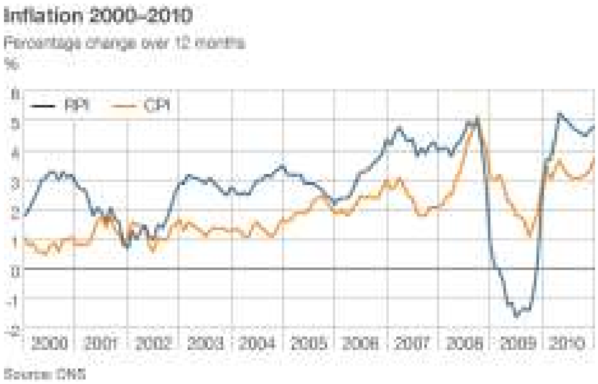
Investment View January 2011

Economic concerns are switching from double dip recession to inflation and the likelihood of interest rate rises. It is, nevertheless, encouraging that more and more commentators are sharing our view of cautious optimism for 2011, and indeed investors are slowly migrating from lower risk asset classes into equities. 2010 marked the third consecutive year of net outflows from equities. Over the past three years, outflows have totalled $268bn while inflows into bonds have totalled $644bn. While it is too early to call for a definitive shift, early signs do appear to be pointing to an inflection point.

Inflation has risen to an eight-month high of 3.7% in December. The figure is well ahead of forecasts and means inflation has been above the Bank of England’s 2% target for over a year. The VAT rise at the start of this year is not yet in the figures and inevitably this will add further fuel to increase inflationary pressures.



Many commentators expect the Bank of England will raise interest rates sooner than expected, although this is not a unanimous view, with others still believing a rate increase will not be seen until late summer or autumn. ” Raising rates at a time when fiscal policy is being tightened, while businesses and individuals are facing greater pressures, would be a mistake and should be avoided," was a view endorsed by many commentators.

We share the view that the MPC is unlikely to move interest rates until it has more compelling evidence that higher inflation expectations are becoming embedded and, crucially, that wage settlements are beginning to reflect this shift.

The MPC has insisted that recent price pressures are driven primarily by temporary factors such as tax rises, the past depreciation of sterling and a short-term spike in food and commodities prices. It argues that none of these factors warrant a knee-jerk reaction and continues to stick to its forecast that excess capacity in the economy will constrain the medium-term path for inflation.

December is traditionally a strong month for equity markets, and this year was no exception. Large gains were seen across the board as the market responded to positive survey data, signs of an improving US labour market, and hopes of policy measures to support European government bond markets. Among the positive survey data, the ECRI Index, which is a weekly leading index of US economic growth, has been in an up-trend since July.

All indices gained - the FTSE All Share Index was up an impressive 7.1% in December, and 15.3% for the year; but it was the Mid Caps that continued to shine, up an even more impressive 9.1% over the month, and 28.4% for the year. The FTSE continues to trade around 6,000, and most expect it to show a healthy rise over the year.

We remain positive about UK equities as corporate balance sheets strengthen and cash balances build. Most commentators are forecasting substantial increases in the FTSE over the year; we would not disagree but consider that income will be a route to consider in a portfolio. It should also be remembered that inflation tends to be positive for equities.

The Eurozone continues to give rise to debate about the future of the Euro as various countries seek help to repair their economies. In April this year Spain will be in the market to raise finance and that will be a challenging time. The breakup of the Euro would seem unlikely but there will probably be further pain to be endured before the politicians create greater fiscal harmony that is needed to allow the currency to properly function.

Germany in particular is performing well, as indeed is France and Italy to a lesser extent. We remain positive about the Eurozone, and believe short term issues will be resolved, but will be keeping a watchful eye on developments over the next few months. Exposure to the Eurozone remains a sensible strategy for a portfolio to provide diversification.

The change in global growth expectations over the last quarter has delivered a powerful change to financial returns, with investors in long duration government bonds particularly heavily affected. The over 10yr sector of the Treasury market had, by the end of the third quarter, delivered total returns approaching 20%, but it has given back almost half in the final quarter of the year.

We continue to favour corporate bonds. They remain attractive and although valuations have softened from the peak in 2009, yield spreads against sovereign debt remain wide while strong corporate balance sheets make default risk minimal particularly in the 'investment grade' sector. However, we believe high yield (sub investment grade) has even more to offer, but with the extra risks only suited to pre retirement portfolios.

The combination of strong earnings growth, better than expected economic data and quantitative easing has helped push equity markets higher. The S&P 500 has exceeded its post-Lehman's high. Crucially, the post-credit bubble collapse doesn't seem to have left some other highly powerful attributes of the US economy severely damaged. Its underlying productivity performance, together with its relatively more favourable demographic dynamics, suggests that the US might at some stage shift back into a growth trend of close to 3 per cent. The strength of US labour dynamics is a key reason why Japan-style comparisons are not valid.

The pace of performance in some emerging markets has slowed as investors are becoming increasingly concerned about rising inflation. China's gross domestic product (GDP) grew 10.3% last year and the government has been trying to control growth amid fears that the economy could overheat. One fund manager in the sector was recently quoted as saying "Growth going forwards may be more around 8 per cent annually rather than the 10-12% we've seen in recent years, but qualitatively that growth will be better as it is more from wealth created within China, rather than export-driven." We still consider emerging markets have a place in a sensibly balanced portfolio, but acknowledge that risk of greater volatility must be endured.

UK commercial property delivered a 14.5% total return last year – the strongest return for four years, according to the IPD UK Monthly Index. In 2009, the total return was 2.2%. The first full account of 2010 performance reveals positive capital growth continued unbroken throughout the year with the final month returning a modest improvement, at 0.3%. This contributed to an annual capital growth figure of 6.9%, compared to -5.6% in 2009, while last year's income returns were down from the 8.2% in 2009 to 7.1%.

UK commercial property delivered an identical annual total return to equities, at 14.5% in 2010, based on the FTSE All Share Total Return Index, after a substantial final month rally in equity markets. The outlook for the property sector remains muted at least in terms of capital appreciation. "The rebound in capital values, which emerged so aggressively at the back end of 2009, had virtually run its course by the mid way point of 2010," explains Phil Tily at IPD. However yields remain attractive and we will continue to maintain portfolio weightings accordingly.

Surprises in 2010 have generally been of the pleasant variety. The recovery has strengthened, investors have enjoyed gains across a broad range of assets and none of the major structural issues we face have led to real stress, unless you are Greek, Irish, Portuguese or Spanish! No doubt 2011 will not disappoint in delivering surprises, but hopefully they too will be pleasant.

We will continue to keep you posted on our views in the months ahead and in the meantime - a Happy New Year to one and all!

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