

MARKET OUTLOOK FOR JULY 2011

Global Investment Strategy

Investors reviewing the monthly and half yearly performance of the UK equity market could be forgiven for thinking indices have remained in a narrow trading range for the first half of 2011, with the FTSE 100 index around 0.7% lower in June and around only 1% lower than the start of the year. If you had sold in May and gone away, the first three weeks of June would have proved rewarding with the index falling by 5.3%, only to regain its poise over a few days in the last week of the month. “Risk on, risk off” trading remains the order of the day.

So what prompted June’s volatility after the ebbs and flows of the index in May, when FTSE stayed within a 3% range? The simple answer remains the European Debt Crises and specifically the Greek sovereign debt issue with policymakers’ indecision on the best way to resolve the country’s problems. The French have taken the lead, (probably because they are acutely aware of the potential damage to their own Banks if Greece actually defaults), and have presented a plan which would involve lenders rolling over 50% of the Greek

bonds maturing in the next three years, into Bonds with a 30 year maturity and carrying an interest rate of 5.5%.

As an incentive to the private sector, the French are proposing an additional interest payment of up to 2.5%, depending on economic growth achieved by Greece. Whilst praised for its similarities to

“Brady Bonds” which helped resolve the Latin American debt crisis, some commentators believe the plan will only further hinder the country. The political wisdom to suggest the country has a liquidity issue rather than an insolvency issue, as voiced by Bank of England Governor Mervyn King, looks set to simply postpone an inevitable default.

Meanwhile the credit ratings agencies have again shown their influence over capital markets by stating that they would view the French plan as a “selective default”, leaving the European Central Bank (ECB) in the difficult position on its rules on sovereign debt held as collateral. With an estimated €100Bn of outstanding Greek

debt held by the ECB, governor Jean Claude-Trichet, a long time critic on the influence of the ratings agencies, now faces a dilemma and it looks like “back to the drawing board” for the policymakers.

Back in the UK, signs of economic recovery remain mixed with the June Purchasing Manager’s Index (PMI) reading at 53.6, suggesting expansion whilst in manufacturing, which had been growing robustly, the composite PMI figure continued its decline from the peak in January and fell to 51.3; a twenty one month low. A figure above 50 indicates expansion and below, contraction so although the sector continues to expand, the rate of expansion is slowing. It is these conflicting factors which have the Bank of England’s Monetary Policy Committee divided on the direction of interest rates and certainly we cannot see any rate rises in the second half of the year without a significant upside surprise. All the while, inflation remains above the MPC’s stated 2% target but the Bank is unwilling to use the interest rate tool, to curb it. Latest minutes from the MPC showed a vote of 7-2 for no change in rates and there were even suggestions that some members of the committee were open to a further round of quantitative easing.

In the US, President Obama has used his first press conference since March, to emphasise the importance of increasing the US debt ceiling from \$14.3Tr and resolving the current Congressional

“impasse”. With the 2nd August deadline looming, before the country technically defaults, he warned that a failure to agree would have a “significant and unpredictable” impact on capital markets and the US economy. These remarks followed a warning from the International Monetary Fund (IMF) that financial markets worldwide faced a “severe shock” if the ceiling was not raised. Not wishing to miss out on the American front, ratings agency Moody’s warned of an imminent downgrade of US debt, just as the Fed’s second quantitative easing programme (QE2) has come to an end.

On the economic front, there are signs that the soft patch in the US economy was a feature of the first half of the year, as the US Institute for Supply Management’s (ISM) PMI number rose to 55.3 in June, from 53.5 in May. Faced with the possibility of increased taxes, jobs creation remains key to the muted recovery being witnessed and June’s non-farm payroll numbers (published this month) will be closely watched after a disappointing May figure.



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Efforts by the Chinese authorities to contain rising inflation appear to be having an impact on the economy with Chinese manufacturing at its lowest levels in two years and the June PMI figure falling to 50.9, from 52, not far above the contraction threshold and not the birthday present the authorities wanted as the Communist Party celebrated its 90th year. Whilst the Chinese are having some success in tackling inflation, the Reserve Bank of India (RBI) is still struggling with rising prices despite increasing interest rates for the tenth time in eighteen months, to 7.5%. Although rising food prices were the prime cause for the high inflation figures, the RBI has now warned of the impact of QE2 and the threats posed by high commodity prices.

An unexpected bright spot in world markets has been the speed at which confidence has been restored in Japan following March's earthquake and tsunami. With supply chains being restored both Toyota and Honda have indicated intentions to increase production and the Nikkei has been trading at its highest levels since the disaster.

Currencies

Sterling has come under pressure following the weak PMI figures released and the likelihood of delayed interest rate rises with the pound trading at around sixteen and five month lows against the euro and dollar, respectively. Recent data has shown that traders have increased their positions against the pound to their highest levels in over a year. The euro has also benefitted from Chinese support as the country continues to diversify its foreign currency reserves away from dollar denominated assets.

Commodities

As OPEC members failed to agree production increases at their recent Vienna summit, the International Energy Agency (IEA) took the unprecedented step to intervene in the markets for only the third time since its inception in 1974. The move caught markets off-guard and prompted an immediate 7% fall in the price of crude. The rationale stated by the IEA, was to replace lost production from Libya however some have questioned the political agenda, as the US will contribute around 50% of the 60 million barrels being released over a



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31 day period and Mr Obama is seeking to curry favour with the American electorate.

Elsewhere commodity prices have softened, with weaker Chinese manufacturing and an apparent loss of investor appetite for the asset class being cited. Recent data from Barclays Capital estimated that investors withdrew \$6.9Bn from commodities markets in May whereas a total of \$8Bn was withdrawn for the whole first quarter of 2008. In Chile, which mines around 14% of world copper production, the threat of strike action has ensured the metal has continued to trade close to record highs around \$9,500 per tonne.

Conclusion

With the holiday season upon us, market volumes are likely to be subdued and reactions to breaking news on Peripheral Eurozone developments may become exaggerated. Whilst this will present opportunities for short term traders and those seeking to play the “risk on, risk off” trade, we continue to believe in our longer term thematic approach and the international dynamics of many of our

favoured investments should ensure that portfolios are insulated from disappointing economic performance.