Market Overview

While equities have taken something of a battering in recent months, they are still better value than bonds, and for the first time in two years, says Alistair Peel, developed markets look to be better value than emerging

The last ten years have been fraught for trustees of charities. Not only have they had to contend with Gordon Brown fading out their tax benefits; being told they need to know more about investments by Paul Myners; told to spend some of their endowments by the Charity Commissioners; watched donations fall in a three-year bear market and then seen funds recover over the last three years, they are now confronted with volatility in world equity markets.

Despite a positive second quarter, with the Federal Reserve indicating that the peak for interest rates was 'likely to be near', by the time we reached June global equity markets had fallen significantly. UK equities rose one per cent in April, but were nearly five per cent lower in May, as was Wall Street, although dollar depreciation exacerbated losses for sterling investors.

Economic numbers and a weaker dollar hinted at inflationary pressures in the US with the Chairman of the Federal Reserve suggesting that interest rates might increase from the current five per cent level.

This generated concerns about corporate profitability, as did the rise in energy prices, an easing in housing starts, the rise in mineral prices, the stubbornly high oil price and the US trade deficit. Consequently, we believe the US market looks fully valued at current levels and could struggle to make headway in the short term.

Corporate activity continues to support the UK equity market as bids, (or rumours of them) abounded. Nasdaq bought 15 per cent of the London Stock Exchange and investors continued to speculate about a possible break up of Vodafone. BAA is also the subject of a bid from Ferrovial of Spain, all after successful bids for BOC Group, Excel and P&O earlier this year.

Unlike the US however, forward looking price/earnings (P/E) ratios suggest the UK market is not expensive, even factoring in modest forecasts for earnings growth. The current P/E is 12.5 times, falling to 11.5 for 2007, which is some way below the long-term average for the UK. With a dividend yield over three per cent we believe that the market looks good value. The FTSE Europe ex UK index was down seven per cent in May, following a relatively benign April. Again, interest rates were the catalyst with the European Central Bank (ECB) indicating that rates could rise in June. Export related companies were hardest hit as the euro gained ground against the dollar.

Japanese equities weakened over the second quarter, falling 12 per cent during April and May. The prospect of higher US interest rates and a strengthening yen hit sentiment and, once again, it was export-orientated stocks that bore the brunt. Domestic economic numbers have been strong; GDP growth at an annual rate of 1.9 per cent in the first quarter has improved economic confidence. Despite 2005's spectacular performance, we believe that Japanese equities remain attractively valued.

Emerging equity markets had a positive start to the second quarter but were sent reeling by the shock waves of higher global interest rates. The MSCI Far East ex Japan Index fell nine per cent in May with markets in India and Singapore retreating from all time highs. Emerging markets look expensive relative to developed markets as the discount at which they trade is at its lowest point since the mid-90s, which does not seem to compensate for the additional risk. Having said this, there is still good value to be found selectively, with Asian markets still offering good value although, in our view, Eastern Europe and Russia look expensive.

Bond yields rose in April with the US 10 year bond trading above five per cent for the first time in over three years. This trend continued throughout May as global economic growth continued apace causing central banks to hint at further rate rises.

From an asset allocation perspective, in our view, equities still look better value than bonds, particularly now markets have had a correction. For the first time in two years, developed markets look better value than emerging markets. As with all investments, diversification across asset classes reduces risk and, in our opinion, Charities should seek to maintain diversification not only across the recognised asset classes but should consider widening exposure to alternatives such as Absolute Return and market-neutral strategies.

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WM Charity Fund Monitor Q1	Latest quarter		Last 12 months		3 Year annualised	
Returns %	Inc prop	Ex prop	Inc prop	Ex prop	Inc prop	Ex prop
Total charities	6.3	6.4	25.0	25.2	20.4	20.6
Unconstrained funds	6.4	6.4	25.3	25.5	20.5	20.7
Funds constrained by income	6.2	6.2	24.5	24.6	20.1	20.1