

## MARKET OVERVIEW AND INVESTMENT OUTLOOK

JANUARY 2012

### Market Overview

Over the three months to January, equity markets have continued to stage something of a rally, despite Europe continuing to dominate the headlines. Numerous periphery governments have fallen, the Germans have continued to play hard ball (demanding further fiscal austerity and harmonisation prior to discussing Quantitative Easing) and the rating agencies have started to get even more twitchy regarding sovereign credit ratings. 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. Furthermore, recent news out of China suggests the decline in the rate of economic growth may be moderating.

Over the quarter, the FTSE All-Share returned +3.2%. Fears that demand may have fallen significantly towards the end of 2011, have (generally) been dispelled by a more than adequate results season. Although, there have been some notable exceptions such as Tesco (where we have no exposure).

In local currency terms, US equities continue to perform strongly (S&P 500, +5.2%), helped by encouraging macroeconomic data releases. The Japanese equity market performed poorly (Nikkei, -2.1%) as concerns heightened that the new Japanese Government would not have sufficient resolve to confront some of the country's economic problems. The improved sentiment towards the global growth outlook helped Asian and emerging markets to perform strongly in January. This has reduced some of the material relative underperformance the asset class exhibited during 2011.

Gilts continued to do well, rising by 4.3% over the quarter. 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. Corporate bond performance relative to gilts was positive during the last three months, as investors began to embrace riskier assets.

The Brent oil price has risen 1.3% over the past three months, boosted by a tight demand/supply balance and more vocal sabre rattling from Iran and her opponents. Improved global demand prospects have also helped sentiment.

The gold price has risen strongly (+13.3%). Perhaps perversely, an additional round of Quantitative Easing to help the housing market is under active consideration, despite the stronger macro-economic statistics coming out of the US. 2012 is a presidential election year and we are mindful of the commentary from Greenspan, the former Federal Reserve chairman, who said after leaving office that the Federal Reserve can never be truly independent from its political masters.

### 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 its performance relative to other markets and the 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. 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. Real disposable incomes are not growing, household net wealth continues to shrink and consumers were 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 its 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.

It is interesting to note that Private Sector Involvement (PSI) in the Greek debt restructure has yet to be concluded. 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 future. Understandably, private holders of Greek debt are objecting to being singled out in such a manner. It may be in the interests of some of the private holders of Greek debt to see Greece formally default.

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 its 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, where he is currently trailing the opposition's candidate) 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 them to continue to address their solvency issues. Indeed, Unicredit has completed a 7.5bn euro rights issue, whilst Commerzbank has wrong footed the market by claiming they have no need to tap the market for new capital.

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 (inc Japan) equity markets 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.

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