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Market Update

For immediate release

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Market stress ‘creating negative feedback to real economy’

Latest market comment from Paul Niven, Head of Asset Allocation at F&C:

Financial markets continue to face severe stress with seemingly relentless downward pressure now pushing US equities towards their worst monthly performance in seventy years. Many global indices have fallen by more than a quarter in October alone with Emerging Market equities posting losses averaging close to 40% while credit spreads are blowing out.

Events in global financial markets have moved at breakneck speed over recent months with global policymakers struggling to keep pace with events and, so far, failing to get firmly ‘ahead of the curve’ in action to stem the relentless tide of deleveraging sweeping financial markets. Coordinated rate cuts, widespread banking recapitalisation programmes and huge global liquidity injections have, so far, provided no respite for investors, who have seen spreads in many credit markets move to record levels and equities pummelled.

Having seen the banking crisis unfold over the past months, we are now seeing the contagion take out whole economies, with Eastern European emerging markets in the firing line. Post the Icelandic collapse, we now have Hungary and Ukraine suffering a classic emerging market crisis, led by high levels of borrowing in foreign currency denominated debt. The IMF has again come to the rescue but these economies are heading towards deep recessions and debt moratoriums. The effect on many European banks will be significant, forcing further losses to already precarious balance sheets. This, in turn, will add further pressure

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to credit supply which is already threatening to choke any remaining life out of global trade and push the global economy deeper into recession.

Evidence of the deleveraging process can be seen from the foreign exchange markets, where the dollar has enjoyed a sharp recovery, the largest in decades, rising markedly against the Euro and Sterling. Surpassing these gains, however, the yen has been benefiting from an unwinding of the carry trade by leveraged investors. This phase of deleveraging which is crushing markets is leading to a self feeding downward spiral in risk assets which will ultimately add more pressure to the global economic outlook. It is tempting for commentators to place the 'blame' for recent weakness at the door of the hedge fund industry, under huge pressure after posting (in generalised terms) significant absolute losses and facing a wave of redemptions, leading to an unwinding of leverage and an exit from positions. In addition to this, we have seen large mutual fund redemptions and there is evidence of institutional 'forced selling' where investors are being pushed out of open positions, regardless of the price. This short term pressure is intensifying and is creating a negative feedback loop which is pushing the crisis into the non financial areas of the economy with potentially serious consequences.

At this stage, it is impossible to ascertain when the deleveraging process in financial markets will end, or at what level prices will finally settle. We know, however, that the real economy deleveraging process will go on for years (and has barely started) and that the outlook for growth and for corporate earnings is becoming more desperate by the day. In addition, deleveraging is clouding the conclusions over whether the policies undertaken to unfreeze the credit markets are insufficient or are simply not working yet. Quantifying the economic and corporate impact of the downturn is guesswork at this stage but both operating and reported earnings still have a long way to decline to match the drops seen in previous recessionary periods. Fortunately, markets seem to have discounted much of this decline already.

With so much economic uncertainty and markets in uncharted territory (in terms of the speed and magnitude of declines) there are a number of indicators suggesting that markets have moved away from fundamental anchors. With implied default levels in credit markets at extreme levels and traditional indicators suggesting that markets are as oversold as at any point in history, investors are 'capitulating'. Our central case is that we are in the throes of a cathartic deleveraging process in financial markets which will likely mark a short term bottom in risk assets. At this stage, with market volatility at unprecedented levels, timing the exact trough cannot be estimated with any level of precision. A few days moves in the current environment can easily equate to 10-20% movement in equity prices. We believe that policymakers globally are making the right steps in terms of what is required to restore confidence and unblock critical money markets. More, however, is required, and in the short term we are likely to see further cuts in global interest rates, perhaps in another coordinated move. It is our belief that authorities globally will go as far as is required to address the (treatable elements of) malaise but will now likely have to inject greater amounts of capital into banks than originally intended and take more direct control of banking operations. Full nationalisation of complete

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banking systems is entirely possible along with blanket guarantees on both deposits and liabilities before the crisis fully runs its course. For investors this may well mean further dilution of equity stakes in financials but such a move may be necessary before we can see an end to the current problems and to restore market confidence. Until the banking system can be seen to be operating in a more 'normal' fashion we cannot realistically call the end of the crisis.

For investors, the appropriate strategy will depend upon duration. The short term outlook is likely to provide the greatest risks in terms of portfolio outturn and the magnitude of market movements will continue to test the resilience of market participants. That said, it is our central belief that the authorities will undertake all necessary steps to address the crisis and that, with time, the credit markets will show signs of improvement. This is not to say that we will avoid an extremely challenging period in the global economy, with long recessions in most of the major blocs. It is also not to say that default rates in credit markets will reach record highs. In addition, we fully expect that earnings will be declining (in reported terms) by levels similar to previous recessionary period, indicating a further 25% downside to market earnings from where we currently stand. Furthermore, the outlook for the major economic regions will likely be recessions stretching for most of the next twelve months at a minimum and several years of sub trend growth.

As investors trying to navigate the financial maelstrom, we cannot, with any level of certainty, assess when the absolute bottom in risk assets will be reached. What we can say is that credit markets are now pricing in extraordinarily high levels of implied defaults and that equity markets are as cheap, in most regions, as they have been at any point in many decades. Historically, based upon current levels of valuation, investors are effectively being compensated for taking risk and have been subsequently rewarded with high levels of return over the medium term. Our belief is that we have such a situation now. In the short term we are seeing the largest margin call of all time, squeezing leverage from the financial system at the same time as problems are engulfing financial institutions and, latterly, whole economies. That said, policymakers have shown their willingness and (increasingly) determination to respond and, so far, have done so in a relatively coordinated manner. More will still be required, however, and as well as an extension of existing recapitalisation programmes (in terms of duration and scale) much more fiscal expansion will be forthcoming in an attempt to offset private sector declines.

Paul Niven
Head of Asset Allocation, F&C
October 28, 2008

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Notes to Editors

F&C Investments

- F&C Asset Management (F&C) is a London Stock Exchange listed asset management group which traces its origins back to 1868 with the launch of the Foreign & Colonial Investment Trust, the first ever publicly listed investment fund. Foreign & Colonial Investment Trust remains a client of F&C.
- F&C is an active fund manager with a multi-specialist investment model where individual teams have strong accountability for their products and processes. The group is also an active shareholder with a leading franchise in governance and sustainable investment.
- F&C now manages £96.5 billion (€121.9 billion) of assets* for a diverse range of institutional, insurance and retail clients across all major asset classes – equities, bonds, cash and property – as well as alternative and specialist product classes such as Socially Responsible Investment funds, hedge funds, funds of hedge funds, private equity funds, Global Tactical Asset Allocation products, enhanced alpha funds and Liability Driven Investments. F&C invests globally and has been a longstanding investor in emerging markets.
- F&C manages assets principally from three investment centres: London, Amsterdam and Edinburgh. The group has an office network spanning ten countries: China (Hong Kong), France (Paris), Germany (Frankfurt), Ireland (Dublin), The Netherlands (Amsterdam), Portugal (Lisbon), Sweden (Stockholm), Switzerland (Geneva), UK (London, Edinburgh, Dorking) and the United States (Boston).

* As at 30 June 2008.