The Street Lamp News

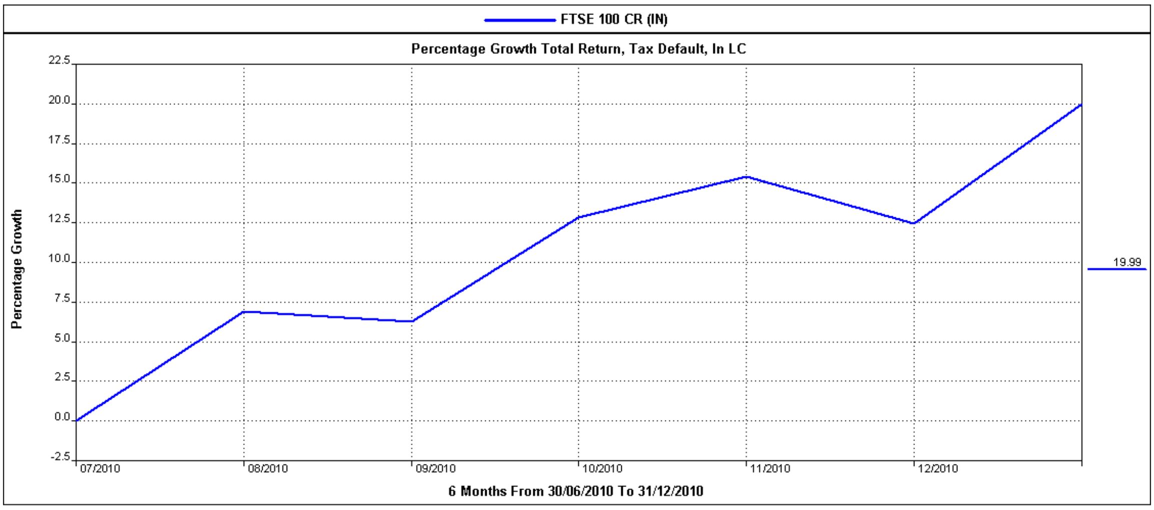
Winter 2010/11

While the past 2 years have all been about focusing on the financial crisis, 2010 was really the year of stabilization. Developed economies started to recover albeit slowly, partly as a result of strong growth in the developing world. This recover has in part been held back by fear. Governments worried about making tough decisions which could cause a setback. Companies built up cash reserves but made little investment, preferring to keep the cash on the balance sheet.

The recover could well continue to be slow because the impact of some of the action that was taken could for instance be short lived. Indeed the Organisation of Economic Co-operation (OECD) has already begun to cut back future growth expectations. Fiscal stimulus packages across the world have helped in 2010, for instance in the motor industry and housing market. As these policies are fazed out and expire, economies will have to rely on more traditional means of growing. Throughout 2009 companies built up inventories which had been a driver for growth. Now that companies have rebuilt stocks this stimulus will subside. Also with the worst of the crisis over there is less co-operation between Governments. 2011 is likely to be the year of 'work- in –progress'. Whilst this could be challenging for economies as they pay off debts it could be a good year for companies who are in a strong position following the balance sheet repairs of 2010.

In the UK the new Government had its emergency budget in June and its effects were felt throughout the rest of the year. The Comprehensive Spending review led to the announcement of large scale spending cuts. Despite this, the Manufacturing index remains in positive territory, indeed it is growing at its fastest rate for 16 years. The coming months will see those companies who have repaired their balance sheets and changed their business models outperform. This could have the impact of improving the general level of the stockmarket as sentiment improves. Those investment managers who focus on individual stocks and on 'recovery' situations could well outperform in 2011. Some companies who have cash on their balance sheets have already begun to consider acquisitions or share buy backs. Indeed it is the mergers and acquisitions activity which could well push the main UK markets higher throughout 2011.

There are still concerns whether the Government has done enough or whether they are allowing the UK to inflate its way out of debt. If kept under control this could be positive however the Government and Bank of England do need to be mindful of the problems other economies have suffered in the past. In order to avoid the economy falling back into recession the Bank of England may well consider further Quantatative Easing following the publication of the February inflation report.



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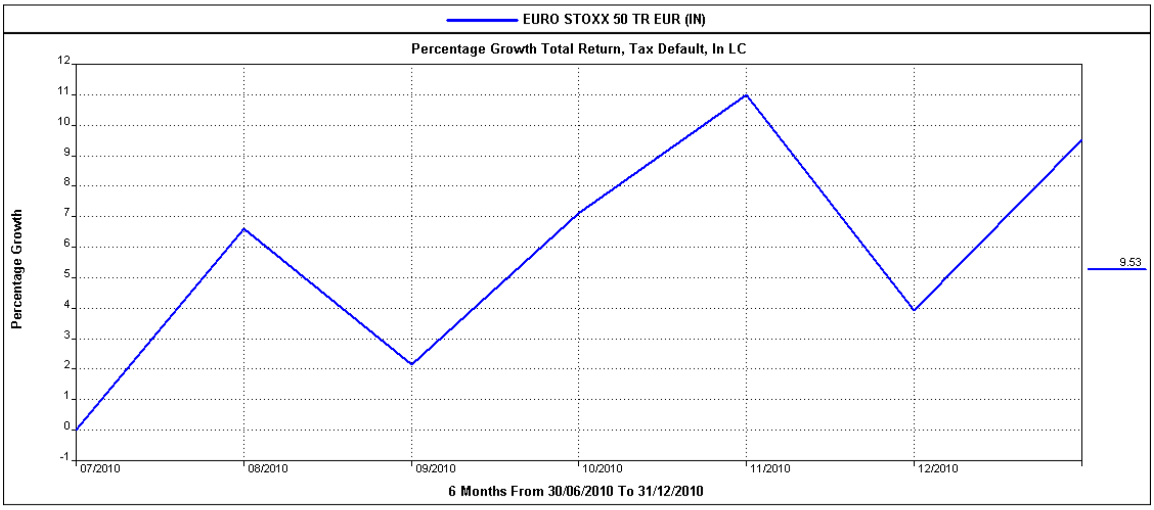
Problems continue in the peripheral regions of Europe, with particular issues in Portugal Spain and Ireland as well as continued issues in Greece. It is Ireland which gathered the most attention in the second half of 2010 with major concerns about it's banking sector.

For these periphery countries, the European Financial Stability Facility (EFSF) is designed to provide assistance by creating a funding source guaranteed by the AAA-rated eurozone countries until June 2013. There are however several issues with this plan. First, the EFSF raises money only once it has been called upon, i.e. immediately after a eurozone country has declared that market access has dried up. This is unlikely to be an opportune time for any Government to raise money. Second, the EFSF's AAA rating would come under threat if AAA eurozone countries were to be downgraded. Third, there is uncertainty over what happens once the EFSF expires in 2013. Investors would need clarity well in advance of this date, and as this does not leave much time for the necessary economic improvements and structural reforms to take place, we could very soon be staring the same problem in the face.

There are other alternatives if this does not work. The first is a more explicit and permanent cross-boarder guarantee of funding, i.e. a eurozone bond. The second possibility is a break-up of the eurozone, with one or more periphery countries leaving the common currency and immediately benefiting from devaluation. The third possibility is a restructuring of a eurozone country's debt, postponing maturity dates and cancelling coupon payments, ultimately subjecting bondholders to actual or implied losses. However, if such an event was to happen before structural and economic reforms had taken place, the impact could also be catastrophic. There would be an immediate loss of confidence in the country's banking system, which would have to be put on life support by some European entity (the ECB perhaps) for fear of contagion spreading as it did following Lehman's bankruptcy. Of course these are all long term issues and in the meantime European Companies are well positioned, like those in the UK, to benefit from some economic recovery, particularly those with strong balance sheets and cash available for investment.



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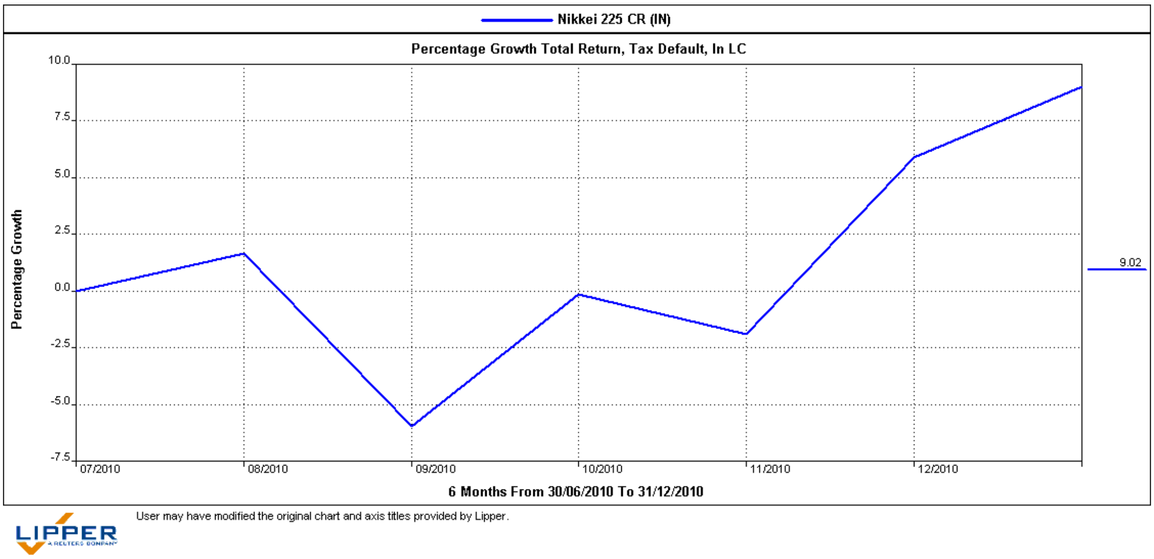
In the US the Federal Reserve is focused on pushing stock markets higher to stimulate growth. The first step was to introduce phase 2 of Quantatative Easing. As long as inflation remains under control the Federal Reserve may need to introduce a further tranche of assistance to the market in 2011. To encourage investors back to the markets when house prices are still falling and unemployment is still high could indeed take even more stimulus.

The past few months have seen investors buying US bonds not equities. As with all investments, investors may not return until the market has begun to improve, missing out of the first stage of the market rally.

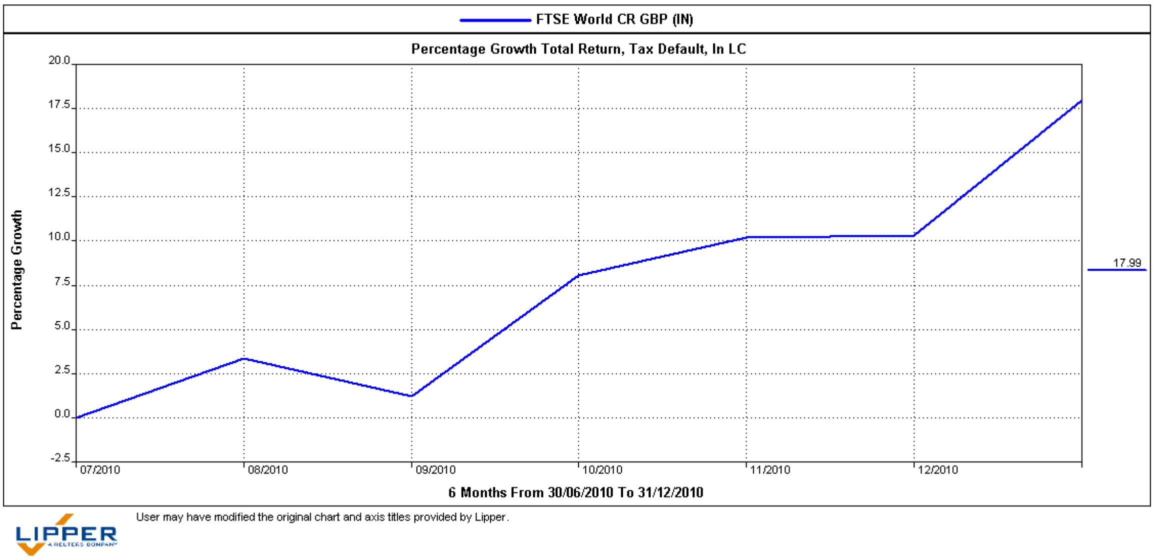
With the economy expanding and the increase in liquidity profits from US companies are set to grow, potentially passing their all time high. Most corporate balance sheets are robust, giving further strength for companies to expand, either organically or by acquisition.

Over in Japan improvements are being made. Japanese companies have had to improve efficiency and reduce costs. In addition the US is no longer such an important export destination. The US has been overtaken by China as Japan's largest trading partner. China is also likely to become it's biggest source of external investment. Companies are beginning to capitalise on this.

Yet the value of the Japanese stockmarket continues to trade below book value (the value of Companies assets). It is widely predicted that after years in the doldrums Japan could be the fastest growing major economy in 2011.



Throughout the rest of Asia 2011 is likely to be the year Governments focus on improving domestic demand for their own goods rather than developing export markets further. There will however be more and more Chinese and Asian companies appearing in the headlines as they use lower valuations and cash reserves to acquire assets in the Developed World.



With returns on corporate bonds in 2010 far above normal, concerns have been made that, perhaps, a bubble is forming. For a bubble to occur investors must believe that returns will continue to be above expectations. Investors predominantly buy corporate bonds for their income stream and given that this income is at historic lows and with investors not expecting the high levels of returns to continue our view that there is no corporate bond bubble.

For the corporate bond markets the returns of 2011 will be very much determined by the success of various Government policies. If they manage the fine balancing act of growth without excess inflation then bond returns will be positive in 2011, albeit lower than the return experienced in 2010. Any signs of inflation becoming excessive and investors will take profits from bonds and prices will fall. Any unexpected rise in interest rates could also see the value of corporate bonds fall as investors move out of bonds into the returns available from cash. We do not envisage this as being an issue in 2011. Finally the issues in Europe could also have an affect on the returns from bonds. If there is more debt re-structure and more bonds issued then the value of existing bonds could fall. Merger and acquisition activity could also have an impact, specifically if it funded by debt and not cash reserves.

For property investors rental income should begin to improve in 2011. Yields currently available are in excess of gilt and equity yields which makes property investment attractive for those looking for income. With a stable economy the amount of time a property is empty will fall, again improving returns. The UK Government is likely to offer further encouragement to the banks to increase lending which should form a solid basis for sustainable returns in 2011.

MARKET REVIEW

During the six months ending 31st December 2010 capital changes in the main markets have been as follows:-

Indices	30/06/2010	31/12/2010	Percentage Change %	Adjusted Change % *
United Kingdom				
FTSE 100 Index	4916.87	5899.94	+19.99	
FTSE All Share Index	2543.47	3062.85	+20.42	
FTSE Mid 250 Index (exc. Inv trusts)	9782.85	12156.60	+24.26	
FTSE Small Cap. Index (exc. Inv trusts)	2205.40	2631.48	+19.32	
FTA Brit. Gov. Securities Index				
Fixed Interest - All Stocks	157.44	156.38	- 0.67	
Index Linked - All Stocks	368.57	382.71	+ 3.84	
North America				
Standard & Poors Composite	1030.71	1257.64	+22.02	+16.60
Japan				
Topix Index	841.42	898.80	+ 6.82	+11.37
France				
CAC 40 Index	3442.89	3804.78	+10.51	+15.66
Germany				
DAX Index	5965.52	6914.19	+15.90	+21.30
Switzerland				
Swiss Industrial Index	6128.06	6436.04	+ 5.03	+16.11
World				
FT World Index	303.73	358.36	+17.99	+17.99

*This column adjusts the capital changes to reflect the movement of Sterling against the relevant local currency.

Composite Index	18.27%

This Index is calculated on the basis that a client's Portfolio is invested as detailed below with net income re-invested at the payment date:-

Building Society Deposits	30.00%
UK Government Index Linked Stocks	10.00%
UK Equities	40.00%
Overseas Equities	20.00%

Pensions

Pensions remain a very tax efficient way of providing an income in retirement and with increasing longevity it is desirable to build up a fund that will provide an adequate income over what, hopefully for us all, will be a long time.

However the rules keep changing and 2011 will be no exception. Whilst the basic framework remains in place, from April 2011 the maximum annual contribution to a pension policy will reduce from £255,000 to £50,000. For most of us this is not a problem. For anyone who has, say, an exceptional year and wants to soak up this subsequent tax liability then any unused relief from earlier years can be carried forward. Some of you will recall that this has echoes of the past when unused relief from the previous six years could be carried forward.

It is also proposed that there will be more flexibility available to investors by being able to choose how and when they take the benefits. Also those continuing drawdown arrangements will not be restricted to the levels of income as they are now. Indeed providing you can prove that you have a certain level of income from other sources, presently set at £20,000 per annum, you may draw down the whole value of your pension fund subject, perhaps needlessly to say, to income tax. Alternatively you may leave your fund untouched to pass on to your beneficiaries as a lump, less, and I am sure you know what I am going to say, 'a tax charge'.

I have only briefly outlined the new proposals and if you wish to discuss them in detail please, as usual, do not hesitate to contact us.

And finally....

Thursday 13th January 2011 proved to be unlucky for us as 'gremlins' got into our telephone systems and all lines went dead. After a week an engineer finally arrived and the system was up and running again. We must apologise for those of you who tried to contact us during this period and please be assured that normal service has now resumed.

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