Investment Solutions

# Monthly Market Commentary

December 2011

## Review

The Bank of England's Monetary Policy Committee maintained the Base Rate at 0.5% in December and increased quantitative easing measures to £275billion.

UK and Global Markets had a moderately positive month as company news was better than expected, although negative macro news flow continued. Uncertainty surrounding global sovereign debt issues remained elevated by the continuing political wrangling around workable solutions.

The European Central Bank remained preoccupied with the significant sovereign debt of many member states particularly, Italy, this contributed to market volatility during the month. The British Prime Minister's use of the veto in negotiations on re-drawing the Lisbon Treaty, to find further funding for Euro Zone countries incurred the wrath of Europe's political elite.

| | Index Level 31 Dec 11 | % Change | | |
|---|---|---|---|---|
| | | Dec | YtD | 1 Year |
| FTSE All Share £ | 2858 | 0.8% | -3.5% | -3.5% |
| FTSE 100 £ | 5572 | 1.3% | -2.2% | -2.2% |
| MSCI World $ | 1183 | 0.0% | -5.0% | -5.0% |
| S&P 500 $ | 1258 | 1.0% | 2.1% | 2.1% |
| | Index Level 31 Dec 11 | Index Level 30 Nov 11 | Index Level 31 Dec 10 | Index Level 31 Dec 10 |
| UK 10 Year Gilt Yield % | 1.98 | 2.31 | 3.40 | 3.40 |
| GBP USD | 1.55 | 1.57 | 1.56 | 1.56 |
| GBP EURO | 1.20 | 1.17 | 1.17 | 1.17 |
| OIL - WTI $ | 98.8 | 100.4 | 91.4 | 91.4 |
| Gold $ | 1564 | 1746 | 1421 | 1421 |
| Wheat $ | 653 | 596 | 794 | 794 |

The Emerging Markets had a flat month overall and as they grappled with potential inflation and political unease surrounding the death of the North Korean leader Kim Jung-il. The Russian Parliamentary election also produced a surprise with a smaller majority for the ruling United Russia party than expected.

Gold had a poor month from a performance perspective as it retreated towards the $1500 level as investors preferred to hold US dollars instead.

## Outlook

The global economy is experiencing a particularly prolonged period of weak economic growth. Our key areas of concern are inflation and global sovereign debt. Our expectations for market volatility in 2011 exceeded our hypothesis and we believe these elevated levels will continue well into 2012 whilst markets remain macro driven. Central banks have indicated that they expect to remain with the current loose monetary policy for some time; this carries the risk of a policy error with inflation exceeding targets for a significant period of time and puts the credibility of some central banks at risk. However, central bankers are bracing themselves for the potential of a recession in 2012.

The unravelling of the sovereign debt situation in Europe, particularly Greece, Portugal and Italy is particularly unsettling. We do not currently see the euro ending 2012 as it started but how this currency is to be reshaped is not clear. The possibility of the global economic recovery being seriously derailed is a realistic threat from the current uncertainty, especially with several of the larger emerging economies revising down their expected rates of growth. We are also concerned about the US debt management plans or lack thereof, particularly in this Presidential election year.

On a more positive note, companies appear to be in reasonable shape globally, and many have strong balance sheets and are maintaining a good dividend policy. Financially companies appear to be in a better position to weather a market downturn than they were in 2008.

The general lull in global growth experienced recently combined with broadly disappointing global macro news-flow, leads us to be cautious on investment markets in the short-term. The periodic setbacks and occasional weaker patches are expected to continue as market sentiment fluctuates and policy makers struggle to innovate solutions. In the long-term, it is our view that markets and the global economy will move forward and grow, albeit below trend.

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## Asset Allocation

| View | Positive Points | Negative Points |
|---|---|---|
| **UK Equity**<br>Neutral | • Companies have strong balance sheets and reduced cost base.<br>• Corporate earnings and margins are proving resilient. | • Concerns remain on the extent of government and consumer debt as well as the impact of remedial measures as we appear to be in an economic soft patch.<br>• Global sovereign debt issues weigh on markets.<br>• Stability of the coalition and the global political environment.<br>• Earnings expectations are starting to slow. |
| **Global Equity**<br>Neutral | • The Global recovery broadly intact with strong corporate earnings figures, though earnings growth is slow.<br>• Current climate benefits well capitalised businesses with more stable earnings. | • Concerns remain on the extent of Global government and consumer debt.<br>• Optimistic earnings over the next few years may already be priced in.<br>• Inflation; particularly from agriculture. |
| **Emerging Market Equity**<br>Neutral | • Emerging Markets have been somewhat insulated from debt issues as governments have less debt and private savings ratios are far higher than developed economies.<br>• Economic growth favourable demographics<br>• Emerging Markets have experienced recent outflows of investment and a sensible retrenchment in market levels. | • Inflation concerns as the base effect works itself out. Particularly wage inflation in India/China.<br>• EM equity is slightly expensive relative to history<br>• Monetary policy and spillover from euro crisis.<br>• Government policy responses to international capital flows are a concern e.g. Brazil.<br>• Volatility in the short-term compounded by currency volatility. |
| **UK Fixed Interest Gilts**<br>Neutral/Negative | • Defensive characteristics remain partially intact.<br>• Government continues to promote fiscal discipline.<br>• Continues to be the safe haven investment of choice. | • Inflation continues to be above government targets and QE remains in place and possibly extended.<br>• Global sovereign debt problems will heighten volatility.<br>• Real yields remain unattractive. |
| **UK Index Linked Gilts**<br>Neutral/Negative | • Inflation continues to remain above target.<br>• Limited supply from the DMO and demand remains strong at both the short and long ends. | • Real yields remain unattractive. |
| **UK Corporate Bonds**<br>Positive | • Spreads are widening; increasing the risk return characteristics compared to cash and gilts, for Investment Grade Bonds.<br>• Prefer industrial to financial credits due to uncertainty over effect of sovereign debt issues on banks. | • Interest rate risk remains a concern.<br>• Economic weakness in Europe may lead to spreads widening further. |
| **UK Property**<br>Neutral | • Reasonable yields, improving rates and increased activity following large flows into the sector make this an attractive asset class only if investing in Prime Property.<br>• There is a degree of inflation protection. | • Non-prime Commercial Property markets are likely to continue to lag as demand in this area is weak.<br>• Growth fears lead to shorter term leases.<br>• Government spending cuts are likely to exacerbate the perceived problem in secondary and tertiary property. |
| **UK Cash**<br>Negative | • Short-term safe haven. | • The investment value of this asset class is being eroded by current interest rates being below inflation. |
| **Absolute Return**<br>Positive | • Following the strong run in equity and bond markets over the last year, a more defensive and diversified approach may be prudent.<br>• Expect volatility to be elevated. | • Non trending markets can cause problems for directional strategies thus resulting in short term underperformance. |

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