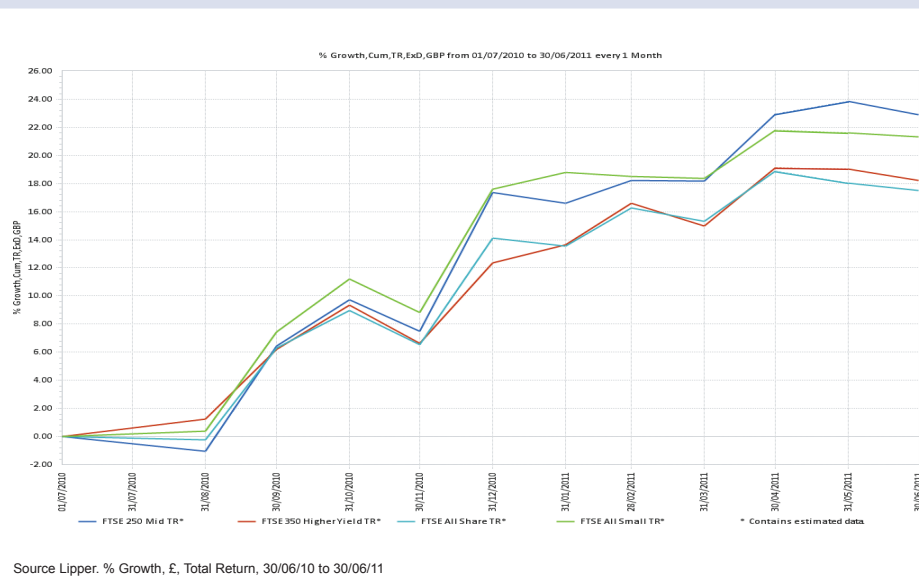


JULY 2011

UK EQUITIES

The budget deficit, the difference between government spending and government receipts from taxation, currently stands at 10% expressed as a percentage of current gross domestic product (GDP). In terms of economic policy, George Osborne, the Chancellor of the Exchequer, aims to reduce this deficit to a little less than 8% of GDP in 2011, on the way to being no more than 3% by 2014. The Chancellor intends to achieve this through increased taxation (fiscal tightening) and reduced spending (budgetary restraints). Tax rises already implemented include increases in VAT, National Insurance and the top rate of income tax on annual incomes over £150,000. As a result, the year-on-year tax take in May was 8.2% higher, reflecting a near 17% surge in VAT receipts and a 4% increase in National Insurance payments. In the coming year we will see the delayed effects from the change to income tax. So far, fiscal tightening has proved to be effective. Government spending has increased though, at a slightly higher rate than that forecast, seemingly because of the increased cost of interest payments on government debt which is linked to the Retail Price Index.

In summary the outlook for the UK economy continues to remain a weak one.



US EQUITIES

There is a government debt crisis which, if unresolved in the next few weeks, could have a far more severe effect on the global economy than that in Greece. In fact, if Congress does not act to raise the 'debt limit' (the amount the US government is authorised to borrow to meet spending requirements) before 2 August the US Treasury will be forced to default on its debts and obligations. A US default would very likely bring about a depression. It is probably for this reason that market participants are not crediting this scenario with a high chance of occurrence. Indeed, "since 1960, Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the debt limit – 49 times under Republican presidents and 29 times under Democratic presidents" (source: US Treasury website 4 July). Increasing the debt limit is akin to increasing taxes in the minds of many Republicans, particularly those who owe their place in the House of Representatives to the recent "tea-party" movement. Brinkmanship is one thing but it is hard to believe that Congress will not reach a consensus and act to raise the debt ceiling, in the end. From then on, we might see a good deal of improvement in the US economy.

Earlier in the year we saw impressive economic performance, though momentum has been lost in recent months. High food and energy prices, along with the disruption in global trade caused by the Japanese earthquake, have taken their toll. Looking forward, there is some

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JAPANESE EQUITIES

Japan's economy was fragile before the latest natural disaster, although there were indications of some progress particularly in manufacturing. The final quarter of 2010 saw a sharp contraction in the region of 0.8% on the previous quarter. Then the estimates from the Economic and Social Research Institute for the first quarter of 2011 confirmed a second quarter of shrinking growth, this time even sharper with a fall of 0.9%. Consumer spending, capital investment and exports contracted as government spending increased. 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 we may well see a much more subdued recovery in output 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 consumer confidence.

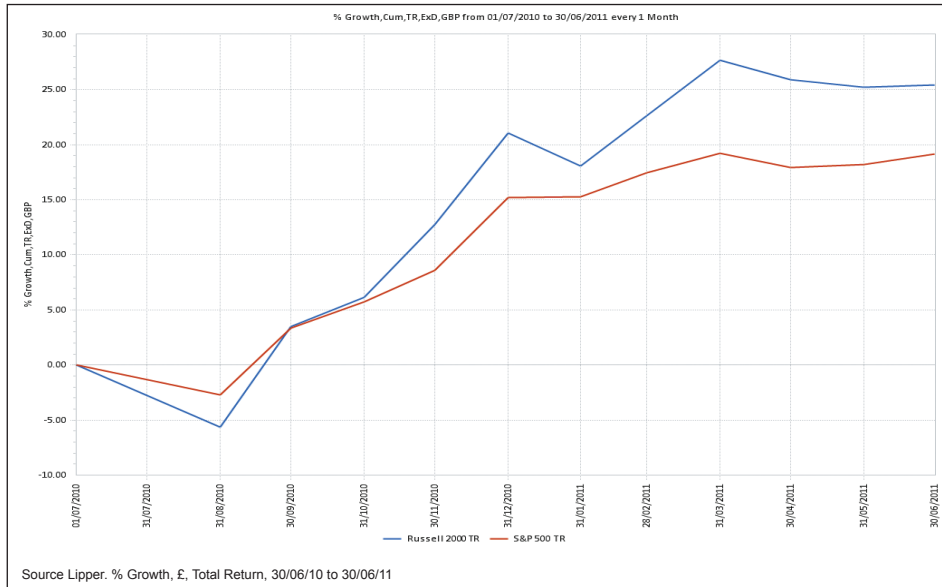
The one bright spot in Japan's current economic malaise is inflation. Prices rose further in May (by 0.6% year-on-year) following the rise in April which was the first positive rate of inflation since the close of 2008. Unfortunately year-on-year price increases are likely to be a temporary phenomenon, prices 12 months previous formed an artificially low base during which time education costs fell 13% when the government waived school fees at senior public high schools. The most recent price rises are not a symptom of rising demand.

ASIA PACIFIC EQUITIES

Given a slowing US economy, an anaemic UK recovery and a euro zone beset by crisis it is imperative that Asia manages to bring its inflationary pressures under control without damaging growth potential, if the global economy is to sustain reasonable rates of growth. 'Soft landings' are difficult to pilot, and perhaps the Chinese are close to achieving that. It will not be accomplished in the short-term. Much needs to be done to encourage a shift from the current over-reliance on export and investment to a more balanced economy which sees growth in domestic consumption too. According to Moody's Economy.com the current share

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evidence to suggest that consumer spending will continue along muted lines. The labour market remains weak and income growth is relatively low. All of this is likely to prove temporary.



EMERGING MARKETS

Slowing global growth and the problems in Europe concerning sovereign debt have continued to pre-occupy investors in these higher risk markets. Policy makers in emerging markets have continued to face the challenges associated with strong economic growth and inflationary pressures. Many countries are experiencing inflation levels well above target. Increasing interest rates and further lending restrictions have been adopted to meet this challenge. Latin America continues to offer good longer term opportunities. It remains highly competitive in the production of both hard and soft commodities. Global demand for commodities is still likely to grow and new resources have been discovered, for example in oil fields in Brazil, which supports the investment case. Economic growth is being boosted by growing domestic demand and rising investment.

EUROPEAN EQUITIES

The bond markets are sceptical about Greece's ability to avoid a default in the coming years. The 3-year Greek government bond yield is around 27% per annum, a rate that implies that the private bond market is all but closed to the Greeks. The 10-year bond yields are almost 17%. On the one hand, the mass demonstrations outside the country's parliament building make it clear that the controversial policies which are a pre-requisite of further EU-IMF loans will be opposed as far as possible. On the other hand it is the huge scale of the debt, now 150% of GDP, and the large proportion of it that is due for redemption in the next few years that is most worrying. Even if the Greek government is able to press ahead reasonably successfully with the latest measures, further tax rises and a mass privatisation programme, it seems some restructuring is inevitable. It remains to be seen if any apparent restructuring of Greece's debts is classified as a 'default' by the ratings agencies. A default does have significant consequences for both European banks (with direct exposure) and for US banks (with insurance obligations on the event of a default). The default problem has not gone away and it is likely to hang over the global economy for some time, with uncertainty over Ireland, Portugal and Spain too.

France and Germany will continue to power the euro zone economy. Even with the debt crisis the euro has risen 18% against the dollar over the most recent 12 months (of course the US has its own debt problems). The apparent strength in the euro does have implications for the euro zone's more successful economies. Germany is France's key trading partner and is in turn powered by the remarkable strength of its exporters as global trade recovers from the collapse in 2008 and 2009. A stronger euro though, coinciding with some slowing in global growth, coupled with continued austerity within Europe means that the euro zone economy faces strong headwinds in the year ahead.

of consumer spending in China is 35% of GDP compared with 53% in Korea and 58% in Japan. An overvalued currency is a significant part of the problem, favouring exporters over consumers. Even in China, these are issues that will take time to resolve. Inflation remains a key concern for this region. Malaysia, the Philippines and Korea all raised interest rates with Taiwan indicating further rises were likely.

UK FIXED INTEREST AND MONEY MARKETS

The official measure of annual inflation, the Consumer Price Index (CPI), fell in June to 4.2% from 4.5% in May 2011. The Retail Price Index (RPI) also fell to an annual rate of 5.0% and RPI excluding mortgage interest payments (RPIX) similarly to 5.0%. Discounting of electrical goods, lower insurance premiums, reduced mobile phone charges and lower priced second hand cars all had downward pressure on the inflation figure. Food inflation is still present though. Overall UK CPI stands higher than that in the rest of the EU where inflation, measured on a similar basis, is currently 2.7%.

The Bank of England's Monetary Policy Committee (MPC) voted in July to again maintain both the policy rate of interest and the quantitative easing limit (£200 billion) at current levels. At the June meeting, the three-way split in the voting pattern was maintained with seven members voting to hold rates at 0.5% with Martin Weale and Spencer Dale voting for a rate rise of 0.25% with Adam Posen voting in the opposite direction, to increase the quantitative easing programme by a further £50 billion. This was the first meeting for Dr Ben Broadbent (voting to maintain) as an external member of the committee, replacing Dr Andrew Sentance (previously voting for a 0.5% increase).

The MPC remains concerned that CPI may breach the 5% level in the months ahead but it concludes that the price rises currently affecting the official measure are likely to dissipate. Indeed, the minutes from the latest meeting reveal that the committee judged that 'on balance... the downside risks to the prospects for medium-term inflation had increased over the month'. The Bank's key concern is one of sustained lack of demand for goods and services; GDP and consumer spending are very weak and the outlook for global growth has slowed.

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