Monthly Update

July 2010

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Markets Overview

Cash

Sterling:

The Monetary Policy Committee (MPC), once again, left interest rates unchanged at 0.5% in July and the quantitative easing programme was also left unchanged at £200bn. The minutes published after the meeting revealed a split vote of seven to one to keep rates on hold, the same ratio of voting that applied at the previous meeting. Commentators noted the minutes did make reference to a discussion to increase the quantitative easing programme should economic conditions deteriorate in the UK. This issue was brought into focus with the announcement second quarter GDP rose by 1.1% quarter-on-quarter, significantly ahead of consensus forecasts. The MPC faces a difficult challenge - fiscal retrenchment and public sector pay-cuts will be headwinds to economic growth, however, inflation remains above the target rate and the rise in VAT will further exacerbate this issue. The committee will want to be supportive for the economy, but its mandate is to control inflation. The credibility of Mervyn King and his colleagues will be tested.

US Dollar:

Evidence of a loss of momentum across US economic indicators has prompted speculation the Federal Open Market Committee may have to provide further stimulus to the economy. Weak retail figures, a slowing of the growth in manufacturing, housing numbers continuing to disappoint and unemployment remaining stubbornly high, all point to the possibility of further intervention by the central bank. This has unsettled currency markets and the dollar has slumped against the euro - down 6.2% - and the Japanese yen, which is trading close to a 15-year high against the dollar.

Bonds

Sterling:

The fixed income markets were buoyed by the results of the European bank stress tests, which resulted in only seven of the 91 banks undergoing the tests failing. The spreads on bank debt narrowed and the high yield sector was also a beneficiary of the renewed positive sentiment to wash over the asset class. Despite this, public balance sheets remain under stress and the rating agencies have continued to downgrade sovereign debt across the eurozone. In an environment of sub-trend economic growth, corporate debt has historically rewarded investors relative to other asset classes. Increasingly, analysts appear to agree with the Morgan Stanley acronym that the economic outlook is GRIM - Growth Really Is Mediocre - and, with this in mind, corporate bond funds should continue to attract investors' cash.

US Dollar:

The release of disappointing second quarter GDP numbers triggered US two-year Treasury yields to fall to record lows. The government bond market is clearly signaling tough times ahead, which contrasts with the equity market, which rallied strongly through the month of July fuelled by a raft of strong earnings results and an improving environment from a corporate perspective. Both the bond market and the equity market cannot be correct and we should expect either bond yields to rise, or the equity market to give back some of its recent gains. There is every likelihood markets will face disappointing economic data in the coming weeks and months ahead and equities will react negatively. Notwithstanding this, growth in Asia and Latin America remains strong and global growth, and therefore sentiment, might not be as impaired as some economists have forecast.

Property (Sterling and US dollar):

According to a new report by Savills, fears over government spending cuts and a lack of lending have created a negative outlook for the UK commercial property market. These concerns have extended to property investment firms on fears the forthcoming public sector austerity measures will affect the demand for office space. This view has been endorsed by recent figures issued by CB Richard Ellis which reveal the UK commercial property recovery lost ground in July, with average prices falling for a fourth straight month.

World Markets

Index	Price	Up/Down on month
FTSE 100	5,258.02	↑
DJ Ind. Average	10,465.94	↑
S&P Comp	1,101.6	↑
NASDAQ	1,864	↑
Nikkei	9,537.3	↑
£/$	1.5689	↑
€/£	0.83157	↑
€/$	1.3052	↑
£Base Rate	0.50%	↔
Brent Crude	78.18	↑
Gold	1,181	↓

Prices quoted as at 31/07/10

Source: Bloomberg

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Equities (Sterling and US dollar):
Despite the softening of economic data, equity investors enjoyed sparkling returns in July as strong corporate results boosted confidence. The MSCI World Index gained 8.1%, the S&P 500 was up 7%, this being 0.1% lower than the return delivered by the FTSE 100. Volatility has been high in recent months, albeit the VIX Index has traded off its highs through July. Despite the shift in investor confidence, there remains widespread concern headwinds remain strong for equity buyers. The National Bureau of Economic Research (NBER) in the US has still to declare the economy has exited recession and the Atlanta Federal Bank Chairman recently stated – “the economy has not yet arrived at a state where healthy and sustainable demand is underpinning growth”. It is clear some companies, both in the US and around the globe, have hugely successful business models and are able to capture strong operational leverage such that even anaemic top line sales growth translates into strong profit growth. Investing in the equity of these companies and enjoying the share in these profits, distributed by way of dividends, is the right strategy for high composure investors able to tolerate the volatile journey equity investors are likely to face.

Alternative Investments (Sterling and US dollar):
Hedge Funds:
The positive flow of second quarter corporate earnings and the upbeat sentiment which accompanied the release of eurozone bank stress tests have boosted the returns from long/short equity hedge fund managers carrying net long positions in the high beta environment which prevailed through July. Global macro managers will also have benefited from the rise in commodity prices and sizeable moves in foreign exchange markets.
Commodities:
The price of gold fell 6% as the appetite for risk surged. In contrast, oil prices rose, with Brent Crude higher by 7%, ending the month at $80 a barrel. In separate reports, both the International Energy Agency and BP found China’s energy use to have surpassed that of the US. BP calculated China had consumed 2.2bn tonnes of oil equivalent last year compared to the US’s 2.17bn. The Chinese, sensitive to their image as environmental polluters, have challenged the credibility of these estimates.

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