



MONTHLY REPORT

MARCH 2010



The recent economic data have been generally weaker than expected, casting some doubt on the prospects for the recovery. However, economic recoveries are not usually associated with steady growth across sectors. Growth is inherently uneven. That means that some economic reports will be strong and some weak – and that is especially true in the current environment, where the economy has to deal with a number of serious headwinds. Economic statistics are also subject to seasonal adjustment difficulties and, as we're likely to see in much of the February data, the peculiarities of the weather.

Consumer confidence in the US fell unexpectedly in February. Monthly changes of one or two points in the headline figure are not unusual, but a 10-point plunge is hard to ignore. The details of the report showed that evaluations of current job market conditions remained depressed. In addition, respondents were somewhat more pessimistic about future job availability.

Economic indicators continued to improve in Europe, despite the Greece situation. Data released during the month showed that eurozone industrial production climbed month-on-month. Moreover, German business confidence, increased to the highest level in 18 months sparked by a revival in exports. The European Central Bank (ECB) kept interest rates at a record low, while consumer prices in the eurozone edged up, pushed by a rise in oil prices to a 15-month high. Meanwhile, although the rise in the

region's unemployment has slowed in recent months, it still seems poised to trend higher and reach 10.0% of the workforce.

European equities ended the month lower as concerns about the economic and financial condition of peripheral eurozone economies weighed upon sentiment. The fiscal health of Greece came under scrutiny as the European Commission questioned the nation's statistical data. Financials were also hit by fears about the possible removal of some stimulus measures and US President Barack Obama's plan to curb risk taking in the financial sector. Elsewhere, energy names declined in response to weaker oil prices and materials firms tracked commodity prices lower amid worries over tightening monetary policy in China.

The UK economy resumed growth by less than economists forecast in the fourth quarter as service industries and manufacturing expanded just enough to pull the UK out of its longest recession on record. GDP grew just 0.1% from the third quarter in the last three months of 2009.

The UK is the last major economy to exit recession.

For all the recent concern over deficits, debt and defaults, investors were reminded of another 'D' – deflation – that will warrant their attention. The -0.1% US core CPI reading for January was the first negative print since 1982 and highlights another one of the hangover effects of the recession. One month, of course, does not a trend make, but even on a 3-month basis US core inflation has flatlined.

Commodity prices have rebounded sharply from their recession lows, catapulting global headline inflation rates higher across the developed world. However, excess capacity and high unemployment rates are keeping a tight lid on other prices across much of the developed world.

Historically, it has been typical for core inflation to lag the economic cycle, falling in the early stages of the economic recovery as the spare capacity generated

by the recession keeps a lid on pricing power. Of course, the severity and synchronized global nature of this particular recession have made the deflationary threat especially acute.

Household saving rates have risen sharply in the US and UK and, for the first time since records began, we are witnessing simultaneous declines in US household and corporate sector debt. Federal Reserve Loan Officer survey data have recently shown improvement in bank attitudes towards lending, but the same surveys also reveal that private sector demand for credit is extremely weak.

These deflationary forces have been matched by an aggressive reflationary policy response by the Fed and other central banks, but the mild nature of the recovery so far and recent volatility in financial markets serve as reminders that these efforts are still work in progress.

The rebound in Treasury bond yields from their lows last year tells us that investors began to raise their inflation expectations as the recession came to an end. Inflation breakeven rates have increased from close to zero at the end of 2008 to more normal levels recently.

Until unemployment rates begin to decline meaningfully, however, actual inflation outside commodity prices seems unlikely to intensify. Recent sovereign debt stresses may add to deflationary pressures, with fiscal tightening and/or higher bond yields potentially weighing on growth at a time when the global recovery is far from entrenched.

We therefore see little justification for initial unease over the Fed's 25bps increase in its discount rate, which we see mainly as an adjustment in the terms of one of its emergency lending facilities and not as a sign of an impending policy rate increase.

Given the parlous state of the UK's public finances, it was almost inevitable that attention would eventually swing from southern Europe's debt burden to Britain's. The pound sterling swooned against the euro and the dollar. News that showed the UK government borrowed £4.3 billion in January, which is normally a surplus month, put downward pressure on sterling. A larger than expected drop in retail sales sent the currency even lower.

The dollar initially soared after the Fed increased its discount rate by 25 basis points to 0.75 percent at the request of the regional Federal Reserve banks. This fueled speculation that the Bank would soon begin to tighten monetary policy. While the Fed has been telegraphing the move for some time, the actual event shocked market players

Favorable commodities trends largely remained in place as the global recovery progressed and broad gauges of commodities markets climbed for the three-month period. However, late-period strengthening in the value of the U.S. dollar had an impact on energy and precious metals prices

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