

### **Market Background**

Financial markets declined over the quarter, as concerns over Eurozone sovereign debt and banks, along with worries over a slowdown in the US and China, led to a sharp sell off in May and June. A number of factors came together in July to improve confidence in the stability of the Eurozone. These included the establishment of the European Financial Stability Fund and Spain remaining able to access the government bond market for funding. Most important were the Europe-wide bank stress tests, which provided an essential degree of credibility to the financial system as a whole. In addition, US second quarter earnings figures were broadly positive, with early reports in the UK and Europe also supportive.

### **United Kingdom**

The emergency budget delivered in June addressed some of the difficult issues surrounding the UK government deficit, in particular mandating future spending restraint. This has proved vital in heading off a sovereign downgrade and a precipitous rise in yields, which we believe will be helpful in boosting confidence in the economy at large. The first estimate of 2Q GDP was a positive 1.1% quarter-on-quarter, helped by a rebound in construction. After three positive quarters, GDP remains 4.6% below its peak. Looking forward, we expect a continuation in the recovery, but weak growth by historical standards, with household incomes squeezed by tax rises and lower public sector employment. Inflation has remained above the Bank of England target, at 3.2% year-on-year (y-o-y), but for now monetary policy remains focussed on supporting a return to growth, with expectations for the first interest rate increase next year. We remain broadly positive on the UK stockmarket as valuations take little account of improving profitability.

### **United States**

US equities rallied strongly in July as the earnings season produced strong results from much of corporate America. Overall, 78% of companies posted results better than the market had been expecting. Overall earnings were 11% better than expected. Sales grew on average by 9% y-o-y. The sales growth is encouraging as there had been fears

that the last couple of quarters of earnings growth had been driven by cost cutting and that, once costs could no longer be cut, sales growth would fail to materialise to drive earnings. The employment market remains weak with negative revisions to the previous non-farm payrolls numbers and lower-than-expected private payrolls gains this month. A positive note was that manufacturing payrolls increased by more than had been expected showing that manufacturing continues to lead the recovery despite signs of cooling. Corporate balance sheets and profits growth are strong and should lead to further hiring and investment. The main risks to the recovery come from a weak consumer, as consumer confidence remains low. The employment outlook and its impact on the currently elevated savings rate will be key for the overall outlook of the economy.

### **Europe**

Despite the backdrop of high unemployment and concerns over sovereign debt and weakened financial systems, the growth in Asia is leading to remarkably robust export and manufacturing-led recovery, especially in Germany. The most recent Purchasing Managers' Index from Germany was very strong, with the overall indicator for Europe also strong. The bank stress tests, whilst not applying as harsh a scenario as some would have liked, have at least provided greater transparency to enable investors to perform their own stress tests and have for now eased the considerable pressure that had built up around the Spanish banking system. We expect further business investment to improve the prospects for equities in core European countries going forward.

### **Japan**

Japan has performed well this year on the back of a manufacturing recovery. In January, expectations for growth were only 1.4%, but they have been revised up to 2.2%, which compares favourably to many other developed countries. Forecasts, however, are for growth of 1.6% in 2011, which is a return to Japan's long-term trend of 1-1.5%, which has been in place since the banking and property collapse of 1989-90. Overall, industrial production forecasts are for 19.1% this year and 5.4% next year. The loss of the

DPJ's majority in parliament is likely to hinder the implementation of the reforms necessary to turn around the economy's long-term underperformance.

### **Asia Pacific**

This year, China's policy has been to slow the pace of economic growth, due to the success of the stimulus package in 2009. This has seen growth moderate from 11.9% y-o-y in the first quarter to 10.3% in the second, with 9% expected in 2011. House prices have been rising in China, with new apartments in Beijing up 21.5% y-o-y, but we believe controls on loan-to-value ratios will ensure the pace in future is manageable, and that the long-term prospects for consumer spending remain positive, as wages continue to rise, up 7.4% y-o-y. The decision to allow the Chinese yuan to fluctuate and appreciate slowly versus the US dollar will also benefit the Chinese consumer in the long term. We remain positive on the outlook for China in particular as well as the broader Asian region including India.

### **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. The region is further through its fiscal adjustment than is the Eurozone, however, and the equity markets had begun to respond to this, and the higher oil price, before losing ground again as the Eurozone's challenges unfolded.

### **Investment Outlook**

The key issue remains the future pace of economic growth. Recent data suggests that the pace of recovery is now slowing as momentum from fiscal stimuli and inventory rebuilding wanes. We acknowledge these headwinds, and the likely fiscal consolidation in developed economies, but do not believe that a further global recession will occur, given the growing support to growth from business investment, and its effect on employment rates.