rallies from their lows in March this year (see Share Market Indices graph below), once it appeared that the financial intervention by various governments around the globe had averted the possibility of the banking system imploding, although economic recovery in the indebted developed world remains muted, and slow, which is typical of a recovery from a financial recession, as companies and households repay debt and borrow less.

Total return of the FTSE100 Index in the UK (red), the S&P 500 in the United States (blue) and the Emerging Market Index (black), in sterling, over the last five years.



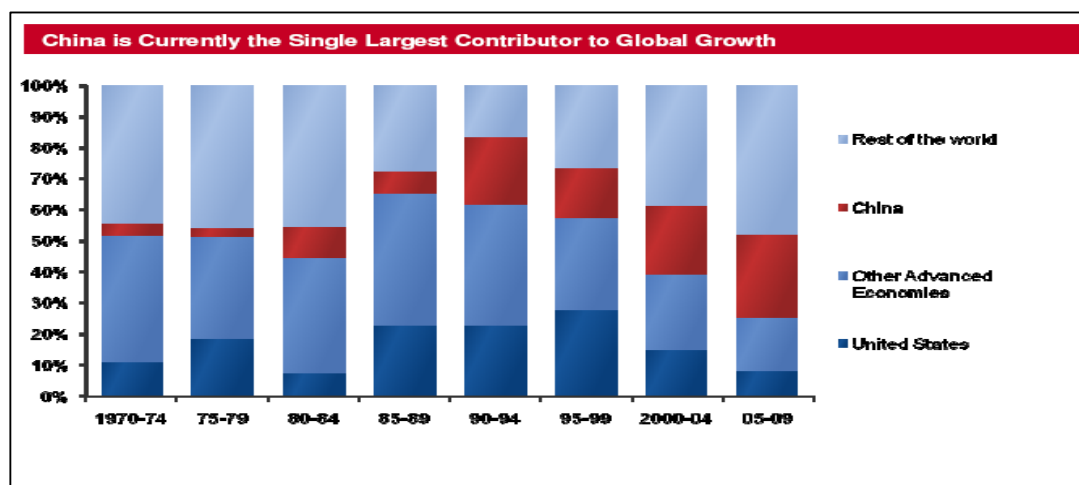
23/11/2004 - 23/11/2009 © Data provided by Financial Express 2009

Source Financial Express 23/11/09

The developed world's governments have also taken on a lot of extra debt, by acting as the lender of last resort to support the banking system, which will mean future cuts in government spending down the line. The £200bn of quantitative easing (purchasing of government gilts in the market place) in the UK to stimulate the economy will also have to be unwound at some stage, which is likely to put downward pressure on the price of government gilts. However, HSBC estimates that the UK banks will probably have to buy 60% of all gilts issued next year in order to meet new liquidity measures, and this purchasing will last for several years at least, which should help. The government is also likely to be loathe to unwind their positions too quickly, as they don't want the UK economic patient to have a relapse into recession.

We are also seeing a tentative signs of a pick up in business production, while retail sales numbers increased by 3.4% in the year to the end of October, according to the Office for National Statistics. This should begin to help government tax revenues and ease public retrenchment, while ample spare capacity in the economy should help keep inflation low for now, which will also enable policy makers to keep interest rates low to stimulate developed economies still further, probably until late 2010 at least.

The balance of global economic power is moving to the East



Source:- Gavekal, and Brooks McDonald October 2009

Increasingly the emerging markets with their favourable demographics (large number of young workers), wealth of natural resources, and low debt levels, are becoming more important economically, which can be seen in the bar graph above. This has resulted in them becoming a more frequent part of investment portfolios for growth investors, despite their more volatile history. Nonetheless, the rewards in terms of dividend/income rewards to investors will still take time to come through. Interestingly, work at the London Business School looking at 100 years worth of data suggests there is little correlation between a country's GDP growth, and investment returns, despite these markets huge outperformance over the last ten years.

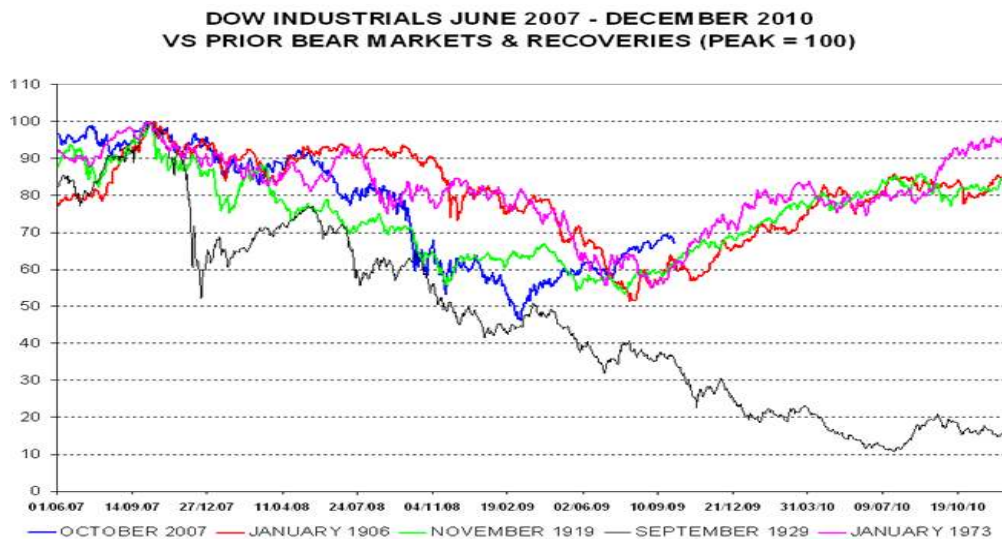
## Tax

The UK government is seeking to reduce its debt by increasing tax rates. Trust tax rates and income tax for those earning over £150,000 will increase to 50% in April 2010, while those earning over £100,000 will start losing their personal allowances until it is completely lost for those earning over £114,000 ie an effective marginal rate of 60% on those earning between £100,000 and £114,000. From 2011, those with total income over £150,000 will start losing higher rate pension tax relief, while complex anti-forestalling measures limit current contributions to about £20,000 pa.

## Investment Market Prospects for 2010

I concluded my February newsletter (see my website) by saying that in most recoveries, corporate bonds lead the way, followed by equities, and lastly residential and commercial property. We are likely to have had most of the corporate bond rally already, and we are probably part way through the equity rally, while the commercial property rally appears to be beginning. There are also signs of stabilization in the residential property market, although it still seems expensive compared to earnings.

As far as equities are concerned, the difference between the income paid by the FTSE All Share companies and government gilts is actually the biggest in nearly 30 years, which has traditionally been viewed as meaning that equities now look cheap compared to bonds. The prices of global equity markets compared to their earnings also appear about average historically, as recent market gains were based on the increase in profitability created by corporate cost cutting.



Source:- Henderson New Star October 2009

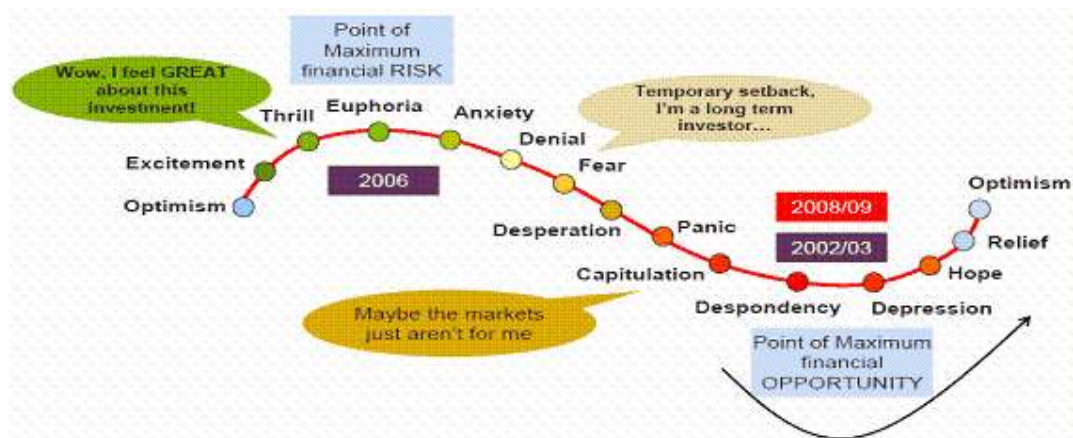
The chart of the US stockmarket above compares the five largest peacetime bears of the last 100 years. The 1929-32 fall was 89%, while the others range between 45% and the 2007-09 bear of 54%. A similar recovery to most would involve the Dow rising to within 5-15% of its October 2007 peak by the end of 2010, implying an index level of 12000-13500, (10,318 today), however that is not guaranteed !

Much of the UK equity rally to date has been confined to the banking and mining sector, the so called “dash to trash”, however the blue chips have lagged, and still appear to many to be undervalued, which gives scope for further rallies. Over 60% of profits in the top 100 companies in the UK comes from overseas, and many are again forecasting modest amounts of dividend growth in 2010. Equities generally tend to benefit in an environment of low interest rates and moderate inflation, and both are forecast to prevail until at least the second half of 2010.

There is also still plenty of cash on the sidelines available to drive future gains when investors gain more confidence in the economic recovery. For example, US money market funds’ value is about 36% of the money invested in US equities, compared to an average of about 15%, and a previous peak of 25% at the bottom of the 2000-2003 equity bear market, when again investors were unsurprisingly nervous.

Technical strategist Robin Griffiths, has found that equity market returns over the last 45 years were markedly stronger in the months from November to April. Although past performance is no guide to future performance, I still find that his findings add to my cautious optimism for the next few months returns at least, and I suspect that we may be at the “hope” dot of an equity bull market on the graph below.

### Investor’s Rollercoaster of Emotions



Source: Westcore Funds / Denver Investment Advisors LLC, 1998, Fidelity

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24/11/09

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*Past performance is not a guide to what might happen in the future. Please note the value of an investment and the income from it can go down as well as up, so you may get less than you invested. The ideas and conclusions in Kay Burt’s market update are her own, unless stated otherwise, and they are for general interest only and should not be taken as investment advice or as an invitation to purchase or sell any specific security. Discussion about future prospects involve best guesses rather than a guarantee of a particular outcome.*