

Schroders Private Banking Investment Outlook

Market Commentary and Outlook

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The waning confidence in the eurozone means that Europe is heading into recession. We expect global growth to be sustained due to continued expansion in the US and the emerging world, albeit at a lower pace. Commodity prices are off their peak. This will bring down inflation and allow interest rates to come down in those countries where rates are not already close to zero. The outlook for the year ahead is likely to be determined in Europe. We are pessimistic that a solution can soon be reached. Therefore the most confident prediction we can make about 2012 is that markets will remain volatile.

Chart 1

US, UK, Euro stoxx indices

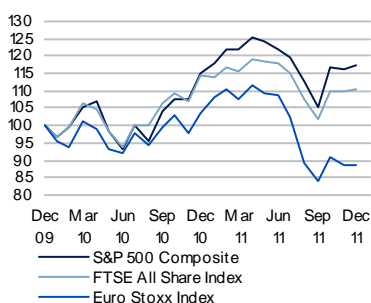


Chart 2

US, UK, German 10-year bond yields

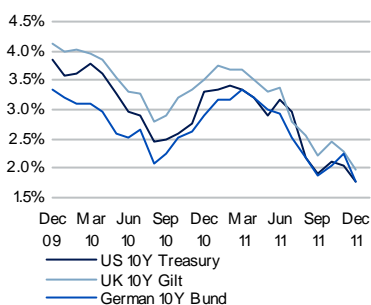


Chart 3

US Equity market volatility (VIX index)



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

Economic data releases provided few major surprises in the final quarter of 2011. There were growing signs of a slowdown in Europe and China but this was balanced by stronger than expected growth in the United States. The Japanese economic recovery from the aftermath of the Tsunami remained on track, with industrial production returning to pre-crisis levels. Inflation levels became uncomfortably high in the UK and China earlier in the year and remain elevated, but have retreated from their highs. The European Central Bank responded to weaker economic data by cutting interest rates back to 1% in December.

Equity markets recovered from the sharp falls of the summer despite the deteriorating political situation in Europe, with the notable exceptions of the Tokyo and Shanghai exchanges. Energy shares led the rally while financial stocks continued to lag.

The UK gilt market, US Treasury market and German bunds all delivered positive returns to domestic investors as expectations for both growth and inflation were cut. However, elsewhere the stresses in the euro area spread from the periphery to the core, with yields rising in France, Spain and, most significantly, in Italy, which is Europe's biggest bond market.

The uncertain outlook for Europe also led US and other international banks to withdraw funding in the wholesale banking market, pushing up the cost of capital for European banks. This in turn pushed up the cost of credit for companies, which led to a widening of corporate bond spreads relative to government bonds. The euro weakened slightly against the US dollar, but there were no significant shifts in currency markets.

Commodity prices finished the quarter broadly unchanged. The oil price was stable despite the resumption of production in Libya on the one hand and growing tensions around Iran on the other.



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The gold price also finished close to its starting level, but traded 18% below its September peak at one point.

Elsewhere, property continued to deliver returns broadly in line with its yield. Hedge funds on average posted modest declines, with no strategy standing out significantly in either direction.

ECB to the rescue?

Building pressures within the euro area mean that the outlook for economies has deteriorated to the point where we expect recessions across the continent. Authorities have not done enough to satisfy either markets or rating agencies. Rating cuts for France, Spain and Italy (amongst others) are looming and risk triggering a downward spiral. The only way we see this spiral being broken is through quantitative easing by the European Central Bank (ECB). At present, we see this as likely to occur in the Spring. This is because Germany and the other stronger countries want to see greater commitment to structural reform by the stressed nations before allowing the ECB to step in. However, Italy and Spain have huge funding requirements in the first quarter of the year. This means that the situation is likely to get worse before it gets better.

We continue to believe that the authorities in Europe and beyond will do all that they can to prevent a break-up since the economic and social impacts would be severe. In addition, the financial system would go through a period of chaos (even for those who had prepared for this eventuality).

Europe is the biggest export destination for the UK economy.

This fact together with the on going austerity programme means we see the UK heading into recession in tandem with its European partners.

The scale of the domestic economies in America, China and Japan provides some insulation from events in the rest of the world. We see the US economy continuing to grow in the absence of a more severe crisis in Europe. The US faces its own budgetary challenges due to a rapidly ageing population and associated unfunded pension and healthcare liabilities. There will be no significant policy shift this side of November's presidential election. A continued policy gridlock beyond that date could see the debt crisis cross the Atlantic.

The Chinese economy is expected to continue to slow as government measures to cool the property market take effect. The recently announced reduction of bank reserve ratio requirements marks the start of an easing cycle. However, we do not see scope for any significant stimulus since banks are already weighed down with substantial non-performing loans and the rate of inflation is above the lending rate. Meanwhile we expect growth to slow in Japan as the rebound from the Tsunami has largely occurred.

Record corporate profits: a mixed blessing

The combination of record profit margins in a number of industries and strong balance sheets leaves equities looking attractive on current earnings. Yet record levels of profitability is a mixed blessing since this can reliably be expected to revert to the mean

over the longer term. This is particularly true when the market is priced above average on long-term trend earnings, as it is today. Indeed, a review of history shows that times when profitability is at extreme highs has led to disappointing equity returns in the future. Yet despite this, a long-term investor can sensibly predict a modest positive real return from equities from current levels.

In contrast, buying 10-year government bonds at current yields, which are below the average level of inflation, and holding to maturity should be expected to produce a negative real return. This is particularly true when governments are pursuing a policy of quantitative easing despite inflation remaining stubbornly above target. We see greater merit in holding index-linked bonds that can profit from an increase in inflation if official rates remain below the level of inflation, which is currently the case and we expect to continue.

While the long-term outlook clearly favours equities over bonds, there are plenty of reasons to be cautious on equities in the shorter term. In particular, recessions are never good for equity investors and the risks right now are skewed to the downside. We continue to favour quality companies, defined by characteristics such as strong balance sheets, a secure dividend and a sustainable business model. We see extreme valuations in some less favoured areas of the market but do not expect to be well rewarded for seeking value in the near term. In contrast, we see a strategic role for energy equities in portfolios

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despite the risks associated with our downside scenario. We are confident that emerging market demand will lead to tight markets in a few years time. In the shorter term, this exposure offers something of a hedge against further instability in the oil producing nations of the Middle East.

We are more cautious on other commodities. Inventories are generally ample. High prices in agricultural commodities has encouraged more planting and this year has seen bumper harvests for a number of crops. From a portfolio perspective, commodities have not offered any real diversification benefits for equity investors.

Gold remains different. We expect the US Federal Reserve, the Bank of England, the European Central Bank and the Bank of Japan to implement more

quantitative easing this year. This is unlikely to provide a major boost to growth, may do little to help equities or bonds, but reinforces the case for gold.

We continue to see value in investing in hedge funds that are able to profit in a volatile environment and that offer diversification benefits for holders of equities. In 2008, systematic trend-following macro strategies made significant gains in the final quarter of the year when equities fell further and bonds rose higher than most investors were able to contemplate. 2011 proved to be a tricky year for these funds as choppy markets left most managers in negative territory. In contrast, a number of discretionary macro managers fared well during the downturn in economic data in the third quarter. We cannot be confident in which strategy will provide the

best returns in 2012 but we are confident that there will be periods when investors will be glad to have some exposure to managers that can profit from an increase in volatility since this is inevitably associated with falling equity markets.

In conclusion, current valuations favour equities over bonds. Indeed, the yield alone means that you are being paid to ride out the inevitable volatility in prices. Yet we are cautiously positioned since we do not see an imminent change in direction in the crisis in Europe. With government fixed interest securities priced to lose money for long term investors in the US, UK and Germany, we look to balance equity risk instead with holdings in index-linked government bonds, property, select hedge funds and gold.

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