

Monthly Update

February 2011

Markets Overview

World Markets

Cash

Sterling:

The Monetary Policy Committee (MPC) kept both base rate and quantitative easing (QE) unchanged at its meeting in February, a decision it has repeated again in March. The outlook for interest rates has received considerable attention in recent weeks as inflation, measured by the Consumer Price Index, has climbed to 4%. Commentators claim the credibility of the MPC is being called into question, given its consistent failure to deliver on its mandate to keep inflation within the target range. It is apparent committee members are split in terms of what action is appropriate for the UK economy; according to the latest minutes published, three members voted for a rise in rates (ranging from 0.25% to 0.5%), one member voted for a further £50bn injection of QE and the remaining members voted to leave rates and QE unchanged. Markets have interpreted the content of these minutes and the subsequent rhetoric from members as a signal rates will rise sooner rather than later - possibly as early as May, albeit many consider this will be a mistake.

US Dollar:

A Federal Reserve bank official announced the outlook for the US economy was 'considerably brighter than six months ago' with signs of 'broadening and strengthening across the board'. Notwithstanding this, the central bank does not yet appear to have an appetite to withdraw the stimulus it is providing. A downward revision to US fourth quarter 2010 GDP to 2.8% from 3.2% muddied the waters although macroeconomic data, including strengthening purchasing managers' indices (PMIs) and improving consumer sentiment, point to a continuing recovery. President Obama submitted to Congress a \$3.7 trillion budget. The deficit for the current fiscal year is forecast to hit a record \$1.6 trillion, or 10.9% of gross domestic product.

Bonds

Sterling:

Having started the month in a weakening phase, gilts rallied in February as the increasing uncertainty in the Middle East saw them benefit from their safe haven status. The return from the 10-year benchmark bond was 0.76%. Credit markets enjoyed a positive month as the attractive risk-adjusted returns available from the sub-investment grade end of the spectrum benefited from inflows. Corporate balance sheets are strong and the bond-friendly profile this creates is resulting in the asset class remaining a feature of many portfolios.

US Dollar:

Quantitative easing has resulted in a sell-off of the US 10-year bond, steepening the yield curve still further. Inflation expectations have increased, but while inflation-linked bonds may compensate holders for future inflation, the real interest rate they offer is too low to offset the risk of rising interest rates - a reflection of their duration risk. High yield debt markets have enjoyed significant investor inflows and, according to Lipper, their allocations within mutual funds focused on high yield have increased by a net \$4.6 billion. This demand has driven down yields on the asset class to levels last seen in 2004.

Property (Sterling and US dollar):

US REITs, after a 30%+ rally over the last 12 months, are priced at an average 20% premium to net asset value (NAV) - the asset class looks expensive. By contrast, the European REIT sector is trading at a 5%-10% discount to NAV and has started to attract increased investor attention. A record share of US residential mortgages are in foreclosure - and, combined with mortgages with overdue payments, 14% of loans (one in seven) are in various stages of default. To compound matters, it is estimated 15.7 million homes are in negative equity - the highest share since the first quarter of 2009. Justifiably, the property market remains a concern for policymakers and commercial banks alike.

Index	Price	Up/Down on month
FTSE 100	5,994.01	↑
DJ Ind. Average	12,226.34	↑
S&P Comp	1,327.22	↑
NASDAQ	2,350.99	↑
Nikkei	10,624.09	↑
£/\$	1.6257	↑
€/£	0.8492	↓
€/\$	1.3806	↑
£Base Rate	0.50%	↔
Brent Crude	111.80	↑
Gold	1,411.48	↑

Prices quoted as at 28/02/11

Source: Bloomberg

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Equities (Sterling and US dollar):

A recent survey from Merrill Lynch revealed 67% of fund managers were overweight equities - this is the highest number in the history of this monthly survey and puts the asset class into potentially over-owned territory. This said, equities continue to be cheap relative to government bonds and their recent history, although many markets are approaching their 10-year average price/earnings ratio. Emerging markets have continued to under-perform developed markets as investors have rotated from the former to the latter. The same Merrill Lynch survey reported managers were a net 5% overweight developing markets - this contrasts to a net 43% overweight in the previous month. This illustrates a dramatic shift in sentiment driven by inflation worries and fears of over-valuation.

Alternative Investments (Sterling and US dollar):

Hedge Funds:

Assets under management in global hedge funds has been reported as reaching US\$1.68 - making them on course to be in excess of US\$1.7 trillion by quarter end. Over 50% of managers are above their high-water mark since December 2008 - confirming the asset class is supported and delivering to the investor community. With fund structures facilitating greater levels of liquidity and transparency, good managers are once again having to soft or hard close their funds in reaction to investor demand.

Commodities:

Nomura has predicted oil prices could surge to \$220 a barrel if both Libya and Algeria were to halt production together. OPEC spare capacity would be reduced to levels last seen during the Gulf War, when prices hit \$147 in 2008. Speculators can be expected to drive the price higher given the relative ease with which access to crude oil investments can now be made. The rise in agriculture prices has driven farmers and investors to bid-up the value of land; farm values in Iowa climbed by 16% in 2010. The escalating unrest in the Middle East and North Africa resulted in a flight to the safe haven of gold which rose in value by 6% over the month.

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Source: Bloomberg



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