AFFINITY CONSULTING GROUP

Property Bubble Soon To Burst? 5th May 2004

I hope that 2004 is treating you well and that you are in good health.

The last 12 months has seen the largest growth in the major stock markets for 4 years. The appetite to invest is returning but there are still risks and we recommend that you maintain a balance of assets (Property, Equities, Bonds, Cash & Alternatives) in your pensions and investments. Regular savers who have continued their investments over the last 4 years are now seeing the benefits of this "dollar cost averaging".

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1. Economic Outlook

I have distilled the following economic summary from a number of economic reviews and journals. The general consensus is very positive, but there are now very serious concerns for the housing markets. The other concerns are whether growth in China is overheating (as this has been helping Japan & US to recover) and over interest rates.

Growth

- America, Britain and Asia are now enjoying their healthiest economic conditions since the early 1990's. This confounds the pessimists that predicted a US led global depression after the bursting of the internet bubble in 2000 and the terrorist attacks in 2001.

- The USA created 308,000 new jobs in March giving a monthly average of 171,000 per month so far this year. This disproves the recent theory that America is experiencing a "jobless recovery" in which rapid economic growth would fail to generate additional employment, wages and consumer spending.

- GDP in the USA is growing faster than at any time since 1983. Alan Greenspan's strategy of weakening the US dollar has worked, however this will lead to inflation (prices rose by 0.5% in March) and there is concern that by the time he raises US interest rates, it will be too late and inflation will become a problem.

- The Bank of England is facing a different dilemma. Inflation in the UK is under control at 2% but a large component of this comes from the house price boom. The housing market is calling for a raise in rates to stop the boom and try to ensure a soft landing. However inflation is below target and the pound is very strong. A raise in interest rates is likely to strengthen the pound and reduce inflation and so the Bank of England has resisted it. The UK economy is seeing good GDP growth and employment levels and this will enable the Bank to increase rates soon, probably in May.

- This brings me to the title of this letter. An increasing number of analysts and economists are now predicting the fall of the housing market. It has every characteristic of a bubble. There is a reprint of a Financial Times article taken from the Gulf News on the "News" section our website www.affinity-consulting.com which sets out a well argued case. The UK market is now 37% above its long term trend, something I have been highlighting for a year now. The average house price is now about 6 times the average earnings and this puts property out of the reach of first time buyers. It also makes it less affordable in general and people have to borrow more, which as interest rates rise, will raise the cost of debt servicing to a high level. Tony Dye, an economist nicknamed "Dr Doom" for his forecast of the internet debacle wrote in the FT recently that everyone is hoping for a soft landing, but he predicts it will come down with a big bump.

- The trigger for the bursting of the bubble is likely to be the rise in interest rates that everyone is predicting will occur this year. With banks lending higher multiples of salary and house buyers taking on very large mortgages, repayments will be harder to make. The buy-to-let market will be particularly hard hit as rents may no longer cover mortgage payments and with better returns available in the stock markets, many people will sell up and revert to other investments. It is not just the British market that will suffer, the same bubble is occurring in most developed countries and we are likely to see varying degrees of fall in prices in all developed countries where prices have seen an unrealistic growth in recent years.

- In contrast to the growth in America, Britain and Asia, continental Europe remains stuck in a period of economic stagnation, which started with the launch of the euro in 1999. The European Central Bank seems to refuse to acknowledge this and refuses to cut interest rates. It is expected they will cut in June and by that time it will be too late to prevent the European economy suffering another year of negligible growth. The economic slowdown is likely to worsen in the coming months as the lagged effect of the overvalued euro takes its toll. Weakening the currency in Japan and the USA has resulted in the recovery of their economies recently, so do not be surprised to see the ECB try the same approach, with a large cut in euro interest rates.

- The arrival of ten new members of the European Union has continued to prompt discussion on their likely impact on the region's economic fortunes. The latest additions have increased the EU's population from 380 million to around 454 million with around half of the new citizens coming from Poland. The likely economic impact may be less notable. While the population will rise by 20%, the increase in gross domestic product will be just 5%, which is the smallest increase following new entrants since the entry of Greece in 1981. The arrival of the accession countries will provide a competitive manufacturing base in the form of cheaper labour in comparison to the rest of Europe which should assist continued inward investment. Even allowing for the fact that productivity in the new member states is not as high as in western Europe, the labour cost advantage is considerable. The new member countries also have the potential for continued rapid growth. They have been growing rapidly and, according to projections by Lehman Brothers, will continue to do so. Annual average growth of 4% to 6% between now and 2013 has been predicted.

- Economic growth in eastern Europe has outpaced that in western Europe over the last year and has been reflected in the performance of eastern European stock markets. There is an expectation that economic growth will continue to be fuelled by foreign direct investment, a cheap and flexible labour force and low corporate tax rates. Falling interest rates should encourage spending and stimulate further economic growth which may also be supported by further direct investment on the back of an educated workforce that is flexible and cheaper. It reportedly costs about the same to hire one Polish worker for a day as one German worker for an hour. Corporate tax rates should also be an attraction for businesses. Estonia has a zero rate, Hungary has a rate of 16% and Poland is lowering its rate to 19%. These figures compare with 30% in the UK and an average of 33% in the 15 euro zone countries

- The Chinese economy has shown good growth but it may be in danger of overheating. It has been one of the main engines of the world's economic recovery (particularly Japan's) with its huge capital spending programme (estimated at 30% -40% of GDP). Over the last year equities have soared 52.8% in local currency terms while the economy has grown by more than 9%. This growth has been fuelled by increased exports, foreign investment and a growing middle class who are driving consumer spending. In addition, local governments and businesses have been investing in infrastructure to accommodate the rapid growth in trade, foreign investment and consumer spending. There are concerns that the growth in infrastructure could result in an oversupply of goods, with the prices of some consumer goods already starting to fall. There are also reported to be concerns from the government that the steel, aluminium and cement sectors are under pressure from excess capacity.

- Japan's economy grew 2.3% last year compared with a contraction of 0.3% in 2002 and was well above its 10-year average of 1.3%. It is expected to expand by 3% this year. This growth has been fuelled by exports to America and China, but analysts are apparently hopeful that the domestic economy will also pick up and support a sustained recovery. Unlike previous recoveries, which have been based on the manufacturing sector, there are reported to be indications that this recovery may see an upturn in the service sector which should create jobs and increase consumer spending. There is also a view that Japan's bad debt and deflation problems are being resolved. Non-performing loans have declined by 26% over the year and deflation is easing with consumer prices having turned positive last October for the first time since 1998. Other positive indicators are that office rents have bottomed out and apartment prices in Tokyo are rising. The risks to the recovery are based on external influences such as any slow down in the US economy or if China takes steps to prevent its economy overheating.

- India is another country receiving attention, not just because of the current election which is causing concern that it could result in a hung parliament. The economic data has shown considerable improvement, it has a skilled workforce and a number of world-class companies that have better corporate governance and a higher return on assets than Chinese firms, for example. Its service industry is very competitive in world markets and the software and call centre industry in particular is doing well. Their stock market is volatile and has dropped this year but the long term prospects are good.

Interest Rates

- With the lowest interest rates for 40 years and strong economic growth, there is only one direction they can go. It is expected that the UK will have 3 quarterly rises of a quarter point starting in May and that the US will also have 2 or 3 rises of a quarter point, starting in the summer, As consumers have refinanced their property in recent years fuelling a consumer boom in most developed countries, a rise interest rates will slow down consumer spending but the corporate world is expanding and making capital investment again which will sustain economic growth.

- As mentioned above, the euro interest rate is expected to be cut significantly in June as the ECB are expected to make a policy change and recognise that interest rates should be used to promote economic growth and not just used to control inflation.

Currencies

- The US dollar is still very weak. The acknowledgment by Alan Greenspan that interest rates will have to rise and strengthening economic data prompted a little strengthening in April. Do not expect any significant change though until we see US interest rates rise. Warren Buffet is betting against the strengthening of the dollar short term.

- The pound is still to strong and served as a break on raising interest rates. As interest rates have risen 0.5% this year and are likely to continue to rise, it is unlikely the pound will weaken until the US dollar recovers.

- The euro is likely to weaken if or when the ECB cuts interest rates.

- The yen has been strengthening slowly this year, as I expected in my last letter. However the Japanese central bank has been intervening to keep it down. There is now an expectation that this intervention will cease and the yen will bee allowed to rise, at least until it reaches 100 to the US dollar. The strength is due to the improving economy but much the impetus for this has come from exports to China and if China overheats and slows its imports, Japan and much of the world will be affected.

Markets

- We are seeing the best quarterly corporate earnings reporting season now for 10 years. American & British companies are making good profits again. The dividend growth of the 500 companies comprising the S&P500 index is at its highest for 40 years. Despite this, the American & British markets have been almost flat for the first quarter and then dropped in April. Some of this earnings growth was priced into the market already and now the concerns over interest rates and the weakness of the US dollar are holding the market back. As the anticipation of interest rises becomes priced in, then when they are raised, the US dollar should strengthen as confidence in it is restored. This should lead to more money flowing into the US stock market.

- I mentioned in my last newsletter that the Far East was likely to be a big growth are this year. A survey of 300 funds mangers conducted by Merrill Lynch this month showed that Japan is their favourite ,with ratings for Japan at an all time high. The Nikkei 25 index gained around 50% last year (the FTSE 100 gained 13% and the S&P500 gained 22%).

- The Chinese market grew 52% over the past year in local currency. However there are concerns now that is overheating. Another of SE Asia's big growth areas, Thailand, took a hit with the bird flu scare but continues to perform well. India gained 64% last year and although a volatile market, it is still favoured by many fund managers.

- The bond market, particularly US government bonds, has also developed into a major bubble. It is predicated on 2 factors: 1) US interest rates remaining low and 2) euro interest rates not going down. As both these factors are likely to change in the near future, bond yields will be very unattractive. Many fund managers are reducing their exposure to bonds and increasing their global equity investments.

- Oil prices are at very high level s but this does not appear to have affected corporate earnings and whereas OPEC is "hawkish", they are also more realistic. The discipline of most of its members has not been fully tested (most of them are still producing way over their quotas). Expectation seems to be that prices are at a peak and will settle long term at $28-32 per barrel.

2. Pension Crisis

This is not a new issue, but will slowly have an effect on the world's economy. Actuaries have been agonising over this for years. The problem is that there is huge gap between the retirement income that workers romantically expect and that which they are likely to be paid. The inequality is primarily due to increased longevity but has been exacerbated by the Treasury's tax raids on pension funds in the nineties. The shortfall is difficult to estimate but is probably 5-10% of GDP (according to Sarasin Investment Management). Overcoming the problem is not easy. Asking workers to make extra contributions would be politically unacceptable and economically disastrous. The government that proposed it could be unseated and economically it could cause a depression. The only practical solution is to encourage people to defer their retirement. This causes contributions to be increased and disbursements to be reduced. Even a small number of years will make a big difference and the process has already started.

Most governments are now modifying regulations to allow workers to work beyond normal retirement age. They may yet go further and encouragement may turn to enforcement. The consequences of this on the economy are that the supply of goods and service would show an increase whereas demand will hardly increase. It will also have a negative effect on wage settlements with consequent employee problems. It is likely to be a drag on the world's economy.

3. Investment Strategy

From a personal point of view it is very important that you ensure you make adequate provision for retirement as increasingly, employers and governments can no longer afford to do this for you. The earlier you start, the easier it becomes. Saving 15% of your salary since you started working is generally sufficient to provide for old age, provided it is in a well managed investment and grows at 8% per year. The longer you wait to start, the more you have to save. There are some guidelines in the "Financial Planning" section of our website.

One thing is proven, that the way to accumulate wealth is by saving regularly each month. Many people forget this when markets are down but those who have continued to save through the down periods will show the most gain as markets recover. Regular saving means that you "average in" over a long period and are not so subjected to market fluctuations.

With the "baby boomer" generation starting to retire soon, the effect on the western stock markets are uncertain as this generation stop adding to their investments and start drawing money out. It is very possible that the emerging markets will continue the trend of recent years and show better growth than the USA and Europe.

This all strengthens our investment philosophy that it is best to use actively managed funds of funds as this year's top performing market will not necessarily be the same as next year's. These actively managed funds constantly review the best performing regions and adjust their asset allocations regularly to take advantage of the best growth. Long term monthly savers should expect to see the best return in actively managed funds of funds such as Lanson Financial and Collins Stewart who are primarily equity based but also use hedge funds and bonds. They select the best funds from regions that are showing good growth and adjust and rebalance frequently.

We also offer funds of funds, funds of hedge funds, fund of property funds, funds of traded life policies and funds of endowment polices, gold fund, bond funds and capital guaranteed funds.

It is important to ensure that your savings are kept in line with your salary and bonuses. How long is it since you last looked at this?

4. Fund Performance

To 30th April 2004

	Price	1 month	YTD	1 year	since 1 Jan 2002	
Lanson International Growth	1.127	1.0%	-1.0%	26.0%	28.4%	**Since launch in May 2002**
Lanson Optima Fund	0.677	0.3%	0.9%	27.3%	27.3%	
Collins Stewart Aggressive USD	1.259	-5.7%	4.7%	35.1%	36.6%	
Collins Stewart Growth USD	1.021	-3.7%	1.7%	24.8%	25.1%	
Student Accommodation (GBP)	1.241	0.5%	2.0%	5.8%	19.0%	
Momentum All Weather (USD)	1.099	0.4%	2.1%	7.0%	10.1%	
S&P 500 Capital Return	1,117	-2.1%	0.8%	20.1%	-4.7%	
Dow Jones Indust Cap Return	10,314	-1.5%	-0.9%	20.2%	0.5%	
NASDAQ	1,939	-5.8%	-3.4%	29.0%	-5.9%	
FTSE 100 (in GBP)	4,490	0.5%	-0.5%	13.6%	-15.7%	
MSCI World Index	2,959	-2.0%	0.7%	30.1%	8.3%	
Quadriga GCT USD	2,315	-15.0%	-1.7%	15.5%	210%	

As you can see, the fund of funds approach of Lanson Financial and Collins Stewart has considerably outperformed the market indices, and most other globally managed funds, over the past 2 years. The Collins Stewart Aggressive fund has achieved stunning performance but it is higher risk as it has only a small number of investments and most of these are in the Far East and emerging markets. The asset allocations and fund reports for all the funds we work with can be found on out website in the “Investments” section.

The Quadriga GCT fund is a high risk managed futures fund and it had a good first quarter which put it back to the levels of February 2003, but then this fell away again in April

5. Other services

Please don’t forget that we can organise your medical insurance, life insurance, critical illness insurance and if you are British, income protection insurance. For those of you buying property, we will be pleased to arrange your mortgage protection insurance. Please let me know if you would like more information.

Also, if you would like a review of your investments then please let us know and your consultant will be pleased to meet you to go through them.

Clive A Ward