



This weekly Briefing Note aims to pick out some of the key financial and economic issues touched on in the press over recent days and from time to time includes the views of some of our independent fund managers.

## To the Rescue

After months of slow torture, Portugal finally admitted defeat last week by asking its European partners to bail it out via the eurozone's stabilisation mechanism. For months the country denied it had financial problems and was on track to meet its planned austerity cuts – unfortunately international investors were sceptical and used the government bond market as the vehicle to demonstrate their concerns. In turn the price of Portuguese bonds fell, pushing up yields; and with them, the cost of borrowing for the government, thus exacerbating an already painful situation. At one point last week, yields touched almost 10% before the EU rescue operation swung into action. Portugal's Prime Minister, Jose Socrates, confirmed on Wednesday that his country would seek assistance from its regional partners, meaning that Portugal is set to follow in the footsteps of Greece and Ireland.

Analysts expect the loan to be worth between €70bn and €80bn but in the meantime the government was forced to pay 5.9% to raise short-term loans – a rate described as “outrageously high” by economists. Economists believe the price to be extracted for the EU bailout is likely to be high, with severe cuts in the Portuguese government's budget following the general election set for 5 June. Britain's Chancellor, George Osborne, attending the eurozone crisis talks in Hungary over the weekend, took the opportunity to justify his planned cuts to tackle the UK deficit. “We can see the risks that would face Britain if we were not dealing with our debts,” he said.

Meanwhile the European Central Bank (ECB) was as good as its word following hawkish comments from the ECB president the previous week – Jean-Claude Trichet announced that the Bank was increasing official eurozone interest rates by 0.25% to 1.25%. Acting against inflation was “in the interests of all members and partners of the single [European] market and single currency,” he said, adding that it would help boost economic confidence. However the ECB's decision to raise interest rates was condemned by EU trade unions who said that higher borrowing costs would result in extra hardship for people all over the region. Conversely, in inflation-averse Germany, ministers welcomed the ECB action, seeing it as a positive move to help slow inflationary pressures. The euro remained little changed on the news but nevertheless, close to a 14-month high against the US dollar.

The sanguine response from Germany, the eurozone's largest economy, accounting for around a third of GDP, is probably unsurprising given the very robust state of its economy and its post-crisis growth surge. Its exports continue to expand rapidly and were up 2.7% in February alone. In contrast, the eurozone's peripheral economies are struggling, with low or negative economic growth and high levels of unemployment. Also with a predominance of variable rate mortgages, the likes of Spain and Ireland are expected to be hardest hit by the rate increase.

## Two-speed Recovery

The global economic recovery witnessed over the last two years has, as **The Financial Times** pointed out, been anything but evenly spread. It probably comes as no surprise that the emerging market economies are accounting for the lion's share: according to the IMF, they are, on aggregate, growing at rates close to 6%; while rates of 2–3% are the ambition for most advanced economies. According to the OECD, world trade export volumes have now exceeded pre-crisis levels with the US leading the way, boosted by a weaker currency – one outcome of the US Federal Reserve's controversial \$2,700bn quantitative easing programme. But even within the developed economies themselves, there is another two-speed growth story: the US and Germany leading the way with Spain, Greece et al lagging. However, Germany and the US are following different strategies.

Germany has eschewed high levels of indebtedness as have its world-class manufacturing companies, who have benefitted enormously from their efforts to contain employment costs over the years and who hoarded labour during the crisis, leaving them ready to roll out production once recovery began. Today German manufacturers are feeling bullish and they are also recruiting significantly, with one industrialist saying the economic recovery will continue for at least 12 quarters.

In the US, manufacturing output has also grown swiftly, accounting for around 11% of GDP – but the sector was severely affected by the recession, with more than 2m jobs lost. Having had their fingers burnt three years ago, many of America's smaller and medium-sized businesses are still holding back on creating jobs, as was illustrated in the latest payroll numbers. Manufacturing created just 17,000 of the new 216,000 added in March: it seems that they are not, as yet, sharing the same levels of confidence as their German counterparts. Yet, according to a recent survey, 20% of the sector's companies have more than 15 openings on their factory floors.

## UK Growth Recovers

Here at home the economic recovery has been less spectacular – especially following the setback in the last quarter of 2010. Hopes are high, though, that the recovery may be back on track following the latest data from Britain's services sector. In March, the purchasing managers' index (PMI) for services (produced by Markit Economics) was close to its highest level since the summer of 2007, before the financial crisis. The PMI jumped from 52.6 in February to 57.1 last month with any figure over 50 indicating rising activity. Employment in private services – which accounts for around 40% of the UK economy – rose for the first time in nine months. To date, the main bright spot for the economy has been manufacturing but it seems that now, alongside services, the construction sector is also growing robustly. The Markit/CIPS index for March was 56.4 – only marginally down on the eight-month high of 56.5 set in February.

Overall, economists now believe that the economy grew by 0.8% in the first quarter of the year but most believe the Bank of England (BoE) will continue to hold interest rates – as it did last week – at current low levels until the outlook is clearer. “Frustratingly for policymakers, with the economic data for the last two quarters distorted by bad weather and subsequent rebound, it will probably not be until the second quarter that true underlying growth momentum can be properly estimated,” was the view of economists at Markit. But the pressure will be on for the BoE which is pursuing a policy predicated on the fact that inflation will fall back towards its 2% target by mid-2012. A recent survey by the British Chambers of Commerce of its 6,000 plus members found that inflation was their major concern, with about half complaining about rising prices and their difficulty in passing on the costs to consumers.

Inflation is not just worrying for producers, though; higher food and energy costs are hurting household expenditure too. The matter was not helped by last week's continued surge in oil prices, where the cost of a barrel of Brent Crude hit a record \$127. Whilst oil prices have yet to hit their all-time high of \$147 per barrel recorded in June 2008, the 17% fall in sterling against the US dollar over the last two years means the sterling price of a barrel is now at an all-time high of £74.60. This is bad news for inflation with fuels and lubricants already up 16% over the last year, transport services up 10%, and with official overall UK inflation of 4.4%. As every driver knows, petrol and diesel prices have risen sharply in recent months and, as **The Financial Times** pointed out, high energy prices reduce household income levels and spending on goods and services. Meanwhile, though, by holding interest rates at 0.5% once more, the BoE is obviously hoping that the recent sharp rise in inflation is, as it believes, going to be short-lived.

### Time for a Breather

Following the sharp rises of the last fortnight, global equity markets enjoyed a breather last week as investors took time out to reflect on events. Sentiment though continued to be very positive, with what could have been perceived as bad news being shrugged off. As mentioned, oil prices surged as did other commodity prices including corn and copper, which doesn't augur well for inflation – fears about which, helped gold to hit a record high of \$1,474 an ounce. However investors chose to ignore the rise in commodity prices by taking the view that the price rises are being driven more by global demand than the risk, in the case of oil, of supply disruptions. Even news that China was raising its benchmark one-year lending rate by 0.25% to 6.31% – the fourth rise in the last six months – to curb inflationary pressures was met with indifference. Against this stoic backdrop, it was no surprise then that Portugal's ignominious request for international financial aid had little impact. By the end of the week, the bullish view on riskier assets being taken by investors pushed emerging market equities to their highest level for 34 months. Most of the developed market indices held their previous week's levels with London's blue-chip FTSE 100 Index closing once more above the key 6,000 level.

### A UK Bull

UK equity manager, Ian McVeigh of Jupiter, shares the UK market's bullish posture believing there are plenty of opportunities still in the current market. “Despite global equity markets entering a potential period of uncertainty following the Japanese earthquake, valuations are, in my view, extremely low. At current levels equity prices should be robust and my portfolio will be resilient. I also think the rapid oil price movement is overblown and that investors are too pessimistic about the implications for GDP growth. Energy accounts for around 3–5% of global GDP and a \$10 increase in the price of oil will have a marginal – around 0.2% – impact on growth.

“In terms of the portfolio, I own some banking stocks which I believe will eventually recover – Lloyd's offers great value at 60p. I accept the UK economy is sluggish but this creates opportunity – take the housing market where transactions continue to fall. People are now more inclined to develop their homes rather than move up so I own a company called Howdens, a manufacturer of high quality kitchens, who are benefitting from this scenario. More globally, I own Burberry – a company which is benefitting from a rising demand for luxury goods in places like China. So I am very confident that the portfolio is well placed to generate excess future returns based on the current opportunities in the UK market.”

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