

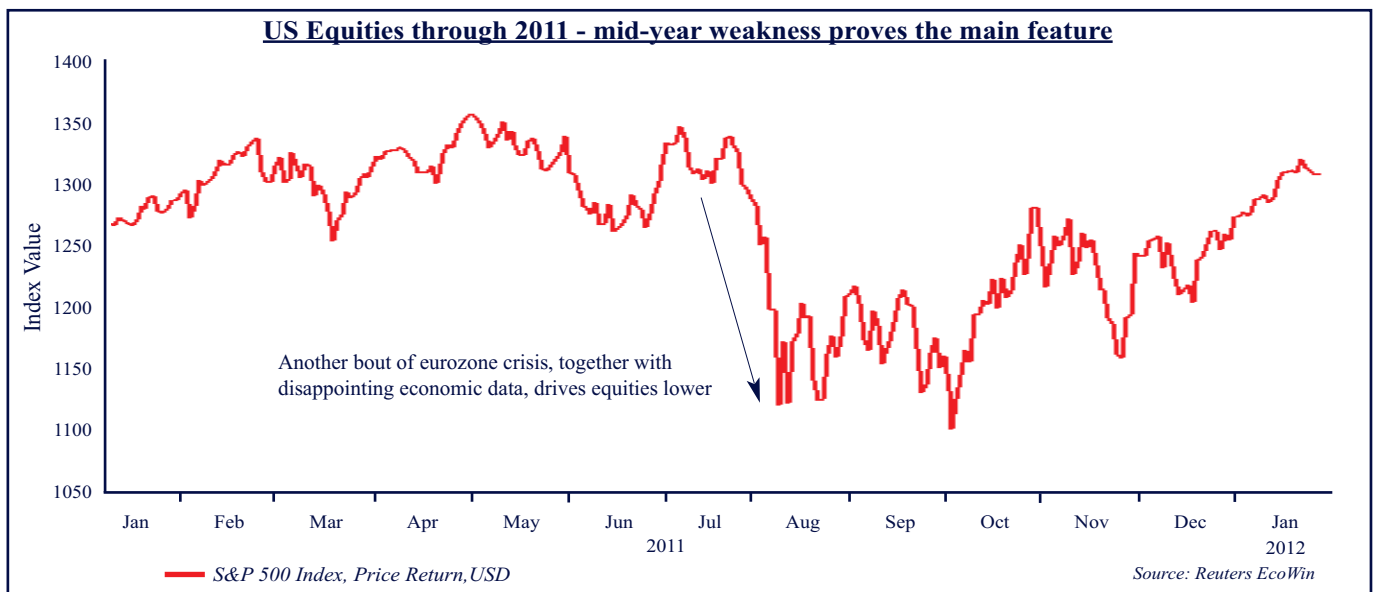
2012: RECOVERY OR ANOTHER FALSE DAWN?

January is, of course, the time for reviews and previews. In this note, we look back briefly at some key developments of 2011, commenting on how we fared in terms of our recommended asset allocations. We then consider the prospects for 2012, and provide our thoughts on the outlook for investment markets. We conclude that, while returns from risk assets and recommended portfolios were disappointing last year, developments in 2011 have reinforced our conviction that current allocations are appropriate.

2011 - Review

Twelve months ago, equity markets were surfing a sea of optimism. Investors seemed convinced that the acceleration of economic growth apparent in the final quarter of 2010 would gather momentum, share prices would move higher and interest rates would begin to normalise. As a result, government bond prices fell as investors switched into risk assets.

This optimism soon began to ebb, undermined by a weakening in economic data and outlook surveys. By summer, optimism had faded entirely; another Greek bailout looked inadequate as soon as it was announced, and fears of contagion to other nations on the eurozone periphery spread rapidly. In response, equity markets fell sharply (see chart below).



Autumn saw steeply rising government bond yields in those struggling nations locked inside the eurozone, including ‘too big to save’ Italy and Spain, while yields fell almost as quickly in ‘safe havens’ such as the US and Germany. Concerns mounted about the solvency of some European banks and the world economy appeared to be, once more, on the brink of financial crisis. However, it is noteworthy that equity markets, while weak, refused to fall to the same calamitous extent that they had in late 2008 and early 2009.

In response to the threat of crisis, numerous emergency summits between heads of European governments, the IMF, the ECB and European Union officials took place. There was also a flood of action in individual countries - new governments in Greece and Italy and new austerity packages voted through in others. While these responses were regarded as inadequate by investors and commentators alike, their worst fear, renewed financial crisis, failed to materialise. Government bond yields in key peripheral nations, having risen to levels at which their debt burdens appeared unmanageable, receded, aided by the policy responses and a slight improvement in economic data. An air of relative calm descended and equity markets finished the year in slightly better heart.

2011 – Investment Market Experience

Despite the late rally in risk assets, 2011 was very much a ‘risk off’ year. The best returns were achieved in defensive assets such as ‘safe haven’ government bonds, particularly those offering protection against inflation. By contrast, global equities, as measured by the MSCI World Index, lost 7.3% over the year. Here in the UK, the FTSE 100 Index lost 2.2% on the same, total return, basis. Developed world equities, with the exception of continental Europe, fared better than emerging markets.

Portfolios recommended by Saunderson House benefited from allocations to index-linked bonds, fairly low allocations to equities and heavy weightings towards developed, rather than developing, market equities. However, our corporate bond holdings did not prove as defensive as government bonds and our reallocation early in the year towards strategic bond funds, to protect against the risk of rising bond yields, proved to be an unnecessary insurance. As a result, over the year, our more defensive recommended portfolios made little or no progress while those with higher allocations to risk assets generated small losses. However, despite a lacklustre 2011, 3-year returns remain strong, with portfolios showing high single-digit annualised returns, despite the challenging investment backdrop.

2012 - Preview

Early 2012 bears an uncanny resemblance to its predecessor. Survey evidence and economic data releases are now pointing to strengthening activity, particularly in the US, and equity markets have responded accordingly, with the S&P 500 Index gaining 5.4% in the first four weeks of the year to stand more than 20% above its early October low. Like 2011, this upward impulse has been provided by policymakers. In early 2011, economies and markets were buoyed by the impact of the Federal Reserve’s QE2 programme of quantitative easing (delivered in quarter 4 of 2010). This year, the updraft has been provided by the ECB’s liquidity facility, which injected €489bn into the European financial system in December 2011. This has soothed frayed nerves and helped ease pressure on peripheral eurozone bond yields, in turn dispelling concerns about renewed financial crisis and a repeat of the deep recession of 2008/9.

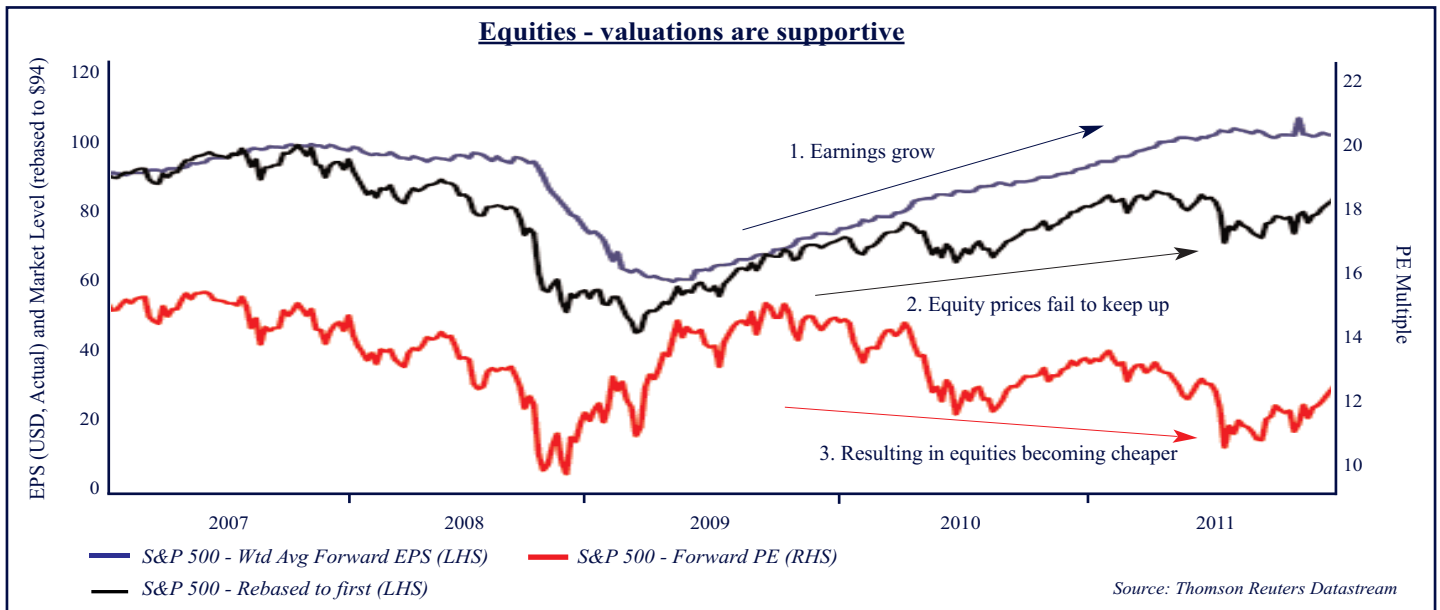
This resemblance begs questions such as, ‘will the better economic data endure?’ and ‘will the progress in equity markets reverse, as it did last year?’.

In answering these questions, it is useful to consider some points of difference between this year and last:

Firstly, and most simply, more water has flowed under the bridge. We are now more than three years from the depths of the financial crisis. The weaknesses exposed by the crisis - overvalued US housing, over-leveraged banks and the existence of too many complex financial instruments - are all now well understood and are being addressed. While issues remain, a good deal of restructuring and rebalancing has taken place;

Secondly, the policy response is firmly in place. It is clear that in developed economies monetary policy will remain exceptionally loose while banks, consumers and governments address their over-indebted balance sheets. Further measures, such as additional bouts of quantitative easing, will be forthcoming if economies remain in the doldrums.

Finally, and with regard to equity markets, valuations now look more attractive than in early 2011 as share prices have fallen while corporate earnings have continued to grow (see chart on following page). In many markets, valuations are close to the low levels reached in early 2009. While equities could fall further, in our view it will take a severe recession, with steep falls in company earnings, to bring this about.



2012 – Outlook and Conclusions on Asset Allocation

These points lead us to conclude that the global financial system is slowly healing and that, while economic conditions are still far from normal, developed economies should be able to continue to grow, albeit slowly. They will remain hampered by structural issues, but supported by policy action and secular growth in emerging markets. With respect to equity markets, while many commentators remain highly cautious and another disappointing year cannot be ruled out, the valuation case is increasingly supportive.

Turning to asset allocation, of all the events of 2011, the key moment in our view was October's confirmation by the Bank of England that a further £75bn of quantitative easing would be undertaken, despite inflation in that month being 5.2% - almost three times the mandated target. This, to us, was a clear signal that monetary policy has taken on a new direction. Both governments and central banks need growth in order to dilute away the debt hangover from the crisis. Whether this growth is real or nominal (i.e. the result of inflation) is a secondary issue. Central banks will keep the monetary taps fully open to achieve this. As investors, we believe it is unwise to expect them to fail. To this end, we restate our conviction that investment portfolios need to be protected from inflation and exposed to nominal growth. This is achieved by holding real assets.

We therefore continue to recommend a combination of equities (where companies can respond to inflation by raising prices), property (where rents are usually linked to inflation), index-linked bonds, and strategic bond funds where managers can collect attractive yields but have the flexibility to take out protection against the losses that would come with rising interest rates and bond yields. We are encouraged by developments in 2012, to date.

This note is for general guidance only and represents our current understanding of law and HM Revenue and Customs practice as at 27 January 2012. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments and any income therefrom can go down as well as up and you may not get back the full amount you invested. Levels and bases of, and reliefs from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor. Saunderson House Limited is authorised and regulated by the Financial Services Authority.