

# Schroders Private Banking Investment Outlook

## Market Commentary and Outlook

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The year has started on a positive note. The establishment by the European Central Bank of a significant refinancing operation for the banking sector has successfully broken the downward spiral in asset prices in Europe. Equities have rallied, the euro has recovered and the yields on Italian and Spanish bonds have declined. As the euro crisis was the key concern of investors in 2011, this has led to a reversal in market leadership across all asset classes, with equities outperforming government bonds, cyclical stocks outperforming their defensive counterparts, and emerging market equities outperforming developed markets. Will this set the tone for the year ahead?

Chart 1

MSCI World index; MSCI EM index  
(rebased to 100)



Chart 2

Euro-Dollar exchange rate



Chart 3

Italian and Spanish 10-year bond yield



Source: Datastream. Past performance is not a guide to future performance.

### Banking crisis averted (or at least delayed)

The creation of a 3-year long-term refinancing operation (LTRO) by the European Central Bank at the end of last year has provided a much needed liquidity boost to this troubled sector. A second auction at the end of February is expected to see the size of funds provided approximately double to around one trillion euros. This removes the funding risks for the banking sector for at least a year. This in turn has reduced the stresses within the euro area debt markets, with bond yields in Italy and Spain falling to more sustainable levels.

While these measures buy time, we are no closer to a permanent resolution to the crisis. Still, our expectation is that we will neither see a definitive solution nor a complete disintegration of the currency in 2012. Instead we expect another year of muddling through, interspersed with the odd crisis, which remains a required ingredient of achieving political progress. This expectation of further crises ahead means we maintain a cautious investment stance.

A degree of caution towards European banks also remains appropriate in the absence of a resolution to the crisis. The ongoing deleveraging cycle

represents a negative backdrop, while regulatory pressures will intensify whenever earnings increase. The sector needs to raise more equity capital and shrink loans. However, the news is not all bad. We see value amongst the stronger banks in Switzerland and the Nordic countries. For those willing to take on more risk, there are some credible restructuring stories (RBS) and national champions in the euro area (BNP and Deutsche) that offer significant upside as long as we avoid the worst case scenario. It is worth highlighting that banks in Spain, Italy, Ireland, Portugal and Spain now account for just 20% of the sector across Europe.



### Greece still represents a threat

Carmen Reinhart and Kenneth Rogoff published “this time is different: eight centuries of financial follies” in 2009. It is a study of government defaults, banking crises and inflationary spikes from medieval currency debasements to the subprime crisis and instantly became required reading for the investment community\*. One fact that struck a chord with investors was that modern-day Greece has been in default for approximately half of the years since its independence in the early part of the nineteenth century. The price of Greek bonds headed south from then on as investors worked out that history was about to be repeated. Yet three years on, while it is clear to all that the country is unable to repay its debts, the issue remains unresolved and the potential for a disorderly resolution continues to be a major threat to the stability of the euro area. We expect an agreement to be reached on a partial default ahead of the 20th March, the date of the next major Greek government bond maturity. If we are wrong, expect a rapid resumption of the stresses in the euro area bond markets.

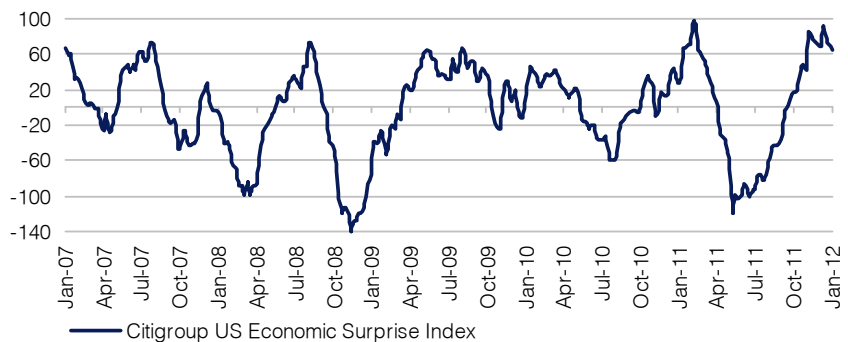
### US: surprisingly good or as good as it gets?

US economic data has continued to surprise on the upside. The scope for positive data to boost the US equity market may diminish going forward as a measure of the level of positive surprise relative to expectation has approached a five-year high (see chart 4). The US Federal Reserve has extended the period for which it expects to keep interest rates at current

\* We hosted Carmen Reinhart at our Secular Market Forum in 2010. You can read her key conclusions on Schroders Talking Point.

Chart 4

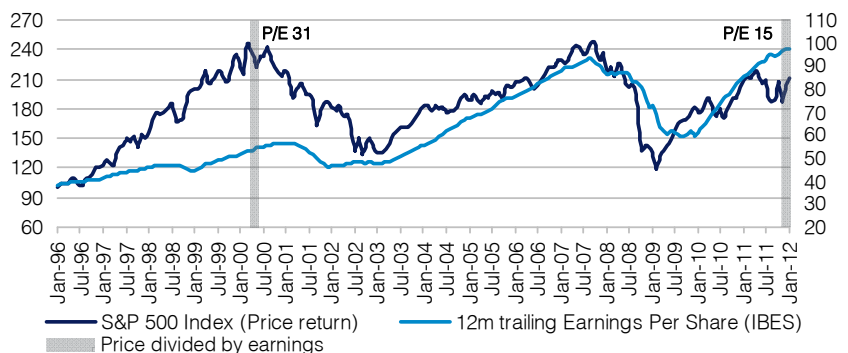
Citigroup US Economic Surprise Index



Source: Datastream. Past performance is not a guide to future performance.

Chart 5

The relationship between the share price performance of US equities and earnings



Source: Datastream. Past performance is not a guide to future performance.

levels to 2014. This will also support the US bond market. However, with yields already below 2% and below the prevailing rate of inflation, we do not find US Treasury bonds attractive investments. The US faces significant cuts in government spending as existing programmes expire in the absence of agreement between the two major political parties. While achieving consensus will be challenging in an election year, we expect at least some agreement on providing stimulus to the economy as neither political party will want to carry the blame for sending the economy back into recession.

The US housing market remains weak, with new home sales falling in December and prices dropping. The fall in prices has left many home-owners in

negative equity and the large number of foreclosed houses being sold continues to act as a downward force on prices. However, excess supply is gradually diminishing and the ratio of house prices to income is back to pre-bubble levels. Low interest rates make housing very affordable. After peaking in 2006, US house prices may be approaching a trough. This will remove a drag on the economy but the recovery is likely to be very gradual.

The US equity market has undergone a decade of derating, with the S&P index still trading below its 2000 highs (which were briefly exceeded in 2008) while earnings outside the banking sector have hit new records (see chart 5). Equity valuations look attractive based on current earnings and extremely so

compared to bonds (both government and corporate). The key threat to equities, therefore, is earnings expectations. With consensus expecting growth of 23% over the next two years at a time when margins are already at historic highs, we see scope for disappointment. However, companies able to sustain or grow their earnings, together with those able to deliver an attractive

dividend return, offer investors a more compelling investment than either cash or government bonds.

In conclusion, the ECB has acted to give the region more time to address its imbalances. This removes the immediate threat of banking failures. The US looks in better shape and should continue to grow in the absence of a deeper crisis in Europe. China is

slowing but not collapsing. Overall this means slower global economic growth, lower inflation and a continuation of expansionary monetary policies. If this scenario pans out, it is positive for risk assets. However, we see further crises ahead in Europe and see economies across the continent heading into recession. Another year of market gyrations is the most likely outcome.

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**Important information: Past performance is not a guide to future performance. You should remember that investors may not get back the amount originally invested as the value of investments, and the income from them can go down as well as up and is not guaranteed. Exchange rate changes may cause the value of overseas investments to rise or fall.** This document is intended to be for information purposes only and it is not intended as promotional material in any respect. The views and opinions contained herein are those of Robert Farago, Head of Asset Allocation, and do not necessarily represent the Schroders House view. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide, and should not be relied on for investment advice or recommendations. Opinions stated are matters of judgment, which may change. Information herein is believed to be reliable, but Schroder & Co. Ltd does not warrant its completeness or accuracy. This does not exclude or restrict any duty or liability that Schroder & Co. Ltd has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. For your security communications may be taped or monitored. Issued and approved by Schroder & Co. Limited, 100 Wood Street, London EC2V 7ER, which is authorised and regulated by the Financial Services Authority. 938725