

Quarterly Investment Review

January 2012

Produced in association with our investment partners



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General Overview – Quarter Four 2011

Despite the intense political manoeuvrings over the last quarter we appear to have moved very little from the economic position that we described in our last Investment Bulletin. Europe still dominates the considerations of most investors, with the debt issues unresolved and the political environment controlling the markets rather than company fundamentals.

In last quarters overview we highlighted the need for a set of comprehensive measures to be in place for Europe to ensure the survival of the Euro with its current membership, and that a resolution to the issues in Europe would be a critical factor in allowing a market rally before the year end. We are now two years into this crisis and it is far from resolved, as recent vetoes and wavering support for greater fiscal union has shown. This remains the major cause of market uncertainty as we head into 2012. The weight of opinion is that the final solution will have to involve formal backing from the ECB and in some ways they have moved towards this by propping up the banks in Europe by offering unlimited three year loans to replace the lack of public funding currently available. The market is clearly looking for a defining position from the ECB before yields can begin to fall in peripheral Europe.

We have seen some conflicting data from the US market, with unemployment remaining high but company profitability remaining resilient. The news towards the end of the year has been more encouraging with both housing and sales data improving. However there is still the unresolved issue of debt reduction – arguably the biggest issue for the US – which remains in a political standoff with no real solution in place. The US market outperformed other markets as the safe haven status of the US strengthened investors faith in both the dollar and US treasuries.

The Far Eastern markets generally fared the worst over the last quarter despite having the more resolute and financially solvent economies. Growth has been far ahead of Western economies however the fear of a slowdown in Europe and the US combined with the additional threat of inflationary pressures reducing domestic growth meant that market falls of 20% were not unusual. The good news at the end of the year is that these pressures appear to be easing and China, the engine of growth in the area, has indicated its continuing domestic expansion.

Other than some contrarian Japanese investments, the main source of returns has come from holding safe haven assets such as gilts and US Treasuries where yields have fallen despite reaching all time lows. In particular the long dated market has done well as the fear of inflation receded from the beginning of the year. Investors are still holding a substantial level of these assets in the final quarter however it seems unlikely that this will be the sensible choice over the medium term. With such low yields and capital values close to being maxed out these investments do not look like sources of growth.

Equity Markets

Equity markets have clearly suffered from the lack of political agreement during the year and the final quarter has replicated the previous two with volatile investor behaviour as a risk on risk off mentality has dominated investment patterns. November saw a rally at the beginning and end of the month as hopes were high of a resolution in Europe. These failed to materialise as the latest agreements fell short of market expectations. The FTSE started the year at just over 6000 but finished just over 5500 after falling to below 5000 briefly in September. This is a reflection of many world markets with Emerging Markets in particular being sensitive to the macro environment as well as the tightening in China and inflation hitting India and Brazil.

With a total return of 2% on the S&P 500 in 2011, US equities have outperformed all major equity markets:

- developed markets as measured by MSCI EAFE returned -12% in US dollar terms, with Germany and Japan being two of the worst performers at -17% and -12%, respectively;
- Emerging Markets as measured by MSCI EM returned -18%, with Brazil and India being two of the worst performers at -22% and -37%, respectively.

Similarly, US Treasuries provided some of the best returns in global government bond markets. Using a basket of maturities based on the J.P. Morgan Global Bond Index 7–10 year series, US Treasuries returned about 15%, outperforming German and most other European bonds as well as Japanese bonds in their respective currencies. They barely lagged Swedish bonds and lagged Australian bonds by 3%. (Source: Goldman Sachs)

Chart showing 2011 returns for major market Indices

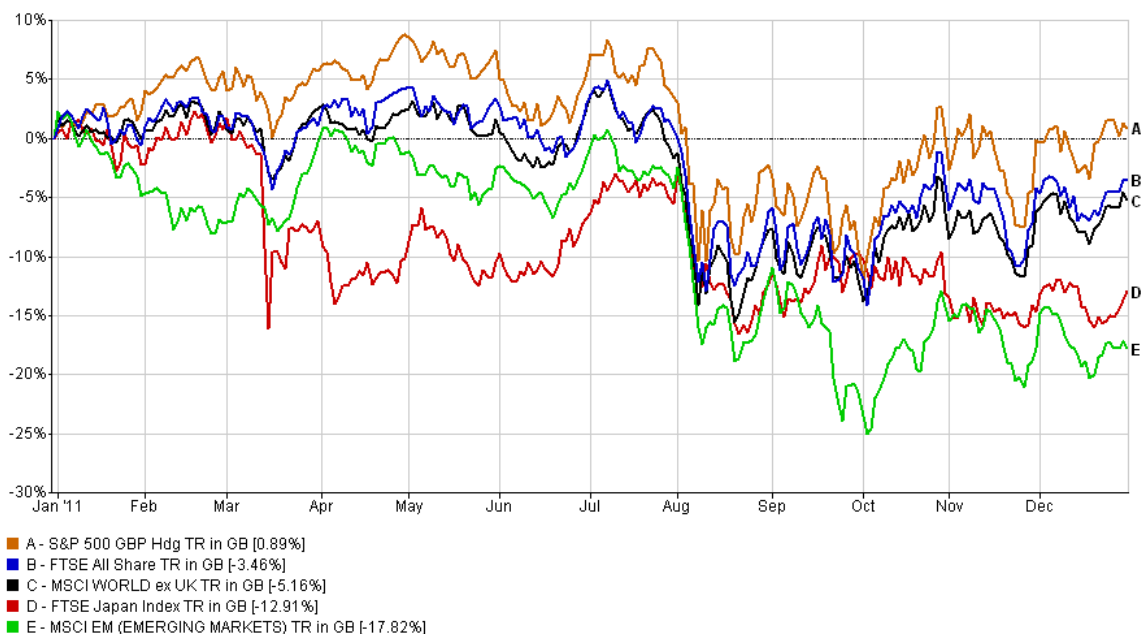
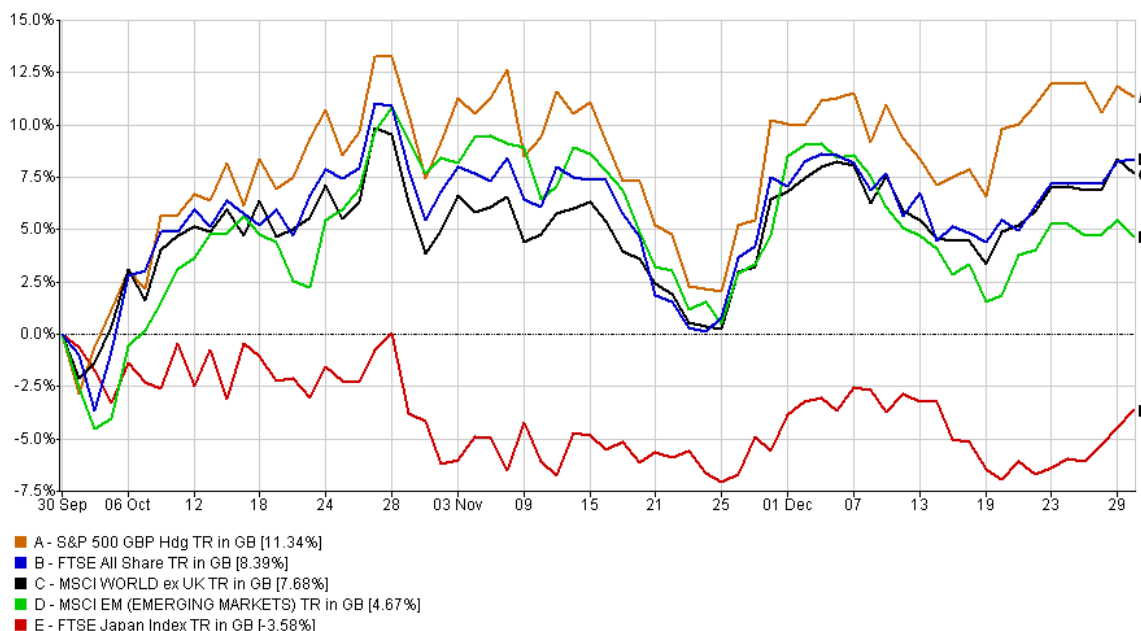


Chart showing fourth quarter returns 2011 for major markets



30/09/2011 - 30/12/2011 Data from FE 2012

Sector Review

UK

Despite the focus on Europe, the UK seems to have avoided much of the international criticism because of its abstention from the Euro currency block. The UK economy is by no means a safe haven although the government bond market in gilts has been so strong it has sometimes felt like it. With growth around 0.6% in the third quarter, overall predictions of UK economic growth have been gradually reducing as fears of rising unemployment and falling consumer spending has put pressure on the governments predictions as to the levels of austerity needed to rebalance the national debt. The threat of a ratings agency downgrade has once again arisen in recent weeks.

The UK equity market has been more volatile in the second half of the year as any focus on fundamentals has been blown away by the seesaw of political manoeuvres to try and resolve the Eurozone crisis. The FTSE has fallen just over 3% year on year but this doesn't reflect the much greater falls that took place during the year, with many value based managers suffering and those with large cap defensive portfolios having the better returns.

There is no immediate end in sight to this weakened environment with any recession in Europe certain to spread to the UK, given the volume of exports. Those companies with a more diversified global outlook have more opportunity to survive in this situation.

Europe

The focus of all economic attention in the last six months has definitely been on Europe with China and the US adding some peripheral gloom. The real issue, as most commentators acknowledge, is the inability to find a political solution acceptable to the members of the Euro and the ECB. The recent European treaty to strengthen the union did move things along but the detail has not yet been scoped and there are already countries other than the UK that are beginning to distance themselves from the more intrusive economic and banking requirements. The core European countries that finally sign up to the treaty may well be less than the initial seventeen perhaps leading to a two or three tiered union.

Ultimately the markets require a more definite level of financial support to the peripheral European countries and it looks as if this can only be resolved by the intervention of the European Central Bank. The ECB is currently reluctant to play this role but under the new leadership (Draghi) seem to have taken a softer stance recently supporting European banks with a short term funding package that has been well taken up. It may be that a combination of greater financial easing and voluntary restructuring of debt, as occurred in Greece, will pave the way to a solution. European leaders do not want to trigger defaults in the huge credit default swap market which would severely affect a weakened banking sector.

A number of managers still think that a European recession is likely in 2012 and that even if the politicians do resolve the issues related to the crisis, it is difficult to see how they can reverse the current trends where many governments have austerity planning in place.

Fixed Interest

The uncertainty in the political and economic climate has resulted in investors continuing to favour safe haven assets. These have been the sovereign debt markets of those countries in the West that have the highest rated government bond markets – the prime markets being in the US, UK and some Scandinavian countries. Despite the fact that a number of Emerging Market countries have far better fiscal positions, these safe havens have seen yields continue to fall to historic lows and the spreads to corporate bonds, especially in high yield, widen to levels that many managers feel offer unusual value.

Corporates outside the financial sector remain in good shape, having re-financed after the 2008 downturn. Whilst there is a need to be selective in corporate credit, managers with strong research teams should be able to deliver above inflation returns to investors in this asset class.

Overall within fixed interest markets, despite the difficult short term economic outlook, government bonds do continue to look poor value at these yield levels. Whilst official interest rates and government bond yields are at or close to all time lows inflation has picked up and so investors in government bonds will see negative real returns if holding these instruments to maturity.

Fixed interest investors holding longer duration assets in safe haven sovereign debt have seen some strong returns in 2011 – whilst this may hold in the short term we feel it is unlikely to be a safer long term investment.

US

The US has remained one of the stronger western economies in 2011 despite the challenging unemployment and housing data. Whilst these figures have improved of late they are too fragile to indicate whether any stronger trends have begun to establish themselves. Like many markets the US has continued to oscillate with the influence of Europe and the publication of economic data. The strength of the dollar as a safe haven has returned in the third quarter as some investors have moved away from gold as the ultimate safe asset.

A crisis on the real US issue of an increasing budgetary problem was averted in August with the transferral of responsibility to a new US ‘Super Committee’ charged with finding a solution to the US budgetary impasse. This again has been an area of slow progress with the latest sitting reaching few resolutions. With the Republicans controlling Congress and the Democrats the Senate it seems that little can be moved until after the elections (November) although this may be too late if the automatic cuts are allowed to take effect in defence and medicare.

The American economy has however shown resilience in the fourth quarter of the year with most economic data surprising on the upside. This positive run of data, combined with the safe haven status of the American market, has resulted in strong relative performance from the US stock market in quarter four. US equity market valuations still seem reasonable as long as a US or global double dip recession is avoided and the earnings backdrop for US companies is quite robust. The S&P operating earnings per share in the third quarter of 2011 reached their highest level ever, eclipsing the 2007 second quarter record by 5%, and full-year 2011 earnings appear on track to reach the highest level on record. This earnings achievement is even more remarkable in the face of zero growth in real GDP since the beginning of the financial crisis. If the much publicised work by Reinhart and Rogoff proves to be reasonably accurate then towards the end of 2012 more consistently positive economic data will lead to growth rates approaching pre-financial crisis levels.

There are still factors that can hinder US growth – the Eurozone credit crisis is certainly a cyclical factor requiring concern – but barring a complete meltdown in Europe, we do not expect it to have a materially negative impact on US growth. The main threat however remains the burgeoning debt-to-GDP ratio in the face of political gridlock. The safe haven status of the US Dollar however, means US Treasury yields are likely to stay at historic low levels, thus funding the US deficit is not likely to be a problem for the US in the short term.

Asia and Emerging Markets

The focal point for this region remains China which, in 2011, saw doubts appear as to the ability of the Government to combat inflation and to keep the economic growth on track. Estimates for the growth of the economy have certainly been revised downwards over the year but it still remains at or about 7-8% (CSLA) which is far from a contracting economy.

At the start of the fourth quarter high inflation, property prices and shadow banking were some of the negative factors weighing on investor sentiment but since then we have seen a sharp drop in inflation which has surprised many investors. Much of the inflation generated over the last twelve months has been from food, notably pork following an outbreak of porcine disease. This has now worked its way through the system encouraging higher production, and soft commodity prices have moderated and in many cases fallen back quite substantially. The result of this has seen Inflation fall from 6.5% to 4.2% and is likely to fall further.

The property market in China remains under pressure, partly because of government worries about social unrest due to poor affordability. Whilst investors have expressed concern about headline news showing house prices falling, in reality the Party has finally succeeded in its objective of bringing prices down in the residential sector.

Other areas of Asia continue to benefit from linking to the Chinese market. Indonesia is a prime example of the wealth creation feeding off expanding domestic Emerging Market growth. China wants to move up the value chain in manufacturing leaving space for other entrants to take advantage.

Other Emerging Market areas have also suffered from the issues of inflationary pressure in particular Brazil and India and these have proven more difficult to control although both countries have much stronger domestic economies where centralised government policy can have much greater effect than in previous inflationary periods.

Japan

The Japanese market continues to confuse foreign investors who are often the main movers of the market. It has moved less than others during the last quarter and remains less correlated to other large stock markets, being less affected by the macroeconomic news and data.

The fact that the economy has taken less time to recover from the Tsunami at the start of the year shows how they can focus resource when necessary. The more recent strength of the yen has put the manufacturing base under pressure but the government has chosen to intervene to prevent the currency rising higher.

Japan does however have its own economic and political difficulties to overcome. The economy continues to show very low levels of growth and political instability remains with the recent

appointment of yet another prime minister. Corporate Japan however continues to make improvements and still has some of the world's leading companies within certain industries. The market looks undervalued both on an aggregate and stock level.

Property

The market for property is still flat at the end of the quarter with the real returns expected to come from yield for some time to come.

In the UK there are clearly pockets of resistance which have remained strong throughout the crisis such as London and the South East and supermarkets but the values of office, stores and warehouses are still 34% below their June 2007 peak after rising just 1.7% in the twelve months to October, according to IPD data.

Whilst availability of good quality stock remains low, the yield compression that has been driving the market appears to have halted. Properties offering asset management opportunities are becoming more attractive as investors look further up the risk curve in order to generate acceptable returns. Risk of tenant default and falling rental values are still having an impact on secondary property, which is expected to see capital decline going forward. Rental growth at an all property level has been marginally positive since the middle of quarter two 2011, with continuing positive growth for offices.

Summary

At current levels markets are pricing in slower growth in the developed world for many years to come and at extremes some markets are now pricing in zero growth which seems unlikely despite the European political stagnation. This is not to deny that deleveraging in the global economy will result in slower growth than has occurred over the last 20 years.

Market weakness has been compounded by continued mistakes by policy makers. The US had an opportunity to resolve its budget deficit issues but missed it as political issues intervened.

The main macro concern for investors remains a break-up of the Eurozone. The realisation of the disastrous consequences of such a step means in the short term policy makers will go to extraordinary lengths to avoid this. Overall, it seems likely that a disorderly break-up of the Euro will be avoided. A resolution of the Euro issue would likely result in strong gains for investors in a short space of time however unfortunately, a quick resolution seems unlikely.

Equities look likely to remain volatile this year with a lot of bad news already priced in. A change in investor sentiment where the survival of the Euro was accepted as the likely outcome would allow risk assets to rally.

Valuations for equity investors remain favourable, even if news flow and sentiment are not, with markets continuing to trade at valuation levels below historic averages. Patient investors holding equities at current levels are likely to be rewarded over the next 5-10 years.

Core government fixed interest investments continue to be buoyed by both their safe haven status and Central Bank buying (QE) but longer term there seems little value in core government bond markets.

Within fixed interest, credit continues to offer good value for long term investors. Passive investment in this area is unlikely to deliver the best returns as bank and other financial bonds are big index constituents and have lagged this year due to the fear of some form of bondholder burden sharing. Investment houses with strong credit research teams still seem likely to do best.

In summary, many factors remain the same as at the end of the third quarter. A lack of decisive action by policy makers has compounded problems in the global economy and for equity markets. Signs of resolution would be viewed positively, but investor confidence in such an event will remain justifiably low until concrete steps have been proven to be taken.

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January 2012

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