

# Investment Outlook and Review

## – Summer 2011



JLT INVESTMENT MANAGEMENT



Markets in the last quarter have continued to be dominated by news from Greece as the seemingly endless negotiations between the EU authorities and Greek politicians have tried to solve Greece's financial problems. Markets have reacted positively or negatively to each new announcement (or rumour) – and the upshot has been very little in share price terms, which, despite all the volatility, are not much changed from the beginning of the year.

This is discussed further below but as the quarter ended another austerity package was passed by the Greek parliament – just – and some more breathing space was achieved.

Other news has been largely ignored. The ongoing unrest in North Africa and the Middle East has hit the headlines, but so far has had little effect on financial markets. The only exception has been the oil price, where an unexpected (and unnecessary?) release of oil stocks by the International Energy Agency has dampened speculators' ardour and reduced the price in the short term. This is widely being considered as a political, rather than an economic, decision.

Economic news has been mixed in all of the developed world (Japan being the obvious exception, due to the aftermath of March's earthquake) but again largely ignored on anything other than a short term basis. One set of statistics will indicate a pickup in economic activity, only to be contradicted by another set a few days later.

This has caused investors to remain confused and uncertain – not a good background for equity markets generally. However in the major economies of the developed world interest rates have stayed persistently low – and show no signs of rising in the short to medium term. Cash is earning little to nothing and due to quantitative easing and other measures there is an awful lot of liquidity in the system. As a result cash has remained (and still remains) a most unattractive asset class for all but the most bearish investors. Markets of all types have benefited from this – not by rising very much, if at all, but by not falling by as much as the background might have suggested they could. How long this unsatisfactory state of affairs can continue is the biggest question mark facing investors as the year progresses.

### **FIXED INCOME**

As we have repeatedly stated in these reviews, developed countries government bonds look expensive or at least seem to fully discount current economic conditions. Yields seem most unlikely to fall further. Emerging market bonds have suffered somewhat from governments tightening, raising interest rates to either dampen or stave off inflationary pressures (often caused by the rise in commodity prices and

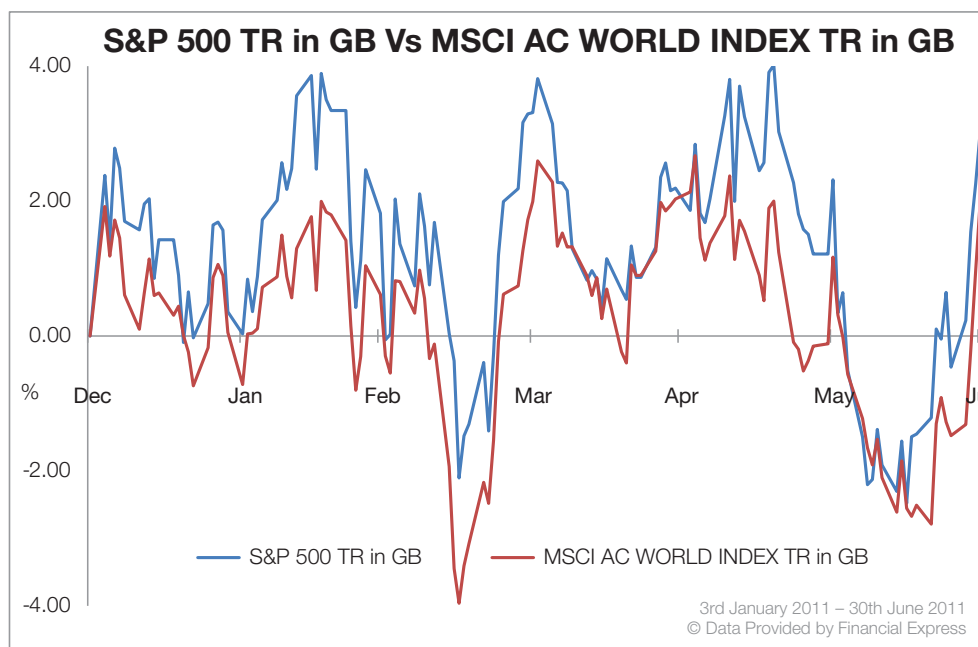
currencies partly due to the US's use of quantitative easing). As discussed elsewhere several European country bond markets can only be considered by the very brave – or foolhardy.

As a consequence, investors looking for a decent return on their cash have been flooding into corporate bonds and bond funds. After the panic of 2008, where yields plummeted and defaults were expected to be widespread, sanity eventually prevailed and corporate bond yields have now returned to 'normal' levels. This means that the spread between the yields on corporate bonds, and those on their equivalent government bonds have also normalised, with the underlying credit rating of the borrower again being the most important factor in investors' decision making.

At some stage interest rates will rise, as will yields on government bonds. This could lead to similar falls in corporate bond prices if spreads remain the same, but for the time being we are still happy to maintain positions for income. The chances of any further capital appreciation seem slim.

## U.S.A.

Economic data in the US has been giving mixed signals in recent weeks, suggesting to some commentators that recovery has stalled. The unemployment rate remains higher than expected at this stage of any pickup in economic activity (and the long-term unemployed rate is much higher and increasing) and house prices continue to fall.



Both of these indicators weigh heavily on consumers – and voters – minds and 2012 is a presidential election year.

The Administration would like to enact further stimulus measures, despite the lack of any real evidence that the second round of Quantitative Easing (QE) has benefited the US economy to any great extent. It has, however, seemingly led to major problems (rising commodity prices, rising currencies against the dollar) elsewhere in the developing world. QE3 is being mooted, but is coming up against a deadlocked Congress where the Republicans are demanding real deficit reduction measures before being willing to consider anything else.

The market has performed reasonably well under these circumstances with corporate profits in many areas exceeding expectations (helped by the relatively weak dollar, which has boosted exports). But input costs have been rising and margins are coming under pressure. Many companies are raising prices, adding to potential inflationary problems in the US and the situation needs to be watched closely.

As we have said before it is always wrong to underestimate the US's ability to engineer a domestic recovery. But the Administration is potentially building up even greater problems for the future. This has become a major political issue as we approach next years' elections, and rhetoric from the various political parties could spook markets over the coming months.

Despite this, in the short term US assets still appear a relatively 'safe' equity haven whilst the recovery continues – assuming the recovery does continue - but longer term this situation may change as the extremely accommodative monetary policy is unwound and interest rates eventually rise.

## UNITED KINGDOM

Over the quarter the main UK indices were not immune to events elsewhere, reacting both positively and negatively to the Greek negotiations (the main influence) as they progressed – British banks having exposure, albeit not excessive, to Greek debt. Domestic economic concerns were largely ignored, although above target inflation figures or below forecast growth rates occasionally intruded onto investors' consciousness.

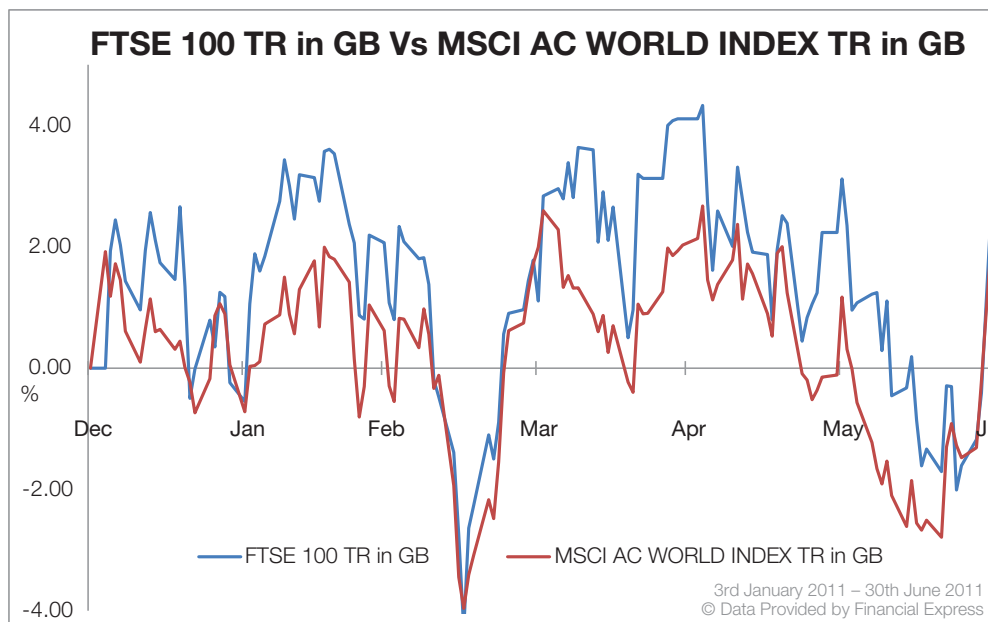
There is no question that the Coalition's austerity measures are beginning to bite – and are causing not inconsiderable pain in many areas. The UK consumer is under attack from all sides, with ultra low interest rates the only factor providing some assistance. Recent news from the High Street, with companies either filing for bankruptcy or stores being closed, encapsulates the problem. Consumers' real incomes are falling, as is disposable income.

The Bank of England's Monetary Committee is still being persuaded that the current official rate of inflation is 'temporary', thus enabling them to keep interest rates at very

low levels to aid economic recovery. Only time will tell if their optimism is justified. Should inflation prove more stubborn than expected – and as a result wages begin to increase significantly – interest rates will have to rise. Good news for beleaguered savers but bad news for the rest of the economy.

Despite this unhelpful background many companies, especially exporters, continue to flourish, raising profits and dividends, and share prices have reflected this. It is domestic UK that should be avoided (the FTSE 250, a good barometer for the domestic economy, has performed well largely because of bid activity within its constituents, not because of underlying profit growth) where the situation can only get worse in the short term.

Elsewhere many UK registered companies are, to a large part, shielded from these considerations and should continue to prove to be worthwhile investments as (if?) world growth picks up.



## CONTINENTAL EUROPE

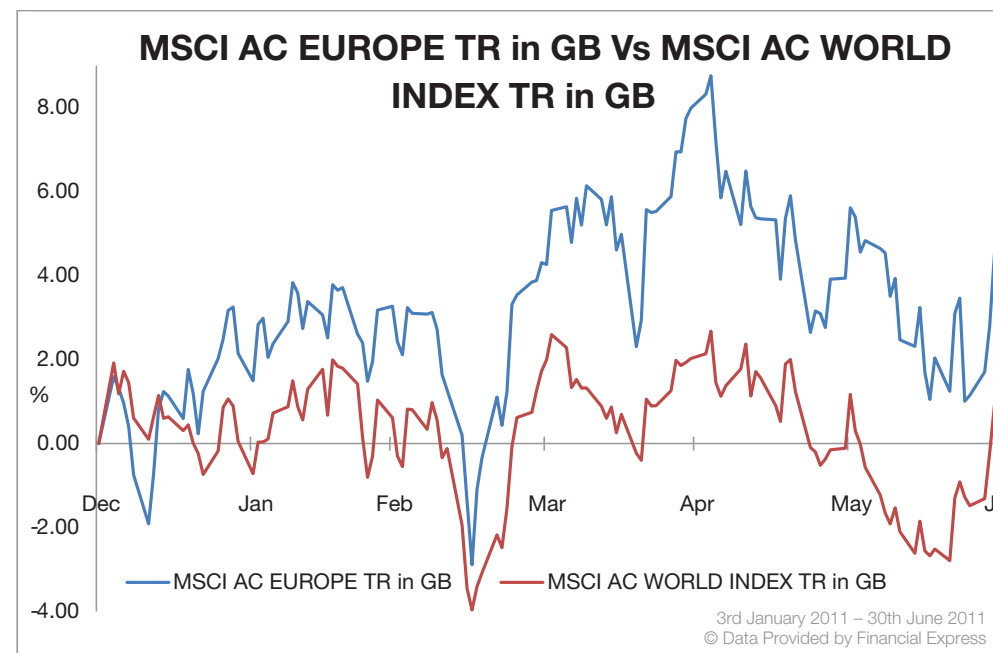
As mentioned in the introduction above the crisis in Greece has been the predominant influence on markets in Europe (and elsewhere). There has been another stay of execution by the passing of the latest round of austerity measures by the Greek parliament – thus allowing another payment of funds by the EU and the IMF to avoid any default on debts in July. There are also other proposals to allow a gradual rollover of debts in the next three years. Markets have breathed a sigh of relief and rallied sharply in the last few days of the quarter.

But – will it work? The signs are not good. Greek voters violently oppose the proposed measures (which were only passed by a small majority – there is no cross-party consensus in Greece as there appears to be in Portugal and Ireland). Bond markets are still discounting an 80% probability of default in the next five years and the credit agencies have downgraded their outlook again.

The problems in Greece (and elsewhere) have been deferred, not solved. Over the summer the bureaucrats in Brussels and at the IMF will continue to try and find a more permanent – and acceptable, both politically and economic – solution, hopefully before markets finally take the matter out of their hands and force the issue, with possibly fatal consequences for Greece – and the euro.

There is still the possibility – as yet a small possibility, given German voters' reluctance to countenance the idea – of the euro nations agreeing to full fiscal union. This would seem to be the only logical solution that would prevent the longer term demise of the euro in its current form.

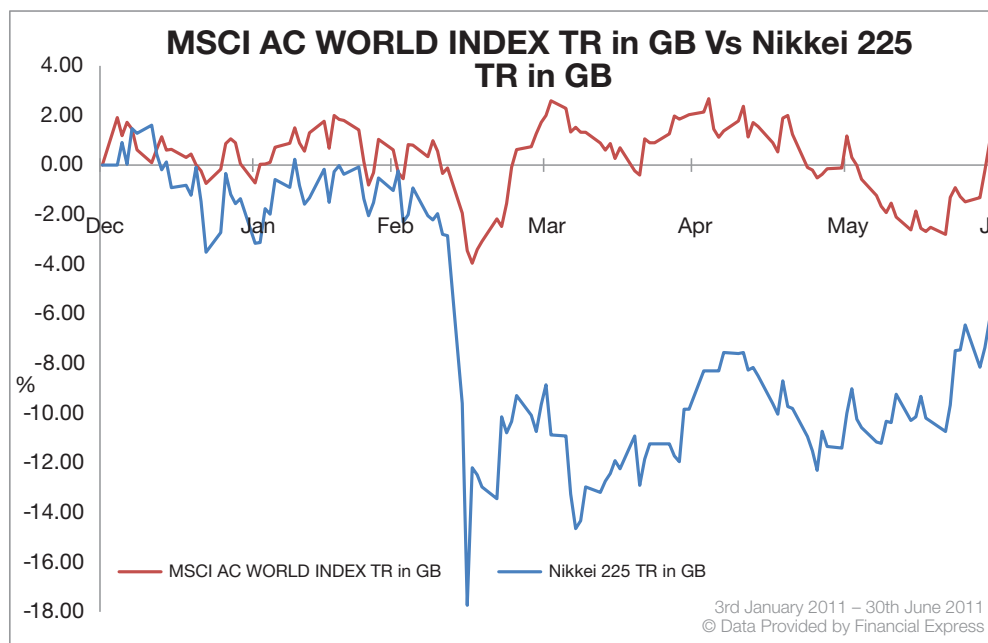
It would appear from the headlines that Greece is the only country on the Continent. Luckily this is not the case and elsewhere in Europe economies and companies continue to perform well and exceed expectations. Despite all the background noise this has been a fruitful area for investors in equities, not just in the major Western European markets but also in developing Europe, and we believe this will continue. Despite everything, we remain selectively positive on the region.



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## JAPAN



Japanese stocks have been lacklustre for some time now as the aftermath of the earthquake and tsunami has been dealt with. Who will pay for the damage and the necessary reconstruction is still causing much debate, and the government's handling of the crisis is still the major cause of the lack of confidence. The current Prime Minister has agreed to step down soon, the Reconstruction minister has just resigned after a week in office and until there is change little is likely to be achieved.

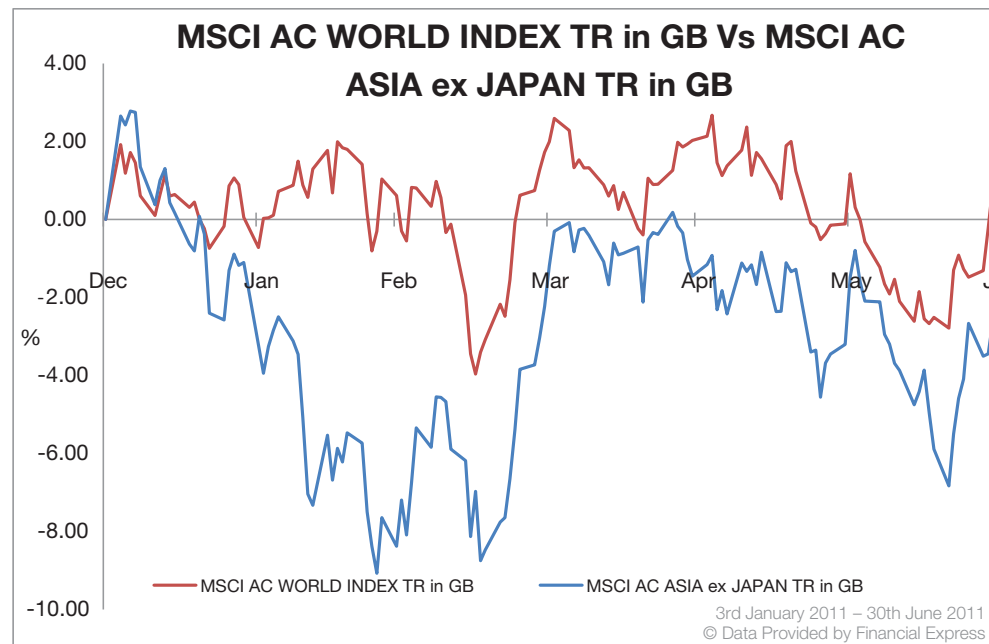
However things are very different at a corporate level where evidence would suggest that any necessary reconstruction or reorganisation is already largely complete. Supply

disruptions have been resolved, and companies have adapted to the continuing power shortages. Recent industrial production data has shown a sharp rebound (up 5.7%) exceeding all forecasts. Profits going forward should show strong momentum, after this year's inevitable decline.

With political uncertainty (not unusual in Japan) and a fiscal background which, in theory, is worse than Greece it is easy to write off the Japanese equity market. But the numbers belie this negative stance. Average stock prices remain below replacement value, indices are once again at the bottom of the range of recent years, and further budget stimuli are anticipated.

As seemingly always, patience is needed to invest in the Japanese market, but could prove very rewarding as the year progresses and investors realise all is not as bad as they think.

## ASIA ex JAPAN

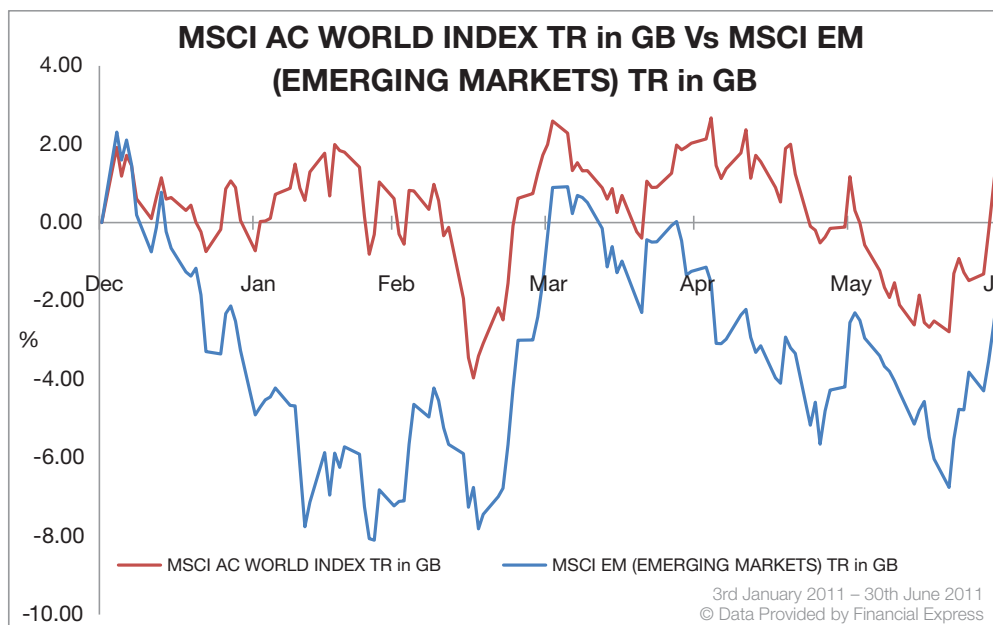


Equity markets across the region have been volatile due partly to the international concerns mentioned above, but also to concerns over continuing monetary tightening in China and India. For instance China's Central Bank raised its reserve ratio for the eighth time since last October (and the fifth time this year) in its ongoing attempt to lower inflation.

On the plus side China, Japan and South Korea (a historically most unlikely combination) are discussing a possible three-way free trade area, and China and Taiwan are in further talks about extending economic ties.

We have not changed our medium to long term positive view on the region. Question marks over global economic growth will hold back markets in the short term, as will fears of further restrictive measures in China – however temporary these may prove to be – but the longer term outlook remains positive and any periods of weakness should be used as a buying opportunity.

## EMERGING MARKETS



The major Emerging Markets are one of the few areas where prices have seen little recovery from the falls in the earlier part of the year (themselves largely caused by profit-taking rather than any deterioration in economic fundamentals).

We have mentioned in previous quarterlies the importance of commodity prices to many developing markets and this has been exemplified by the volatility in the oil price affecting the Russian and Brazilian markets in particular. The fear of the resulting inflation has led to interest rate rises in several countries, as mentioned above, and this trend is likely to continue.

We have not changed our longer term strategic view that emphasises investments in the developing world over those in the developed markets. Taking advantage of the continuing volatility in prices, additional purchases should be made on any weakness.

## CONCLUSION

'The greater the difficulty, the more the glory in surmounting it' is a Greek quotation from Epicurus, apt in current circumstances.

There are many difficulties affecting markets at the moment, both political (Greece, Japan, the USA potentially, the Middle East actually) and economic (Greece and Japan again, the developed world generally). All are out in the open, being discussed ad nauseam and, possibly, largely discounted by investors.

This last statement is the key to market movements, certainly in the short term. Investors are understandably nervous about the outlook, fearing the developed world's recovery is faltering. But they are still net purchasers of risk assets, looking for a home for unattractive cash, and unless or until something totally unanticipated happens we would expect this to continue.

We recommend staying fully invested, diversified geographically (with a short-term emphasis on the developed world over the developing) and by asset class (preferring corporate to government bonds). Later in the year, as the outlook becomes clearer and some of the problems mentioned above achieve resolution (or are perceived to be resolved) we could see a repeat of 2010 with better prices by the year-end.

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