HARGREAVEHALE

INVESTMENT BULLETIN

Fog Clearing

28th June 2011

About the Investment Bulletin:

- It is issued as a marketing communication.
- In its preparation, we are not obliged by FSA rules to comply with legal requirements designed to promote the independence of investment research; which include a prohibition on dealing ahead of the dissemination of investment research.
- It is not intended to address the circumstances of any particular individual or entity and it does not constitute a personal recommendation.
- The opinions and suppositions contained within the Investment Bulletin are those of the author and are held at the time of issue.
- All information contained in it is believed to be correct at the time of issue but cannot be guaranteed.
- Prices quoted in this newsletter are indicative market prices only. Prices are taken at the times stated.
- The main assumptions we have used are included in the text.
- The bulletin has not been disclosed to any of the companies referred to herein
- The bulletin will be issued on a monthly basis. However, we are not obliged to provide any updates on any of the investments previously recommended. Due to market conditions any opinions and recommendations included in this document may change without notice at any time after the document is issued.

Risk Warning - Please be aware that the capital value of, and the income derived, from any market investment can go down as well as up. Investors may not get back the original amount invested. Significant losses can be made even on 'low risk' investments. Past performance is not necessarily a guide to future performance. If you are not prepared to accept these risks to your capital please do not invest in the securities referred to herein.

Conflicting Interests - Conflicts of interest may affect the objectivity, independence and impartiality of this newsletter. Hargreave Hale Limited, its officers, employees, representatives, associates and directors may have already acted on the information contained in this newsletter and may have previously bought or sold, or may have a material shareholding or other interest in any of the mentioned investments. They may have provided significant advice or investment services in relation to these companies in the last 12 months.

Please read the important information at the back of this newsletter. More information is available on our website www.hargreave-hale.co.uk. Hard copies are available on request at any of our offices, for readers who do not have internet access.

Registered and settlement office: 9-11 Neptune Court, Hallam Way, Blackpool FY4 5LZ
Telephone: +44 (0) 1253 754700, www.hargreave-hale.co.uk
Member and SETS Participant of the London Stock Exchange, Member of the PLUS Market, Member of APCIMS
Authorised and Regulated by the Financial Services Authority, no 209741
Incorporated in England and Wales, Company Number 3146580. Telephone calls may be recorded.

HARGREAVEHALE

Fog Clearing

As some wag on the FT wrote last week; "Forecasting is a difficult game, particularly if you are forecasting into the future." Fog is on the brain because the Governor of the Bank of England made reference to it in his statement on Friday. The Chairman of the Fed did not actually refer to it last week but he did admit to being a bit bemused .He said: "We can't explain the entire slowdown in the US.....growth at least in the near term might be a little less than we anticipate." If two people who should be in the know aren't, what about the man in the street? The European Gaming Regulator, AAMS has released data for May which indicates that the volume of punting on the State lotteries in Italy is growing at the unprecedented rate of 22% year on year. Makes sense. No details of what is going on in Greece and Portugal seem to be available.

The fog is going to clear because the quantitative easing (QE) programmes are coming to an end. A lot of mumbo jumbo best defined by Wikipedia as follows: "A Central Bank implements quantitative easing by purchasing assets from banks with new money that it creates electronically. This action increases the reserve assets of the banks and also raises the prices of financial assets bought, which lowers their yield."

The theory is that as a result of much bigger reserves, the Banks go out and lend. History says sometimes this happens, sometimes it doesn't. It usually depends on the state of the loan books of the banks, whether they have been written down to sensible valuations giving the banks confidence to lend again. You also need somebody to lend to. Someone who has the confidence to ask the banks to lend out some money. Somebody who is not already borrowed to the hilt.

The recent QE2 in the US was big. At $100 billion a month, the best comparison would be with US Federal Debt which is valued at around $14 trillion. The programme was 37 times the size of the World's silver supply, around 35% of the world's supply of gold. This programme is coming to an end and investors do not know what is going to happen. To answer this you have to try to assess the impact of the programme.

On the plus side, the programme has flooded money markets with cash and stopped banks in the US and Europe from going bust. Difficult to know whether this is good or bad, but QE has also resulted in a jump in asset prices world wide. Stockmarkets, prime property, commodities, emerging market currencies have all been boosted. This is because the money created by the programmes was not invested in new businesses because of lack of demand from hard up over-borrowed customers, and because the banks knew that despite the boost to their reserves from QE, they were still busted if they had to writedown their loan books to realistic levels.

In fact, the QE programme had a bad side to it. First it delayed the inevitable writedown of assets that the banks will have to make. So whilst the banks survived, their lending continued to contract. Because QE1 and QE2 had the effect of lowering interest rates and bond yields, and flooded money markets with cash, we had the flight to assets, in particular commodities and emerging market currencies. Nobody can be blamed, for money goes global if real interest rate returns are not available in the West.

The reason Bernancke has stopped the programme was not just because it was starting to fuel inflation in the US, but because it was starting to trigger much larger inflation from an already higher inflation base in the emerging market economies. And as these so called BRIC economies remain the only serious engines of growth remaining, to threaten them with even higher interest rates in response to higher inflation was unwise. QE flows of cash from the West started to dislocate these economies because the cost of food as a percentage of total consumption was becoming too high. The Arab spring and food riots in China are obvious symptoms of the malign impact that commodity speculation fuelled by QE2 was having on the BRIC economies.

Ending the printing of money by Western Central Banks could have extremely interesting consequences. It could increase the rate of divergence between the West and the BRIC economies. Western consumers will benefit in a number of ways, in particular from falling commodity prices. It would be odd if the recent nnouncement by the International Energy Commission was not in some way coordinated with the US Fed. For three months dozens of senior oil officials from the US, South Korea, Germany and Japan worked on the biggest release of strategic oil reserves onto the open market since the creation of the International Energy Commission in 1974. The plan was said to have been masterminded in the White House, but the timing is interesting. It is saying that policy makers in the West are looking at other ways to boost economic activity, by lowering costs to consumers. They are also starting to chivvy the banks to recognise the real value of their loan books in an attempt to get the banks to restart lending. Yesterday Mervyn King said; "the UK banking's most severe problems may lie in commercial real estate, for which regulators do not even have the most basic data on forbearance. Studies suggest that 30% to 80% of commercial mortgages may be in forbearance." No wonder Mr Clegg is so happy to give the taxpayer RBS and Lloyds.

But the most interesting remark made by Mervyn King was about the difference between liquidity (QE 2) which can buy time, and solvency which has yet to be addressed. He also incidentally warned against those exchange traded funds, investment vehicles that offer to replicate the performance of a group of assets, who use complex derivatives rather than buy the assets they promise to track.

Western consumers could well benefit from lower costs but unfortunately they remain in a leaden straight jacket, victims of their policy-makers attempts to reduce deficits on rolling deficit reduction programmes going forward in time, on and on, until the magic moment of budget surpluses surprises them. The tax man their persecutor, and the unemployed victims of the idea that raising taxes reduces deficits. Meanwhile the engine of growth triggered by lowering interest rates is not available.

This suggests a flirtation with deflation, which UK investors should be alerted to. This is not just because aggregate demand is stagnant and falling. It is because headline inflation of 4.5% could obscure the deflationary backdrop of the UK economy particularly now that the UK's own QE programme has been ended. Speaking at the Global Borrowers and Investors Forum recently in London, Paul Fisher, the Bank of England's Executive Director for Markets said: "It should not be assumed that the recent £200 billion QE programme is over just because inflation is more than the target level at 4.5%. If inflation gets too high, becomes embedded, we know what to do. If we get stuck in a deflationary rut, it's not clear that we have sufficient ability to get out of that very easily. We already tried £200bn of asset purchases. We'd probably have to do an awful lot more in those circumstances with no guarantee of success." Deflation can happen very quickly, usually as a result of policy makers taking no action because they prefer to rely for too long on historic inflation indexes rather than take the risk of extrapolating inflation data forward.

The reality is that Western Consumer's have to pay the price of protecting their Government's ability to roll over Sovereign debt, and Sovereign debt has to be protected to avoid their banks going bust. That said, UK and European investors are probably taking these issues too seriously because there is a less inflationary way to finance the roll-overs of Sovereign debt than QE2/3/4 programmes. Step up to the plate, China, the skill of whose policy makers makes the West's finest brains look a little inadequate.

China began diversifying away from the US dollar this year. Economists at Standard Chartered Bank say that China's foreign exchange reserves expanded by about $200 billion dollars in the first four months of the year, with three quarters of the new inflow invested abroad in non dollar assets. China has repeatedly pledged to aid European countries struggling with Sovereign debt. It makes quite a lot of sense because Europe remains China's main export market and yields look quite attractive compared to US Treasuries. During a recent trip to Portugal, Hu Jintao, China's premier said Beijing would take concrete measures to help the country including the purchase of bonds. Klaus Regling, the head of the Eurozone's Euro 440bn bail out fund, said that China has shown considerable enthusiasm for buying his agency's funds. According to the President of the China Institute of International Studies, who is also a member of China's Foreign Policy Advisory Group, "China is working with the European Union and the International Monetary fund to avoid debt restructuring by any European country."

And the task is not that demanding from a Chinese viewpoint. To get things into perspective, the Chinese are said to own roughly 25% of US credit market debt, which amounts to $53 trillion. In Europe by comparison, the market is much smaller, being $16 trillion and only a proportion of this debt is toxic or potentially toxic. So given that the Chinese currency is now rising against Western currencies at a rate of 5% to 6% a year, buying such debt gets progressively cheaper, with more than a little comfort in the high yields available, especially if you are secure in the knowledge that you yourself are financing a rollover. In addition, there are trade and other advantages involved. For example, the Chinese have asked for the lifting of a long standing arms embargo as they continue to build military capacity.

Investors who consider that liquidity one way or another will be provided to roll over Sovereign debt might well, particularly against a possibly developing deflationary environment, consider some limited investment in such debt. Treasury 4% 2016 has risen nearly 5 points to just under 110 in the last eight weeks. Somebody is ignoring recent inflationary statistics and taking the deflationary risk post QE seriously. Meanwhile UK equity investors are still best advised to avoid purely domestic businesses and concentrate even more on those UK businesses exporting product to the BRIC economies because consumer demand will be accelerating as monetary conditions ease.

It is the BRIC economies and Stockmarkets that stand to benefit the most from the ending of the QE programmes as interest rates start to fall in response to lower asset prices as the inflationary consequences of QE2 subside.

And it is the BRIC Stockmarkets that have fallen the most. For example, in the year to date, the FTSE100 is down 3.4%, and the FTSE All Share is down 2%. By contrast, the Shanghai Composite Index is down by over 20% in the last eighteen months, whilst the Indian market has fallen by 10% year to date.

This is because both Chinese and Indian Central banks were able, unlike their Western counterparts, to use conventional weapons in their fight against an inflation at least partly caused by Western QE money. They were able to impose higher interest rates and monetary tightening because they did not have the disadvantage of bust banks and over borrowed consumers. As a result they have largely completed their battle against rising inflation, and interest rates look to be near their peak. In the words of China's Premier, quoted in the FT last week: "There is a concern as to whether China can rein in inflation and yet sustain its rapid development. My answer is an emphatic yes.....our measures have worked ....the overall price level is within a controllable range and is expected to drop steadily..... the output of grain improves and there will be abundant supply.....we are confident that price rises will be firmly under control this year....."

If the long cycle of interest rises in China and other BRIC countries is ending then the imperative for UK investors to diversify from domestic equities intensifies. And the possibility, albeit still remote, of deflation in the West in the aftermath of the ending of QE adds emphasis to the need for equity portfolios to be increasingly diversified. The fog for the BRIC economies is lifting.

George Finlay

June 2011

HARGREAVEHALE

Office Network

Registered Office: 9-11 Neptune Court,
Hallam Way,
Blackpool FY4 5LZ
Tel: 01253 754700

London: Accurist House,
44 Baker Street,
London W1U 7AL
Tel: 020 7009 4900

Blackpool: 4 Neptune Court
Hallam Way,
Blackpool FY4 5LZ
Tel: 01253 621575

Lancaster: 25 Brock Street
Lancaster LA1 1UR
Tel: 01524 541560

Bangor: 2nd Floor,
30 Dean Street, Bangor
Gwynedd LL57 1UR
Tel: 01248 353242

Worcester: Virginia House,
The Butts,
Worcester,
Worcestershire, WR1 3PL
Tel: 01905 723551

Carlisle: 10b Clifford Court
Cooper Way
Parkhouse, Carlisle
Cumbria CA3 0JG
Tel: 01228 515224

Direct Deal: Virginia House,
The Butts,
Worcester, Worcestershire,
WR1 3PL
Tel: 08457 423325

Email: bulletin@hargreave-hale.co.uk

Important Information

Hargreave Hale Limited has approved this newsletter. Hargreave Hale Limited is authorised and regulated by the Financial Services Authority and is a Member and SETS participant of the London Stock Exchange, and a Member of PLUS Market and of APCIMS. The company is incorporated in England and Wales, Company Number 3146580. The registered office is: Marsden House, 4-10 Springfield Road, Blackpool FY1 1QW. Hargreave Hale Limited is an associate company of Investec Bank (UK) Limited, which is part of the Investec financial services group. Investec Bank (UK) Limited is also authorised and regulated in the UK by the Financial Services Authority.

Jurisdiction - The information herein is intended for publication to UK residents who are clients of Hargreave Hale Limited and who have read our customer agreement. It is not intended to be published or made available to any person in the USA or any other jurisdiction that would result in contravention of any applicable laws or regulations. Therefore, if it is prohibited to make such information available to you, it is not directed at you and you should not review it. By reviewing the information contained in this newsletter, you confirm that you are satisfied that you are not in contravention of any laws and regulations and that your reading this newsletter is not prohibited.

Risk Warning - The investments or investment services referred to may not be suitable for all investors. Therefore, we recommend that you consult your independent financial adviser at Hargreave Hale Limited prior to taking any further action.

Taxation - Any reference to taxation may not be relevant to all readers as it depends on the individual circumstances of each individual and may be subject to change in the future. Please consult your tax adviser before investing in any product mentioned in this newsletter.

Information - The information contained in this newsletter has been obtained from reputable sources including trading statements, financial statements and other documents issued by companies, published broker research, trade and financial journals, government issued information, trade shows, analyst visits and presentations, other publicly available information. Every effort has been made to ensure it's accuracy, although Hargreave Hale has not independently verified all the information. The accuracy of the information, the reliability of its sources, nor it's completeness cannot be guaranteed, and neither Hargreave Hale Limited nor any if its directors, officers, representatives or employees accepts liability for any loss arising from the use hereof, no representation or warranty, either express or implied is made. Information, opinions and estimates contained in this newsletter reflect a judgement of individual stockbrokers acting for Hargreave Hale Limited at the original date of the opinion's publication by Hargreave Hale Limited and are subject to change, without notice. These opinions are not necessarily those of the company or other stockbrokers acting for the company, who are not obliged to follow recommendations included in this newsletter. We are not agreeing to, nor required to, update any commentary or data contained herein. Therefore, information may not reflect events occurring after the date of publication.

Risk Profiles - The profiles used to categorise investments contained herein are in accordance with Hargreave Hale Limited's customer agreement at the time the opinion is given, which may be subject to change without notice. Copies are available at any of our offices. Shares in the FTSE 100 index are considered lower risk than those in the FTSE 250 index, which in turn is considered lower risk than smaller companies.

Liability - We shall not be liable for any loss or damage arising out of the use of or reliance on the information provided including without limitation, any loss of profit or any other damage, direct or consequential. This does not however exclude or restrict any duty or liability to you that we have under the Act or under the regulatory system.

Distribution of information - The contents of this newsletter cannot be reproduced in whole or in part without consent from Hargreave Hale Limited. If permission is granted you must not distribute any information in this newsletter to any other person without attaching a copy of this 'Important Information' and obtaining the agreement of such other person to comply with the above terms.

Data Protection - We are a registered data user in accordance with the Data Protection Act, and we will treat data we have on you in accordance with that act. Telephone calls may be recorded.

External Interests – Hargreave Hale is an associate of the Investec group of companies, but for the purpose of research documents can be considered as independent from the group as the rest of the group have no influence on the timing or the content of such documents. The Investec group may have a relationship with any of the companies covered in our research which may lead to a conflict of interest. This may involve Investec acting as a market maker or liquidity provider in the company's securities, being lead manager or co-lead manager in respect of a publicly disclosed offering of the company's securities within the last 12 months, providing investment banking services to the company, or being party to an agreement with the company to issue research recommendations. © Hargreave Hale Limited 2011