MARKET OVERVIEW AND INVESTMENT OUTLOOK

DECEMBER 2011

Market Overview

The final quarter of 2011 saw equity markets stage something of a rally after the very poor showing during the third quarter. Europe continued to dominate the headlines as numerous periphery Governments fell, the Germans continued to play hard ball (demanding further fiscal austerity and harmonisation prior to discussing Quantitative Easing) and the rating agencies started to get even more twitchy regarding sovereign credit ratings. Furthermore, GDP forecasts for the Eurozone were cut significantly, such that the consensus forecast is looking for the Eurozone to go into recession during 2012.

None of the above really argued for a decent rally in the equity markets, however macroeconomic releases out of the US have consistently been stronger than already reduced expectations. This has resulted in US economic growth forecasts for 2012 being revised upwards.

Over the quarter, the FTSE All-Share returned +8.4%, which helped limit the damage for the full year to -3.5%. A fairly remarkable performance given the scale of earnings downgrades witnessed and the dramatic loss in confidence in the banking system.

In local currency terms, US equities continue to perform strongly. The S&P 500 returned 9.5% within the quarter and -0.3% for the full year, helped by encouraging macroeconomic data releases. The Japanese equity market performed poorly with the Nikkei returning -2.4% over the quarter as concerns heightened that the new Japanese Government would not have sufficient resolve to confront some of the country's economic problems.

Gilts continued to do well, rising by 5.0% over the quarter. This resulted in the asset class returning 15.6% for the year as investors bought into the Conservative/Liberal Democrat deficit reduction plans. Internationally, UK Treasuries are seen as something of a safe haven. An additional Quantitative Easing package also helped to maintain enthusiasm of the asset class. For the year as a whole Corporate Bonds underperformed Gilts due to heightened risk aversion. However performance relative to Gilts was positive during the final quarter.

The FTSE All-Share continues to trade on a Price/Earnings (P/E) ratio of around 9.5 times and has a forecast dividend yield of 4.0%. This dividend yield can be compared with the 10-year Gilt yield of 2.0%. The differential between the two figures, in post war terms, remains exceptionally high. Other valuation measures also suggest that UK equities relative to Gilts look good value.

However, it should be noted that the trough in P/E ratios during the systemic equity market crash of 2008/09 was significantly below current levels, which suggests there could still be downside should the current economic slowdown slide into something more structural. As growth in some developed economies falls to near stall-speed, the risks to the downside rise, as the ability to contain systemic shocks falls.

The Brent oil price has risen 4.5% over the past three months (+13.3% for the full year), boosted by a tight demand/supply balance and more vocal sabre rattling from Iran.

The Gold price is down 3.7% over three months, but up 10% for the full year. The stronger US macroeconomic indicators are forcing investors to reconsider the probability of a near term, additional round of quantitative easing in the US.

Investment Outlook

The US economy is currently surprising forecasters with its resilience. Indeed, consumer and business confidence survey results are more robust than expected and this is being reflected in the relative performance and valuation of the US stock market. It is undoubtedly true that the competitiveness of the US economy has improved, however it would be wrong to think the US is out of the woods.

Due to the rigidities built into the political system and the fact that Congress and the Senate are currently controlled by opposing political parties, tough decisions on fiscal austerity are being delayed. This cannot persist ad infinitum, although it is difficult to see how such difficult fiscal decisions can be taken before the Presidential election in November 2012, given the failure of the so-called ‘Super Committee’ to come to a negotiated settlement. Furthermore, housing is a significant driver of US economic activity and recently HSBC has warned that house prices may fall further as foreclosure activity increases following a hiatus in the process.

The relative economic strength exhibited in the US recently, may dissipate as the year progresses as real disposable incomes are not growing, household net wealth continues to shrink and the consumer has been spending savings in the run up to Christmas. This may reverse in 2012 as the reality of fiscal austerity post the presidential election dawns.

On this side of the Atlantic, the Eurozone has reached a precipice. Another false move and the economies of the member states could be seriously compromised. With French (and Italian) Government bond yields rising sharply, the credibility of the European Financial Stability Fund has been compromised and therefore it’s ability to raise adequate funds has diminished. The European Union are, therefore, looking to the IMF to provide additional sums. Again, the quantum of what is available from this source has fallen short of what is being demanded by market participants. Furthermore, Germany has made explicit, its requirement that the successor of the European Financial Stability Fund does not exceed 500bn Euros.

It is interesting to note that Private Sector Involvement (PSI) in the Greek debt restructure is far from a done deal. Banks are being strong armed into agreeing a 50% cut to the value of their Greek Government bond holdings. However, the European Union has subsequently strongly implied that PSI would not be invoked should any other Eurozone country need to restructure its debt in the future. Understandably, private holders of Greek debt are objecting to being singled out in such a manner.

Following the December European leaders summit, Eurozone member states will look to their domestic Governments to ratify treaty changes over the next three to six months, in order to bring about closer fiscal integration. This, to our minds, will be exceptionally difficult to complete satisfactorily. Will Italy (amongst others) be told it has to implement austerity until it meets the Maastricht criteria of 60% net debt/GDP? This could take 20 years! Will Ireland be told to double its corporate tax rate? Even if the political classes accept this, it is highly questionable that the electorates will. Furthermore, the French economy is at a critical juncture as growth slows and their ability to meet budget deficit targets is questioned, particularly given the potential need to inject capital into ailing French banks.

Logically, the only long term solution to the Eurozone crisis is the formulation of a United States of Europe, where there is a directly elected executive, tax rates are harmonised and transfer payments can be made across boundaries. This, of course, is as far away as ever. Indeed, President Sarkozy (no doubt with one eye on the forthcoming French Presidential election) has recently ruled out greater federalism.

On the positive side, central banks of the major economies are providing significant help to the banking sector. The US Dollar overnight funding market for European banks has been freed up, and the ECB has instigated a Long Term Refinancing Operation (LTRO) for banks, which provides cheap funding for up to three years. This is helping to address the very serious liquidity problems the banks have and is buying time for the banks to continue to address their solvency issues. Indeed, Unicredit has announced a deeply discounted rights issue to raise 7.5bn Euros of new capital. The scale of this capital raising should be judged against the company’s market capitalisation prior to the announcement, which was circa 12 billion Euros. Other banks will follow suit in the following weeks and months.

We believe it is likely that markets will once again challenge the resolve of Eurozone leaders in the coming months, particularly, as the only solution on the table (as championed by Germany) is fiscal austerity. This is seriously crimping the prospects for growth, which in turn begets further austerity as budget deficit targets are missed. An example of this is Spain, which has just announced further fiscal austerity measures as a result of its widening budget deficit. Without a sustained improvement in global economic growth, the ECB will be obliged to undertake quantitative easing at some stage in the future.

With Government, consumer and bank sector deleveraging the only game in town for the next couple of years (at least), an extended period of low growth, low interest rates and high unemployment is about as good as can be hoped for. This does not necessarily have to be bad news for equity markets and we certainly believe there are many good quality, highly cash generative businesses that can win out in such a scenario.

It is encouraging to note a piece of research from the Royal Bank of Scotland, which shows that the ten largest stocks in the UK (the so called 'mega caps') have, in the past when trading at similar cheap valuations as they are today, tended to generate significantly positive average annual returns going forward. Furthermore, on 2012 numbers they are forecast to generate a dividend yield of more than twice that of the 10 year Gilt yield, despite exhibiting strong balance sheets and relatively conservative dividend payout ratios. In addition, the number of shares in issue for this group of companies has reduced by some 15% over the past ten years (due to share buybacks), whilst the amount of Government debt issued has grown substantially and is set to continue to do so for the foreseeable future. Without wanting to endorse every one of the UK mega cap stocks, I know where I would rather put my money.

We continue to favour Asian equity markets (including Japan) both in terms of the ability for policymakers to stimulate growth, and valuation. We are intrigued by the valuation of the European markets, but remain content to sit on the sidelines for now, believing that further earnings downgrades will be forthcoming. It feels difficult to believe that the US stockmarket will achieve 23% earnings growth over the next two years as the consensus suggests when economic growth is likely to come in below average for this period.

A low growth, low interest rate environment should ensure decent returns for holders of investment grade corporate debt.

Source: Cornelian Asset Managers – January 2012

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