



Ian Kernohan, Economist at rlam, looks at developments in China and the likely impact on the west of capital markets reforms

Robert Talbut, rlam's Chief Investment Officer, considers a more political, more unpredictable and more volatile world for the asset allocator

Craig Inches, Government Bond Fund Manager, on the need for a flexible approach to identify diversified sources of outperformance

www.rlam.co.uk



Ian Kernohan,
Economist

GDP growth numbers are often reported with the slant that faster must be better, and rarely with any mention that the data are likely to be revised at some point in the future. However, slower growth numbers are sometimes the preferable outcome, especially if inflationary pressures have been building in an economy. Since late 2010, China's government has sought to slow the economy, in order to contain inflation, and there is growing evidence that this strategy is working. While early estimates of GDP can be very inaccurate, prices are much easier to measure and so we take the recent decline in China's producer price inflation as a good indicator that growth has slowed to a more sustainable pace.

The slowdown in the global economy has impacted China's exports, while a boost to food supply has helped contain food prices. A soft landing, while by no means a given, looks more likely than it did a few months ago. The growing share of trade with other emerging economies should help contain the impact of the Eurozone recession, while growth momentum has shifted from the coastal to inland provinces, where average incomes are lower and hence catch-up potential is much greater. We expect GDP growth to remain at or around 8% per annum for some time to come.

Although policy settings have now shifted in favour of loosening, we shouldn't expect a repeat of the massive policy easing seen in the wake of the Lehmans collapse, more a fine tuning exercise. The authorities have sought to slow the housing market via home purchase restrictions and these are unlikely to be removed until inflation falls further and/or until supply and demand for property is better balanced. Increased public housing may help achieve two objectives: to correct the imbalance in housing and to provide a fiscal boost at a time when the global economy has slowed.

Aside from these shorter term questions about growth, inflation and housing, longer term issues such as reform of capital markets remain important. Changes in this area should unlock the tremendous potential for RMB investment around the world. A reduction in capital controls will boost two-way capital flows and help promote cross border usage of the RMB. This would allow China's banks to expand more rapidly in global markets and provide a useful prop for the damaged banking systems of the west. China's goods have long been part of our high streets. We have yet to see the full impact of China's vast pool of savings.



Robert Talbut,
Chief Investment Officer

Markets have breathed a collective sigh of relief during the past month. Equities and bonds have both showed good gains and, in the case of the former, regained the levels of last summer prior to heightened concerns over sovereign risk and potential recessions. We have recently seen some of the steps I was looking for in terms of policy response. There has been an increasing trend towards lower interest rates and, in Europe, monetary measures have been implemented to assist the banking sector and ward off a renewed credit crunch. The crucial question is whether this simply offers some respite, or whether it should be seen as altogether more fundamental.

Good thinking. **Well applied.**

My expectation is that the measures of the last two or three months will be followed by more 'emergency' type action. This will include another significant injection of money into the European banks next month, to further limit the damage to both the banks and the real economy as they reduce the size of their balance sheets and improve capital positions. We will see further interest rate reductions in more of the emerging world, while I also expect more QE in both the UK and the US. Overall this will provide a supportive backdrop to financial markets and to the real economy, and encourage an optimistic asset allocation stance towards riskier assets.

In contrast, we have to consider several remaining strategic issues. First, while it is helpful for European banks to have received liquidity support, this merely signposts the degree to which the banking sector cannot raise true private sector funding and remains completely dependent upon 'emergency' measures. Effectively the banks are so inextricably linked with governments and central banks as to be de facto nationalised institutions. There is no real prospect of weaning them off this support, and the situation will continue for years and may well drive further changes in behaviour over time as this relationship becomes more obvious. Second, developed economies still face unsustainable debt levels, requiring continuing austerity and significantly restraining their ability to grow. On top of this will be rising political risk through this year. Incumbent governments are increasingly being replaced as electorates punish their politicians. Meanwhile, as the austerity measures continue with little end in sight, we should expect risks to emanate from rival camps who may reject the current policy prescription no matter what the economic logic may be.

The combination of these risk factors may temporarily have receded, but they have not disappeared. I continue to see the future being made up of bursts of optimism over short term runs of positive economic data, followed by second thoughts as the strategic constraints hold growth back. This will be overlaid by significant policy and political risks as markets question



Craig Inches
Government bond fund manager

The global economic environment remains challenging, with growth in the developed world forecast to remain weak and inflation expected to moderate. Central bank policy is likely to remain broadly on hold for the time being and we do not expect interest rates to start to rise until 2013 and even then, not by very much.

As we have seen from the debt ceiling crisis in the US and now more recently the Eurozone debt crisis, political considerations are having an increasingly significant influence on markets. This is likely to remain the case for the foreseeable future, resulting in much higher levels of volatility and unpredictability.

Over the last five years we have witnessed a sharp fall in UK interest rates from almost 6% to 0.5%. Consequently ten year government bond yields have fallen from 5% to 2%, whilst ten year real yields have declined from 3% to -0.5%! These declines in yield have resulted in very healthy returns for government bond investors, with the average gilt fund returning almost 8% per annum over this period.

The world is now an extremely difficult place for investors seeking a low risk return on their capital. In a low yielding environment with a benign economic outlook, the majority of future investment returns will be harnessed by actively capitalising on market volatility. Since the introduction of Quantitative Easing not just in the UK, but around the world, bond market volatility has increased fourfold. This market intervention by government agencies has led to inefficiencies within the UK and other G7 bond markets.

Therefore the key to delivering consistent outperformance is an investment approach that identifies diversified sources of alpha and is flexible enough to enable market inefficiencies to be exploited quickly and stealthily. Coupled with this is a need for a high degree of risk awareness, in order to avoid unforeseen risks arising from portfolio positions. Such an approach should enable continued strong levels of risk-adjusted return against a backdrop of extreme ongoing market

For more information email: quentin.smith@rlam.co.uk or call: 020 7506 6582

Source: **rlam** as at 25 January 2012

rlam is a marketing brand including the following companies:

Royal London Asset Management Limited registered in England & Wales number 2244297; Financial Services Authority (FSA) register number 141665.

Royal London Pooled Pensions Company Limited registered in Scotland number SC048729; FSA register number 110456.

Royal London Unit Trust Managers Limited registered in England & Wales number 2372439; FSA register number 144037.

Royal London Cash Management Limited registered in England & Wales number 19632; FSA register number 121844.

All of the above are authorised and regulated by the Financial Services Authority.

It also includes Royal London Asset Management Bond Funds Plc registered in Ireland number 364259 and regulated by the Irish Financial Services Regulatory Authority (IFSRA).

All these companies are subsidiaries of The Royal London Mutual Insurance Society Limited registered in England and Wales number 0099064. Head office: 55 Gracechurch Street, London EC3V 8R

Our reference: **029-PRESS-01/2012-QS**

Good thinking. **Well applied.**