

Every penny counts, it's a competitive world!

The expected upward revision to UK's fourth quarter economic growth was announced last week by the Office for National Statistics (ONS). Preliminary data, released in late January, suggested that UK's economy grew by 0.1% in the final three months of last year; this figure has now been revised to 0.3%. This followed the news earlier in the month that inflation in January measured by the Consumer Prices Index (CPI) rose by 3.5% and by the Retail Prices Index (RPI) 3.7%. According to the ONS, the return of VAT to 17.5% and rising fuel prices were the major contributing factors. The Bank of England uses the CPI to set interest rates whereas RPI is often referred to in wage negotiations. A letter of explanation from Mervyn King, the Governor of Bank of England, to the Chancellor is required if the CPI is more than 1% above or below the Government's 2% target. In his recent letter to the Chancellor, Mervyn King expressed his belief that the recent rise we have seen in inflation is only temporary and he predicted that it will fall below the 2% target later in the year. As a result interest rates were left unchanged at 0.5% at February's MPC meeting but it was decided to put Quantitative Easing on hold.

The rather lacklustre 0.3% economic growth that we have just received doesn't seem a lot to show for what has been an unprecedented amount of stimulus and a significant devaluation of the Pound. What it does indicate is that the recovery is a fragile one and may still be reliant upon this stimulus. Any exit strategy, after the abundant liquidity in 2009, will need to be carefully planned and co-ordinated in order to sustain the recovery and avoid the double dip recession that the UK Economy is still susceptible to. It is also important to be realistic, whilst the UK economy is now officially out of recession; we are still lagging far behind other developed world economies that saw a return to economic growth much earlier in 2009. This is a concern particularly as the UK is competing, in the absence of a high domestic savings rate, to attract international investors to buy gilts to fund its increasing debt burden.

Furthermore, after the debt issues facing Dubai late last year and the Greek sovereign debt issues that we have more recently seen, international bond investors are clearly scrutinising each country's fiscal position far more closely. Abu Dhabi stepped in with a bailout that helped with the debt position in the Middle East and it is expected that similar assistance will be advanced to Greece by Europe. Unfortunately the UK does not have the luxury of such deep pocketed friends.

So the forthcoming General Election, still expected to be held in early May, may turn out to be a very significant event. A hung parliament is a real possibility as the current government gains

ground in the polls on the Tories despite the growing split between the Prime Minister and his Chancellor. The future health of the UK economy requires a trustworthy government with a majority and, most importantly, strong leadership. The monetary and fiscal medicine that has been administered so far is not a long term cure. What is required is a credible fiscal budget to reduce the UK's deficit.

In an environment where the economy is growing, albeit at a lacklustre pace, inflation is above target, Quantitative Easing is on hold and uncertainty about the forthcoming General Election, the longer term outlook is one of rising gilt yields. With spare capacity in the economy the deflationary threat is still real and this may well temporarily provide support to gilt prices. However, this will also provide bond investors with further opportunities to reduce duration and rotate to a more defensive stance as gilt yields begin to rise. At North, we have constructed our own structured product to reflect our bearish stance on gilts within our portfolios. Whilst, it is difficult to directly sell short government bonds, the 10 year swap rate does provide a suitable alternative. Essentially we are looking to make a return of 12% per annum should 10 year gilt yields rise from their current level of 4% to 6% over the next five years, a return, for our investors, of £1.60 for every pound invested.

We may be negative on gilts, but the credit markets, in our opinion, still offer further value despite the increased levels of issuance and the equity like returns that we saw from this asset class last year. With the banks reluctant to lend, many companies have turned to the credit markets to raise liquidity. The high yield market has been seen as a popular source of funding for many corporations. With fundamentals improving, spreads have tightened as default risk declines. We do, however, believe that we are nearer to the end than the beginning of this story and we are starting to shift our emphasis towards total return bond funds that can hedge out duration and interest rate risk.

Outside of the UK, the theme of tightening liquidity is being played out at varying speeds. The World's largest economy, the US, is preparing to withdraw Quantitative Easing as their recovery gains momentum. Whereas, in contrast, countries like China and Australia are now pursuing a policy of monetary tightening as their economies have quickly returned to previous growth rates and inflation is now rising. The importance of the economies of the Asia Pacific region and Emerging Markets to overall global economic growth continues to grow in importance as the West staggers along, weighed down by growing deficits. Today, the main threats to global

markets are the premature removal of stimulus in the West and/ or an overly aggressive policy of monetary tightening in the developing economies.

Investors are closely monitoring events and this year we have certainly seen a marked increase in volatility. This is what we describe as, a “risk on, risk off” market. The “risk on” market is characterised by a weak dollar and rising equity and commodity prices. Conversely, the “risk off” market is one where the dollar is strong and equity and commodity prices are declining. More recently, though, as attention has been turned to the Greek’s fiscal position and fears around potential sovereign default have increased, this relationship has broken down. The Euro has come under great pressure due to bailout of Greece and the prospect of having to potentially provide assistance to other member states. The US dollar has been the main beneficiary of these events. Yet despite everything equity markets have rallied back towards the levels when they started this year.

We said at the beginning of the year we wouldn’t be surprised to see the wider market move sideways in 2010. If the key word used to describe the events of last year was “unprecedented,” then the key word for 2010 would have to be “tricky!” That is not to say that you cannot make money in “tricky” markets, you certainly can, however, you need to look at this as “a market of stocks”, rather than a stock market. In this environment it is the stock pickers who will succeed as the distance between winners and losers begins to widen. There will also be good opportunity for those investors backing quality, stable companies with a track record of dividend growth. The current environment continues to support equity and commodity prices, however, be wary of becoming complacent. Look for opportunities to take out cheap insurances for portfolios to hedge against risks in the equity market, rising government bond yields, volatility and, of course, currencies movements.

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North

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