



Is the Party Over?

Maybe, but the secret is to keep the music playing!

Making money over the last four months has not been difficult. Equity markets have rallied over 50% since March, Bond markets have recovered, and commodity markets continue to surge (e.g. Gold at all-time highs of \$1,100/oz). Such a strong recovery has certainly come as a relief to all participants; from beleaguered fund managers who took both barrels squarely in the chest last winter; they suffered the double whammy of collapsing financial markets and surging redemptions as investors withdrew from the mêlée, to individual investors who welcomed their change in fortunes. Those that remained invested during the downturn greeted the reduction of their losses and those that consolidated their holdings (and potential losses) during the falls looked for opportunities to re-enter the market (partially sustaining the strong rallies we experienced).

The “feel good” factor that emerged during the summer has resulted in extremely high levels of inflows

into the investment fund universe. Figures show that inflows are even accelerating as we reach year end, suggesting that 2009 will show the largest annual net inflows for many years. But most relevantly the figures highlight that many investors are only now joining the party. Unfortunately one must question the longevity of the current recovery and ask; are these investors joining the party too late?

The debate clearly centres on the current dichotomy between the very positive market activity we are currently experience and the worrying weak underlying economic fundamentals we still face. As mentioned above World stock markets, commodity markets, corporate bond markets and even property markets have all benefitted from the return of investors risk appetite. Indeed the much watched measures of market risk, credit default swaps and option volatility, have fallen to pre-Lehman collapse levels. Even corporate merger activity has increased with Kraft making a hostile bid for Cadburys for example, and banks (e.g. Barclays) even re-instating dividends payments.

Unfortunately fundamentals are not keeping pace; Although most developed economies have re-emerged from “official” recessions by posting at least one quarter of economic growth (as measured by GDP), the UK, and others, still remain in sedentary state with positive growth not forecast until year end, and a return to normal (r desired growth not anticipated for several years). Much of any improvement in growth must be attributable to the unprecedented levels of quantitative easing, unfortunately even central banks pockets are not bottomless and they are clearly looking for suitable exit strategies. Unfortunately no one knows what the final outcome will be, will the economy be able to stand on its own or not once such stimulus is removed? There remain so many structural problems in the economy, surging unemployment (now at twenty six year highs in the US), rising bankruptcies and Repossessions and ever increasing credit card default rate.

Liquidity issues are still strangling economic growth. Although liquidity within, and between banks, has moved to a more normal situation, and larger corporations can now again access funding through capital markets, small to medium sized companies and retail consumers are still struggling to access credit; a situation that must surely constrict a proper ground-up recovery. This very point was made by the Bank of England within their most recent inflation report.

So with some many headwinds remaining and equity markets again failing to break recent levels of resistance how are we set for a winter of harsh realities?

Fortunately not! Uncertainty offers opportunity. We have moved sufficiently far from the wealth

destructive phase of economic activity when almost no asset class offered sanctuary to an investor, to a phase where a more normalised equilibrium exists – when one asset falls, another will rise. The art to successful investing over the next six-months will be to identify those asset classes that are showing signs of strength and equally those that are showing signs of weakness as well as maintaining the flexibility to move between them at key times.

Equity markets may continue their fractured recovery but within the broader markets certain sectors will stand head and shoulders above others. Many of the more traditionally defensive companies have not fully participated in the recent market resurgence offer compelling investment opportunities. Even if the UK economy, for example, lags the recovery of others, UK equities can perform well given fully two-thirds of the income earned by companies listed on the London Stock Exchange comes from outside Britain.

Fixed income markets still offer significant opportunity; confirmation this week that interest rates in the more developed economies will not rise until later next year bodes well for both sovereign and corporate issues. Although the spread dislocation (the difference in yield between a bond and a comparable sovereign bond) has contracted to more rational levels there are still opportunity in the higher yielding (typically lower credit) issues that offer both capital gain and attractive income yields.

Commodity markets are uniquely tied to into the economic recovery though individual dynamics offer potential investment opportunity; gold for example, has risen by over 30% in recent months (unfortunately far less for a sterling based or Euro based investor given the weakness of the Dollar), buoyed by inflation, currency weakness, reduced supply and renewed demand not economic recovery.

In Summary we anticipate some consolidation within financial, particularly equity markets, as the gap between market valuation (and expectations) and underlying valuation falls. But rather than a quick correction in either we foresee a slow and tepid reversion well into 2010. Such activity will offer medium to longer term investors an excellent opportunity to invest at levels not seen for many years.

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