

JUNE 2011

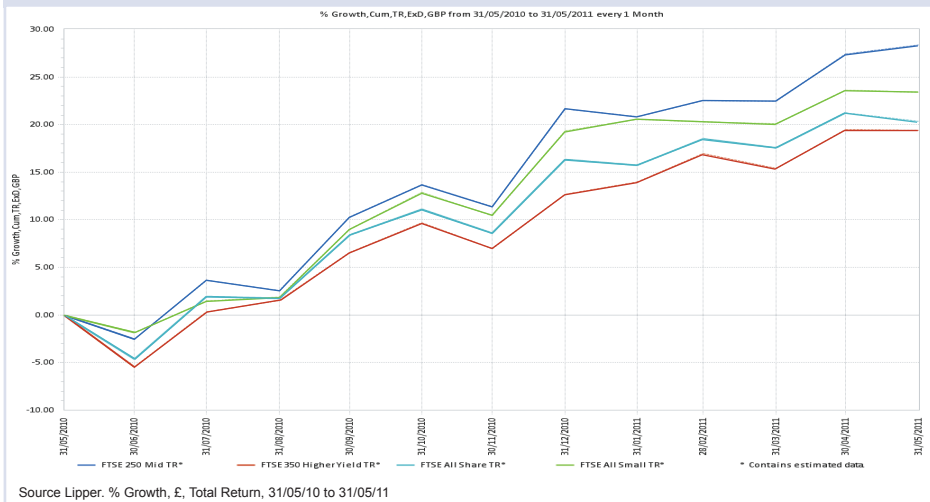
## UK EQUITIES

It seems likely now, following the release of the second estimate, that the British economy increased in output by 0.5% in the first quarter of 2011. The recovery, save for some hesitation in the fourth quarter of 2010, is on track and has now clawed back a third of the output lost.

One of the distinguishing features of the recession has been the significant decline in the strength of sterling. Between late 2007 and early 2010 the pound lost around a quarter of its value when compared with the currencies of our most important trading partners. This led to substantial improvement in the balance of trade. At the mid-point in 2007 the value of imports to the UK exceeded the value of exports by around £13 billion. At the same time two years later, when the recession was at its deepest, the deficit had narrowed to around £7 billion. Though the trade balance remained in deficit, the sharp reduction provided much-needed assistance to the UK economy. The Office for National Statistics has indicated that the likely contribution to GDP growth averaged 0.5% for each quarter of 2008. Unfortunately, this trend has reversed of late. The current trend is for net trade to act as a drag on growth. Exports have indeed increased but so too have imports. The somewhat disappointing inference is that the earlier positive effects of a reduced exchange rate have not stimulated a significant switch from foreign produced goods and services to those produced domestically.

The outlook for the UK economy remains a weak one. Consumer spending accounts for around 60% of UK output but household finances are under a great deal of pressure. A weak labour market and high inflation have resulted in a decline in real household income for the first time in a generation. Government spending too is being reined in. Business investment, though likely to expand, remains muted and the boost from inventories is having less of an impact. Of course, history bears witness to erratic growth during a recovery from recession. It seems likely that we are in line for a prolonged period of sub-par growth.

Against this background, we still favour investment in larger, high yielding companies for their defensive qualities. Those with strong balance sheets and established market positions should be well placed to continue to pay attractive dividends. These dividends are likely to form a significant proportion of total returns.



## US EQUITIES

It seems the US recovery, impressive in its performance to date, is losing momentum. The Federal Reserve has revised its growth forecasts and has estimated that unemployment will stay above 8% next year. Looking forward, there is some evidence to suggest that consumer spending will continue along muted lines. In the wider economy, manufacturing sentiment has

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## JAPANESE EQUITIES

The Japanese economy continues to suffer following the catastrophic earthquake and tsunami in March. GDP contracted in the first quarter by 3.5% with consumer spending and capital investment both down. Private consumption accounts for 60% of the Japanese economy. This contraction is larger than expected. Exports are much reduced due to the interruption in the supply chain and a relatively strong Yen. It is likely that the economy will continue to shrink in Q2 with growth eventually coming through in the last six months of the year.

## ASIA PACIFIC EQUITIES

Asia Pacific markets have been negatively impacted by the prospect of a US recovery being more protracted than expected and sovereign debt fears in Europe. GDP data for the first quarter was robust with strong export and private consumption figures. Inflation remains a key concern for this region. Malaysia, the Philippines and Korea all raised interest rates with Taiwan indicating further rises were likely.

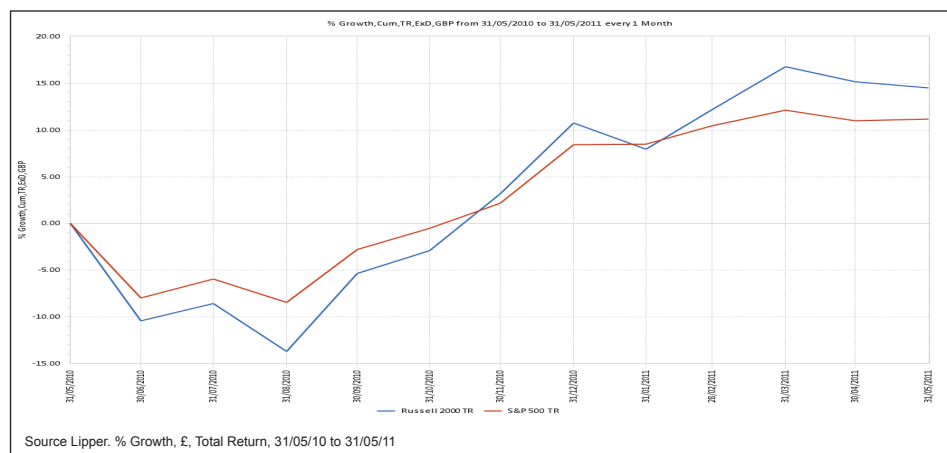
## EMERGING MARKETS

Returns from Emerging Markets have been muted recently as risk aversion has increased. Concerns about the ongoing sovereign debt crisis and slowing global growth have weighed heavily on markets. Worries about growth were partly influenced by the Chinese central bank curbing bank lending. Weak employment figures and consumer spending levels in the US also led to less robust investor sentiment. Manufacturing statistics in China and India have indicated growth slowing but still positive. Inflation in many economies does seem to be slowing as a result of monetary tightening measures. The Middle East and North African regions have continued to be impacted by the civil and political unrest in Libya, Syria and Yemen. Russian oil and gas stocks have underperformed recently due to fears over the global slowdown.

## US Equities Continued

slowed and factory orders have declined a little more than might be expected in the light of the impact the Japanese earthquake and tsunami have had on global industry.

It seems likely, at this stage at least, that slowing momentum in the world's largest economy will prove temporary. The Federal Reserve has reiterated that a further round of monetary easing is not likely. It also believes that higher energy prices will prove short lived. Business balance sheets are impressively strong (with large cash reserves and little debt) and profitability has far surpassed expectations. This strong position will allow business to invest and to hire more workers – both of which are likely to lead to higher rates of economic growth. The question remains as to when American business exploits that strong financial position and begins to increase production. Without further shocks, and as long as consumer spending continues to expand, however slowly, there should be further acceleration in US growth.



## EUROPEAN EQUITIES

Greek Government bond yields have surged and Greek debt is now the lowest rated in the world below Ecuador and Grenada. The cost of insuring Greek debt against default has risen too, pricing in a 70% probability of default in the next five years. The rating agency, Moody's, suggested the chances of a default are 50-50 as they downgraded its assessment of Greek debt. Moody's is of the view that "...Greece is increasingly likely to fail to stabilise its debt ratios within the timeframe set by previously announced fiscal consolidation plans." The Greek Government recently survived a vote of no confidence with a further vote at the end of June on a €28 billion, five year austerity package agreed with the International Monetary Fund and European Union. Greece has to pass this package in order to receive the next €12 billion tranche of bail out loans. The initial €110 billion package has proved to be insufficient and a further package of €120 billion is now under discussion.

It remains to be seen if the Greek Government can push through the latest round of austerity measures given the scenes witnessed during the confidence vote.

The concern is that the longer the crisis continues, the greater the risk of contagion to other highly indebted European countries, such as Ireland and Portugal and perhaps Spain. If the Greek Government does default on its loans, the banks holding their debt will be impacted. Many large banks, the European Central Bank, German and French banks, hold significant amounts of Greek debt. It could lead to a further credit crunch as inter-bank lending could cease as it did after the Lehman crisis. If other troubled countries were then to default more banks further afield would be impacted.

The problems surrounding Greece are impacting negatively on European markets and higher risk markets. However, corporate Europe has reported positive earning surprises in 2010 supported by demand from emerging markets and consumers in the stronger European nations. There are longer term opportunities in European markets but in the shorter term, markets are likely to remain volatile.

## UK FIXED INTEREST AND MONEY MARKETS

The Bank of England's Monetary Policy Committee (MPC) voted at its June meeting to maintain interest rates and quantitative easing amounts at current levels. With the arrival of Ben Broadbent to replace Andrew Sentence, the voting pattern changed to 7-2 in favour of maintaining rates at 0.5%, for the four previous months the vote had been 6-3. Most of the MPC members were concerned that the weakness in demand would continue for longer than expected. The latest minutes of the MPC also highlighted the potential for shocks to demand as a result of problems in Greece and over peripheral European countries.

Inflation as measured by the Consumer Price Index (CPI) was unchanged in the 12 months to May 2011 at 4.5%. The Bank of England has overshot its 2% target in 51 of the last 60 months. More positively, a recent survey of inflation expectations has shown that commentators anticipate that the inflation rate will be 3.2% in two years time. The previous month the equivalent figure was 3.4%.

Inflationary pressures are a key concern for the Bank of England and the MPC is concerned that the CPI may breach the 5% mark in the months ahead as the recent increase in commodity prices feeds through into higher food and energy costs in particular. It remains the case that the price rises currently affecting the official measure are likely to dissipate and that the recent run of above-target inflation has not led to a significant increase in inflation expectations. There is real concern too for the outlook for the wider economy; such that the Bank believes there is also a risk that inflation could fall below target. Growth in the first quarter of this year was much lower than expected. There was not a bounce back in activity after the severe weather of late 2010 – indeed construction spending continued to decline. The UK economy is recovering, but the nature of that recovery is exceedingly fragile and government spending cuts will test its limits. It is unlikely that the MPC will increase interest rates in the near future.

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