quarterly
Q2 2010

vestrawealth

economic review

Concerns about the momentum of economic recovery in the US increased last quarter, but a slowdown in GDP growth still looks more likely than the “double dip.” Germany benefited from the weaker euro, but this only served to highlight the dire state of several other countries in the EMU. Growth is also slowing in China (albeit from a very high level), which will impact on other economies in Asia.

There is disagreement as to how quickly deteriorating budget deficits should be cut and how far this should be supported by monetary policy. The BIS called for fiscal and monetary tightening but several countries have (or are about to) embark on fiscal tightening. The major central banks left rates unchanged.

China introduced greater flexibility in the Renminbi (RMB)-US$ peg. Euro weakness prompted a strengthened US$ (until the end of the quarter) and, after the British election, the pound also gained ground.

outlook

growth and output

In several countries, including the US, fiscal and monetary stimuli and a turnaround in inventories has seen a significant recovery but, after a “V” shaped bounce, the future path remains uncertain. Consumers have to get into a position where current and future revenues are sufficient to meet current and future expenditures and today’s debt.

Any return to “normal” requires a rise in the rate of return on investment (so that businesses can be profitable at “normal” and higher interest rates, which are themselves necessary to restore an appropriate balance between spending “today” and “tomorrow” or, put another way, between spending and saving). There are several ways to achieve this. First, is to accept a protracted period in which the capital stock is run-down to a level where new investment does earn a higher return. Second, is a fall in real wages brought about by currency depreciation. Third is a fall in real wages via a squeeze on nominal wages (in practice through high unemployment) and fourth, by introduction of specific “pro-market” measures to increase rates of return.

The last has been discarded by most governments. In other respects Britain is relatively better placed than most other countries; the pound is competitive (despite recent strengthening) and since the peak, domestic demand has fallen to a level that is consistent with “inter-temporal” equilibrium. This is not the case in the US (or several economies in EMU) and a dollar depreciation on a scale to “re-balance” the US would wreck the international system (and until recently moved the other way) while EMU has condemned several countries to deflation and/or ultimate default.

inflation/deflation

In several countries of Europe and (possibly) in the US deflation is a greater threat than inflation. Britain is different; inflation has remained stubbornly high and the BoE is showing increasing interest in the potential impact of the financial crisis on supply and with it the size of the so-called output gap and thus, potentially, the threat of inflation. However, even making some pessimistic assumptions about lost capacity still leaves the output gap looking wide enough to withstand a prolonged period of above trend growth before inflation becomes a problem. The increase in VAT has been timed to avoid a “spike” and CPI inflation should come in line with the two per cent target next year.

interest rates and monetary policy

The Bank of Canada and the Riksbank raised interest during the quarter but indicated that no further early moves were likely, though the Reserve Bank of Australia may be tempted into another rise. Some members of the FOMC

have been publicly pressing Ben Bernanke for an early rise in interest rates and/or withdrawal of QE. However, weaker economic data will help undermine the case of the “hawks.” No US rate rise is expected this year (least) and QE may well be revived later this year. At the June meeting, one member of the MPC voted for an increase in interest rates but the subsequent fiscal tightening is likely to strengthen opposition to higher rates. No rises in policy rate are expected this year, though the BoE is (probably) less likely to revive QE than the Fed. The ECB will continue to provide unlimited liquidity and keep policy rates low and at some stage will almost certainly embark on QE.

deficits and fiscal policy

In Britain and within the G20 there has been a debate about the timing of cutting budget deficits. The notion that a deficit should not be reduced until recovery is secure is predicated on entering the recession with the public finances in good order. This was not the case in Britain or several other countries and deficits and debt were on unsustainable paths.

Nonetheless, a significant fiscal tightening is not without its risks (though probably less risky than doing nothing) and short term official forecasts for GDP growth in Britain – 2.3 per cent in 2011 – may be too optimistic. However, there is no uncertainty about the implications within EMU where raising taxes and cutting expenditure in the “periphery” countries simply increases the danger of debt deflation and (ultimately) default.

exchange rates

Any appreciation of the RMB (as a result of “de-pegging”) is likely to be modest and in the next quarter euro weakness is likely to predominate (with periodic recoveries if markets are duped into believing the crisis has been “solved”). With the dollar strengthening (perhaps, despite disappointing data), sterling should remain firm over the next three months.

investment review

Internationally equities fell heavily over the last quarter. Government bond performance was mixed (see below). With the exception of gold, commodities performed poorly and in the FX market, ‘reserve’ currencies (US Dollar and Japanese Yen) performed at the expense of others, notably the Euro.

In the UK it was a ‘game of two halves’! Ahead of the general election Gilts and Sterling experienced major bouts of nerves as investors fretted about a possible hung parliament. However, the formation of the Conservative/Liberal coalition was looked upon favourably and confidence was further boosted by a very austere ‘emergency’ budget which set out a credible plan to pay down the huge national debt. Consequently, Gilts and Sterling ended the quarter strongly.

The last three months saw the first major equity sell-off since the credit-crunch ended in March 2009. Selling began in April when Greece revealed further ‘inaccuracies’ in their official economic numbers. The bond market took fright and the cost of borrowing soared. Fearful of contagion, the ECB announced a one trillion Dollar support package. However, hesitation and lack of clarity early in the crisis left investors uneasy and, after a temporary respite, the selling resumed. It was further fuelled by a faster than expected slowdown in China and an unexpected deterioration in US economic data in June.

During the quarter clear divisions emerged in Government Bond markets. Traditional ‘safe haven’ countries, such as the US and Germany, saw huge inflows pushing yields down to levels not seen since the midst of the credit crunch. Simultaneously, bond yields rose sharply in more risky countries, such as the ‘PIIGS’, along with Hungary and Belgium where investors fear possible default. Consequently, across the Euro zone, the difference between the German Bund yield and most other countries debt is now as wide as it’s ever been, implying that investors are positioning themselves for a possible country default, or a split in the Euro.

outlook

When assessing the outlook for investing at present, one is reminded of the story of 'Goldilocks and the Three Bears'.

Until recently, someone who knew nothing of the 'credit crunch' could be forgiven for thinking that the background for equity investing was ideal. Interest rates are at record lows and look like staying that way, while inflation is low and under control. Global growth is back and the US is beginning to recover. Company profits have been beating analyst's expectations, leading to earnings upgrades. Companies are financially strong and have selectively begun taking over weaker peers through mergers and acquisitions. As Goldilocks would have said a month or so ago, everything seems 'just right' for equity investing.

Sadly, as we know from the children's story, the house in which Goldilocks found herself was occupied by three bears.

'Baby bear' is the huge amount of external interference now prevalent across markets, namely: the German's ban on naked short selling; the US trying to restrain proprietary trading by regulating integrated investment banks; the ECB pledging to bailout weak countries who have breached the supposedly 'non-negotiable' fiscal rules; and the US and the UK's 'Quantitative Easing' policies. It is hard to remember when there have been more potential distorting external factors in so many markets at one time. This throws up the question 'what is real and what is not?' And that begs the question 'are we gambling or investing?' At Vestra we are 'investors', not 'gamblers', so the current backdrop is most unpalatable.

'Mummy bear' is the forthcoming 'austerity' measures in Europe and the UK. For better or worse, many Governments have decided that it is better to begin paying down the credit crunch bailout debt now, rather than leave a crippling burden for the next generation. The private sector has been living with static pay, under-funded pensions and continual cost cutting for much of the last decade. However, for the first time in a generation, public sector employees now face the same prospects. How they react is difficult to call but given circa 40% of the UK's employees are either directly, or indirectly, employed by Government, the potential impact is worrying and we cannot see this as anything other than negative and deflationary.

'Daddy bear' is the threat of 'sovereign default' or Euro 'devaluation'. Last quarter's equity sell-off was sparked by these fears across Europe and in particular, Greece, Hungary, Belgium and most worryingly, Spain. The burden of debt repayment within the confines of a currency such as the Euro, governed by countries with different economic agendas is potentially

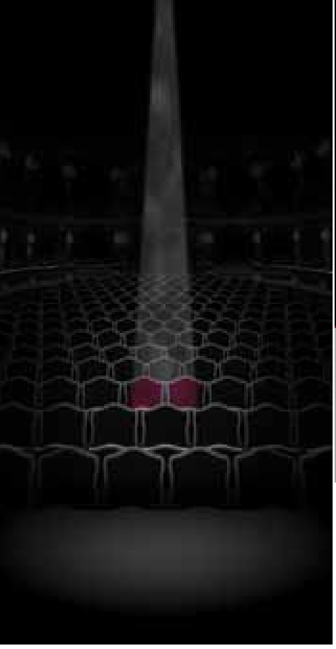
It seems clear that the stock markets are now pointing to a possible 'double dip', or a 'W' shaped economic progression at best. Given markets typically look forward six months and in our experience are rarely wrong, this new pattern does not bode well!

Three months ago the FTSE 100 had done this...

And now it looks like this...

source: Bloomberg

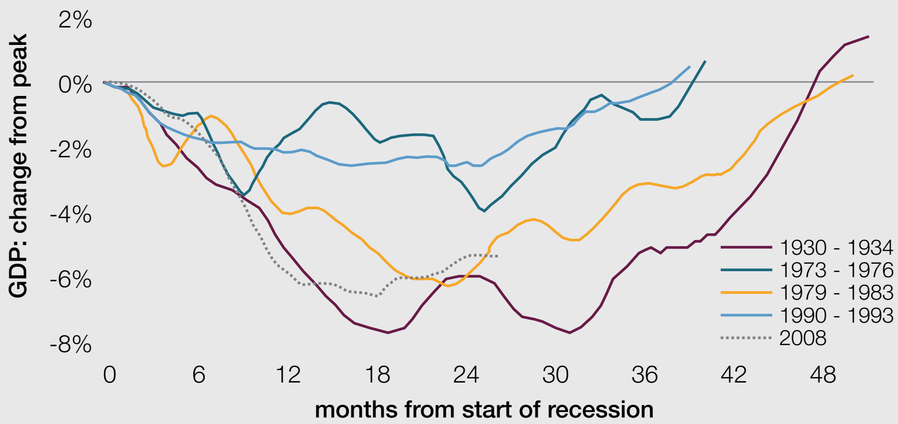
Past performance is not a reliable indicator to future performance and that the value of investments, as well as the income from these, can go down as well as up and investors may get back less than the original amount invested'



untenable (as we found out when the UK was forced out of the ERM in 1992). Without a currency devaluation, costs must be cut in order for the relevant country to stay competitive. If they don't devalue, extreme cost cutting is required and often, as we have seen in Greece, the public backlash is dramatic. On the other hand, had Greece left the Euro and re-introduced the Drachma when the crisis first started (probably at half the level of the Euro), we would all be off on holiday to Greece this summer in search of a fantastically cheap holiday and the Greek people would be welcoming us with open arms. Instead the cost of holidaying in Greece is prohibitive and that's without the prospect of running into rioters in the streets of Athens! For a country with limited alternatives to tourism for its income, the outlook is bleak.

The trouble with the 'three bears', is that apart from 'baby bear' everything else is 'deflationary'. Deflation is an equity investor's worst enemy. Without strong economic growth to offset it, the outlook is potentially very negative. We all know how the children's story goes and it's not a happy ending! The big question is what do other investors think?

The UK's GDP (grey dotted line) data is progressing like this...



source: NIESR

As with last quarter, we remain very cautious.

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