

Market Themes

February – 2011

- Concerns about peripheral debt in Europe led to an initial drop in the Euro during January. However, stronger growth indicators and hawkish rhetoric from the ECB drove interest rate expectations higher, leading to a strong recovery in the euro. In addition, there was a recovery in sentiment towards peripheral bond markets as Portugal and Spain completed small though successful auctions of government debt, and speculation mounted that the scope and size of the European stability fund would be reformed.
 - The strong run of data globally continued over the month. This has led to rising concern about inflationary pressures emerging as a secular trend in emerging economies, driven by very strong Emerging Market growth, coupled with strong commodity price rises.
 - The euro ended January 2.3% higher against the US dollar, driven largely by higher euro-zone interest rate expectations. Higher commodity prices are becoming a focus of attention for the ECB, contrasting sharply with the views of the Bank of England and the Fed, where the focus remains on core inflation rates. This has given interest rate support to the Euro.
 - The global equity market fell in euro terms over the month (by 1.1%).
- At a regional level, concerns about overheating in emerging markets led to a fall of 6.2% in euro terms, followed by Australia (-4.6%), Canada (-2.4%) and Japan, which fell by 2.2%. The Euro Stoxx was the best performer, rising by 4.4% in euro terms. The S&P 500 fell by 0.2% in euro terms.

OIL PRICES



- At a sector level, Energy led the way, rising by 2.6% in euro terms, supported by the strong oil price and tensions in Egypt. This was followed by Technology, which rose by 1.2%. The Basic Materials sector lagged, falling by 4.6%, followed by Consumer Staples (-4.0%), Consumer Cyclical (-2.9%) and Healthcare (-2.2%).

Strategy Changes

- We remain overweight equities in our balanced portfolios.
- We have reduced our exposure to Basic Materials but remain overweight. We have increased our exposure to Utilities (but remain underweight).
- Portfolios are overweight Energy, Consumer Cyclical and Basic Materials, and underweight Financials, Utilities and Telecoms.
- We have reduced our underweight in bonds in our balanced portfolios. This is a tactical rather than a strategic move. Within our bond portfolios, we remain overweight core bond markets and underweight peripheral bond markets.

Market Outlook

- Leading economic data points continue to suggest that the global recovery remains on track. A lead indicator for the commercial construction sector, the Architectural Billings Index, has now been in expansionary territory for two months suggesting the recovery is becoming more broad-based within the US at least.
- While unemployment rates have yet to improve in the periphery of Europe, unemployment appears to have peaked in the US and unemployment rates in Germany are close to/at record lows.
- Inflation remains a risk and is most evident in the soft commodities where prices have been rising dramatically. The risk of inflation may force emerging countries to tighten monetary policy and while this would be a long term positive the short term impact on emerging market equities could be negative.
- Markets for now appear to have sidelined the sovereign debt issues which may be overly optimistic as a final solution has yet to be agreed upon for Europe.
- Whilst equity valuations are not as attractive as they were, they continue to be attractive for the long-term investor particularly when compared to government bonds.