OUTLOOK FOR INVESTORS IN 2012

Our conclusion on the highs and lows of the past year and, looking forward, the challenges we face for 2012.

The main topics of discussion are:

- Can Germany continue to "wriggle on the hook"?
- Immunity for the U.S.?
- China – the next credit bubble?
- Emerging Markets – best left to Q3 2012?
- Gilts
- UK Equities – Defensive stocks appear the core proposition
- The Gold Rush continues
- Commodity prices moving higher?

Few investors will have mourned the passing of 2011. A year which had begun with modest optimism increasingly became mired in a Eurozone debt crisis and fears of a double dip recession. Against this background it is perhaps not surprising that equities fared so poorly; the U.S. market managed a modest gain, the FTSE 100 'only' lost 5.5% but elsewhere it was carnage. The All EuroStoxx index was down by 17.7% and, contrary to our expectations at the start of the year, Emerging Markets were the weakest of all. Distance from a European debt crisis counted for little, since their dependency on customers in the U.S. and Europe for export led growth ensured that ever-dwindling GDP in the developed markets gave rise to a 20% fall in the MSCI Emerging markets index. Only for investors in U.S. and UK Government bonds was there reason to cheer. The strategy of 'Quantitative Easing', which was pursued on both sides of the Atlantic forced bond yields ever lower and this, coupled with the global flight to safety, produced a total return on the Government All Stocks index of 16.3% and, for the over 15 years Gilt index, the return was an eye-watering 27.7%.

Year to 30 December 2011

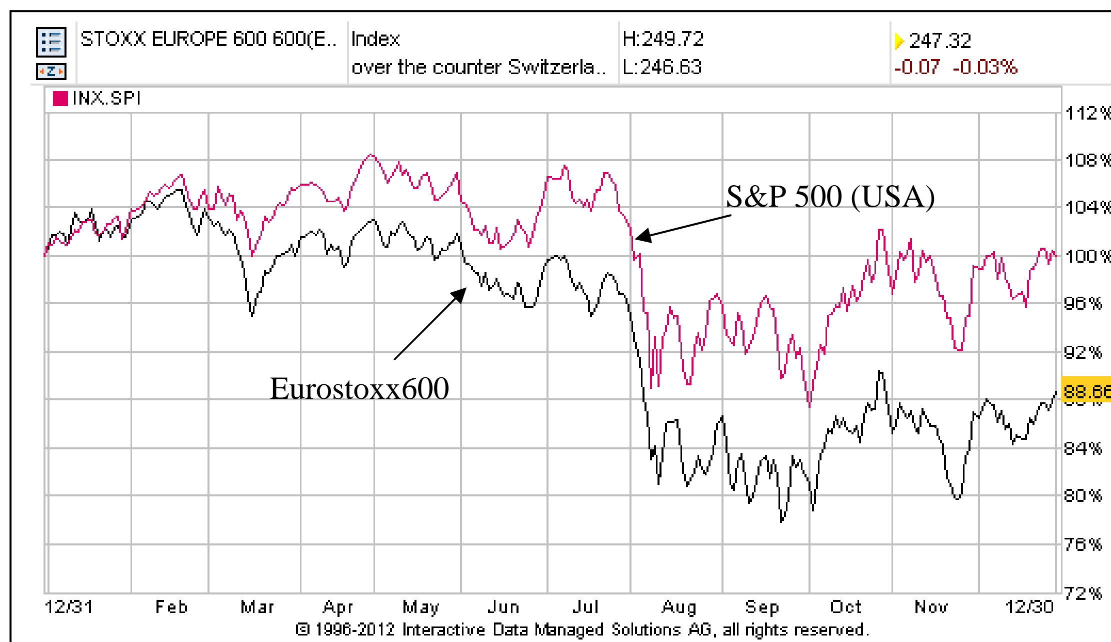
Unfortunately, although we may have entered a new year, we are still confronted with the same problems and, in particular, the over-indebted status of virtually the whole of Europe. During 2010 and 2011 we have witnessed the rescues of Ireland, Portugal and Greece along with Spain and Italy teetering on the edge of the precipice. The worry for all of us is that in the year ahead the level of debt which has to be repaid within the Eurozone will be even greater; according to figures from Citigroup which were recently quoted in the Financial Times, "In the first three

months of 2012 alone, eurozone governments have to repay €457.6bn, of which almost a quarter is owed by Italy…..Overall, eurozone governments have to repay €1.23 trillion". It is almost impossible that private investors and banks will be able to soak up such colossal figures. Default is one option, but in that case the debt becomes near worthless and whilst this would ease the burden on sovereign states it would also plunge many of Europe's leading banks into collapse and quite likely lead not just to a recession, but rather to 'depression'.

Can Germany continue to "wriggle on the hook"!
Thus, it appears to us that the need for decisive action grows ever nearer. The International Monetary Fund can help with its $387billion, but that would just about cover Italy. The European Financial Stability Fund may also be able to use part of its €450bn, but that still leaves us a long way from a resolution. Much as Germany may wriggle on the hook, the focus will shift towards them and permitting the European Central Bank to act as the 'back-stop'. It could well be that such a move would then deliver such a boost to confidence that the European Central Bank (ECB) would not need to soak up a relentless tide of eurodebt and yields would move down to sub 5% levels, where long-term viability would seem assured. Perhaps Germany has forgotten that it has been the prime beneficiary of the Euro. Moving from a highly valued Deutschemark to an inferior currency has delivered Germany an export boom for over a decade. Their income has been the expenditure of the very countries that are now awash with debt.

But what if Germany fails to permit this back-door rescue of the Eurozone ? After all, they believed that market forces should be allowed to prevail when the UK was faced with its exit from the Exchange Rate Mechanism. In our view they will not allow prejudice to overcome their own likely demise. If Greece exits the Eurozone, perhaps followed by Portugal, then for each departure from the Euro of a weak nation, the currency will gradually appreciate, to the point where investors begin to see the single currency as a diluted form of a Deutschemark. In our view this has already begun to take hold, and is one reason for the seemingly illogical strength of the Euro throughout the crisis of the past two years. But Germany cannot stand back and let this happen, since the more upward pressure that is applied to the currency then the greater likelihood that weaker members will leave.

For investors, this presents a dilemma. Logically we should have no exposure at all to European equities, given this critical background. Certainly our view has been to progressively reduce exposure over the past eighteen months to this asset class, seemingly with success- particularly when measured on a relative basis against the U.S market.



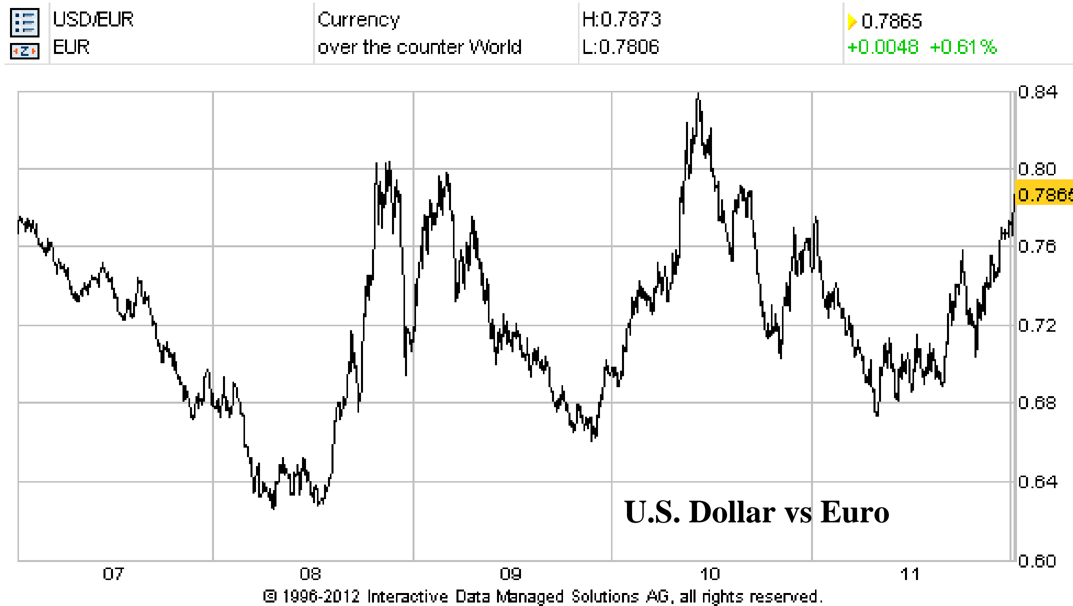
Year to 30 December 2011

On the one hand, a wholesale collapse of the European monetary system would probably see equity prices fall to below their 2009 lows, but the probability of such a scenario is not yet looking more than an outside chance. Just muddling through without any concerted action for another two years is, though, not particularly likely either. So at some point the ECB will have to step in, and at that point we might see a huge relief rally in equity prices. But before we anticipate vast riches at such a solution it may well be that action would only be precipitated after sharp falls in the price of European equities. So the safer portfolio strategy seems to be a continuation of the past year: equity rallies will be just as great in the U.S. and UK markets and these two also provide relative downside protection, so it is appropriate to maintain them as the dominant two equity asset allocations. Either way, European markets look set to under-perform other developed nations at least for the first half of 2012.

Immunity for the US?

A preference for investing in the United States is not built on the premise that the economy over there will be immune from the downturn in Europe but, given the size of the U.S. economy and its domestic bias, it is fair to assert that it will be able to weather the storm better than elsewhere. Although a fifth of U.S exports go to Europe, this, as Bank Credit Analyst Research point out, is only equivalent to 3% of total GDP. Manufacturing surveys at the end of 2011 pointed to the resilience of North America, with GDP in the fourth quarter running at an annualised 2.5%, far ahead of anything in Europe. Further confirmation of this trend has come in the first few days of the new year in the form of global steel prices. This important barometer is a very reliable measure of industrial demand, with prices still rising in the U.S. to the point where they are now some 20% ahead of those in Europe, where they continue to retreat.

Perhaps of even greater importance is that the U.S. banking system is well capitalised, following measures put in place to cope with the 2008 crisis and ongoing property debacle, and has also very limited exposure to European sovereign debt. In some ways the U.S. is a good each way bet. A recovery in global economic activity will benefit their economy, stacked full of market leading companies but a major collapse in Europe will once again see investors move to the safety of the U.S markets and, at the same time, push the Dollar higher against most other leading currencies.



From 2007 to 2011

China – the next credit bubble?

Whilst the worries that surround Europe's financial system are all too well known, if there was one potential topic that could blow up and spark its own crisis then we would point to China, and in particular its property market. There can be little doubt that the 2008 Chinese credit expansion saved the global economy, but it also had the effect of creating a domestic property bubble that not only sucked in huge quantities of raw materials, whether it be copper, coal or oil, but at the same time drove the prices of these base commodities to levels which propelled rising global inflation. Whilst the Chinese authorities have taken steps to tighten credit in 2011, there is now a legacy of numerous buildings with no tenants and roads with no traffic on them. But, more importantly, there are now also numerous property developers who are unable to service their loans and banks with over stretched balance sheets. Sounds familiar, doesn't it ?

One also has to worry for the Chinese economy's dependence on exports to the rest of the world. Just as activity has contracted in Japan and the Far East, North America and Europe, so too has the level of exported goods from China and, whilst most of us would be only too happy to have a growth rate of 6%, this represents a substantial contraction from the 10% and more which China has experienced for much of the past decade.

Ever mindful of the need to avoid social unrest and a repeat of 1989, our view is that China will resolve its own problems by easing monetary policy by an expansion of credit from the Central Bank which will be specifically targeted at key high tech / added value industries, rather than the free-for-all which they permitted four years ago. Fortuitously, the fall in commodity prices has lowered inflation, thereby giving scope for a fiscal stimulus without overheating the economy. It's also worth bearing in mind that China has one big advantage over the rest of us: they still have the scope to ease interest rates and to ease debt burdens since their interest rate is 6%, not 0.5%.

Shanghai Composite Index, 2009-11

Whether or not one would wish to invest into Chinese equities is another matter altogether. Their stock market has already proved in the last two years that high rates of economic growth don't necessarily provide riches for investors. Last year alone saw the China Shanghai Composite index fall by 21.7% and high profile equity funds lose over 37% of their value. Prudence dictates that one should avoid this area for the next few months until the picture becomes a bit clearer, and this also has implications for other areas, too. Mining stocks, such as Rio Tinto, Billiton etc have already been de-rated on the assumption that reduced demand from China would lead to declining profits, but it's difficult to see any catalyst in the near future which could reverse this trend. Quite probably this will also reduce the value of the Australian Dollar, so at least when England next go over there for the Ashes, we'll find the beer a bit cheaper.

Emerging Markets – best left to Q3 2012?
The sharp falls in Emerging Market equity prices in 2011 surprised most of us, but there were good reasons for most of these declines. For Latin America, particularly Brazil, the exporting of commodities had been a key feature of recent prosperity. With global consumption in decline, the consequences were inevitable. For Eastern Europe the problem was not particularly one of falling commodity prices but more of the proximity to a stalling western economy and the withdrawal of credit by a number of banks. Commerzbank were the first to make such a move, but they certainly won't be alone. India was badly affected by rampant inflation forcing sharp increases in interest rates, with a resultant fall in economic activity. Much of the Far East has also become dependent on exports to China and the West, but at least in Asia we see the potential for near term recovery. Elsewhere, we feel it best to leave Emerging Markets to the second half of the year, as they look likely to continue their under-performance against the likes of the USA and UK.

Gilts
Government borrowing costs in the UK have not been this low for over a century and, whilst they are a result of the financial crisis, it is also the case that the Bank of England's 'quantitative easing' policy has pushed Gilt yields down to the point where the 10 year borrowing rate for the Government is hovering around 2%. A year ago there were many who felt that we were in a low yield bubble, but since then yields have halved again.

Year to 30 December 2011

Whilst we probably have a jaundiced view of the health of the UK, for global investors looking inwards we are perceived as a very low risk haven, free of eurozone control, politically stable, pursuing a package of austerity measures and still with a triple A rating. Given that much of Europe is in danger of losing top-notch status, by the end of this year it is possible that the UK could be almost the only country left with a triple A rating on its debt. Questions are even being asked about the sustainability of Germany's rating, should it be forced into a rescue of the rest of Europe. Under these circumstances one can see that Gilts will become even more attractive on an international front. If £28.9billion was snapped up in October and November last year then the Debt Management Office's task of shifting £180bn this year may not look so arduous after all. Moreover, with negligible economic growth for the next year, at least, we anticipate that interest rates will remain at current levels for the rest of 2012 and thereby allay fears that the price of Gilts could move into sudden reverse.

UK Equities – Defensive stocks appear the core proposition

With a weak economic background it is difficult to be too optimistic about likely returns from the UK equity market. But it's also all too easy to be overly pessimistic. The progressive de-rating of shares over the past decade has ensured that whilst they may not be dirt cheap, they are also far from being expensive. The current price /earnings ratio on the FTSE All Share index already factors in a benign rate of growth. Corporate balance sheets in the UK, and most other developed nations, are loaded with more cash than at any point in history, which not only bodes well for survival but also the ability of many companies to pay out progressively higher dividends to shareholders. With cash yielding virtually nothing, and high grade bonds providing a low and static income, investors are increasingly having to look at lower grade corporate bonds and equities as their source of income. It is highly likely that this trend will continue in the early months of 2012, so a UK portfolio of above average yielding defensive equities still looks to be the core proposition. Should we see some key leading indicators turning upwards in the domestic economy then it will be a sign to move away from the likes of pharmaceuticals, tobacco, food retailers and beverages and re-direct investment to cyclical sectors. Unfortunately there is only a slim chance of that happening in the very near future.

The Gold Rush continues….

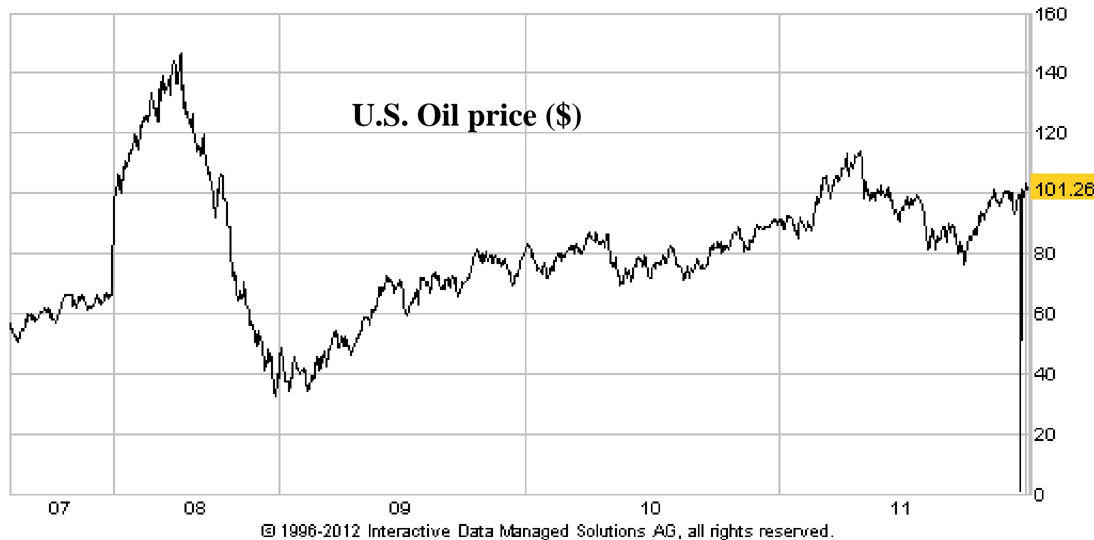
Investors who are prepared to look outside the traditional realms of bonds and equities have been rewarded in a number of instances since the crisis broke, and none moreso than with gold. Having reached a peak of $1920 in August, it finished the year at below $1600 for no apparent reason other than because it had risen so strongly it was one of the very few assets that could be sold to deliver a profit.

From 2009 to 2011

Now as we move into a new year we envisage a recovery in the price of gold not just as a reaction to the sharp sell-off but also because it remains the preferred global store of monetary value in troubled times. If one also believes that the printing presses at the U.S. Treasury continue to work overtime then the longer term debasement of the dollar looks a strong probability and another positive for gold.

Commodity prices moving higher?
Commodities have provided volatility over the past few years, and the immediate outlook doesn't look to be too different, either. It has already been mentioned that we believe the prices of basic raw materials may not see much of an increase in the first half of this year but, following some very sharp corrections, the outlook for soft commodities, including grains, suggests that prices will be moving higher. Shortages of seed and adverse weather conditions have come together to offer an opportunity to speculators.

Unfortunately we also believe that the price of oil may move higher, even though one might assume that as global economic activity declines there would be reduced demand and a falling price. The evidence so far is that this is not happening, with the oil price staying resolutely in excess of $100 per barrel due to a succession of supply reductions from the Middle East and also the fear of on-going political instability in that key area of the world. Without doubt the greatest cause for worry surrounds the intentions of Iran, as they flex their potential nuclear capability as well as threatening to close the Straits of Hormuz. A growing minority of forecasters are predicting that a major dispute involving Iran could push oil prices back to the $147 a barrel peak of June, 2008, in which case we would expect a further downturn in the global economy and a correction in equity prices.



From 2007 to 2011

Conclusion: Realism or too much gloom?
The overwhelming consensus is that 2012, and possibly 2013, will continue to produce low returns for investors. Capital growth in asset values will be a struggle and income will be a major part of the total return. This could well be the case, and just to depress us even further Bill Gross, the head of PIMCO, the world's largest fixed income manager, has recently stated that he believes we are locked into a prolonged period of making just 2% -5% per annum. Hopefully he will be wrong, otherwise few of us will be retiring before our seventies, but perhaps we should consider whether all of this gloom is already factored into market perceptions. Further bouts of bad news, short of a meltdown of Europe, may not actually hit asset prices very hard at all. If anything, we should consider that the danger of surprise lies on the upside. An unexpected resolution to the Euro crisis would lead to a surging relief rally and a constant flow of better than expected data from the United States would lead to the recalculation of many economists' predictions. Few would have guessed that when gloom surrounded us in March, 2009, that the UK equity market would rise 60% by the end of the year. More recently, in early October of last year, FTSE 100 at below 4950 seemed unlikely to go past 5700 within the month.

Year to 30 December 2011

Even in adverse times a strategy of asset allocation rotation and shrewd timing can deliver rising portfolio values.

Source: Brown Shipley and Interactive Data Managed Solutions

The information contained in this commentary is provided by Brown Shipley for information purposes only. It does not constitute investment advice and should not be treated as a recommendation for investment. The past performance of an investment or market is no guarantee of future results. The value of investments and any income from them may fluctuate and are not guaranteed. Investors may not get back the amount originally invested. Currency fluctuations may cause the value of underlying investments to go up or down. Opinions, recommendations and conclusions expressed in this commentary are given in good faith and may be subject to change. © Brown Shipley January 2012 reproduction strictly prohibited.

Brown Shipley is a trading name of Brown, Shipley & Co Limited, which is authorised and regulated by the Financial Services Authority. Registered in England and Wales No.398426. Registered Office: Founders Court, Lothbury, London, EC2R 7HE. Brown Shipley's parent company is KBL European Private Bankers which, from Luxembourg, heads a major European network of private bankers.