

Investment View October 2011

Since early October we have seen eight consecutive positive trading sessions, with the FTSE rising by over 10%. So what are we to expect from the last quarter of 2011 and into 2012? As we have stated many times, much will depend on European policymakers and their ability to agree a credible solution for the Eurozone, and continuing evidence that the US economy is moving ahead positively. Until this happens, markets will continue to be very volatile.

Investors took the messages from German politicians and officials to indicate the summit was likely to disappoint expectations, leading to immediate falls in both Global stock markets and the Euro. Frustratingly, no conclusions have yet been reached. Managing expectations before important European summits are common, but markets remain unsettled. However, the recent advance in world stock markets is not 'built on sand'. In this regard, better than expected macroeconomic data, coupled with some positive noises from the Eurozone, has provided the catalyst for markets to bounce back. The main issue is sustainability.

The European market has been down 20 per cent (peak to trough) over the past three months. There was a lot of bad news already in the price. What wasn't in the price was the recent improvement in economic data, which again must question the growing sentiment that a double-dip recession in the US and Europe is inevitable: it isn't. The past week or so has brought the first round of hard growth numbers for Europe and the outlook for growth looks much better than it did over the summer. The other driver behind the equity market rally was the pledge by the leaders of Germany and France to deliver a comprehensive package of measures to stabilise the Eurozone by the G20 summit in Cannes in November, following the ongoing Finance Ministers meeting. This is something the market had not heard before. The promise had been taken well by financial markets, until the German Government made their varying comments aiming to temper upside expectations.

The risk of recession still lingers over the Eurozone, much more so than the US, but the region's policymakers seem likely to introduce a package this month that is comprehensive enough to head off that scenario. There certainly are downside risks to the economy. However, the IMF have publicly indicated that they are looking forward to the European leaders' agreement on a comprehensive package to deal with Europe's financial and economic issues.

Such a plan of action would include the creation of "firewalls" that would protect nations that aren't facing immediate problems but whose markets have taken a hit from recent strains in some parts of the Eurozone. It would also include the recapitalization of banks to ensure that they can lend and foster economic growth. The European Banking Authority's board of supervisors have approved in principle the idea that banks should be made to raise a key measure of financial strength to 9% after absorbing write downs on the value of their sovereign debt holdings. The good news for UK investors is that all of the big banks listed in London (even RBS) look like they will pass. The package should also include measures to deal with the immediate problems facing Greece, which is mired in an ongoing struggle to pay its bond debts. It is likely IMF will grant approval for another tranche of assistance for Greece - provided it is one component of a larger package for the Eurozone as a whole.

Political decisions taken today will have a profound effect on markets for years to come. As the Chief Executive of Standard Life Investments recently stated "We know that central banks will not raise interest rates for months, if not years, to come. We know that the engine of global economic growth is inescapably moving away from the Atlantic to the Pacific economies. We know that the corporate sector remains much healthier than the household or government or financial sectors in many countries. We know through many lessons in history that economic and financial market contagion of the sort we have been experiencing comes to an end when politicians and policymakers come to understand the full extent of the problems."

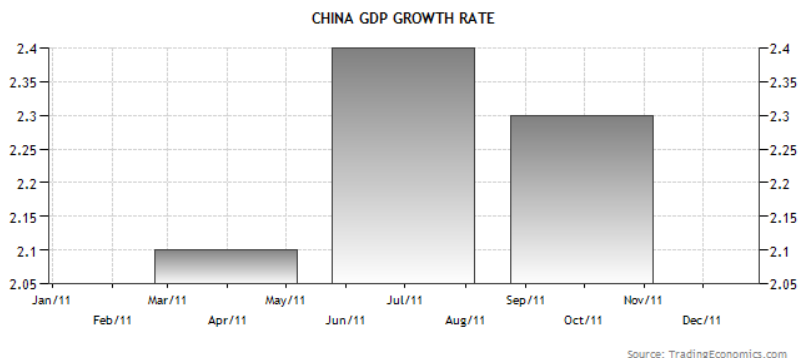
While many fund managers, investors and market commentators appear now to have been overly optimistic about the prospects for global growth at the start of 2011, the converse is now being seen, and scare stories abound about many of the developed economies falling back into recession.

It was perhaps optimistic to hope that following the financial turmoil of 2008 many countries would achieve 'above trend' growth. Certainly various factors, such as higher oil prices, the disasters in Japan and policy tightening in several key emerging economies, all contributed to a noticeable slowdown in activity in Q2 and Q3. We share the view that recessions can be avoided as long as a major financial crisis can be averted. The current reality is that this means avoiding a fall in credit growth in Europe and beyond thereafter as banking stresses grow. This is the 'contagion' risk.

Once again the benefit of structuring diversified retirement portfolios has been proven. Many investors ran from commercial property funds after the 2008 technical downgrades, but according to the IPD UK Monthly Index the overall commercial property delivered a quarterly return of +1.9% for the three months to September, despite the wider market turmoil and falls in world equity markets.

Our diversification strategy has also worked in the context of non defensive equity exposures.

Although Emerging Markets have been buffeted China's tightened monetary policy appears to be having the



desired effect on inflation as figures for last month showed CPI dipped to 6.1% in September. Chinese GDP figures recently released showed a 9.1% 'year on year' increase for the third quarter, and although marginally down from Q2 is still a key indicator of the 'de-coupling' of the emerging markets.

This is a key driver for the world economy but China is not alone. Emerging market equities are on their longest streak for over a year – gaining for nine days in a row this month. Once again exposure to Emerging Markets Funds (either directly or indirectly) is essential as that is where growth is shifting and probably faster than many thought likely only a few years ago. GDP Growth is now predicted at over 8% next year, which developed economies can only dream about!

Regarding other asset classes, we are reassured in our current strategy that both 'investment grade' and 'high yield' corporate bonds have been robust in the recent turmoil and unlike during the previous downturn corporate credit is currently not considered high risk. This is a testament to good business management and stronger balance sheets, with households and governments now playing 'catch up'. Additionally, if the low level of government bond yields persists, the demand for yield should underpin the market. September saw 10 year gilt yields fall to a record low of 2.4% with real yields on index-linked bonds also reaching unprecedented levels. The cause was continuing fear of a Greek sovereign default, which most fund managers now believe is inevitable by the first quarter of 2012.

Equities have taken the brunt of the falls, but our conversations with fund managers confirm our 'house view' that substantial 'over-selling' has taken place in major world stock markets and that unlike some government's finances the 'corporate world' is in relatively good shape. The equity funds that we use all take a long view and invest in companies with strong fundamentals for solid growth. Unlike short term players they are not "renting" stock by the hour, day or week, for short term gains but are committed to the longer term growth story. Recent market turmoil has been driven by the short term traders, causing unnecessary panic to clients all of whom are investing on a long term basis.

All summer it has felt like a 'two steps forward', 'two steps back' approach to policymaking in the Eurozone and Politicians now have to deliver. It now looks very possible that many of the economic 'headwinds' might just be turning into modest 'tailwinds' in the second half of 2011. Prime examples would be the fall in oil prices and thus headline inflation, recovery in supply chains after the Japanese earthquake, and the potential for monetary policy easing. The end result is that many now expect a cyclical upturn into the year-end, led by the US. But in the short term we think the markets are unfortunately still playing *roulette*, which is certainly not a game we are willing to play with our clients' money!

Anthony Stephen Patterson, Managing Director.