

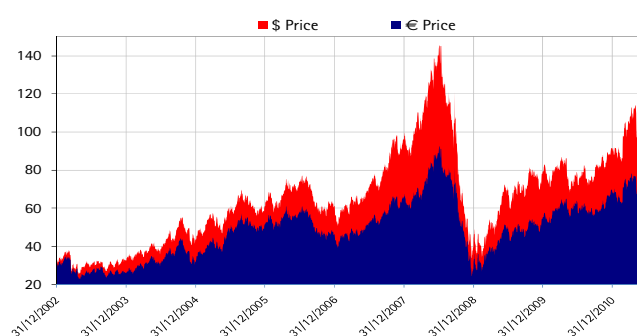
## Market Themes

July-2011

- Markets were dominated by two factors during the second quarter: (i) the inability of EU leaders to deal with the sovereign debt crisis and (ii) concern that the weakness in economic growth was a precursor to recession rather than a temporary slowdown.
- Peripheral Eurozone sovereign debt concerns, centred on Greece, once again came to the fore in the second quarter. Significant slippage versus deficit reduction targets in Greece led markets to speculate that the latest tranche of loans would not be forthcoming and that a Greek default was imminent. In the event, the Greek government passed new austerity measures, paving the way for the next tranche of loans to be paid, removing the threat of an immediate Greek default.
- Discussions on a new bailout package for Greece are ongoing. The German and French proposals for "voluntary" rolling over of maturing Greek debt by private investors as part of the new aid package being met with some level of optimism by markets, but is being seen as a selective default by rating agencies.
- Economic growth concerns were also a concern during the second quarter, as economic data, particularly from the US, showed a significant deterioration both in absolute terms and relative to expectations. Whilst some weakening of the economic expansion was not unexpected given policy tightening in China, the Japanese earthquake and high oil prices, the extent of the weakness in the data has nonetheless taken the market by surprise.

Despite the concerns about peripheral Eurozone sovereign debt, the Euro strengthened over the quarter (by 2.4% against the US dollar) as the ECB implemented the first rate hike in three years and hinted that there was sufficient concern about inflationary pressures that further rate hikes may be necessary. This is in marked contrast to US Federal Reserve's insistence that the rise in inflation is caused by temporary factors, rates will remain on hold for a considerable period, and even though Quantitative Easing has ended, the Fed will maintain the size of its balance sheet by reinvesting the proceeds of maturities into US Treasuries.

### OIL PRICES



Global earnings estimates were broadly unchanged during the quarter. In terms of regions, U.S. equities had the strongest upgrades over the period, while Japanese equities continued to see downgrades to consensus estimates following the earthquake in March.

## Strategy Changes

- Macro, technical and valuation analysis continues to support a strong relative exposure to equities versus bonds.
- At a sector level, we have reduced our overweight in Basic Materials and Energy (but we remain overweight) and we have increased our overweight in Industrials. In addition, we have further reduced our exposure to Telecoms and removed our long-standing underweight in Utilities. Portfolios remain overweight Healthcare and underweight Consumer Staples.
- At a regional level we remain overweight Japanese equities.
- Within our bond portfolios, we maintain a bias towards debt of "core" countries and underweight "peripheral" bond markets.

## Market Outlook

- Economic data, despite the recent weakness, remains consistent with continued expansion, albeit at a more modest pace than before.
- The second half of the year should see a rebound in growth as the Japanese economy in particular recovers from the effects of the earthquake and the global economy works through the post-earthquake supply-chain disruptions.
- Our valuation analysis continues to tell us that equities remain cheap relative to alternative assets such as bonds and whilst technical / price action does cause us concern, the trend in place since March 2009 continues to suggest ongoing price appreciation for equities.
- Sovereign debt in the developed world, not just in the periphery of Europe, continues to be a key issue for markets and will remain so for the foreseeable future.