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The first quarter of 2008 was characterised by financial market stress, huge price volatility, currency turmoil and corporate damage.

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The first quarter was characterised by continued financial market stress, huge price volatility in certain areas, currency turmoil, corporate damage (Bear Sterns, UBS, SocGen), hedge fund losses and collapses and, until the Fed stepped in decisively over Bear Sterns, equity market damage. On the one hand, we had rising credit dislocation and recessionary fears; on the other, we had booming oil/agricultural commodity prices, fuelling already evident inflationary pressures. The Fed has at least allayed fears on the former, although the stagflation threat has by no means gone away. Hence the continued strength of index-linked government bonds.

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Equity markets are now working on the basis that the Fed will do what it takes to keep the US 'on track'. We now have a normal yield curve and US 10 year government bond yields are back above 4% - as recessionary fears abate. Negative real interest rates and a $170 billion fiscal stimulus should see the US beginning to move away from the recessionary rocks in the second half of the year. This is the thinking underpinning the Consensus Economic forecasts below.

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There are doubters, however - the IMF is in the very slow growth camp (forecasting 0.6% GNP growth for the US in 2008 and 2009). HSBC believes the US economic turnaround will not be U shaped, as per consensus, but rather W shaped, presaging a slow 2009.

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Who is right?
The most encouraging chart seen recently is one showing that annual US growth of bank credit/commercial paper remains positive at 5% levels (in line with nominal GNP growth). This compares with zero growth at the time of the last - shallow - recession in 2001 and 10% + levels prevailing between 2004 and early 2007, as banks gorged themselves on credit opportunities in a booming real estate market. Provided banks continue to take their medicine and successfully recapitalise, credit dislocation - THE enemy - should be avoided. Credit growth in the emerging world continues strong and both credit and monetary growth in the Eurozone are satisfactory. So the banking system would seem to be alive and operating; the US segment of it is taking a powerful emetic to disgorge the ills contained within it. While this process is unpleasant (with commercial banks estimated to cut up to 200,000 jobs in the next 18 months), it should lead to a positive result eventually.

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What has been the cost?
It is almost poignant to compare the early estimates of losses of $100 billion with the current $280 billion IMF estimate and the $1trillion estimates of credit losses, if the IMF 'worst case' economic scenario comes to pass. These figures compare with the $150 billion losses arising in the savings and loans debacle of the late 1980s. What has happened is not unique. The IMF in 2002

Forecast Growth rates (source Consensus Economics) (e)=estimate

GDP%	2006	2007	2008(e)	2009(e)
US	2.9	2.2	1.4	2.3
Eurozone	2.9	2.6	1.5	1.8
UK	2.9	3.1	1.7	1.9
Japan	2.4	2.0	1.3	1.8
Asia ex Japan	8.4	9.0	7.7	7.5
China	11.1	11.4	9.8	9.3
Latin America	5.3	5.0	4.4	4.3
Eastern Europe	6.8	6.7	5.9	5.8
World	4.0	3.7	2.9	3.2

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had identified 112 systemic banking crises in 93 countries since the late 1970s. But this is deeper and more pervasive - and its epicentre is in the US.

The 'moral hazard' question for banks will continue to be debated.
'Too good to fail' must replace 'too big to fail'. Regulators have the hugely difficult task of squaring the need for a dynamic, competitive financial system with the need for a safe one.

One final thought - marking instruments to markets in dislocated non-markets has to have added to the problem. It may well be that in 3 to 5 years' time , provisions made at the end of 2007 - reflecting a very poor US housing market , complexity and an absence of transparency - will be seen as excessive in the light of subsequent income flows.

How will matters develop?
In the same way as the NASDAQ equity crash of 2001-2 has subsequently resulted in a steady derating of equities, as investors remained steadfastly cautious, so it may well be that investors will remain wary of credit and credit instruments for years to come - indeed, spreads in US BBB corporate bonds - relatively simple and transparent instruments - have ballooned out to 2001/2 recessionary levels. They now look attractive. The desire to add risk will re-emerge in some new, undefined area. Securitisation will reduce; investment banks are likely to become regulated, in return for liquidity access, and this could extend to hitherto conflicted rating agencies. US banks will consolidate. Hedge funds will find their ability to gear up and operate further reduced and many will probably exit. Private equity will return to their original focus on management buyouts - on a much smaller scale than recently. The 50% fall in Blackstone' share price from its original issue price last year says volumes about how the opportunity set has changed. To quote one industry participant private equity firms 'have returned to the obscurity we so richly deserve'.

Corporate Earnings (source IBES) (e)=estimate

	2008 EPS Growth % (e)	2008 PER (e)	2009 EPS Growth % (e)	2009 PER (e)
US	13.3	14.5	15.5	12.6
UK	5.3	11.2	9.0	10.3
Europe ex UK	10.2	11.3	12.8	10.2
Japan	10.2	14.0	9.4	12.8
Pacific ex Japan	21.6	14.7	15.0	12.6

The basic US data - leading indicators, the labour market, consumer confidence and spending - shows that the US may have moved already into recession. If it has and the outturn is 'normal', past experience suggests that we should be thinking about putting on risk. Directors are buying their company's shares in size; maybe we should too. Certainly, they would seem to offer value but, then, they have for some time.

However, the corporate earnings table above is too sanguine, as the response to the very recent General Electric profits warning would suggest. There will be further setbacks, which means that additions to equity risk have to be made selectively and carefully. To buy a UK equity market tracker may look sensible, given the carnage suffered by UK active managers, but it has to be sub-optimal, given the degree of concentration and inherent stock specific risk. If one cannot bring oneself to buy bank equity, in view of all that has happened, then there has to be a question mark over buying equity at all.

The requirements of diversification continues to reduce UK equity positions in portfolios and this process is likely to accelerate, with the declining momentum of the UK economy and the potential - via house price falls or City layoffs - for negative shocks. As we said in the last issue of Perspectives, there are better places to focus on and better things to do - in the emerging world, in infrastructure funds, commodity related funds, global long or long/short equity funds, property funds outside the UK. We do have significant choice. A recent client workshop pointed to a 30-40% UK equity weighting, with the remainder in global equities, partially hedged. As portfolios continue to explore diversification opportunities, it is encouraging to report that the outlook for the emerging world - at least from a broad macro economic view point - continues to be reasonably stable. This is an emerging world economic expansion and market falls have moved equity valuations back to more attractive levels.

Emerging Markets (source HSBC/UBS) (e)=estimate

	2008 EPS Growth % (e)	2008 PER (e)	2008 Inflation % (e)	2008 Current Balance (e)
Mexico	13.3	16.0	4.0	-1.5
Brazil	30.0	11.8	5.0	-0.8
Korea	8.1	11.5	3.8	-1.3
Taiwan	18.1	13.9	2.4	6.2
India	23.9	16.3	6.6	-2.7
South Africa	23.7	11.5	6.5	-6.4
China	38.6	15.5	6.4	8.4
Russia	18.5	9.8	11.3	5.9

In each issue of Perspectives we give a list of 10 questions trustees should explore with their investment managers. Here is our updated list:

1. How much should we rebalance away from UK equities to overseas equities - in the overseas segment, how much should we focus on Asia and Emerging Markets?
2. What do we do about currency overlay now that sterling has weakened?
3. Commodities/energy/resources infrastructure - should we get involved? How and when?
4. Hedge funds - what is the right exposure, given the turbulence in the traditional asset classes?
5. Commercial property - do we add now or continue to wait? Do we diversify into overseas property markets?
6. Private equity - credit spreads have widened significantly, to what extent is the party over?
7. What do we sell if we want to add to equity risk - reduce cash weightings, or sell property or bonds?
8. Is the time yet right to consider high yield bonds?
9. 130 : 30 'extension' portfolios, unconstrained strategies - to what extent should these form part of a pension fund asset allocation?
10. Should we be considering so-called 'liability-driven investment' approaches ('LDI')?

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