

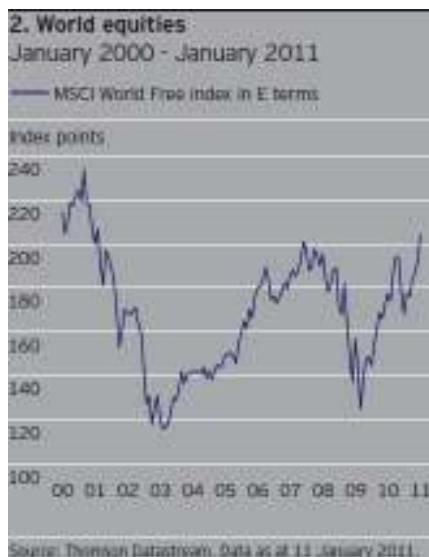
## Investment View February 2011

Since the start of the year three topics have continued to grab the financial headlines. Economic growth, or indeed the lack of it, inflation and increasing interest rates have now taken the place of recession, double dips and the 'demise of the Eurozone'. These topics are all very important to the successful management of any economy but before pressing the panic button, let's reflect.

The ONS only had about a third of the information it needed to complete the GDP quarterly estimate accurately. This is more important than normal as this estimate had little data for December, the worst of the three months for weather disruption. The second GDP estimate, due imminently, is likely to report a revision from a decline of 0.5% to nearer 0.1%. Not great but not Armageddon! If the weather continues to behave itself this quarter, then the bad weather effects should reverse, adding half a percentage point to current forecasts. This should help the UK avoiding the double-dip.

"In an environment where the base effects of the VAT hike will be dropping out of the annual calculation next January and with consumer demand constrained by negative real household disposable income, tight credit conditions and falling house prices, we believe inflation will spend much of 2012/2013 below 2% whether the BoE raises interest rates or not" said an economist from investment bank ING. Indeed, excluding tax and duty increases, inflation is around 2.3%. In a letter to George Osborne, the chancellor, The Governor of The Bank of England said inflation was "likely" to return to the 2 per cent target.

Undoubtedly interest rates will increase at some point but many share the view that the market may be over-pricing the speed and extent of the interest rate hikes. Furthermore, the general cautious tone of the Governor's remarks indicate that he is by no means convinced that interest rates need to rise yet or as quickly as the markets have been pricing in.



We looked forward in our closing Investment Review of 2010 with some cautious optimism for 2011. Confidence in global equities hit its highest level in at least a decade as investors foresaw strong economic growth despite the threat of rising inflation.

The latest Bank of America-Merrill Lynch Fund Manager Survey which covers 188 fund managers overseeing assets of \$569bn and is regarded as a reliable measure of investor sentiment. It found that a net 67% of asset managers were overweight global equities, the highest level since the survey began asking the question in April 2001. Holdings of cash and bonds hit comparable lows.

The shift came, the survey found, despite current expectations that interest rates, particularly in the US, would rise sooner than previously thought. The biggest winning region of the survey was Europe, as investors no longer identified Eurozone sovereign default as the primary risk. A net 34% of global investors said that the Eurozone was the most undervalued region, up from 25% last month. Only a net 5% remained overweight emerging markets, down from a net 43% in January. That fall is the steepest monthly decline in the survey's history. In place of sovereign debt risk, one-third of investors identified commodity price inflation as the biggest risk for markets. Rising UK inflation and the spectre of a Bank of England interest rate increase pushed investors to continue with their dim view of the UK market. A net 8% of investors were underweight on the UK, down from a net 2% underweight position in January.

This comprehensive survey reflects how we have been looking (and continue to look at) client portfolios for several months now. We consider an 'internationalising' of portfolios a sensible strategy and have been strong supporters of European funds both in the large and small company arena. We are not so pessimistic about emerging markets, and indeed the current sentiment is very much a short term view over inflation concerns in China in particular, with most commentators positive on a longer term view of that area.

Equally, we are less pessimistic about the UK, as indeed many of the larger companies are generating revenues and profits on a global basis. However, we continue to believe that equity income funds are a sensible and attractive component of any portfolio. The most recent Barclays Equity Gilt Study reported that £100 invested at the end of World War II would have given a capital value of £5,721 at the end of 2008 in nominal terms but reinvesting the gross dividends would have increased this total to £92,460! We continue to believe that capital growth seen over the last two years, particularly in the small company arena, will be nigh impossible to repeat in 2011 and the income component will be key.

High-yield bonds should continue to perform as long as growth remains relatively stable and a 'double dip' recession is avoided. New supply in the high-yield market has been very well received in recent months. Some companies have issued for the first time, which has added diversity to the high-yield universe. High-yield exposure also makes sense in the longer term – its lower correlation with government bond markets will benefit investors when interest rates finally rise.

Over the last two years, companies have made concerted efforts to reduce their absolute levels of debt. They have continued to rebuild their balance sheets, converting bank debt to bonds and so on, meaning that UK companies are in quite robust shape. The corporate bond sector has managed to perform well, despite relatively slow economic growth.

Our view for a while now has been that the economy will improve gradually, with some volatility along the way. Overall, growth of between 1% and 3% historically is very good for investment-grade credit. Less than 1%, there is the prospect of a significant pick-up in defaults. Above 3%, there is the risk of inflation and equity-style bubbles. Therefore, economic growth between 1% and 3% should prove supportive for investment-grade credit. Whether government or corporate, bonds struggle during periods of high inflation when interest rates are normally high but we are a long way from that right now.

There is little to report on property other than to emphasise that as with equities, income or yield will be the driver of value. Sharp declines in capital values would seem to be behind us, especially after the renewed fall in government bond yields over the past months, which has continued to highlight the attraction of property's income return.

Interest rates are projected to remain low throughout 2011. There still exists a substantially higher yield premium of property valuation yields over the yields on most other asset classes compared to the long term average low risk asset classes: nominal government bonds, index-linked government bonds and cash, and property looks attractive from an income perspective as a consequence.

No doubt the Eurozone will be back in the headlines during the next few weeks as Spain will be in the market to raise finance!

**Douglas Kearney C.A. Investment Director**