



## MONTHLY INVESTMENT REVIEW

January 2011

### ECONOMIC AND MARKET BACKGROUND

It is now clear that the slowdown witnessed during the summer months was nothing more than a temporary pause in the upswing of the current economic cycle. Talk of double dips and “growth recessions” are now few and far between. It is now clear that heading into 2011 the economic background is very positive throughout most of the World. As yet, and maybe never, problems in the Euro zone have not destabilised the World economy with one of the major surprises of last year being how well the region fared economically despite the debt crisis. Unemployment remains a major challenge with the rate in Spain over 20% (higher for young people) and hovering around 10% in the US, but even in this area there are some positive signs. On the back of much higher than expected growth, more and more reports are showing a rise in the number of jobs being created. It is modest at the moment, but the trend is very positive.

Despite the clear signs of improving economic activity the authorities are continuing to pursue an extremely accommodative monetary policy in most of the World. The best example of this has been the decision by the Federal Reserve Board to undertake another round of quantitative easing (QE II) late last year. Further stimulus has come in the form of a decision to revoke tax increases for the highest earners in the US and reluctance on the part of the People’s Bank of China to slow economic activity down significantly. Growth forecasts are calling for North America to be up to 3% this year from 2.8% last year, Europe to be 2% from 1.7% and the Global rate to slow modestly from 4.9% to 4.2%.

Accommodative monetary policy coupled with strong economic growth has historically produced very positive returns to risk assets such as equities and commodities. In the US, which accounts for approximately 22% of World economic activity, the political impasse following the Congressional elections in late 2010 is generally viewed as a positive development as it means little is likely to change structurally in the way the economy operates. Taken altogether, some believe that the current environment is as positive for financial assets as it was in 1998 immediately before the technology boom.

As always there is an offset to all the good news. Bonds, most significantly government, have still a long way to fall. Changing asset allocation decisions will see selling, inflation is likely to be more of a concern in the future and so the yield will be forced to rise and the Sovereign debt crisis has not gone away. If any of these factors cause a sell-off in the major bond markets it is difficult to believe that equities will not be adversely affected. Politics may enter the equation (it is the third year of the US election cycle, typically when the incumbent does all they can to ensure re-election) but in the absence of this, it is difficult to imagine the current accommodative monetary policy being sustained throughout the year. Such a policy change would have an adverse impact on risk assets even if the rise over the last year has been due to real economic growth as opposed to just a liquidity driven reaction.

Earnings growth forecasts continue to be very healthy. Globally companies are expected to grow their earnings by 14.9% with the largest increases coming from the Far East and the Emerging Markets, but even the developed markets of the US and Europe are expected to produce a reasonably healthy return of 13%. Valuations are not demanding based on these numbers with many measures still below their long term average.

Sector strategy has remained essentially unchanged since the last report with the only notable move in the UK being healthcare equipment companies (essentially Smith and Nephew) and General Industrials rising up the rankings based on takeover speculation. Globally, software and electronic companies have risen up the rankings with retailers falling out. The moves seem to be consistent with the trend to higher levels of economic growth seen in the real economy.

The long- and intermediate-term trends remain in clearly established up trends. Our main concern is that everyone is optimistic. Such a state usually precedes a market decline. At the moment though, there is no reason to be anything other than fully invested for most clients.

## ASSET ALLOCATION

There have been no changes to our asset allocation since the last review. We continue to monitor the fixed income markets to add to the weighting in the UK Equity and Bond Income Fund to ensure we meet the minimum levels required within our IMA sector, but are reluctant to do so given the clear down trend in bonds and the very poor returns being offered.

## EQUITY STRATEGY

No change to our strategy. As stated above there have been only minor changes to the sector rankings. There are some early signs that momentum is returning to the banking sector. We have a very small allocation to this sector and so will begin to invest selectively as the evidence suggests a case to buy exists, such a situation dictates that relative risk reduction should be implemented. The steepening yield curve, improving economic landscape and improved sentiment towards sovereign debt (specifically, China committing to buy Spanish bonds) is all constructive for the banks.

## IMPORTANT INFORMATION

The information in this document is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. Past performance is not a guide to future performance and might not be repeated. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore, we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices, which may be subject to change. The value of any tax benefits will be dependent on the individual.

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