



MONTHLY INVESTMENT REVIEW

March 2011

ECONOMIC AND MARKET BACKGROUND

The Middle East, especially Libya, and policy responses to mounting inflationary pressures dominated financial markets. Continuing tension in the Middle East saw oil prices rise to multi year highs with Brent trading at a level last seen in 2008. Inflationary pressures continue to mount, due almost exclusively to the rise in commodity prices, and are bringing out differing policy responses between the US and Europe. The European Central bank (ECB) has warned very clearly that it will increase interest rates in the near future to address these inflationary pressures with many expecting the first increase in April. In contrast, the US regards the rise in commodity prices as temporary and unlikely to lead to a significant increase in inflation (this is supported by recent inflation data in the US). In the US unemployment remains the biggest single issue which continues to remain high and so monetary policy is unlikely to change anytime soon.

Comparisons with 2008, when the oil price surged to \$140 a barrel and lead to the last recession, are also beginning to be discussed. The causal link goes like this; higher oil prices produce higher inflation which in turn reduces disposable income which reduces consumption and consequently economic growth. Estimates indicate that an oil price over \$100 a barrel reduces growth by 0.2% p.a. while a price over \$125 reduces it by 0.4% to 0.6%. Adding in higher rates, the multiplier effect and loss of confidence, it is not difficult to see these numbers falling even further.

Within the UK, which appears to have the largest inflation problem as well as one of the weakest growth outlooks, monetary policy is polarised between the US and Europe. The Governor of the Bank of England sides with the US view whereas a growing number of members of the MPC are arguing in favour of higher interest rates; tightening monetary and fiscal policy is not an attractive prospect.

In Asia, including China, inflationary pressures are a growing concern and many countries have tightened policy to combat these. China, being the second largest economy in the World, has been at the forefront of these moves and appears to be successfully slowing its growth rate to nearer the targeted 8% down from 11%. Where these countries differ are the strong underlying economies, sound financial systems and job creation.

Despite the problems and deteriorating macro economic environment, financial markets have maintained a remarkably positive stance with the primary trend in all major markets in an up trend and the intermediate trend just holding on to an upward trend. A major sector rotation, out of the mining sector and into a range of others, has masked some weakness in the underlying dynamics of the equity markets although the recovery of the Shanghai market has been a significant positive factor. Fixed income markets have reversed their previous negative trend and, despite the prospect of higher rates, are seeing higher prices. Belatedly, and in a very modest way, we are beginning to see some declines in commodity prices such as copper. Maybe, the market is applying its own corrective measures and the need for formal policy intervention will be reduced. Only time will tell.

For now, if you can predict what happens in the Middle East, you can predict equity markets.

The corporate earnings recovery remains well set with the vast majority of companies reporting both better earnings and sales growth than had been expected. Mining companies, while doing very well operationally, have started to discount slower economic growth with their share prices beginning to underperform the market. We have significantly reduced our exposure to this sector which was recently one of our largest positions. We are currently, modestly under weight. Property companies have generally beaten expectations during the recent round of reporting and the sector has broken out on the upside. We have cautiously started to buy into this sector recognising that there have been a number of false signals in the past. From a cycle perspective, selling the miners and buying property is attractive given the disparate performance over the last two years. Life insurance companies have also started to take over some market leadership with very good earnings being reported by a number of these companies. The sector rotation we have mentioned before continues to gather pace. The key challenge will be whether this can take place without destabilising the market.

Looking at the trends in most markets the primary up trend remains in place with commodity and equity markets well established. Physical property may be another story but the quoted sector looks to have just moved into a primary up trend. Fixed income markets look more challenging and if the talk from certain monetary authorities is to be believed then the benign bond market environment which has existed for many years is set to end.

Secondary trends are more questionable. It appears that the UK market has breached its shorter term secondary trend whereas the US hasn't. Events in the Middle East are clearly impacting sentiment as is talk of interest rate increases discussed above. We look to see confirmation in more than one market before concluding that the secondary trend has changed direction and so have only modestly increased our cash holdings. A rapid resolution to the Middle Eastern issues will see a sharp rise in equity markets but how sustainable that will be is questionable but it is not something we want to be on the wrong side of.

ASSET ALLOCATION

Cash has been allowed to accumulate in all the funds due to the macro environment and signs that the secondary trend may be reversing. However, given the rising levels of uncertainty and impact higher oil prices would have on growth we are not ready to make a major switch into cash. When we do, most of this will be done within our funds thereby protecting the gains many clients have made over the last two years.

EQUITY STRATEGY

The sector rotation has continued to gather pace. We have been following these moves with the funds sector weightings changing accordingly. More details can be seen on the individual fund allocation.

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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