



Overview to November 2009

The recent crisis in Dubai has made investors realise there are still significant risks in financial markets. Indeed some global stock markets have suffered small losses over the last two months. However the chart below shows that most markets have recovered strongly from their lows and have produced decent returns in 2009.

The high level of government borrowing is a concern for the UK. Increases in taxation and spending cuts are looming and will be a drag on the economy. However many UK companies make a large part of their earnings from overseas regions and this could continue to provide support for the UK stock market.

We expect interest rates to remain low for sometime and this will be a support for fixed interest investments. However the end of Quantitative Easing and the need for the government to borrow large amounts could put pressure on the value of gilts. At last there is some good news from the UK commercial property market, with prices rising again for the first time since July 2007. There are concerns about how sustainable this recovery will be in view of the poor economic outlook.

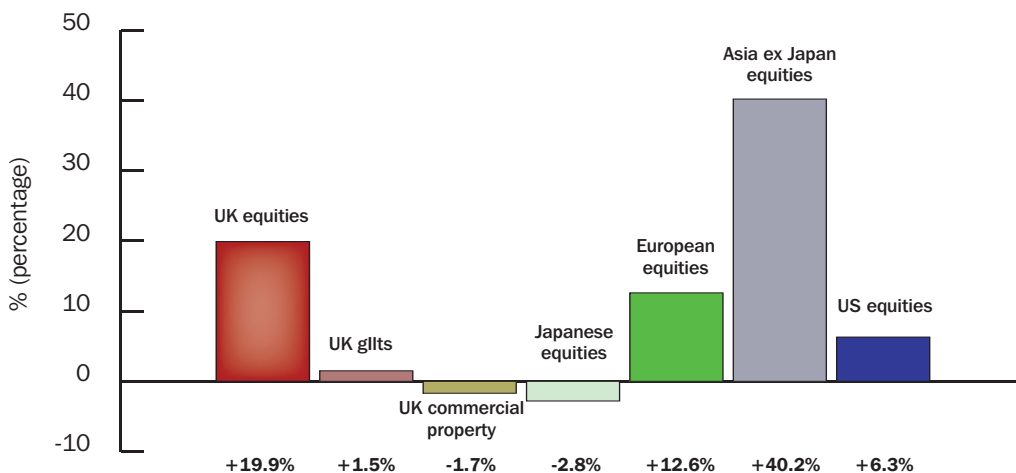
Asian markets have produced the best returns spurred on by good economic growth in the region. Despite this, the current value of stock markets is still fair by historical standards.

Economic growth in some European countries has returned sooner than many expected and as a result company earnings are being revised upward. If this trend continues then we could see quite good returns from European markets next year.

In the U.S. we have concerns about the sustainability of economic recovery and if growth slows then the stock market is vulnerable to a correction.

The Japanese market has been one of the worst performers in 2009. Most of the bad news has already been accounted for and so there is potential for the stock market to rise from here.

World markets – 11 months to 30 November 2009



See note 1 for explanation of indices. All returns converted into pounds sterling.

Source of figures: Lipper Hindsight



UK Equity Market

UK companies' exposure to overseas earnings could continue to support the stock market

The economy shrank by a surprisingly weak 0.3% in the third quarter of the year. The Bank of England injected a further £25 billion by way of Quantitative Easing, to shore up the economy. VAT will return to 17.5% in January 2010 - this will increase the inflation rate as well as being a drag on consumer spending.

The housing market has been recovering and mortgage approvals are increasing. This has helped improve consumer confidence.

Government borrowings are rocketing. Paying for this later will likely prove painful. A general election is due by May 2010 – policy changes loom.

The FTSE All Share Index is up almost 20% this year. Forecasts for company earnings in 2010 have been increasing. This quarter Lloyds Bank raised £13.5 billion in new capital from the stock market. This was a UK record and indicates a return of confidence in the banking sector. Lloyds will now be able to exit the government's expensive insurance scheme.

We are cautious on the outlook for the UK economy. With unemployment still rising and political change ahead, companies exposed to the UK consumer will face a challenging year. However, many companies have overseas earnings and significant exposure to high growth regions. This could continue to provide support for the UK stock market.

UK Fixed Interest

Reported inflation is set to rise sharply

Reported inflation is set to rise sharply. The official annual rate was 1.1% in September, down from 5.3% a year earlier, but it will jump to well over 3%, possibly as high as 4%, when VAT goes back up in January. This will be a headache for the Monetary Policy Committee (MPC), whose inflation target is 1–3%.

Despite inflation concerns the MPC's greater desire is to see economic recovery. They will not raise interest rates until recovery is clearly in place. With only weak growth expected in 2010, interest rates may be kept at 0.5% all year.

Low interest rates will support gilt prices. But the biggest support has come from the Bank of England's Quantitative Easing (QE) policy. Over the last few months the Bank of England has been buying gilts faster than the government has issued them. This episode is now drawing to a close, and the markets face the difficult switch from the public sector being a net buyer of gilts to a very large issuer.

For gilts to hold these levels it will be essential for the government and the Bank of England to maintain confidence in the British economy. If they fail, the value of gilts will fall and the Pound will drop sharply.

Investment grade corporate bonds have provided exceptional returns in 2009, well above those achieved by gilts. While we do not expect such strong returns in 2010, good quality corporate bonds should continue to outperform gilts.



UK Commercial Property

The UK property market is finally seeing an uplift in values

The UK property market is finally seeing an uplift in values. Capital growth began in August for commercial property, showing a 1.2% positive change to September, the first rise since July 2007. The retail sector was the first to recover in July, seeing a 1.8% increase in values to the end of September 2009.

Other indicators are the fall in initial yields and vacancy rates. The initial yield decreased from 7.87% for commercial property as a whole in July 2009, to 7.72% in September. The initial yield is a measure of the current rents from property over the value. The decrease indicates that values are going up. The rate of vacant property also decreased from 12.3% in August to 12.0% in September.

Is this rally sustainable? This is a point of debate as the economy and occupier demand remains relatively fragile. Low interest rates have pushed investors to search for higher yields and property has been the beneficiary. The critical path is what happens when interest rates rise. There is the danger that a double dip could occur with property values falling again in the next twelve months.

So how does one navigate this maze? The focus remains on rental income, the quality of the property, its location and ability to adapt to change. In other words, it is the property fundamentals at the end of the day which will provide sustainable performance.

Source of figures is the Investment Property Databank monthly statistics.



Europe

We are still relatively optimistic about the European markets

We are still relatively optimistic about the European markets; the German economy is forecast to grow by 1.5% next year and will drive the recovery in the other European core markets.

The European stock market has risen by 55% from its low point. Despite this rise the market's value is average based on current prices and forecast company earnings. Analysts are now upgrading their forecasts for earnings.

The economic recovery will drive earnings and the market should continue to rise. We believe that we could see a 10-15% return next year.

There should be good opportunities in the market for Merger and Acquisition (M&A) activity, once companies can raise the cash. M&A activity normally has the effect of pushing stock prices higher. Shares also look better value than fixed interest investments at the moment.

In the past the start of rises in U.S. interest rates has indicated the peak for the European markets. Although recent indicators show a small pick up in inflation, we believe that interest rates will remain on hold for the time being. The European Central Bank (ECB) will wait for a lead from the United States before discussing rises. Other potential pitfalls to market recovery include prolonged weakness in peripheral countries such as Spain, Ireland and the Baltic's. In addition the refinancing of the banking sector will have the effect of taking cash out of the market.



United States

Should economic recovery slow then we fear that equity markets look rather vulnerable

Economic data looks much better with a whole variety of indicators demonstrating that recovery is taking place. This is most obvious in the industrial parts of the economy where the money coming from the government stimulus package is having the greatest impact. The U.S. economy is expected to show a decline of 2.4% for 2009, followed by a decent bounce next year to a growth rate of 2.7%.

We think it is important to take a step back and try to understand what the economy is doing and what the longer term prospects are. Interest rates remain very low and the vast fiscal stimulus package is still being implemented. This is supportive of the economy and should allow some growth. But, and it's a big but, consumers are still reducing debt and companies are still very cautious about committing to capital spending. These are large components of the economy and are quite likely to remain a drag on growth for sometime yet.

In the next few years we expect short shallow economic cycles with trend economic growth in the region of 1.5%, with a range of approximately -0.5% to 2.5%. In the short term, this raises some concerns. Should economic recovery moderate then we fear that equity markets look rather vulnerable. We are not forecasting a crash, but feel that the easy returns are already on board and that some form of correction in markets is quite likely.



Asia ex Japan

Despite strong recovery the current value of stock markets is fair by historical standards

Economies in the region showed strong recovery in the third quarter of the year. Forecasts for economic growth in 2010 have been raised as a result.

The concern for 2010 is inflation and prices of assets increasing too much too soon. Central banks are likely to try and slow economic growth ahead of western countries. Australia was the first country in Asia Pacific to hike interest rates. A number of Asian countries are likely to follow in 2010.

China has achieved the 8% growth in its economy that it was aiming for in 2009. China's policy stance has changed from promoting growth to managing inflation. This will mean policies to slow economic growth.

It is expected that Chinese currency (the Renminbi) will appreciate 3-5% in 2010. China has set up arrangements with six countries to settle trade in Renminbi rather than U.S. dollars. It is in talks with nine others to do the same. This could be the start of the Renminbi becoming an internationally accepted trading currency.

Foreigners continue to buy equities in Asia Pacific. Companies have reported robust recovery in earnings. Many analysts expect earnings growth of 28% for the region in 2010. Demand from domestic consumers and companies is likely to continue to recover strongly in 2010 and this is likely to be the main theme. Despite strong recovery the current value of stock markets is fair by historical standards.



Japan

The market should not fall much further in the near future, and could rise going forward

The Japanese economy continued to grow in the July-to-September quarter, having come out of recession in the April-to-June quarter. Exports remained firm, whilst the domestic economy improved, helped by stronger consumer spending and capital expenditure by companies.

Despite this, the Japanese stock market was weak. Several reasons may have contributed to this situation. Many companies that have suffered depressed earnings during the recent recession have been raising capital by issuing new shares. When there are more shares in issue this has the effect of reducing the price of these shares. The new government has implemented or hinted at policies that the market has not liked, such as encouraging a strong currency. The country has a high level of government debt, and this is growing due to a combination of more government spending and less tax revenues. Finally, the economic outlook is unclear, and many people believe growth could dip should global stimulus measures recede in the future.

These points have been well documented and have led to weakness and low expectations for Japanese stocks. However, the value of the stock market is low on many measures and the market seems oversold in the short term. As a result, we feel the market should not fall much further in the near future, and could rise going forward.

Notes

1. The indices used for the returns on the bar chart are as follows;

UK Equities – FTSE All Share capital return

UK Gilts – A British Government All Stocks total return

UK Commercial Property – ABI Direct Property Pension Fund Index

Japanese Equities – Nikkei capital return

European Equities – FTSE Europe ex UK capital return in GBP

Asia ex Japan equities – FTSE Asia Pacific ex Japan capital return in GBP

U.S. Equities – S&P 500 capital return

Past performance is not a guide to the future. The value of your investments can fall as well as rise.

Currency fluctuations can also affect performance.

The above summarises the views of the Canada Life Investment Team at the time of publication.

The views expressed are subject to change at any time without notice and should not be taken to constitute a recommendation for investment in any area or product.



Canada Life

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