

Contents

	Page
1. Introduction	1
2. Affinity Consulting Group News	2
3. Market Indices Table at end of September 2005	3
4. Graphs of Market Indices	4
5. Fund Performance Table at end of September 2005	5
6. Performance Commentary	6
6.1 Lanson Financial	6
6.2 Collins Stewart	7
6.3 Brandeaux Funds	7
6.4 Infiniti Capital Hedge Funds	8
6.5 Quadriga	8
7. Where To Invest Now?	10
8. New Funds :	12
8.1 Capital Guaranteed Fund	12
8.2 Bollywood Fund	13
9. Economic Outlook	14
The spending dilemma	14
Inflation	15
The British Economy	15
The American Economy	16
The European Economy	17
Eastern European Economies	17
The Russian Economy	17
The Japanese Economy	18
The Chinese Economy	18
Asian Economies	19
Latin American Economies	19
10. Markets	20
10.1 Interest Rates	20
10.2 Currencies	20
10.3 Stock Markets	20
10.4 Bonds	21
10.5 Property	22
10.6 Gold	23

1. Introduction

We hope you like the new format and that it makes it easier to read and to find the sections that interest you.

The past 12 months have seen strong performance in the equity markets but with emerging concerns about inflation, oil prices and bird flu, October has seen more volatility, bringing a small decline world wide. There is much pessimism about the USA and to some extent, the UK and "old European" markets. The housing ATM, as it is sometimes called, has run dry and with the housing market settling and interest rates rising, consumers have stopped spending.

I have developed the waterbed theory of investing, it won't win me a Nobel prize, it says that when the kids (speculators) jump up and down on it, it sends small waves throughout the world but when someone heavy, like Uncle Sam (US government), lies down on it, the other side pops up. So by contrast, the emerging markets, particularly Asia, are still showing good growth and likely to continue for some time to come. Asian countries are seeing good earnings through their cheap labour exports and then lending their earnings to USA, so the Americans have the money to buy more cheap imports.

As always, in times of rising interest rates and inflation, the price of gold is rising, helped by concerns that the recent strength of the US dollar is short lived.

This newsletter will show you how the main funds that we recommend are performing and make suggestions for the future. It will also give you an overview of world markets and the global economy.

I hope the rest of the year is good to you and we would welcome your feedback.

Clive A Ward

clive.ward@affinity-consulting.com



2. Affinity Consulting Group News

We are pleased to let you know that we are expanding steadily. The Dubai office of [Affinity Solutions](#) has the following consultants:

- David Davies
- Bernadette Hancock
- Bijay Shah
- Richard Thomas

The Singapore office of [Affinity Financial Consulting Pte Ltd](#) has the following consultants:

- Lee Sanders (manager)
- Fraser Morrison
- Mark Bradshaw
- Geoff Bass
- Mark Sekree

Mark joins us from UK in November. Unfortunately Geoff Bass is experiencing health problems and is in UK at present. All our consultants have worked in the UK and hold UK qualifications.

I live in Dubai but travel to Singapore frequently.

Donald Morrison has retired to live in Ho Chi Minh City in Vietnam.

We strive to be a “one stop shop” for all your financial requirements. Our main focus is investment business but we can also provide:

- ⇒ [Life insurance](#)
- ⇒ [Critical Illness insurance](#)
- ⇒ [Medical insurance](#)
- ⇒ [Mortgages](#)
- ⇒ [Currency exchange transfers](#)
- ⇒ [Trusts](#)
- ⇒ [Estate and inheritance tax planning](#)
- ⇒ [School fees planning](#)
- ⇒ [Retirement planning](#)
- ⇒ [Tax planning](#)

David Davies in Dubai is a tax accountant (ex Ernst & Young) and can provide qualified tax advice for the UK and USA.

If you would like a review of your investments or help and advice on any of the above topics, then please contact me or your usual consultant.

3. Market Indices Table at end of September 2005

Name	Currency	Price	1 month	1 year	2 years	3 years
MAJOR INDICES						
MSCI World CR	US Dollar	1224.314	2.47%	16.84%	34.59%	65.86%
MSCI World TR	US Dollar	3588.41	2.63%	19.51%	40.58%	77.15%
Dow Jones Industrial Average CR	US Dollar	10568.70	0.83%	4.85%	13.95%	39.21%
Dow Jones Industrial Average TR	US Dollar	16595.52	0.94%	7.23%	19.03%	48.91%
S&P 500 CR	US Dollar	1228.81	0.69%	10.25%	23.38%	50.72%
S&P 500 TR	US Dollar	1849.33	0.81%	12.25%	27.82%	59.01%
NASDAQ Composite CR	US Dollar	2151.69	-0.02%	13.44%	20.41%	83.58%
FTSE 100 CR	UK Pence	5477.71	3.41%	19.84%	33.89%	47.18%
FTSE 100 TR	UK Pence	2959.08	3.54%	23.97%	43.23%	63.34%
CSFB/Tremont Hedge Fund	US Dollar	333.1	1.63%	11.86%	21.30%	36.89%
CSFB/Tremont Hedge Multi Strategy	US Dollar	280.31	1.61%	9.49%	18.27%	30.24%
CSFB/Tremont Investable	US Dollar	112.62	1.19%	7.34%	11.17%	22.48%
CSFB/Tremont Investable Multi Strategy	US Dollar	111.31	0.97%	8.89%	10.48%	21.58%
Gold Troy Ounce	US Dollar	474.70	9.22%	13.83%	21.93%	46.11%
Goldman Sachs Commodity TR	US Dollar	7472.48	0.06%	26.28%	84.85%	106.78%

CR = Capital return, - this is the index ignoring dividends and is the one quoted on TV and in the papers

TR - Total return - this is the index with dividends reinvested

Note that many funds in the CSFB hedge fund index are closed to new investment, so they run an investable index of those that are still open.

There is no NASDAQ TR index

The FTSE TR index is lower than the CR index in absolute terms as it started at a later date.

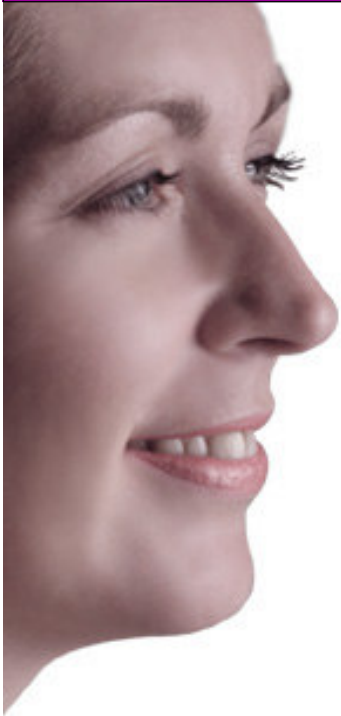
Comment:

The MSCI world index has performed much better than the American market due to strong growth in Asia, UK and Europe.

Hedge funds have had a very slow year with convertible arbitrage funds still negative and managed futures funds and fixed income arbitrage barely positive year to date.

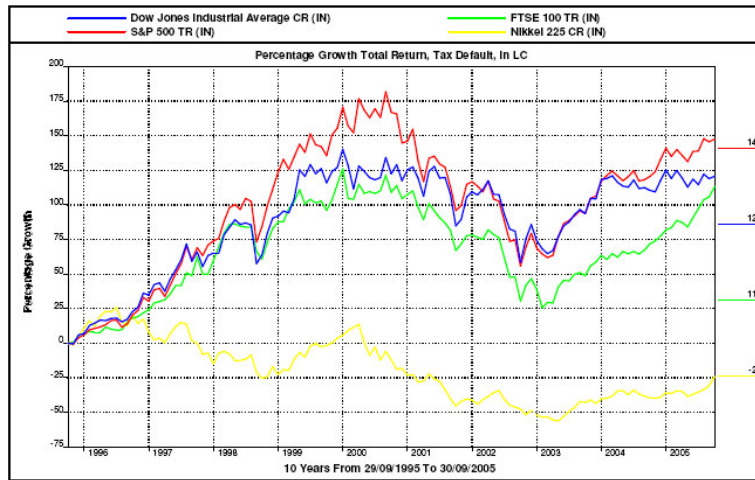
Commodities continue to outperform equities due to strong demand from China and a recent "flight to gold".

Source of all fund data and charts: Lipper Hindsight (unless otherwise stated)

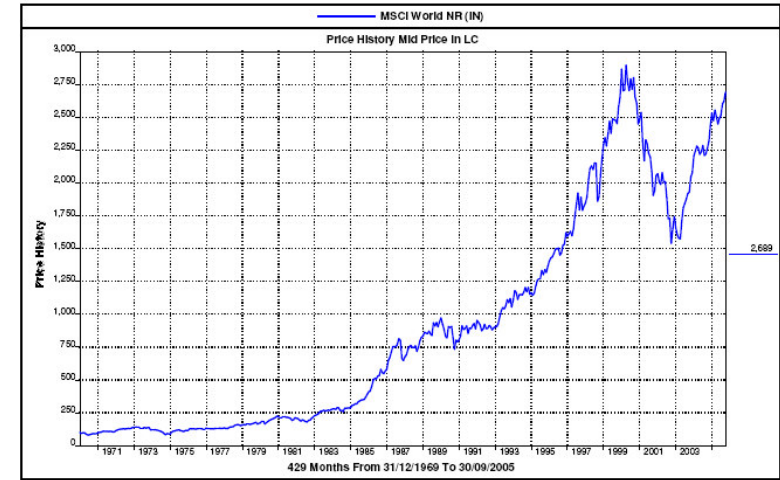


4. Graphs of Market Indices

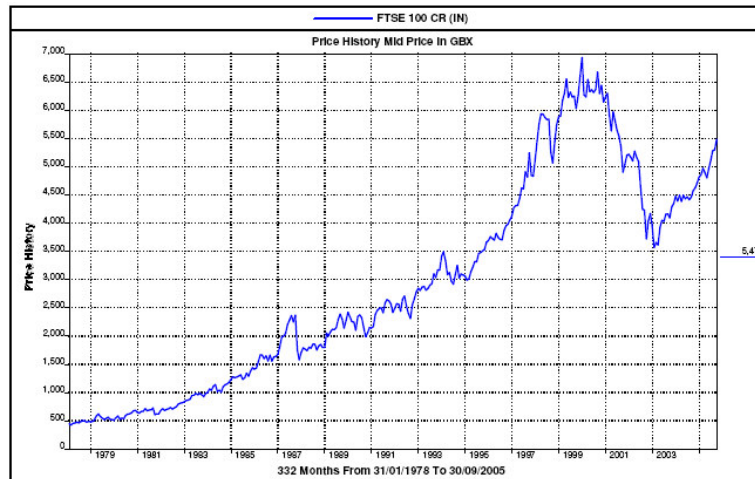
Major Indices—Last 10 years in local currency



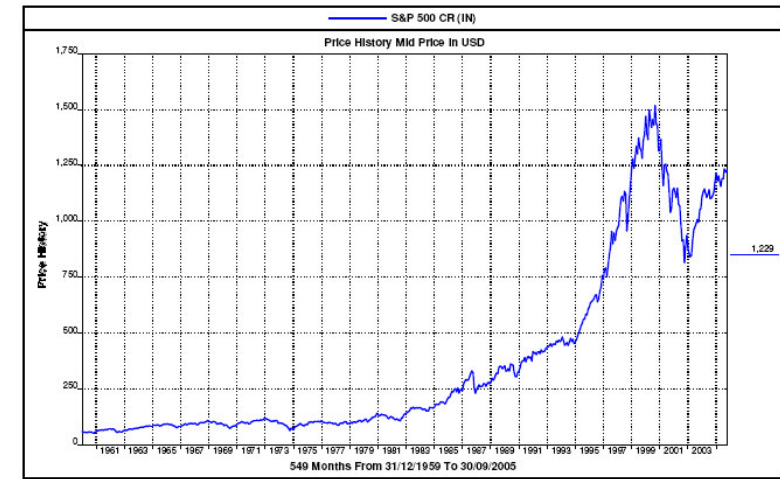
MSCI World Index since 1969



FTSE 100 since 1978



S&P 500 Index since 1959



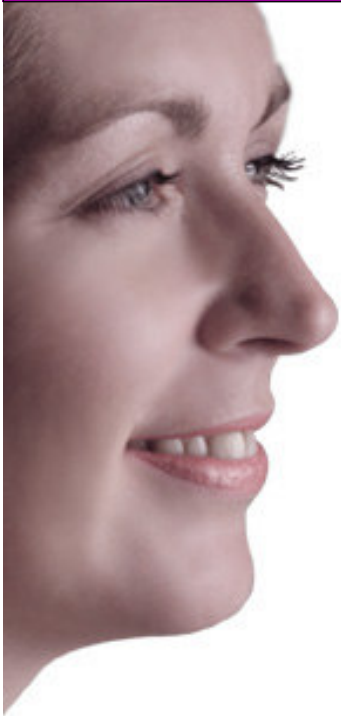
Sorry to test your eyesight!

October 2005

Full Of Eastern Promise

5. Fund Performance Table at end of September 2005

Name	Currency	Price	1 month	1 year	2 years	3 years
<u>FRIENDS PROVIDENT FUNDS</u>						
Lanson Optima	US Dollar	0.742	3.63%	18.53%	22.64%	42.42%
Lanson International Growth	US Dollar	1.257	4.40%	22.28%	22.87%	45.82%
FPIL Collins Stewart Aggressive Managed USD	US Dollar	1.596	4.93%	25.18%	41.36%	81.78%
FPIL Collins Stewart Growth Managed USD	US Dollar	1.161	2.11%	13.49%	25.11%	46.96%
FPIL Ground Rent Income	UK Pound	2.058	0.73%	9.82%	17.13%	23.90%
FPIL Ground Rent Income 2	UK Pound	1.310	0.61%	8.09%	16.86%	24.29%
FPIL Student Accommodation	UK Pound	1.358	0.44%	8.38%	14.60%	21.14%
FPIL Momentum AllWeather Liquidity	US Dollar	1.161	0.61%	5.45%	9.63%	17.15%
<u>OTHER FUNDS</u>						
Brandeaux USD Property Fund	US Dollar	1.160	0.87%	8.41%	16.00%	launched 2003
Protected Asset TEP GBP	UK Pound	1.468	0.60%	7.48%	16.62%	25.24%
Protected Asset TEP USD	US Dollar	1.129	0.58%	7.07%	launched Dec 03	
Protected Asset TEP EUR	Euro	1.131	0.60%	7.15%	launched Dec 03	
Protected Asset TEP No.2 GBP	UK Pound	1.195	0.66%	7.96%	launched Dec 03	
Protected Asset TEP No.2 USD	US Dollar	1.103	0.63%	7.49%	launched May 04	
Protected Asset TEP No.2 EUR	Euro	1.103	0.65%	7.52%	launched May 04	
<u>Hedge Funds</u>						
Barclays Infiniti Capital Note 138	US Dollar	1004.90	0.45%	0.38%	YTD	launch Dec 04
Infiniti Security Fund	US Dollar	878.82	0.36%	3.28%	4.25%	14.09%
Infiniti Growth Fund	US Dollar	886.19	0.50%	8.57%	9.50%	23.53%
Infiniti Momentum Fund	US Dollar	918.97	1.02%	6.80%	15.59%	36.23%
Quadrige GCT USD	US Dollar	2319.80	3.41%	9.09%	23.07%	20.57%





6. Performance Commentary

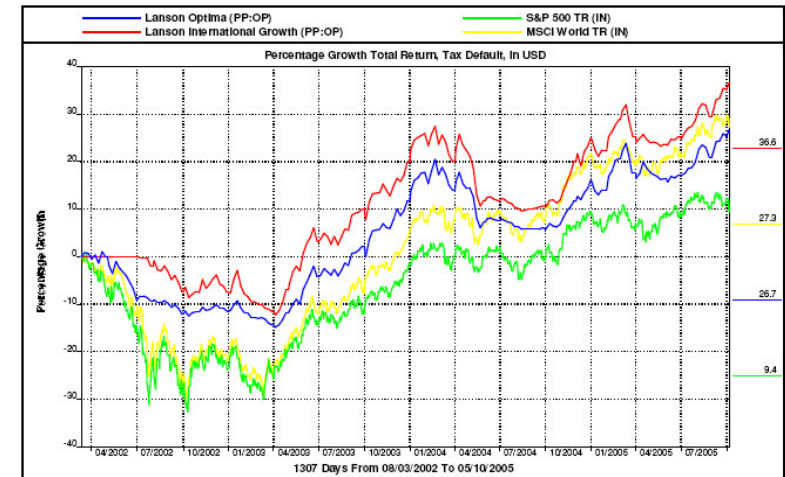
It is our preference to use funds of funds, to ensure that your money is being actively managed across a broad range of markets by professional fund managers. Friends Provident International offer you the choice of over 80 funds, but to save you the choice, Lanson Financial & Collins Stewart run funds of funds specifically for FPI.

6.1 Lanson Financial

The objective of Lanson International Growth is to target its investments into funds showing good growth, regardless of country or region, whereas Optima tries to select broader based regional funds which are less volatile. LIG is quicker to invest in growth areas, whereas Optima likes to see a few months growth before investing. Both funds use proprietary stop loss management to sell a fund if it drops below its stop-loss target.

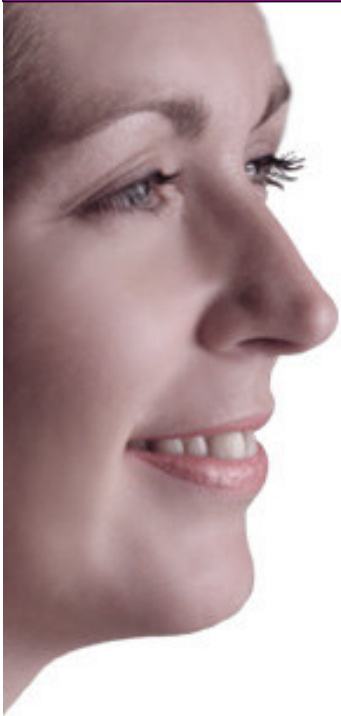
These 2 funds have stayed well ahead of the American markets and just beaten the MSCI world index over the past 12 months. After markets dropped at the start of the 2nd quarter of this year, the funds went heavily into cash and only reinvested this slowly over the summer to the position you see in the next column. India and China were added to the portfolio in July.

Lanson Optima & International Growth v Indices in USD since the launch of LIG on 8 Mar 2002



Lanson Fund Holdings on 8th September 2005

	Optima	LIG
Investments		
Fidelity European	15.46	16.62
HSBC India	14.03	15.92
Merrill Lynch UK Dynamic Acc	13.86	9.89
HSBC Chinese	12.74	14.72
JF ASEAN	12.32	9.01
JF Japan Equity	11.41	11.96
MLIIF Emerging Europe	10.92	11.46
AHL Diversified Futures	0.68	3.61
Equities	0.13	0.72
Cash & Deposits		
Cash	8.45	6.09



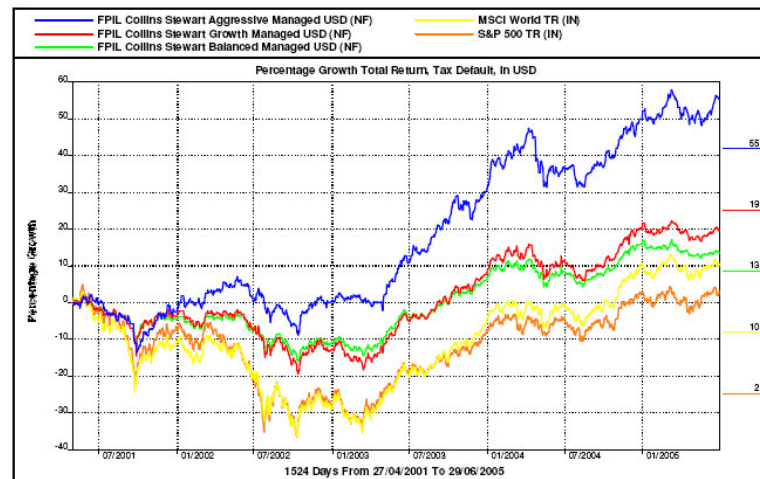
6.2 Collins Stewart

The CS Growth fund has beaten the US market but lagged well behind the MSCI world index. This is because the fund keeps at least 25% in low risk holdings - bonds and gilts - and it also has a high allocation in the American equity market, which has not performed well this year.

The CS Aggressive fund has continued its strong performance, with very low allocation to the US market, this being in an energy fund, a strategic growth fund and a healthcare fund. The balance has been in Asia and emerging markets.

Collins Stewart manage their portfolio using only FPI mirror funds, whereas Lanson have the ability to select from any regulated fund in the world.

FPIL Collins Stewart USD Funds v Indices in USD since launch on 27-04-01



6.3 Brandaux Property Funds

The Brandaux Group manage 2 main funds, the first is Ground Rent Income which buys up the freeholds of properties, often from the aristocracy, and collects the ground rents and manages them efficiently. The second is Student Accommodation which buys university halls of residence and runs them efficiently for the students and provides additional services (laundry, bar, café etc).

FPI have opened Ground Rent 2 and the Student Accommodation to NEW money (you cannot switch into them). These funds have very low volatility and consistent performance, over the past 5 years the average compound growth rates have been:

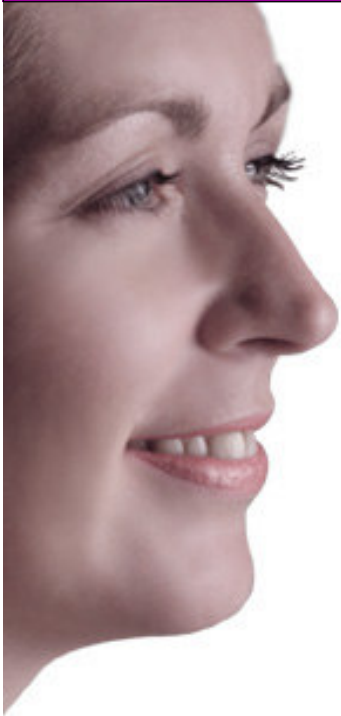
Ground Rent 1	8.5% pa,
Ground Rent 2	7.2% pa
Student Accommodation	7.0% pa

Brandaux also have 3 funds that invest in these 2 funds and also buy and manage low cost housing for key workers. These are not mirror funds and can only be accessed through an insurance portfolio bond. The funds are all sterling based but Brandaux have a euro and dollar version which use hedging to remove the currency exposure. They launched 2 years ago and have achieved the following annual compound growth rates:

	Since launch	last 12 months
Brandaux Sterling Fund	9.2%	10.1%
Brandaux USD Fund	7.4%	7.3%
Brandaux Euro Fund	7.4%	6.4%

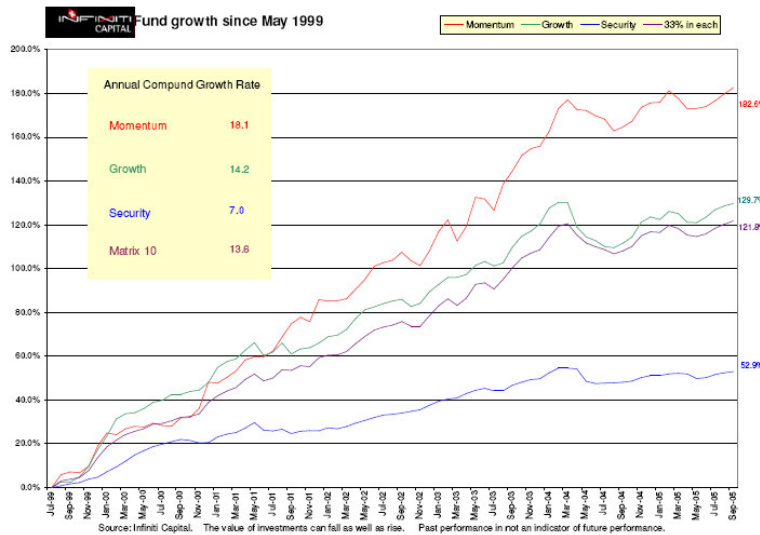
As interest rates converge, so the differential between the sterling and other 2 funds should also reduce. Brandaux are also looking at using a cheaper method of hedging.

The Brandaux Group started 10 years ago and now have over £1 billion under management. Their low volatility and consistent performance with no losing months has made them very popular.



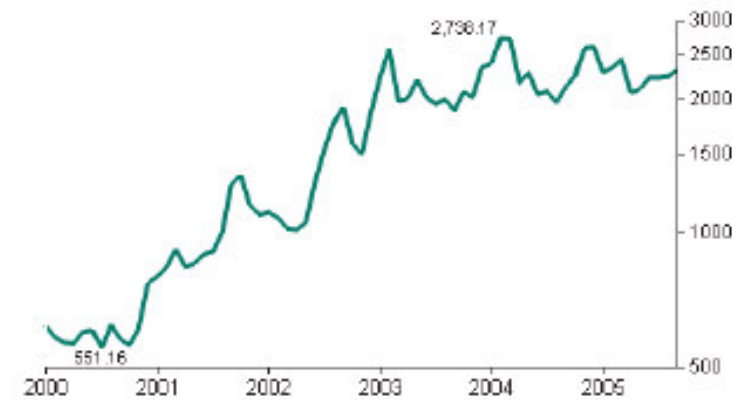
6.4 Infiniti Capital Hedge Funds

The hedge fund market has had a very slow 12 months after over 10 years of very strong performance. The 3 Infiniti Capital funds had a very strong performance up to the end of last year, but have been slower this year. The Barclays Infiniti Capital Note has not quite kept up with the indices this year. We have raised this with them and they are putting a report together which will be distributed to investors. We are keeping an eye on this.

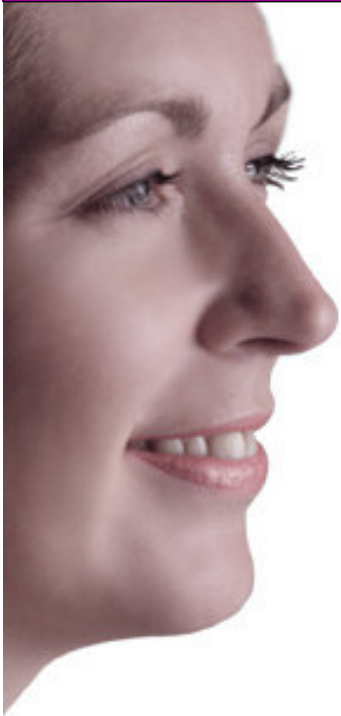


6.5 Quadriga Managed Futures Hedge Funds

This sector has had a particularly bad year and Quadriga have fared worse than most. MAN AHL for example did not take the big dip that Quadriga took in the first quarter. To be fair to Quadriga, their computer trading model has had other times in the past when it dropped 25% and then went on to make 75% gain. Investors in this funds accepted the risk when joining it and now is not the time to bail out. With commodity prices on the rise, there should be good opportunities for the fund to recover. It is highly leveraged and remains high risk.



Source: Quadriga



6.6 Others

The **FPIL Momentum All Weather Liquidity** fund is achieving its objectives of having very low volatility and of beating USD cash deposits by at least 2% and has gained 5.5% over the past 12 months. It is a good safe haven for locking in profits or depositing money as you approach retirement.

The **Protected Asset TEP Fund (PATF)** invests in UK traded endowment plans and has been particularly skilful in the acquisition and accounting of these, enabling it to see consistent high returns for a low risk fund. As you will see from the table on page 5, the sterling funds are consistently achieving 7.5 - 8% pa returns and the USD and euro funds are growing at 7 - 7.5% per annum. They have a lower cost of hedging than Brandeaux. The original version is suitable for short term deposits as there is no exit fee.

Standard Life has announced that they will pursue demutualisation in 2006. At the time of the announcement, PATF said they held over 5000 policies which according to media sources could benefit

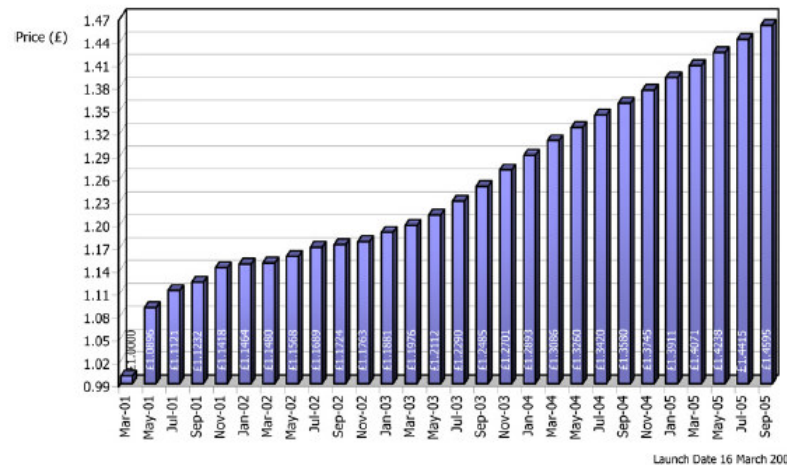
from a 'windfall' of c. £1000 per policy. This benefit will not be received until demutualisation and the Stock market flotation. They plan to call a shareholders meeting to approve this in mid 2006 and then float after that.

The **Asset Backed Securitization Bond** is gaining in size as it achieves wider distribution. It is a fixed term bond with security of capital and returns. It invests in American traded life policies, buying only life policies from people who are over 70 years old, who no longer require their policies. The bond then pays the premiums on the policies and collects the face value of them when the life assured dies. It has nothing to do with viatical policies - which buy the life policies of terminally ill people. It is paying fixed coupons of:

3 year bond	8.5% pa
5 year bond	10% pa
7 year bond	11% pa

These can be paid quarterly or reinvested.

Share Prices of The Protected Asset TEP Fund Plc. (Sterling Class)





7. Where to invest now?

This section does not change much as it is our philosophy that most clients and even many advisers do not have the time and qualifications to monitor their investments closely, let alone keep abreast of all the market changes and new funds. With so many investments to choose from 2 things become important:

1. Use a fund manager if you do not have the expertise yourself. Even they do not get it right all the time so what chance do you have? The advantages are:
 - They are professionals and spend all their time studying investments to spot trends, find bargains etc.
 - They have economies of scale and can deal more cost effectively
 - It allows smaller investors to pool their money and spread it over a larger number of investments than they could manage on their own and so reduces risk.
2. Use actively managed funds where possible. As the world changes so much over the life of an investment, you need to know that your money is being applied to the best regions. An active manager will allocate his money to the regions and funds that are showing the best growth, he will not leave money allocated to funds during their bad years, simply waiting for them to recover.

This is why we have chosen Collins Stewart and Lanson Financial, as these fund managers are both active managers running funds of funds. Their track record over the past 3 years has been good relative to the markets and to their peers. Over the period, they have made many changes of allocation and have used many of the Eastern Europe and Asian funds, also bonds, gold and commodities. They are mainly focussed on equities, as traditionally this is where there is most potential for growth, particularly on a world wide basis.

The other factors to consider are

- How long you want to invest
- The amount of risk you are willing to take. Risk is about volatility and time, the longer you remain invested, the lower the risk becomes. Investing in equity funds for 1 year is very risky, but for 10 years, the risk is very small.
- Your base currency. Undoubtedly there are more funds available in US dollars but many either hedge to euro and sterling or offer investments in these currencies which have different asset allocations to the dollar versions. (Collins Stewart run sterling funds for example)

Prognosis

In general we do not see much growth in the US equity markets next year. Technical analysts have cogent arguments why we will not see growth for many years, as we have seen unsustainably high growth for the past 3 years. Even though stocks are now trading at their long term average price/earnings ratios, many believe the US economy is slowing and these will look expensive next year. The baby boomers start to retire soon and are likely to move money out of equities into safer investments. The US economy is expected to slow next year and the enormous current account deficit is likely to cause the dollar to weaken. If you are retiring soon and do not need US dollars, then it is probably a good time to convert them to your base currency.

Asia is likely to continue to see good growth for some time to come. The emerging markets of Eastern Europe, and to some extent Latin America are likely to see good growth, but slower than of late, as interest rates rise.

Bond yields have risen recently but still remain very low, despite rising interest rates. They are expected to improve soon.

October 2005

Full Of Eastern Promise



Conversely, gold has risen strongly and is likely to continue its rise for a while yet.

In the coming years asset allocation is critical, as the traditional models that show high allocations to the USA are unlikely to show the best growth in the coming year or so.

Long term monthly savers are best served by diversifying between the Collins Stewart and Lanson funds. Particularly in the early years of the plan, as you are building up capital, the volatility is not so significant. For lower risk sterling investors, the Ground Rent & Student Accommodation funds offer a predictable and consistent growth of 7-8% pa. As USD investors near their maturity date, they could allocate some of their money to lower risk funds such as Momentum All Weather or bonds.

Lump sum savers need to identify their time frame and risk and diversify across a number of asset classes.

LOW RISK

- Brandeaux Property Funds. The FPI mirror funds achieve 7-8% pa. The combined funds are only available through a portfolio bond and are achieving 10% pa in sterling and 7.5% in US dollars and euros.
- The Protected Asset TEP Fund is averaging 8% pa in sterling and 6 - 7% in USD or euro.
- Australian dollar investors can use the LM Mortgage income fund returning 7% pa on the A\$.
- The Asset Backed Securitization Bond pays 11% pa over 7 years, 10% pa over 5 years and 8.5% pa over 3 years. (minimum \$50,000)
- The Premier Optima 3 is a fund of a European equity fund, an emerging market bond fund and a managed futures hedge fund *with a capital guarantee* and possibility of early redemption is a good choice for medium term money. See

the next section. (minimum \$20,000)

MEDIUM RISK

- The funds of funds managed by Lanson Financial and Collins Stewart are beating most of their peers and the world index.

HIGH RISK

- We have found 2 new funds of hedge funds that have launched within the past year, one run by Oria in Hong Kong that invests in Asian hedge funds, the other run by Aurum in London that invests in 5 Indian hedge funds. Both have got off to a good start and we are monitoring them.
- For clients interested in investing in Bollywood, a new fund has been launched that will invest in movie productions (where the production company can provide a bank guarantee for completion) and multiplex cinemas in India (see next section)

We have access to most funds on the market and I know some of you manage your own investments actively. If you would like a review of your investments please contact your usual consultant or let me know if you have lost contact.

Fund Suggestions



8. New Funds

8.1 Premier Optima 3

You should have received information on this Barclays capital guaranteed fund from us last month, but I have included it again here as it is performing well. The capital guarantee is valid in May 2015 but the likelihood of the early redemption feature being triggered in the next 2.5 years is high. It follows our preference of being a fund of funds and it also has a low entry amount of \$20,000. In addition, there is a version with a loan facility to double your investment stake.

This is a fund of 3 funds, denominated in sterling, US dollars or euros:

- ◆ **European equity fund:** Gartmore European Select Opportunities. Average annual growth: 13.0% over past 10 years, last 12 months growth: 32.8% ranked 4/58 within sector over 10 years. Euro fund
- ◆ **Emerging markets bond fund:** ABN AMRO Global Emerging Markets Bond Fund. Average annual growth: 19.7% since 1988, last 12 months growth: 19.3%. USD fund
- ◆ **Managed futures hedge fund:** Millburn Ridgefield Corp Diversified Trading Company 2. Average annual growth of strategy: 9.4% since inception in 1995, last 12 months growth: 12.9%. USD fund.

Maturity in 10 years but with a unique early redemption feature:

- i) if the reference price related to the underlying Notes (after redemption costs) reaches £1.30, US\$1.30 or €1.30, before May 2008, they will be redeemed at that time or
- ii) if the 3 year early redemption is not achieved, then investors have a second opportunity of early redemption if the reference price reaches £1.50, US\$1.50 or €1.50 during the **fourth and fifth year.**

The fund launched in May this year and the capital guarantee will

be set at the highest price achieved by each fund prior to closing to subscriptions. The prices at 1st October were:

GBP: 1.139

USD: 1.135

EUR: 1.090

They have grown 9-14% in the last 6 months since opening for subscription in May and if this continues, the likelihood of them achieving 30% growth from launch (after redemption costs) before May 2008 to trigger redemption, is high.

There are 2 ways of investing in the fund:

- ◆ **Managed Guaranteed Option.** This is a straightforward investment with protection of your initial investment.
- ◆ **Optima Select.** The investment amount will be matched with a 1 for 1 loan therefore doubling the investment stake, to offer increased exposure to the underlying investments and potentially greater returns. The loan doubles the amount invested but deducts the cost of the loan from the fund price.

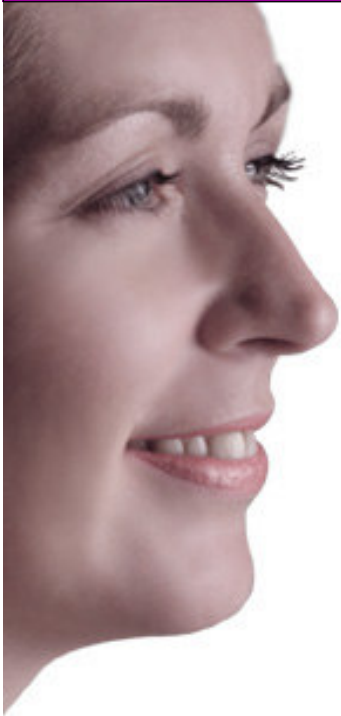
The benefits of this are:

- ◆ access to a diversified portfolio of assets with outstanding potential performance
- ◆ participation in rising equity and bond markets but with diversification of assets to protect against any single market exposure;
- ◆ tax efficiency - investments can be made to suit investors' personal circumstances;
- ◆ multi-currency - available in £, US\$ and €; with a minimum investment of £10,000, US\$15,000 or €15,000.

For full details are available on our website at http://www.affinity-consulting.com/inv-premier_optima.php

Capital guaranteed fund of equities, bonds and hedge funds. High expectation of early exit.

Min investment \$20,000



8.2 Bollywood Fund

If you are looking to diversify into something different with interesting investor benefits, this fund is a good way to benefit from the growth in Bollywood productions and associated industries.

The fund was launched earlier this year and invests into the Indian film industry. This includes providing financial assistance to Bollywood themed productions, foreign companies seeking to outsource their operations and co-production of movies with production houses in India. In addition, the fund may invest part or all of its assets into listed companies operating in the same field and in Cineplex complexes.

Funding will be available to recognised and established media and entertainment companies that are engaged in the business of production, distribution, media and entertainment and those providing technology services for various forms of entertainment, broadcasting and news services. It will be conditional upon their bank providing a completion guarantee so that the investment is returned if the project does not complete. Distribution rights are pre-sold for guaranteed income once a film is completed.

The cost of making a small budget Bollywood movie in India can be up to \$500,000. A large budget movie costs over \$2 million. These budgets are relatively small compared to the Hollywood production and therefore, very profitable in terms of return of investments. As a general rule of thumb:

- Blockbuster earns five to ten times its cost.
- A super hit earns three to five times its cost.
- A hit earns two to three times its cost.
- An overflow film earns one and a quarter time to two times its cost.
- Even a flop movie usually recovers half its cost.

These earnings only relate to first time sales; almost all movies recover original investment through repeat sales – usually between

three and five years. This means that the rights are returned to the intellectual property owner every few years and re-sales take place again and again. With the effects of inflation and emerging platforms, Indian movies are like annuity plans and keep on earning.

- The Indian Media & Entertainment Industry is one of the fastest and growing business sectors in the world.
- Total Revenue in this Industry has grown by 30%.
- Turnover from the Entertainment Industry stands to quadruple by 2007. Leading professional firms predict strong economic and industry growth.
- The Fund has appointed an Independent Film Advisory board to access the financial and commercial viability of Films, media & entertainment projects.
- The aim of the fund is to target a return of 12 - 18% p.a. with income and capital protection.
- Through repeat sales, Indian movies are like annuity plans, they keep earning revenues over the years.
- Additional investor incentives:
 - Premiere in the Park.
 - Invitations to attend Premieres of films invested in.
 - Dinner Galas for investors to meet film stars and celebrities.
 - Invitations to Award Ceremony's and private functions.
 - DVD's and CD's will be available to all investors.



Medium - high risk fund targeting 12% pa and investing in Bollywood movies and Indian cineplexes.

Min investment \$20,000



Too much saving in Asia,
too little saving in the
West.

9. Economic Outlook

As usual, I have distilled a large number of economic reports over the past months. I have put together this consensus for you and hope you find it useful.

It appears the global economy is slowing down. This is mainly the effect of rising oil prices but rising interest rates are also contributing. Both raise the cost of doing business and so lead to inflation. Higher oil prices have not worked through into wages as yet and the expectation is that oil prices have peaked for now.

The past few years have seen the US and Europeans take advantage of low interest rates to invest in property, pushing up house prices and remortgaging their homes and spending, creating economic growth. Saving levels and industrial investment have been low. The US economy has run up a massive debt, Americans are spending \$700 billion a year more than their economy produces.

Contrast this with Asia where the currency crisis in 1987 caused severe recessions and they had to increase exports dramatically to get through it. They have kept their currencies undervalued and with their cheap labour, they have seen high volumes of exports resulting in large cash surpluses. This cash has been invested in US Treasury bills. Asia lends America money to buy Asian goods. These cheap goods have helped to keep prices down in the USA and given the Americans more money to spend.

The spending dilemma

The Economist last month reported Ben Bernanke a former Princeton professor and central bank governor who attributes the US current account deficit to a "global savings glut". [It may be no coincidence that has just been appointed as the next Fed chairman and this theory exonerates GW Bush's tax rebates and profligate spending.] I have to oversimplify their argument here, but traditionally it is households who save most money in the economy and corporations who invest the most. However in the past years, cor-

porate profits have exceed investment. Japan has seen the most dramatic change. After their economic bubble burst in the 1990s, they were saddled with a massive burden of bad debt, investment was low and already the world's greatest savers, they saved even more. Japanese companies over-invested in the 1990s and have been saving heavily in the 2000s.

After the stock market bubble burst in 2000, firms in most industrialised nations have been under-investing and saving more, whereas households have been spending more. Although this trend is reversing, the level of corporate investing has been low, given the strong economies and profits.

The rising imbalance can be explained by investment "busts" and different ways the policymakers reacted to them. However, 2 other factors are important, the high saving rate in China and the price of oil.

China features in every economic article these days and here they buck the trend with increasing corporate investment, but also their savings have been growing even faster. Their investment rate at 46% of GDP is the world's highest by far. Their savings rate is even higher at 50% of GDP and this has been rising by 12% per year over the past 5 years.

High oil prices have brought windfall profits to the oil producing countries who have chosen to save instead of spend. These oil producing countries are the biggest counter party to the US deficit.

The outcome of this is that capital is flowing from poor countries to rich countries. Last year the emerging economies including Asia sent \$350 billion to rich countries in contradiction to textbook economics. The other change is that outside of China, consumers have become the engines of economic growth by spending (instead of saving), as opposed to the traditional impetus of industrial investment.



This cannot continue, household saving cannot continue to fall and America's borrowing cannot continue to rise. As always, there are at least 2 possible outcomes.

The first is that this is a cyclical phenomenon and that with ageing populations, households will save more as they prepare for retirement and that investment will recover in USA, resulting in higher interest rates. However, if investment is concentrated outside of USA, then the flow of surplus funds will dry up and cause other foreign investors to start fretting, with the consequence the dollar will weaken and interest rates rise.

The other possibility gaining credence is that the "savings glut" is a long term structural shift and if so, it could last for decades. The Asian economies could continue to export their savings for commercial reasons (keeping their currencies cheap to create jobs and exports) and for demographics (China's population is ageing faster than America). If American households also start saving more, because the housing market falters or high fuel prices begin to bite, then the world will be short of spenders and go into global recession.

The Economist takes the view that America's creditors will allow the situation to continue for a while as they do not want to provoke recession, but correcting these imbalances will require new thinking both inside and outside America.

Affinity are doing our bit to help change the trend and are encouraging our clients to save. I don't think we have enough clients yet to cause a global recession by this action.

Inflation

Before getting into the nitty-gritty, let me add a few words on inflation. The main concerns worrying investors are:

- Oil prices
- Rising interest rates

- Rising inflation

Central bankers can control the demand side of inflation by raising interest rates, restricting money supply when companies raise prices. At present though, largely because of a prolonged period of global under-investment, we are seeing supply-side inflation. Oil prices have risen dramatically (but hopefully peaked) and industries from mining (particularly building materials), to timber and oil refining are supply constrained, resulting in higher prices. Eventually the profits these high prices generate will cause more investment, but there is a time lag. Inflation may be close to a peak.

Inflation	04	05	06	Real GDP Growth	04	05	06
US	2.7	3.4	2.6	US	4.2	3.5	3.1
Japan	0.0	-0.3	0.2	Japan	2.6	2.5	2.5
Euro-12	2.1	2.1	2.0	Euro-12	1.8	1.2	1.7
UK	1.3	2.1	1.9	UK	3.2	1.9	1.9
G7	1.9	2.3	2.0	G7	3.1	2.6	2.5
Asia x Japan	3.8	3.6	3.6	Asia x Japan	7.5	7.0	6.7
World	3.9	4.0	3.7	World	5.1	4.3	4.3

Source: Henderson Global Investors

The British Economy

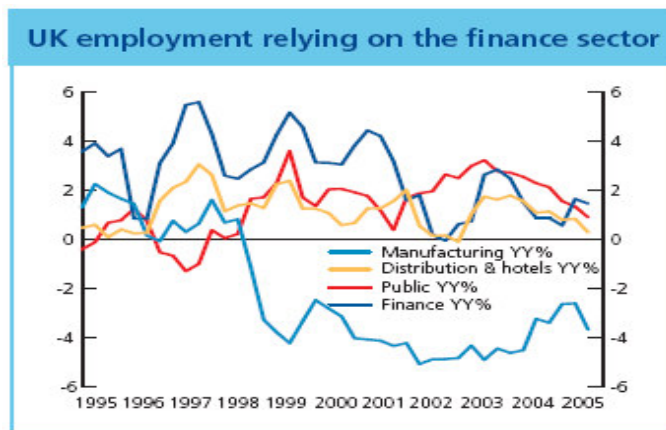
- Inflation rose to 2.4% in August exceeding the Bank of England's target of 2% for the first time since the new consumer price index was fixed in December 2003.
- The economy has grown 2.2% over the past year, well below its sustainable long term trend of 2.5 - 3%
- Interest rates dropped from 4.75% to 4.5% in August to try to boost flagging consumer demand and corporate investment. This means that the peak of 4.75% is the lowest interest rate peak since 1953 and is lower than all interest rate troughs of all the economic cycles since 1964. The economy is operating in totally different environment than anything seen in the last 50 years. It should boost business and consumer confidence and steady house prices.

Inflation may be close to a peak as oil prices stabilise.

UK economy has done well but is likely to slow down next year.



- Interest rates typically take 18-24 months to have impact and so this has not rippled through to consumer spending which has been flat for the past 2 months and retailers are struggling.
- The slow down in the housing market is blamed for the reduction in consumer spending. Although economists still argue houses are overvalued, it seems they will have a soft landing. It is unlikely that we will see much growth in house prices in the foreseeable future though.
- Manufacturing employment is in long term decline, employment in distribution and hotels has shrunk with consumer spending. The finance sector is the only one that has expanded employment, all of which points to an economic slowdown.

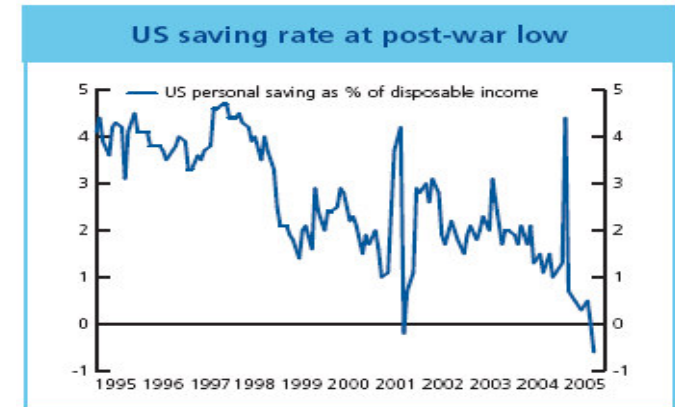


The American Economy

- The economy is strong but inflation is becoming a concern. It is not just the supply-side mentioned above, with oil prices increases and more importantly natural gas - which rose 150% over the past 3 months - but government spending is also a root cause. The cost of the Iraq war, hurricane Katrina and the propensity of GW Bush to keep spending, is going to increase inflation, drive up the budget deficit and weaken the dollar.

US economy has been strong, but expected to slow next year.

Greater divergence of wealth.



- A poll of 66 economists believed that the consumer price index will rise 3.7% by the end of this year. This will be the biggest rise since 1990.
- The saving rate is the lowest since world war 2, reflecting the borrowing boom in the housing market. If the housing market turns down, there would be a huge reduction in mortgage borrowing and an increase in savings. This would deal a massive blow to consumer spending and the US economy.
- The US housing market is lagging Europe and is only now beginning to show signs of slowing. It is mostly anecdotal at present, but the figures could start to reflect this early next year.
- The Fed are expected to continue to raise interest rates and these could go as high as 4.75% by the end of next year.
- Citibank published a study recently that shows that the top 1% (1 million people) in the USA accounted for 20% of the country's income in 2000, almost as much as the bottom 60% (60 million people) put together. This disparity means that whereas the majority of the population are feeling the effects of higher prices, it has not affected the wealth producers as heavily.



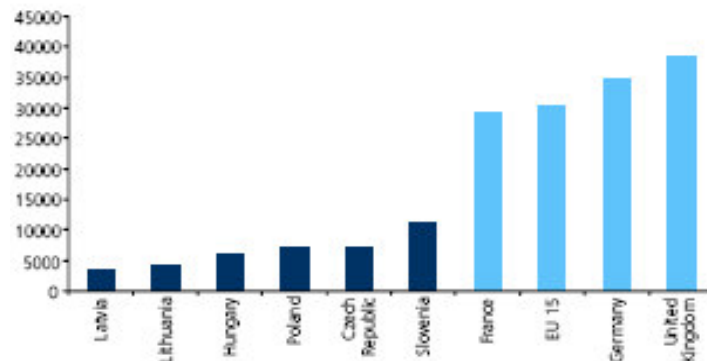
The European Economy

- The European economy is still struggling to get going. GDP is slowing and is now running at 1.2% whereas inflation is rising and is now at 2.2%.
- The ECB would like to reduce interest rates but has held them at 2% to try to combat inflation.
- Demand in the economy has come from exports as European consumers are not spending.
- The stalemate in the German elections has dented confidence, although this is likely short lived. Consumer demand has been flat for 4 years

Eastern European Economies

- The 10 Eastern European countries that joined the EU continue to grow and supply cheap labour to the older economies. Their combined population of about 70 million is 16% of the new combined EU total.
- These economies have moved from inefficient communist control with over-employment, interested only in building capacity and output, to free market economies. The process has been

Annual Salary, in EURO



Source: European Statistic, data 2002

Europe struggling, but companies have seen good export growth

E Europe doing well

Russia begins to emerge

tough with hyperinflation, bankruptcies of inefficient companies and high unemployment.

- Today, these economies are market oriented with inflation under control, although unemployment is still high. The old state monopolies are now highly successful private companies. They have limited raw materials and depend on Russia for gas and oil.
- Their focus is on building a strong high quality industrial production base and offer a highly skilled and educated work force at much lower cost than Western Europe. They have growing internal consumption and many foreign companies are investing in the region.

The Russian Economy

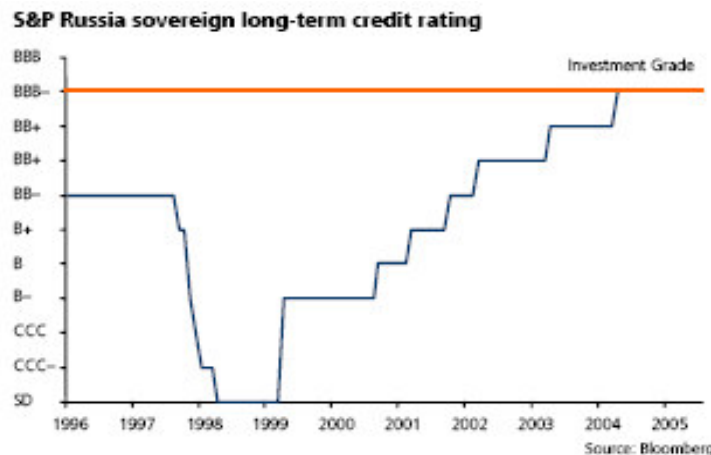
- Russia has the good fortune to be a net exporter of energy. Strong global demand for commodities translates into a double surplus of the country's current account and government budget and a healthy cash flow for Russian companies. Consumer confidence is rising, with the unemployment rate below 8% and average wages expected to increase in 2005-2006 at least 10% p.a. in real terms.
- Standard & Poor's upgrade of Russia's sovereign debt to BBB- in January 2005 was followed by a Fitch's upgrade to BBB in August 2005.
- The robust macroeconomic outlook for Russia over 2005/2006 means good prospects for further upgrades in the next 18 to 24 months.
- Increasingly, Russian companies show prudent financial and operational management. International Accounting Standards are substituting for opaque financials. Capacity upgrade and new investments are slowly and surely happening.
- This will be the 7th consecutive year of GDP expansion, spurring domestic consumption.
- A middle class is emerging in Russia which is vital for the long-term stability and prosperity of the region.



- Russia is now a top 3 emerging bond market (with \$8 bn raised so far this year) and a top 7 emerging equity market in terms of index weightings.

The Japanese Economy

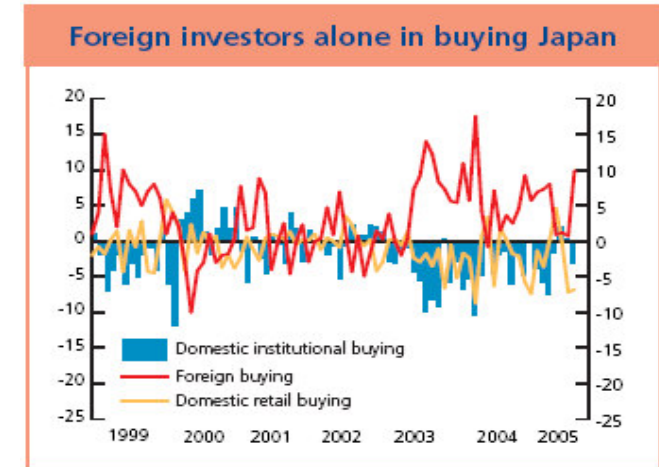
- Japan is witnessing a revival this year, with domestic consumption increasing, following rises in income and employment. Oil price increases have caused inflation, which has broken the deflationary spiral.



- Japanese companies are still generating substantial cash surpluses and this should result in an increase in domestic consumption.
- The economic picture is coming together nicely and Prime Minister Koizumi's convincing victory in the recent elections will allow his reform process to move forward.
- Domestic bank loans increased in August for the first time since 1998 and property prices in Tokyo rose for the first time in 15 years.
- Consequently the Japanese stock market has shown a recov-

Japan is starting to pull out of its 10 year recession.

China is still the world's fastest growing economy and sucking in large volumes of commodities.



ery and is attracting substantial funds from overseas. Domestic buyers have not come back yet.

- The end of the zero interest rate is in sight but is dependent on seeing positive inflation figures.

The Chinese Economy

- I discussed the probability of the yuan peg to the dollar being removed and the implications in my last newsletter. The yuan was allowed to float during the summer, albeit within very tightly controlled bands, but it is a step in the right direction.
- The world produces more than 60 million vehicles a year. That figure is growing by 6% annually and fuel-efficient hybrids will not account for even 1% of annual production for several years. In the USA, there are roughly 750 vehicles per 1,000 people, a figure that has increased 60% in five years, while in China there are 6 to 7 vehicles per 1,000 people, and only one vehicle per 1,000 in India. China, however, has begun to enter the age of mass car consumption. In 2002, demand for automobiles soared 55%, and in 2003 demand growth accelerated 75%. After the government tightened credit, sales growth rates eased to 15-20%, which is likely to be a sustainable figure. Ownership is

October 2005

Full Of Eastern Promise



Asia is booming

Latin America showing
good growth

still minuscule in per capita terms compared with a global average of 120 cars per 1,000 people. Indeed, the number of private autos in China - around 10 million - is about half the number of cars in America at the start of the Great Depression. That said, China is already a net importer of oil as well as the world's second-largest consumer. China's oil imports jumped 35% last year as sluggish domestic production failed to keep up with booming domestic demand. If vehicle ownership in China doubles, the country will need to double its oil imports to 14 million barrels per day, or 16% of current world-wide daily production!

- GDP growth in China is expected to be around 9% this year and remain at over 8% next year, the world's highest growth rate.

Asian Economies

- India is expected to see GDP growth of around 6.5% this year, which should continue into next year.
- Over \$8 billion of foreign investment has gone into the Indian stock market so far this year and it is expected to reach \$10 bn by year end.
- An interesting piece of trivia: the Bombay stock exchange is the oldest stock exchange in the world.
- The rest of the Asian stock markets are attracting levels of foreign investment unseen for many years as companies are undervalued by traditional standards. The prospects for equity growth appear much better than in western markets.
- Other Asian countries continue to benefit from growth in India and China. The politicians are encouraging personal spending to increase consumption and Hong Kong is a good example of an economy dependent on consumer spending

Latin American Economies

- Latin American economies are reaping the benefits of the growth in domestic savings. Their decreasing reliance on for-

eign capital flows has enabled a greater degree of monetary autonomy through exchange rate stability.

- Countries such as Brazil have been able to reduce interest rates despite recent increases in inflation.



10. Markets

10.1 Interest Rates

Official Interest Rates	28 Sept 2005	05 Sept 2006
US	3.75	4.75
Japan	0.00	0.25
Euro-12	2.00	2.00
UK	4.50	4.00

- The Fed is set to keep raising US interest rates until it has restored them to a more normal level, assumed to be around 4.75%.
- The ECB may keep rates on hold a little longer as some inflation worries are offset by weak growth.
- Slowing consumer spending growth is likely to prompt further cuts in UK rates.

10.2 Currencies

The US dollar has risen on the back of rising interest rates which have widened the gap with the Euro rates. However many analysts believe this is a short term bounce and that it will decline again next year.

Sterling and the euro have fallen against the dollar, as interest rates have risen in the USA, whereas they have fallen in UK and remained static in Europe.

The Japanese yen strengthened during 2004-5 but has seen a steady decline this year. The effect of the improving economy and new government has not filtered through to the currency yet, but it is expected to do so soon.

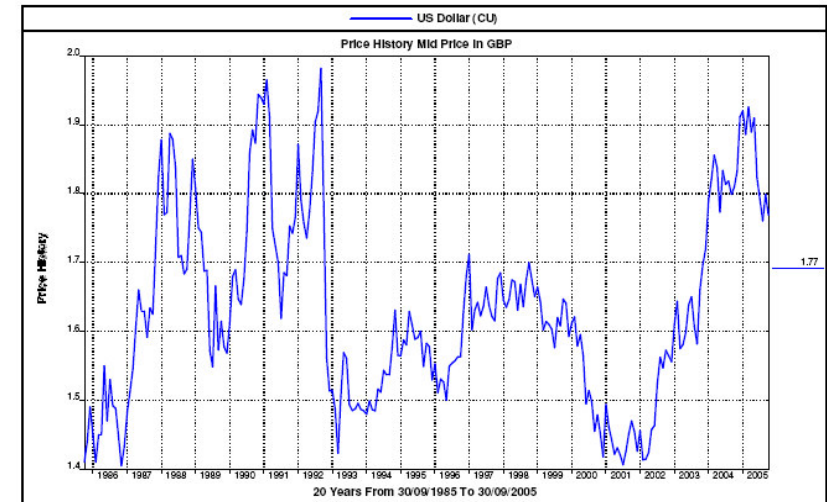
US interest rates rise,
Europe stable, UK falls

USD strengthens, but not
for long

Yen due to rise

US stocks perform badly
and could continue to do
so.

UK Pound vs US Dollar over past 20 years

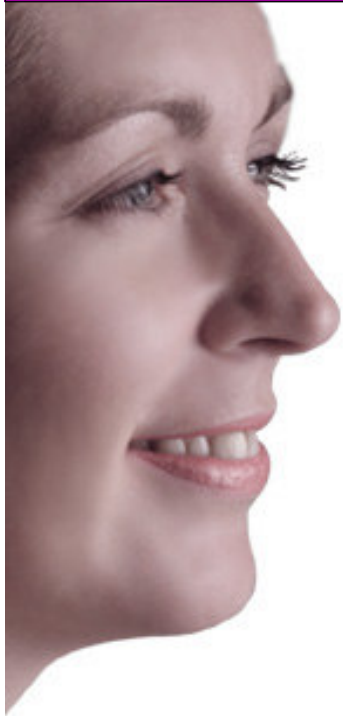


10.3 Stock Markets

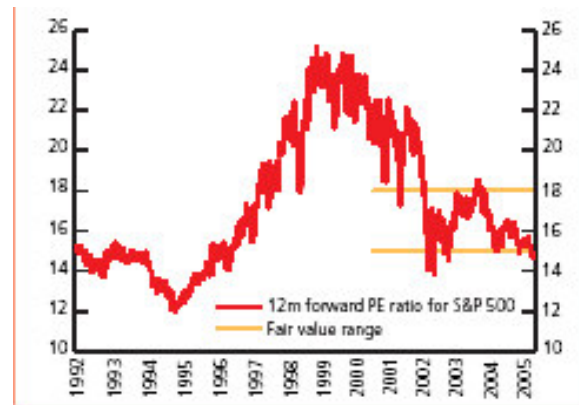
The US stock market has performed badly this year and is below its start of year prices. It should end up positive but it will not be by much. The bulls are trying to talk the market up but there is a compelling body of evidence that says the market will struggle again next year and maybe for longer. Companies are generating cash for major capital projects but with rising raw material costs affecting costs and with interest rate rises and high fuel prices, combined with a slow down in the housing market, consumer spending will slow. Company profits will be hit and this has not been factored into share prices at present, making them look expensive, even though price/earnings ratios are at their long term average and at the low end of their "fair value" range. As usual though, nobody can agree and some fund managers believe these low p/e ratios are a buying opportunity, we think this is a short term view.

October 2005

Full Of Eastern Promise



US Price/Earnings Ratios for the S&P 500



The UK stock market was slower to recover from the crash than most of the world's markets but has caught up this year with very strong performance. An increase in merger activity has lifted the market recently and some analysts think the oil sector is undervalued. However it is not expected that this growth rate will be sustained next year as consumer spending and the economy slow. The shift by large company pensions away from stocks and into bonds will also act as a continuing drag on the market.

The European stock market indices reached 3 year highs recently in the major markets. The stronger dollar made exports cheaper and boosted corporate profits. There is still good value in some stocks, particularly in Germany where expectations are still low. It is not expected that next year will see the same growth but there is more scope than in the US & UK markets.

The Japanese stock market rose sharply after the election and share prices underestimate the effect of an improving economy. Improving property prices in Tokyo are beginning to spread to other major cities and this improvement in asset

valuations will lead to higher book values and hence higher share prices. Many global fund managers have invested in this market in the past months. The price/earnings ratio of the Nomura 400 is around 17, which does not suggest an over-valuation.

Asian stock markets are still below the levels they achieved before the currency crisis of 1987. Since then, companies have improved profitability and strengthened balance sheets and many still have room for considerably more improvement and are under valued. The corporate structural reform and economic outlook for the region make this a favourite place for investors as they believe the region has the ability to out-perform.

Emerging Market stock markets offer investors a wide and varied set of investment opportunities, where companies are benefiting from increasing foreign direct investment and the global trend of outsourcing. As companies from the developed world strive to drive returns higher, the emerging economies are the principal beneficiaries offering low wage costs and a plentiful supply of labour.

10.4 Bond Markets

- Global bond yields have risen as continued deliberation over monetary policy has affected sentiment. Real yields remain low and this is as true in index-linked markets as it is in the conventional arena. The reason for this seems to be the continued low level of real short term rates. The present low yields are not expected to continue much longer.
- Corporate bond yield spreads are mostly dictated by three variables, the level of short rates, shape of the yield curve and supply of government debt. All three of these are thwarting further spread compression, but there appear to be sustained flows into corporate securities which are continuing to keep the market expensive.
- Any increase in equity market volatility though, may cause under performance from this sector.

UK & European stocks perform well.

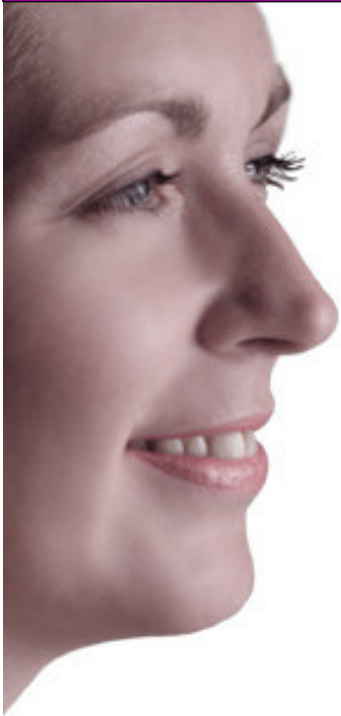
Japan stocks rise and should continue.

Asian & Emerging Markets do very well.

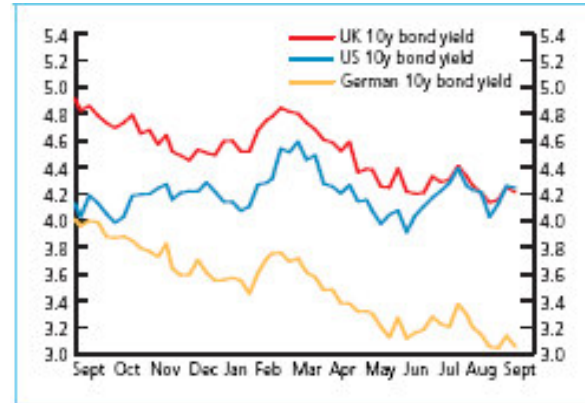
Bond yields rise, but still low

October 2005

Full Of Eastern Promise



- The UK and Euro-zone government bonds are being favoured by bond fund managers as monetary policy in these regions is likely to remain supportive of yields.

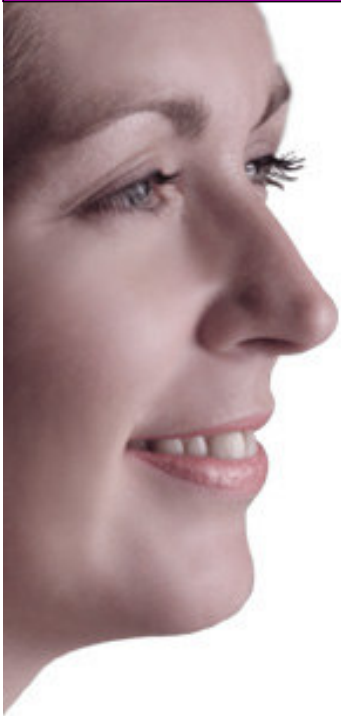


10.5 Property

- Commercial property is still showing good growth around the globe and is not affected by the potentially over-inflated residential market. Europe is expected to see low double digit returns in the next 1-2 years, particularly in UK, where the office market is recovering and Real Estate Investment Trusts (REITs) are being introduced next year.
- The average national house price in USA has not fallen in a calendar year since the great depression of the 1930s. By contrast, the S&P500 has dropped in 12 years and the bond market has had 17 negative years since 1950. House prices have averaged 5% pa growth since 1950, which is little more than 1% net after inflation. In 2004 they rose 8.3% and they are rising faster this year at 11%. The concern centres around consumer debt levels, which are the highest in over a decade, but low interest rates have kept the debt servicing burden stable. If interest rates rise or unemployment increases significantly, there would be a problem.

Property markets look like having a soft landing.

- UK property prices are showing mixed signals. The average UK house price is £186,000 but in Greater London it is £248,000. In the south generally it is £215,000 and in the north £136,000 and in Scotland £103,000. This is the smallest percentage difference between north and south for 10 years. This seems to be because prices in the south (apart from the area around E London where the Olympics will be staged) are dropping, whereas they are still rising in the north. The average price paid by a first time buyer in August was £153,000
- There are arguments that with permanently low interest rates, the established measures that we have used for 50 years to measure house prices against average incomes are no longer valid. This may be true, but dangerous, as homeowners learn to live under a massive debt burden, then if interest rates do rise eventually, it will cause a severe recession.
- Australia has also seen a slowdown. The Reserve Bank have said that the market has been flat for a year: Brisbane +1.2%, Melbourne +1.5%, Adelaide +4.5% Perth +12.5%, Darwin +17.1% but Sydney -4.7%. Excess supply has disappeared, new starts have fallen and so vacancy rates have fallen to around 2% nationally. If there are no further interest rate rises, it is expected that the market may see modest gains again next year.
- The Dubai property market has slowed down. Rents have gone up 34% this year on average, whereas personal incomes have risen only 1.5%. The Central Bank have given a warning about over-supply of property and the effect it could have on rents and sales prices, particularly next year when more dwellings are released in the year than all those that have been released so far. The IMF have urged the UAE government to take steps to handle the real estate and asset price (stock market) boom so it does not go out of control. Concerns about the lack of a freehold law and absence of control over ground rents are beginning to weigh on the property market. One thing that struck me is how few people involve a lawyer in their purchase, even expats who would never consider buying a property at



Gold rises and looks like keeping on going.

home without legal advice, do not think to consult one in UAE where the laws are far from clear.

10.6 Gold

- The price of gold has risen to 17 year highs recently and could go much higher. Gold is as much about investor's state of mind as it is about the status of the mines. Demand has been very strong from the traditional market of India this year for jewellery. However when investor sentiment for equities and the US dollar turn bearish, money has always moved to gold. Its real value is a mystery to most people, it does not have a p/e ratio and is not essential to everyday life, it goes through cycles of lust and indifference.
- Gold supply is finite and difficult to access. It is popular because it is regarded as a store of wealth. Central Banks used to use it to underpin their currencies and reserves, but have been moving away from it over the past years. Yet gold fans will tell you that the old saying that an ounce of gold buys you a suit (and pair of shoes, depending on where you shop) has remained true throughout the centuries.
- The theory is that if terrorists knock out an ATM network or currency becomes debased, you can swap a gold coin for sacks of food more readily than a personal cheque. So in times of uncertainty or stock market or dollar weakness people move money to gold and the price rises. It now seems that gold is on an up trend. You can participate in this through the Merrill Lynch fund in the FPI portfolio, but this would fall into the category of speculation.

References:

- Aberdeen Asset Managers
- Clariden Financial Products
- CNBC (MSN)
- Financial Times
- Henderson Global Investors
- National Australia Bank
- The Economist
- The Gulf News
- The Times of London

Thanks for making it to the end. We hope you found it useful.

The information and opinions contained in this document have been obtained from sources Affinity considers to be reliable, however these have not been checked or verified by Affinity. The information contained herein is provided as a guide only and any person who may receive this document must make his own investigations and must satisfy himself as to the accuracy and completeness of information and suitability of investments for his investment purposes, needs or requirements. Affinity, their directors and employees may have positions in investments mentioned in this document.

This document and its contents are not intended to constitute an offer for sale, prospectus, invitation to subscribe for or purchase or otherwise acquire any of the instruments referred to herein. For the avoidance of doubt, there is no intention to create a legal contract.

This document is published for clients of Affinity only and does not have any regard to the specific investment objective, financial situation and the particular needs of any specific person who may receive this document.

Past performance and any forecast are not necessarily indicative of the future or likely performance of any fund. The value of units and the income from funds may fall as well as rise. A copy of the term sheet or prospectus for funds mentioned here is available on our website www.affinity-consulting.com Investors should read the prospectus before investing.

Affinity Consulting Group Ltd
Administrative Office:
c/o Intelcom Ltd, 54 Broadway, Peterborough PE1 1SB, UK
+44 1733 555555
enquiries@affinity-consulting.com