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Is the recent bout of market volatility set to continue?

In our last strategy update, we focussed on the spectre of a possible European Sovereign default crisis spreading from Greece to other regions in the south, with Portugal and Spain as the most likely candidates. In early June we had our answer, with Hungary's debt concerns prompting a further bout of market volatility and risk aversion, which placed increased pressure on the Euro, causing it to fall to a four year low against the US dollar and an eighteen month low versus Sterling.

Despite the approval of a €500 billion support package, the lack of a unified and cohesive approach from Euro-zone policy makers, has merely fuelled speculation that the Euro is unlikely to continue in its current form for much longer, with numerous alternative structures being mooted. Ultimately, investors will have to solve the conundrum of whether a European debt crisis, primarily located in the south, will spread globally and undermine the dynamics already evident in the developing world. More specifically, whether the forced austerity measures will cause wider social unrest in the countries most affected thereby pre-empting further bouts of equity market volatility?

In response to the recent bout of market weakness, the VIX volatility index has more than doubled since the middle of April, rising from 15.89 to a high of 36.57 in the early part of June. Given the current uncertain global economic outlook, we feel that it is highly likely that this pattern will be repeated in the months ahead, as investors grapple with a continually changing investment environment.

Ben Bernanke recently testified to the US House Budget Committee, stating that the US economy appeared to be on track and that consumer and business spending combined would be enough to ensure domestic economic growth in the region of 3.5%. Whether or not you accept his estimates, which appear to be fairly optimistic, one must acknowledge that the US administration appears to be addressing its structural problems in a more pragmatic and cohesive manner than the European Union, which is why we favour US assets generally. On a three month time horizon, our most favoured investment themes are long only equities, particularly in North America, precious metals and oil / gas. Our least favoured themes are European equities, international property REITS and the Euro.

We have maintained a relatively cautious investment policy throughout the year, restricting our long only equity exposures to 12%, 40% and 53% for our core discretionary managed Conservative, Balanced and Growth strategies, which is generally lower than our peer group. In previous strategy updates, we have expressed our intention to take advantage of attractive tactical trading opportunities as they arise. Hence, over the last few weeks, in core Conservative and Growth strategies we have increased our long only equity exposure to 16% and 57%, respectively.

On a year-to-date basis, our Strategist Global Equity Fund is up +2.2% in the Sterling class and +7.4% and -4.5% in the Euro and US dollar classes, respectively. The Alternative Strategies Fund is up approximately +3.1%, +2.8% and +0.2% for Sterling, Euro and US dollar classes, while the Alternative Equity Fund is down approximately -1.0% for all three currency classes.

Current Asset Allocation in our Model Discretionary Portfolio Strategies

Investment Strategy	Long Equity Allocation	L/S Equity Allocation	Fixed Income Allocation	Multi Strategy Hedge Allocation	Commodity & Other Allocation	Cash Allocation
Equity	85%	10%	0%	2%	0%	3%
Growth	57%	14%	9%	5%	10%	5%
Balanced	40%	14%	25%	5%	11%	5%
Conservative	16%	15%	47%	5%	12%	5%
Absolute Return	0%	16%	59%	6%	11%	8%

Global Asset Allocation Summary

Asset Classes

	Recommendation
Equities – long	Slightly Overweight
Equities – long/short	Slightly Underweight
Fixed Interest	Underweight
Government	
Fixed Interest Other	Overweight
Alternative Strategies	Underweight
Commodities	Slightly Overweight
Property	Slightly Overweight
Cash	Slightly Overweight

- Opinion over the future direction of global equity markets still remains polarised, ranging from optimists supporting the recent rally, citing positive corporate earnings results and reasonable price/earning ratios, to those more pessimistic, fearful of either a double-dip recession, or a major Sovereign default, pre-empting a sharp reversal.
- Although we feel that volatile market conditions are likely to persist for sometime, with negative macro economic considerations overriding more upbeat corporate news, there will nevertheless be attractive tactical trading opportunities.
- On a three month time horizon, our most favoured investment themes are long only equities, particularly in North America, precious metals and oil / gas. Our least favoured themes are European equities, international property REITS and the Euro.

Equities – Geographical

	Recommendation
North America	Overweight
Europe ex UK	Underweight
United Kingdom	Neutral
Japan	Slightly Overweight
Other Far East	Neutral
Emerging Markets	Neutral

- Equity markets continue to be range bound, as global macro concerns surrounding government debt issues in Europe remain, with Hungary being the most recent focus of attention. The impact of these concerns has led to an increase in volatility and poor returns in May for global equities generally. The necessity for austerity measures across Europe is obvious and could lead to the scenes witnessed on the streets of Athens recently being repeated in other European capitals.
- The inconclusive general election result in the United Kingdom has added an extra element of uncertainty for financial markets, as the coalition government has to take some strong deficit reduction action, whilst appeasing two parties who are not natural bedfellows. At the corporate level, balance sheets appear to be healthy and generally encouraging economic data has seen investor buying at lower levels. With the onset of summer it may well be that markets remain range bound for some time.
- We believe that whilst developed markets remain more attractive than developing, in the short term selectivity is required, therefore we remain underweight Europe and neutrally positioned in the United Kingdom, whilst recognising that many export orientated companies in these regions will be major beneficiaries of increasing demand from emerging market consumers. Our overweight exposures remain focussed on the United States and Japan.

Fixed Income

	Current Weighting
G7 Government	Underweight
Investment Grade - Supranational	Overweight
Investment Grade - Corporate	Overweight
High Yield	Neutral
Emerging Sovereign	Overweight

- US treasuries benefitted from a meaningful flight to quality in May and pushed 10 year yields significantly through key moving average levels. Having extended durations earlier in the year, we took advantage of this rally and crystallised profits by reducing our exposure at the longer end of our 1 to 10 year maturity range. We aim to reverse this trade in the coming weeks if 'risk on' persists.
- We view the Eurozone debt crisis as far from over despite the EU/IMF package and forecast more negative news from the highly indebted nations. The prospect of a double-dip recession in the Eurozone remains a possibility but at the very least, severe austerity measures will ensure that interest rates remain on hold for the foreseeable future, if not reduced again.
- The UK is bracing itself for the emergency budget on the 22nd June which is likely to be very devoid of good news. A credible plan however may be well received by the UK government bond market if it appears to be sufficient enough to keep the credit rating agencies at bay.

Currencies/Interest Rates

	Recommendation	
	Currencies	Interest Rates
		Current Direction
US dollar	Underweight	0.25% →
Sterling	Overweight	0.50% →
Euro	Underweight	1.00% →↓
Canadian dollar	Overweight	0.25% →↑

- Our 'maximum underweight' Euro strategy continues to add considerable value as the single currency remains plagued by a crisis of confidence in the high deficit countries. Recent co-ordinated action by the EU and IMF have lent short-term support but in our view the austerity programmes are overly ambitious and lack of flexibility in Eurozone policy could lead to a negative vicious circle.
- With no credible alternative currency, the US dollar enjoyed it's 'reserve status' in May and in the midst of risk aversion, rallied accordingly. Whilst we envisage further gains versus the Euro, we think it is above fair value against Sterling and remain underweight in Sterling and US Dollar International portfolios and expect cable to re-test the 1-50 level before long.

Important Information

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