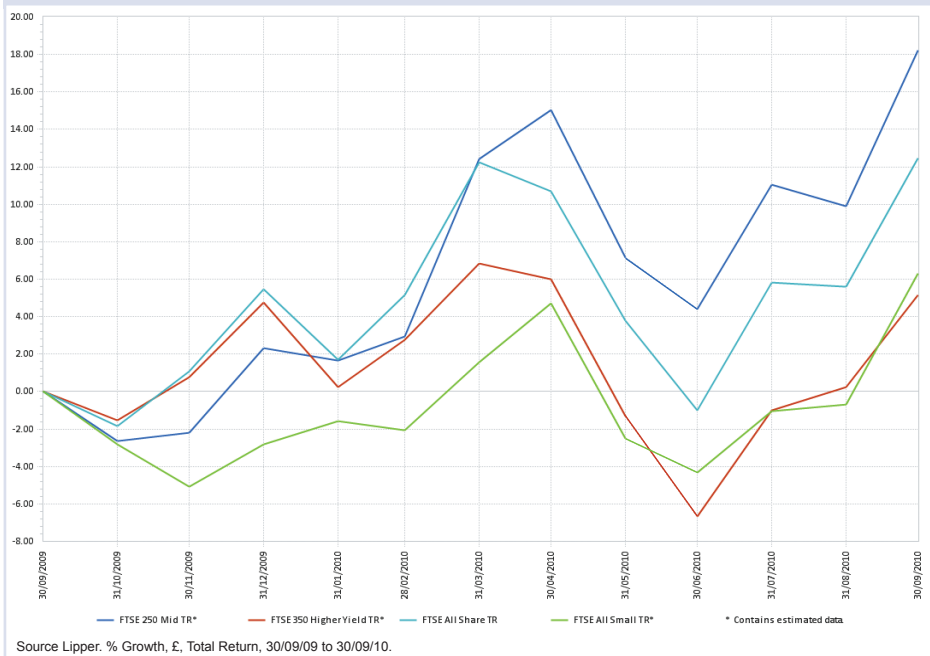


OCTOBER 2010

UK EQUITIES

The government budget deficit reached a 17-year high in August necessitating net monthly borrowing of just over £15 billion. The Office for Budget Responsibility is forecasting a deficit of around 10% of GDP for 2010, down marginally from 2009 as a result of spending cuts. Expectations are for total debt levels to rise still further as tax receipts remain diminished. Total UK debt as a percentage of GDP, at 64%, now exceeds the maximum allowable under the European Union fiscal rules. This is the backdrop to the forthcoming spending review, the point at which austerity measures will begin to take effect.

There is little doubt that government spending cuts will impact the labour market negatively. Most apparent will be public sector redundancies. These job losses will be compounded by slowing private sector job creation as credit for small and medium sized business remains scarce and consumer demand stutters. Unemployment is likely to rise from the current rate of around 8% and consumer confidence will weaken further. The outlook for strong consumer spending – and a continued strong domestic recovery – is not at all convincing. Barring a surprising turnaround in the fortunes of Britain's exporters, we are expecting diminished rates of economic output in 2011.



US EQUITIES

In September, the National Bureau of Economic Research (NBER) confirmed that the US recession ended in June 2009. The NBER's Business Cycle Dating

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EUROPEAN EQUITIES

Euro zone unemployment remained at a 12-year high in August at a rate of 10.1% (reached initially in May). The employment data show mixed results across the monetary union. The rate of unemployment has fallen in Germany where a strong export-led recovery has combined with government-led subsidies to protect the number of employed positions. In contrast, unemployment rates have risen in France. Continuing recession in Ireland and anaemic recovery in Spain are leading to further job losses in these countries.

It is difficult to see where the stimulus for large scale job creation will come from on the continent. The austerity measures adopted throughout the euro zone will combine with fiscal tightening to bring about further recession, perhaps in the final months of 2010 or early in 2011, for the euro zone in aggregate. As a result unemployment could continue to rise and profit margins for companies in the region could come under considerable pressure.



SOUTH EAST ASIAN EQUITIES

Growth is still strong in China and the US has been vociferous in calling for the Renminbi to be allowed to weaken against the Dollar. China's

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Committee analyse a broad spectrum of data (some of which is available months after the event) to try to identify with some certainty how the world's largest economy has performed. Their findings were accompanied by a striking caveat; they "did not conclude economic conditions since that month have been favourable or that the economy has returned to operating at normal capacity". Harsh recessions are very often followed by sharp recoveries. We know now that the recovery is proving to be slow and protracted.



UK FIXED INTEREST AND MONEY MARKETS

Interest rates remain at historically low levels and we expect this to continue as the prospects for growth appear muted in the shorter term. Annual consumer price inflation remains above target, standing at 3.1%, and we can expect some further price pressure as consumers bring forward larger purchases in the final months of 2010 to beat the January deadline for the planned VAT rise from 17.5% to 20%. The earlier restoration of VAT (from 15% to 17.5%) and a weak period for sterling are the temporary factors that have led to higher than anticipated inflation. We continue to expect UK inflation to subside and do not believe that the conditions are right for inflation to be sustained and problematic. Deflation remains a real risk. Inflation expectations implied in the prices of government securities have reduced in recent months. Deflationary pressures are evident in the euro zone, in the US and in Japan. If the UK economy stalls and bank lending declines further, we could see those deflationary pressures re-emerge in the UK. At that point we are likely to see the Bank of England resume its quantitative easing programme.

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weak currency is giving its economy a trading advantage. This is illustrated by China's large trade surplus of \$16bn in September. The People's Bank of China has increased the one-year lending rate unexpectedly. This is the first increase in three years and is a move to cool the economy. In particular, it should dampen the demand for property which in some cities appears to be creating a bubble in prices. Taiwan has increased interest rates for the second time this year as its economy is growing at its fastest pace in 30 years. In Korea, the Won has appreciated against the US Dollar threatening export growth and therefore recovery. Interest rates have remained at 2.25% for the past three months. Consumer prices are now increasing close to the top of Korea's Central Bank's target rate. The Monetary Authority of Singapore is allowing its currency to appreciate as currency management is the main tool used in curbing inflation rather than a benchmark interest rate.

JAPANESE EQUITIES

The Bank of Japan (BoJ) has announced various policies to try to shore up the faltering recovery. Surveys have indicated slowing household and corporate confidence. The overnight call rate target has been reduced to virtually zero, the first cut in two years with a commitment to hold rates at 0% until deflation is eliminated. Fiscal loosening has continued with BoJ buying back government bonds and other assets to the value of around \$60bn. In addition, inexpensive credit facilities are being offered. The Yen has remained strong against the dollar so imports are cheaper, thus adding to deflationary pressures. It remains to be seen if yet another stimulus plan meets its objectives.