



Investment View November 2011

November's now infamous weekend of Eurozone talks was supposed to deliver a set of solutions that would finally contain the sovereign crisis. However, almost four weeks on bond yields are running at 14-year highs and sovereign and banking problems are still closely entangled. The headlines that came out of this round of talks were enough to trigger an improvement in equities. Over the month to early November stock markets around the world enjoyed one of their best months on record, with most indices up more than 10%. Even MSCI China, usually slow to respond to rallies, gained close to 30%. Markets are eager to respond and rally, but European governments constant lack of real and deliverable solutions to Europe's debt problems continues to drag markets back down and threaten to put Europe back into a recession due to the uncertainty engulfing the region.

In an uncompromising message, the new European Central Bank's President said "robust" economic governance of the Eurozone was essential for financial stability and criticised the delay in deploying the European Union's bail-out fund, the European Financial Stability Facility – originally launched 18 months ago. France and Germany can't agree about the ECB's role as a possible circuit breaker, with Paris seeing the central bank as key to resolving the crisis but Angela Merkel, German chancellor, warning further central bank action would violate European Union treaties. If they continue to prolong their lack of action there may be no Union and no treaties to worry about.

Most commentators believe the ECB has the ability but not yet the mandate to resolve the crisis. The President of the ECB's comments highlighted how the ECB sees its contribution as strictly limited, and the initiative lying with governments. The new ECB president, who took over on November 1, noted that Eurozone leaders had first agreed on a €750bn Eurozone rescue plan in May last year.

He went on: "We are four months after the summit that decided to make the full EFSF guarantee volume available; and we are four weeks after the summit that agreed on leveraging of the resources by a factor of up to four or five and that the EFSF would be fully operational and that all its tools will be used in an effective way to ensure financial stability in the euro area."

Although some of the substantial gains in October and early November will have been down to the Federal Reserve's shift in policy at around the same time, the main driver of the climb in stocks was events in the Eurozone and pledges, no matter how concrete, that came out of the discussions to recapitalise the region's banks and leveraging of the EFSF. So it remains firmly with the politicians to deliver the solution and action: not just words and headlines. Do so and markets will rally.

It is very clear that the Eurozone predicament is a political issue and political uncertainty is currently very high in relation to the Eurozone. No investor can forecast how politics will change in several important but very different countries into 2012. Social tensions continue to rise, complex problems need attention, often in rather short periods of time, and political views are divergent across many parties and governments.

We continue to share the view that the EMU will survive for the time being. The economic cost for any country breaking away is currently too great. Several reports suggest that the cost for a country such as Greece leaving the Eurozone could be towards 20-25% of GDP. This is due to the implosion of the banking system, the lack of access to external capital and the impact on cross-border assets and liabilities.

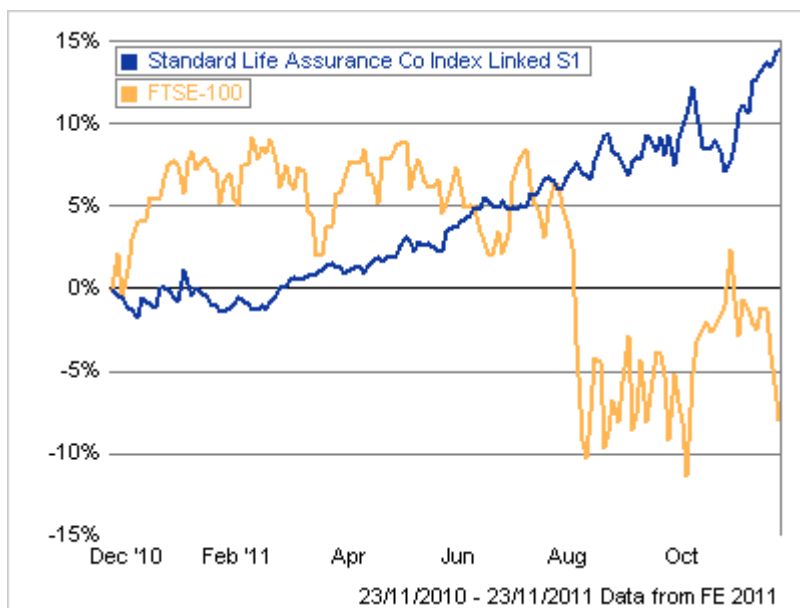
Currently political obstacles are high to the idea of fiscal change within Europe, such as the creation of Eurobonds. It is a clear and equitable solution. Discussions about creating much stronger fiscal discipline will take time. Nevertheless, most agree that the combination of the European Financial Stability Facility (EFSF), the IMF and the ECB should be able to keep funding open to governments, through capital transfers and bond purchases until private investors regain confidence. All will require strong evidence that governments are taking hard decisions on fiscal policy, structural reforms and growth programmes. Political cohesion will be vital in individual governments and amongst Europe's leaders, which has sadly been lacking.

The consequence of this political prevarication is likely to be that the European economy will see stagnation at best for most of 2012. There are clear signs that companies are delaying investment plans due to the uncertainty. The worse case, of an actual recession, could come about if a small scale credit crunch appears as European

banks pull back on lending in order to boost their capital ratios in the face of large losses from their sovereign bond holdings. Regrettably, investors should anticipate seeing a series of small and large crises in Europe for some time to come.

We continue to monitor all markets closely but are loath to recommend substantial changes to portfolios during this volatile time. Since the beginning of August the average daily high/low point on the FTSE 100 has averaged a daily movement of over 145 points. Markets need to settle and will settle, but until then we believe patience will have proved to be worthwhile.

We constantly stress the need to have a balanced portfolio to cope with conditions such as we are currently experiencing. Most of the media coverage focuses on the primary share indices, usually the FTSE 100 or the Dow Jones and perhaps some Asian or European indices. All the indices comprise equities. This often creates the impression that all asset classes have fallen in a similar way, but that is not necessarily the case. A balanced fund is built using a variety of asset classes, which will include equities but also property and bonds. In the credit crisis of 2008 property assets and funds were severely impaired and mirrored the performance of equity funds, which had never happened in downturns. This time property has been more robust



Another asset class in most portfolios is likely to be bonds, whether investment grade or high yield corporate bonds, or Government bonds depending on the circumstances, or a combination. At present UK Government Bonds or US Treasuries look expensive as the yields have been driven very low as demand has increased and interest rates have fallen. But for clients in drawdown, as in the previous downturn, the upside has been greatly beneficial, with UK Index Linked Gilts showing particularly strong gains as the chart shows.

For pre-retirement clients the short term market volatility may be causing anxiety but markets tend to over react rather than under react

to bad news and over the longer term ironically this is often the best time to be buying. Provided money is not needed to be drawn down from portfolios, as we have often said before any 'losses' are only on paper, it's selling the holdings at a loss that makes them a reality!

As we have also promoted for some time equity income funds are another valuable component in our portfolios, generating yield, and they will prove their worth to investors as part of a diversified portfolio.

It is not all doom and gloom, but the Eurozone is overshadowing almost all financial news. Last month it was Greece we were all watching, this month Italy, where next? Although equities have been severely impacted by the lack of clear direction and political will, the equity fund managers are constantly reviewing their portfolios and adjusting to cope with market conditions, and are currently taking more defensive positioning until there is greater clarity. Some encouraging economic indicators from the US suggest that it may be building positive momentum. China's control over its economy seems to be working successfully and continues offer opportunities for the developed economies and inflation in the UK may have peaked. Time moves on and things will improve.

Lastly, I found this and thought it worth sharing: It has been reported that there are more Porsche Cayennes in Greece than people who declare earnings of over €50,000 to the tax authorities! Now we know why its economy needed even more bail out money.

Anthony Stephen Patterson, Managing Director.