



TAM Outlook for 2011

"Traversing the financial markets in 2011 will be more straight forward but we must remain vigilant as to the path we follow" - Lester Petch - CEO TAM Asset Management.

We believe that 2011 will be another year of good opportunity for investors able to proactively position themselves to deal with transient volatility and market dislocation we can anticipate. The fragile economic recovery which started in 2009 gathered strength last year and proved resilient enough to overcome a number of obstacles thrown in its path. There are unprecedented global efforts firmly underway to maintain the momentum of the recovery and we expect economic and corporate earnings growth to remain a positive factor. This we believe will lead to a clear polarisation between the performances of individual asset classes. Asset Allocation will be key to performance in 2011.

- Equity Markets: will end 2011 higher by some 12-18% with sporadic periods of volatility. We expect leadership from larger capitalisation stocks able to benefit from global growth. OVERWEIGHT

- Fixed Income markets: will continue to struggle throughout the year as inflation and eventually interest rate hikes will have a negative effect. Whilst government bonds will potentially erode wealth, there will be some opportunity in higher yield and international bonds. Trading opportunities in Government Debt will appear in times of market stress UNDERWEIGHT
- Property: having made some welcome gains from the sector last year we see little to encourage us to re-enter either the residential or commercial real estate space this year: UNDERWEIGHT
- Commodity: inflation fears and developing economy demand led a surge in precious metals, energy and soft commodities. We do not expect these drivers to abate. OVERWEIGHT
- Absolute Return: Will improve on their 2010 positive performance and act as an ideal replacement to exposure in Fixed Income. OVERWEIGHT

The Story of 2010/11 - European Troubles to Continue?

Given all the turmoil of the financial markets last year, one theme continued to dominate headlines and sway investor sentiment; the sovereign debt crisis in Europe. 2010 clearly demonstrated that the global economy was dragging itself out of recession but the impact of 2008-2009 remains. In a similar way to which household budgets had been affected Governments around the world faced growing financing problems particularly, it transpired, in the Euro zone. When Government outlays exceed their tax receipts in a fiscal year they are said to be running a deficit, which necessitates borrowing money to make up the difference. Such borrowings comprise selling 'sovereign debt' to foreign and domestic creditors. If those creditors are unsure whether a government is able, or willing, to repay those borrowings then they demand a higher interest rate. Creditors may even refuse to purchase any bonds at all in which case a government would have no choice but to cut expenditure, raise taxes, or borrow from international agencies such as the International Monetary Fund (IMF). This is the situation Greece unfortunately found itself in last year and the catalyst for Euro-wide fears.

Basically Greece had borrowed too much money during the previous years and was living beyond its means. (Like Many Others) The global recession exacerbated this, and as the economy slowed and tax revenues decreased this made it even harder to make the debt payments. This at a time when its debt-to-GDP ratios rose to near 115%, which means its debt was higher than its annual gross domestic product. This figure, although high, was actually only a little higher than that of the UK's. However what alarmed investors was the question, could Greece manage to maintain this ratio or would it simply spiral out of control? Matters were made even more uncertain because, unlike the UK, Greece was a member of the European Union. This meant it could not independently devalue its currency, nor indeed implement unilateral monetary policy decisions (we must be mindful of the pitfalls of 'one size fits all' monetary strategy across Europe). Ultimately the other Euro zone countries and the IMF agreed to a €110 billion loan for Greece. This was swiftly followed by the European Financial Stability Facility, a rescue package worth over a trillion Euros aimed at, as the name suggests, financial stability across Europe.

Greece's problems, though serious, were not the real cause for such concern: contagion to other countries was. As Greece's troubles increased other peripheral European countries finances were placed

under the microscope. Four countries quickly became a focus of concern, Portugal, Ireland, Italy and Spain or as commonly known the “PIIGS” when Greece was included. As we now know this was, and is, cause for concern; with Ireland succumbing to its own indebtedness and received an €85 billion bailout towards the end of last year.

So will this be the final chapter of the story? Unfortunately not, a lack of political will (especially following the many strikes and civil disturbances across Europe) to enforce urgent austerity measures across the indebted nations continues to highlight the imbalances across the euro zone. More austere countries, such as Germany, the largest and now the strongest growing economy in Europe, are being forced to finance its more frivolous neighbours. European finance ministers have engineered a plan to hopefully end speculation against its member’s states once and for all, but one must remain doubtful to its effectiveness. This story will continue to add to market volatility throughout 2011. However, as and when there is clarity, we may get to the point where PIIGS may fly??

Will the fear of recession remain a licence to print money?

The announcement of a new round of quantitative easing by the US Federal Reserve proved the catalyst investors were looking for to increase their risk appetite and banish (albeit temporarily) from their thoughts the problems rife in the Euro zone. Confirmation that the US Fed would start to intervene in treasury markets was enough to ensure that equity markets recovered from their summer lows and continued to move into positive territory for the year. However it was not until the beginning of November that firm details of the new programme were announced; Six hundred billion US dollars of longer-term treasuries would be bought by the end of June 2011.

Such action is unprecedented and clearly underlined the US government’s intention to underpin financial markets and support economic growth whatever the cost. Indeed at a time when many are imposing strict austerity measures to reduce their liabilities the US balance sheet will swell to a near eye watering three trillion dollars by the time this round of easing is complete. This figure may even continue to grow if the US feels compelled to increase their programme; certainly comments in the New Year that the level of economic growth was no yet sufficient enough for them to reduce their level of easing led many to speculate that QE3 may not be far away.

Inflation, the true cost of quantitative easing? There can be no doubt that one of the many costs of any accommodative policy will be upwards pressure on inflation. Printing fresh money increases the money supply, and can, if unchecked, devalue a currency thereby pushing up import costs. For most developed economies this will increase the price of food and energy. In addition all the newly printed money must find a home. With interest rates at near zero levels, saving is not an attractive option and money will find its way into higher-yielding equity markets and speculative investments, again inflating their prices and adding to the overall inflationary effect.

Inflation in the UK now appears unchecked, with the Bank of England putting their inflation-targeted approach to monetary policy firmly on the back burner, preferring to stimulate economic growth instead. UK inflation above the government imposed upper limit seems to have become the norm (the Governor of the BoE must be running out of new reasons in his now frequent explanatory letter to the Chancellor

of the Exchequer). Indeed the latest consumer price index rose at an annual rate of 3.7% rise (against a target of 2.0%) and with the January VAT rise and recent acceleration in energy prices can be expected to hit 4.0% in the first quarter. Although the Bank of England will be loathe to do so, one must expect that both political pressure and economic sense will dictate they begin to tighten monetary policy by the second half of the year, at the latest.

Should we be concerned about this seemingly 'runaway inflation'? As we will explain later in this report there will be negative consequences for certain asset classes, (fixed income for example) which will shape our overall asset allocation modelling. However, one must keep the current situation in context; as we suggested the inflation we are experiencing now is different from that which caused so many long-term economic and structural problems in the past. Initially, the sheer magnitude of the problem is far less. Inflation is expected to peak at no more than 5% (though BoE forecasts have been notoriously wrong) far below the 20% level reached in the early eighties (when interest rates passed 15%pa!). It is not a fair comparison.

Secondly, the drivers behind the recent inflation are not due to an 'over-heating' economy. We do not have full employment; with the consequential upward wage pressures, nor are we in a situation where raw material prices are being inflated by excessive production demand. We are actually facing inflation caused by a VAT increase (up to 20% in January) and a rise in the world price of oil (nearing \$100/barrel) and rising food prices (mainly due to numerous crop failures). Therefore, will an increase in UK interest rates have any effect on these factors? We would suggest not.

The positive effects of inflation at this time however cannot be ignored. Today we are facing a 'debt-crisis' and as identified by Keynes in the thirties, inflation can be the least painful solution to easing debt related problems (deflation, default and debasing of a currency being the others). As inflation rises the real value of debt is eroded, indeed Inflation running at 4%, for instance, would virtually halve the debt burden in less than ten years. In addition to this an upward wage pressure would move some into higher tax brackets (increasing much needed tax revenue). Wage increases could actually fall behind inflation, as many firms abandon an inflation-pegged pay policy, easing pressure on firms and critically reducing overall demand within an economy without actually increasing unemployment. Nobel Prize winning economists Franco Modigliani and Robert Solow once suggested that society as a whole probably functions better and is happier with 5% inflation and 5% unemployment than with 1% inflation and 9% unemployment. Let us not forget the lessons of Japan where twenty years of near zero (and often negative) inflation has saddled the country with a debt burden of almost 200% of GDP (the UK is nearly half of this) with no possibility of reducing it in sight.

We therefore believe that modest inflation will actually prove beneficial for the UK economy and, if kept at levels below 5%, will aid our ascension from the current crisis. It is worth noting that inflation in the US and Europe is far lower than the UK making their debt issues even more serious. We do not believe therefore that we are heading towards the abyss of 'stagflation'; negative growth and rising inflation and that our theory of positive economic growth for the UK this year remains intact.

How Do We View the Various Asset Classes in 2011?

EQUITY MARKETS, in our opinion, will post a third year of solid gains, though they will be subject to similar volatility that we witnessed throughout 2010. Overall, we would expect equity markets of developed countries to range higher and end the year with estimated gains of between 12% and 18%. It would be foolish to predict this to come as a result of a steady gain month on month but rather, as last year, to be generated by periods of strong performance followed by periods of fear and uncertainty. Further shocks to the market cannot be discounted and when they arrive many will question the ability of the markets to bounce back; but bounce back they will. A concerted effort by central banks and governments around the world to underpin the current recovery will ensure that the markets are given every opportunity to prosper. Both companies and individuals have taken advantage of historically low interest rates to reduce debt and rebuild their balance sheets. Corporate profits continue to improve, which combined with the observation that stock market performance is now lagging behind a noticeable recovery in GDP, suggests that further appreciation is highly likely. With governments effectively making every other asset class unattractive, through low interest rates and warnings over inflation, investor appetite for equities will remain unabated during 2011. We expect strong inflows from bond funds back into equities over the coming year. With alternatives to equities seemingly less and less attractive we see a liquidity driven impact on equity returns.

An unconstrained approach to UK equity investment will generate higher gains. During such a period we believe that UK focused fund managers that are unconstrained by tracking any specific benchmark will again find rich pickings within the equity universe and generate positive alpha during the year. A clear divergence has, and will continue, to emerge between those companies positioned to benefit from a new era of economic growth and the international growth that will continue. Managers that can identify and exploit these trends will outperform managers more tied to index tracking methodologies. We expect a number of themes to emerge; international presence and economies of scale, for example, will have an important bearing on company valuations and revenue growth during 2011. These characteristics are typical of many of the larger capitalisation stocks listed on the UK stock market – expect them to outperform smaller capitalisations stocks for the first time in two years.

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