Investment Report for the Quarter ended 31st December 2010

Market Commentary

The index returns and currency movements both for the quarter and year ended 31st December 2010 are shown in the tables below.

Index returns expressed in sterling

		Quarter ended 31st December 2010
		%
Equities		
Japan	FTSE Developed Japan	12.8
North America	FTSE North America	11.6
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	9.3
Emerging Markets	MSCI Emerging Markets Free	8.1
UK	FTSE All Share	7.4
Europe	FTSE Developed Europe (ex UK)	4.7
Fixed Interest		
UK Index Linked Gilts	FTSE British Government Index Linked Over 5 years	1.1
UK Gilts	FTSE British Government All Stocks	-2.1
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	-2.4
Property	IPD	Not available
Cash	Merrill Lynch LIBOR 3 Month	0.1

Currency Movements for quarter ended 31st December 2010

Currency	30th September 2010	31st December 2010	Change %
USD/GBP	1.576	1.566	-0.6
EUR/GBP	1.154	1.167	+1.1
USD/EUR	1.365	1.342	-1.7
Yen/USD	83.540	81.105	-2.9

Index returns expressed in sterling

		Year ended 31st December 2010
		%
Equities		
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	23.7
Emerging Markets	MSCI Emerging Markets Free	22.9
North America	FTSE North America	19.1
Japan	FTSE Developed Japan	19.0
UK	FTSE All Share	14.5
Europe	FTSE Developed Europe (ex UK)	5.7
Fixed Interest		
UK Index Linked Gilts	FTSE British Government Index Linked Over 5 years	9.1
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	8.5
UK Gilts	FTSE British Government All Stocks	7.2
Property	IPD	17.6*
Cash	Merrill Lynch LIBOR 3 Month	0.1

* For the year ended 30th November 2010

Currency Movements for year ended 31st December 2010

Currency	31st December 2009	31st December 2010	Change %
USD/GBP	1.615	1.566	-3.0
EUR/GBP	1.126	1.167	+3.7
USD/EUR	1.435	1.342	-6.5
Yen/USD	93.095	81.105	-12.9

As the return table for the quarter shows, head of the leader board was Japan (+12.8%) making up for its lacklustre negative performance earlier in the year. This reflected a degree of increasing confidence in the Japanese economy which had disappointed for so long. Next came North America (+11.6%) on the realisation that its economy was demonstrating appreciably better economic growth than expected by most economists. Asia/Pacific (+9.3%) continued to be a favoured area for investors as it managed to maintain very robust rates of GDP growth. For much the same reason Emerging Markets returns grew by 8.1%. The UK featured next with a very respectable +7.4%. Last, but certainly not least, came Europe (+4.7%), despite the well publicised financial and economic problems within the smaller Eurozone countries and fears for the future of the euro. As so often in the past, it was Germany with its dominating export powered economy which continued to be the bedrock of the Eurozone. All in all the quarterly equity returns provided an exceptionally strong end to a truly banner year.

Fixed interest returns were negative for the quarter except for Index Linked Bonds. This was not surprising given the strength of fixed interest earlier in the year and the recent perception that yields on gilt edged securities stand at extremely low historic levels. This is reflected in their return of -2.1%. However, this disappointing return is exceeded by Corporate Bonds which, after a strong positive 8.5% return for the year, produced a negative 2.4% for the quarter on the apprehension that the best may have been seen from this part of the Fixed Interest market. The return of +1.1% for Index Linked bonds was due to the continuing relative popularity of this class as an insurance against of the possibility that UK inflation rates are most likely to experience further rises.

Property continued its recovery and benefited from increased investor confidence in the sector both from the UK and internationally. City of London offices performed particularly well with the largest increase in markets for 22 years. Residential property values, on the other hand, continued to fall.

The reported quarter brought to an end a year of unprecedented market and economic activity triggered by a plethora of mostly urgent initiatives from both governments and central banks in order to control and resuscitate their respective economies with the emphasis on growing their rates of GDP. This was especially prevalent within the industrialised nations of the Western Hemisphere, especially within the beleaguered peripheral Eurozone countries together with the UK and the USA with their most burdensome trade deficits. These resuscitating actions included an amalgam of financial bail outs, quantitative easing programmes, bank rescue packages including nationalisations, and emergency economic stimulatory measures. For the year as a whole the market pendulum swung between fear and greed. The former was particularly prevalent in the first quarter of the year with worries of double dip recessions and the increasingly parlous economic state of the Eurozone peripheral nations.

There is no doubt that the above litany of gloom and doom acted as a severe depressant to equity market levels, particularly towards the end of the first quarter of 2010. However, very few investment strategists and commentators could possibly have foreseen the strong rate of equity recovery that was to come between March and the end of the year. The cause of this recovery was the fact that, as time went by, it became increasingly apparent that the government and central bank measures outlined above were causing respective economies to "muddle thorough" despite quantitative easing programmes (printing money by any other name) which, in the past, have almost always been followed by rising inflation rates. Apart from the surprising resilience of economies, it also became apparent that corporate health was in much better shape than once forecast. That is to say, earnings were better than expected, balance sheet strength was greatly improved with lower levels of debt and, most importantly, dividends were appreciably better than expected. It also became evident to investors that fears of double dip recessions were receding. Another important market influence was that, within the Western Hemisphere, the maintenance of extremely low levels of interest rates were helpful both to consumers and corporations alike. So, for all the aforementioned reasons equity markets took heart as is clearly shown in the above return tables both for the year and quarter ended 31st December 2010.

With regard to the markets of the Eastern Hemisphere and Emerging Markets, their economies grew at an appreciably faster rate compared with their Western counterparts. Particular strength was shown by China, India, Australia and Brazil.

UK

Positive Influences

- Much to the surprise of many, on Christmas Eve the FTSE 100 Index broke through the 6,000 barrier at 6,009, a level it reached 2 ½ years ago. However, at the year end it reacted to 5,900.

- Private Equity demonstrated a strong revival and accounted for a record 75% of all UK mergers and acquisitions in the first nine months of 2010.

- The newly formed Office for Budget Responsibility estimates economic growth in the UK of 1.8% in 2010 followed by 2.1% in 2011.

- The purchasing managers' index for December reached a 16 year high of 58.3 (November 57.5).

Negative Influences

- GDP for the third quarter of 2010 was revised down marginally to +0.7% from the previous estimate of +0.8%. This was attributable to weaker North Sea oil production.

- In the quarter to 31st October unemployment increased by a larger than expected 35,000 representing a rate of 7.9%, fractionally higher than the previous quarter's rate of 7.8%.

- The Office for National Statistics reported that the Consumer Price Index (CPI) in November was 3.3% p.a. versus the Bank of England's target of 2.0%. CPI has now exceeded its target for the past 49 months.

- The British Bankers' Association reported mortgage approvals for October of 30,766, down from 31,058 in September. This compares with an average rate over the previous 6 months of 33,914.

USA

Positive Influences

- November durable goods orders rose by 2.4% recovering strongly from October's fall of 1.9%.

- On 14th December the Federal Reserve Board left interest rates unchanged and stated that the Federal funding rate would remain at "exceptionally low levels" for an extended period.

- On 7th December President Obama transacted a landmark fiscal deal with the opposition Republican Party in order to extend the Bush era tax cuts for two years. This could boost GDP in 2011.

- New claims for jobless benefit in November fell to a 2 year low of 407,000.

- The Institute of Supply Management's non manufacturing index advanced to 57.1 in December from 55.0 in November. This compared with estimates of 55.6. The Institute's index of factory activity rose to 57.0 in December (November 56.6) representing the seventeenth monthly rise.

- The private sector added 297,000 jobs in December up from 92,000 in November. This was the eleventh consecutive month of expansion. This result was appreciably higher than consensus economists' estimates of 100,000.

- Chicago's purchasing managers' index (a measure of manufacturing activity in the Mid West of America) increased markedly to 68.6 in December from November's 62.5.

Negative Influences

- Although October house prices rose by 0.7% they recorded a fall of 3.4% on an annualised basis.
- The unemployment rate in November rose higher still to 9.8% from 9.6% in October.
- In mid December US Treasury stocks were hit by the biggest sell off for two years, directly attributable to soaring borrowing costs.
- October housing starts dropped by a marked 11.7%.
- On 30th December, the US $ fell to a record low against the Swiss Franc of 0.9351 and a 28 year low against the Australian dollar of 1.1098.
- The Conference Board's index of consumer confidence decreased to 52.5 in December from 54.3 in November versus misjudged estimates of 57.0.

Europe

Positive Influences

- On 28th November the European Union arranged a €85B bail out for Ireland and agreed a formal mechanism for dealing with future debt crises in the Eurozone. This mechanism is specifically designed to head off further corrosive contagion. In that regard there is to be a new institution called the European Financial Stability Facility.
- The German economy has benefited considerably from the weakness of the euro.
- The German IFO November business survey hit a post unification high.
- Angela Merkel the German Chancellor was re-elected as leader of the ruling Christian Democratic Union.
- German industrial orders advanced strongly by 5.2% in November (October +1.6%).

Negative Influences

- Silvio Berlusconi's centre right coalition came under acute pressure and only just survived a vote of no confidence by 314 votes to 311. It does seem that his political days at the helm are numbered.
- Financial contagion spread to Spain which is of distinct concern as it accounts for approximately 11.7% of the Eurozone's GDP.
- Eurostat stated that Eurozone inflation in December rose to 2.2% p.a. from 1.9% p.a. in November. This compares with the ECB's target of "close but below" 2.0% over the medium term.

- The Eurozone unemployment rate in November was unchanged at 10.0%. This masks a wide range of rates within the individual member countries e.g. Germany 6.7%, Ireland 13.9% and Spain a staggering 20.6%.

Japan

Positive Influences

- GDP increased in the third quarter of 2010 by 3.9%.

- The purchasing managers' index for December increased to 48.3 from 47.3 in November.

Negative Influences

- The Finance Ministry stated that November exports grew by 9.1% p.a. whilst imports advanced by a marked 14.2%. Thus, the all important trade balance deteriorated.

Asia/Pacific

Positive Influences

- On 25th December the People's Bank of China increased its lending rate to 5.81% in order to combat rising inflation.

- On 21st December China promised to take "concerted action" to support the Eurozone "if necessary" this includes purchasing Eurozone sovereign bonds.

- China's retail sales in October grew at a most robust 18.6% p.a.

- In the fourth quarter of 2010 China's foreign exchange reserves (the largest in the world) rose by a record £199B to $2,850B.

- India's GDP growth in the third quarter was a substantial 8.9% which was much higher than expected. It is therefore hardly surprising that the Reserve Bank of India intends to raise interest rates in order to cool economic growth. The government estimates that GDP growth for 2010 will be 8.5% which compares with 7.4% in 2010.

- South Korea's industrial production in November increased by 1.4% compared to the 4.2% drop in October. Retail sales in November grew by 2.9% (October +0.2%).

Negative Influences

- China's CPI for November rose by 5.1% p.a. appreciably higher than the 4.4% p.a. increase in October. The government's target is 3.0%.

- China's purchasing managers' index for manufacturing slipped to 54.4 in December from 55.3 in November.

- New Zealand's third quarter rate of GDP decreased by 0.2% largely due to the strength of the New Zealand dollar and its negative effect on the nation's export growth.

- On 23rd November the inflammatory move by North Korea in shelling the South Korean island of Yeon Pygong reminded the whole region of North Korea's antagonistic regime with its nuclear capability.

- On 16th November South Korea increased interest rates by ¼% to 2.5% in order to better combat inflation which for October was up 4.1% p.a.

- On 2nd November the Reserve Bank of Australia raised rates by ¼% to 4 ¾%. This move caused the Australian dollar to temporarily reach parity with the US dollar.

- As widely expected, the Reserve Bank of India raised its interest rate by ¼% to 6 ¼%.

Principal influences of a general nature were as follows:-

- Most commodity prices boomed. On 7th December gold rose to a record $1,430.95 whilst silver rose to a 30 year high of $30. Copper achieved a record high of almost $9,447 a tonne in part due to the large demand from China. This represented a rise of 33% for 2010 which compared with an advance of 139% for 2009. Oil broke through a 26 month high of $90 with consumption levels the strongest for 30 years. Food commodities e.g. cereals also demonstrated substantial strength. It goes without saying that this unprecedented commodity strength was bad for the containment of inflation levels.

- The Organisation for Economic and Co-operative Development (OCED) forecast that the global GDP rate in 2011 would be 4.25% to be followed by 4.5% in 2012.

- Governments continued to be greatly influenced by wide spread trade protectionism as respective countries sort to benefit their vital export trade by manipulating their currencies.

- The pronounced build up of corporate balance sheet cash and lower debt levels caused increased merger and acquisition activity together with higher investment in research and development.

- Emerging Market economies were enhanced by a marked increase in the spending power of their growing middle classes.

Conclusion

As we start 2011 the background for capitalism both in the UK and globally appears to be distinctly more promising than that of a year ago. This more conducive background applies not just to equities, but to most other asset classes. That is to say, private equity, property, infrastructure, hedge fund of funds, commodities, global tactical asset allocation and foreign exchange. The clear omission from this list is fixed interest. The reason for this is simply that the predominant allocation to this sector is usually in gilts, sovereign debt and index linked gilts. The yields on these sub sectors in such a low rate environment have been driven down to unprecedented low levels which makes them, with the exception of index linked bonds, look unattractive at this time, particularly as and when interest rates rise. Also sovereign risk is on going within the weaker economies of the Eurozone. However, with regard to the other sub sectors of Fixed Interest, corporate and secured bonds still seem moderately attractive with very few defaults likely. The sub sectors with more obvious attraction are high yield bonds, emerging market debt and absolute return bonds, provided they are sufficiently liquid. There is no doubt that future Fixed Interest strategies will need to be much more nimble and flexible than heretofore with gilts and sovereign debt constituting the minority part of a Fixed Interest portfolio from here on.

With regard to the other aforementioned sectors, private equity should continue to benefit from improved prospects for increased activity in IPOs and mergers and acquisitions which are both continuing to recover. Property also is recovering well with attractive valuations still available with a better environment in which to manage property assets. Infrastructure managers should continue to take advantage of an increasing flow of opportunities across the spectrum. Hedge fund of funds, after a generally poor 2010 relative performance, should be able to benefit from a likely increase in volatility with less correlation. Factors on which their returns are so dependent. It is hoped that there will be a considerable improvement in their long/short and global macro activities which proved such a performance detraction last year. Although both hard and soft commodities boomed in 2010 especially in minerals, useful gains should still be possible in 2011. However, a nearer term pause for breath could easily occur. Both the GTAA and foreign exchange sectors should be able to produce worthwhile gains on the back of increased volatility in the currency market, caused by more central bank and corporate treasury hedging activities.

In sum, even after the strong showing of most asset classes last year, conditions exist which should translate into meaningful gains in 2011, especially for high quality equities with strong balance sheets and the ability to produce consistently rising earnings and dividends. However, it seems sensible to caution that the course of markets for 2011, though upwards, is unlikely to be smooth with many periods of volatile uncertainty. After a 9 month period of an unexpectedly strong equity run it would be all to easy to fall into the trap of unbridled optimism. As always, much will depend on the macro economic news flow from around the world which can be summarised with the following conditions:-

- In the UK, the coalition government must continue to hold firm as its belt tightening austerity measures impact consumers and corporations alike. The absorption of the VAT rise to 20% from 17 ½% will be important. So far the British propensity to take the necessary harsh medicine has been surprisingly good. But it needs to remain so, as severe austerity is destined to last at least three more years. It will also provide a test for the Trade Union/Government relationships, particularly in the area of unemployment. At their current valuations equities could surprise on the upside with appreciably stronger balance sheets than a year ago. A double dip recession seems most unlikely.

- In the USA, President Obama will need to show that he can live with the Republican Party majority in the House of Representatives and demonstrate an ability to compromise on essential issues. Corporate profitability is likely to remain strong and could translate into higher rates of GDP than market forecasters currently expect.

- In Europe, the joint efforts of the European Central Bank, Angela Merkel, the German Chancellor, and the International Monetary Fund should show that they can cope with the grossly indebted economies of Greece, Ireland, Portugal and Spain. Above all, it is imperative that the domino effect of leverage contagion can be contained and the future of the Euro assured. In the near future it seems probable that the Portuguese economy will have to be bailed out. Eurozone unemployment rates will likely remain of constant concern. Certain high quality equities are on surprisingly cheap valuations.

- In Japan, it is imperative that the Government can demonstrate that the tired and unsuccessful policies of the past are undergoing a radical change in order to spur consumers and corporations to spend so that the nation can grow itself away from the systemic deflation in which it has been mired for so long. A weaker yen would be helpful to Japanese exports, particularly to the Asian region.

- In Asia/Pacific, rates of GDP growth should continue apace, although at marginally lower levels than in 2010. This applies to China, India, South Korea, Singapore, Australia and less so to Russia. In particular, the People's Bank of China will need to continue with measures to cool down its very strong rate of economic growth and, at the same time, to be seen to revalue its currency the renminbi. China seems well capable of achieving this, but it will have to keep a close eye on inflation, particularly in respect of food for its massive population. China has, without doubt, become the centre of global trading with its insatiable demand for minerals, cars and so many big ticket items. It seems certain that it will continue to flex its muscles on the international stage.

- Emerging markets will most likely continue to attract long term investors, particularly the BRIC group which has really already matured from its emerging chrysalis stage such is the rapidity of their development. The same could be said of South Korea and Taiwan. There seems no doubt that in the longer term the equities and economic growth of the emerging market countries will outperform those of the classic Western Hemisphere developed countries. However, an area of concern for many emerging nations is the rapid rise in their inflation rates.

- In general, it seems both likely and essential that the Bank of England, the ECB and the Federal Reserve Board will continue to maintain their currently very low level of interest rates.

- The encouraging upturn in world trade is likely to continue with the International Monetary Fund forecasting global growth of 4.3% in 2011. There has been a sharp increase in shipping container transport which is usually a reliable barometer of trade activity.

- As always, inflation rates will have to be carefully monitored. In that regard pressure is likely to come from the accelerating rise in food and energy prices.

Finally, at the risk of being repetitive, it should be stressed that portfolios that embrace globalisation in all asset classes are most likely, in the long term, to be rewarded in peer group performance tables.

Valentine Furniss
14th January 2011