MONTHLY INVESTMENT COMMENTARY

CARTLIDGE MORLAND

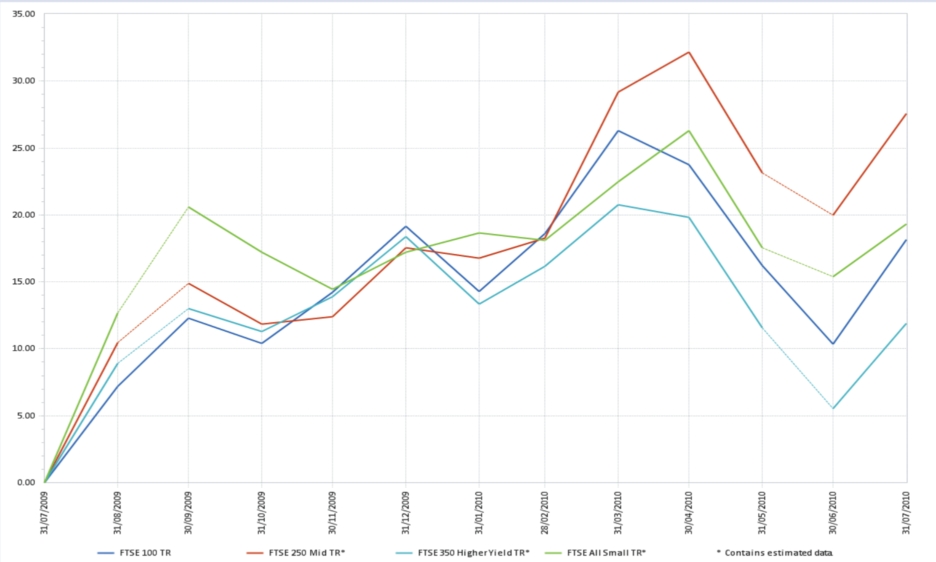
AUGUST 2010

UK EQUITIES

The preliminary estimate for economic growth in the UK for the second quarter of 2010 is surprisingly strong. The Office for National Statistics estimates that real gross domestic product increased by 1.1% compared with that of three months earlier and 1.6% on a year-on-year basis. It seems certain that this figure will be revised, as this early estimate is based on only around 40% of the final surveyed data. This level of surprising momentum is undoubtedly good news. It is also encouraging that the data suggests the economic gains were broad with signs of growth in services, manufacturing and construction.

The outlook is not one that supports sustained strong momentum. Britain's exports, upon which so much depends, are likely to diminish as demand from Europe weakens. Prime Minister David Cameron's high profile trip to Turkey and India was business-minded, as an attempt to open markets outside the EU to British companies, and he will be hopeful of emulating German success in this regard. For the moment though, the euro zone is still the destination for around half of all UK exports. Austerity measures on the continent will almost certainly cut euro zone demand, added to which the recent resurgent strength in sterling will have the effect of increasing relative costs of British goods in the EU market place.

The coalition government's commitment to cutting the deficit so swiftly is likely to weigh on domestic demand. The labour market will remain weak and it will not be before 2011 that job creation will start to have a positive impact. In the meantime, fiscal tightening and welfare reforms will add to renewed concerns against a wider backdrop of constrained credit conditions. The Bank of England's monetary policy committee will soon represent the only support to a nascent recovery.



Source Lipper. % Growth, £, total return, 31/07/09 to 31/07/10.

US EQUITIES

US economic indicators and consumer confidence, in particular, are showing signs of the slowdown that we were anticipating. We continue to expect a protracted recovery. In fact, our expectations are similar to those of Ben Bernanke, Chairman of the Federal Reserve

Continued over page

EUROPEAN EQUITIES

The euro zone saw two key pieces of good news in July. Unfortunately, one of them is largely irrelevant. The Committee of European Banking Supervisors (CEBS) has confirmed that EU banks are capable of withstanding further shocks to the credit market and wider economy, with only seven simulated failures out of a sample size of ninety-one. We think that if more realistic assumptions were made, the number of failures would have risen to over twenty. Aside from some additional and welcome clarity about participating banks' balance sheets, the CEBS exercise was only going to make a difference if the number of failures was unexpectedly high (in the event the number of failures was probably below consensus) given the fairly tame level of assumed risk involved in the analysis.

Much more meaningful is the surprisingly strong climb in German business confidence. Confidence in Germany is now comparable to its June 2007 levels. This might indicate that businesses are less concerned about EU-wide austerity measures than we might have thought would have been the case. Generally we consider confidence measures to be leading indicators, by reaching peaks and troughs ahead of the wider economy. Perhaps rising confidence on this occasion has only a short horizon, coinciding with the tail of improvements brought about by the fiscal stimulus, not to mention the inventory cycle, both of which will fade towards the end of the year.

SOUTH EAST ASIAN EQUITIES

The Asia Pacific economy stands in stark contrast to that in the West. In Europe and the US, growth in economic output is

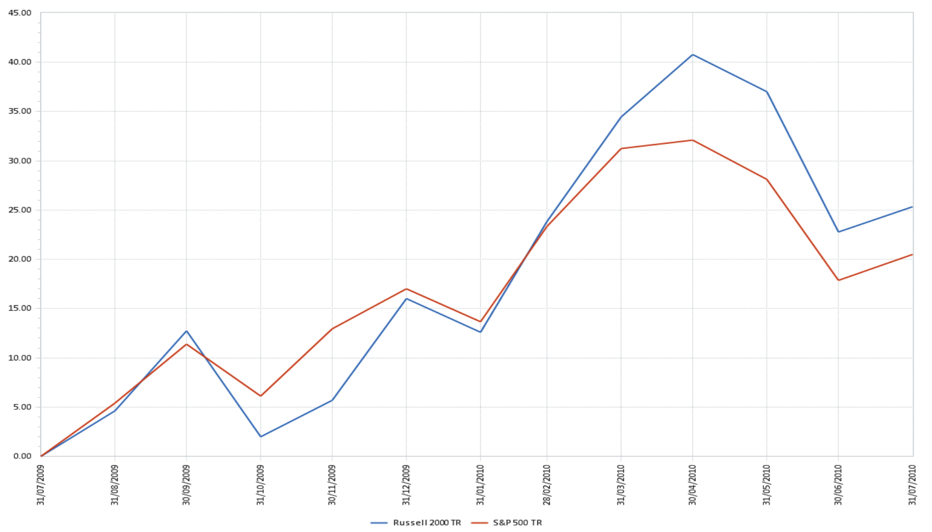
Continued over page

83-85 Mansell Street London E1 8AN T: +44 (0) 20 7709 5560 F: +44 (0) 20 7709 5561
E: enquiries@cartlidgemorland.co.uk W: www.cartlidgemorland.com

US Equities - Continued

Open Market Committee. In his testimony to Congress in late July, Bernanke suggested that the recovery was losing momentum but the central bank still expects the recovery to gather speed in 2011.

A great deal rests on the state of the labour market. Mainstream reports have adopted a tone that suggests we are seeing improved job creation. In fact the pace of job creation is worrying. The Great Recession saw the biggest fall in US employment in over sixty years. If job creation continues along its current trend, it will not be until 2020 before full employment is reached. Most obvious is the effect this will have on discouraging consumer spending, thus limiting growth in economic output, as consumer spending is the lion's share of gross domestic product. It also has worrying connotations for the inflationary outlook. Weak labour markets are accompanied by weak income growth and this time are likely to be allied with diminished public spending. Deflation is the most potent of economic risks. It will remain a risk until growth in jobs is real and significant.



Source Lipper. % Growth, £, total return, 31/07/09 to 31/07/10.

JAPANESE EQUITIES

Naoto Kan, the Japanese Prime Minister has likened Japan's position to that of Greece. Of course, it is true that only Zimbabwe (280%) has a greater debt to GDP ratio than Japan (190%), which in turn is much greater than that in Greece (113%). However, the situation Japan occupies is very different to that of the peripheral EU state of Greece. The most obvious difference is that households and businesses in Japan save rather than spend and this creates strong domestic demand for safe assets, reducing the country's dependence on foreign lending. When Naoto Kan spoke of a Japanese debt time bomb, the ten-year Japanese Government Bond was trading at its lowest yield in seven years. Contrast this with Greece's equivalent trading at its highest yield in over a decade. The Japanese electorate has also been critical of the ruling Democratic Party of Japan, denying them a majority in the House of Councillors (the Japanese upper house) in the July elections. Japan is in great need of political leadership and that need is now less likely to be satisfied in the near future.

Japanese equity market revivalists are pointing out that share prices are offering tremendous value. The case for and against post-bubble Japanese investment is as mixed as it has ever been. On the one hand are the new and exciting opportunities which are opening up for Japanese exporters in China and on the other is the dire domestic economic malaise. For now, we remain unconvinced of the potential for the Japanese stock market to provide a sufficient risk premium in the medium and longer term.

Would you prefer to receive the Monthly Investment Commentary by email in future?
Please email James Simpson (commentary@cartlidgemorland.co.uk) to request this service.

South East Asian Equities - Continued

slow and the real risk of further recession remains. Inflation in the old economies is muted too, with a persistent threat from deflation. The emerging economies in Asia are seeing high rates of growth in both economic output and inflation. Inflation has surged in recent months in Australia, India, Vietnam, Singapore and China. Of more concern than a temporary spike in inflation, a mild form of which we are seeing in the UK, is the suggestion that future inflationary expectations are rising across the Asia Pacific area. Inflationary expectations have played an increasingly powerful role in central bank policy in the last two decades; this is equally true of the Asia Pacific region as it is of the West. Low future inflationary expectations played a key role in anchoring interest rates in the boom years prior to the Great Recession. Now, rapidly rising expectations will be the key concern for policy makers.

UK FIXED INTEREST AND MONEY MARKETS

Comments from the Bank of England Governor, Mervyn King, suggest that interest rates are not set to rise in the immediate future, despite an inflation rate which remains stubbornly above the 2% target. Inflation is expected to remain above target until at least the end of 2011 according to the Governor. Most members of the Monetary Policy Committee (MPC) feel that inflation will be tempered by a difficult job market. Inflation is not likely to be stoked by high pay rises. There has also been some consideration of re-introducing quantitative easing as growth prospects for the UK have been revised downwards. The MPC voted to maintain rates at 0.5%, the same level since March 2009. The prospect of sustained low rates is a favourable environment for the fixed interest market.

The demand for UK gilts has increased very recently as investors have become more risk averse.

Corporate balance sheets remain relatively strong and there has not been the same level of issuance by high quality companies this year as there was in 2009. These are positives for the corporate bond market. The relatively positive results of the European bank stress tests did help returns from subordinated bank debt and therefore returns of some corporate bond funds.