

MONTHLY INVESTMENT COMMENTARY

MAY 2011

UK EQUITIES

According to the first estimate from the Office for National Statistics, GDP expanded by 0.5% in the first three months of the year. Assuming that the estimate is reasonably accurate, it means that the UK has escaped the prospect of further recession following the 0.5% decrease in GDP in the final quarter of 2010. On a year-on-year basis the economy expanded 1.8%. The service sector of the economy grew by 0.9% in the first quarter, benefiting perhaps from pent up demand following the bad weather at the end of 2010. Construction contracted, this time seeing a 4.7% decline compared with 2.3% previously, whilst manufacturing remained strong with a 1.1% increase on the previous quarter, but the most recent data from the Purchase Managers' Index indicates some slowing in this important sector. The monthly index is now at its lowest in seven months.

In the three months to February (the most recent figures), unemployment among the economically active population fell to 7.8% from 7.9% previously. According to the Office for National Statistics (ONS) the total number of unemployed fell by 17,000 to 2,480,000, which is a little below its highest level in 17 years.

Weak growth and sustained high unemployment in the face of major fiscal consolidation coupled with persistently high inflation provide a difficult backdrop against which the Bank of England's Monetary Policy Committee has to take decisions in the months ahead. Its recent inflation report estimates growth for 2011 to be around 2%. In August 2010 it estimated growth at 2.8% for 2011. The Bank of England expects inflation to reach 5% this year as energy prices are forecast to rise further. An increase in the interest rate is now expected towards the end of 2011.



US EQUITIES

The US economy is improving and it is likely that a self-sustaining recovery is now underway. Much depends on the employment situation and it seems that monthly job gains are numbering 200,000. This is a high enough level to lower the overall rate of unemployment (now a little under 9% compared with 10% a year ago). If business balance sheets remain solid and profitability remains steady we expect that increased employment opportunities will be sustained. Encouraging and improving

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JAPANESE EQUITIES

Japan has to cope with the ongoing effects of the March earthquake and tsunami. The containment of nuclear fall out from the Fukushima power plant has not helped confidence. Power outages have exacerbated concerns with manufacturing output declining as a result. Japan's sovereign debt outlook has been cut by Standard and Poor's rating agency to "negative" from "stable". It has cited that the increased costs related to the disasters would lead to a greater increase in the country's fiscal deficit than previously estimated.

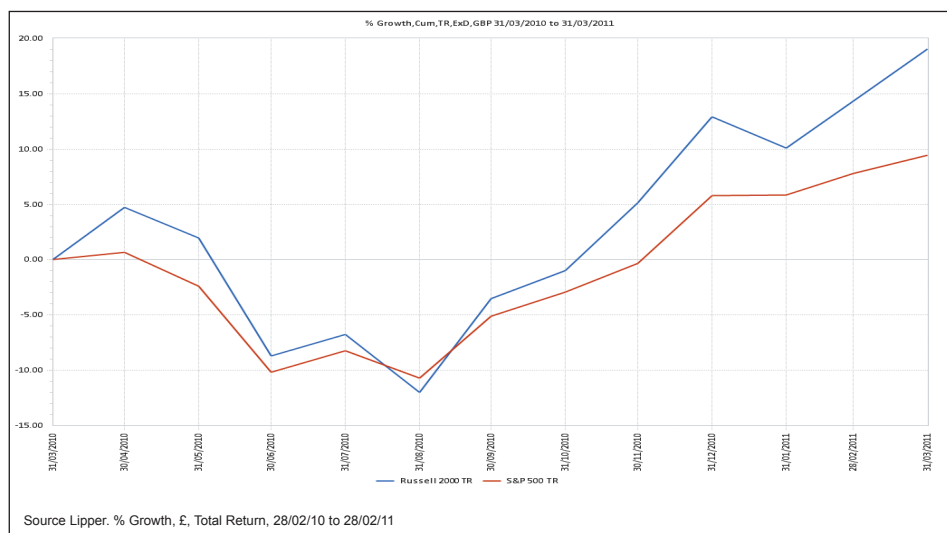
ASIA PACIFIC EQUITIES

Stabilising prices has been identified by the Chinese government as its top priority for macro-economic policy. China has experienced above target Consumer Price Inflation (CPI) of around 5%. The official government target is 4%. A third of the index comprises food which has seen inflation of about 10% in prices. It is supply side disruption, cold weather in particular, which has led to this increase and it should abate as supply increases. To address inflation, China has increased its interest rates and bank reserve requirements. Lending requirements have also been tightened to cool the property market. The impact of monetary tightening depressed performance of the Chinese stock market in 2010 and early 2011 but is now unlikely to be significantly more restrictive.

Taiwan has benefited from good corporate results and unexpectedly higher GDP growth. In Korea, consumer discretionary and industrial sectors have supported the market. Korean equities have also benefited from the expectation that Korean companies will increase market share at the expense of its Japanese competitors which have been adversely affected by the recent earthquake and tsunami.

conditions are to be found in the credit market too. Commercial and industrial lending to smaller and larger businesses has increased, though outstanding debt among households continues to decline.

There are significant risks to the outlook for the world's largest economy. The effect of the Japanese earthquake and tsunami on trade and the ongoing debt crisis in the euro zone could impact negatively. Our primary concern is the possible effects of continued social turmoil in the Middle East and North Africa. High oil prices tend to lower corporate profitability and reduce real household income thus affecting both growth in jobs and consumer spending. At current prices, oil represents an unfortunate headwind. If the oil price rises to around \$125 and remains there, unemployment could start rising again.



EUROPEAN EQUITIES

After emerging from recession earlier than many of its peers, Germany's economic output accelerated to an impressive rate of 2.2% quarter-on-quarter in the middle of 2010. Since then the pace of growth has slowed apparently hampered by the poor weather. It expanded by 0.4% in the final quarter of last year. Overall the German economy grew by 3.5% in 2010, the second highest rate of growth that the country has achieved in two decades.

Exports, which have benefited from a rebound in global demand, have been an obvious reason for strong growth. Carmakers have reported record sales with increased demand from China and Russia, in particular. There is evidence of rising demand across Asia for a range of German manufactured products from computers to chemical products. Another contributory factor is just how well the German economy weathered the financial crisis in the first place, maintaining a firm base for subsequent recovery. At the height of the recession, unemployment rose from 7.6% to 8.3%, much less than the 2.5% increase in the jobless rate in the rest of the euro zone. Germany did not experience such a dangerous boom in housing and the associated debt that has weighed on other western economies.

Concerns over sovereign debt have emerged once more as it appears likely that Greece may have to renegotiate its €110bn bail out package. The outcome may be that the European Commission seeks to lower interest rates for loans made to Greece and Ireland. Alternatively, emergency funding may be sought from the European Financial Stability Facility (EFSF) so that Greece can roll over its debts.

EMERGING MARKETS

Inflation remains a challenge for many emerging markets, with policy makers again moving to raise official interest rates to try and contain it. India, Brazil and Russia are among the countries to take action. Inflation has been driven by surging exports in Brazil. The Russian government is keen to be seen to be taking action to subdue consumer prices ahead of parliamentary and presidential elections. Increasing bank reserve requirements is another way to contain inflation. Exports from Central European countries have been helped by the strength of economic growth in Northern Europe. Emerging markets in the Middle East and North Africa continue to be impacted by the unrest in Yemen and Syria, and the conflict in Libya. Recession is likely to result from this turmoil.

UK FIXED INTEREST AND MONEY MARKETS

The Bank of England's Monetary Policy Committee (MPC) has voted in May to again maintain both the policy rate of interest and the quantitative easing limit at current levels (0.5% and £200 billion respectively) for the 27th consecutive month. Recent signs of economic weakness have led to rates being left unchanged. Effectively the growth in the economy has been flat over the last six months with the latest GDP figure for the first quarter showing growth of 0.5% after a negative figure of -0.5% in the previous quarter. Austerity measures are now taking effect with higher taxes, public spending cuts and real incomes being squeezed leading to the prospect of muted growth. Growth in the services and manufacturing sectors has weakened and the construction sector is contracting.

Although inflation remains high, the MPC have considered weakness in demand more problematic for the economy in the medium term. Against this background it is likely that interest rates will remain low for many months to come.

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