

Outlook for 2012

Looking past the abyss

EN ESTA EDICIÓN

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1. Highlights

- 2011 proved an extremely volatile year, largely due to ongoing uncertainty surrounding the eurozone sovereign debt situation
- Growth has slowed throughout the year, with the International Monetary Fund (IMF) cutting its 2011 Gross Domestic Product (GDP) economic growth forecast for Western economies from 2.5% to 1.6%
- Developed economies – with the US a major exception - are engaged in austerity measures while the emerging world is looking to dampen its much stronger growth to stave off any threat of inflation
- Any improvement next year rests largely on the eurozone finding an appropriate solution to its problems
- Against this background, many investors have fled to what they saw as safe havens, forcing gold prices to record highs and government bonds yields to generational lows
- Short-termism is rife in such volatile markets, creating opportunities in some asset classes for investors who can take a longer-term view
- Equities currently look to offer the best value, with many corporates in solid financial shape after applying their own austerity measures amid the credit crunch strong balance sheets are allowing ongoing dividend growth
- Share valuations remain low, reflecting the muted economic outlook in the West. This ignores two key factors: that many Western companies have growing Eastern earnings exposure, and the potential for emerging market equities to benefit from the region's stronger macro outlook
- Core Western government bonds represent poor value, with short-term safe haven investing forcing yields down. In some instances this asset class currently offers the prospect of negative real returns (returns after adjusting for inflation)
- A combination of more persistent longer term inflation and the industrialisation of emerging markets favours physical assets like property and commodities. A positive supply and demand picture is also supportive for the latter
- Gold has proved popular as a safe haven but with no yield, the precious metal is challenging to value and is likely to suffer when investors want to move into more risk orientated assets again

2. Markets looked into the abyss once again in 2011

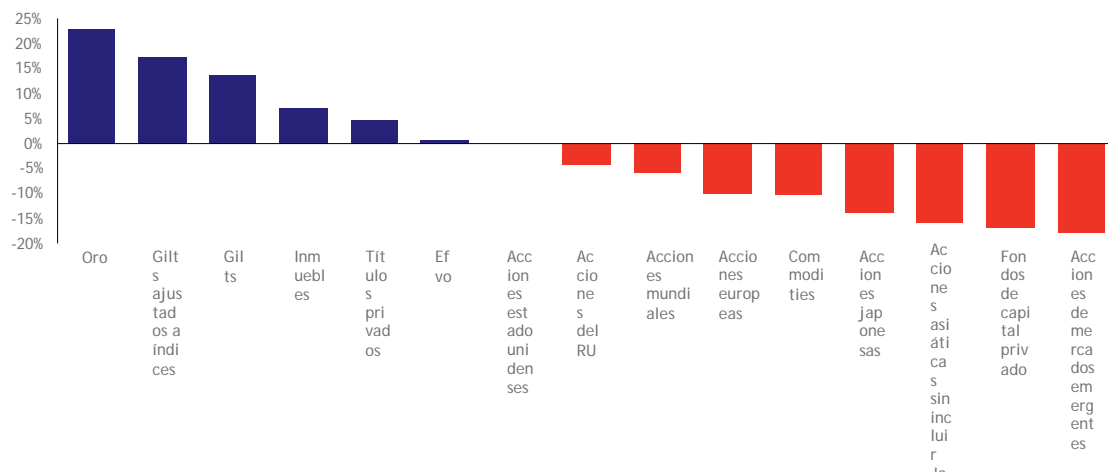
Having started the year robustly enough, the outlook deteriorated sharply as the year progressed, with investors facing the prospect of recession (and some would argue depression) and even questioning the future of the financial system. Faultlines were evident early on, with civil unrest in the Middle East spreading to Libya and resulting in oil prices rising to a two-and-a-half year high. Japan then suffered a huge earthquake, tsunami and nuclear incident in March, causing supply chain issues for much of the year.

The real test for investor nerves came over the summer. Fears centred on Europe, with many nations suffering from high sovereign debt to GDP levels, budget deficits and low growth. While this focused on peripheral Europe until the autumn, signs of contagion spread to larger nations such as Italy and Spain as bonds yields rose through 7% and 6% respectively. This in

turn put pressure on the banking sector, a significant holder of sovereign debt, and concerns resurfaced that many in Europe would need to recapitalise or accelerate deleveraging (lowering its debt levels). Furthermore, as bank funding costs rose, their ability to finance themselves was restricted, preventing them from supplying credit to the real economy. Another challenge faced by markets was one of slowing economic growth. Global growth had been recovering steadily since the end of the recession caused by the 2008 financial crisis (albeit rather unevenly, with muted growth in developed regions and much stronger figures in emerging markets).

Moving through 2011 however, this growth started to fall rapidly. In January, the IMF forecast 2011 GDP growth in advanced economies of 2.5% but had already revised this down to 1.6% by September. Emerging economies continued to benefit from structural growth drivers but were not completely immune from the slowdown in the developed world, having to raise interest rates in their battle against inflation. As a result, the IMF cut its 2011 growth forecast from 6.5% to 6.4%. All in all, the combination of slowing economic growth and fears that the euro and even the European Union may cease to exist in their current forms saw investors flee riskier asset classes such as equities and commodities, as the chart below shows. They looked for solace in traditionally defensive areas such as 'safe haven' government bonds and gold. Unusually high levels of volatility in the value of different types of investments was evident for much of the year.

Performance of major asset classes in 2011, (GBP £)



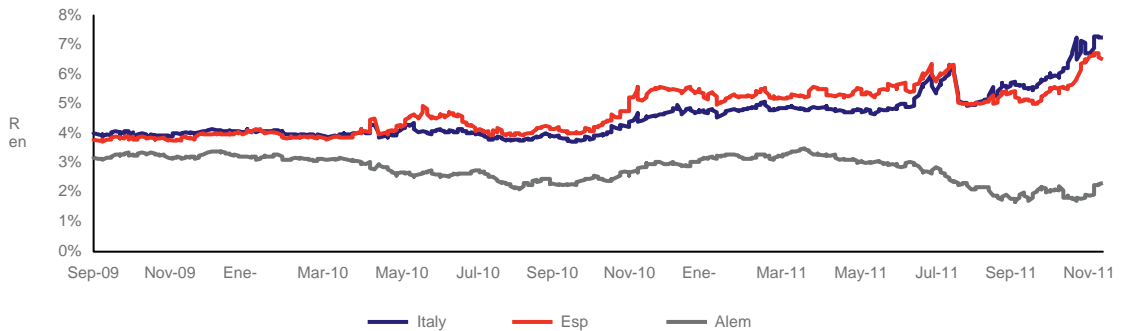
Source: Morninastar, Sterling total returns. 31 December 2010 to 30 November 2011

3. Outlook for 2012

Central to any outlook for 2012 is that European authorities deliver a comprehensive solution to the ongoing eurozone sovereign debt crisis. Officials have been applying a 'sticking plaster' approach to their problems: rather than tackling things early, politicians have only acted when faced with severe market pressure, and only then delivering just enough to stem the tide. This only served to highlight the fundamental inadequacies of the eurozone's structures. Such a too little, too late approach is rarely an answer to market problems – investors invariably move onto the next problem and often, what started as a small issue quickly escalates into something far more serious. The situation in Europe over summer serves as an example. Almost from day one, investors deemed the package to bail out Greece as inadequate.

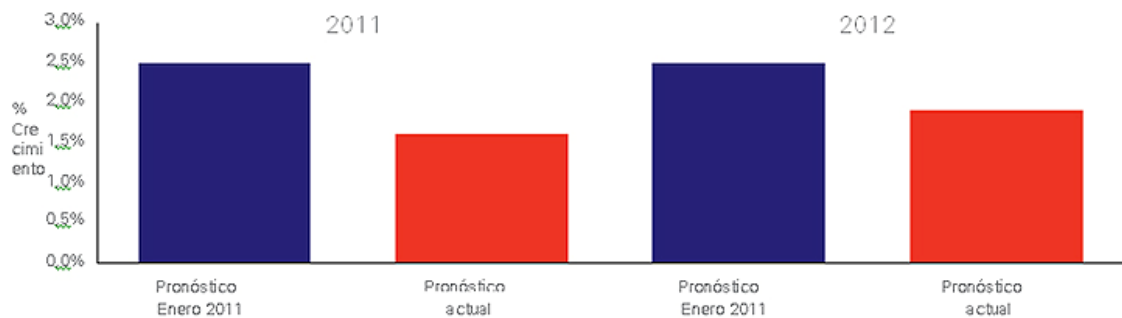
They quickly moved on to attack the systematically far more important Spanish and Italian government bond markets, forcing yields up to unprecedented levels. Global economic growth is likely to remain under pressure – as the second chart shows. This is partly due to many developed economies instigating austerity packages and emerging markets stepping on the brakes to slow a growing inflation threat – but Europe is clearly compounding the problem. Despite many European companies being in relatively robust financial positions, they have simply stopped investing, preferring to wait until confidence increases before spending their cash.

The cost of government borrowing increased significantly for Italy and Spain



Source: Reuters, from 30 September 2009 to 29 November 2011

Deteriorating economic growth for developed markets



Source: International Monetary Fund (IMF), as at September 2011

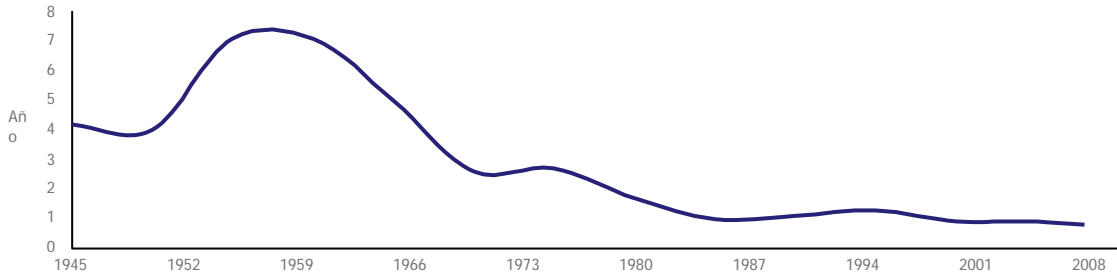
In the face of such uncertainty, how can investors position a portfolio and even continue to hold more risky asset classes? Perhaps the best answer to this is encapsulated by Warren Buffett, who said 'be fearful when others are greedy and greedy when others are fearful'.

4. The shift to short-termism

Underlying these words though is something far more fundamental. In short, markets have gone from being dominated by investors with longer-term investment horizons to being driven by short-termism. To a large degree this is understandable. When volatility is high, as it is now, investors quickly turn from targeting wealth generation to focusing on preserving it. The prospect of seeing hard-earned capital fall sharply in value is simply too much for many investors to bear. They would rather avoid riskier areas and invest in more conservative asset classes, even if the latter appear expensive in the long term. Compounding this shift to short-term investing though are some deeper, structural trends within world stock markets. Historically, pension funds were classic long-term investors. They had long-term liabilities and needed to invest in assets that could grow to meet these – importantly, short-term volatility was not a major concern and seen as a price worth paying for capital growth. More recently though, there has been a shift in behaviour, with many funds now no longer targeting future liabilities but rather focussing on contributions. The need for holding risk asset classes has fallen, with bonds doing the job regardless of whether or not they generate value in the long term. We see this as a fundamental weakness in how we fund individuals in their retirement. Further, regulation is such that many funds have been required to sell down their riskier asset classes and switch into bonds. The rise of hedge funds and high frequency investors has exacerbated this problem by accentuating volatility. To describe hedge funds as an asset class is something of a misnomer – some are rather they are a group of different investment strategies. Their common feature though is that they typically look to generate positive returns regardless of market conditions. It is this requirement that often builds in a negative behavioural aspect to the way in which they invest – if markets start to fall sharply, hedge funds often sell to preserve capital rather than looking for value, typically forcing asset prices down further (as the chart below illustrates). High-frequency traders are perhaps even worse,

often holding investments for milliseconds depending on the outputs of their computer models and further compounding short-term volatility. Here though is the opportunity for investors prepared and able to invest for the longer term; short-termism creates some exceptional investment opportunities.

US institutional investors have become more focused on the short-term

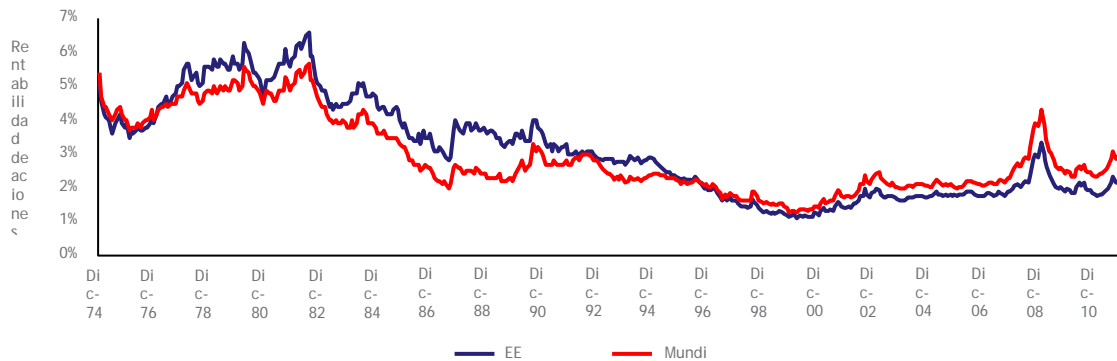


Source: Based on Morninastar and NYSE data. Goldman Sachs Research

5. The case for equities

If you can look through the short-term fog, equities offer some excellent opportunities for building wealth in the longer term, as part of a balanced portfolio. Companies, in contrast to governments and the consumer, have been managing themselves extremely prudently. While the former were building debt to unsustainable levels, companies were paying down borrowing and building cash balances. Equity dividend yields currently stand at attractive levels – as the first chart shows - compared with government bonds, while company balance sheets are enabling them to grow dividends – a very attractive combination in a low interest rate environment.

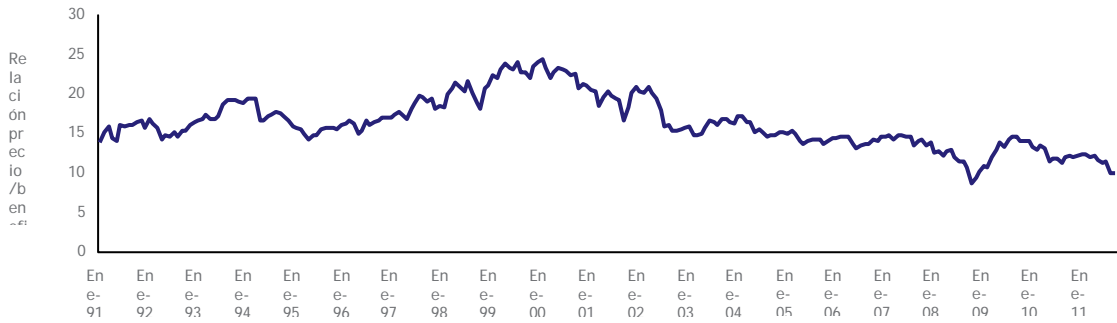
Equity dividend yields are currently at attractive levels



Source: UBS from 31 December 1974 to 30 November 2011

Valuations are also extremely low by past standards, as illustrated by the chart below. To some degree, this is justified with growth in developed economies likely to be somewhat lower than it was historically. But focusing on lower growth rates in developed economies ignores two key features. First, companies in developed markets are increasingly global in their outlook. They are not just a play on the economic growth of the country of their domicile, but instead can benefit from higher global growth.

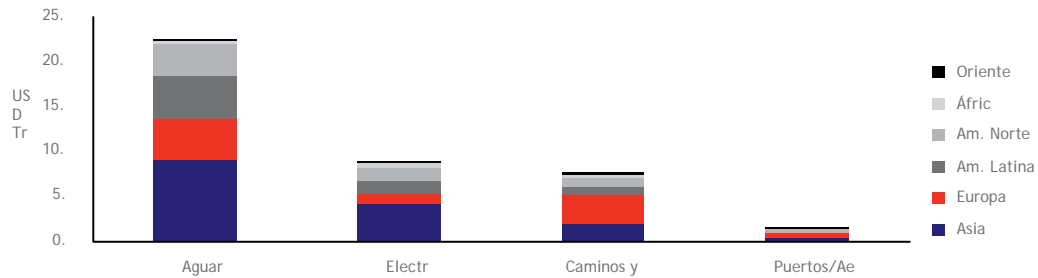
Equity valuations look attractive



Source: HSBC as at 30 September 2011

Second, emerging market equities themselves offer investors the opportunity to benefit from the positive structural growth trends exhibited by developing economies. That said, performance of many emerging markets in 2011 shows they are not self-sufficient yet, with a high reliance on exports to the developed world. As they continue to grow however, there will inevitably be greater spending on domestic infrastructure – as the chart below shows - and an increasingly wealthy population will look to consume more. This will reduce the dependence on exports and with it, make emerging market economies and possibly stock markets increasingly guardians of their own destiny.

Emerging Markets' future infrastructure requirements are high



Source: Booz Allen Hamilton, Global Infrastructure Partners, World Energy Outlook, OECD, Boeing, Drewry Shipping Consultants, US Dept. of Transportation as at 2007

6. The case against government bonds

The mirror image of this value in equities is the overvaluation within many government bond markets, with yields in many cases not sufficient enough to cover inflation. Government bonds have not only been one of the main beneficiaries of the shift to short-termism but also the long-term down trend in global inflation and interest rates. Again, much of this has been driven by emerging markets, which have increasingly become the manufacturing engine of the global economy.

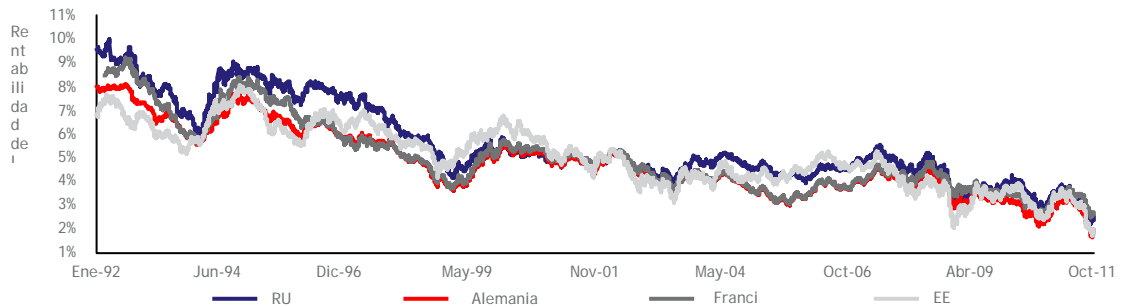
This phenomenon has had two related impacts, with both driving down bond yields. First, by exporting cheaper consumer goods into Western economies, inflation rates have been held down. Second, these exports have created significant current account surpluses within developing markets, which have in many cases been recycled into Western government bonds, further pushing down yields (as the chart below shows).

While inflationary pressures look muted in the near-term as austerity packages in the West kick-in, we see the structural downtrend in inflation coming to an end. Wages in many emerging markets are now rising rapidly as these economies grow richer and their workers demand higher wages.

Also, as the global economy rebalances over the long term, the flows into western government bonds of recent years are unlikely to be repeated. Hence bonds have been the beneficiary of an almost perfect storm - a long-term downward shift in yields, (as the chart below shows), accelerated by investors' pursuing safety in the short term. However, surely

just as the bond evangelists' calls for structurally lower yields become more vocal, investors with a long-term outlook should be avoiding an asset class with the prospect of negative real long-term returns.

Falling government bond yields

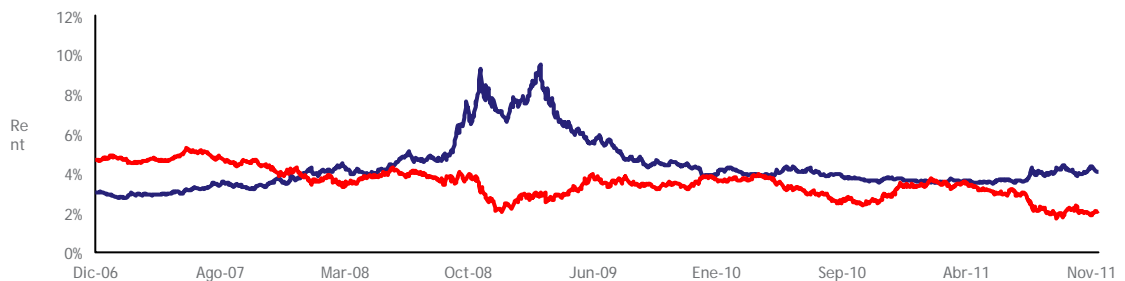


Source: Reuters from 02 Januarv 1992 to 03 October 2011

7. Commodities and property

A combination of inflation proving increasingly persistent and the industrialisation of emerging markets favours physical assets. Areas of the market such as commodities and property see their values rise with inflation and also benefit from growing demand as emerging markets urbanise. Although many commodities have seen price declines in 2011, reflecting the global slowdown in economic growth, they should benefit longer-term from the seemingly unstoppable pressures of rising demand from infrastructure projects and limited supply in many cases. Prices in the long-term are seeing significant upward pressure. Property yields also often give investors a decent uplift over many government bonds (as the first chart below shows), always an attractive feature in a low interest rate environment.

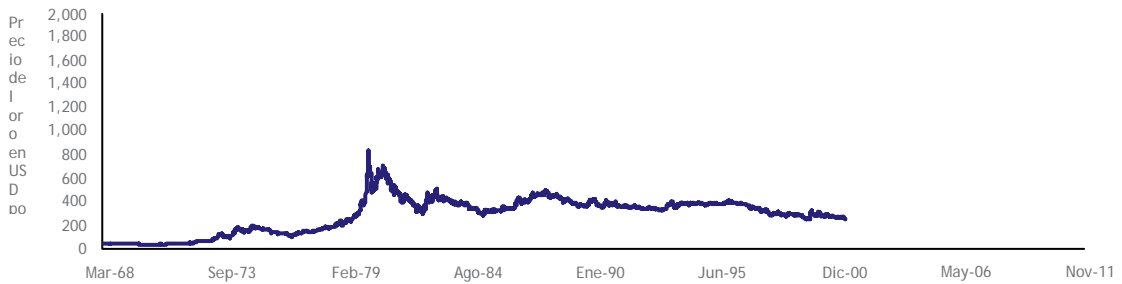
Property yields look attractive compared with government bonds



Source: Datastream from 29 December 2006 to 06 December 2011

The one exception to this is gold (as the chart below shows). To many, this represents the ultimate safe haven investment – it is a physical asset and, much to the unease of many a central banker, you cannot print any more of it. To some extent, we sympathise with this view, with gold typically enhancing portfolio returns at the same time as reducing risks. It does however have one major problem; with no return, you just cannot assign a fundamental value to it. In all probability as an investment it represents the flipside of the coin to investing in risk assets – that is, the more people avoid risk assets, the more they will look to buy gold with their capital. When risky assets turn though, you really do not want to be the last person holding gold.

Gold is seen as a relative safe-haven



Source: Reuters from 03 January 2005 to 30 November 2011

8. Our outlook for the asset classes

UK EQUITIES

While the outlook for the UK economy remains subdued and dependent on developments on the eurozone, we have a more positive view on UK equities. They benefit from significant exposure to international economies, with global GDP arguably a more important driver of UK equities than UK GDP. Unlike the UK government, many companies enjoy robust balance sheets and the equity market also tends to exhibit defensive characteristics, which should be supportive in times of economic uncertainty. Valuations are attractive, on a forward earnings ratio of about 8.6 times (compared to a 10-year average of about 14 times) and a dividend yield of about 3.6%. Furthermore, Sterling investors in UK equities would benefit from any depreciation in the currency, which may result from extended quantitative easing by the Bank of England and further weakening in the economic outlook.

Positive

CONTINENTAL EUROPEAN EQUITIES

Prospects for continental Europe remain dominated by the eurozone debt crisis and the ability of politicians to arrive at a permanent resolution to the problem. European equities trade on a low multiple of 8.8 times forward earnings, implying the asset class offers significant value should a solution be found. However, the debt crisis is already having an impact on the European economy with Purchasing Managers Index (PMI) manufacturing and services indices moving firmly into contraction territory in October. A break-up of the eurozone, which is not our central scenario, would have severe negative implications for the European economy and equities would likely see significant downside in this event. But the effect on individual companies is likely to vary considerably, particularly due to the re-emergence of currency risk and potential balance sheet impacts.

Positive

US EQUITIES

The outlook for the US economy remains tough, particularly as unemployment is stubbornly high at about 9%, with consumer spending a key driver of growth. However, the US does appear to be seeing stronger growth than other developed economies. This may provide some support to 2012 corporate earnings, at least compared with other developed markets, especially if economic stimulus measures are extended into 2012. Although valuations are somewhat higher than for other developed markets, with a 2012 forecast price/earnings ratio of 10.9 times, we consider this a fair premium given the stronger economic momentum and lower tail risks compared with Europe. Political deadlock has been a severe impediment to the US dealing with its budgetary problems, with the country standing alone among major economies in not enacting fiscal austerity. 2012 sees presidential and congressional elections and we would hope that post the primary stages of the contest, which are likely to see candidates appeal to their narrow party bases, they seek common ground and realistic ways of resolving the long-term budget pressures.

Positive

JAPANESE EQUITIES

Japanese equities frequently traded in a disconnected manner from other markets in 2011. Like other equity markets, valuations remain attractive, particularly if Japanese companies can boost their levels of return on equity, although this is likely to be a longer-term

development. For 2012, Japanese equities are likely to be affected by the slowdown in global growth, while the appreciation in the yen is also likely to dampen corporate performance.

Positive

EMERGING MARKET EQUITIES

Powerful longer-term phenomena such as industrialisation and urbanisation, as well as more robust fiscal positions, underpin our positive view on emerging market equities. We continue to see stronger growth from emerging economies compared with developed economies in 2012, albeit at slower rates than previously. Emerging market equities have underperformed developed market equities in 2011 and there is some risk further downward revisions in global growth could lead to them continuing to trade as higher-risk plays rather than reflecting the superior structural features of their economies. However, valuations are attractive with aggregate emerging market equities trading on about 9 times next year's earnings, against a 10-year average of about 11 times. Eastern European equities are exposed to the risk of a credit crunch as deleveraging banks withdraw credit from the region. Within Eastern Europe, we favour Russian equities, where valuations remain low at about 4.9 times earnings (against a 10-year average of about 8 times) and the country is a play on oil and other hard commodities where we have positive views. The outlook for the oil price represents the key risk for the asset class and a more pronounced economic slowdown, which will likely lead to a material fall in the oil price, would be particularly negative for Russian equities, although this is not our central scenario. Political risks also remain, particularly in a presidential election year.

Latin American equities are also extremely attractively valued on a P/E ratio of 9 times 2012 forward earning, compared with a five-year average of 11.4 times. Slowing worldwide demand and falling commodity prices have raised fears for Latin America, however, despite this, commodity supplies remain tight overall and, so far, the likelihood of a crash similar to that of 2008/2009 seems low. Should there be a prolonged downturn, the region's economies have many tools at their disposal to counter this – for example, there is ample room to cut rates if necessary (Brazil has already started this measure). On a macroeconomic level, many LatAm countries are in better shape than their developed market peers, with higher levels of consumer confidence and solid fiscal accounts.

Positive

ASIA EX JAPAN EQUITIES

The slowdown in global economic activity has had an impact on Asia ex Japan, given its relatively high levels of exports to developed countries. However, we still view the economic backdrop favourably, with its economies offering stronger growth than the developed world. Inflation is showing signs of moderating and we could see loosening monetary policies in 2012, which we would regard as positive for the region's economies and equity markets. Within Asia ex Japan, we favour Chinese equities where valuations are low in our view, with the market trading on about 8.2 times 2012 earnings, significantly below the market's 10-year average of about 12.5 times. There are risks the rapid rises in residential real estate prices could reverse and become destabilising to parts of the economy, but overall, we forecast a soft rather than a hard landing for the economy and forecast 2012 economic growth of about 8% in a year due to a foreseeable change in the Chinese leadership.

Positive

UK GOVERNMENT BONDS

The UK government's extensive austerity measures have ensured interest rates remain low, particularly in comparison with some of the more distressed sovereign bond markets in the eurozone. The UK is increasingly seen as something of a safe haven. Furthermore, as the expected path of inflation has fallen, the Bank of England has expanded its asset purchase programme. These events have seen government bond (gilt) yields fall to levels we do not believe offer attractive return prospects, particularly given current inflation rates. In the absence of an improvement in the UK's macroeconomic data, yields may well remain at low levels for some time, although constructive steps to resolve the eurozone sovereign debt crisis could see gilt yields rise and prices fall, as the safe haven premium of the market is reduced.

Negative

EUROPEAN GOVERNMENT BONDS

The outlook for the eurozone economy has significantly deteriorated over the last quarter. Economists are now forecasting a mild technical recession (two consecutive quarters of negative real output growth) in 2012. Countries with high debt and/or budget deficit ratios witnessed their funding cost surging to all-time highs since the euro was launched, with Italian and Spanish yields causing particular concern. Even core economies supposed to be immune to peripheral contagion saw government bond yields rising well above corresponding German

benchmark yields. The probability of a eurozone break-up has increased, but although the situation is difficult to predict, we would anticipate politicians will eventually establish a decisive programme to restore market confidence as the collateral damage would be so severe. This may imply a stricter application of a revised Stability Growth Pact over the medium term, opening the way for a more drastic involvement of the European Central Bank in the short term. Overall, we are cautious on the more 'distressed' European sovereigns as well as on German Bunds due to the low yields on offer, with a resolution to the eurozone's problems leaving Germany with additional financial obligations.

Neutral

US GOVERNMENT BONDS (TREASURIES)

US government bonds (treasuries) yields remain extremely low despite investors losing confidence in the role of political institutions to tackle fundamental budgetary problems. The US Congressional Budget Super Committee failed to reach a bipartisan deficit reduction agreement after three months of intense negotiations, despite a similar political deadlock over the summer leading to the US credit rating being downgraded by one notch by Standard & Poor's. More positively for treasuries, the Federal Reserve decided to lengthen the average maturity of its treasury holdings by selling USD400bn of short-dated securities and purchasing longer-term bonds. They also committed to keep Fed fund rates low for a longer period of time. Notwithstanding Federal Reserve actions that are currently supporting prices, we remain cautiously negative on US treasuries as an asset class. We believe the positive surprise seen in economic data can continue and should the eurozone reach agreement on a lasting solution to its sovereign debt crisis, the safe haven premium embedded in US treasury prices may start to evaporate. This would force yields to rise to levels more reflective of the current economic and fiscal backdrop.

Negative

CORPORATE BONDS

Concerns over the difficulties facing Greece and other troubled European nations, as well as slowing economic momentum, led to corporate bonds underperforming the government bonds in 2011. Financial issues were weaker than non-financial, largely dictated by the extent of their exposure to peripheral Europe. Debt with less priority for repayment within the capital structure – such as Tier 1 instruments – suffered most. Corporate bonds issued by other non-financial sectors also suffered due to contagion effects and an increased expectation that companies will fare less well if the economic backdrop deteriorates. The poor performance of corporate bonds in 2011 has seen yield differentials over the safest sovereign issuers rise to relatively attractive levels, particularly if fears of a double-dip recession are overdone. Therefore the asset class looks attractive on a forward looking basis.

Positive

SOVEREIGN EMERGING MARKET DEBT

Emerging market debt markets have seen a transformation over recent years, with countries showing significantly improved fiscal positions and trade balances as well as robust economic growth. Valuations remain reasonable and we see emerging market sovereign debt outperforming the 'safe haven' developed economy bond markets, the latter of which offer very low yields to investors in our view.

Neutral

PROPERTY

We are broadly positive on property as an asset class. It offers an attractive yield uplift over government bonds, which should persist as central banks maintain accommodative monetary policies. Asia Pacific has the strongest fundamentals, although rental growth may moderate should the global economy slow. High levels of US unemployment and the tough outlook for the European economy are likely to provide a challenging environment for rental growth.

Positive

GOLD

Low interest rates, and the prospects for further liquidity brought to the market by governments in developed economies, have been supportive for gold. We remain alert to the risks that a bubble could be forming in the asset class. The sharp sell-off in September 2011 indicates gold is not necessarily defensive and could see significant downside in the event that the world's imbalances are corrected and the uncertainty lifted. This risk and the difficulty in valuing gold makes us wary of holding significant positions over the longer term. However, as it can provide something of a hedge to extreme negative events, we continue to advocate modest holdings in diversified portfolios while the outlook for the global economy remains so uncertain.

Neutral

COMMODITIES

We believe hard and soft commodities offer the prospects for attractive longer-term returns, given continued demand growth from emerging markets. This is growing from a low base, and supply remains restricted due to a decline in mining capital expenditure post the 2008 financial crisis. Many commodity markets have seen declines in 2011, as economic activity has slowed. However, as emerging economies are the key drivers of demand growth and we do not forecast a global recession, we believe the price declines seen in 2011 are corrections rather than the end of positive longer-term trends.

Positive

CURRENCIES

Many currency markets have been driven by similar factors as equities and bonds, such as the Swiss franc, for example, which has seen significant appreciation. We would see a resolution of the eurozone sovereign debt crisis as positive for the euro and negative for the Swiss Franc, and possibly the dollar and yen, should such a resolution be accompanied by a wider increase in risk appetite. Longer term, we see the emerging market currencies as well placed to appreciate, reflecting their long-term structural advantages, although policy actions may slow down the process.

Positive

9. Conclusion

We are keen not to underplay the risks of investing in global stock markets at present. Unfortunately the short-term direction is in the hands of politicians.

In the West, politicians are grappling with excess debt, global economic imbalances and perhaps most importantly how to solve the eurozone debt crisis in the face of inadequate governance. Conversely in Asia, they are walking a tightrope of reducing inflation without killing off growth completely. Historically, the Chinese authorities in particular have been successful in achieving this but the risks remain. This makes the short term uncertain, but for those with the luxury of being able to take long-term investment decisions, this increasingly short-term world is creating some rare opportunities to generate wealth. The start point may be uncertain but eventual upside is potentially significant.

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