

I hope you are enjoying the summer and that you are in good health.

This is proving to be one of the years when the old stockbroker adage of “sell in May and go away” holds true. In fact it has been a year of very little movement so far. Markets have been trading within a narrow range all year. Some of the reasons for this are explained below. As always, we recommend that you maintain a balance of assets (property, equities, bonds, cash & hedge funds) in your pensions and investments and since my last newsletter we have added 2 more funds to our recommended: a high performing range of 3 hedge funds run by Infiniti Capital Trust and Australia’s top performing mortgage income fund, the LM Mortgage Income Fund.

However as the USD has weakened this year, those of you looking at your USD investments from a sterling aspect will have seen them struggle to keep pace with the dollar devaluation. The pound is 15% stronger against the dollar than at this time last year. However most economists do not see this as sustainable and expect to see it reverse over the next few years.

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1. New Website

Our website is expanding all the time and we have added a substantial amount of useful information to it. If you have not had a chance to look at it, I think you will find a visit worthwhile. Please bookmark www.affinity-consulting.com The site includes:

- details (including fact sheets and performance graphs) for the core of funds we recommend, so you can track their performance
- daily market indices for a range of equity, currency and commodity markets
- a currency converter
- details of mortgages for most countries
- a facility for currency transfers that is much cheaper than your bank
- a wealth of useful information, including expat tax advice by country, graphs of stock markets, major currencies, inflation and property movements.
- financial planning information
- explanation of the benefits of using a trust, also wills and inheritance tax for UK
- brochures and forms form for Friends Provident & Aviva
- full explanation of life insurance, income protection, critical illness and medical insurance.

I hope you find it informative and I would welcome feedback on its usefulness.

2. Economic Outlook

I have distilled the following economic summary from a number of economic reviews and journals. The global economic recovery has suddenly slowed over the last quarter. However recoveries, like markets, never go in straight lines. Previous recessions in the early 1980s and in 1990/1 both had early cycle slowdowns and each preceded a stronger second cycle. However, the markets are very preoccupied with 3 factors:

- the effect of rising interest rates
- the price of oil
- the threat of terrorism

Growth

- ◆ The world growth suffered a slowdown over the last quarter and markets came down. Japan, Europe & USA have all announced unexpected reductions in GDP growth. The exception seems to be Britain, whose growth accelerated from an annualised 3.1 per cent in the first quarter to 3.8 per cent in the second. China is still importing all major commodities in large volumes, although the government has taken action to cool the potential overheating by putting some constraints on the banks.

- ◆ The British economy continues to expand with the consensus of GDP estimates on HM Treasury's website showing 3.2% growth this year, slowing to 2.6% next year. Inflation in the retail price index is running at 3.1% this year and forecast to drop to 2.6% next year.
- ◆ The US election is already dominating headlines and an interesting report written by a market trader explains that these elections are usually decided in April and May, not in October and November. At the end of May, 60% of the voting public believed the country was on the wrong course. Nearly the same number wanted a change. Meanwhile, Bush's overall approval ratings had fallen to the mid-40s. Only 10% of the voting public is undecided, and when the majority thinks the country is on the wrong course, this undecided group historically breaks to the challenger.

There are many factors that may prevent history repeating and while it remains a close run contest, the markets will probably continue to oscillate on low trading volume. Corporate profits are good but these are already factored in. If Bush looks like winning, the short term effect will be positive, but if Kerry emerges in front, it is likely to cause a blip. If Al Queda succeed in making a terrorist attack, this is likely to help Bush but would still cause markets to drop, but from 9/11 experience, this will only be short term.

Of course all this is short term, as whoever wins, markets will stabilise and continue their long term upward trend. The "bottom line" is that after months of little direction in the US markets, we are likely to see some volatility over the coming year but with a general upward trend. We are really only looking to the long term in our investments.

- ◆ Alan Greenspan was criticised for being too slow to raise interest rates but as the US economy has slowed down from an annual growth rate of 4.5% in the first quarter to 3% in the second quarter but is expected to reach 4% at the end of the year. Wholesale prices have dropped (energy 1.6%, food 0.6%) and industrial production for June was down 0.3% and retail sales by 1.1%. The consumer has been saving less (average 1.4% of income in 2003) which is a reflection of high consumer confidence, but it will be less likely to drive future expansion as interest rates rise. Companies however, have been showing good profits again and Business Week reported that they sampled 374 of the top 500 companies in the S&P500 and they were holding \$555 billion of cash and short term investments which is \$56 billion more than at the end of last year and double those at the end of 1999. Whereas consumer expenditure has driven the western economies in the past 3 years, on the back of cheap loans and higher house prices, future economic growth is likely to come from the corporate sector.
- ◆ In Europe, by contrast, the second quarter slowdown really does represent bad news, since the expansion has not yet acquired a self-sustaining momentum, but for the world as a whole it is the US cycle that commands more attention — and with good reason, not only because of its size but also because its enormous appetite for imports has tended to drive the cycles of demand since the Second World War.
- ◆ Luckily a re-acceleration is probably under way already in the US. The improvement in US prospects is strongly suggested by the latest purchasing managers' and consumer confidence figures, which are both consistent with 5 per cent, rather than 3 per cent, growth. The upshot is that US economic growth for 2004 as a whole will probably end up close to the 4.7 per cent rate that became the consensus expectation in the early summer, representing the strongest year of growth since 1984
- ◆ The sustainability of **Japan's** latest economic recovery has been receiving much comment, given the slowdown from 6.6% in the first quarter to 1.7% in the second. Growth at 6.6 was too fast, but the average of 4.2 is more sustainable. Moreover, the reported slowdown in Japan was exaggerated by a collapse of government spending. Private consumption in the second quarter grew at a respectable 2.5 per cent annualised rate. Company reform is reported to be one of the foundations for the recovery, as over the last few years, companies have reduced debt and overheads and have either merged or concentrated on their core businesses, according to the Bank of Japan, which has issued comments about the prospects for a strong recovery.

Given that this is Japan's third recovery since 1990 there is understandably an inclination to scrutinise the data for the world's second largest economy very thoroughly. Deflation is reported to be slowing and business confidence and profits are improving. Standard and Poor's has lifted its rating on several large Japanese banks for the first time in 21 years citing an improvement in the operating environment, backed by the bank's efforts to reduce non-performing loans. In addition, deflation is also reported to be closer to being eradicated than at any time since it gripped the economy in the mid-1990s. Corporate profits and business confidence are also the strongest in more than a decade and the Nikkei 225 has risen over 55% since May last year.

- ◆ It seems unlikely that the world is facing a serious slowdown, a 1980s-style “double-dip recession” or even a long period of depression. While the high oil price has obviously had a depressing effect on global economic activity, it is not the main culprit behind the slowdown. And if oil is not the main cause, there is every reason to believe that global economic expansion will continue even with oil above \$40.

Anatole Kaletsky of The Times (London) explains: the fact is that the kind of slowdown in the second quarter is a perfectly normal cyclical phenomenon at about this stage of every long-term economic expansion. Economic expansions do not move in straight lines, any more than financial markets. It was always likely that the inventory-led boom of the winter quarters would be followed by a few months of slower growth.

In fact, a slowdown was not just normal but healthy and desirable, at least in America, Britain and Japan. The third year of an expansion is typically the point at which we begin to see the fading of an initial boom created by the rebuilding of inventories and pent-up demand for consumption and investment.

These initial boom conditions were encouraged by extremely low interest rates, but the early-cycle euphoria among businessmen, consumers and homeowners fades as interest rates start to rise. This cooling of early-cycle exuberance is exactly what finance ministers and central bankers need to achieve in order to lay the foundations for a more sustainable period of non-inflationary growth.

Interest Rates

- ◆ The **UK** has now had 5 interest rate rises, taking the base rate to 4.75%. This is intended to slow the property market and the rate of consumer debt which has passed the £1 trillion level. The interest rate is still below the “neutral rate” which means it is stimulating the economy. Above the neutral rate it slows the economy. The Bank of England has implied that the neutral rate is around 5% and it is expected that they will raise rates to this level in the autumn and wait until next year before making any more changes.
- ◆ The Federal Reserve has now raised **USD** rates twice to 1.5%. Another 0.25% rise is expected after the US election and rises totalling 1.75% next year taking the base rate to 3.5%.
- ◆ At the start of the year economists were predicting a fall in the **euro** interest rate as the euro was too strong and this was hindering economic recovery. Since then it has strengthened and rising oil prices are causing concern about inflation and so there have been no rate cuts. Now the ECB are considering raising the interest rate. Either way, it is not expected that the euro interest rate will change significantly in the near future.
- ◆ The **yen** was strengthening slowly early in the year and is still forecast to continue. However in recent months, it has weakened again, partly as China is trying to slow their economy and much of Japans growth is coming from exports to China.

Markets

- ◆ Investors have generally reacted to the market data by selling equities and buying bonds as we have seen stock markets drop and bond prices rise. Bonds have risen as investors believe that interest rate rises will not be as fast as they first thought, however their medium term trend is still downwards as yields become less attractive as interest rates rise. In general bad news for the bond market is good news for everybody else.
- ◆ A Sunday Times article questioning Gordon Brown’s effect on the UK stock market pointed out that since Labour came to power in May 1997 the FTSE 100 index has grown 1% compared to:
 - Japan Nikkei -41%
 - Germany Xetra Dax 13%
 - USA S&P500 17%
 - France CAC40 39%
 - Australia All-Ordinates 41%
 - Spain 61%

The reason that UK has lagged behind is blamed on the Chancellor’s raid on pension schemes in his first budget. His abolishment of the dividend tax relief for pension funds made fund managers reassess equity portfolios when the markets crashed in 2000-01. Combine this with the change in accounting rules that meant large corporations had to show their pension funds on their balance sheets and many pension fund managers reviewed their equity holdings. Many moved assets to bonds and this is a factor in the rise in bonds markets in the past few years.

With the addition of extended longevity, the majority of British companies have stopped pension schemes based on final salary and moved to pensions based on the amount contributed. This has the consequence that British pension funds are no longer the envy of the rest of the world and has moved the onus to the individual to provide for his own retirement.

- ◆ In the Morningstar European Funds Trends survey of European Fund managers published in July, 54% of managers surveyed said hedge funds would encroach on traditional managers' territory at least to some extent while 4% said the encroachment would be substantial. Hedge fund activity has been booming recently. Over half of the survey participants already offer in-house hedge funds while 50% plan to launch new hedge funds in the coming year.

Expectations for the performance of the global stock market, as measured by the MSCI World index, in the next year have reduced. Some 70% said they expected returns of 5-10%, (59% in May). Only 14% expect 10-15% returns (25% in May).

Japan was expected to be the best performing market over the next year. Some 44% chose Japan with Europe, excluding the UK, coming a distant second with 21%. Fund managers must be expecting more growth in Europe than the economists! Asia excluding Japan, which had topped the regional preferences for a number of months until recently, came in third with 14%. Overall, managers said America would be the worst performing region with Britain and Latin America following.

The fund managers said larger companies would outperform their smaller counterparts. Only 7% said small companies would be the top performer over the coming year while 61% favoured large firms. Managers were split when it came to whether growth or value would be the top investment style. Just over 30% said growth while 22% said value and the rest were neutral.

- ◆ With little or no direction in the major markets this year, many hedge funds have also seen problems in the last quarter. A majority of these funds need to see good trends in the markets to make money. They make money as markets rise and then as they fall the funds reverse their positions and "sell short" (borrow assets to sell in the expectation of buying them back at a lower price later). In a market with small movements, the trading costs can outweigh the gains. Consequently MAN AHL and Quadriga have suffered losses.
- ◆ The **oil** price has been causing major concerns in all markets. Matthew Simmons, a Houston energy analyst and banker at Simmons & Co. also a member of the Council on Foreign Relations and a previous advisor to President Bush's election campaign and Vice President Dick Cheney's infamous energy task force, has been attracting a lot of attention recently with his well documented reports that the world is fast running out of affordable oil and gas, and that no amount of Middle Eastern pumping can bail us out. U.S. oil production -- once the highest in the world -- topped out in 1970, while natural gas production topped in 1973. Both are now in decline. With world consumption of oil at about 1 billion barrels every 12 days, oil companies have pressed hard to find oil and gas in other parts of the globe. He claims that Saudi oil reserves (like Shell's) have been overstated and that their production has peaked. He sites this as a reason why they fail to deliver on promises to increase output. Russia has enormous reserves of oil, much of it in inaccessible places and is investing heavily to improve production and distribution.

The problem with oil is that China has soaked up all the spare capacity in the world and demand is starting to exceed supply. Hence the market reacts very sharply to any threat in production, from problems in Iraq or terrorism in Saudi Arabia, to the Russian government feud with Mikhail Kordorkovsky which looks like it will have the effect of breaking up Yukos, or the political unrest in Venezuela. Many hedge funds are predicting that prices will rise to the mid \$50's per barrel. This sounds alarming but when inflation is taken into account the price of oil was over \$100 in 1979. The Bank of England point out the OECD countries use just over half as much oil for a given level of GDP now than in 1970 (UK uses only 40% of 1970 levels). The Sunday Times calculate that for high oil prices to have the same devastating effect on the UK economy as in the 1970's it would have to reach \$200 per barrel. However with the US and UK running huge balance of payment deficits and changing from net oil exporters to net importers, any increase in price is going to affect them.

The Economist's house-price indices			
% changes	Q1 2004*	Q4 2002	1997
	on a year earlier		-2004*
New Zealand	22.0	11.7	47
Australia	17.9	18.4	113
Spain	17.3	17.4	121
Ireland	12.9	11.1	174
France	11.8	9.3	59
Italy	10.6	9.8	54
Britain	7.8	25.2	116
United States	7.7	7.6	53
Netherlands	6.9	4.1	75
Canada	6.3	7.0	30
Sweden	6.1	9.2	67
Belgium	5.5	9.9	54
Switzerland	3.4	4.3	11
Denmark	3.1	4.2	41
Germany	-1.7	-3.3	-3
Japan	-5.7	-4.7	-22

*Or latest

Sources: Bulweil; ESRI; Japan Real Estate Institute; Ministerio de Fomento; Nomisma; NVM; ODPM; OFHEO; Quotable Value; Stadim; Swiss National Bank; government statistics offices

The **property** bubble is showing signs of ending. The governor of the Bank of England put out a warning in June, which slowed the UK market. According to The Economist (who publish a quarterly house price index in 16 developed countries), the UK slowed down to 8% annual growth in the year ending March 2004, down from 25% pa at the end of 2002. Australia has already seen their market turn round. Properties in Sydney dropped 8% in the first quarter and by 13% in Melbourne. This has not been prompted by a rise in interest rates (they have risen only 0.5% to 5.25%) nor by a rise in unemployment (now at a 30 year low). It is attributed to the fact that first time buyers have been priced out of the market and demand from buy to let investors has fallen away as yields are unattractive. This is a lesson for other markets.

The ratio of average house price to average income exceeds the past 30 year average by 25-60% in America (av income \$55,000, av house price \$184,000), Australia, Britain (av income £25,000, av house price £150,000), Ireland, Netherlands, New Zealand and Spain. With wages rising by only 3-4% per annum in most countries, it will take many years for inflation to erode house prices to normal levels. They would need to fall 10% in America, 15% in New Zealand and 20-30% in the other 5 countries.

The Economist argues that there may be a soft landing, as lower interest rates than in the past justify a high ratio of house prices, but then goes on to point out that when a housing boom turns to bust, it undershoots the average by 10%.

- Currencies.** It is thought unlikely that the Australian dollar will see more interest rises this year, but with further US\$ interest rates likely, the gap in their interest rates will narrow, stabilising the exchange rate near the \$0.70 level.

Sterling is still very strong and likely to remain so in the short term. Rates have been trending back towards the \$1.90 level they reached in February, but seem unlikely to exceed this level.

The euro is also very strong, which is not helping economic recovery and the European Central Bank is reluctant to let it go over \$1.30

The Singapore dollar at S\$1.71 is probably at the limit of its strength against the US\$ and therefore this number is likely to drift upwards.

The Morningstar survey showed the yen and the euro were as the most favoured. Almost 40% of managers said the yen would be the best performing currency over the next 12 months while 32% chose the euro. The dollar is by far expected to be the worst performing. Sterling and Swiss francs were also favoured.
- Gold** has been very volatile, dropping from around \$420 at the start of the year to the \$380 level in May from where it rose to over \$400 before dropping back a little. Gold traditionally moves in a contrary direction to the USD as it becomes cheaper to non Americans as the USD weakens. It is used as a safe haven in times of international instability and uncertainty. The market is trying to talk it up again to the \$420-430 level. Much will depend on world events, but if the USD recovers strength in the coming years, gold can be expected to fall.

3. Investment Strategy

So what does this mean from an investment point of view? This is not specific to you, but I will be pleased to guide you if you have questions. Only those in red can be accessed through Friends Provident.

Firstly 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% or more per year. This can be achieved on a long term basis by using the **Lanson Financial & Collins Stewart funds** mentioned below. The longer you wait to start, the more you have to save. There are some guidelines in the "Financial Planning" section of our website.

Within a [long term savings plan](http://www.affinity-consulting.com/inv-monthly_savings.php), we recommend that you use funds of funds. http://www.affinity-consulting.com/inv-monthly_savings.php This ensures that somebody is looking at the asset allocation for you on a regular basis. **Lanson Financial & Collins Stewart** run funds at different risk levels for Friends Provident. Lanson are around 90% in cash at the moment as their stop loss strategy has caused them to liquidate most of their holdings, following market falls in the spring. You can select the fund most appropriate to your risk level and currency preference.

For clients approaching retirement who want more stable returns, then we recommend using the **High Income Bond funds**, property funds and the **Momentum All Weather** fund of hedge funds. Selection depends on currency and time scale.

For lump sums, the choice is extended to a wider range of funds, which are all explained on the website. We recommend that you diversify as much as possible and use actively managed funds to prevent your money stagnating in low performing funds. http://www.affinity-consulting.com/inv-monthly_savings.php We have selected:

Hedge funds: these are gaining in popularity and being used increasingly by institutions. The 2nd quarter saw hedge funds add US\$43.3 billion in assets, the 5th consecutive quarter of increase, according to TASS Research. This brings the total amount under management to nearly \$1 trillion. Their popularity stems from the fact they can make money in falling as well as rising markets and they strive for absolute rather than relative returns. They typically have higher risk as they are unregulated and can use leverage (borrowing). The way to reduce this risk is to use a well structured and well managed fund of funds. We have selected **Infiniti Capital Trust** who run 3 funds that invest in over 200 different hedge funds. They have a low, medium and high risk fund and these have averaged 9%, 17% & 23% per annum over the past 5 years. <http://www.affinity-consulting.com/inv-IC%20Growth.php> There is a minimum investment of \$50,000 in each fund, but for larger investors, these have a valid place in a medium term portfolio.

For those who want a more adventurous ride, we also offer the **Quadriga** and **MAN AHL** managed futures funds, but these are very volatile. MAN have another offering of their capital guaranteed fund, the **MAN RMF Multi-Style Series 2**. It guarantees that you will get your money back in 12 years if the fund does not perform, but it targets 13-15% growth pa with 7-9% volatility in USD & euro. It has a minimum investment of \$50,000 and closes at the end of September.

Equity funds: the same approach of funds of funds is recommended to spread risk and keep your money working in the best funds. We recommend **Lanson Financial** http://www.affinity-consulting.com/inv-lanson_optima.php & **Collins Stewart funds** http://www.affinity-consulting.com/inv-stewart_aggressive.php They have medium and higher risk funds which have been amongst the market leaders over the past few years.

Scottish Life offer a capital guaranteed product that allows some participation in major market indices on a fixed or variable basis. Called **Secure Investment Portfolio**, it offers a managed service called "Safe Combination" that allows you to benefit from the potential of the stock market and protect your capital, whilst giving you the option of locking in your profits each and every quarter.

Lower risk funds: we suggest

- A fund of traded endowment policies that has averaged over 9% pa in sterling and 6% in US dollars and 6.5% in euros, with very low volatility (**the Protected Asset TEP fund**) UK property funds, Minimum £10,000 and no penalty for redemption at any time. http://www.affinity-consulting.com/inv-aap_fund.php
- An Australian Mortgage Income Fund (**LM Mortgage Income Fund**) that yields up to 7% net per annum in Aus\$ and they are launching a USD version which will perform about 3% lower at 4% per annum, with investments starting at \$10,000 for 6 months or more. <http://www.affinity-consulting.com/inv-LMmortgage.php>
- **Commercial property funds** which are UK based and yield around 8-9% pa. Because they have long lease tenants, or are in niche markets, they are less vulnerable to a downturn in property prices. <http://www.affinity-consulting.com/inv-premier-property.php> and http://www.affinity-consulting.com/inv-brandeaux_property.php
- A blue chip US deposit fund that pays around twice the US deposit rate, with a guaranteed growth of 3% pa but you need to leave your money for 10 years or more. **The North Western Life - Optimum 5000** http://www.affinity-consulting.com/inv-optimum_5000.php

As far as **currencies** are concerned, the USD is weak and it is therefore a good time to be making investments in USD assets, depending on your time scale. The only major currencies that appear to have a prospect of rising against the US dollar in the near future, according to fund manager consensus, are the euro and the yen. It is certainly not a good time to be converting from USD to other currencies. Do remember

that if you are converting currencies, we can arrange the transfer and conversion more cheaply than your bank. See <http://www.affinity-consulting.com/serv-caxton.htm>

4. Fund Performance

To 31st July 2004

	Price	1 month	YTD	1 year	since 1 Jan 2002	
FRIENDS PROVIDENT FUNDS						
Lanson International Growth	1.026	-1.7%	-8.0%	7.7%	9.6%	Since launch in May 2002
Lanson Optima Fund	0.629	-1.6%	-4.8%	10.9%	4.9%	
Collins Stewart Aggressive USD	1.223	-3.7%	-0.2%	15.3%	31.6%	
Collins Stewart Growth USD	0.995	-3.3%	-1.9%	11.0%	10.5%	
Student Accommodation (GBP)	1.247	-0.1%	2.5%	5.8%	19.5%	
Momentum All Weather (USD)	1.098	0.1%	2.0%	4.0%	10.2%	
S&P 500 Capital Return	1,107	-1.7%	-0.2%	12.9%	-5.6%	
Dow Jones Indust Cap Return	10,179	-1.0%	-2.2%	11.2%	-0.8%	
NASDAQ	1,892	-5.7%	-5.7%	10.3%	-8.1%	
FTSE 100 (in GBP)	4,416	0.2%	-2.1%	7.7%	-17.1%	
MSCI World Index	1,027	-3.34%	-0.9%	15.7%	2.3%	
NOT AVAILABLE THROUGH FRIENDS PROVIDENT						
Protected Asset TEP Fund (GBP)	1.350	0.6%	4.7%	9.1%	17.8%	
Infiniti Security Fund	847.43	-0.7%	-1.5%	1.5%	17.1%	
Infiniti Growth Fund	820.82	-0.8%	-3.4%	4.7%	28.2%	
Infiniti Momentum Fund	877.44	-0.8%	5.5%	16.4%	45.2%	
Quadriga GCT USD	2,085	0.2%	-11.5%	6.9%	89.4%	

As you can see, the fund of funds approach of Lanson Financial and Collins Stewart has considerably outperformed the market indices over a 2 year period. Lanson and Collins Stewart came down more than the western indices last quarter, as they were more exposed to emerging markets and India in particular took a large hit after the election. Lanson is over 90% in cash as a result of nearly all its stop loss points being triggered.

The fact sheets, graphs and commentaries for all the funds we work with can be found on our website in the "Investments" section.

With so little movement in the main markets in the past few months since the drop in the spring, the hedge funds have suffered as well, as explained above.

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. We also have links with a property consultancy in Dubai that will find a property and arrange a mortgage for you. Details of these services are on our website, but please let me know if I can help.

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

Clive Ward