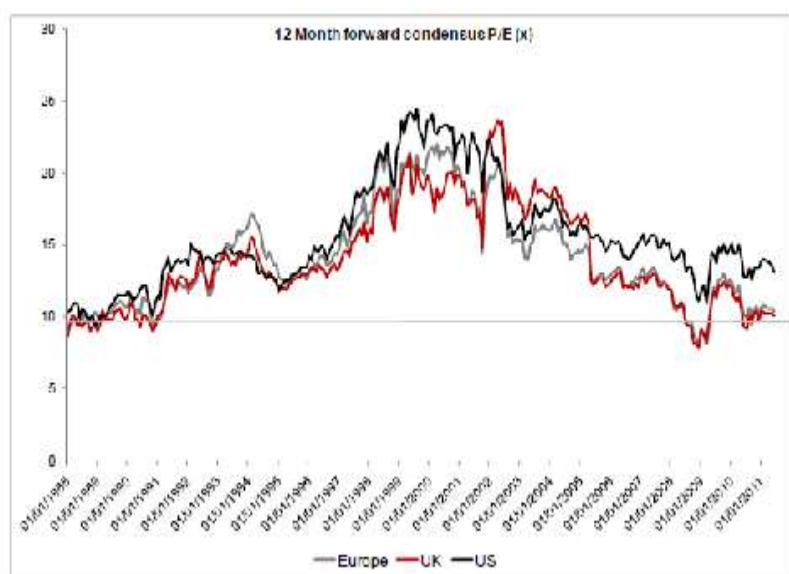


Investment View June 2011

About three years have passed since the eruption of the financial crisis. Thanks to the joint efforts of the international community, the global economy is recovering. Yet there remain many uncertainties and the recovery is fragile. Global growth is uneven; unemployment in developed economies remains high; government debt risks in some countries have mounted; inflationary pressure is increasing. While the shock of the crisis has yet to end, new risks have emerged. The world must co-operate closely to meet the challenges and would seem determined to do so.

The International Monetary Fund has warned that the risks facing the world economy have increased. The IMF said it was concerned about the continuing Greek debt crisis, the arguments over US deficit plans and the need to curb growth in Asia. But it said it expected global growth to remain on track, though it lowered its forecasts for the US and UK. The IMF predicted that the world economy would grow at a rate of 4.3% in 2011 and 4.5% in 2012.



Source: Datastream

The FTSE All Share Index posted a return of -0.5% in May, underperforming gilts, as sentiment took a hit on the softness in US economic data. Within the UK, mid and small caps outperformed large caps mostly because of the weakness in the financial and basic resources sectors.

The end of QE2 is seen as a threat to risk assets, as the liquidity-rush is replaced by the risk of renewed slowdown and earnings risk. However, many fund managers believe the market looks cheap with 12-month forward consensus P/E's at recessionary levels.

This was further confirmed at a recent presentation by a respected fund manager who broke down anticipated corporate earnings for 2011 to demonstrate equities are indeed cheap and the FTSE could reach 6,900. We remain positive on UK equities but are still focussing our investment strategy on seeking income, which is a more certain driver of performance in the short term.

However, the expectation that global growth momentum will accelerate back above 4% in the second half of the year is deteriorating with every data release. The current slowdown is likely to be less dangerous than the one that we experienced in the summer of 2010. Companies are now more robustly financed, and if anything, corporates are turning expansionary again and exploiting their strong balance sheets. Merger and acquisition (M&A) opportunities are being explored by companies with excess reserves and cash is being returned to shareholders at a rapid pace. This is a significant positive for the overall equity market, providing a cushion to any short-term headline 'news flow' risk. Although global growth might be stuttering we remain committed to exposure to global equities.

The latest downgrade of Greece's sovereign debt is again raising concerns about a pan-European economic slowdown and structural strains on the euro-zone. Against this backdrop, it is important to remember that many European 'corporates' continue to enjoy stronger credit ratings than some of the region's 'sovereigns' – issued by state, local government or municipal entities. These stronger ratings are reflective of the robust fundamentals of many of Europe's leading companies. Across Europe's equity universe many companies enjoy strong balance sheets, are generating very healthy cash flows and benefit from better access to finance than these sovereign borrowers.

Around 30% of geographic Europe is not tied into the euro-zone and hence is not directly impacted by the problems affecting its peripheral economies. In addition, growth rates in the region's largest economy, Germany, continue to deliver strongly. Moreover, many of Europe's listed companies enjoy successful global franchises, with these companies as a whole generating around 40% of their revenues outside the region's borders. Consequently many companies continue to report growing sales and strong profit margins. European equities remain in our strategy and, whilst some short term volatility continues, the longer term story is still compelling.

Greece is really proving to be a much more intractable problem than initially thought. The reason why fears of a Greek default have come back is because it has become apparent that Greece will not be able to raise funds from the market in 2012 and is likely to default. The IMF warned that if Greece was unable to pay its debts, other countries such as Spain or Portugal may also be affected. European banks which lent money to these countries would in turn lose out. This uncertainty is a major cloud over markets but fund managers appear less anxious about the consequences than the media. What, as Standard Life commented, is defying logic and gravity is the continuing strength of the Euro.

In the US, Quantitative Easing officially ends this month. It is unlikely that this will have much effect on the economy because a lot of the money that the Fed has put in has remained in the banking system, the banks have not lent it and so there has been minimal impact. It has helped to boost market confidence because it has signalled that the Fed is willing to support the recovery. The end of QE2 could cause some temporary volatility until the markets become convinced it is not going to have a significant effect on the economy. At home, the Bank of England signalled this month that the UK economy might be even weaker than it had previously believed, sending sterling back to levels not seen since the end of last year. Minutes from the Monetary Policy Committee's June meeting showed that some members believe that the BoE might have to consider further quantitative easing, more gilts purchases, to stimulate the economy. For most investors gilts remain unattractive with the preference continuing to be for corporate bonds or high yield bonds, where yields are substantially more attractive. 10 year UK Government Bonds are yielding around 3.1% and are viewed as expensive with Governments the main buyers.

Emerging markets continue to attract headlines, not all positive, and will do for many years to come. The IMF has projected that the Chinese economy will be larger than that of the US by 2016. A projection by The Economist, made just before Christmas, foresaw China becoming number one in 2019. The debate about the future of China is in danger of becoming pointlessly polarised. One camp argues that China is the world's emerging superpower. The other insists that China is an intrinsically unstable country, constantly at risk of an economic and political crisis. In fact, both ideas are true. The thrust of China's economic policy has been to expand domestic demand and stimulate the real economy, strengthen the basis for long-term development and make growth domestically driven, whilst controlling inflation. They seem to be succeeding and we remain convinced that investors should have exposure to emerging markets, albeit volatility and adverse headlines must be endured.

Latest data suggests UK Commercial Real Estate values continue to increase at a slow pace whilst at the same time rental decline is moderating as rents edge closer to positive territory. Investor demand continues to search for relatively low risk assets. Due to the limited availability of these types of assets, investors are moving modestly up the risk curve and are prepared to consider better quality secondary assets. It is expected that positive total returns will be achieved for investors as the strong income yield compensates for any modest capital declines. Income is likely to be the main component of returns through 2011 in the absence of capital growth. Property offers an investment opportunity for the longer term investor.

Overall, we continue to believe that equity markets remain a good place for investors to be at the moment. Equity yields are quite high, earnings yields are attractive and as long as the 'soft patch' doesn't turn into a double-dip, and ultimately a recession, then earnings will continue to grow and equities should deliver good returns. There is a case for a market breakout in Q3, when these temporary drags start to fade, revealing current events to be no more than a mid-cycle showdown rather than a return to recession.

Douglas Kearney C.A. Investment Director