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Market Update

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“Short term caution needed after huge bounce in equities”

Summary of latest views:

- **S&P500 Index** up 42% from intraday lows on 6 March
- **Normalised price/earnings ratios** in the US are now close to long-run average levels.
- **Technical indicators** suggest markets are becoming overbought.
- **Government bond markets** are beginning to look more attractive

Commentary:

Risk and cyclically sensitive assets such as equities, credit and commodities have enjoyed a strong recovery during the second quarter of the year as fears of systemic failure in the financial system have been replaced by the hope that economic recovery is imminent and that the global recession is close to an end.

The moves in asset markets have, in many instances, been extraordinary with the bellwether S&P500 index moving up by 42% from its intraday low of 666 on 6 March and many emerging markets showing even greater gains. Economically sensitive commodities, such as oil, have doubled from lows and credit spreads have tightened considerably, with the Itraxx Main index closing in on 100, from highs above 220.

Despite the significant rally seen across markets, we still stand some way from pre-Lehman levels across asset prices and economic indicators, which is being seen by some as a bullish precursor to a ‘normalisation’

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of market conditions. Our view, however, is somewhat more cautious in the near term and we feel that investors may now be too sanguine on the outlook for the economy and the risks that remain prevalent.

The collapse of Lehman clearly led to a seizure in credit markets. Almost overnight, there was an (arguably) unprecedented systemic meltdown. The macro data reported on the latter part of 2008 and the early part of this year painted a picture of collapsing world trade, massive reductions in factory output and industrial production, and a significant rundown in inventory positions. The extraordinary collapse in output, leading to double-digit annualised declines in GDP (and 40%+ declines in exports) even in developed economies, created a massive overshoot to the downside in many market and economic indicators. The decisive action taken by authorities in monetary and fiscal stimulus, as well as intervention in the banking system, financials and manufacturing, have been successful in restoring some confidence and ensuring that credit, the lifeblood of the economy, may begin to flow (albeit slowly) once again.

Is the upturn sustainable?

From the artificially depressed levels of activity seen, we have enjoyed a bounce as most market and economic indicators have moved higher from often record lows and begun to look forward to a period of expansion. This period of expansion is still some months away but, in our view, the 'V-shaped' recovery was almost inevitable given how low many indicators had fallen and, importantly, due to the inventory rebound which is currently pushing growth closer towards positive territory. The question for markets, in fundamental terms, is just how sustainable this economic upturn will prove to be.

The reality is that a significant amount of uncertainty exists over whether we can generate sustainable recovery beyond the inventory bounce. Our view is that the initial 'V-shaped' recovery will give way to an altogether more turgid economic backdrop. We believe it will be some years before the global economy returns sustainably to trend rates of growth as deleveraging progresses, demand for credit remains muted, access to credit remains relatively low, capital formation is low (due to oversupply in property and excess capacity) and consumer end demand is weak. That said, we will see a return to positive rates of growth in many economies in the next quarter and there is every likelihood that many emerging areas will remain relatively robust, giving greater credence to the 'decoupling' theme. Nonetheless, the hangover from the credit crisis will be long lasting and not easily forgotten.

We would certainly take the view that the economic and corporate backdrop is significantly more positive today than at any point since Lehman went under. Nonetheless, having been underweight equities a large part of 2008, and overweight through the rally, we think that positions on 'risk' should begin to be reined in.

US equities now trade on 15.5x trend earnings, just below long-run average levels, and credit markets have moved from pricing in defaults consistent with depression to a situation more consistent with severe recession. There is certainly enough of a valuation gap in equities (particularly outside of the US) to warrant

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the expectation of good longer-term returns both in excess of cash and government bonds, but we are a long way from the unconditional value offered just two to three months ago.

Our measures of risk appetite, which were close to a 30-year low in November and March, have bounced materially with broad risk appetite now neutral and equity risk appetite becoming stretched. This is a contrarian signal. In addition, insider buying is now low and technical indicators suggest that markets are reaching overbought territory.

In contrast to equities, credits and commodities, government bonds have had a torrid time. Yields have backed up aggressively as inflation concerns have resurfaced, supply of paper has ballooned, creditworthiness of issuers has been undermined and the economy has returned from the dead. Here, however, bond markets are looking more interesting to us. We do not dispute that long-run valuations are poor and are certainly mindful of the inflation and rating risks associated with government bonds, but we feel that economic disappointment, ongoing risks of deflation and a likely desire of authorities to cap the rise in yields (which could derail recovery) will help yields down in coming months.

Within markets, we continue to favour emerging markets and are negative on Europe and the US. We are reversing our long position on UK equities, partly in response to the rapid rise in sterling. While we expect the dollar to weaken over the longer term there is scope for outperformance of overseas assets in sterling terms and the UK equity market now has no clear relative attractions on an unhedged basis.

Bear market rally nearing the end; will a new asset price bubble be next?

Our view, then, is that we are close to the end of the bear market rally. History shows that such rallies can be huge, although it is rare to get one as explosive as we have seen in such a short a period of time. From here, with valuation broadly fair and limited scope for upside surprises in economic and corporate newsflow, we see the risks on equities and credits as much more finely balanced.

The risks to our view on the upside relate less to the prospect of sustainable recovery in the economy in the near term and rest more on the psychology of markets and liquidity. Markets have shown they are capable of rising on 'no news' or even on what, on the face of it, appears to be 'bad news'. With the move upwards in risk assets occurring in such a short space of time and on modest overall volumes there is an argument that most have missed the opportunity and are now being sucked in, which may force prices higher. Indeed, history has shown that the authorities have tackled each successive crisis with the inflation of a new asset bubble. To move much higher in the short term, beyond an overshoot, and into a new bull market will require fundamental improvement beyond what we believe is reasonable to expect.

Paul Niven, Head of Asset Allocation, June 2009

- Ends -

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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 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 £92.7 billion (€100.1 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, private equity funds and Liability Driven Investments. F&C invests globally and has been a longstanding investor in emerging markets.
- F&C REIT Asset Management is the group's global property asset management business. It was formed in 2008 from the merger of F&C's property division and REIT Asset Management. F&C REIT operates from offices in London, Dublin, Istanbul, Munich, Mumbai and Stockholm.
- F&C manages assets principally from three investment centres: London, Amsterdam and Edinburgh. The group has a global office network spanning twelve countries: China (Hong Kong), France (Paris), Germany (Frankfurt & Munich), India (Mumbai), Ireland (Dublin), The Netherlands (Amsterdam), Portugal (Lisbon), Sweden (Stockholm), Switzerland (Geneva), Turkey (Istanbul), UK (London, Edinburgh, Dorking) and the United States (Boston).
- In March 2009 F&C signed a Memorandum of Agreement with Hua Xia Bank, one of China's twelve nationwide joint stock commercial banks, to establish a joint venture fund management company in China in which F&C will have a 19.5% interest.

* As at 31 March 2009.