

Investment View January 2012

2012 looks set to be another year of volatility and uncertainty for investors as the developed world continues to deal with reducing debt and spluttering growth. Although the Eurozone's debt crisis seemed to reach new heights of urgency in 2011, political leaders are still struggling to find a definitive solution that will preserve the European monetary union's stability and credibility. Meanwhile the region slides closer to recession.

In the US, the run-up to the presidential election will put debt reduction, job creation and revenue increases 'front and centre' in 2012, though it seems likely that campaigning will crowd out any significant action, even as increased austerity measures bite. Meanwhile, emerging markets should be a beacon of light for global growth, though their growth rates are slowing, and leaders face the delicate task of diversifying their economies away from a heavy reliance on exports to more domestic consumption. Many of these issues could come to a head in 2012, with markets twitching to new information, both good and bad.

The degree of volatility in financial markets in 2012 will depend on how politicians, regulators, central bankers, companies and households react to a series of problems and threats.

Unlike in the Financial Crisis of 2008 the global economies of today are less in unison now with some facing inflation problems and others enduring slow growth. The US economy has moved away from the double-dip concerns seen in the early summer and is now expanding at a 2-3% rate. Confidence is picking up and the outlook for employment growth is improving. The Japanese economy has recently slowed, following the initial burst of activity after the March disaster. However, from spring of this year the latest reconstruction budget should help to boost growth back towards the 2-3% range. In contrast, many economies in Europe are entering recession - the only debate is whether the downturns will be severe, as in Greece or Spain, or moderate, as in the UK and France. Only Germany amongst the major EMU economies looks set to see positive growth in 2012.

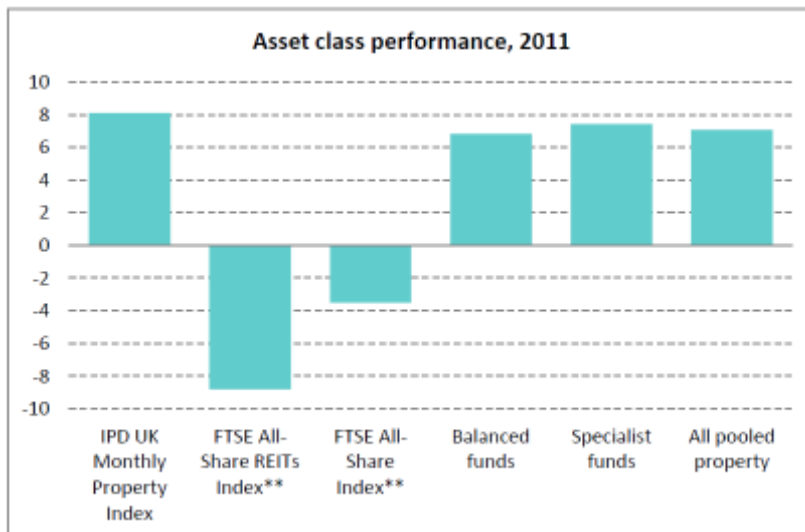
The good news for Europe is that the latest actions by the ECB, in cutting interest rates and ensuring that the banking system has sufficient funds, look to be sufficient to prevent the financial system from seizing up. The bad news is that European leaders are making only slow progress in trying to resolve the sovereign debt crisis. This has severely damaged consumer and business confidence causing unfortunate delays to investment and spending plans. Even Germany faces risks as some of its major export markets, such as India and China, are clearly slowing. At the end of last week Standard and Poor's (S&P), which had threatened European downgrades at the end of last year, implemented them across nine countries including France and Italy. This leaves a very small number of AAA ratings in the Eurozone area; Germany and the Netherlands are the two crucial ones. S&P cited a lack of sufficient progress in policy to reduce deficits as the catalyst for their decision. The downgrades had been widely expected for some time and the spreads of the more affected countries had already widened in anticipation. Therefore, while there was some volatility in yields and share prices on release of the news, it was not spectacular. European equities finished only very slightly lower than they started which provides some reassurance that expected bad news is already priced in.

Some would suggest that the positive start to 2012 is little more than a typical January effect in which stocks tend to rise at the beginning of the year but Standard Life suggest there is more to it than that. In part, they believe the upward moves of January can be attributed to the fact that many investors (including active fund managers) came into the year underexposed to risk assets following a disappointing 2011, and who are at this point beginning to put their cash to work

So what will it take for the market's winning ways to continue in the year ahead? Many now seem cautiously optimistic that acceptable returns for stocks will not require strong economic or earnings growth this year, nor will they require significant upside surprises. As expectations and investor sentiment are quite depressed, if the world is able to avoid major accidents and policy mistakes and if existing sources of risk are contained, hopefully we should begin to see some decline in volatility levels and a reduction of investor uncertainty and fear. These trends, in turn, should allow more investors to move back into the markets.

Although there is a great deal of uncertainty about just how 2012 will pan out there are some outcomes that seem more predictable than others. These include: the US economic outlook looks to be relatively firmly based; although the profits environment is under pressure, it should remain

positive as long as a deep global recession is avoided; corporate balance sheets generally remain healthy, a cushion to future shocks; core inflationary pressures will be limited due to restraints on wages and salaries; interest rates will stay anchored in most countries but are likely to fall further in some, such as in Europe and Brazil. More central banks will be tempted to adopt or expand various forms of quantitative easing (QE), notably the ECB and the Bank of England; and there will be increased political uncertainty in 2012 due to the number of elections; hence the gap between fiscal rhetoric and fiscal reality could become very large indeed. "Watch what they do, not what they say".



Through the recent downturn in markets property has sustained the recovery from the crash of 2008/9. Property funds outperformed equities in 2011. Property remains a key component in most client portfolios and it is anticipated that further steady growth should be achieved over the current year.

We continue to support Corporate Bonds and High Yield Bonds. Confronted with a dysfunctional banking sector and historically low interest rates, companies

have been turning to credit markets, both to raise fresh capital and to refinance existing paper more cheaply. Even cash-rich companies, with no immediate requirement for funding, have been keen to take advantage of the relatively cheap borrowing costs. Gilts and Treasuries remain poor value and are avoided at present, with judicious profit taking on existing holdings particularly index linked stock.

Our focus for equities in 2012 will be to further develop the globalisation of portfolios with an increase in our North American and Emerging Markets exposure. We also continue to be committed to building equity income into portfolios and we will now be extending this theme beyond the UK and introducing Global Equity Income funds. Although we do expect some equity growth, we consider equity income be a key performance component during the continuing uncertain and fragile market conditions.

We remain cautious on European equities as political risk and tighter fiscal policies may put a brake on activity, but we feel the fear factor does offer good value for long term investors with some sectors probably having been oversold. One of our preferred European large cap funds, BlackRock Continental European, has risen by over 8% in the last month, while even smaller companies such as Threadneedle European Smaller Companies, used in many pre-retirement strategies, rose by 8.6%.

There are always many diverging views about Emerging Markets. The performance prospect of this market is exposed to the impact on global growth from weaker trade with Europe and negative business sentiment. Investor sentiment towards this part of the world is vulnerable to concerns over slower growth in China. On a more positive note, the fall in inflation should help the emerging economies. It is true these economies will not have such easy times exporting to the EU, as European economies slow or decline further. However, the rising numbers of people in emerging countries who have money to spend means higher domestic demand led growth. We continue to believe Emerging Markets are a key component for the long term investor especially in pre-retirement portfolios.

Few will mourn the passing of 2011. Only one in five collective funds produced a positive return last year, according to figures from Morningstar. Nevertheless, unless the world enters a global recession in 2012, equity markets should outperform bonds and cash this year. We are not suggesting that stocks will move inexorably higher and we are quite certain that we have not seen the end of market volatility. However, with reasonable earnings prospects, plus healthy dividend yields, plus a moderate improvement in valuations, there should be enough for improved returns in 2012.

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