



## MONTHLY INVESTMENT REVIEW

February 2011

### ECONOMIC AND MARKET BACKGROUND

Divergent trends are becoming increasingly apparent with different regions of the world seemingly at various stages of the economic cycle. The Far East and the emerging markets of Latin America, which in the main escaped the bank induced recession seen in the west, continue to expand rapidly. Signs of slowdown during the latter part of 2010 have now been reversed with growth estimates being increased in a number of countries such as Korea and Taiwan even Japan is seeing signs of improving growth. Much of the increased demand is coming from the export markets but encouraging and important signs of improving domestic demand are beginning to appear. China, officially now confirmed as the second largest economy in the world, is taking steps to slow its growth rate to curb inflationary pressures, but is still targeting an annual growth rate of around 8% (down from over 11% last year).

Inflation in most countries is now the dominant theme, even where growth is limited and unemployment high. Emerging Asian Central Banks have continued to tighten monetary policy with China increasing its rates for the third time and is expected to increase them again in the next month or so. India and Brazil are similarly increasing rates to slow growth.

In the US, we are now seeing better growth and falling unemployment but the Fed has recently indicated that unemployment was “stubbornly above” and inflation “persistently below” the Fed’s mandate and that the Federal Reserve “would typically ease monetary policy” if there was scope to do so further. These comments lead one to assume that the current round of stimulus will continue and may even be extended later in the year. This is a very positive sign for financial assets at the moment, but does make them vulnerable later in the year if this policy is reversed.

Within Europe, the ECB remains concerned about inflationary pressures, but not to the degree many had expected. Recent comments on the state of the European economy have talked about the need to ensure that inflationary expectations are “anchored” to sustainable levels, but seemed to indicate that currently there are no signs that a change in policy is needed. The decision by Bundesbank President Weber throws the European macro economic policy debate into a state of some confusion as does the future direction of the ECB, of which he was expected to take over the running later this year. Within the UK, the greatest problems exist as inflationary trends remain persistently above the Bank of England’s target, but economic and jobs growth are both very subdued.

On the corporate front, the news has almost been universally positive. With most of the end of year reports now out, earnings came in better than expected for most companies and sales growth was above expectations showing that there was real sustainability behind the growth. Outlook statements were also positive and encouraging. Ironically, the areas of most concern came from the staple companies, most of whom are dependent on commodity inputs of one sort or another. Financials reported a clear stabilization in their credit trends and technology companies have a number of new product offerings.

Equity and commodity markets remain in clear up trends. Fixed income markets have recently broken down below support levels and which held during the latter part of 2010. Such trends seem to reflect the prevailing economic dynamics discussed above. For now our indicators keep us fully invested in equity markets with minimum exposure to bonds. However, we are concerned that a repeat of 1994 could be ahead where a sudden increase in official interest rates rocked the financial markets over a number of months. Both equities and bonds fared badly with cash being the only safe haven. We will be monitoring the situation carefully and will respond accordingly.

## ASSET ALLOCATION

No change has occurred since the last report. Government bonds have broken down through support levels which have held firm since early December. With the inflationary environment, especially in the UK, continuing to deteriorate it is likely that bonds will continue to fall in value (rates rise).

## EQUITY STRATEGY

Following a very strong end to 2010, and further interest rate increases in China, equity markets saw some sector rotation out of the industrial, technology and mining companies into areas perceived as having more value. While such a development is not unusual during January the recent move was the most pronounced in the last 15 years. There has been limited if any follow through to this rotation with signs that the growth companies which lead the market up last year are returning to the leadership position again. Technology companies have recovered their January losses and more with signs that industrial manufacturers are beginning to do likewise.

## IMPORTANT INFORMATION

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