



This weekly Briefing Note aims to pick out some of the key financial and economic issues touched on in the press over recent days and from time to time includes the views of some of our independent fund managers.

Achilles heel

Renewed worries about Greece's debt and its ability to service it continued to play on investors' minds, as the threat of further downgrades to its credit rating put the country's fiscal woes back at the top of the markets' agenda. The rekindling of sovereign concerns came as another batch of disappointing data releases in the US and Europe added to scepticism about the strength and durability of the global economic recovery. Both Moody's and Standard & Poor's warned that the Greek's rating could be downgraded within a month, depending on whether the country was smoothly enacting the promised fiscal reforms. Such concerns sent the euro and peripheral government bond yields tumbling – a downgrade would make it hard for the country to tap the markets for loans and might mean that Greek bonds would no longer be eligible as collateral in the European Central Bank's refinancing operations.

The deterioration in global risk appetite was also compounded by news earlier in the week that China's central authorities had moved to tighten liquidity by increasing the bank reserve requirement ratio by 50 basis points to help control the pace of lending to customers. This reinforced concerns that expected interest rate rises might be brought forward, although Lena Komileva, head of G7 market economics at Tullett Prebon, suggested that the People's Bank of China was responding to normalising market conditions and aiming to take preventative measures against excessive financial leverage and asset bubbles.

At the end of a roller-coaster week, which on Thursday included the FTSE 100's steepest decline for three weeks, markets were largely unchanged. The FTSE 100 ended the week just 0.07% down, whilst the US S&P 500 index fell 0.42% - in part boosted by generally better than expected corporate results.

The pound in your pocket

The Sunday Times opinion poll showing a substantially reduced Tory lead highlighted the possibility of a hung parliament, with Labour as the largest party. Combined with concerns over the size of the national debt, expected to reach 12% of GDP, and the long-term health of the economy, the inertia created by a potential hung parliament led to a sharp sell-off in the pound. Sterling was down to its weakest level against the dollar since May last year at \$1.52 and even lost ground against the bedraggled euro. Potentially good news for exporters but less welcome for those seeking to book holidays in a sunnier clime this summer!

The Financial Times reported figures showing that business investment in the final quarter of 2009 had fallen far more than expected, having dropped 5.8% between October and December compared with a fall of 1.8% in the previous three months. Analysts described the figures as a horrible surprise, following a succession of weak economic data for January, damaging the prospects for sustainable and rapid growth. Good news of sorts did emerge, with revised GDP numbers for the fourth quarter showing that the UK economy grew by 0.3% rather than the original 0.1%. However, this was tempered by the fact that this was entirely due to the numbers for the first part of 2009 being revised downwards, highlighting that the recession was even deeper than originally feared.

Carrots given to charity

Bankers' bonuses hit the headlines again last week as Eric Daniels, the chief executive of Lloyds Banking Group, turned down the £2.25m bonus offered by his board, following the lead of Stephen Hester, his RBS counterpart. However, as **The Financial Times** observed, RBS did admit that more than 100 of its investment bankers will take home bonuses of at least £1m for 2009 – a year in which the bank posted a net loss of £3.6bn.

In a further attempt to defuse the row over bankers' pay, **The Daily Telegraph** reported that the bosses of HSBC and Standard Chartered, Michael Geoghegan and Peter Sands, were to forego their bonuses and donate them to charity. Whilst Lloyds and RBS have racked up huge losses, both HSBC and Standard Chartered are expected to announce strong annual profits and neither received any direct taxpayer bail-outs. Their decisions mean that none of the UK's 'big five' bank chiefs will have taken a penny in bonuses for last year.

However, bank chiefs did not escape the ire of Warren Buffett, the veteran US investor, writing in his annual letter to shareholders in Berkshire Hathaway. As **The Sunday Times** reported, Buffett lashed out at the chiefs of failed banks who have "long benefitted from oversize financial carrots" and now need "meaningful sticks". He went on to say "It has not been shareholders who have botched the operations of some of our country's largest financial institutions. Yet they have borne the burden, with 90% or more of the value of their holdings wiped out in most cases of failure....the chief executives and directors of failed companies, however, have largely gone unscathed".

Prudent deal?

HSBC and Standard Chartered were also in the news as **The Sunday Times** reported plans by Prudential, Britain's biggest insurer, to purchase the Asian assets of troubled American rival AIG. The sale of AIA, the AIG subsidiary, for an expected \$35bn (£23bn), would amount to one of the largest ever such fundraisings by a British company and would cement the Pru's position as a huge force in Asia, ranking alongside the aforementioned banks. A deal would more than double the size of Prudential and mean that its business would be dominated by Asian sales and profits.

Any deal will require the approval of the US government – the US Treasury and New York Federal Reserve have an 80% stake in AIG following repeated bail-outs. AIG is already in advanced talks with its US rival MetLife over the \$15-\$20bn sales of Alico, its international insurance arm.

Corporate bonds return to type

After a stellar run over the last 12 months, the future for the credit markets was thrown into sharp relief by the announcement of an end (temporarily) to quantitative easing. In a recent interview, Paul Read of Invesco Perpetual who manages the Corporate Bond and Investment Grade Corporate Bond funds for St. James's Place outlined his views on the outlook, "2009 was an absolutely amazing year, with unbelievable valuations in the first part of the year, leading to once in a lifetime opportunities which, by definition, cannot be repeated. However, that does not mean the asset class is a sell, and whereas some parts of the market are fully valued, there are other parts that continue to have value.

The forecast for default rates has fallen significantly over the last 12 months and is likely to continue to fall for most of this year so the fundamentals for corporate bonds I think are improving, default rates peaked, refinancing is possible and is being used, extension of financing is possible and that's also going on. I think corporate management is very focused on the balance sheet and earnings are pretty good. At the same time, management doesn't want to have a concern with its bank so we'll see the continued use of bond financing as a substitute for bank lending.

Contrary to some, I don't really expect a big sell-off in Government Bond yields. I do accept the fact that there will be a lot of issuance of gilts and sovereign balance sheets are a concern. Having said that, I don't have a big inflation concern and I think short-term interest rates are unchanged at pretty low levels.

Now I also think it's important to remember that from here performance is going to be more bond like, if that doesn't sound a silly thing to say – because what we experienced last year was equity like returns from fixed income. What I think we get this year is bond like returns – so your coupon and your income stream are a very, very important part of your overall return.