

SEPTEMBER 2010

UK EQUITIES

The UK has seen some positive news with second quarter economic growth in the UK being revised upwards from the initial estimate of 1.1% to 1.2%. Exports rose more than imports which improved the trade balance. Manufacturing output figures have continued to rise and employment figures are also rising. The UK is now expected to borrow £10bn less than predicted. However, lending to businesses is still falling which is dampening growth prospects.

Next month the results of the spending review will be known. Drastic cuts are expected with the likelihood that these will impact negatively on domestic demand so growth is expected to be muted. Although the economy is likely to be adversely affected, the stock market may still be capable of rising through these difficult times. Good companies can continue to do well and market valuations are discounting the low growth outlook. The majority of earnings of UK listed companies are derived overseas, particularly from Asian and emerging market economies, and there are opportunities for expansion abroad.

Merger and Acquisition (M&A) activity has returned to the market indicating that companies are perhaps more confident than most investors. Prudent companies now have strong balance sheets with cash available for expansion through M&A. Dividends are returning after a significant drop (15%) last year, signalling that some companies had far reaching problems. The situation is improving, with some companies restoring suspended dividends and others increasing them significantly. These indicators should give confidence to investors.



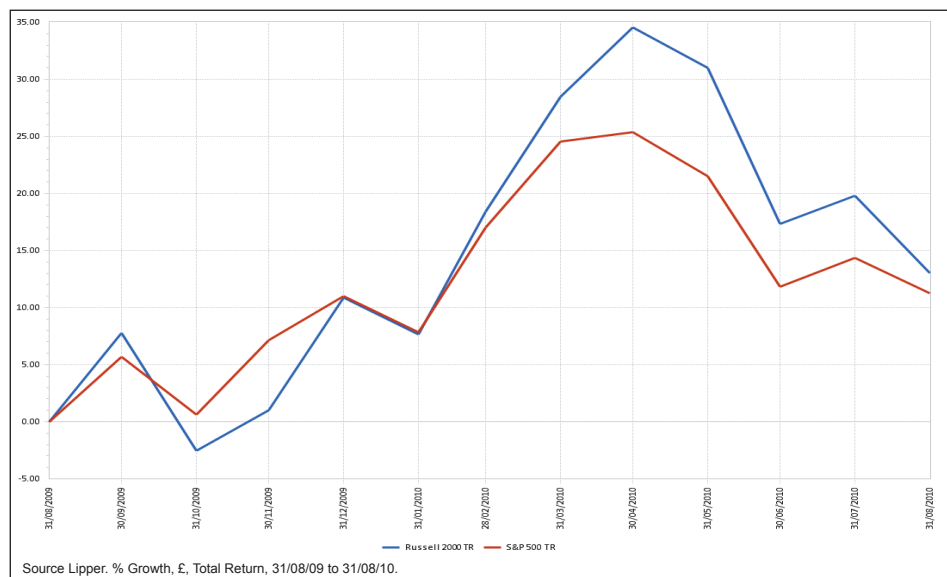
EUROPEAN EQUITIES

The most recent data suggest that the euro zone economy grew by 1.9% year-on-year following a 1% jump in Gross Domestic Product in the April to June period. Germany was again the region's powerhouse with a 2.2% quarter-on-quarter increase. The Italian economy expanded 0.4% and there was solid growth in France at around 0.6%. The most notable contribution to growth has been the euro zone's net trade position. Strong export growth and falling imports have been key factors. The falling Euro has helped to make exports more attractive.

It seems that the euro zone recovery will be sustained for the remainder of 2010. Both manufacturing and service industries remain reasonably optimistic although the manufacturing surveys reveal some considerable slowing in the pace of new orders. It may be that a slowing global economy will impact on euro zone export orders in the months ahead. Further into 2011 harsh government-led austerity measures will probably begin to have a significant impact on domestic demand. If global growth does continue to slow, falling domestic demand could combine with falling international demand and bring about a serious risk of further recession.

US EQUITIES

The estimate for second quarter growth in the US has been revised downwards from 2.4% (annualised) to 1.6%. This was good news as expectations were for a sharper slowing in the rate of growth. More frequent economic indicators, such as consumer confidence, had been showing signs of slowdown. Our expectations are not dissimilar to those of the Federal Reserve and a number of large economic institutions. We anticipate low growth for the remainder of 2010 with some acceleration in the pace of expansion in 2011. One of the more positive signals is the current high level of corporate profitability. Hopefully corporate America will use these excess profits to invest more heavily and to hire more workers.



UK FIXED INTEREST AND MONEY MARKETS

The Bank of England kept interest rates at 0.5% once again. We are not expecting interest rates to increase in the near future as this could put the fragile recovery in jeopardy. Relatively low growth and low inflation is a good, stable backdrop for corporate bonds. There is less chance of default and coupons are not being eroded. Spreads on corporate bonds are still wide with a severe recession being priced in. Opportunities still exist in this sector with careful stock picking. The recently announced Basel III requirements for banks are supportive of bank bonds. Banks will need to issue more equity which provides a cushion for bond holders.

Gilts have unexpectedly performed well this year to date as investors looked to them as a safe haven when concerns about global growth increased. Yields on gilts are low and they look expensive. It is likely that inflation will increase in the medium term as a result of quantitative easing (QE). The £200bn already pumped into the economy has not led to a sustained recovery and further QE may be forthcoming. There is a strong possibility that the response will be overdone and that inflation will result. Some exposure to index-linked gilts will provide an element of protection against this.

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SOUTH EAST ASIAN EQUITIES

Central banks across the region have recently been withdrawing monetary stimulus, including Vietnam, South Korea, Taiwan, Thailand, Malaysia, India and China, although not yet in the form of interest rate rises in the case of China. The Reserve Bank of Australia has been most aggressive, raising interest rates from a low of 3% to something approaching a normal rate at 4.5%. The Australian central bank policy appears to be having some success in curtailing inflation expectations, although it remains to be seen how successful other central banks in the region will be. Tightening monetary policy and targeted policy responses to rapidly rising property markets will undoubtedly slow the rapid pace of economic growth in the Asia Pacific region. Talk of a slowdown in the East is misplaced. China is a good example, as it is very unlikely to see growth rates as high as the reported 11.9% year-on-year rate we saw in the first quarter of 2010. With the growth rate already slowed to 10.3% in the second quarter, we would be surprised to see growth fall below the assumed 8% target in the year ahead.

JAPANESE EQUITIES

The Japanese economy has been recovering with further liquidity injections and spending packages announced to boost the economy. The strong Yen could undermine this export-led recovery. For the first time in six years the Bank of Japan has intervened in the market. It has sold Yen and bought US dollars to lower the exchange rate between the two. The idea is to make Japan's exports more attractive and to increase import prices which could help tackle persistent deflation.

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