

DECEMBER 2010

UK EQUITIES

The Office for Budget Responsibility (OBR) published the first of its Economic and Fiscal Outlooks, this one covered the 5-year period to 2015/16. Its central forecast provides that “the economy will continue to recover from recession, but at a slower pace than in the recoveries of the 1970s, 1980s and 1990s. This relatively sluggish medium-term outlook reflects the gradual normalisation of credit conditions, efforts to reduce private sector indebtedness and the impact of the Government’s fiscal consolidation”. The OBR is forecasting a sluggish recovery with growth in 2010 amounting to around 1.8% followed by 2.1% next year, 2.6% in 2012 and a peak rate of 2.9% in 2013. Following that, as population growth recedes, output will fall slightly to 2.8% and 2.7% in 2014 and 2015 respectively.

The OBR expects unemployment to peak next year at perhaps 0.4% ahead of the current rate of 7.7% and for inflation to fall from over 3% at present to 1.9% in 2012, both more or less in line with Bank of England expectations.

Interestingly, the report’s authors expect spare capacity to be eliminated by 2016. This may sound like a point of obscure fact, but it is fundamental to the outlook for inflation. The OBR is frustrated in its efforts to accurately estimate the level of spare capacity in the economy. “There is considerable uncertainty around even contemporaneous estimates of this unobservable output gap.” Indeed there is. Spare capacity is one of the major factors in keeping the level of inflation low. Once capacity is fully used, inflationary pressures start to mount, in particular wage inflation.



Source Lipper. % Growth, £, Total Return, 31/11/09 to 31/11/10.

US EQUITIES

Third quarter GDP growth in the US was revised upwards from 2% to 2.5% confirming the recent trend for tentative recovery. It is clear that some support for the economy is beginning to fade, most notably the fiscal stimulus and the inventory cycle. Future local government cutbacks in spending and employment are likely to be a drag on the economy too. Without sustained improvement in global trade volumes, the US recovery will be overwhelmingly dependent on the private sector, especially business investment and consumer spending.

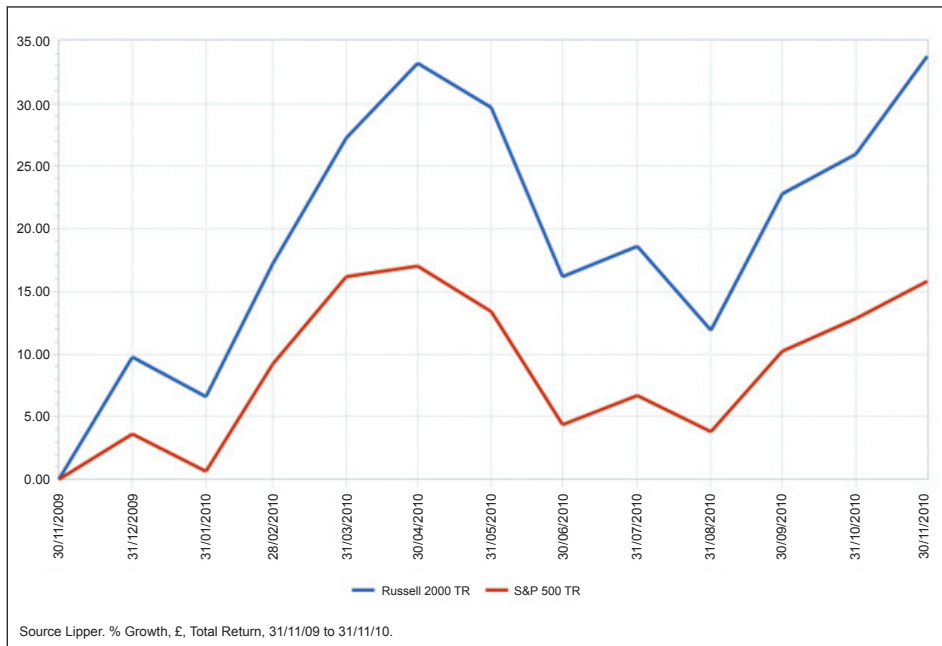
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EUROPEAN EQUITIES

There is an argument for a two-tier euro zone. If Germany, Austria and the Netherlands leave the euro their new currency (presumably a new deutsche mark) would rise in value and the old euro would fall in value. This would lead to an advantage for the “old euro” economies (Portugal, Italy, Ireland, Greece and Spain) because the value of their troubling debts would diminish and, with their exports more attractive, the outlook for growth would be more positive. Crucially, the beneficial aspects of a two-tier euro only exist if Germany decides to leave the euro and not the other way around. If Portugal were to leave, its new currency would depreciate leaving the value of its euro-denominated debt much higher and a default inevitable. The drawback in this hypothetical scenario is that Germany would be putting its own banking system at risk. German banks have a EUR340 billion stake in Portugal, Ireland, Greece and Spain. The French have a similar amount, as do the British banks.

Few commentators in the UK acknowledge the political aspects that bind Germany to the euro, though the German authorities are mindful of the costs of remaining a member of a currency union of which it is the chief architect. Transfers of capital (ie taxpayer’s money) from richer countries to poorer countries are inevitable if the euro is to survive which we believe it will. Much of the costs associated with such transfers will be the burden of those in politically less sensitive circumstances (ie private bondholders and traders). Private bondholders are increasingly aware of this and credit spreads on European government bonds continue to rise, from 5% in January to 8% in November for Ireland and 4% to 7% for Portugal. Euro zone banks will be reliant on support from the European Central Bank (ECB) in the short to medium term. The ECB is likely to keep its official rate of interest low for some time to come. A sovereign default in the euro zone is unlikely, but there is the possibility of further EU-IMF partnership bail-outs. These bail-outs will be accompanied by harsh austerity commitments, harsh enough to push the euro zone back into recession in 2011.

Therefore it is encouraging to see corporate profits reaching record levels. Household income is rising, this might lend some support to consumer spending whilst jobless rates remain stubbornly high and house price falls still persist.



JAPANESE AND ASIA PACIFIC EQUITIES

Japan's government has stepped up its package of fiscal stimulus in the last 18 months or so to greater levels than those seen much earlier in its long period of malaise. Those in 2009 and 2010 account for around 2.5% of gross domestic product and there is some evidence of a positive return; growth in the third quarter is estimated at around 4.7% on a seasonally adjusted annual rate. Growth for 2010 may well exceed the anticipated 3% level.

The government may be unable to sustain the necessary fiscal stimulus package to maintain growth in the future. Debt-to-GDP is around 215%. According to Moody's Economy.com, the cutbacks in government spending made to support the stimulus now see government spending in Japan at a lower rate than in any other developed world economy. This is in spite of a large social security bill associated with a rapidly ageing population.

The Bank of Japan, having previously insisted that the government must do more, is now taking further action itself. More quantitative easing has been announced and this time not only will government debt be targeted, but also commercial debt. We wait to see how effective this new round of actions will be.

Inflation in China is threatening to reach excessive levels relative to the official target rate. Politically sensitive food prices are the main cause and are likely to remain so in the immediate future. The authorities are attempting to combat this pressure with interest rate rises, further yuan appreciation, increased reserve requirements and a greater intervention in bank lending. We expect more such interventions in early 2011, but also to continue to see growth in excess of the 8% target. In South Korea interest rates were left unchanged after rates increased in July and November. Growth in Korea, expected to be around 6% in 2010, is being lifted by exports, consumption and investment. Taiwan's exports and total shipments are also strong indicating improvements in the US economy and the wider global economy.

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EMERGING MARKETS

The relative strength of emerging market economies together with strong investment inflows are causing various challenges to the respective central banks. India's central bank has increased its key repurchase interest rate six times this year to try to combat an inflation rate of around 7.5%. Now it is buying back government bonds to ease tight liquidity conditions in the financial markets. In addition, the liquidity ratio for banks is being reduced slightly to improve conditions. In contrast, Turkey's central bank has recently reduced the main lending rate by 0.5% as it feels that inflation is under control and is likely to drop further. Brazil's central bank has kept its interest rates at 10.75%, one of the highest rates in the world. It has increased bank reserve requirements in an attempt to curb growth and contain growth in credit. High interest rates have attracted capital inflows which are leading to an appreciation in the Brazilian Real. This is impacting adversely on the country's competitiveness. Russia's central bank is indicating that interest rates may rise in Q1 2011 which signals a shift in its focus to inflation.

UK FIXED INTEREST AND MONEY MARKETS

The Bank of England Monetary Policy Committee (MPC) once again voted to keep interest rates at 0.5% with no further quantitative easing measures planned. Gilt yields increased as macro-economic data proved stronger than expected and the prospect of a double dip recession receding. UK manufacturing figures pointed to this sector growing at its fastest rate for nearly twenty years. Investors want to protect against potentially rising inflation. The prospect of stronger nations having to contribute to further bail-outs of weaker peripheral European economies and the consequent need to raise further debt is not supportive of government bonds. Although extremely marginal, it does increase the uncertainty of repayment.

