



July 2011 Market Commentary

>> Markets have been remarkably resilient over the last six months despite growing inflation pressures, sovereign debt concerns, interest rate uncertainties, widespread unrest in the Middle East, the disaster in Japan, the end of quantitative easing and fears about the sustainability of global economic growth.



Quilter

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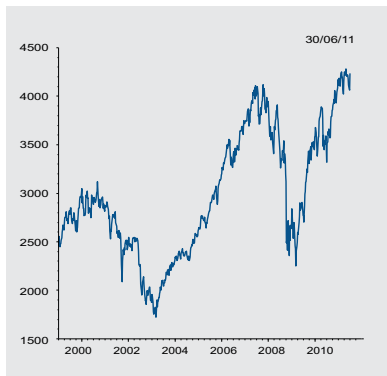
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We see the recent weakness as a temporary soft patch rather than a new cyclical downturn and believe risk assets offer better value than bonds.

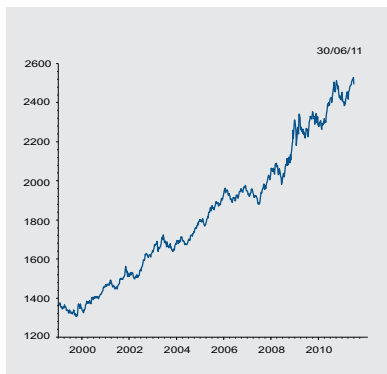
The US S&P 500 index ended the period at 1,320 giving a return of +6% since 31 December. The heavy exposure of the FTSE 100 to commodity stocks meant the index fared less well ending at 5,946 - a year to date return of +2.7%. With the exception of peripheral Europe, fixed interest has benefited from the lull of uncertainties. UK gilts returned +1.6% with yields touching a low of 3.1% just before the end of June. Hedge funds were able to exploit anomalies in the pricing of financial assets and returned +4% while rental flows on better quality commercial property helped the FTSE Real Estate index return +3.7%. The euro strengthened against both the US dollar and sterling which is somewhat counterintuitive given the sovereign debt background but is likely to have been a combination of sovereign funds re-allocating currency reserves and the ECB's unwillingness to 'print money'.

Economic growth forecasts of 3.4% for 2011 remain around the long-term average albeit this would be lower than last year. Those for developed economies have been trimmed marginally in recent weeks but the sharp uptick in Japanese industrial production suggests there could be a fairly strong rebound over the next six months. The pattern remains uneven with emerging economies (6.3% GDP) the dominant contributor although in the short-term policy stimulus has resulted in an upside risk to inflation and excess demand for commodities. Although China has been tightening policy since last autumn using higher interest rate and increases in bank reserves, other economies are only just starting to rein in activity. Signs of exceptionally strong growth are evidenced by Far East exports as well as indicators like the price of copper (just 7% off its recent peak). Brent crude spiked at \$120 bbl although the price has since fallen back to around \$106 after last month's unusual decision to release strategic oil reserves. Working out the supply/demand balance - and

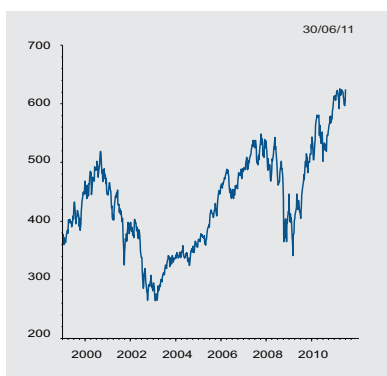
FTSE ALL SHARE TOT RETURN IND



FTA BRIT. GOVT. FIXED ALL STOCKS - TOT RETURN IND



FTSE W WORLD £ - TOT RETURN IND



Source: Datastream

appropriate investment exposure - for commodities is complicated by government subsidies in many emerging economies as these tend to increase price fluctuations within the broader demand uptrend.

Meanwhile, the industrialised world remains mired in a multi-year deleveraging process. 1.9% GDP this year will be modest by historic standards and dependent on government initiatives aimed at rebalancing growth away from the consumer. The political imperative of maintaining growth to help reduce budget deficits and unemployment means central banks are likely to continue their accommodative monetary policies and hope that inflationary pressures are transitory. Interest rate expectations - probably a token 25bp or 50bp over the next year - have eased again. 'QE2' measures in the US are about to expire and the UK has long ceased its quantitative easing programme. The long-term benefits of QE are unclear but, given the size of budget deficits, further measures appear increasingly unlikely. Unlike the Federal Reserve and Bank of England, the ECB has not resorted to 'printing money' and has already started normalising interest rates although this is more of a technicality as there will be continued pressure to cross-subsidise peripheral economies until the long-term solvency issues are resolved. Unless inflation eases, yields on government bonds are likely to rise over the next six months.

Companies continue to benefit in areas where government policy is aimed at boosting nominal growth. Alongside ample liquidity, reasonable valuations - the dividend yield recently crossed over the UK 10 year gilt yield for the second time in twelve months - and low investor

expectations, risk assets should continue to offer relatively attractive returns.

However, this does not mean that all companies are equal. Banks continue to rebuild their balance sheets but face another round of stress tests this month as well as an increasingly tough regulatory environment. While the latter may be well intentioned, previous cycles have shown that this can be counterproductive and restrict the availability of capital. Although bank valuations are very depressed, it is difficult to identify the catalyst for a re-rating. Elsewhere, the benefits of cost reduction programmes during the downturn can be seen in record margins and improved free cash flow which has helped underpin share prices as well as boost merger and acquisition activity. The next phase is likely to see investors differentiate between companies with genuine long-term sales growth and those whose fortunes are more transitory. Profit estimates have been revised up since the start of 2011 to +17% this year and +14% in 2012. The highest growth is expected to come from companies able to benefit from the expansion of global trade and emerging market expenditure on infrastructure and investment. While these estimates - which equate to prospective earnings multiples of 12x and 11x - are not excessive by historic standards, there is always a risk that outlook statements accompanying the impending first half results could disappoint. With markets at the lower end of their trading ranges, any weakness over the summer should provide an opportunity for longer-term investors.

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