

There is a lot of information here, too much for some maybe, so I have restructured the format of the newsletter to give you the performance information first, as I realise that not everyone finds the economic outlook a riveting read. I hope you find it of interest.

One thing before we get too far into this, with a new year starting, it is opportune to review whether you are saving enough to meet your goals. I would be pleased to review this with you.

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### 1. Introduction

2004 was a lack lustre year in most markets. Stocks rose in Q1, dropped in Q2, went flat in Q3 and then saw good growth in the last quarter. Bonds saw much lower growth than in 2002-3, the brakes were applied to the property markets, even hedge funds, which have seen excellent growth for at least 5 years, slowed considerably. Commodity growth has beaten equities and bonds for the past 3 years but even they turned down significantly at the end of the year. After the big slump in 2000-2, global profits & industrial output rose substantially after falling back a little in 2003, creating a substantial cash pool that is awaiting investment as confidence returns.

Global trends are swinging away from small governments with small deficits to big governments with big deficits, from world growth being led by the USA to being Asian led, from a US boom to a US dollar decline, and from growth in large capitalisation stocks to small capitalisation stocks. As more of the world's underdeveloped nations become more advanced, their requirement for the basics of water, energy and healthcare increase. We are seeing a switch from technology led stock growth to companies supplying these fundamentals.

The economic climate is stable at the moment and so 2005 is likely to be a year of benign growth in the US, UK and western European markets but with good growth in Asia and Emerging Europe. Overall, global growth is predicted to slow from around 6% last year to 3% this year. Commodity prices are expected to slow down and even drop in some markets, similarly, property should slow down and possibly fall a little. Equity, commodity and currency markets could show more volatility than last year and this will be good for hedge funds which should come close to resuming their more recent growth rates. The US dollar has become the world's dominant currency and without confidence in it, the world has no reserve currency. By definition though, the dominant currency becomes weak as everyone holds too much of it. Confidence is therefore a key factor. It is anticipated that it will continue its decline but is unlikely to crash.

### 2. Affinity Website

If you have not looked at our website, [www.affinity-consulting.com](http://www.affinity-consulting.com) please do take a little time to have a look. If you have used it, I would be grateful for feed back please. It contains:

- ◆ Factsheets, prices and performance information for the main investments we recommend, updated weekly
- ◆ Currency converter and daily summary of the main stock market indices, currencies, interest rates and precious metals
- ◆ Information on expat mortgages, which we can arrange for you (except in Dubai)
- ◆ General explanatory information on types of insurance
- ◆ Explanatory information on trusts
- ◆ Financial planning information, including how much to save for a pension.
- ◆ Graphs of the major stock markets, currencies, property prices and inflation in the Useful Information section

And much more!

### 3. 2004 Performance

A study of the figures below indicates that the main growth last year was in Asia and the emerging markets and most of it came in the last quarter. It was a year of low volatility with lack lustre stock market performance, reducing bond yields, rising commodity prices until they suffered a dramatic fall in the last 2 months. Small companies grew more than big ones, as can be seen from the Dow Jones Index (top 30 companies in USA) rising only 3.6% whereas the wider Standard & Poor's 500 (top 500 companies) rose 9.3%. The FTSE 100 coming in midway between them. These markets are still well below their 2000 peaks and the FTSE is much slower to recover than the American markets for the reasons discussed later.

Compare these to the MSCI (Morgan Stanley Capital Index) for Asia and the emerging countries:

Emerging Eastern Europe	32.1%
Emerging Market Index	22.4% (all emerging markets, S America, E Europe, Asia etc)
Asia Pacific	19.0%
India	11.0%
Also:	
Nikkei	7.6% (Japan)
FTSE Eurotop	8.8% (Top 100 European companies)
Credit Lyonnais China	-3.5%

#### To 31<sup>st</sup> December 2004

	Price	1 month	1 year	since 1 Jan 2002
S&P 500 Capital Return	1,212	1.7%	9.3%	3.4%
Dow Jones Indust Cap Return	10,783	1.8%	3.6%	5.1%
NASDAQ	2,175	1.3%	8.4%	5.6%
FTSE 100 (in GBP)	4,814	1.4%	6.7%	-9.6%
MSCI World Index	1,453	3.8%	15.2%	24%
Goldman Sach's Commodity Index		-10%	17.3%	87%

#### FRIENDS PROVIDENT FUNDS

Lanson International Growth	1.162	4.1%	4.2%	24.9%	Since launch in May 2002
Lanson Optima Fund	0.687	3.9%	3.9%	15.1%	
Collins Stewart Aggressive (USD)	1.416	4.0%	15.6%	54.6%	
Collins Stewart Growth (USD)	1.131	3.5%	11.5%	25.3%	
Student Accommodation (GBP)	1.302	2.0%	7.0%	24.8%	
Momentum All Weather (USD)	1.125	1.3%	4.6%	12.3%	

#### NOT AVAILABLE THROUGH FRIENDS PROVIDENT

Protected Asset TEP Fund (GBP)	1.389	0.6%	8.2%	17.8%	To 1st Dec 04
Protected Asset TEP Fund (USD)	1.067	0.6%	6.7%		Launched Dec 03
Protected Asset TEP Fund 2(GBP)	1.120	0.7%	12.1%		11 months to 15 Nov 04
Infiniti Security Fund	875.83	1.5%	1.9%	21.1%	
Infiniti Growth Fund	862.80	1.1%	1.5%	34.7%	
Infiniti Momentum Fund	894.62	0.6%	7.5%	48.1%	
Quadriga GCT USD	2,618	0.8%	11.2%	137%	

Details of all these can be found on our website [www.affinity-consulting.com](http://www.affinity-consulting.com)

I have added the Goldman Sach's commodity index for comparison, but this is weighted 72% towards oil & gas. You will see it has outperformed the stock markets over the past 3 years.

Hedge funds had their worst year since 1998. The slow year was a combination of a number of factors. Hedge funds can and do borrow money to invest to enhance their performance, but once they could see interest rates rising last year, many unwound their loans and this reduced their growth. Because hedge funds make money by exploiting anomalies in the markets and following trends, they need movement. Last year saw little direction in any market and hedge funds suffered accordingly.

The **Collins Stewart** and **Lanson Financial** funds have comfortably beaten all the major indices over the past 2 and 3 years. Lanson lagged behind a little last year as they were exposed to India and China when they took a big drop in the 2<sup>nd</sup> quarter. Nonetheless, they still beat cash deposits in 2004 and were ahead of Collins Stewart in 2003. To keep up with the MSCI world index, a fund would have to have been heavily invested in Asia and Eastern Europe which are traditionally more risky areas. Therefore it is only the aggressive funds that followed that strategy. The Collins Stewart Aggressive fund has been a star since it launched in 2001.

The active management fund of funds strategy that these 2 fund managers follow, is out performing most other managed funds which are not so actively managed. Lanson have performed better than some funds which have received awards from Standard & Poor's last year. The Collins Stewart Aggressive fund has outperformed most funds of hedge funds over the last 3 years. We recommend that clients diversify between the 2 managers, according to their risk profile.

The **Student Accommodation** fund will still accept new money but will not allow switches of existing money into it. It has maintained its consistent growth and is expected to be able to sustain this, even if property prices slow down.

The **FPIL Momentum All Weather Liquidity** fund used to feed into the Pioneer Momentum All Weather fund, but this closed in the middle of last year as it was getting too big. A new fund, Momentum Strategies II was launched with a very similar strategy – a fund of low risk hedge funds - seeking a consistent absolute performance. It is possible that being a new fund with a smaller amount of money to invest initially, it could see better performance than the original fund this year. The FPIL AW Liquidity fund maintains its investment in the original fund but feeds new money into the new fund.

The **Protected Asset TEP Fund** (PATF) invests in 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. It also hedges to US dollars and euros. They have also launched a new fund, imaginatively called PATF 2 and this is performing better, as it was launched at the bottom of the markets and has been buying endowments at very good prices.

We started to work with the **Infiniti Capital** hedge funds last year. These are a set of low, medium and high risk fund of hedge funds. They work with up to 200 fund managers and have rigorous criteria for selection and management. They have been very successful and are highly regarded in the industry. Like the whole industry, they suffered their worst year so far in 2004 but still maintain a very strong long term record over the 5.5 years they have been operating. The average of the 3 funds over this period is over 16% pa growth. They are much more optimistic about the prospects for 2005. They also launched a capital guaranteed version of their fund in conjunction with Barclays Bank last year and due to its success, they will repeat it this year.

The **Asset Backed Securitization Bond** that we brought to your attention at the end of last year has another tranche. The 5 year bond guarantees your capital and a coupon of 10% per annum in USD, sterling or euros. What is more, the original tranche is now being rated by S&P at A (or better) and will be floated on the Luxembourg exchange in May and so those of you that bought it could sell it at a substantial premium (15-20%). It is planned to float subsequent tranches as well, so this gives you the choice of holding the bond and receiving your 10% each year, or selling it for a premium and buying another. It is rather like an IPO but for a bond.

**Currency** may well have played a part in your investments. If your home currency is not USD based, then some of your gain will have been eroded by the weakening of the dollar. However, many international funds that are priced in USD are holding assets in another stock exchange in local currency. Consider a \$1000 investment in European fund when the euro was at \$1.0, you would have bought 1000 euro's worth of stock. Assume the stock price did not move but the USD is now \$1.30 to the euro, your investment is now worth \$1300. The more aggressive Collins Stewart and Lanson Financial funds moved most of their assets outside of the USA last year in anticipation of the weakening dollar and of higher market gains. This also increased their exposure to these more volatile markets.

To make the point, the gold price rose by 3.9% last year but the dollar lost 2.3% against the euro and 1.6% against sterling. Over the last 3 years, the gold price has risen 52% but the dollar has weakened by 45% against the euro and 30% against sterling. Gold is still a good hedge against currency fluctuations but depending on your base currency may not see gains that are better than high interest cash deposits. An American once said to me that 1 oz of gold through time has always "bought a suit and a pair of shoes", - true if you don't use designer shops.

#### 4. Where To Invest for 2005?

It can be difficult for the layman to keep up with the trends in the world and for a busy person to monitor their investments closely. 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

1. How long you want to invest
2. 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. This can be seen from the 3 year figures in the table above. Even the FTSE is likely to recover and show reasonable growth in the next 7 years.
3. 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)

This year is likely to be one where we see:

- ◆ the US dollar weaken a little more
- ◆ Emerging Europe and Asia outperform the US, UK and Europe in equity markets
- ◆ hedge funds do better than last year but maybe not the stellar performances of 3-4 years ago
- ◆ property funds continue at 7-9%
- ◆ bond yields decline as interest rates rise in the USA
- ◆ gold to move inversely with the value of the US dollar and commodities in general slow their rapid rise as growth in USA and China slows.

**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. As you near the end of the term, you could move some of money to lower risk funds such as Momentum All Weather or property or bonds.

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

- ◆ Short-medium term (5 years or less) savers can use the PATF in sterling (av 8% pa), USD (6-7%) or euro and there is a similar fund for Australian dollar investors, the LM Mortgage income fund returning 7% pa on the A\$. Also, the Asset Backed Securitization Bond pays 10% pa and it will be floated on the Luxembourg exchange, enabling an early exit at a premium.
- ◆ Medium-long term savers can use the Collins Stewart and Lanson fund of equity funds and also diversify into hedge funds offered by Infinity Capital. As well as the funds above they have an 8 year capital guaranteed fund (by Barclays Bank) that has achieved 19% pa over the past 5.5 years and pays out the higher of:
  - The end price

- 80% of the highest price over the 8 years
- Your initial capital

For low risk, we recommend the PATF, property funds and low risk funds of hedge funds, the best being one that we have stated to work with more recently, the Aurum ISIS fund of hedge funds which has averaged 9.9% pa over the past 5 years with very low volatility.

Please do contact me if you would like to review your situation.

## 5. Economic Outlook

As usual, I spent a considerable time after Christmas reading and distilling a large number of economic forecasts for 2005. I have put together this consensus for you and hope you find it useful.

Since the market crash in 200-2001, the markets have been coming to terms with the end of the 1990s bubble and have been in react mode. Confidence is rebuilding, but slowly. Markets react to event but can also help shape events as they did in the late 1990s. "The Economist" believes that this will be the year when the big adjustments that usually happen early in the global growth cycle finally start to take place. Previous recessions in the early 1980s and in 1990/1 both had early cycle slowdowns and each preceded a stronger second cycle. There is a possibility that these adjustments will be damaging but the consensus seems to be that markets will be orderly.

When I last wrote the markets were very preoccupied with 3 factors:

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

They have come to terms with terrorism and the oil price has receded to manageable levels, but supply is still a major concern. The main concerns now are:

- oil supply
- the effect of increasing interest rates on the US economy and on global growth
- the weakness of the US dollar
- how much the application of the brakes to the Chinese economy will affect global growth

On the positive side:

- inflation should remain low
- interest rates are close to their peak in UK & Europe
- house prices worldwide will cool or fall modestly but should not crash
- the oil price will remain high, but has probably peaked.

### Growth

- ◆ The world saw good economic growth last year (around 6%) and this is expected to continue this year but at a slower pace. Confidence in investing has been returning slowly, after a long bear market in stocks, the war in Iraq and the fear of terrorism.
- ◆ **The British economy** grew at 3.25% last year but it rarely grows at over 3% for 2 consecutive years (last in 1997/8) and so it is anticipated it will grow around 2.75% this year. Inflation in the retail price index has averaged 2.5% for the last 12 years and although there are some predictions it will increase, the consensus is that it will be just below the target of 2% this year. This bodes well for employment which has been increasing over the past decade. The surplus in the labour markets in the 1980s caused by the baby boomers, led to high unemployment. The steady fall has meant more people have been drawn back into jobs and the number claiming unemployment is only 2.7% (wider measure 4.7%) and this may be as low as it can go. This robust level of employment bodes well for the property market and consumer spending. The OECD predicts that the economy will run out of spare capacity in the second half of the year and growth will slow or risk inflation. The Treasury does not dispute this.
- ◆ **The American economy** grew by 4% last year, creating over 2 million jobs and reducing unemployment to 5.4%. However, productivity is rising, leading to a slower creation rate of new jobs. Consumer confidence was high, with the weak dollar bringing European tourists to the US for Christmas shopping. Most economic indicators point to another good year. Incomes are rising faster than inflation, giving consumers a boost. Americans are wealthier now than a year ago, with rising house prices and increasing stock market values and with low interest rates, consumers are likely to keep spending. Businesses are also in good shape and according to Standard & Poor's, American companies are sitting

on a cash pile of almost \$600 billion compared to \$260 billion five years ago. Many have lacked the confidence to invest, but with an easing in oil prices and a lowering of tension in the world, it will not be long before they start investing in long-approved capital projects.

- ◆ There is no quick fix to the problem of the **US current account deficit**. With intense competition and plenty of surplus labour, America is unlikely to see any real inflation for a year or two and so it may be inclined to allow the dollar to continue its devaluation. It will probably allow the deficit to rise and expect Asia to continue to finance it (the Asian central banks are massive buyers of US Treasury Bills).
- ◆ As always when I read the many articles, there is a great divergence of views. The Wall Street Journal ran an article "Market Outlook for 2005? Depends Whom You Ask" in which it pointed out that respected Wall Street analysts vary considerably in their forecasts for **growth in US stock markets** from 0% to 20%. Similarly, Business Week surveyed 60 economists on their predictions for US economic growth which varied from 2.3% to 4.6% with the consensus at 3.5% for 2005.
- ◆ **Europe**, by contrast is still struggling. It failed to meet its growth target of 2% last year and looks as though it will be lucky to achieve 1.5% this year. It is suffering from high unemployment and weak consumption caused by restrictive labour markets. Germany in particular, is more dependent on exports than UK or France and so is the weakest. Germany has some of the highest labour costs in the world. They are 44% higher than the USA, 50% higher than Japan 380% more than Central Europe and a staggering 510% more than China (according to Credit Suisse private banking). The strong euro has affected the European export market and exposed them to competition from America and Japan. At the same time, even cheaper Chinese and Korean exports destroy the low-cost labour-intensive industries which provide millions of Europeans with jobs. Whereas Asian countries intervene in currency markets to stop their currencies becoming uncompetitive, Europe has a free market approach, which Anatole Kaletsky of The Times (London) points out, is bizarre as the weakness of their domestic economies is because they have rejected free market policies. If the euro maintains its strength, then the European Central Bank will face intense pressure to reduce interest rates. If it does so, it will give Europe its first chance of recovery since 1999, which would in turn reduce the US trade deficit, strengthen the dollar and allow an orderly decline of the euro.
- ◆ **Emerging Europe** has shown good growth and their stock markets have been amongst the top performing markets for several years now. Historically countries joining the EU have seen significant outperformance in the years that follow. With lower taxes and up to 80% lower wage cost, they are poised to continue this growth. Watch Poland, Hungary and the Czech Republic.
- ◆ **The Japanese economy** grew at an annualised rate of 3% in 2004. The Bank of Japan governor said this month that he was confident about the Japanese economy given there is rising capital expenditure, shrinking excess capacity, falling unemployment and a reduction in non-performing loans. With signs of a solid recovery, Japan stopped selling yen after March as the economy can now withstand a stronger yen. Japan's recovery has been on the back of China's expansion. 80% of all Japanese exports went to China over the past 2 years. The Credit Suisse economist made the analogy that in the US gold rush, it was not the average prospector that made money, it was the guy standing at the bottom of the hill selling shovels that did best. Japan has been selling a lot more than shovels but its recovery is inextricably linked to China. With China expected to slow a little this year, Japanese growth is forecast at 2% for 2005.
- ◆ The 18<sup>th</sup> & 19<sup>th</sup> centuries were the British centuries when industrial, political and imperial development in Britain shaped the world, the 20<sup>th</sup> century was the American century where the USA changed the world, helping achieve victory in 2 world wars and developing most major new technologies – computers, telephony, cars, entertainment, pharmaceuticals etc. The 21<sup>st</sup> century is likely to be the **Chinese century**. Lord William Rees-Mogg, former editor of The Times of London wrote an interesting article in The Times pointing out that there is an economic principle of marginalisation which says that all economic change is determined by what happens at the margin of transaction. The extra apple sets the price of all apples, if there is one apple short, all apples cost more, if there is one surplus, they all cost less.

Although the USA is still by far and away the most powerful economy with the most powerful defence technology, it is China that is changing the global economy. Almost all economic forecasts for equities, bonds, commodities and currencies depend on China. As an exporter and importer, China is pulling the marginal levers of global supply and demand. China and the USA account for half of all world trade. **The Chinese economy** is growing at twice the rate of the USA. Over the past 30 years the whole Asian economy has averaged 3% higher growth than the rest of the world. China is outperforming the rest of Asia. Over 60% of the labour force still works on the land at low wage and peasant productivity, but it gives an indication of the massive reserve of manpower that can still be brought into the economy.

China has understood the importance of good domestic and international freedom of trade and of having good relations with trading partners. China has been one of the biggest contributors to the tsunami disaster. The economic maturity has been accompanied by economic maturity and this should give the economy another 25 years of high growth.

The rapid growth of the past years has run the danger of the economy overheating and the brakes have been applied by restricting bank lending. This year growth is forecast to slow to 8% from 9% last year. The stock market is still small and retail dominated and Credit Suisse has warned it may be due for a correction.

- ◆ **Asia**, excluding Japan, is forecast to slow from 8% growth last year to around 6.5% this year. India is a major driver of this growth and could be nearly as significant as China as a future engine of world growth in years to come. Together, the two countries represent over one third of the world's population but only 6% (India 2%, China 4%) of the global economy. The Indian market may see some profit taking after last year's big run up, but its long term trend is good. India has been invited to attend the next G7 meeting for the first time. China and Russia have already been attending. Exporters who ignore India and China for their products and services, do so at their peril.
- ◆ The recent **tsunami** had a devastating and tragic human cost and humbled the human race in the face of such awesome power of nature. However, the economic effect will probably be positive. The huge amount of money needed for reconstruction will provide a boost to the economies of Sri Lanka and Indonesia. The cost to the insurance industry is small, as the devastation was amongst the world's poorest people who had little or no insurance.

## Interest Rates

- ◆ **The UK** has now had 5 interest rate rises, taking the base rate to 4.75%. This has had the intended effect of slowing the property market and it appears unlikely that we will see more rises this year, or at most one quarter point rise, which is where the Bank of England implies the "neutral" level lies. The markets need time to absorb these rates and the Bank needs time to assess their effect. The UK Sunday Times predicts it will finish the year lower at 4.5%.
- ◆ The Federal Reserve has now raised **US dollar** interest rates five times to 2.25%. Most analysts are predicting further rises, possibly another 5 of them, taking the rate to 3.5% by year end.
- ◆ **The euro** interest rate rose to 2% last year but is unlikely to rise again this year as the economic outlook in Europe is still not good. The euro is too strong compared to the US dollar and raising rates would exacerbate the situation.

## Currencies

- ◆ The weakness of the US is continuing to cause worry around the world. It strengthened towards the end of last year, but this is likely to be a short bounce and the decline will continue. Despite the academic debate about the possible collapse of the US dollar, it seems that realistically it is unlikely to drop much more than 10%. It will not be long before the policy mistakes and economic imbalances that caused the decline start to be redressed. The most important of which (according to Anatole Kaletsky of The Times) is not the US trade deficit, but the weakness of consumption and employment in Europe. At \$1.30 to the euro, this is still hurting the export capabilities of Europe and causing an inflow of cheap US products, (which particularly annoys the French). If the ECB fails to ease monetary policy, the markets will force them. By pushing the euro higher against the dollar, hopes of a recovery in Europe diminish and the ECB will be forced to cut interest rates for internal reasons and although this may be too late for recovery, it will trigger a collapse in the euro. If it reaches \$1.35 again, it could be a good time to bail out into dollars.
- ◆ If the dollar reaches \$2 against sterling, it will be driven by bearish views on the dollar, rather than by enthusiasm for sterling. However it is unlikely to remain there for long and would be a good time for sterling holders to buy dollars. The UK current account deficit has risen to an annualised £28 billion (representing 4.5% of GDP - according to The Sunday Times) and looks set to rise to £32 billion this year which should help to weaken sterling against both the dollar and the euro.
- ◆ Talking to traders, particularly hedge fund managers, they all say that currency markets are the hardest to predict. They often move unexpectedly and sharply. Hedge funds accounted for 33% of total currency trade last year with an estimated \$633 billion per day. Non financial corporations traded 14% of the

market, according to the Bank for International Settlements. As I mentioned above, confidence is crucial in maintaining strength in the US dollar, hedge funds take great delight in testing confidence and trying to exploit or create anomalies in markets. If pressure is exerted on the dollar, it could start here.

- ◆ The key focus on currencies is likely to move to Asia where there is discussion on whether the Chinese will revalue the renminbi. Expectations are high that it will happen this year.

## Markets

- ◆ **The US stock market** is expected to show growth this year but it will be lucky if it reaches double digits. Confidence is returning and company valuations are around fair value. Companies have the cash for major capital projects and if they start to apply this, the markets will react accordingly. Forecasts are from 0-20%, not very helpful, except they are positive.
- ◆ **The UK stock market** has been slower to recover from the crash than most of the world's markets. A major factor in this has been the Chancellor's raid on pension schemes in his first budget. He introduced a tax on dividends. This caused UK pension funds to spread their asset allocation over a wider breadth of assets and particularly since the crash, many have not reinvested in equities to anything like the same level as before. Consequently most stocks are still below fair value and so the belief is that with the UK and the world economy continuing to grow, we are likely to see a rise in the FTSE 100 of up to 10% this year.
- ◆ The major gains last year came from the **emerging markets** and this is likely to continue this year. An increasing number of actively managed funds are allocating assets to India, China and emerging Europe. With emerging Europe, it is the debt market that is attracting attention as much as their equity markets. With steady growth, corporate bonds have performed very well over the last 2 years.

## Property

- ◆ The property bubble seems to have ended. The Economist is still arguing (as it has been for over a year) that houses in America, Australia, France, Ireland, Spain, The Netherlands and UK are overvalued. House prices and rents are linked and rents are low while house prices are high. In investment terms, the p/e (price/earnings ratio) is too high. On this basis, property in Australia, Spain & UK is 40-60% overvalued. They argue that in the past, incomes rose with inflation so that mortgage payments quickly became a smaller part of monthly income. However with low inflation, this will not be the case and many have overextended themselves with cheap mortgages and they will feel the impact as rates rise. The other argument that because land is limited, prices have to rise. is flawed. If population growth was pushing up prices, rents would be going up as well.
- ◆ In UK, the Halifax predicts a small fall up to 6% this year with up to 20% in 2006, however the Nationwide takes the opposite view and expects a 2% rise this year. New home loan approvals have fallen to their lowest rate in 9 years. The UK Sunday Times economist thinks the market will rise by 2-3% whereas their property editor thinks it could be plus or minus 2%. Another Sunday Times article predicts a fall of 2% with a further fall in 2006. Despite the 2 biggest lenders having diverse views, most economists in UK believe the Bank of England has engineered a soft landing and that prices will simply stagnate for a while. The reality is that with low inflation, prices will have to stagnate by 5-10 years to allow rents and personal incomes to catch up. The area to watch is the buy-to-let sector in most countries. Whereas owner occupiers can weather the storm by not moving, those who have bought as an investment will be more inclined to sell and put their money elsewhere. House prices have fallen in London and Sydney and just as the price rise spread round the world in the first ever global property boom, so the fall – or stagnation – could also be a global phenomenon. Unlike stocks or commodities, property does not crash but drifts lower over several years. The Economist gloomily and uniquely predicts that prices will fall 10-20% in America, and 20-30% in Australia, Spain & UK. Most other economists are more optimistic. Only time will tell.
- ◆ For those clients in **Dubai**, the property market here is unique in the world. Which other city is planning a five fold (or more) expansion in the next 6 years? A new business district to equal Manhattan, theme parks bigger than those in Orlando, 3 man made palm islands (with rumours of more) and 200 islands offshore in The World, the world's tallest building, biggest shopping mall and largest indoor ski snow ski slope, a sports city of Olympic standards, a healthcare and medical research facility of global proportions, new ports and airports ...and so it goes on. The market is immature and many people have already doubled their money in the property market, even before their property is built. It is a highly speculative market – a property gold rush. At present there are more buyers than property available. Between 60-

65% of all property being built is bought by speculators and with so much going up, it remains to be seen if there are sufficient end users when they are all completed. A simple "light bulb" test shows very few lights at night in the 4 marina towers already completed. Add to that the variable quality of build of some properties, the fact that true freehold title is still not available and the high political risk of the Middle East and the advice I am given by my clients who are builders is to risk the premium and only buy a property after it is built. At least then you know what you are buying and can assess its true market value.

## Commodities

- ◆ Commodity prices were very volatile last year but they have outperformed equities and bonds in the past 2 years. As a consequence, many pension funds have allocated some of their assets to this sector as a counterbalance to equities and bonds. Industry estimates that the money tracking commodity indices rose \$15 billion last year to \$40 billion with most of this extra money coming from pension funds. There is now concern that this may be a bubble. The recent strengthening of the dollar caused a drop in precious metal prices and the slowdown in China means that their previously insatiable demand will reduce this year. Shipping rates have already fallen due to a reduction in Chinese imports.
- **Gold** has been very volatile, ending the year not much higher than it started at around \$420. Gold traditionally moves inversely to the strength of the USD. If the USD weakens further, expect a rise in gold prices. The net effect of holding gold to non USD based investors is that the value against their home currency (S Africa for instance) has rarely beaten cash deposits.
- **Oil** prices are likely to remain high for the foreseeable future, but the world is less dependent on oil today than it was in the 1970s. Also if the price is adjusted for inflation then it rose to nearly \$70 in the early 1980s in terms of last year' money. Much of the rapid rise last year was caused by speculation, particularly from hedge funds, rather than shortage of supply. Saudi Arabia does not have the market muscle to control the price, it can however control supply. Saudi has the world's largest proven oil reserves, followed by Iraq and the UAE and Russia. OPEC could lose its grip on supply if Iraq leaves the cartel and it could also be threatened by Russia, who are unlikely to abide by informal export restraints they may have promised. A free for all could bring prices down again which is good for non oil producing countries, but the petro-dollar economies need a price of over \$20. Most economists believe the price will remain high this year. However according to The Economist, after 2010 and especially after 2020 the Middle East's share of oil reserves will rise dramatically. Two thirds of the world's remaining oil will be in Saudi, Iraq, UAE, Kuwait & Iran. Saudi and the Middle East will eventually have a stranglehold on supply and so on price.

If you have made it this far, well done, I hope you found it useful.

*Clive Ward*