



First Quarter 2011

An overview of the first quarter and views going forward

**31/03/2011**

# 1<sup>st</sup> January to 31<sup>st</sup> March 2011 Overview

Definitely a volatile start to the year, with sell offs in the emerging markets, this has only been profit taking and concerns over inflation, it is not a hint of any major fears, our company view remains the same the emerging markets will provide returns over the medium and long term.

To highlight how the main markets have fared in the last three months see the table below:

Index	31/12/2010	30/12/2010	Low point	March 31 <sup>st</sup> 2011
FTSE 100	5,899		<b>16/03/2011 – 5,598</b>	5,908
Dow Jones	11,577		<b>16/03/2011 – 11,613</b>	12,319
Nikkei - Japan		10,228	<b>15/03/2011 – 8,605</b>	9,755
DAX - Europe	6,914		<b>16/03/2011 – 6,513</b>	7,041
Hang Seng – China	23,035		<b>17/03/2011 – 22,284</b>	23,527
Nifty 50 - India	6,134		<b>10/02/2011 – 5,225</b>	5,833
IBOVESPA - Brazil		69,305	<b>9/02/2011 – 64,218</b>	68,587

As you will have noticed many of the indices have hardly moved in three months and there has been a reasonable amount of volatility.

Most Asian stock markets retreated in February, with investor sentiment dented by further monetary policy tightening in China and a spike in oil prices amid the political turbulence across the Arab world.

The developed markets had their downturn on the back of the Japanese earthquake and Tsunami, our hearts go out to the Japanese people, this has been an awful tragedy.

It's been a turbulent first quarter for investors in Asia Pacific as fears of inflation and the earthquake in Japan took their toll of stockmarkets in the region.

## Overview

Take Japan out of the equation and Asian stock markets put in a fairly resilient performance over the first three months of the year considering the natural catastrophe that struck Japan on 11 March.

The Japanese tragedy does beg the question on whether this offers investors opportunities, we would tend to recommend a small element of portfolio could be diversified to this area as there is potential for the engineering companies and builders to profit, we have carefully reviewed the Japanese funds and found a good candidate in Schroder Japan Alpha which offers exposure to the appropriate companies.

## Damage costs

The estimated cost of damage has been set at between Yen 15 trillion and Y25 trillion by the Japanese Government, albeit that many private sector economists' forecasts are at the lower end of this range.

## Power

While there has been progress in gaining control over the Fukushima nuclear reactors, the potential for adverse developments remains. News flow from the Fukushima plant is likely to be the driver of markets in the days and weeks ahead.

## Middle East and Oil

We have also had the Egyptian crisis, Bahrain crisis and to top it off Colonel Gaddafi vs Libya, all of this was bound to increase the price of oil which is still not levelling off (just look at your oil bill)! That is one commodity that has been soaring over this troubled three months. By the end of the thirty-first day of March 2011 Crude Oil Futures for delivery in May were trading at \$107.10. Having risen 23.9% year to date!

As such Libya only accounts for 2% of the World oil supply and Saudi Arabia and other OPEC Nations have agreed increased output to offset the shortfall from Libya.

The World will not run out of oil soon, but it has already run out of cheap oil. Extracting oil from deep beneath the sea or boiling it out from Canada's shale fields is very expensive and many other potential oil fields are under the control of unreliable regimes.

Unfortunately, petroleum gets into every walk of life, therefore a sharp rise in oil price is a tax on economic activity, as well as a spur to inflation. Neither will help the struggling economies of the developed World.

## UK Equities

Top 5 Sector Winners during the last quarter:

1. Technology: Arm Holdings
2. Life insurers: Aviva, L&G and Prudential to name a few
3. Industrials and construction: Cookson Group
4. Telecoms: Vodaphone
5. Oil and Gas: BP and Royal Dutch

Bottom 5 Sector Losers:

1. General retailers: Dixons, Debenhams and Mothercare
2. Travel and Leisure: Thomson
3. Food and Drug retailers: Ocado and Tesco
4. Miners: Rio Tinto, Xstrata, etc

Unfortunately the UK and more particularly the MPC (Monetary Policy Committee) have a difficult situation the fourth quarter of 2010 showed a slowing economy -0.6% against rising inflation, so pressure to hold interest rates alongside pressure to raise interest rates. Within the MPC the last meeting in March the vote to increase rates had increased to 3 out of 9 members calling for a rate increase.

## Europe

### Overview

In the first three months of 2011 the eurozone was buffeted by turmoil in the Middle East, renewed fears over its sovereign debt crisis, Japan's devastating natural disasters and concerns over inflation.

While economic indicators offered a mixed view of the region, the euro strengthened and major stock markets staged a recovery from mid-March lows to post modest gains on the quarter. The result was a positive return from all the investment funds we follow.

### **Inflation and unemployment in two-tier Europe**

Economic growth data for the first quarter are not yet out, but the eurozone's manufacturing and services sectors continued to expand during the period – despite persisting weakness in 'peripheral' nations – as did business confidence in Germany, the region's largest economy.

Germany's unemployment rate also dropped in March to its lowest since 1992. Yet the overall job market in the 17-nation region was far less rosy. According to the latest comparable data from the Organisation of Economic Cooperation and Development (OECD), while the German jobless rate was at 6.5% in January, that of the eurozone as a whole was 9.9%; France registered 9.6% unemployment and Spain a shocking 20.4%.

The region was also hit by rising inflation, as consumer prices unexpectedly jumped to 2.6% in March, pushed up in part by higher energy and commodity prices.

And on the last day of the quarter, Ireland said its four remaining banks needed another €24 billion (£21 billion) to enable them to withstand potential losses from a worsening of the economy. Plus looking increasingly likely that Portugal will need a major bail out very soon, as it is bankrupt!

## **US**

The sheer size of the economy helps to ensure that they manage their way out of most problems, there has been reasonable growth here, however, there remain issues; residential housing market, for one.

### **Housing market**

In short there is not much interest in home buying, but massive excess inventory. The outlook remains bleak with foreclosures at an all-time high and prices unlikely to recover previous highs in the next 5 years.

### **Commercial Property**

Recovery is materialising in most global real estate markets. This is consequently leading to tenant demand improving as occupier confidence and business investment increases. Vacancy rates are falling as a result, and strong rental growth is being recorded in some of the highly cyclical, supply-constrained office markets, such as Hong Kong, Central London and Paris.

Globally, prices look to be stabilising, as are rents. However, there is a broad spread of rental movements across the markets, from the strong growing cyclical office markets to the weaker peripheral European markets where oversupply and weak demand continue to put downward pressure on occupier rents.

A key question for commercial real estate investors attracted by a relatively high income is how resilient is the yield in an environment of modest growth? Furthermore, how does the yield compare to that on other assets and does the additional margin compensate for the limited liquidity associated with investment in bricks and mortar? The answer is favourable. US offices currently yield 6.2%, which compares favourably to the US 10-year government bond yield of 3.3%, a proxy for a "risk free" asset. This is a 2.9% margin, so a reasonably high additional return.

## **GILTS and Corporate Bonds**

I am not going to dwell in this area, we are slowly reducing our weightings in this area, particularly GILTS, although index linked stock may still offer some return, purely as it is inflation proofed. For much of this asset class it is the end of the good returns (or in the last three years amazing returns) as a company we are now looking towards asset allocation managers for this class such as CF Miton Special Situations portfolio and Newton Real Returns, ensuring not all your eggs are in one basket.

## **Jersey**

### **Housing Market**

Our local housing market has certainly had the spark of a match this first quarter, whether it can turn into a fire yet remains to be seen. Helping this recovery has been the return of Jersey Home Loans (Kent Reliance Building Society (aka JC Flowers money)) they have offered a 95% loan to value mortgage, this is correct and sensible particularly in the local market with prices as high as they are. This ratio has suddenly allowed many young couples to once again believe there is hope for them to buy property in Jersey and without them Jersey is a steadily slowing economy! All retirees and no workers.

### **Commercial Market**

I still cannot believe the amount of office space that is still under construction or planned when wherever you walk in St Helier within 500 yards you will come across an agents sign 'to let' but still some of the agents are trying to give office space the same rental value as 3 – 5 years ago when there was less capacity and more requirement. I know that ultimately lower rent reduces value, but as our investors are aware this has already happened in the UK but Jersey is still trying to hang on to its valuations. The problem we have is; how attractive is Jersey to new companies are they ever going to fill the empty office space there is or will there now always be capacity in Jersey, therefore eventually dragging commercial valuations down.

### **Alternative Investment – Jersey based**

A solution which we have tried personally in the last 12 months and a relatively small investment that at one point or another we have all shown an interest in whether as a child or later in life is Stamps.

We believe that investing in rare stamps transcends the conventional investment growth assumptions over that of inflation and demonstrates that there is no correlation with shares, bonds or property.

Whilst traditional investments have floundered somewhat in recent years, rare stamps have continued to rise in value adding validity to the view for greater investment diversification.

As we know, conventional markets tend to be driven in a cyclical manner, more by 'fear and greed' than logic. In contrast, passion drives the collectibles market, in that stamp collectors avidly chase the stamps they need, to fill the gaps in their collection. Historically, this passion has protected the value from panic-fuelled volatility and this factor give further credence to the proposition.

Many investors and advisers still shun the concept of investing in rare stamps on the assumption that there is an inherent lack of liquidity. We do not concur with this view on the grounds that stamps are arguably the most collected items in the world and cash does changes hands albeit not at the flick of a switch but just like any other tradable item where an investor owns the actual asset.

A less well known fact is, by weight, rare stamps are the most valuable commodity on earth.

With an estimated 56 million collectors worldwide including Russian, Indian and Chinese investors growing rapidly, it will undoubtedly increase as these economies mature which should ensure the future of rare stamps. Add to this the diminishing supply, low correlation with other asset classes, rare stamps as I'm sure you will agree offer a strong investment proposition.

However, it is only the right stamps in the right condition that are worth the money so how does a prospective investor know if they are getting a good deal. This is where the risk factor is arguable at its highest. However, the following are offered with each investment.

- A life time guarantee of authenticity on every item
- Free Storage
- Free Insurance
- Free annual valuations

Our only disappointment is that the Jersey Tax office will not allow stamps, wine or actual property within any pension scheme. But this is a great investment as an addition to your portfolio.

### **Ashburton, Orchard and Spearpoint**

All three of our local fund management groups have provided positive returns year to date, nothing to write home about but correct to the for the level of risk of their managed funds. The Ashburton Chindia fund has suffered a little as discussed earlier, but we are not concerned that this will continue, added below is comment from one of the team of managers of Ashburton Chindia; Craig Farley: Written on the 28<sup>th</sup> March 2011.

*Our key message today is that we have turned bullish on China and have positioned the portfolio accordingly over the past week.*

*First and foremost, the standard argument for avoiding China in favour of emerging market peers or the ultra-expansive policy-fuelled Western markets has been that China is in 'tightening mode'. History shows us it has rarely paid to bet against Beijing and this cycle has supported that argument as the Party has attempted to rein monetary policy back in to pre-stimulus levels. Inflation, property and loan growth data all suggest to us that we are approaching the end of the cycle if we haven't already, whilst valuation support and recent announcements from Beijing provide added comfort.*

*Like it or not, China remains a policy-driven market. Comments over the past six months from various Party officials have confirmed Beijing's stance that fighting inflation and managing inflation expectations remain top priorities. We have argued for some time now that we expect CPI inflation to peak in the first half of this year and we see nothing in recent figures to change that view. Further reserve requirement ratio rises cannot be ruled out but these are being utilised to mop up excess liquidity (accumulation of foreign exchange reserves) but do not constitute monetary 'tightening'. A structurally higher level of inflation is to be expected due to greater demand stemming from the country's rapidly increasing wealth and consuming middle class, but this is not a cause for concern.*

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*to rise in February amid policy pressure, but at a slowing rate to last year. Strong underlying fundamental demand, double-digit income increases and low homeowner leverage all reflect milder growth, and the underlying premise that Beijing will not crash the market remains. The unwritten contract of rule between the CCP and the Chinese people that was 'entered into' post Tiananmen Square - increased prosperity and living standards for all in exchange for a one-party system - necessitates a buoyant market, even if it does lead to isolated instances of gross capital misallocation. Government policies in the form of investment restrictions and property taxes are now having a major impact on speculative demand, and an abundant supply of residential and social housing is coming on-stream this year. Property transactions are approaching 2008 lows whilst developers are less flexible given their own balance sheet limitations, therefore we expect clearing prices to happen sooner rather than later.*

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*Several other factors also deserve a mention. The 11th China National People's Congress has recently concluded with a clear mandate that targeted economic growth for the next five years will be 7%. The number itself is irrelevant, as no doubt this will be exceeded, but the manner in which it has been accepted by the market is pleasing – not so long ago, anything short of the 'magic 8% figure' needed to ensure employment (and by extension social stability) would have been met with consternation. At the market level, analysts have not been shy to downgrade forecasts over the past 12 months and with consensus numbers now expecting somewhere in the region of 12-13% EPS growth for 2011, upside risk across selective sectors is achievable. We are also impressed with the A-share market action which has now been outperforming Asia ex-Japan in dollar terms for the past two months.*

*Bill Cosby once remarked that whether the glass is half full or half empty depends on whether you are pouring or drinking. We believe, on a risk-reward basis, that China is a very attractive investment proposition at current levels given the confluence of positives that have developed over the past month. Additional exposure has been taken in selective oil and gas and industrial machinery stocks, and we have taken on property exposure (with a view to adding further in due course). We are drinking and recommend that investors consider doing the same...Gan Bei!*

*(N.B. This should not in any way detract from the India story, which we still regard as the world's most exciting on a long-term basis. Whilst we have been structurally underweight the market for some time, the recent market correction has resulted in some attractive buying opportunities within selective sectors. We will be writing more in due course).*

## Looking forward

Our belief is the markets hold many positives for all the negatives that we have seen in the last quarter and look forward to a further positive year, albeit possibly slightly lower returns overall than 2010:

Exciting areas:

Commercial property funds, relatively low risk with high potential for good returns, this may be a slow boil process, as in single figure returns (but considerably better than cash). However, once the economy really is on full track recovery (i.e. without current fears) we will see a good double digit return. N.B. I am talking about UK and possibly some global exposure commercial property, which has been substantially discounted to valuations of 2007 and is still way below these values. (Unlike Jersey commercial premises).

Emerging Markets and Commodities:

Volatility – yes bags of it at times, but as long as you are taking more than a two – three year view, growth will be delivered in bundles. Profits need to be taken regularly 6 monthly or annually and the portfolio rebalanced, if the emerging markets drop it is likely a good time to profit take from the developed markets and invest more! £ cost averaging works no better than in volatile environment.

## Finally

We have just moved office and look forward to greeting you in our new professional offices, we have enclosed a small flyer showing our new office location.

Should you wish to discuss any of the enclosed comment please feel free to contact your adviser. Wishing you all well and looking forward to catching up with you during the course of the year.

Kind regards

A handwritten signature in black ink that reads "David". The letters are cursive and slightly slanted to the right.

David C Troy  
Managing Director