

Newsflash – 2 July 2010

Equity Markets

What's happening?

Equity markets have continued to fall recently and currently the FTSE 100 Index stands at around 4,830 (10am on 2 July 2010).

This is 17% down from the 5,825 level it reached on 15 April 2010.

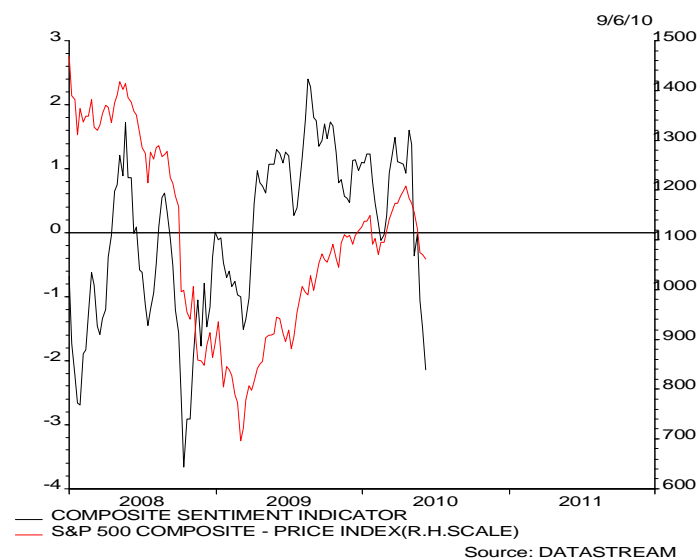
So why are the markets falling?

After the European sovereign debt concerns at the start of the year, there has been a succession of small pieces of “bad news”. Strangely, there have been no really big shocks to the market. It is a build up of negative sentiment from all these “small” stories.

To us, most of these bits of bad news are no surprise. We've all known for some time that governments are going to end up with high levels of debt. We've also known that it will be a struggle for economies to recover from this recession, and so things like the poor employment figures in the US, and disappointing manufacturing data across the world are to be expected.

This is almost the opposite of this time last year when markets strongly rallied as the newsflow was “less bad” than expected. Maybe we have now moved from a “less bad” rally to a “slightly worse” dip.

“Sentiment” (based on surveys) can be charted and interestingly, very low sentiment is actually seen as a positive indicator of future market direction, whilst very high sentiment is negative. The chart below shows how sentiment (black line) was high when markets (S&P 500 - red line) started falling in 2008, whereas it was very negative just before the rally in 2009. It is now very negative again:





Newsflash – 2 July 2010 (continued)

For a long time we have been concerned that there could be some form of correction before markets move ahead again. This correction has come much later than we had thought, meaning that the fall has been steeper than we thought, but equities remain 14% higher than this time last year when the FTSE was around 4,200.

Resistance levels

Many analysts talk about “resistance levels” where a market has fallen or risen to a particular level where people are likely to take stock.

For example, there has been a resistance level at around 5,000 points, an important psychological barrier. When markets fell, until recently they have always rebounded slightly at around 5,000 as people buy back in. That level has recently been breached and the next level according to some chartists is around 4,700, whilst the next psychological resistance level is 4,500.

Some analysts believe that when an index breaks through a resistance level, that can indicate further big shifts in that direction. However, a better term is a “support level”; these are levels where people often decide that a change of direction is required.

Our view

We remain positive on equities and believe that the fundamentals (such as high dividend yield compared to gilts, and low P/E ratios) will win out in the end.

At 5,000 our outlook score for equities was the maximum +5, meaning we’d expect returns equivalent to 15% per annum over the next 18 months. As we mentioned in our recent newsletter, this means we would expect at least a 22.5% return over the next 18 months. The table below explains why we believe this is realistic.

Current FTSE level	Plus dividends	Growth required to obtain 22.5% total return	FTSE level required
4,830	3.5% pa = 5.25% over 18 months	17.25%	5,663

Given we were at 5,825 just 3 months ago, we believe this is realistically achievable before January 2012.

In the meantime, we may see some further falls and even go down as far as 4,500. In our view, anything much further than that is unlikely but of course nothing is guaranteed. However, we are extremely positive about the longer term outlook.

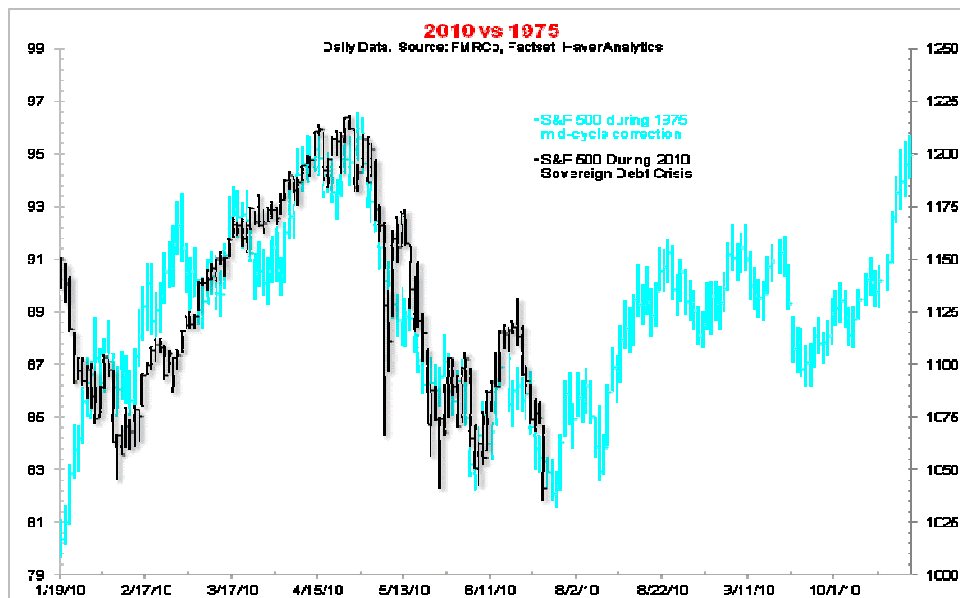
To benefit from this sort of move, rather than just recover, we believe the sensible course of action is to invest money now.

Newsflash – 2 July 2010 (continued)

Has this happened before?

Take a look at the chart below.

After the 48% bear market of 1973-74, the S&P 500 Index in the USA staged a 77% bull market from October 1974 to September 1976. Within that bull market, after having rallied 59%, there was a 15% correction from July 1975 to September 1975. If you overlay what has been happening now with what happened then, the similarity is startling:



In the 1970s the type of move we're seeing now was followed by a strong rally. Of course past performance is not a guide to future performance, but it does illustrate that the sort of moves we're talking about have happened before. This just shows that a situation that looks very similar to now has happened before.

What action should you take?

Please let us know if you wish to top up equities.

If you have had a review in June then you may not need to take any action. However, if you have not had a review since April your equity level will have fallen and therefore we need to top up.



Newsflash – 2 July 2010 (continued)

We also recommend that those who have the risk tolerance consider moving to a higher risk approach than that you are currently taking. For example, if you have a balanced asset allocation right now would you be comfortable with moving to an adventurous allocation in the short term?

We believe that many of our clients would be comfortable taking on slightly more risk and if the market rallies clients would benefit by doing so.

In either case, we would look to set a “trigger point” to reverse this temporary move, perhaps at a FTSE level of 5,500.

Please could all clients let us know:

- 1. If you would like to top up to your previously agreed equity level. We will work out how best to do this and let you know what we have done.**
- 2. If you would like to discuss increasing the risk in your individual portfolio. We will then contact you to discuss whether this is right for you.**

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