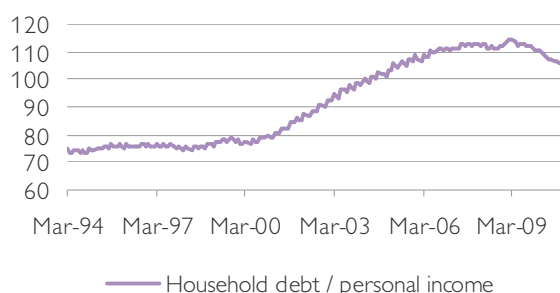

Our 2011 outlook

In this article, we consider the prospects and risks of developed and emerging markets, not only in terms of their economies but also investments.

- We believe the global economy will continue to recover in 2011, but deleveraging will remain a major theme and risk to the outlook.
- Developed world inflation is not yet a threat, which should allow monetary policy to remain loose.
- We think this is a good backdrop for risk asset prices and favour the ongoing recovery of equities in particular.

We expect the global economy to continue adjusting to a prolonged period of deleveraging (i.e. reducing debts), which is now well under way in the developed world private sector. Despite the headwinds, world GDP looks set for another year of above-trend growth.

US consumers starting to reduce their debt



Source: Bloomberg

The drivers of growth in 2009-10 were unprecedented demand from the emerging world, the fiscal stimulus measures in the developed world and a rapid recovery in trade. The most solvent recovered the fastest, with the corporate sector leading the consumer sector and emerging markets outpacing the developed world.

We think this uneven growth pattern will continue, but the global growth gap is likely to narrow as the developed world continues to recover and the emerging world moderates.

Asset class	Our view
Equities	++
UK	++
US	+
Europe	++
Japan	--
Asia & EM	++
Bonds	-
Sovereign	--
Corporate	-
Gold	Neutral
Property	--
Private Equity	--

Demand to remain supportive

Fiscal policy is becoming a drag on developed world GDP, but other factors should compensate. We expect demand from the emerging world to be maintained, albeit at a slower pace.

We also expect some improvements in developed world consumption, as the employment backdrop improves and disposable income is freed up by a slower pace of debt reduction. In countries like Germany, the prospects for domestic demand growth are high, and the extension of tax cuts in the US has bolstered growth expectations there.

Central banks play an important role

Global monetary policy will remain varied. Spare capacity in the developed world combined with low levels of credit creation should keep core inflation low and monetary policy loose even if interest rates are increased by the end of the year. In the emerging world, where there is less capacity, we expect moderately higher inflation to mean tighter monetary policy, ultimately resulting in a slower pace of economic growth.

QE = Questionable Effects?

Quantitative Easing (QE) measures are supporting asset prices rather than increasing goods prices, and this should continue whilst wage growth remains subdued. Such unorthodox monetary policy remains a concern, however, as it also increases tensions in global exchange rates, risking disorderly dollar depreciation and proliferation of capital controls. Provided global trade remains strong, this risk should be contained.

The European debt crisis could also cause more bouts of risk aversion in 2011, and Portugal is likely to require financial assistance, but Spain should escape provided its banking system is successfully restructured. These are short-term solutions, however, and the longer-term problem of a two-speed European economy remains.

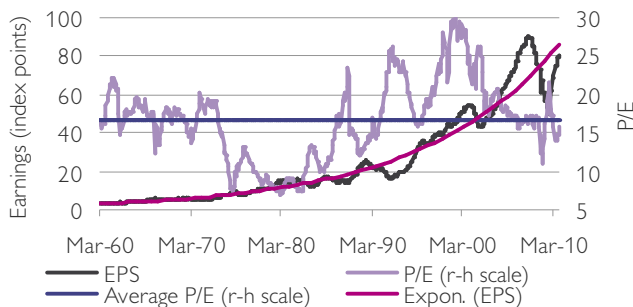
Although we do not generally regard inflation in the developed world as a significant problem for 2011, increased commodity prices, in particular the cost of energy, could cause an inflation shock, particularly if combined with an unexpected currency depreciation. In the emerging world, we believe inflation is under control, but cannot rule out the risk of central banks making policy errors.

Companies are generally in good shape

This environment of steady growth, controlled inflation and loose monetary policy should mean companies can maintain profit margins at reasonably high levels.

Consequently, we expect consensus expectations of 15% earnings growth for global equities to be met comfortably, along with higher dividends and more acquisitions.

US equities look reasonable value



Source: Bloomberg

Valuations have reverted back to their historic average levels following the trough of two years ago, and the greater earnings certainty that the improved economy affords should permit a further moderate re-rating in 2011.

Regional equities

We are positive on UK equities, due to their long standing exposure to global trade and a supportive exchange rate. The government's proactive austerity measures have reduced the specific risk to the stock market of a burgeoning fiscal deficit.

The US equity market should also prosper in 2011, as wages and employment improve, giving a lift to their more domestic sectors.

We also favour European equities, in particular those exposed to global trade. Germany is a good example, and companies there should also benefit from growth in the country's domestic demand.

By contrast, we maintain a negative view on Japan, where we see little domestic potential.

Within the emerging world, we think higher inflation will lead to interest rate rises and could result in more modest but still respectable returns. We expect emerging markets in Asia to fare better than others.

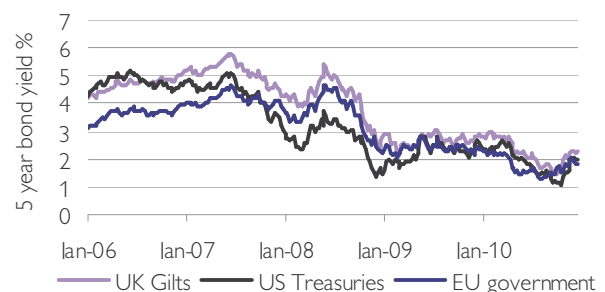
Sector-wise, business investment should remain strong as the recovery deepens, which we expect to favour large technology companies.

Faster economic growth in the US should also provide the marginal demand to increase the oil price, so we think the outlook for the energy sector continues to be positive.

Bonds

Real bond yields should rise further in 2011 in reaction to the growth outlook, but we think inflation is unlikely to rise substantially. We are increasingly negative on sovereign bonds overall and are maintaining a short duration, meaning holding bonds that, on average, are less sensitive to interest rate increases.

Bond yields to rise as economy recovers



Source: Bloomberg

While the outlook for corporate bonds is not negative given the economic backdrop, returns are likely to be contained to the dividend, with the yield spread coming down only modestly versus sovereign bonds. Given our expectation of rising benchmark yields, we are also increasingly negative on corporate bonds.

Alternative assets

Gold remains a good hedge against investors' expectations of sovereign distress, monetary debasement and rising inflation, but we believe a pullback could occur if US growth gains momentum. We still do not see opportunities arising in commercial property, due to the stock overhang in the banking sector.

Currencies

An improved risk backdrop should weaken the dollar over the year, the counterpart of which should be stronger emerging market currencies and a stronger euro. That said, the dollar could retain its safe haven status if the risks identified above come to fruition, as they are likely to be played out in the foreign exchange markets.

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Published on the 11th January 2011 by C. Hoare & Co., 37 Fleet Street, London, EC4P 4DQ.

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