

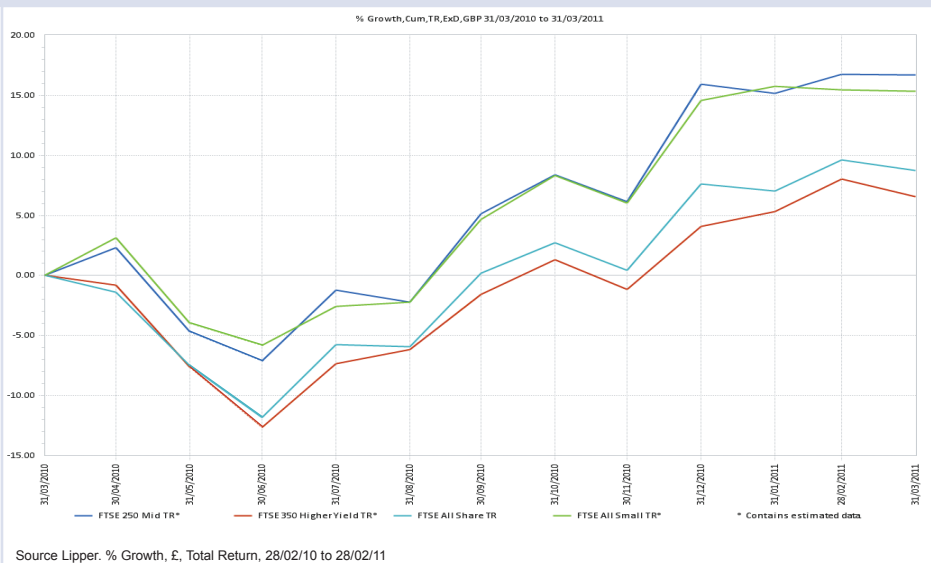
APRIL 2011

## UK EQUITIES

The final estimate from the Office for National Statistics (ONS) for growth in the fourth quarter of 2010 established a contraction of 0.5% on the previous quarter, slightly less than had been suggested earlier. The ONS attribute much of the fall in output to poor weather, suggesting that the economy would have remained broadly flat had winter conditions been benign. On a year-on-year basis the British economy grew by 1.5%. The national accounts reveal a quarterly rise in output from production industries (0.8%), government expenditure (0.4%) and inventories (£3.1 billion). Falling output was seen in construction (0.3%), services (0.6%), household expenditure (0.3%) and gross fixed capital formation (1.8%).

There has been positive news on the trade deficit for February. The difference between how much the country imports to how much it exports has narrowed. The growth in goods exports has been beneficial. Exports to European markets fell but those to other countries showed a marked increase. Imports fell by 2.2%.

Looking forward, it seems likely that the UK will escape a second recession with GDP expanding in the first quarter of this year. Services, construction and manufacturing, according to early (but volatile) data will provide much of the impetus for renewed expansion. The Purchasing Managers' Index for industry hit a 17-year high in January and remained close to that level in February. Strong export orders are also supportive. Consumer confidence is not improving along with house prices, the labour market and mortgage lending. Growth might be resumed, but it is likely to be sustained only at low levels.



## US EQUITIES

US economic growth for the fourth quarter of 2010 has been revised upwards to 3.1% from the previous estimate of 2.8%. While the recovery is likely to be sustained in 2011 the recent rise in the oil price is likely to reduce growth from an expected rate of close to 4% to around 3.5%. Oil price rises have a significant impact on the US economy with an estimated \$50 billion in extra oil costs (source: Moodys economy.com) flowing overseas. Ordinarily, a difference of 0.5% in annual growth would not be so significant, but this lower rate of growth could bring with it only a modest improvement in the employment situation. The US needs a relatively high growth rate to create enough employment opportunities for its rising population. We are mindful that rising tensions in the Middle East have the potential to inflate oil prices still further. Increasing costs will have an increasing impact on potential growth.

*Continued on page 2*

## JAPANESE EQUITIES

Following the tragedy of the Sendai earthquake and tsunami coupled with nuclear leaks, Japan is now faced with vast reconstruction costs. Its economy was fragile before this disaster, although there were indications of some progress particularly in manufacturing. Now, there are widespread power shortages and supply disruptions that will hamper Japan's nascent economic recovery from the financial crisis of 2008. Depending on the extent and duration of these power shortages, a much more subdued recovery in output may result as reconstruction and rebuilding work begins. Worse still, from the perspective of economic output, is that any deterioration in the nuclear situation will further undermine investor and consumer confidence.

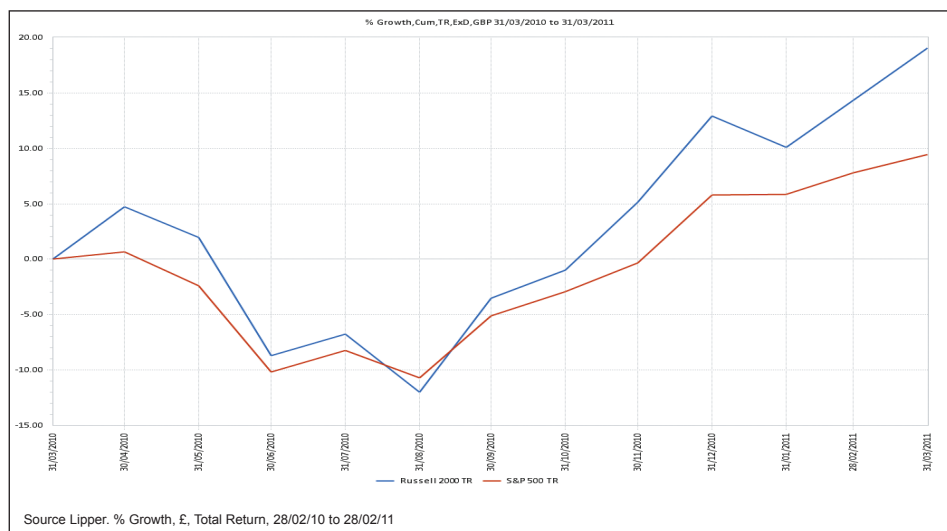
In the wake of the disaster the Japanese yen rapidly gained in value as speculation arose that Japanese corporations would repatriate vast cash reserves (purchasing yen in the process) to pay for immediate reconstruction efforts. A stronger yen would harm Japanese competitiveness first and foremost but there are other harmful side effects with regional implications (according to the World Bank about a quarter of foreign currency debt issued by East Asian nations is denominated in yen). In response to this risk the major central banks acted together in selling the yen and forcing its value down. These efforts have proved very effective – far more effective than the Bank of Japan's sole efforts in recent months – and may signal a turning point in the recent trend for a strengthening currency.

## ASIA PACIFIC EQUITIES

Chinese authorities are continuing to take action in the face of persistent consumer price inflation. Unwilling, and probably unable, to allow its currency to appreciate and nervous of raising interest rates for fear of attracting further foreign capital inflows, the People's Bank of China is increasing capital reserve ratios for Chinese banks. Banks are now required to deposit 20% of capital with the central bank at rates which are well below the commercial market rate. This has the effect of reducing loans in the economy, though it is a crude tool for controlling inflation.

*Continued on page 2*

Beyond oil, US businesses appear well positioned with sound balance sheets. Arguably, this extends to the country's major banks and it seems that credit is set to expand. Households seem to be improving, although the housing market remains woeful and consumer confidence has fallen by a significant extent in March. The outlook is finely balanced.



## EUROPEAN EQUITIES

With inflation now running above target for the euro zone, the European Central Bank (ECB) voted at its April meeting to raise its main policy interest rate to 1.25%, up 0.25%. This is the first rise since October 2008 and first change since June 2009. The move was expected by the market due to various warnings given by the ECB President. The ECB is worried in particular about higher food and energy prices leading eventually to wage inflation.

At the end of March leaders from the European Union agreed in principle on the shape of a permanent European Stabilisation Mechanism (ESM), to replace the hastily created European Financial Stability Fund. The new mechanism will be able to lend up to €500 billion with that level assessed for effectiveness every five years. We are likely to find out if this amount is enough long before the first 5-year review. Portugal has finally asked for assistance following multiple downgrades to its debt and the collapse of the coalition government. A reasonable estimate for a bailout for Portugal is around €80 billion, well within the ESM's capacity. If Spain was to request assistance that would be a very different matter; estimates here are around €300 billion. Spanish banks are still struggling and are likely to require further assistance from the government. This comes at a time when the Spanish Central Bank has suggested that the country may miss its budget deficit target. Help for both Portugal and Spain could see much of the €500 billion capacity used.

## EMERGING MARKETS

Emerging markets have underperformed developed markets in the first quarter of 2011. Concerns about rising inflation, further monetary tightening and political unrest in the Middle East have led to negative investor sentiment. There have been significant investment outflows from the region. Inflation has been mainly driven by soaring food prices as bad weather has led to poor harvests. The increasing oil price could further exacerbate inflation in some regions in particular Asia Pacific and parts of Eastern Europe. Russia and some Latin American countries benefit from a higher oil price as they are significant oil producers. Authorities in many countries continue to combat inflationary pressure with further increases in interest rates and reserve requirements for banks. Growth rates are likely to be reduced by such measures but continue at reasonable levels. The long term potential for attractive returns still remains.

In addition, the authorities are taking aggressive action to control property prices by ending sales tax breaks, restricting credit, increasing deposits on second mortgages and imposing property taxes. They are attempting to engineer a risky strategy whose goal is sustained property price declines. Currently, property prices in Beijing and Shanghai are around 15 times average white-collar incomes.

These combined efforts to control inflation are allied with changes to economic policy in the most recent five-year plan. Premier Wen Jiabao recently announced a reduction in the target GDP growth rate along with administrative measures to boost agricultural investment and service sector investment. These policy responses, it is suggested, are intended to curb increasing inequality. This reduced growth target may be an acknowledgment of the likelihood that growth in China will slow in any case. Productivity gains are likely to diminish and a raft of bad loans may arise in the next few years. Output should still rise quickly by global standards.

## UK FIXED INTEREST AND MONEY MARKETS

The Bank of England's Monetary Policy Committee (MPC) has voted in April to again maintain both the policy rate of interest and the quantitative easing limit at current levels (0.5% and £200 billion respectively) for the 25th consecutive month. It may be that the MPC is waiting for the impact of higher national insurance to come through. Minutes of the April meeting are released at the end of the month. The March minutes of the MPC show that six of the nine members voted for the carrying proposition with four dissenting voices. Three members voted for an increase in the policy rate with Adam Posen voting in the opposite direction, to increase the quantitative easing programme by £50 billion.

Inflation figures for March 2011 were lower than expected. The Consumer Prices Index (CPI) measured 4.0% down from 4.4% in February. The Retail Prices Index (RPI), which includes mortgage costs, fell to 5.3% from 5.5% in February. Aggressive discounting by supermarkets accounted in part for the lower figures. It indicates that businesses are unable to increase prices as consumers' disposable incomes are being squeezed. It is now likely that the interest rate rise, expected in May, could be postponed. Nevertheless, inflation may increase in future months if the oil price rises further.

**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.

Cartlidge Morland is authorised and regulated by the Financial Services Authority

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. Cartlidge Morland's current views and suggestions in this document are based on research which is obtained from a variety of sources. Whilst these sources are believed to be reliable, the information obtained cannot be guaranteed to be accurate and may be condensed or incomplete. Past performance is not a guide to the future. The value of investments and income arising may go down as well as up.

Reproduction of this commentary is not allowed in whole or in part without prior written agreement from Cartlidge Morland.