

Welcome to the latest investment newsletter from your award winning advisers.

You may or may not be aware that we won **"Investing for Income Planner of the Year"** at the Money Management Awards. Our support team also won **Paraplanner Team of The Year** and we were shortlisted for Best Adviser Firm—Treating Customers Fairly, and Best Investment Adviser at the at the New Breed Adviser Awards.

We are also delighted to announce that we have made the shortlist for **Best Investment Adviser** in the Money Marketing Awards and are hopeful of a win at the award ceremony in March.

We are up against large national firms such as Hargreaves Lansdown and BestInvest. We are really pleased to be competing at this level, and we hope our more personal approach may give us the edge. Wish us luck!

For further details, please see our "Applewood Awards" briefing note.

## Inflation, Deflation and the Low Interest Rate World

You will often have heard us refer to real returns, or in other words, what return has been achieved after allowing for inflation.

We are used to needing to achieve 7.6% per annum for example, if we want to provide a 5% income and grow it above inflation at 2.5%. However, some economists are now forecasting a short period of deflation, or at least a period of very low inflation.

Deflation changes the picture substantially.

As an example, government bonds are currently yielding not much more than 3% per annum.

If inflation is 2.5%, then after tax most investors would be losing money in real terms with this yield.

However, if inflation is below this level, then government bonds look much more attractive.

If we did see deflation, say a short period at -2%, then the 3% yield on a gilt equates to a real return of 5% per annum - not too bad for a government guaranteed investment.



Opinion is divided about whether we will see deflation. As banks hoard money rather than lend it, we see a reduction in the amount of money in circulation. This is deflationary.

However, the demand trends that led to the \$140 barrel of oil last summer are still there. The emerging countries are still demanding more energy year on year, and have greater aspirations for those luxuries we all take for granted. These long term inflationary pressures will eventually win over the shorter term deflationary concerns. But knowing when that will be is difficult to predict.

### A Distinct Lack of Interest

In the meantime, the low inflation environment means interest rates are at their lowest levels in the Bank of England's 315 year history, and are likely to go even further, perhaps almost to zero. This means returns from cash are likely to be very poor in the short term.

Premium Bonds (never good investments at the best of times in our opinion!) now return an average of 1.8% per annum.

The prize rate is currently around 60% of base rate and the last three cuts have not yet been passed on by National Savings. Therefore, the return is likely to fall below 1% in the near future.

Don't forget that for most premium bond holders, the return they receive is slightly below the average return. That's because those returns include the £1 million prize, which is effectively paid for by the rest of the bondholders.

## Fixed Interest Markets and Fiscal Stimulus

We are no longer holding index linked bonds in our ideal fixed interest portfolio, and are continuing to hold non indexed UK Gilts, because of the reasons outlined on the previous page.

At some point we are likely to flip over this strategy, if and when it becomes clear that inflation is coming back.

We are happy to have a portion of our fixed interest holdings in government backed assets even if returns may be low, to provide an element of safety and reduce the overall risk.

The remainder of our ideal portfolio is in investment grade corporate bonds, about which we are extremely positive, but which remain volatile at present.

The next round of fiscal “stimulus” measures likely to be used by the Bank of England, may involve buying up investment grade bonds, exchanging them for short dated Gilts (known as treasury bills).

The reason for this is that the yields on the bond markets are still at record highs, meaning that the cost of borrowing for companies is very high. The Bank of England hope to force down the cost of borrowing, by buying up bonds. This forces the capital values up, and therefore the yields down.

This would be positive for bond markets and if this comes into play we hope for double digit annual returns.

Where clients are holding large amounts of cash, we recommend increasing fixed interest holdings.

## Time in the Market, Not Timing the Market

We have always said it is impossible to time the markets.

No one knows when the direction will change. We can only adjust our plans to reduce risk when markets are high, and increase holdings when they are low to maximise the potential rewards.

We know the equity, bond and property markets will turn at some point, we just don't know when. What we do know is that we need to make sure we are prepared for when they do turn.

Research from fund managers Fidelity shows how important it is to stay in the equity markets.

Their figures show that an investor who kept their money in equities over the last 15 years (one of the worst ever periods for equity returns) would still have received an average return of **9.88%** per annum (source: S&P 500).

However, if that investor had missed just the 10 best days of market growth, that return would have reduced to **6.45%** per annum, and missing the best 40 days would mean a return of **-0.55%!**

We want to make sure that when we see the strong recovery that will surely come at some point, our investors all receive the maximum benefit.

It is better to invest now and risk potential short term losses followed by strong gains, than to stay in cash and miss the recovery altogether.



## The Obama Bounce?

Interesting research shows that the US equity market tends to perform well in the year following a presidential election. This is particularly so when the new president is a Democrat.



Why? Well as we have always said, markets are ultimately controlled by human emotions. A new president brings a wave of hope and optimism, which ultimately leads to strong growth. There is huge optimism about Obama's presidency so it would be great to think we could be in for a good year.

With the current economic outlook things are not so clear cut, and there is a lot of information that the markets still need to digest. We would expect fairly flat markets for some time but it only needs the right catalyst to trigger strong gains.

We would hope all the goodwill towards Obama and the unfaltering American belief that they can turn things round, could increase the chances of seeing some solid returns.

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## The Applewood Active Service

You may be aware of our plans to introduce **discretionary investment management**.

We are delighted to report that our new "**Active**" service is now available for those assets held on the Nucleus wrap platform.

Our new service will allow us to act much quicker and with far less paperwork, as we would not have to obtain your written agreement every time we wish to make a change to your investments.

We feel this is a very exciting development that will significantly enhance our service. We will be writing to all clients who currently hold assets on Nucleus shortly with further information.

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## Coming Soon...

We will shortly be changing our name, our look, and re-launching our website.

Many of you are aware that there are two other firms trading under the name Applewood and this is beginning to cause confusion. The name change is planned for later this year.

*If you have any queries or feedback, please do not hesitate to contact your usual adviser or the investment team.*

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
## General Economic Overview

Recession is likely to last for the best part of 2009. Inflation will remain low in the near term and we may even see a short period of deflation. However, inflationary pressures remain and we will see a return to inflation at some point, probably later this year.

We believe interest rates will remain at record lows for some time and could even come close to zero. Currently they are at 1%.

Asset Class	Applewood View
<p><b>Equity Markets</b></p> <p>Markets remain cheap on a number of indicators, with the FTSE Allshare having a Price/Earnings ratio of only 7 (a long term average is 14) and yields far in excess of gilts.</p> <p>The uncertainty which remains over banks continues to prevent the hoped for recovery. As fear subsides and confidence builds, we could see some excellent returns, particularly from large, profitable multi national companies.</p>	
<p><b>Fixed Interest</b></p> <p>We are very positive for long term returns on fixed interest, particularly corporate bonds from strong companies.</p> <p>There is talk that the government will start to buy up some investment grade corporate bonds to reduce the cost of borrowing for companies. This could provide the stimulus we need to see a recovery in this market. If this happens we could easily see double digit returns.</p>	
<p><b>Commercial Property</b></p> <p>No real change, in that we expect further falls in commercial property prices of maybe up to 20%. This market may begin to recover towards the end of 2009, although there are pockets of value with high yields that may become attractive sooner.</p> <p>We believe property shares are likely to reach a point where they look very undervalued in the near future with yields on the underlying shares of around 7%, and large discounts to net asset value.</p>	
<p><b>Residential Property</b></p> <p>We expect further house price falls, of at least 20%. The lack of available borrowing for many prospective purchasers will continue to reduce the number of buyers, therefore reducing prices.</p>	

### Key:

Positive Outlook		+1 is slightly positive, +5 is extremely positive
Negative Outlook		-1 is slightly negative, -5 is extremely negative
Neutral Outlook		Asset class expected to behave normally

These represent Applewood's collective views. There are no guarantees, although we hope to be right more often than wrong. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take any action without first speaking to your adviser.