

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

Present: M Jennings, F Fulcher, N Kelsall, K Cushway, D Pendlebury, R Hallen

### General Overview

The last couple of weeks in September saw the first hiccups in reported economic recovery. In the US, durable goods fell 2.4% in August, new home sales rose more slowly than expected after a bumper month in July. In Europe, Germany reported retail sales down 2.6% in August, and the UK PMI dropped month on month.

Most economic data up to now has shown a consistent rise each month since January, so a breather is not surprising. Markets took this as evidence to take profits, arguably slowing economic data is bullish as it prolongs the “Goldilocks” economic environment.

Australia unexpectedly became the first of the G7 nations to raise official interest rates (to 3.25%) with the Central Bank Governor making a very upbeat statement on growth expectations.

Key numbers recently include the University of Michigan confidence survey for September coming out at 70.2 versus 67.5 expected. Although expected, a sharp rise in GDP (to be announced on October 29<sup>th</sup>) will provide very visible evidence of recovery and will be good for sentiment.

Gilt yields have fallen further following our last meeting, breaching the 3.50% level for the 10 year. The Bank of England announced that it expects to use its entire £175 billion Quantitative Easing capacity, and rumour has it that this may be raised in due course.

It does seem highly likely that a future Conservative Government will end QE, however, the speed and timing of a *reversal* in QE (i.e., selling holdings) is anyone’s guess. As we have commented before, this will put severe pressure on pricing. From a credit perspective, spreads continue to narrow sharply and as long as corporate recovery continues, this should continue.

In terms of UK economic forecasts, there is a huge potential for error, we know that the budget deficit is huge and rising (approx. 14% of GDP in 2010). Assuming a change of

Government in May, an early “austerity” budget seems likely to increase VAT, freeze many public sector salaries, and raise higher rate income tax, as well as cut spending. This will clearly dampen the rate of recovery.

Assuming that we do not get an interest rate rise before the election, a tough fiscal stance may well encourage the MPC to maintain historically low levels of interest rates. Despite the tight fiscal policy, loose monetary policy may well be conducive to continued strong liquidity and rising equities, theoretically, this combination is also bad for the currency.

There were a few interesting comments recently from a couple of Fed Governors in the US, emphasising that US rates are well below their “neutral” level and that slowly raising them to pre-empt any inflationary build up might be wise. The risk of policy error, and/or markets being surprised by action has risen, again it is interesting to witness lots of negative market commentary followed by a very short lived equity pullback and volumes, interestingly, have fallen sharply in recent weeks.

The current catalyst is the third quarter results season which started in the US last week. This week and next week will see the bulk of US companies report, this is an important inflection point for earnings. Consensus expects a 23.2% *fall* in S&P earnings in Q3 (-30.9% ex financials), followed by a 63.4% *rise* in Q4 (-8.0% ex financials) bell-weather such as GE, JP Morgan, and Goldman Sachs all report this week and will be watched closely, for 2010, consensus expects a 21.5% rebound in earnings led by autos, banks and semiconductors.

The “twilight phase” is now drawing to a close as the “recovery phase” is approaching. Gains should be slower in this phase with the focus on stocks specific valuation, and earnings momentum.

Earnings are now approaching their floor with a 53% fall from peak to trough (don’t forget that the implication is a 110% rise in order to regain the peak levels). With the 40 year average global PE now at 17.6x, the current multiple (on reported earnings) is now 24.2x. We have seen the most aggressive re-rating of the market over this entire 40 year period.

However, do not rush to conclude that the market is now dear. We are now at the worst point in the earnings cycle (when the market should therefore look dear). Expectations are for 2010 and 2011 to each produce 20%+ earnings growth which will bring the multiple down sharply. At the end of each of the last three earnings recessions, the market has emerged more expensively than now.

If we look at other metrics such as Price/Book and taking 10 year average earnings then valuation is below its long term average. Although markets are no longer at bargain levels, we do not think that they are expensive yet as long as the expected earnings growth materialises.

There are plenty of reasons for markets to continue to trend upwards, mainly;

- Economic momentum remains strong (but not too strong!).
- Earnings are about to turn positive.
- Earnings revisions are strong (and the trend normally stays so for 11 months).

- Monetary policy remains very loose.
- Fiscal policy remains loose.
- Quantitative Easing makes valuations relative to (expensive) bonds look attractive.
- Anecdotally there remains plenty of cash on the sidelines (investors are not bullish but still sceptical).

Markets will be driven from here by earnings and liquidity, and therefore these factors pose two big risks. In the short term, watch for outlook statements in the results season, in the long run, when the liquidity tap is turned off, all asset classes will find it tougher to make headway.

### Portfolio Specific Issues

Since the last meeting we have sold the Citigroup 23% Autocall. With the FTSE well above 5,000 as we approached the first anniversary, it looked almost certain that the product would mature on its first anniversary and pay 123p. Given the fact that the majority of the 123p was priced in, we took the decision to sell ahead of the product auto-calling at price of 122p on 5<sup>th</sup> October. As the stock was sold in the secondary market, the proceeds were realised earlier for investors and received in 3 days - generally when a product auto-calls settlement takes approximately one month.

We have also sold the Morgan Stanley FTSE 100 3yr Accumulated Growth. The product was approximately 10 months in to its 3 year life and was pricing at £124. Given that investors would receive a maximum return of 137% but would have to wait a further 26 months for it, we felt it was an opportune time to lock-in the 24% profit and sold the product on 5<sup>th</sup> October.

The Citigroup 10.5% Gilt backed defensive Autocall redeemed and returned 10.5% plus capital to investors.

We are looking for opportunities to invest the proceeds from these recent sales and maturities to keep portfolios in line with the models.

Hedge funds continue to be under review, the closed ended funds are currently trading at a 12%-15% discount to NAV. Whilst we expect our fixed interest exposure, through strategic bond funds, to continue to produce attractive returns, we feel having no exposure to gilts is still prudent given the huge issue over hang.

No changes were deemed necessary to the existing asset allocations.

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