Economic and Market Outlook April 2011

Emerging market indices were the best performing over March, with a gain of 8.6%, compared to a gain of 1.66% for the FTSE All Share. The worst performing market inevitably was the Nikkei, down 10.66% in all having recovered some 7% from its lows following the tragic events there.

Global equity indices quickly recovered their composure following the earthquake as investors established that, notwithstanding the human tragedy, it was not a global macro event. However, a recent announcement for example that Toyota is set to reduce output from its UK plant by 25% due to related parts shortages shows that there will be ramifications outside of Japan.

The investment department took the view that rather than making a knee-jerk investment into Japan on the weakness, it presented a better opportunity to buy UK blue chip stocks that were less likely to be negatively affected in the medium term. It is notable that there have been three further quakes in the region, and the Fukushima nuclear plant remains unstable, thus presenting scope for investor sentiment deteriorating again. Looking forward, Japan's demographic problems have not gone away, and the public sector debt issue looks set to get worse, not better.

Turning to the West, the inflation debate remains critical. Investors are focussing on the likely path of interest rates which whilst important is only part of the issue. The cost of money has already risen; 0.5% is not a reflection of the cost of borrowing, with even the UK Government paying over 3.6% interest on new debt. Markets are factoring in rate rises in the middle of the year, so are 'in the price' and thus should not impact on investor sentiment. We note the Bank of England's rhetoric remains relatively hawkish, presumably in an attempt to control inflation expectations vis a vis wage claims. It seems to be working, with wage growth remaining very muted hence little risk of a '70s style wage price spiral. More importantly however is that higher prices mean less money to spend elsewhere in the economy. Added to the higher taxes and reduced government spending and benefits, this makes us relatively negative on sectors exposed to Western consumer discretionary spending.

With inflationary pressure showing tentative signs of abating and wage growth remaining muted, Q1 GDP at the end of April will be closely studied.

Additionally, Sovereign debt concerns remain an issue; Portugal has requested a bail out, and rumours persist of likely problems in Spain.

The extended bull market continues to climb a wall of worry, and thus we believe that asset allocation should remain relatively cautious.

Global Equities

+ Yields on large-cap stocks look attractive relative to fixed interest.
+ Companies with exposure to Asian and Emerging market economies have an opportunity for top line growth.
+ Many companies have strong balance sheets and are efficiently managed.
+ Companies are continuing share buyback programmes.
+ Companies are looking to secure revenue growth and cost synergies through M&A, so bid interest may drive potential targets higher.

- Global economic recovery is still relatively fragile
- Investor nervousness remains high
- QE coming to an end- liquidity effect will reduce
- Effects of austerity packages have yet to be fully felt, and the synchronised nature of them in the UK, Euro and now the US could exacerbate the impact.
- Monetary tightening in the East may dampen growth
- Increased international concern about currency wars and protectionism could be very damaging to investor sentiment.
- Bull market is now relatively long in historical terms
- Sovereign debt concerns may yet trigger sustained correction.

Global Bonds

+ Poor returns on cash are providing support to short dated bonds
+ Spread of many corporate bonds over government stocks still provides scope for gain, or will protect capital values if government bonds yields rise
+ Interest rate differentials provide scope for currency-related gains

- Valuations of many developed market government bonds look stretched given poor fiscal state of many nations.
- Inflation remains a concern

- Interest rates are very unlikely to fall further in the West, and have risen in the East.

UK Equities

The debate now concerns which part of the market will outperform- defensive large cap, or growth oriented mid cap. We believe that it is best to remain focussed on companies with strong balance sheets, and visible and earnings streams that are not sensitive to the UK consumer, and where margins are less affected by input prices.

US Equities

US economic recovery looks well entrenched, with job numbers, whilst behind expectations, showing jobs are being created. The US housing market is still showing no real sign of recovery. Investor focus is now on the US deficit, which will be negative for the Dollar, which is good news for US exporters, less so for Sterling investors.

European Equities

Debt fears continue to dominate, with Portugal next on the block. Greece is falling behind the terms of its IMF bail out. The Euro has begun to strengthen in trade weighted terms, which is a concern for export led growth. Forward looking business and investor surveys continue to give reasons for optimism on growth in the major Euroland economies. Additionally, Europe remains home to some well-regarded brands, hence giving rise to the possibility of M&A interest.

Emerging Market Equities

Growth levels and outlook remain attractive, valuations less so. Investors should be wary of bubbles developing.

Economic policy tightening increases risk of policy error, despite the beginnings of a shift to internal consumption, many markets remain correlated to Western growth. Overall, whilst we believe that the case for a shift towards these markets as the drivers of global growth remains intact, investors should be more selective in their allocation.

Asia Pacific

The region continues to enjoy robust economic growth. Monetary policy is tightening, leading to strengthening currencies. Growth remains robust compared to the West, but indices have underperformed over concerns over slowing growth rates.

Japan

Investor interest in the region has increased following the earthquake. Some scope for rebuilding related gains, and valuation attractive, but long term demographic and debt concerns remain.

Fixed Interest

Valuations in many global Government bonds look over-extended, and investors should position carefully to avoid capital loss as interest rate expectations rise. Inflation remains a concern in the medium term, but the changeable landscape makes strategic bonds look attractive. In the meantime, yields (and arguably creditworthiness) of corporate bonds globally remain attractive relative to Treasuries.

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