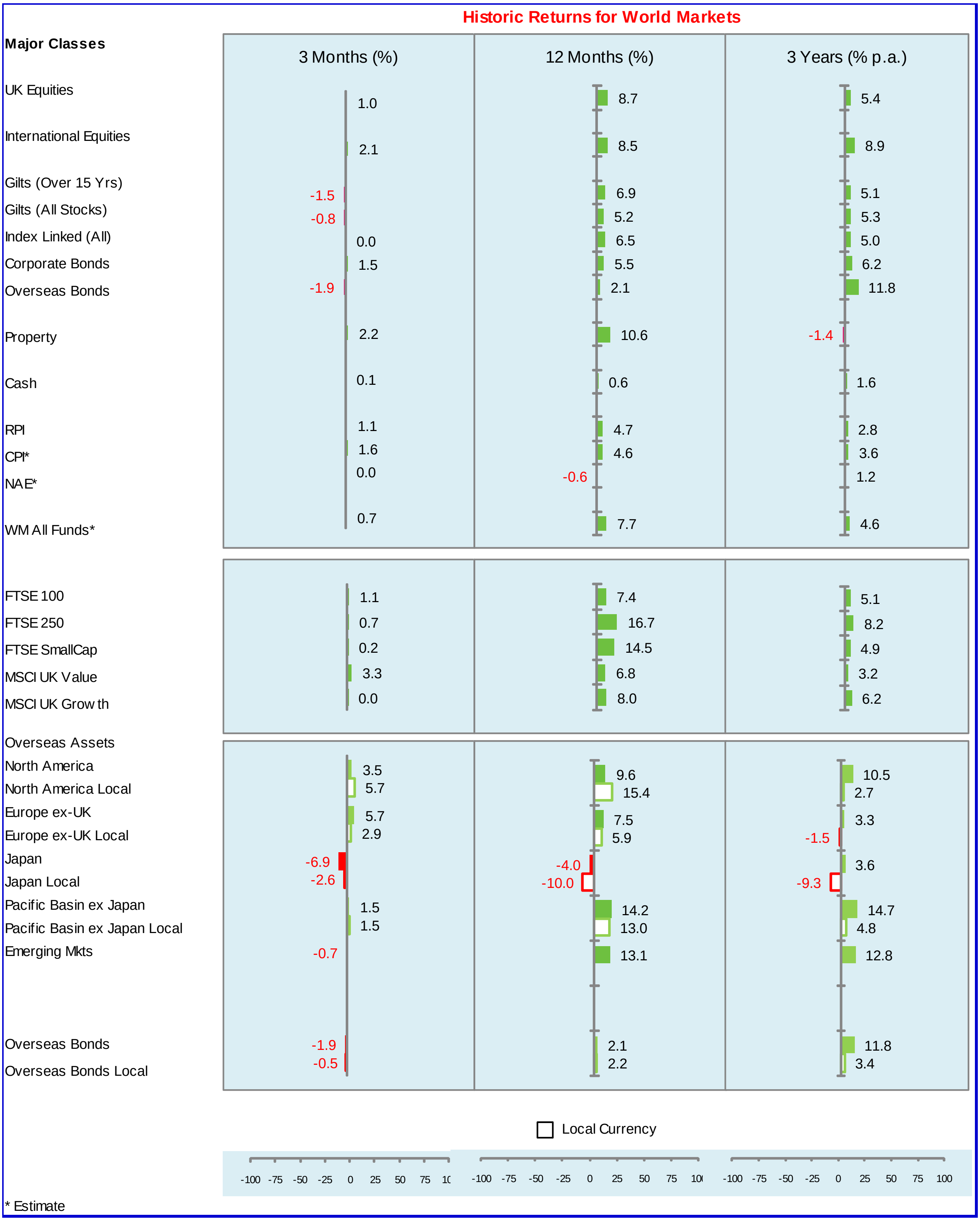
Market conditions – first quarter of 2011



Q1 Commentary

Equity markets proved remarkably resilient to the seemingly endless flow of bad news during the first quarter of 2011. Widespread political tension in Arab countries and the implications of events in Japan were accepted with equanimity by investors.

One of the major influences on markets during the quarter was increasing inflationary pressure, particularly in emerging markets. The main contributors were sharp rises in food and oil prices. In response, a number of central banks in Asia tightened policy, either by increasing short-term interest rates or raising the reserve requirements of commercial banks.

In developed markets, economic 'healing' continues. This has been most evident in the corporate sector; supported by strong earnings growth and the re-building of balance sheets. Manufacturing activity was strong in a number of areas and, for the UK, provides welcome diversification to the economy. As in Asian markets, inflationary pressures present a challenge to Central Banks. No change in policy was announced during the quarter, but expectations of an increase in short-term rates by the year end increased and, in Europe, crystallised in early April.

Key events during the quarter were:-

Global Economy

- IMF upgrades global economic growth forecast for 2011
- Japanese authorities provide support to markets after earthquake and nuclear 'incident'
- Ireland seeks emergency funding aid to support debt laden economy
- US continues asset purchase programme to support economy
- Sovereign debt issues in Ireland and Portugal threaten cohesion within Euro-zone

Currencies

- Sterling appreciates against the US$ and Japanese Yen but falls against the Euro
- Euro appreciates ahead of increase in short-term interest rates (announced 7 April)

Bonds

- Index linked gilts outperform fixed interest issues on concerns over inflation
- Corporate bonds outperform government issues, reflecting strong corporate results and demand for higher yielding assets
- Yield differentials between highly indebted Euro countries and Germany increase widen to very significant levels

Although there are grounds to take a more optimistic view of economic prospects, a number of factors have the potential to deliver a 'shock', not least the scale of the US deficit and the implications of continuing political instability in Arab countries. In the UK, the full impact of spending cuts and higher taxes has yet to be revealed. Households face the worst 'squeeze' on income since the 1920s.

Market Conditions

General

Investors' enthusiasm for risk assets was sorely challenged over the first quarter of 2011 with a combination of inflation (particularly food inflation in emerging markets), unrest in the Middle East and North Africa (MENA) and Japan's earthquake, tsunami and radioactive leakage problems. A significant financial feature was the pair trade between the oil price (up) and US$ (down). Considering this backdrop, financial markets were surprisingly resilient with investors relatively sanguine about prospects. Nevertheless, financial shocks were identifiable in the periodic setbacks and spurts of market volatility over the quarter.

Equities

Equity market returns measured in local currency were generally respectable, led by the US and Europe. US$ weakness reduced the US equity return and modest Euro strength increased the European equity return to sterling-based investors. Japanese equity returns (-6.9% in local terms) reflected the impact of the earthquake. Returns from Pacific markets were more modest at +1.5% while UK equities delivered 1%. Emerging market equities returned -0.7% having been considerably weaker over the quarter; investors felt the markets had become over-extended and became concerned about tightening bank policy in China, due to high inflation. At a sector level, the main feature was the strength in the Oil & Gas sector (+9.1% relative), driven by increases in the oil price. Industrials and Telecommunications stocks had modest rises. All other sectors experienced negative relative returns with Consumer sectors underperforming the global index by approximately 3% relative and Technology -2.7% relative.

UK equities

Large cap stocks (FTSE 100) returned 1.1%, outpacing the FTSE 250 (mid cap stocks) which returned 0.7% and Small Cap returning 0.2%. On a 12 month view, large cap (+7.4%) remains well behind mid cap (+16.7%) and small cap (+14.5%). At a sector level, the strongest sector was Technology (+6.9% relative), but this was largely due to the strong performance of ARM holdings. Oil & Gas returned +5.2% relative. Telecoms returned 3.7% relative, largely due to Vodafone. The weakest sectors was Consumer Services (-5.6% relative) with Retailers and Travel and Leisure the worst affected areas. Basic Materials also performed poorly (-4.3% relative) with Chemicals and Mining the worst of the sub-sectors.

The star performer among FTSE 100 stocks was chip-designer ARM Holdings, up 34.5% relative. Three insurance stocks, Resolution (+25.1% relative), Legal & General (+17.9% relative) and Aviva (+13% relative) performed strongly. Oil & Gas related shares performed well, led by BG Group (+18.5% relative). Mining stocks gave back much of their relative outperformance over Q4, on concerns about slackening growth in emerging markets; the smaller FTSE 100 miners (Antofagasta, Kazakhmys and Lonmin) underperformed by between 14 and 16.4% while the larger companies (Anglo American, BHP Billiton, Rio Tinto and Xstrata) underperformed by between 2.5% and 4.2%. Other poorly performing stocks included Lloyds Banking Group (-12.5% relative), and the grocers Sainsbury (-11.8% relative) and Tesco (-11.3% relative).

Bonds

Gilts experienced a sell-off as investors became concerned with the persistence of UK inflation. Long-dated gilts returned -1.5%, while All Stocks Gilts returned -0.8%. Index-linked gilts were flat over the quarter. Corporate bonds performed rather more strongly, with AA-rated issues returning 1.1%, and A- and BBB- rated issues returning 1.7%. The debate about the risks to gilts from rising yields continued over much of the quarter.

Property

The IPD Monthly index return for Q1 was +2.3%. The net return from All Balanced pooled funds was +1.9%. Central London offices are still seeing rental growth due to strong demand. The outlook for most other areas is lukewarm at best. Retail is likely to be under continuing pressure due to store closures in less than prime outlets.