

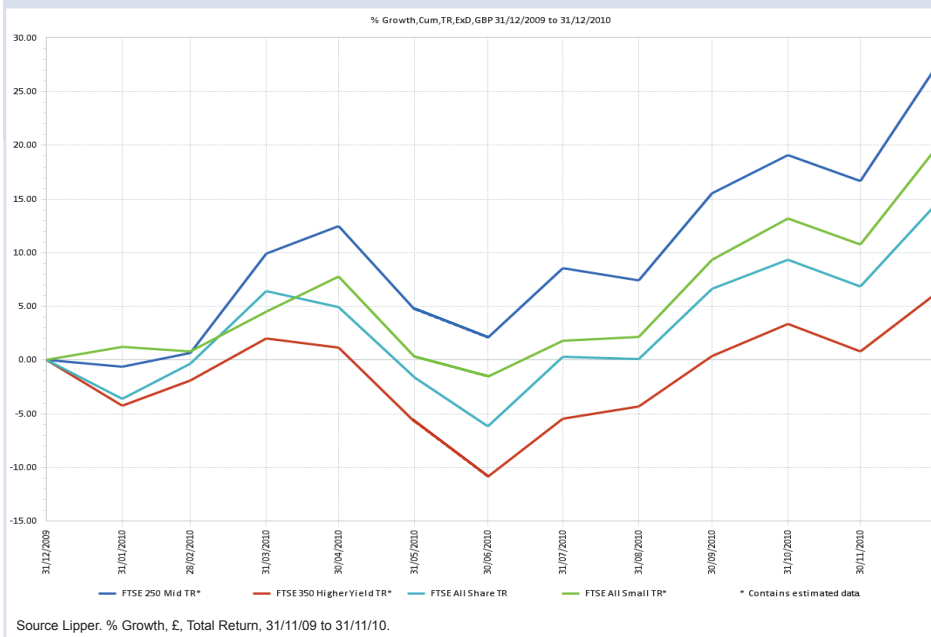
## JANUARY 2011

### UK EQUITIES

The UK economy contracted by 0.5% in quarter 4 2010. This figure was unexpected and caused the equity market and sterling to fall. Fears increased about a double dip recession. Bad weather in December has contributed to some extent to the negative figure illustrated by the 3.3% contraction in the construction sector. The Office of National Statistics has indicated that the growth figure would still have been around 0% if the weather had not been a factor. History shows that recoveries are not always smooth and this recovery is no exception. The economy still has to cope with the austerity measures which will take affect this year which will again lead to sluggish growth.

With some of our major trading partners, such as America and Germany, showing signs of more robust recoveries, the UK should benefit. Weaker sterling should boost UK exports further which should impact positively on growth.

Inflation has increased to a level well above the Bank of England's target and there has been discussion of increasing interest rates. With muted/no growth, any increase in interest rates would only hold back any growth. We do not therefore expect interest rates to increase any time soon.



### US EQUITIES

Late December 2010 brought with it some good news for the US economy. First, the Thomson Reuters/PayNet Small Business Lending Index has now climbed for nine consecutive months evidencing US banks' willingness to once again lend to small businesses. Coincident with this latest rise was also a fall in the number of debt defaults. This may encourage the banks to increase lending to businesses which may then impact positively on the labour market. Secondly, the latest Institute of Supply Management (ISM) survey rose still further (from 55 in November to 57 in December) with considerable improvements in the non-manufacturing sector which had, until this release, been lagging behind the manufacturing sector.

These improvements will come as some relief to policymakers. The US deficit currently sits at around \$1.3 trillion, a little under its record high of \$1.4 trillion or 10% of GDP in 2009. Stronger

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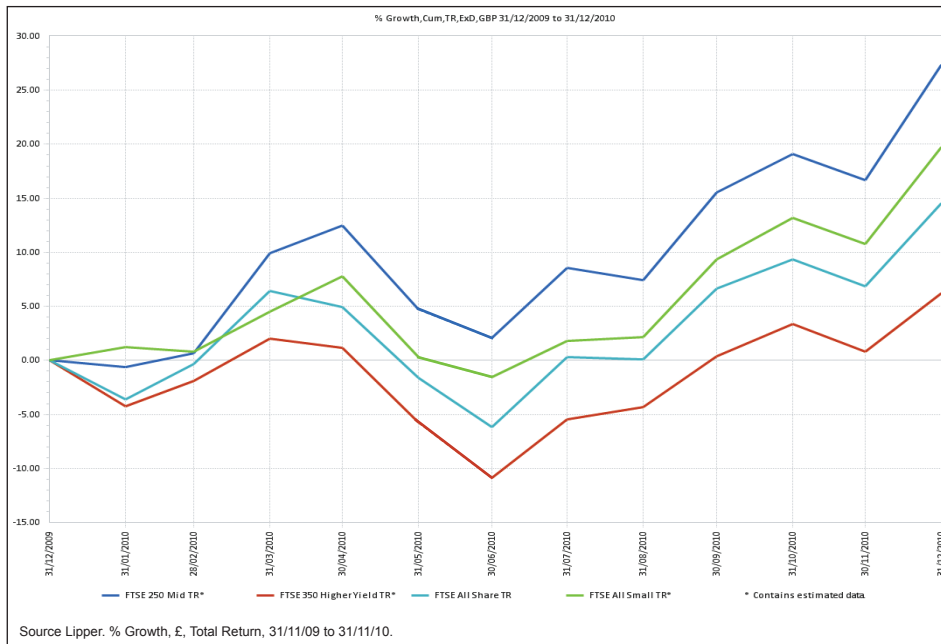
### UK FIXED INTEREST AND MONEY MARKETS

The Bank of England's Monetary Policy Committee (MPC) voted to maintain both the policy rate of interest at 0.5% and the quantitative easing limit at £200 billion, although there remains a three-way split in the voting patterns. Seven of the nine MPC members voted for maintaining the current position while Dr Andrew Sentance voted for a 0.25% increase in policy rate and Dr Adam Posen voted in the opposite direction, to increase the quantitative easing programme by £50 billion. It is testament to the current level of uncertainty that both Dr Sentance and Dr Posen can quite reasonably maintain opposing views.

The majority vote is an attempt to balance economic vulnerability and a weak labour market with above target inflation rates. We expect growth in the UK to slow in 2011 as fiscal tightening both in the domestic economy and elsewhere in the EU combines with the effects of poor credit availability. Inflation on the other hand may gather strength in coming months as the increase in the VAT rate is picked up in both the Consumer Price Index (CPI) and the Retail Price Index (RPI) measurements. The Bank of England projections reveal a peak in CPI early in 2011 with inflation remaining above target for much of the year before falling back in line with target in 2012. In spite of persistent above target inflation, we believe it is not likely we will see interest rate rises of any significance at all in 2011, certainly not until economic recovery is firmly underway and the labour market has shown marked improvement.

Credit spreads for higher yielding debt securities have narrowed in recent months in spite of some evidence of deteriorating credit fundamentals. The number of issuers receiving downgrades, for example, has exceeded those with upgrades. It seems that the promise of further quantitative easing and record low interest rates has driven investors into another potentially dangerous search for yield. This is perhaps best highlighted by the recent surge in corporate bond issuance in the emerging market economies (EMEs) which now stands at record levels. In the December 2010 issue of the Bank of England Financial Stability Report, it was revealed that Bank 'contacts have expressed concerns about a lack of due diligence on some EME corporate bond issuance'. There is a profligacy of new emerging market debt funds and hedge funds coming to market.

revenues should arise as a result of improved economic growth and a strengthened labour market. Rising employment will also have the effect of reducing social security payments. The combination of increased revenues and lower spending should lead to a reduction in the deficit. Having said that, the US appears to have a problematic structural deficit which may be hard to improve upon, particularly as the baby boomer generation ages.



## EMERGING MARKETS

Investor risk appetite increased in December in part due to fiscal and monetary stimuli in the US. Data indicates growth in developed economies, such as the US and Germany, which is likely to support emerging markets. Economic data from emerging markets indicated continuing growth. China's GDP increased at a rate of 9.8% pa in the last quarter of 2010. Central banks continued to tighten monetary policy to fight inflation. The People's Bank of China again increased both interest rates and the reserve requirements for banks to this end. Brazil has announced a further increase in its interest rate taking it to 11.25%. Consumer prices in Brazil are increasing at around 5.5% pa. Growth is expected to slow to 4.5% in 2011 from 7.3% in 2010. With tightening around the regions, we expect equity returns in 2011 to be less impressive than in the previous year.

## EUROPEAN EQUITIES

The European Central Bank (ECB) has once again voted to maintain the interest rate at 1%. The President of the ECB warned after the meeting that the central bank would act if inflation increased so indicating that an interest rate rise would be considered in such circumstances. The euro zone inflation rate rose to 2.2% in December, 0.2% above target. The Euro appreciated against the US dollar following the statement, threatening to undermine European exports. Subsequently, ECB officials have tried to dampen down expectations with the Bundesbank President and Council Member stating that "we do not see a need for an interest rate change in the foreseeable future." The weaker Euro is good for exports and in particular the export-led German economy.

Germany is forecasting growth of 2.3% in 2011. The Government expects unemployment to fall and that its public sector deficit will fall below the European Union's 3% limit in 2011. Manufacturing and non-manufacturing industry surveys in Germany certainly point to strong demand. In the more problematic nations, the Irish Finance Bill is to be passed before Parliament is dissolved which is a key requirement for its bail out by the European Union. The Spanish Government warned banks that they would need to recapitalise or face nationalisation in an attempt to calm fears.

## JAPANESE AND ASIA PACIFIC EQUITIES

The second estimate of Japanese economic growth in the third quarter of 2010 suggested a revised rate of 1.1%, up from 0.9% on the previous quarter. This latest estimate represents impressive growth, more so because the key driver was household consumption. Almost a decade and a half of persistent deflation has led to the Japanese to save rather than spend. Evidence of this can be seen in the low levels of Japanese government bond yields – currently at 1.2% in spite of a debt-to-GDP ratio of 215% – which are suppressed by huge demand from investors in Japan.

It is too early to tell if Japanese household spending patterns have changed permanently. Increased household consumption may be temporary, affected by two fiscal stimulus packages aimed specifically at private demand. Unfortunately further stimulus packages are unlikely. With the lowest public spending of any comparable economy already, the Japanese government cannot even divert funds from public spending elsewhere. Hopefully, Japanese consumers will continue to spend even after government incentives expire as the other areas which support growth are even less promising. Businesses are unlikely to make large scale investment within Japan given likely huge spare capacity and exporters will suffer a loss of momentum as the yen climbs in value and the global economy slows in 2011.

The Chinese economy continues to surge. When official figures are released they are likely to reveal double-digit growth for 2010. This is in spite of a slowing in the rate of growth as the year progressed and as the massive fiscal stimulus package administered in 2009 was withdrawn. The rate of year-on-year growth in electricity consumption – perhaps one of the more reliable measures of underlying growth in an otherwise opaque economy – has slowed markedly in recent months. Retail sales, driven by rising wages in urban areas, are rising rapidly. Exports have bucked the global trend. Even Chinese shipments to the euro zone accelerated in November (the most recent month for which we have data).

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