

Market Background

Financial markets have endured a difficult three-month period, with declines in equities and other risk assets such as credit and commodities, while government bonds have rallied. This has essentially been driven by fears over economic growth in Europe, the US and China, and the possibility of a slip back into recessionary conditions. This has been most apparent in Europe, due to the sovereign debt crisis, and creation of the European Financial Stability Facility (EFSF) to provide a backstop for liquidity. Earnings forecasts have so far held up reasonably well, and we have seen valuations fall and risk premiums rise, due to the cumulative effects of investor caution in what remains a challenging environment.

United Kingdom

The general election of the 6th May was more closely contested than any election for a generation. Financial markets were unsure of the composition of the new government until 11th May, although were surprisingly stable in the interim, given the uncertainty. Investors were pleased with the emergency budget in June, which saw decisive action taken to moderate spending, and address medium-term concerns over national debt levels. Through the Coalition's period in office to date, sterling has risen modestly and gilt yields fallen, although the latter also demonstrate concern over growth worldwide. This has helped keep interest rate expectations low as well, despite inflation above target, at 3.4% year-on-year (y-o-y) headline CPI. Economic data has been satisfactory overall, with manufacturing up 3.3% y-o-y in April, and business investment up 7.8% quarter-on-quarter in the first quarter. Consumer spending remains constrained by modest wage growth and unemployment of 7.9% and retail sales only rose 3.4% y-o-y in May. House price indices remain in positive territory, with the Nationwide up 8.7% y-o-y in June, but this masks significant regional divergences, and mortgage approvals remain low at 49,815 in May.

United States

US risk assets deteriorated as soft economic data emerged casting doubt over the durability of the recovery. The June

ISM manufacturing index fell sharply, particularly the export component and was combined with a fall in retail sales. The employment market has also shown recent signs of weakness with average hourly earnings and non farm payrolls falling. Finally, a sharp fall in new home sales was sparked by the expiry of a buyers tax incentive. Notwithstanding specific data points, employment trends are improving so we believe the recovery will prove durable and spread out to the rest of the economy, from its current focus on investment and exports. This is being borne out in the personal income series, which shows income growth increasingly coming from wages, salaries and employment growth rather than government transfers. In addition corporate balance sheets and profits growth are strong and should presage further hiring and investment. The main risks to the recovery remain domestic, being the housing market and a failure to generate meaningful employment growth.

Europe

European policymakers have moved to shore up confidence in the euro project with the €440bn EFSF and ECB purchases of sovereign debt. However, investor concern has centred on the banking system, which may struggle to deal with a sovereign default. More bank stress tests are set to be published in late July, which if they are realistic, should provide visibility and confidence. Indeed, the successful expiry of the ECB's one-year liquidity facility for banks demonstrated that problems are more narrowly focused than previously thought.

Economic growth will be more subdued than elsewhere, particularly in southern Europe. For the time being, it remains driven by exports but indications in Germany at least are that unemployment continues to fall and business confidence grow. Indeed, anecdotal evidence suggests that capacity is already low in German manufacturing, implying inflation pressures may emerge sooner rather than later. Despite the concerns, globally focused European companies continue to make good progress on earnings and revenue growth, such that we believe equity markets are now decidedly cheap.

Japan

After a sharp slowdown in the economy of 5.2% in 2009, forecasts are for a return to growth in 2010 of 2.4%. This is primarily driven by a rebound in the manufacturing sector, which is up 30.7% y-o-y, and exports, which are up 43.5%, underpinned by shipments to Asia. Despite March unemployment rising to 5%, total cash earnings rose 0.8% y-o-y, the first gain since July 2008. This should have a broad-based effect on the domestic economy, although deflation remains a challenge, with latest figures showing prices fell by 1.1% over the last year.

Asia Pacific

Current growth in China is moderating from the 11.9% seen in the first quarter of the year. This is because the authorities became concerned that the stimulus package, deployed through loans at local government level, was leading to a residential property bubble. Lower loan growth is leading to growth forecasts of 9% y-o-y in Q4, but overall the economy remains healthy, notably through rising exports. In India, growth remains strong but inflation is elevated at 10.2%, necessitating further interest rate increases.

Emerging Markets

GDP is growing rapidly in Brazil, with 2010 growth likely to be 6.8%, the highest in 25 years. Although inflation is rising slightly, the central bank has been quick to react. Central and Eastern Europe are lagging the global recovery given the weakness in its major trading partner, the Eurozone. However, the region is further through its fiscal adjustment than is the Eurozone, and the equity markets had begun to respond to this and the higher oil price, before losing ground again as the Greek debacle unfolded.

Investment Outlook

Every economic recovery has risks that threaten to derail it and although the risks to this recovery, in the guise of public and private sector deleveraging, are large, we do expect that this recovery will prove durable. This is based on our view that corporate cash balances and cash generation remain strong, and will be able to fund capital investment and increased hiring going forward.