

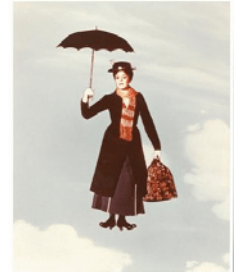
INVESTMENT NOTE

June 2010

Supercalifragilisticexpialidocious?

Should Governments be cutting budget deficits or stimulating the economy?

First we had the “PIGS” followed by “PIIGS”, then as Hungary announced that they could suffer from a Greek-style credit crisis (a claim that appears to be more about political scare mongering than fact) we had the “PHIIGS”; will it soon be all the weak economies and be “Supercalifragilisticexpialidocious”? A difficult question to answer but one which is causing much of the volatility we are experiencing in the global financial markets. With such uncertainty and no long-term confidence as to whether we are in a rising or falling market, the direction appears dictated by the latest news or data released on a day by day basis. Since May the VIX index (an index of the implied volatility of the US S&P500 equity index options) has spiked upwards and remains at elevated levels having steadily fallen for the preceding year. In the UK the FTSE 100 has been oscillating between 5,300 and 4,950 for the last month and Gilt yields have fallen on further safe haven buying. The Euro has been the main casualty continuing to fall in value against, in particular, the US Dollar.



But why is there so much uncertainty? We have a clear improvement in the underlying economic fundamentals in the UK (and across the globe) suggesting that the process of economic stabilisation is ongoing and the risk of a “double-dip” recession has past. Additionally we have positive action being taken by Governments (particularly in the Western Europe) to cut their budget deficits. This issue has been with us for many years but only moved to the fore when Greece teetered on its own liquidity crisis, and threaten the whole Euro experiment. It should be noted that Greece, which does not have the highest deficit (as a percentage of GDP) in Europe, but appears to have the most unsustainable, may have erred when it compiled its economic data when it first joined the euro. We do not feel it is representative of the situation across other Euro countries. But here is where we reach the dilemma that is facing markets; **will the austerity measures implemented by governments which will typically result in lower public spending, higher taxes and job losses, negatively impact upon the economic recovery we alluded to earlier?**

The emergency UK budget when announced on June 22nd will, in its attempt to cut waste in government administration, result in lower wages, job cuts and effectively remove an estimated six billion of public spending from the British economy. This was the campaign pledge of both the Conservatives and the Liberal Democrats, and will be the stance of the new coalition government. The lone dissenting voice was the then Prime Minister, Gordon Brown, who during the election campaign called for continued public spending until the economy was firmly out of the mire. Interestingly this debate continues to rumble on; only this week the governor of the US Federal Reserve, Ben Bernanke, advised Congress that to tackle the record federal budget deficits, it should have credible deficit-reduction plans in place, but should not implement them as “*Right now is not the time to radically reduce our spending, or raise our taxes, because the economy is still in recovery mode and needs that support.*”. One can assume from these comments that the Mr Bernanke would not agree with the knee-jerk austerity measures (pay and pension cuts, new taxes, and cuts in government spending) that European countries are already beginning to implement at the urging of the EU and IMF.

The TAM View Although, at the risk of splinters, we are unusually perched on the fence. By retaining a fairly neutral exposure within our portfolios against strategic benchmarks we are expressing a view that yes we believe markets will improve, but will remain volatile and lack direction in the short-term. However within our asset exposures we are rebalancing. We continue to rotate out of our international exposure which has benefitted from the weakness of Sterling and the Euro, back into domestic markets at levels we consider to offer good value. We have been surprised by the movement in UK Gilts, to which we are underweight, and maintain our negative outlook for Government Debt fearing a sudden correction in the sector when investors realise that they are not being amply rewarded for the risk they are accepting. This correction may be extremely sharp should the equity market begin to trend upwards.

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