



The Road to Recovery

UK Equity Markets have rallied nearly 15% but is this sustainable?

There can be no denying that the latest stimulus plans, announced primarily in the United States, have been welcomed by equity investors. The FTSE 100 has surged over 14% from the recent lows, but still 15% below year-end values. Likewise, the U.S. has rallied an even more impressive 19%. However, should we jump on the “everything’s fixed” band- wagon, or alternatively, worry that the light at the end of the tunnel is actually the headlight of the train hurtling towards us?

Earlier in the year ,the announcement by the U.S. Treasury of a poorly conceived “bail out” package was universally dismissed for its lack of detail and clarity, leading to one of the worst equity market sell-offs so far. To their merit, the Treasury (and new administration) has responded with more thought-out proposals to revitalise the stalled credit markets. To-date, the U.S. Government has spent (or committed) over US\$11 trillion to rescue the U.S. financial system. This figure includes the \$1 trillion

(announced this month) purchase of Treasury Bonds and Mortgage Securities, the \$700 billion “TARP” package, over \$168 billion in tax cuts announced during the Bush reign, and, significantly, \$5.5 trillion in Federal guarantees against default.

The latest proposal, the Public Private Partnership Investment Programme (PPIP), is certainly intriguing. Effectively, the U.S. Government will “loan” funds to private companies to purchase, at auction, the now named “toxic assets” from the country’s banks. This will, hopefully, bid-up the price of these assets from their current fire-sale valuations, thus increasing the selling bank’s balance sheet, but leaving the Government as the ultimate underwriter of these assets. Perversely, many of the private investors are seeking guarantees from the Government that, if they participate, and eventually make, “outsized” profits from the investment, will they be immune from the public criticism now facing companies such as AIG, regarding their recent huge bonus payouts? Fear of being shot down for making money is reaching paranoia!

The question remains - is this stimulus package outlined by the U.S. Government enough? Will it solve the fundamental problems still facing the financial system (and, more importantly, the economy) or is it simply forestalling the inevitable – national and international bankruptcy?! Of even more relevance, will the UK economy/Equity markets go along for the ride or be left “home alone”?

The UK economy shows little signs of recovery, as yet; unemployment has now surpassed two million, car production has fallen 60% year on year and inflation (measured by RPI, i.e. including mortgage payments), is predicted to fall into negative territory for the first time in forty years. The U.K. budget deficit for February amounted to £9 billion - eight times the level of a year earlier, bringing public-sector net borrowing to a record £75 billion for the first eleven months of the fiscal year. If this continues, tax receipts will fall and public borrowing will expand, further adding pressure to an already weak Sterling exchange rate. Indeed, David Blanchflower, the Bank of England’s policymaker who, last year, correctly predicted the current surge in unemployment and deep recession, recently warned that the British economy may not recover this year and repeated his view that unemployment is likely to climb above the 3 million mark. This view is corroborated by the International Monetary Fund (IMF) who predict the UK economy to contract by a massive 3.8% this year.

In summary, we believe that any, and all, stimulus is needed to prevent the economies (on both sides of the Atlantic), from falling further into the abyss. However, the road to recovery will not be an uneventful journey, given that there are more speed bumps and worse pot holes ahead! This recent rally may continue but, further pull-backs are inevitable

We are, therefore, maintaining the investment stance out-lined in previous notes, as follows:-

- (a) Increasing our equity exposure below key levels;**
- (b) Taking profits when we perceive the market has moved too far and too fast, before rotating into a longer-term core positions;**
- (c) Seeking opportunities in high-grade Corporate Bonds where yields and value are compelling; and,**
- (d) Reducing any significant over-weight Sovereign Bond exposure during periods of strength.**

In short, we will maintain our balanced approach to asset-allocation until we are more convinced that the markets have a higher possibility of reaching a positive conclusion of their journey.

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