

## MARKET OVERVIEW AND INVESTMENT OUTLOOK

JULY 2011

### Market Overview

In local currency terms, the best mainstream asset class to be invested in over the second quarter of the year was UK Government bonds (FTSE British Government All Stocks returned 2.5%). Gilts were bought as the market veered sharply from the view that global growth was a little bit too warm and inflation risks were all around, to fears that growth may start to slow and safe havens needed to be sought.

Given the heightened sensitivity to risk, it was not surprising that UK Corporate bonds underperformed Gilts (returning 1.7%) as spreads widened somewhat. Oddly, however, given the extraordinary risk aversion that was seen through much of May and June, UK equities performed relatively robustly (FTSE All-Share returned 1.9%).

However, it was only with the concerted rally during the final days of the quarter, following the Greek vote to accept fiscal austerity that one saw a positive return develop. The outperformance of the UK equity market relative to other equity markets was surprisingly strong given the preponderance of natural resource companies and banks listed on the UK exchange, which together account for around 40% of the market.

Whilst equity markets outside the UK returned a marginal negative result in local currency terms for the quarter, due to Sterling weakness this translated into a small positive performance (FTSE World ex UK Index returned 0.3%).

Oil prices have fallen some ten percent during the quarter as news was released to the market that member countries of the International Energy Agency (IEA) had agreed to release some of their strategic oil reserve to ameliorate the impact of a marked decline in supply of Libyan sweet crude oil. This action is very unusual and had an immediate impact on the price of oil. The Copper price finished the quarter virtually unchanged, whilst the Gold price finished nearly 5% ahead of where it started the quarter.

Property was relatively strong, putting in a positive return for the period, with the IPD UK All Property Index returning 1.4%.

*Source: Cornelian Asset Managers July 2011*

## Investment Commentary

The last quarter saw equity and bond markets fraught with worry over the imminent denouement of the Greek financial crisis and the ending of the second Quantitative Easing program in the US. Neither of these issues can come as a surprise to anyone who has an active interest in the investment markets. What has come as a surprise, however, is the rapid deterioration in a number of indicators used to gauge economic growth prospects, particularly in the West. There has been a rapid and substantial decline in economic momentum relative to expectations recently.

Quite why this has come about is difficult to rationalise. Even Ben Bernanke, the Chairman of the Federal Reserve has professed to not fully understanding the reasons for the sharp loss in momentum. Several contributory factors seem to be at play. Firstly, and most obviously, is the negative economic shock that the Tsunami in Japan has had on the economy. Secondly, the higher oil price started to crimp real disposable income. Thirdly, inventory build contributed strongly to economic growth last year and may have slowed as the economic cycle matured from the recovery phase. Reassuringly, inventories as a proportion of GDP remains low in the US suggesting that companies have not over stocked.

Other reasons may have included the anticipation of the ending of the second round of Quantitative Easing in the US and the tightening of monetary policy in several key emerging market economies as policymakers there have attempted to dampen inflationary pressures. Indeed, just before Chinese Premier Wen Jaibao visited the UK, he wrote in the Financial Times that it was his belief that Chinese inflation had been tamed and would soon to start to fall. The consequence of this, if true, is that China could start to stimulate the economy again.

We currently believe that the slowdown in momentum in the global economy is temporary and although global GDP forecasts are being revised down, nothing more sinister will develop. The slowdown in Emerging Markets has been engineered by policymakers and we think they will be able to deliver a 'soft' landing. Globally, interest rates adjusted for inflation remain exceptionally low, thus encouraging cash rich companies to invest and consumers to spend.

The US housing market has been in the doldrums for several years with prices falling more than 30% since 2006, and transaction volumes at record lows. Recent statistics suggest the negative momentum in house prices has substantially abated, and indeed, the first tentative signs that volumes have troughed also seem to have appeared. The reason for this is that the affordability of housing (following the 30% fall in house prices and very low 30-year interest rates) is good for those with acceptable credit ratings.

Furthermore, rental rates have been rising and this helps make the 'buy', as opposed to 'rent', decision more palatable. The importance of the US housing market cannot be overstated. A lot of houses are in foreclosure as people who should not have been given loans struggle to keep up with repayments whilst others have lost their jobs. The vicious cycle of lower house prices, negative equity and increased foreclosures needs to be broken in order to enable people to start to see their real net wealth stabilise and then improve. Whilst we believe this is likely to be a slow and long drawn out process we are hopeful that we are beginning to see the first signs of stabilisation.

Recently, investors have had to contend with the European bank stress tests and uncertainties regarding the European and US policymakers' responses to their respective debt crises. It is apparent that, due to weak leadership, clean solutions have not been forthcoming in any of these areas. However, comfort can be drawn from the fact that once markets push policymakers a deal is (eventually) cobbled together.

We believe equity markets can make progress during the second half of the year. Many of the perceived threats to equity market performance seem to be dissipating. Solutions to the European and US sovereign debt crises have been presented and the second round of Quantitative Easing is behind us. Momentum in the global economy could reassert itself following a soft patch not helped by higher oil prices (which are now coming off), the short term collapse in the Japanese economy (which is now rebounding) and the uncertainty concerning policymakers actions on both sides of the Atlantic (which has been cleared up to some extent). With food and oil prices stabilising or falling, the threat of inflation rising inexorably higher seems to be wide of the mark. The second quarter results season which has just begun will be a key litmus test for this view.

[Hector Kilpatrick, Chief Investment Officer, 31 July 2011](#)

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