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vestrawealth

economic review

In the last quarter forecasts of economic growth were downgraded in most of the developed economies, while there were signs that the slowdown in the US and Europe was impacting on China and other Asian economies. There was a serious worsening of the euro-zone crisis and growing fears of its implications beyond the euro-zone, reflected in a sharp fall in equity markets at the end of July/early August and a strengthening of the dollar (against the euro) from the end of August.

outlook

growth and output

In the absence of a “post-Lehman-like” *dénouement* of the euro-zone crisis, the US should not re-enter recession in the next couple of quarters and GDP in Q3 may be stronger than (the very weak) Q2. However, the economy is fragile. Consumer spending is about 70% of national income but consumer incomes are being squeezed and confidence is low, federal and state expenditures are being cut while manufacturing is barely treading water. President Obama has proposed a \$450bn stimulus package but the Congress is divided and any further help for the economy is most likely to come from the Fed.

In Europe, German GDP increased by 3% in H1, but recent data suggests that export growth is tailing off, though this is partially offset by domestic growth which should see reasonably robust GDP growth when data for Q3 is published. Q4 will probably be weaker but with its focus on capital goods, Germany’s economy is a lagging indicator and given prospects in the US, China and “peripheral” euro-zone countries, GDP growth could be sharply down in 2012.

The euro-zone crisis is irresolvable within the present framework. The latest tranche of assistance to Greece will probably be agreed by the IMF but Greece’s economic and budgetary position continues to deteriorate. Real GDP was down about 8% in H1 compared to a year earlier and none of the purported “solutions” (debt rescheduling, “loans plus austerity”, let alone “fiscal unions”) deal with the core of the problem – significant loss of competitiveness within EMU.

The fall-out from EMU is probably the biggest threat to Britain’s fragile economy (though prolonging the EMU crisis only increases the ultimate cost). On 29th November, the Chancellor will announce new economic forecasts, probably just above 1% this year (1.7% in the budget). Slower growth means that the deficit reduction target will be missed but further fiscal tightening is not on the cards (nor is the Chancellor likely to ease up on expenditure reductions, though political pressure could force a few new “initiatives” to “boost growth”).

In Asia, China is still in a very difficult stage of the economic cycle - high inflation persists and growth will have to be significantly below trend to bring it under control. Exports will continue to be affected by developments in the US and Europe and the authorities may respond by capping any further appreciation of the RMB. Japan’s exports also seem to be losing momentum (after the bounce following supply chain problems); reconstruction will provide some countervailing boost but consumer spending will remain very subdued.

inflation/deflation

In Britain, latest data suggests that although inflation is still on course to rise (to a peak around 5%) in the next few months, it should fall back sharply next year and deflation rather than inflation is probably the bigger medium term threat. In the US core inflation rose to 2% in August (reflecting earlier rises in commodity prices), but minutes of the Federal Open Markets Committee (FOMC) suggest the Fed expect these pressures to abate soon. This may be too sanguine but slower growth and higher unemployment are more likely influences on policy. Headline inflation rose to 3% in the euro-zone but



core inflation is barely above 1% and the aggregate hides the major deflationary threat in peripheral countries stuck in recession.

interest rates and monetary policies

'Operation Twist' reflects divisions within the FOMC about a further round of LSAPs (Large Scale Asset Purchases) – the US version of QE. The Fed may need to see further evidence of economic slowdown but LSAPs will probably resume later this year. The MPC had given a clear indication that a resumption of QE was actively being considered and increased it by £75bn in October. The ECB is likely to reverse the July 25bp hike though the timing may be (unnecessarily) complicated by the changeover at the top of the ECB.

exchange rates

The continuation of the post-August financial market crisis is likely to see further strength of the US dollar (against the euro) though the probable resumption of LSAPs by the US could presage a period of considerable currency volatility. The weakness of recovery in Britain (and a resumption of QE) will probably keep sterling absolutely weak but its relative performance will be determined by the euro-dollar cross rate.

Derek Scott

investment review

There is little doubt that few equity investors will remember the last three months with any degree of fondness. The S&P 500 fell 14.3%, its worst quarterly performance since 2008 and the FTSE 100 fell 13.7%, its worst three-month performance since 2002. Concerns about global economic growth hit other markets even harder with, for example, stocks in Hong Kong tumbling 21.5%, the worst quarterly decline for a decade. At the start of July it looked as if the US was experiencing a mid-cycle slowdown with production impacted temporarily by post-Fukushima supply chain disruptions and as the stock markets dropped away in August, it appeared as if fears over a fresh recession were overdone but macro concerns are still dominating with potential policy response, good emerging market demand, and low valuations all being ignored.

outlook

The outlook for the developed world is uncertain and growth will be anaemic but developing markets are benefitting from solid structural growth and their influence may still add up to global growth of 3%. The reality here is that developing markets have been important for a while. They have accounted for over 80% of global growth since June 2009 and their share of world GDP has risen to 38%, double the rate that prevailed in 1990.

China is the big engine of emerging market growth. It has had its foot on the brake for a while now but inflation is abating and for 2012, GDP growth is likely to be around 8.3%. This is down from previous forecasts of 9% plus, but even at that lower rate of growth, that's 1.3 billion people doubling their intake of economic goods and services in just eight or so years. With 87m inhabitants, Sichuan is an excellent prism through which to view the heartland of China. It may have entered British consciousness as the home of spicy food, but over a quarter of the Fortune Global 500 Companies have established bases there. It is home to one of Intel's largest and most advanced Asian plants and a hub for Chinese aviation efforts. Development of technology parks and biotech research centres is being reinforced by development of roads, ports, airports and subway systems. This is not growth driven by exports of cheap goods to the West. It is growth driven by the movement of workers from the fields to the cities. New patterns of consumption will emerge and Chinese

infrastructure spending - a vital, justified and intelligent response to the ongoing process of urbanisation – will continue for some time to come.

The developed world is still beset by problems, with low growth and fiscal austerity holding consumers in a painful embrace. But that does not mean that it should be dismissed as having no prospects at all. Capital formation, quality of education and training, innovation and migration are all growth drivers that respond to private and public choices. We may not have seen such micro measures yet but there are signs that the authorities are stepping up their policy response. President Obama has introduced a large new jobs initiative and the US's Federal Open Markets Committee (FOMC) has initiated 'Operation Twist' in order to drive down long-term bond yields. This should stimulate the low cost re-financing of mortgages and hence consumption.

More is needed though and this is particularly true in Europe. Policymakers have procrastinated but demands for appropriate action are now reverberating loudly and clearly down the corridors of power. In the UK meanwhile, the Bank of England's Monetary Policy Committee has initiated a new £75bn four month programme of monetary stimulation and it argued in its latest Quarterly Bulletin that the £200bn QE programme of 2009 and early 2010 had been an effective tool in lifting nominal GDP, with an impact equivalent to a 150 to 300 basis point cut in the Bank Rate!

Stock prices are unlikely to move convincingly higher until there are clearer signs of stability in economic activity and profits growth but equities look attractive. UK equities are close to 20-year valuation lows and over 60 FTSE 100 stocks yield more than 5%. We would be the first to acknowledge that UK economic growth will be anaemic, bumpy and uncertain for some time to come but less than 30% of UK stock market revenues are derived from the UK itself. The right stocks provide one with high exposure to the faster growth regions of the world at an increasingly cheap looking price.

James Follows

award winning service



biographies



Derek Scott is a non-executive director for Liberty Syndicate Management Limited and a Managing Consultant at Europe Economics. Derek was the economic advisor to former Prime Minister, Tony Blair, between 1997 and 2003 and Director of European Economics at Barclays de Zoete Wedd. Derek is a member of the Investment Advisory Board and is economic advisor to Vestra Wealth.



James joined Vestra Wealth as a Senior Investment Strategist in May 2009 having had a career spanning over twenty years gaining investment experience across a number of geographies including the UK, Australian and the Far Eastern markets. He was subsequently appointed Head of Equities in July 2011. James is a key member of Vestra Wealth's Equity & Bond Committee, and the author of the 'View from Cornhill' newsletter. James helps to run the Vestra Wealth Preferred List of UK equities, which has a strong record of alpha generation and he is also a member of the Investment Committee.

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