



**F&C Management Limited**

Exchange House  
Primrose Street  
London EC2A 2NY

**Telephone** +44 (0)20 7628 8000

**Facsimile** +44 (0)20 7628 8188

**[www.fandc.com](http://www.fandc.com)**

# Market Outlook

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## **Foreign & Colonial chief earmarks US as first market to recover; UK outlook remains bleak**

Jeremy Tigue, fund manager of the Foreign & Colonial Investment Trust, one of Britain's most popular investment funds, writes: "2008 has been an unprecedented year and one we hope will not be repeated in our lifetime. The biggest issues actually occurred away from the equity market, in banking and commodities. Busts in both these markets were bigger and faster than anything ever experienced before and one following the other had the effect of a double tsunami on market stability and confidence.

Since the end of September there have been two massive forces at work making the situation even worse. The first has been the realisation of how bad things are likely to be for the world economy in 2009 following events in the financial and commodity markets during 2008. The second has been the explosion of forced selling as hedge funds de-leverage and raise cash to meet investor redemptions. It is hard to disentangle the two and of course one affects the other, however I anticipate that this process should end soon in equity markets.

Liquidity in markets traditionally dries up around Christmas, but this year it will be more of a drought. Market makers will not want to be running positions of any size for most of December, meaning December looks set to be a volatile month even by the standards of recent months.

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Looking to 2009, the US was first to fall and consequently will have to be the first to recover. Cutting interest rates close to zero is part of the solution but other efforts to deal with the problems have been ad hoc, contradictory and may have done more harm than good. The move at the end of November to push down mortgage rates is very significant as the US economy and financial system will struggle to find a floor until house prices stop falling. Key to stopping house price decline is to cut the cost of mortgages, which have been stubbornly high. Getting 30 year mortgage rates down to around 4.5% will be a huge step forward.

The other big positive for the US is the collapse in oil and other commodity prices. US gasoline prices have fallen more than 50% in the last six months compared with only 25% in the UK. This is a huge tax cut for consumers. Lower interest and fuel costs for consumers will help improve personal balance sheets even as unemployment rises. The US went into recession at the end of 2007, earlier than anyone realised. By late 2009, hopefully there should be signs of recovery.

By contrast, 2009 will be bleak for the UK economy. We are at least several months behind the US and house prices are much higher relative to incomes and long-term trends here. Additionally, the fall in sterling is muting the effect of collapsing oil and commodity prices and our economy is far more dependent on the financial sector.

Interest rates will fall in the UK, perhaps as low as 1% in early 2009. Most investors, particularly those with reasonable sums in bank deposit accounts, realise that this translates to practically no income from their savings. As a result, cash investors will either have to run down their capital or find an alternative method of generating income. A protracted and debilitating recession looks likely for the UK during 2009 and into 2010, possibly as bad as that experienced in the 1990's.

Elsewhere, Europe is in a similar position to the UK and also behind the US, with more rigid economies and a central bank that still appears to be fighting the last war. Japan may be forced into recession by the sharply rising yen and the lack of domestic demand from an aging and shrinking population. Emerging Markets are probably the most interesting area in 2009 and some will have a terrible year – notably Russia and other oil dependent markets. Asia should be able to weather the storm better but this depends on the resilience of China.

By this time next year, I anticipate that most major countries will have interest rates close to zero, all will have experienced sharp contractions in economic activity, almost all companies will have reported lower profits than 2008 and many will have cut their dividends. There will be no inflation and possibly some deflation.

It is easy to understand why so many are worried about a 1930's style depression, as it would appear that the interest rate cuts and extraordinary measures of the last year have so far failed to prevent the global

economic slowdown. Nevertheless, I don't think that will happen as the measures already taken have yet to work through the system and when they do they will give a significant boost to economic activity. One sign of improvement will be a return to inflation, as this heralds the return to economic growth.

Another long-term trend from the events of the last year will be a speeding up of the transfer of economic power to China and other emerging markets, away from the US and Europe. One way this will be manifested is in a long-term decline of the US dollar as the world's reserve currency. Sterling weakness in 2008 may well continue but a decline in the dollar may cause additional dislocation in the markets.

But are we now in a completely new world which requires completely new thinking? I would expect the least risky assets – cash and government bonds – to have the lowest levels of income and the easiest access investors have to their money. Low risk equals low return and as investors move away from safe investments towards higher risk, they should expect the returns to go up.

As such, illiquid investments such as property, private equity and hedge funds would require higher returns to justify holding them. By the same token volatile investments such as corporate bonds and equities should also command higher returns. Capital returns are very uncertain and possibly non-existent so investors should concentrate on income returns. Property has always provided higher income returns than cash and bonds but in the past hedge funds and private equity have generated almost all their returns from capital. However any fund targeting an absolute return should really be looked at as an income producer.

Equities are at the bottom of the pile in terms of capital structures and are bound to be more volatile. To compensate for the volatility they should have higher dividend yields with the most risky having the highest yields and the least risky the lowest.

The only reasonable conclusion is that 2009 is set to be grim. The first quarter is likely to see a rise in corporate problems and redundancies, along with other bad news. After banks and hedge funds, the private equity sector is probably the next area likely to have high profile problems. There is one simple rule – anyone with debt will struggle, anyone with cash will be okay. However, by the end of the year there should be some light at the end of the tunnel. If you stop thinking about capital returns and focus on income it becomes much easier to work out what to do – low risk/low income, high risk/high income.

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**Jeremy Tigue is fund manager of the Foreign & Colonial Investment Trust. Launching in 1868, Foreign & Colonial is the world's oldest publicly listed investment fund. To arrange an interview with Jeremy Tigue please contact Jennifer Donohoe in the F&C press office on +44 (0) 20 7011 5017.**

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