MONTHLY INVESTMENT COMMENTARY

CARTLIDGE MORLAND

OCTOBER 2011

Markets are relieved that European leaders at last seem to be making some progress in agreeing a series of co-ordinated measures to address the Greek sovereign debt crisis, capital strength of European banks and the powers of the European Financial Stability Facility (EFSF) rather than a piecemeal approach. These are important initial steps but there is still more progress to be made.

Leaders agreed that the capital strength of European banks should be increased by June 2012. The aim is to help banks bear losses from any government bond defaults and protect larger economies, like Spain and Italy from market turmoil. A revised set of capital stress tests were issued which indicates that the European banking system needed around €106bn in capital. The recapitalisation will be supported by private investor funding sources first, then through national government support and finally with EFSF support. The worry here is that to meet the new targets, European banks will have to reduce their assets severely which could lead the risk of a credit crunch across the euro zone.

A 50% loss or “haircut”, on a voluntary basis, on Greek debt by private investors was agreed which would take the Greek debt- to-GDP ratio down to 120% by 2020. A bond swap for Greek debt is due to take place in January 2012 and a further package is likely. The other part of the Greek problem is lack of growth in the Greek economy. It is likely that austerity measures will take their toll on growth for years to come, even though debts are reduced. This is also the prospect for other peripheral economies as they try to become competitive once again by reducing labour costs. It may be that the European Central Bank will have to act decisively in supporting growth and trying to rebalance economic activity in the euro zone.

The Greek Government has announced that there is to be a referendum on the latest rescue package. This has led to more market uncertainty as a vote against it could lead to a full-scale default by the Greeks on their debt and a question mark over their euro membership.

The EFSF is to be leveraged up by 4-5 times through credit enhancements and special vehicles. This is aimed to give the EFSF firepower of some €1trillion. There are two options available to the EFSF. The fund can offer insurance to purchasers of euro zone countries’ debt so making the bonds more attractive and consequently lowering the borrowing costs of governments. Second, a special investment vehicle can be set up funded by private and public investors. This expansion of the EFSF relies on the creditworthiness of the stronger euro zone countries such as France and Germany retaining an AAA credit rating, which is not guaranteed.

EFFECTS OF THE RESCUE PACKAGE

The European rescue package has led to a rebound in global financial markets. This avoids a disorderly Greek default and erects strong defences for the heavily indebted Portuguese, Italian and Spanish governments. Unfortunately, this solution is unlikely to be a permanent one and it is reasonable to anticipate further financial crises in the euro zone, at sovereign level. The single currency locks the southern European countries into an uncompetitive exchange rate - making their imports cheap and their exports hopelessly uncompetitive. Italian labour costs have risen 30% relative to Germany’s since the introduction of the euro, but previously this imbalance might have been rectified by a fall in the value of the Lire against the Deutschmark. Greece, Spain and Portugal are in a similar straitjacket - a currency union that makes the often more prestigious goods

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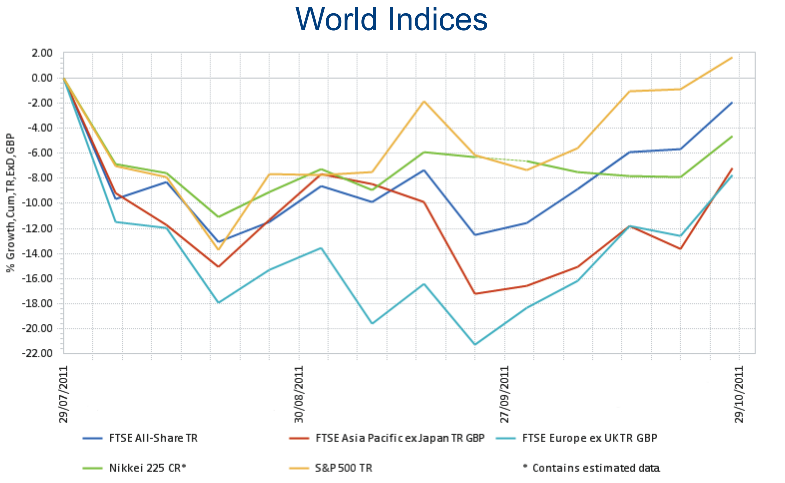
of efficient northern European producers cheaper, relative to their products. Against this background there is little hope of rapid economic growth in those countries providing a solution to their debt problems. Either the latter will get worse, or the condition of euro membership will be a significant decline in current living standards to make those economies competitive. This will be an extremely painful adjustment for the countries concerned and it is questionable whether their populations will tolerate it. The ability or indeed the will of the northern Europeans - and the Germans in particular - to finance the long period of adjustment is similarly doubtful. The dynamics suggest that only different exchange rates can provide the long-term solution needed, but the unquestioning commitment of European leaders to the euro makes this unthinkable for them, despite the dreadful price now being paid by their electorates. Whether the German electorate - or indeed the electorates of southern Europe - will remain so committed to the euro is yet to be seen.



Source: Lipper % Growth, Cum, TR, ExD, GBP from 29/07/2011 to 28/10/2011 every 1 week

VOLATILE MARKETS

Markets have been extremely volatile since the end of July 2011 as the chart illustrates. More positive news flow has lifted markets with Europe recovering sharply from its September low. The UK economy grew at 0.5% in Q3 2011 which exceeded expectations. In the US, the economy grew at an annualised rate of 2.5% in Q3 3 2011. This figure was in line with expectations and significantly better than the 1.3% growth in Q2 2011. Consumer spending has helped growth, as has business expenditure and exports. The employment situation was slightly more positive with new jobless claims falling and 103000 new jobs added in September, ahead of market expectations.

We believe that the package of measures announced for Europe is positive, but that further action will be needed. Global growth is slowing and with fiscal tightening around Europe and no definitive plans to stimulate growth centrally within the latest set of European measures, recession in Europe is a real possibility in the short term. We believe that opportunities do exist in European equity markets where companies are not dependent on their local markets but are active in developing markets in Asia and Latin America. We expect market volatility to continue as markets react quickly to news flow. This is illustrated by the bankruptcy of MF Global, a US based futures broker, which caused markets to fall after its credit rating was cut to "junk" status. The broker's bets on European sovereign debt were to blame. Our portfolios remain cautiously optimistic about longer term growth and we continue to position them with exposure to larger UK companies, particularly those with strong dividend cover and in funds which are run by able stock-pickers in international markets, to take advantage of opportunities as they arise.

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