

I hope that you are well.

A considerably more detailed analysis this month.

After a buoyant April and a mixed May, June was a dreadful month for global markets. All markets shared the pain, with the Dow Jones falling by 10.19%, the largest monthly fall since the days of the Great Depression.

The LWM portfolio, although down, helped to insulate our clients from the level of losses suffered by major markets.

### **Inflation stalks global markets**

In June, a whole swathe of countries saw interest rate rises to combat inflation. These included India (twice), Norway, Mexico, Hungary and Vietnam. Increasing inflationary pressures in Europe saw the European Central Bank (ECB) also raising rates. However, the Bank of England (BoE) and the Federal Reserve (Fed) decided against raising rates, even though Mervyn King, the Governor of the BoE, forecast that the Consumer Price Index (CPI – currently at 3.3%, whereas the target is 2%) would break through the 4% level later in the year. In the US CPI is already at 4.2%.

What explains the different decisions whereby the ECB raises rates but the BoE and the Fed hold them steady?

### **Reasons for inaction**

#### **Inflation vs. growth**

There are several arguments that can be advanced to explain the decision not to raise rates. One is that the central banks have different mandates. The Fed's duty is more geared towards the overall health of the economy and maintaining full employment. The BoE and especially the ECB (which is haunted by fears of the hyper-inflation suffered in Germany during the 1920s) are more inflation targeted.

### **The risk of recession(s)**

Adding to this, the US and UK economies seem more immediately at risk of falling into recession. Raising the interest rate could well tip the balance, particularly given the impact on housing markets. In the US, the housing market continues to fall, with sales of new homes falling 2.5% in May and the Case Shiller 20-city index showing that house prices were down 15.3% in the year to April. Housing starts fell to their lowest level since March 1991. In the UK, the housing market is falling, although not (yet?) to the extent of the US. An increase in interest rates risks a further tipping over the edge.

According to Morgan Stanley, 23% of UK mortgages will “reset” to a higher rate in 2008. According to George Buckley, Chief UK Economist at Deutsche Bank, those people resetting from 2-year fixed deals are currently paying an average of 163 basis points (1.63%) more than when they took out their mortgage. Further interest rate rises will make it even more difficult for people to service their mortgages. Rising foreclosure rates are not what the UK doctor has ordered.

In addition, unemployment in both the UK and US has started to rise. Unemployment in the UK increased to 5.3% and to 5.5% in the US. This is a concern for the UK in particular. One of the strongest arguments to support the UK housing boom has been that supply has increased so slowly whereas demand has increased dramatically. If the jobs in the UK dry up, many of those sucked into the UK economy and whose presence has dramatically boosted demand will leave.

### **External vs. internal**

Another argument is that interest rate rises will not reduce inflationary pressures, because these pressures are due to external factors.

Much of the increase in inflation of late has been driven by commodities, especially oil and food. This is largely down to rapidly expanding demand, especially from Asia. As China, and to a lesser extent India, rapidly increase their peoples’ purchasing power, their economies and their infrastructure, demand for oil, coal, iron ore, steel, pork (far more people in China now eat meat) and the like has increased dramatically. (In poorer countries, expenditure on food makes up a much higher percentage of household spending, so food inflation is felt particularly strongly in the developing world. This is illustrated by the GDP-weighted inflation rate for the 11 biggest Asian economies which jumped from 3.5% to 6.8% over the year to April.).

This impact has been magnified by poor government policies. Subsidies to produce inefficient ethanol from corn in the US has diverted many food crops, reducing supply, raising global prices and causing worries over possible shortfalls. The fear of shortfalls is a significant reason behind second and third-world governments imposing export restrictions on food crops, which further exacerbates supply and therefore further increases prices. Even worse, by removing the opportunity for local farmers to earn more money by selling their products overseas, the economic incentives to plough (pardon the pun) further resources into increasing crops (higher prices would normally lead to increased supply and therefore moderate pricing pressures) are removed.

Given that the inflationary pressures are due to external causes, raising interest rates in such a situation would do little to combat inflation. An increase in commodity prices is viewed as a one-off permanent shift in price and the economy will simply have to adjust. The impact in terms of inflation is short lived and inflation will naturally fall once the increase in the price of the commodities has worked through the system. Given that interest rate rises will not have the desired effect, the best thing is to leave them as they are.

### **Political**

In a US election year the political repercussions of raising interest rates, especially given the pain already being felt by US households, would be tremendous. Whilst the Fed is supposedly independent, it is far from free from political interference (the Chairman is appointed to a 4-year term by the President) and the role of the Chairman is very high profile. In the UK, the BoE is also technically independent. But with Labour's dreadful opinion poll ratings and with an election due by early 2010 at the latest, a decision to raise rates would likely see the ECB as being made an immediate scapegoat. For both the Fed and the BoE, it would take a very brave Chairman / Governor to endure the deluge of opprobrium that a decision to raise rates in today's environment would bring.

### **Global downturn to the rescue!**

The arguments cited above for not raising rates are further supported by the obvious slowing of the global economy. Central banks acknowledge current and short term inflationary spikes, but believe that the accelerating global downturn will reduce the pace of global growth and

therefore the demand for many commodities over the medium to long term. If inflation is a short-lived phenomenon, there is no need to lower rates at this time.

### Reasons for action

#### Self-reinforcing belief

One problem, however, is the way in which inflation is perceived by the populations of the UK and US. If people believe that inflationary pressures are likely to be short lived, then not raising interest rates is likely to be the best solution. But, if people start to believe that inflation will remain high, then they will start to demand higher wages to compensate. If they start to demand higher wages to compensate, then this introduces genuine internal inflationary pressures into the economy, which could then lead to a situation where interest rate rises really do become necessary.

#### The 'real' rate of inflation

Also, people believe that inflation is higher than the rate quoted by the government. (There is good reason for this – over the years, governments have often 'adjusted' the way in which inflation is calculated, usually to try and flatter their records.). Despite assurances that UK and US CPI inflation is 'only' 3.3% and 4.2%, in reality, most people believe that inflation is far higher, as they have seen the likes of fuel prices increase dramatically in a very short space of time. Whether they anticipate that inflation will be short lived or not, this encourages them to seek higher wage settlements to compensate for a dramatic increase in the cost of living.

There is evidence that this seems to be occurring. For example, median pay agreements in the UK rose to 3.8% in the 3 months to April. If this trend continues, the inflationary cat could well jump out of the bag.

From a classical economic perspective, interest rate rises are not necessary. But from a more behavioural economic viewpoint, they may well be required.

### **It's all about confidence**

A significant psychological change in the last ten years or so appears to be the confidence people now have in central bankers' ability to control inflation. This bears directly on peoples' willingness to accept that short-term inflationary pressures are just that.

However, if the central banks do not live up to their reputations, this confidence could easily be squandered. And once lost, inflationary expectations could dramatically increase, becoming a self-fulfilling prophecy. One of the most chilling statistics is that in 1968, with US inflation approaching 4%, the Fed had interest rates at 5%. In 1989, inflation approached 4% and the Fed had a much more robust response, with rates at 10%. Had US central bankers learned their lessons with regards controlling inflation? Perhaps. But, if so, complacency may now have set in. Today, with US inflation hitting 4%, the Fed has rates at 2%.

### **Those with little faith in central bankers' abilities...**

...Might propose an argument to suggest that UK and US central banks have been setting interest rates at too low a level for a decade or more. They failed to see that the positive deflationary effect of an increasingly global labour force meant that a level of inflation that looked perfectly acceptable (around 2%) was actually far too high. This meant that money was too cheap and led to the inflating of a number of bubbles (tech stocks, housing). Greenspan in particular did not believe that a central bank should prick bubbles by raising rates as they formed, but rather that it should be prepared to lower interest rates rapidly to support the economy once the bubble burst. Bernanke has previously been even more a disciple of this than Greenspan (although to be fair he has recently pondered whether this is still the right approach).

For proponents of this argument, the Fed and BoE have not just recently fallen asleep at the wheel. They have been slumped over it in a coma for years and it's only now that people are starting to notice!

## In other news...

The pressure starts to hit commercial banks in the US as all sorts of loan products sold to over-indebted consumers come under pressure. Many loans were made with customers' houses as collateral. However, with many of these customers now in negative equity previously secured loans are now effectively unsecured. Home equity loans are a big concern, with US \$1 trillion of outstanding balances. Often, these loans have been retained on the balance sheets of the banks, rather than the sub prime loans that were usually sold on as quickly as possible.

Car loans are also coming home to roost. This might have a particularly nasty effect on the likes of GM and Ford. Already in all sorts of trouble before the credit crunch, they had resorted to a range of zero-finance deals to try and maintain market share. Now, not only are they unable to shift their gigantic SUVs due to rising fuel costs (SUVs previously offered larger profits to these companies), they may well find that many of those that they thought they'd sold come back to them as the loans go into default.

## Performance for June 2008

In June all indices suffered. Badly. The Nikkei which dropped 5.98%, had the dubious distinction of posting the best returns for the month. The FSTE fell 7.06%, the German DAX fell 9.56% and the French CAC suffered a loss of 11.56%. In the US the S&P 500 lost 8.60% while the Dow Jones was down 10.19%.

The LWM portfolio was down 2.96%.

Our best performing stocks in May were Fremont General (87.50% US) and Aero Inventory (2.16% UK). None of our Asian or European stocks were positive for the month.

Our worst performing stocks were MGIC Investments (-49.17% US), Latecoere (-41.83% Europe), United Microelectronics (-15.85% Asia) and HSBC (-9.0% UK).

At LWM we operate according to a strict value-based investment methodology. We focus on undervalued tangible assets, established companies and strong dividends. By purchasing companies at a substantial discount to their intrinsic value, we seek to reduce risk whilst

# Lowes Wealth Management June 2008 - Performance Update

maintaining the possibility of generating superior returns. Since launch we have outperformed all major markets.

Please forward this to any friends or colleagues for whom you feel this may be of interest. If this has been forwarded to you and you would like to receive monthly performance updates, please let me know.

Kind regards,

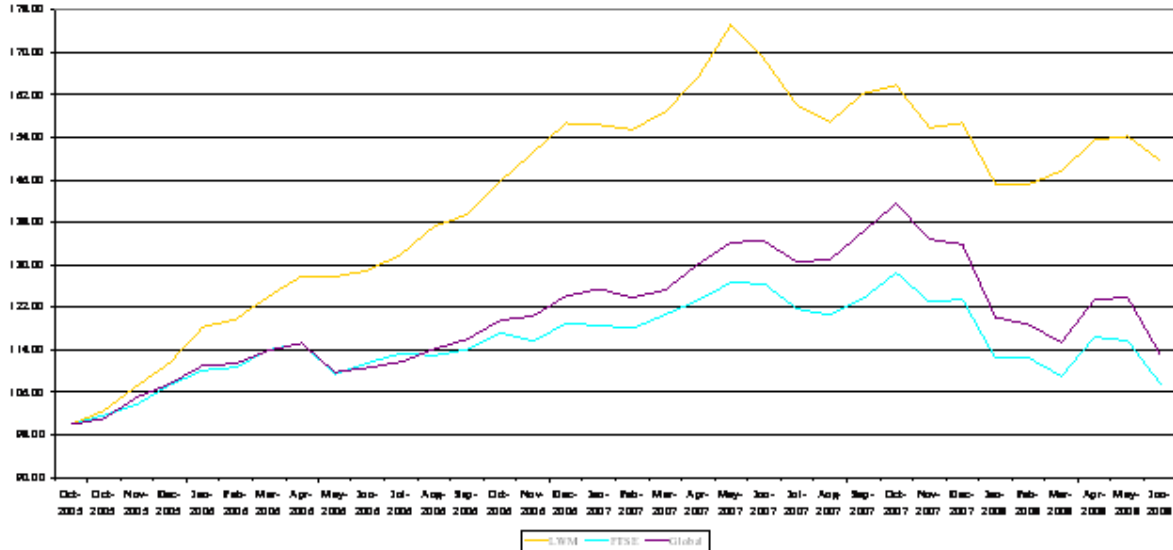
Justin

[www.loweswealth.com](http://www.loweswealth.com)

Lowes Wealth Management End of the Month Performance Table

2005	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
	-	-	-	-	-	-	-	-	-	2.52	4.56	4.08	11.56
2006	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
	6.00	1.30	3.61	3.10	-0.17	0.94	2.36	3.97	1.61	4.52	3.70	3.65	40.41
2007	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
	-0.21	-0.53	2.10	4.21	5.92	-3.78	-5.09	-1.93	3.39	0.96	-4.86	0.53	0.02
2008	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
	-7.23	-0.13	1.76	3.93	0.46	-2.96							-6.95

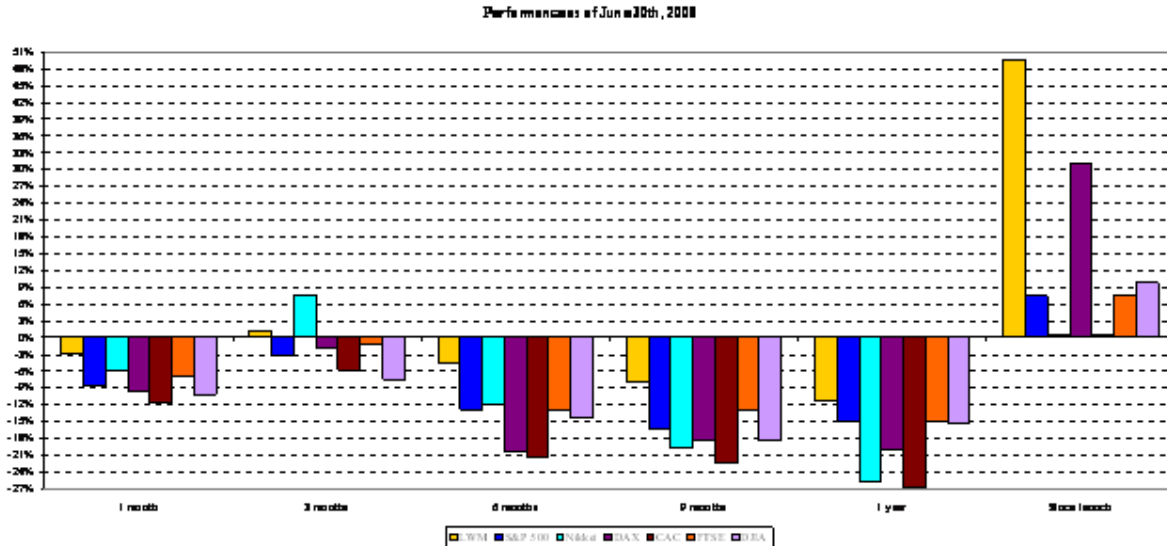
## LWM vs. FTSE 100 & Global Composite Index



The global index is made up in the following way:

S&P 500	(US)	40%
FTSE 100	(UK)	20%
DAX	(Germany)	10%
CAC	(France)	10%
Nikkei	(Japan)	10%
HSI	(Hong Kong)	10%

## LWM Performance vs. Major Indices



	LWM	S&P 500	Nikkei	DAX	CAC	FTSE	DJIA
1 month	-2.96%	-8.60%	-5.98%	-9.56%	-11.56%	-7.06%	-10.19%
3 months	1.32%	-3.23%	7.63%	-1.79%	-5.78%	-1.33%	-7.44%
6 months	-4.47%	-12.83%	-11.93%	-20.44%	-21.19%	-12.87%	-14.43%
9 months	-7.76%	-16.16%	-19.69%	-18.36%	-22.41%	-13.00%	-18.32%
1 year	-11.23%	-14.86%	-25.67%	-19.84%	-26.76%	-14.86%	-15.35%
Since launch	49.66%	7.44%	0.64%	30.97%	0.50%	7.62%	9.72%

### Key

LWM	Lowes Wealth Management
S&P 500	US Standard and Poor's Index
Nikkei	Japanese Index
DAX	German Index
CAC	French Index
FTSE	UK FTSE 100 Index
DJIA	US Dow Jones Index

**An explanation of how we derive our performance figures.**

## Lowes Wealth Management June 2008 - Performance Update

The performance figures that we quote are the returns on our entire equity portfolio. Thus, it measures the performance of all stocks that we have bought on behalf of our clients. This is a gross return (no charges are calculated) and is expressed in US Dollars, the currency most commonly invested by our clients. We measure only the performance of the equities that we hold – we do not factor in any cash that is held.

Whilst this is, therefore, an accurate measure of the performance of our portfolio, each individual client's returns will be different due to charges, the cash that we hold on their behalf and depending upon when and in which currency they invested.

Please note: As always, I've tried to ensure that this will go out only to those who will be interested in this information. If you don't want to receive this in future please let me know and I'll take you off the list immediately.

*Disclaimer*

*Stated performance reflects equity gains, exclusive of any fees.*

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