

Pegasus View Quarter 2 2008

Despite January being reported as the worst start to Investment markets since 1935 in the first quarter of 2008, there was worse to come! Quarter 2 2008, started its 'roller coaster' ride with a rally in April and May, bringing some relief to investors, but was short lived in June when the gains were more than cancelled. In fact it was the worst monthly investment performance for 26 years.

USA

The emergency rescue of Bear Stearns by JP Morgan Chase gave investors a sense that the Central Banks had the ability to ensure the survival of the system. However, continuing worsening global inflation following the surge in oil and food prices, renewed credit concerns and weak US employment numbers soon eroded investor sentiment. The US Federal Reserve (Fed) keeping the interest rate at 2% has allowed home owners some stability and continues to give the belief that the Fed has the ability to deal with problems better than other Central Banks. Particularly given the experience they had with a similar problem, namely the Savings and Loans crisis of the 1990's. The governments guarantee for the larger banks, coupled with the continued interest of Sovereign Wealth Funds has given some stability in the economy and some growth is expected.

UK & Europe

High energy and food costs have dominated the market since mid-May, when the markets fell sharply following the long awaited rally and finished just above the March lows. Dominating the limelight in this quarter has been the concern over UK banks and the continuing reported losses surrounding the credit crunch dilemma. Many have had to raise additional equity in order to strengthen badly damaged balance sheets and in turn have tightened their lending criteria, which, of course has had a negative knock-on effect on the housing market. This in turn will have an effect on employment, where we are likely to see higher job losses and redundancies. Reports are that interest rates will remain at 5% and that the Bank of England will resist reducing them.

Europe's story is very similar to that of the US and the UK due to a combination of high energy prices high interest rates and a strong currency. However it has a much more rigid labour market than the US and we could see growth surprise us on the downside in Europe. At present cheap equity valuation is not just common to the US, as in Europe the Price to Earnings ratio (P/E) is close to single figures.

Credit Crisis

As mentioned in Q1, this topic has been well covered, but continues to effect the economy on a large scale, now and possibly for some time to come. Banks were the worst performers in the FTSE index and banking shares appear to be in freefall. Investors are waiting and fearing further write down by some of the major banks as share prices have fallen below the price at which they seek to raise new capital (rights issue

price). There have been 80,000 job losses in banks and brokers since the sub prime crisis began, with a knock on effect into the estate agency business, with an incredible number declaring bankruptcy. This in turn has led to further job losses in related sectors such as construction and home improvements. Despite this the view is that valuations of banks and house builders are low and share prices will enjoy a significant bounce when we see a market rally.

Commodities

The rising oil price to a massive \$147pb from \$100, due to rising Asian demand, lack of reserves and fears of supply disruption, coupled with the credit crunch is having a significant effect on inflation. However, we are already seeing declines in demand, as Asia is showing a slowing economic growth and the removal of oil subsidies. An increase in supply by Saudi Arabia, together with tighter regulations concerning energy futures trading, should improve market stability and put downward pressure on prices.

We have seen an increase in institutional money being invested in commodity indices, from \$13bn in 2003 to \$260bn, to meet the demand from speculators and this is an area where most managers predict growth.

Outlook

Following our meetings with the Managers at the quarter end, the one area that they all agree on is that this has been an exceptionally difficult year for predicting markets! For the first time all asset classes were posting negative results, with only cash being a safe haven. Saying this, the summary for the outlook is bullish with a rally being imminent. All the Managers have been active in trying to minimise the losses, where possible, decreasing equities where their mandate allowed it. However, market timing has been at its most difficult and just when the 'roller coaster' seems to be stopping, it increases in momentum again. Most Managers believe that we will see a rally by the year end and are increasing their exposure to the US, where they believe the best returns will come from. Should we see a significant decrease in the price of oil or at least some stability, together with the current cheap equity valuations, this should produce a strong rally, however, there may still be a bumpy ride through September and October, with Managers having to select their asset classes and stocks carefully.