



MONTHLY INVESTMENT REVIEW

May 2011

ECONOMIC AND MARKET BACKGROUND

Macro economic themes continue to be dominated by inflationary pressures, debt problems, dollar weakness and what will happen when the US ends its period of quantitative easing in early June. Inflationary concerns saw little respite during the month despite a large fall in the underlying price of a number of basic commodities such as oil. It is unlikely that commodity prices will fall sufficiently to ease inflationary concerns as Global economic growth is forecast to be the highest for many years as most economies have finally emerged from the recession of 2008- 2009. The best that can be hoped for is a slowdown in the rate of growth which in turn will translate into reduced pressure on annual price increases and a moderation in demand from the Far East. Longer term it seems likely that increases in economic growth are going to be accompanied by higher levels of inflation.

Debt problems remain a key variable to the economic background. While there is much concern about the potential magnitude of the consequences if the problem got out of hand there is currently a view that the situation is being contained and that time (for which real growth) will help resolve the issue. It is not a time for complacency but at the moment the situation appears to be under some sort of control. It is widely accepted that Greece will re-structure its debt at some point in the future, most likely early 2012 and that Ireland and Portugal will receive support to resolve their problems in the fullness of time. What needs to be remembered about debt is not necessarily the absolute levels rather than the confidence of third parties about the debtors ability to fund, and eventually repay, it: Were this not to be the case then Japan and the US would be in much greater trouble than they are. What will emerge from this period is a rapid transfer of power from the West to the debt free vibrant economies of the East.

While everyone knows it is coming, the potential disruption which could emerge from the end of Quantitative easing (QE) in the US should not be ignored. Chairman Bernanke has rightly won the confidence of the market for his handling of the beginning of the crisis and so enjoys a degree of trust. The sheer scale, complexity and novelty of removing Q.E. could have consequences no-one has considered and which cannot be anticipated. Such uncertainty could lead to increased volatility later in the year.

China, although much the same could be said for Brazil and India, is trying to slow its economy to a more sustainable level and remove signs of rising inflation. This is a difficult task at the best of times and given the state of economic development in China it is all the more complex. The importance of this process and impact on the West should not be underestimated.

US dollar weakness has been an issue of great interest to policy makers and market participants for many years. The US has often been accused of pursuing a weak dollar policy to make its exports more attractive, although this has been strenuously denied. Speculators have considered the dollar as a one way bet and used its weakness to fund a "carry trade." Were dollar weakness to come to an end then there would be profound implications for many as established positions are reversed. There are some signs that the dollar may have reversed its rise in the short term but the more important intermediate term trend remains intact. Recent action has certainly brought the currency down to the bottom of its trading range but no more. The situation needs careful monitoring.

Within the various asset markets the big positive move has come from property which appears to have successfully moved into a positive trend. This is true for builders and property companies although selectivity is vital as there remain many problem areas. Commodity markets have been very weak with a number, such as copper and to a lesser extent oil, breaking up trends and establishing new downward trends. Others, for example gold, have seen a pull back to the bottom of their trading range. The trend in the industrial commodities suggests that economic growth may be slowing quite rapidly. Maybe China is not slowing in the controlled manner it appears. Corporations continue to post strong earning growth and are cautiously positive about future trends.

North American markets established new highs in early May but this was not generally followed through. This has to be a concern but currently it would be premature to read too much into this currently. Fixed income markets have proven to be resilient as the decline seen earlier in the year has been reversed. Should the dollar change direction then we will need to reassess the implications of this for what the markets are telling us. Currently, there is no reason to believe that the intermediate trend in the market has reversed.

ASSET ALLOCATION

Cash levels have been allowed to build up modestly within the funds as a number of deeply cyclical stocks have been sold as their trends appear to have reversed. We have added to our property holdings. Last month we began to add to the Emerging markets again but have held off from further purchases as the emerging trend has not followed through.

EQUITY STRATEGY

The rotation seen in markets since the beginning of the year has continued. Pharmaceuticals, food manufacturers and utility companies have started to emerge as leading sectors in part due to their defensive nature. Conversely, mining, oil and a number of manufacturing companies have continued their volatile underperformance. As we said last time, now is not the time for large sector positions.

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