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2011 Recap & Outlook Update

Looking back at the returns produced over the first six months of 2011 provides a clear case for geographical diversification in any portfolio. Year to date returns show positive gains in our local stock exchange, the US and much of developed Europe, while the picture in the BRIC countries (Brazil, Russia, India and China), and some major Asian markets looked gloomier.

INDEX	PRICE AS AT 30-Jun-11	Quarterly Return	Quarterly Return	YTD Return	YTD Change	12 mth Return	12 mth Change	2010 Return
GLOBAL STOCK MARKETS								
TTSE COMP	950.09	8.95%	▲	13.70%	▲	14.85%	▲	9.19%
S&P 500	1,320.64	-0.39%	▼	5.01%	▲	28.13%	▲	12.78%
DOW	12,414.34	0.77%	▲	7.23%	▲	27.01%	▲	11.02%
NASDAQ	2,773.52	-0.27%	▼	4.55%	▲	31.49%	▲	16.91%
LONDON	5,945.71	0.63%	▲	0.78%	▲	20.92%	▲	9.00%
PARIS	3,982.21	-0.17%	▼	4.66%	▲	15.66%	▲	-3.34%
FRANKFURT	7,376.24	4.76%	▲	6.68%	▲	23.65%	▲	16.06%
MOSCOW	1,666.59	-8.11%	▼	-1.27%	▼	27.29%	▲	23.21%
SAO PAULO	62,403.64	-9.01%	▼	-9.96%	▼	2.41%	▲	1.04%
MUNMBAI	8,845.87	-3.08%	▼	-8.11%	▼	6.47%	▲	17.43%
HONG KONBG	22,398.10	-4.80%	▼	-2.77%	▼	11.27%	▲	5.32%
SHANGHAI	2,762.08	-5.67%	▼	-1.64%	▼	15.16%	▲	-14.31%
TOKYO	9,816.09	0.63%	▲	-4.04%	▼	4.62%	▲	-3.01%
SYDNEY	4,608.00	-4.75%	▼	-2.89%	▼	7.13%	▲	-2.57%

The second quarter of 2011 has also been a fairly negative and volatile quarter for equity markets. The financial impact of tragic events in Japan came to roost across the globe during the quarter, as there were disruptions in supply chains worldwide causing plants to be closed, employees to be sent home and shortages which affected manufacturers, retailers and ultimately consumers. Japan slipped back into a period of negative growth in the first half of 2011, while other nations experienced a slow down in economic growth as a result.

The monetary policies of the developed world and the developing world moved at odds with each other during much of the first half of the year. Many countries in the developed world remained focused on trying to jumpstart growth in their economies through accommodative policies, while several nations in the developing world pursued tightening measures aimed at reducing inflation which have also had the tack on effect of cooling their growth rates.

Many developed countries have come to crossroads in recent times, asking themselves whom to please? Several European nations are teetering under the weight of massive debt which threatens their very solvency coupled with low growth, high unemployment and rising inflation pressures. In order to gain financial support to maintain payments on these large debt burdens Governments are being forced to implement tough austerity measures to cut spending, sell off assets and raise taxes, much to the ire of citizens whom are feeling the pinch of reduced benefits, wage reductions and even loss of jobs.

North America

At the end of the first quarter Guardian Asset Management reduced their estimated full year US real GDP growth from around 3% to the range of between 2.6% to 2.8%, however given the disappointing news that first quarter growth was only 1.8%, we have reassessed our estimate and reduced it to between 2.3% to 2.6%. This is in line with downgrades from many other market participants including the IMF which reduced their US growth forecast from 2.8% to 2.5% for 2011. Despite the seemingly tepid growth during the first half of the year we anticipate stronger US growth in the second half, as supply chain disruptions are resolved and pent up demand is satisfied.

Our expectations for the US unemployment rate to remain sticky played out even worse than anticipated, with the jobless number actually increasing from 8.8% in April to 9.2% in June. However we expect these numbers to improve in the second half, dropping to below 9.0%, as car manufacturing plants return to normal production levels.

The much anticipated end of QE 2 has happened without officials indicating any plans to extend; as we forecasted, markets saw a pull back which started in May as investors became more cautious on the outlook for the markets. Also contributing to the pull back in US markets was the wrangling over the country's debt ceiling and proposals to reduce long term debt which we also foresaw as a potential spoke in the wheel of the US recovery. Given these concerns we were neutral weight US equities, and recommended sector positioning in defensive sectors such as Consumer Staples.

Despite the current fears of a credit downgrade and slowing growth affecting the US market we believe the S&P 500 will end the year in the positive, our baseline year end target for the S&P 500 is in the 1350 region. We maintain our call for defensive positioning in the short term as we believe there is still some downside risk in the coming weeks, with the potential for a rally in the fourth quarter. Our favoured sectors are Consumer Staples and Technology and we are cautious on Healthcare stocks and Financials. September, historically a negative month may provide a buying opportunity if history repeats itself.

Europe

Across in Europe, leaders have made some unpopular but necessary choices to reduce their deficits. Nonetheless, the nation most at risk of default, Greece, has not "solved" its debt crisis but rather the problem has been delayed as further bailout plans have served as a lifeline to keep Greece afloat. As such we expect to see volatility concerning this issue persisting into the foreseeable future.

In July, the European Central Bank (ECB) raised its key interest rate for the second time this year by 25 basis points to 1.50%, while the Bank of England (BOE), left rates unchanged at 0.50%. This divergence in policy shows the different emphasis of these two Central Banks, with inflation concerns weighing in heavier than slow growth on the ECB's decision, while slow GDP growth and high unemployment being of greater concern to the BOE. This divergence in policy may lead to investor preference of the Euro over the pound, should default risks in the Euro zone subside. While the Swiss Franc may be a beneficiary of further default fears, as the currency is viewed as a safe haven given the country's positive current account balance, low debt and low unemployment rate. We continue to have a neutral weight view on this region, with a select overweight towards German equities, given that Germany is one of the few nations in the 'bloc' to show signs of strong growth.

Asia

In Asia, the theme of monetary tightening has been ongoing with India and China leading the way. China has raised interest rates four times since October 2010; currently the one year lending rate is at 6.56%, while raising the reserve requirement six times effectively locking up 21.5% of deposits with the Central Bank. These efforts to cool its economy are beginning to take a toll on GDP growth with China reporting growth in June of 9.5%, down from annualized growth of 9.7% achieved during the first quarter. However inflation continues to rage on with CPI reported at 6.4% in June, versus 5.5% in May and 5.3% in April.

The big question now is whether China can avoid a "hard landing" given all its attempts to cool its economy; the World Bank is predicting growth to be 9.3% in 2011 and 8.7% in 2012. With much of the stimulus for international growth hinged on China this question will continue to grow in importance. At this time we are cautious on China, given the country's continued battle against inflation, the prospect of a "hard landing", slowing growth and the uncertainty over the condition of the country's banking sector, equities in this market have underperformed and we see no impetus for an improvement in the following two quarters.

Nonetheless, we expect a third quarter rebound in growth in the Asian region as Japan's production returns to levels of normalcy. We have removed our underweight view on Japan and are now neutral weight with a positive view on the Yen, which can benefit in the coming weeks from uncertainty over the US debt ceiling and the sovereign debt crisis in Europe.

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Latin America

In Latin America, the woes of inflation continue to menace Central Bankers. Brazil has raised interest rates for the fifth time this year, with the last hike increasing the Selic rate by 25 basis points to 12.50%. Inflation surpassed the central bank's target of 4.50% in April and is currently 6.75%. The unemployment rate fell to a low of 6.2% in June. The tightening by the Central Bank has had the effect of cooling growth as evidenced by retail sales growing by just 6.2%, the second slowest growth in 20 months. Brazilian authorities are warning of more currency controls to stem the appreciation of the Real, which is at a 12 year high against the US dollar. Despite stellar growth, the Brazilian stock market has underperformed in recent years. We expect yet another rate hike from the Central Bank and then a pause in hikes as slowing growth in Brazil and China begin to have a more pronounced effect on commodity prices and hence inflation. Should authorities halt tightening efforts as anticipated investors may once again find favour with Brazil in the last quarter of the year.

Commodities

The second quarter of the 2011 was a negative period for commodities with the exception of gold. Driving the declines were a combination of factors. During the quarter, oil pared back the gains made in the first quarter as Saudi Arabia and the US intervened in the market to increase supplies to compensate for the shortfall left by the absence of Libyan oil exports. Oil prices also declined on signs of slowing global growth. Copper declined due to signs of slowing growth and reduced demand from China, while silver took a big hit due to regulatory interventions aimed at reducing commodity speculation. Corn and wheat declined on better than expected weather and crop quality. Gold the lone advancer in the space benefited from heightened risk aversion during the period due to debt default concerns over the US and Euro zone.

INDEX	PRICE AS AT 30-Jun-11	Quarterly Return	Quarterly Return	YTD Return	YTD Change	12 mth Return	12 mth Change	2010 Return
COMMODITIES								
OIL	95.42	-10.59%	▼	4.42%	▲	26.17%	▲	15.15%
NATURAL GAS	4.37	-0.34%	▼	-0.70%	▼	-5.24%	▼	-20.94%
GOLD	1,500.35	4.75%	▲	5.60%	▲	20.78%	▲	29.52%
SILVER	34.69	-7.90%	▼	12.20%	▲	86.36%	▲	83.21%
COPPER	427.20	-0.65%	▼	-3.77%	▼	45.50%	▲	33.42%
CORN	629.00	-9.27%	▼	0.00%	–	77.56%	▲	51.75%
WHEAT	584.75	-23.39%	▼	-26.38%	▼	25.82%	▲	46.68%

In the second half of the year we expect that the commodities space will continue to experience softness as global demand declines. Should our base case expectation play out and the US debt ceiling crisis is resolved without a default or a debt rating decrease, we can expect to see the dollar stabilize and perhaps strengthen as no additional liquidity will be added to the market through further Quantitative Easing actions. If the dollar strengthens this may also result in lower commodity prices. We expect oil prices to remain around the US$95 to US$100 region. Risks to these expectations would be heightened socio-political tension in the MENA region which would cause prices to spike, or a greater than expected slow down in global growth which would drag prices down.

Currencies

INDEX	PRICE AS AT 30-Jun-11	Quarterly Return	Quarterly Return	YTD Return	YTD Change	12 mth Return	12 mth Change	2010 Return
CURRENCY/ RATES								
DOLLAR INDEX SPOT	74.30	-2.05%	▼	-5.98%	▼	-13.62%	▼	1.50%
EUR-USD	1.45	2.43%	▲	8.35%	▲	18.50%	▲	-6.54%
GBP-USD	1.61	0.16%	▲	2.82%	▲	7.41%	▲	-3.45%
AUD-USD	1.07	3.80%	▲	4.78%	▲	27.52%	▲	13.99%
CAD-USD	0.96	-0.74%	▼	-3.47%	▼	-9.45%	▼	-5.24%
USD-JPY	80.56	-3.09%	▼	-0.69%	▼	-8.90%	▼	-12.80%
EUR-JPY	116.84	-0.72%	▼	7.72%	▲	7.97%	▲	-18.57%
USD-CNY	6.46	-1.29%	▼	-2.17%	▼	-4.69%	▼	-3.22%
USD-TTD	6.42	0.00%	–	0.31%	▲	1.10%	▲	1.11%

Our currency outlook has shifted and we expect that commodity linked currencies will weaken against the US as the growth in demand for commodities experience a lull. Despite the growing differential in interest rates in the US and Euro zone, we expect that the EUR/USD pair to trade in a range of 1.42 to 1.47 for the remainder of the year, as fear over Greece's debt crisis at times outweighs the carry trade benefits. During periods of heightened concern we expect the Yen and Swiss Franc to benefit from risk aversion. We are negative Sterling at this time, as slow GDP growth will keep interest rates low for some time to come.

Fixed Income

We also maintain our underweight position on US treasuries, the absence of additional stimulus to the US market should result in interest rates beginning to edge up, although we do not anticipate the Fed raising rates until the second quarter of 2012. As such we continue to recommend that fixed income investors position their portfolios towards shorter duration in anticipation of upward interest rates adjustments in the next three months to one year out. We expect the ECB to raise rates once more this year for a total tightening of 75 basis points. We also expect German Bunds to benefit during periods of uncertainty.

The credit quality of many emerging market sovereign bonds look sound given that the trend in many of these nations for higher savings and healthier debt positions than what we are currently witnessing in the US and much of developed Europe. We have a selective overweight EM Sovereign debt view, given that monetary tightening in these nations may be at the tail end as inflation pressures due to rising commodity prices eases. Investors may benefit going forward from capital appreciation in coming years when policy switches to monetary easing making currently available high coupon bonds more attractive. Additionally this asset class has remained resilient in recent months to the numerous disruptions affecting the market, such as the Libyan conflict, the Japanese tsunami and the debt crisis issues in the US and Euro zone, providing a degree of decoupling which often seems to be absent in other asset classes which react to news in unison. Risks to this view would be the introduction of new regulatory and capital controls which make holding these assets more expensive and less appealing, or failure of authorities to get a handle on inflation which leads to further tightening.

Risks to Outlook

As noted throughout this document there are many risks to our views. Some of the main risks which we can see derailing our baseline views are:

1) Greek default in the short term, or risk of a default by another European sovereign;
2) Rising tensions in the MENA region, a disruption of Saudi oil supply could lead to oil prices spiking to the region of US$150 to US$200;
3) A hard landing for China, due to efforts on their part to temper inflation, triggers a global slowdown;
4) A default or credit rating downgrade of the US;
5) Deficit reduction in the US and austerity measures in Europe derails GDP growth in these nations.

Feel free to give us a call at 632-6000 or email us at marketing.communication@ghl.co.tt if you have any questions or concerns.

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