

Assets:		Equities (Geographic):	
Equities:	➡ Hold	UK:	➡ Hold
Bonds:	➡ Hold	US:	➡ Hold
Cash:	➡ Hold	Europe:	➡ Hold
Property:	➡ Hold	Japan:	➡ Hold
Hedge Funds:	➡ Hold	Pacific Basin:	➡ Hold
Alternative Assets:	➡ Hold	Emerging Markets:	➡ Hold
Structured Products:	➡ Hold		
Commodity	➡ Hold		

Minutes

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Overview

As 2009 drew to a close, we witnessed the end of the longest and deepest recession in most western economies since the Second World War. 2010 should see major economies back in synchronised recovery; the UK was one notable absentee from Q3 2009 GDP growth. The general consensus expects a bounce back from recession, with the US recovery expected to be greater than western competitors despite suffering a shallower 2009.

The consensus for base rates suggests that the first 25 basis point rise in the US, UK and Euro zone will be in Q3 2010, with the US and UK rising more quickly thereafter.

On 16th December, the Federal Reserve reiterated that "... (we) are likely to warrant exceptionally low levels of the Fed funds rate for an extended period". Interestingly, the consensus data does not point to a double dip in GDP quarterly data in 2010, despite many commentators regularly raising this possibility.

However, budget deficits and the degree to which Governments and Central Banks tackle them may have material ramifications in 2010. Greece, for example, looks better than the UK on 2010 estimates, yet has just been downgraded by Fitch to BBB+. The rating authorities do not believe that they are tackling the problem with sufficient gusto and total debt/GDP is higher.

The UK is on credit watch and must be vulnerable to the psychological downgrade from AAA. The UK Treasury now owns circa 22% of the Gilt market and in 2009 the Bank of England bought 96% of all new Gilts issued. This creates a large degree of uncertainty about what will happen when this huge buyer leaves the market and what will happen when the Bank becomes a seller. Therefore we find it very difficult to be bullish on Government bonds.

With a general election looming, whoever wins will have to be fiscally tough. The worst case scenario is a hung Parliament and therefore a delay in the necessary 'tough' budget. It is highly conceivable that UK interest rates will not stay on hold for the majority of 2010. From a text book perspective, tight fiscal policy and loose monetary policy equate to a weak currency and it is difficult to gauge whether this is already in the price or whether Sterling could get weaker still.

On balance we feel the economic recovery may be better than markets expect for most economies. Although the UK may lag the US and Euro zone in raising interest rates, once the 'short rate' rising

cycle begins it could be sharp, and assuming no credit downgrade, UK Gilt yields will drift higher over the year.

With regards the 'three stage equity cycle' we are now in the third, synchronised recovery phase. The massive rebound from March 2009 to mid October 2009 is past and we are back to more normal equity market conditions with lower risk and return characteristics.

We are now at the low point of the earnings cycle (Q3 2009). Q4 will see a massive rebound expected to be **+60.0%** in the S&P with ex-financials falling a further -4.5%. Consensus expectations for US earnings growth in 2010 is +24.9% and in Pan-Europe +30.4%. Global equity earnings have fallen 53% from peak to trough in this cycle which means a +112% rise to get back to square one.

In a usual cycle, peak earnings are usually regained approx 18 months to 2 years after they trough. Even with (Citigroup) estimates of global earnings rising 27.5% in 2010 and a further 21.0% in 2011, average earnings are still a long way from their peak. In our opinion these estimates are not unachievable (even with sluggish economies) and could provide a strong tailwind to equities.

Earnings revisions have been positive in aggregate for 5 months and should continue to head upwards for much of 2010, providing a further support to valuation.

Merrill Lynch's fund manager survey suggests that Fund Managers' cash levels are now normal. However, CSFB calculate the value of US money market funds equates to 27% of the equity market capitalisation, compared to the long run average of 18%.

The G20 recently pledged to retain fiscal stimulus programmes. Although the UK will see the programme of fiscal tightening coming through from 2010, the US has only spent 30% of its planned stimulus i.e. \$221bn out of \$787bn. Monetary policy remains historically easy in most economies and is highly conducive to financial and asset price inflation.

Looking at *reported* earnings, it could be argued that global equities look expensive relative to history; however we disagree as long as earnings growth in excess of 20% remains achievable for 2010 and 2011. Bank of America uses a "normalised earnings" methodology and estimates the S&P on 14x 2010 earnings. For Europe, they have 11.7x 2010 and 9.9x 2011. UK numbers (from Citigroup) are similar at 12.2x 2010 and 10.0x 2011. Citigroup have global equities on 17.7x year end 2009, falling to 13.8x 2010 earnings. Relative to a 40 year global average historic PE of 17.6x and with strong earnings growth ahead, valuations seem moderately attractive.

Other metrics such as price/book corroborate these PE conclusions. Europe, for example, trades on 1.6x versus a long run average of 1.7x. Equity dividend yield relative to bonds remains highly supportive of equities, although this metric will deteriorate as bond yields rise in 2010. With strong earnings growth ahead, we anticipate multiples contracting modestly but still allowing 12% to 17% appreciation in global equities in 2010.

We remain positive on commercial property and expect this asset class to be supported by the tight supply, weaker sterling creating foreign demand for weak currency assets and also continue to benefit from low interest rates.

There are numerous, potentially negative, factors which we will be monitoring in 2010 which could surprise the markets, not least there being no outright winner in the UK general election. This could create 'policy paralysis' and therefore Gilts, equities and Sterling could all fall sharply but we would expect equities to recover first after any such initial fall. A big risk for equities in 2010 is from acute bond market weakness undermining valuation, driven by the abrupt ending of quantitative easing and growing concerns over deficit funding.

The fiscal stimulus in most major economies is unprecedented in peace time history; therefore the probability of 'policy error' is high. If inflation is ignited because policy stays too loose, this will be

very bearish for bonds and moderately unattractive for equities. Or equally, if rates rise too soon, this will be a big threat to markets in the short term, although we do not think this is likely. From a macro perspective, parallels will be drawn from Japanese errors in the early 1990's which caused a prolonged depression. We are also very aware that destabilisation within the Euro zone, due to debt downgrades in Spain, Portugal, Ireland and Greece, could undermine the Euro.

Portfolio Specific Issues:-

We are still actively considering various options for new products where we are underweight Alternatives, mainly due to the sales and redemptions of numerous auto calls in the final few months of 2009.

No stock specific changes have been made since the last asset allocation meeting but it was agreed to reduce the cash weighting for conservative strategies from 2% to 1%, in line with the other strategies. The change will be used to increase exposure to UK equity.

A discussion took place regarding the potential negative effect of rising interest rates on bond and fixed interest funds. It was agreed that the current exposure to strategic and dynamic bond funds should leave us better positioned to any unforeseen interest rate or inflation movements.

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