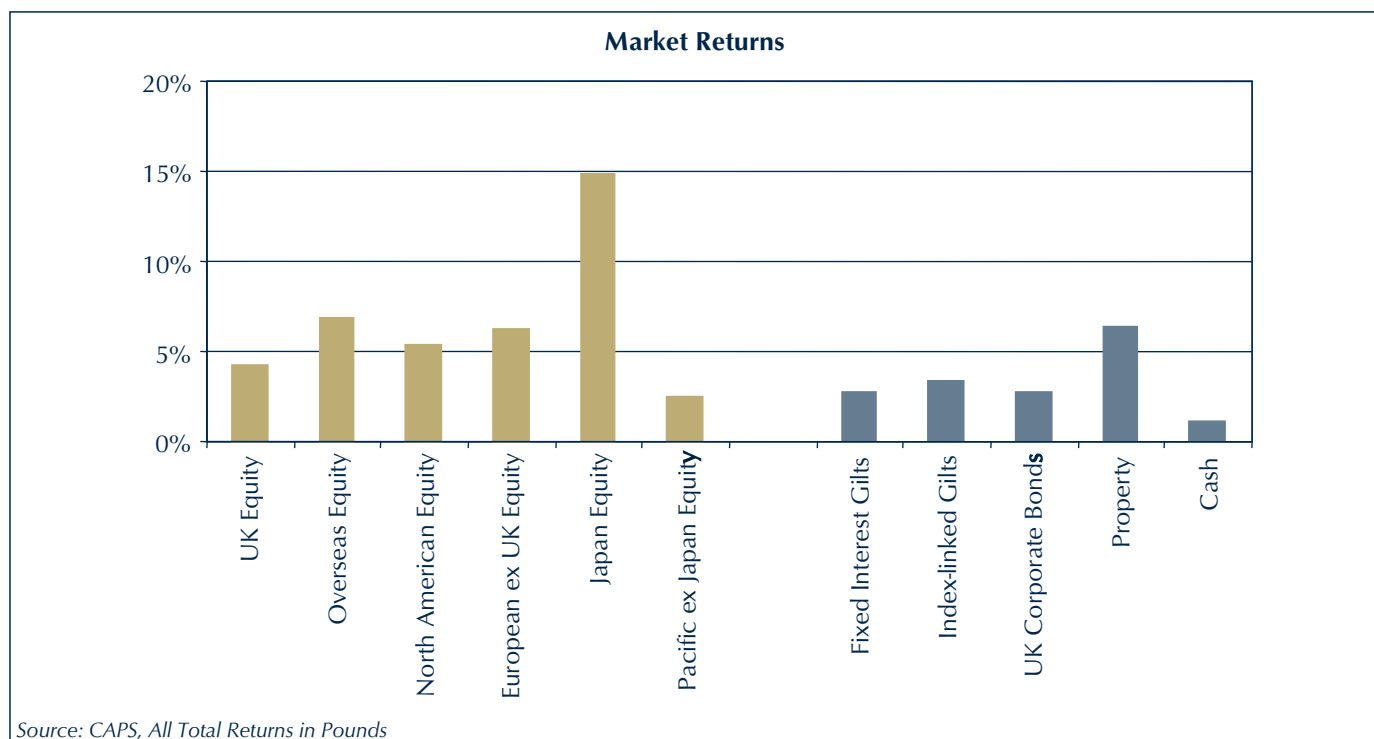


Market Solutions

Fourth Quarter 2005



Economics

- Real GDP growth was 1.7% year on year for the third quarter, indicating growth remains sluggish. Consumer spending and business investment were weak, expanding 0.5% and 0.3% quarter on quarter respectively. Manufacturing activity remained subdued in recent months, with a PMI reading of 51.1 in December indicating moderate growth in manufacturing output.
- The inflation rate moderated during the quarter and dropped to 2% in December – its lowest level in six months – as fuel prices declined and demand pressures remained moderate.
- The Bank of England's Monetary Policy Committee voted at its December meeting to leave the repo rate unchanged at 4.5% after the 0.25% reduction in August. The minutes of the meeting suggest the central bank will leave the key interest rate unchanged for the foreseeable future as economic activity gradually picks up and inflation remains under control.
- The Pound shed 2.3% for the quarter and 10.2% for the year against the Dollar. It was down 0.9% against the Euro for the quarter but up 2.7% for the year.

Equities

- UK equity markets traded at four-and-a-half-year highs in December, boosted mainly by UK corporate activity. The FTSE All Share Index gained 4.3% in the fourth quarter, taking its gains for calendar year 2005 to 22%. Mid-cap stocks continued to outperform, with the FTSE 250 reaching a record high of 8821.6 in late December and gaining 30.2% for the year. Large-cap stocks (FTSE 100) rose 3.2% for the quarter and 20.1% for the year as Resource stocks posted impressive gains. Small-cap stocks, on the other hand, returned 5.2% and 22.4% for the quarter and year respectively.
- Growth investing marginally outperformed value investing during 2005, with growth stocks returning 22.7% for the year compared with value stocks' 21.3%.
- At sector level, General Industrials set the pace with a 46.7% return, while Basic Industries (37.2%) and Resources (37%) were not far off. The laggard was Non-Cyclical Services, which returned only 3.3% for the year. Mining and industrials' 66.7% return for the year reflected the underlying strength of commodity prices as the firm global economy boosted demand.

Bonds

- UK bond values firmed, with the FTA All Stock FIG Index rising 2.8% for the quarter and 7.9% for the year. The yield ended the year at 4.05% compared with 4.48% at the end of 2004.

Global

Asset-class returns are increasingly being affected by globalisation. The key impetus for the global environment during the last few years has been the significant liquidity in the global economy and financial markets. This "sea of easy money", which Investment Solutions has long highlighted, has indeed been the key thematic driver. The best period of global growth since the 1970s, record commodity prices and record corporate earnings have been notable consequences. So, monitoring the direction of global-liquidity conditions continues to provide a good indication of the way ahead.

A key dynamic during 2005 was the measured tightening in US monetary policy. Real US interest rates finally moved into positive territory in January 2005 after being negative since September 2001. Recently, the Fed's tone has become more dovish, suggesting the tightening phase could be nearing its end. A new Fed chairman, slowing economic growth, combined with asset-price inflation and extremely high debt levels, imply a tricky time for monetary policy.

Despite US interest-rate increases, global liquidity remains strong and indeed a key driver of financial markets. The large recycling of Asian current account surpluses, as well as probably even larger recycling of the oil-producing countries' surpluses back into financial asset classes, continues to be the source of large global liquidity flows. Moreover, despite the close-to-normalisation of US monetary policy, global interest rates remain stimulatory. In Europe, real interest rates have been negative for most of the past two years.

Global economic growth was strong throughout 2005 – indeed, 2004 and 2005 combined was the strongest period of global growth since the 1970s. The robustness of global demand was demonstrated by the broad-based strength of commodity markets, with The Economist's Industrial Commodity (25% in Dollars during 2005) and Precious Metals (28%) Indices soaring to record highs. Moreover, there are no signs of a global environment taking strain and the upbeat momentum is likely to be maintained during 2006.

Reasonable economic growth implies a supportive environment for corporate earnings.

Global equities (up 10% in 2005) outperformed bonds (down 7%) for the third successive year, while emerging-market equities outperformed developed-market equities for the fifth year in succession. This partly reflected the Dollar's weakness against emerging-market currencies, as well as investors' appetite for risk in search of higher yields. Indeed, there is still an almost desperate attempt by investors to "lock in" yield, even at valuations that are clearly unattractive. This is in evidence globally, with the EMBI spread (the premium Dollar-denominated emerging-market debt trades above US treasuries) having plummeted to a record low of 2.35%.

Past performance is only one of a number of factors that affect future performance and may not be repeated. It should not be seen by itself as a guide to future performance. The value of investments may go down as well as up and investors may not get back the amount originally invested. Because of this, you are not certain to make a profit on your investments and you may lose money. Exchange rate changes may cause the value of overseas investments to rise or fall. Investors should be aware that investment in emerging markets involves a high degree of risk and should be seen as long term in nature.

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On currencies, Investment Solutions remains negative on the Western-developed Dollar, Euro and Pound, and positive on the Asian currencies, emerging and developed.

Investment Solutions' remains positive on prospects for global growth. Emerging Asia has the best expected-growth profile, thus the transition to a less US-centric world will continue. The company's bullishness for Asian currencies, emerging and developed, is also maintained as it expects appreciation relative to the Western developed currencies. The company expects 2006 to deliver reasonable global growth, with Asia providing the impetus.

Local

The UK economy experienced mixed fortunes in 2005. Short-term interest rates dropped, the Pound's real effective exchange rate fell and the equity market rose. This situation, amid a strong global economy, was supportive of a broad-based acceleration in growth. The services sector was reasonably strong, but manufacturing activity was weak, dragging growth down to below 2% – well below the government's target of between 3% and 3.5%.

The equity market maintained upbeat momentum during 2005 despite evidence of some slack in the economy. The bull trend completed its third year as strong global commodity cycle and corporate activity boosted the market. The 8% Dollar return was below returns recorded in Japan (26%) and Europe (10%), but UK equities continued to outperform US stocks (5%).

Weak manufacturing activity and near-term expectations of subdued growth, coupled with indications that inflation would remain largely under control despite rising oil prices, prompted the Bank of England to reduce its repo rate in the third quarter. Inflation has since fallen to 2% and there are some indications that retail spending picked up steam over the Christmas period. However, manufacturing activity remains under pressure, so Investment Solutions expects interest rates to remain unchanged – with a bias towards easier monetary policy – over the next year. The Pound lost ground against the other major currencies in 2005, particularly against the Dollar (down 10%). On a trade-weighted basis – Investment Solution's preferred measure of currencies – the Pound shed 3.5%. The company remains bearish on the Pound relative to other Western-developed currencies.

The same forces that drove equities in 2005 remain in place, so returns should stay reasonably strong during 2006. Corporate balance sheets are strong, and this, coupled with an abundance of cheap financing, suggests the likelihood of significant corporate activity. Valuations are close to long-term averages but at good historic levels relative to bonds, making an overweight equities/underweight bonds position still appealing.