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INVESTMENT NOTE

February 2010

The UK Gilt Market Revisited

One year of feast and seven of famine?

Throughout 2008, we held overweight positions in UK Government Debt (or "Gilts") for our sterling based clients – it was the only safe haven in a ferociously volatile market. However, our June 2009 Investment Note, "Gilts Face Mounting Headwinds", highlighted some of the issues which we thought would create obstacles for Gilts during the remainder of the year and into 2010. Record low interest rates and substantial quantitative easing efforts (which could not last forever) led us to conclude that Gilts, at that point even, were showing signs that they had run their course. We, therefore, significantly reduced our exposure to Gilts and increased our holdings in Corporate Bonds where we saw far greater value.

Below, we highlight the main factors which continue to support our negative outlook for the UK sovereign debt markets and why we expect to be underweight in this asset class in 2010-2011.

Bond Issuance

The unprecedented levels of "quantitative easing" (asset purchases), by the Bank of England, undoubtedly supported Gilt prices throughout 2009. However, a wave of new issuance will continue throughout 2010 and we feel there is justified concern that the size could overwhelm the markets now the Bank of England has ended its supportive buying. To put the size of the Bank of England support into context, net buying of Gilts in 2009 showed that the Bank bought up £183 billion of the £208 billion issued, the difference of £25 billion, being the lowest net issuance figure since 2003 (interestingly enough, another disastrous year for financial markets).

Some commentators remain hopeful that the gap left by the withdrawal of quantitative easing purchases, can be taken up by UK-based Banks, partly to comply with new liquidity requirements imposed by regulators – but we have our doubts. The Bank of England reported that net Gilt purchases picked up in the fourth quarter, but the real benefit this brought to the Gilt market was, in our opinion, negligible. The timetable for Banks to adhere to the new rules remain flexible and their "phasing in" is contingent upon a pick up in the UK economy overall. As things stand, without the Bank of England support, there appears to be an awful lot of slack to be taken up by the market.

UK Budget Deficit

By the end of 2009, the UK had one of the worst budgetary problems of all the major European economies. Given the sovereign debt issues that are currently befalling several mainland European economies, our earlier warning regarding the possibility of a credit downgrade was not as remote as one might think. Indeed, it has loomed ever larger with the growing fiscal deficit (£178 billion or over 12.5% of GDP), adding to Global speculation that Gilts may lose their AAA-rating. With a General Election due very soon, it is even more challenging to cut through the political posturing and conduct a meaningful analysis of the reforms proposed by each party. The (current) Chancellor of the

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Exchequer, for example, has forecast a halving of the deficit over four years but, at the same time, stands by his pledge to protect spending on education, healthcare and police, making for a difficult balancing act. Whichever Party claims power, they will have to address the fiscal deficit as a matter of priority and, no doubt, implement unpopular reforms – not something they will want to highlight pre-Election.

UK Inflation

Our view on inflation has not changed; the VAT increase in January, rising energy prices and weakness in the value of Sterling (increasing the price of imported goods), has caused inflation to move back towards 3% (and possibly above). The Bank of England, in their most recent forecast, suggests this is a short-term phenomena and inflation should fall below the 2 per cent target in 2011 (although they do concede that inflationary pressures are currently stronger than initially anticipated). Whilst the current level of inflation may be unlikely to provoke the Bank of England into tightening monetary policy, there is still a risk that an unexpected sharp pick-up in inflation, or just better than expected macro-economic news, may be swiftly discounted by the Bond market leading to the selling of Gilts.

In summary, we maintain our negative outlook for UK Gilts and feel that the "one year of feast and seven of famine" analogy, seems truly appropriate to the current situation. We reiterate our 2009 view that, clients' portfolio exposure to Gilts should be minimised for all but strict income purposes and we are happy to stay with that recommendation in 2010. Famine is rife and our only exposure in this area is a Strategic Gilt Fund that has the ability to hedge its exposure and short the Gilt market within certain parameters.

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