



Introduction

This document summarises the views of the Investment Desk's strategy across global asset markets by examining the fundamental background and factoring in the macro outlook.

- There are formidable economic and financial challenges ahead requiring strong political leadership and even greater co-ordinated global action.
- Portfolio construction will reflect this background focusing on income generation through an optimal mix of assets and active management.
- Flight to quality assets are well placed to benefit from slow growth, volatility and uncertainty in the early part of the year.

Executive Summary

- **Investment Grade** borrowers are expected to hold and possibly strengthen their enhanced credit profile through 2012.
- Positioning between defensive and the more cyclical sectors will vary depending upon risk budgets, but holding large, liquid issues will be important so strategy changes can be implemented as the investment climate evolves.
- **Financial bonds** offer a wide range of prospective returns for 2012, highly dependent on the overall investment climate, the issuer, and where a particular issue sits in the capital structure.
- Fortunes of the European financial sector and sovereigns are integrally entwined; financials will benefit from any credible plans to restore the fortunes of Euro sovereigns.
- **Emerging Markets** provide wide ranging opportunities from defensive government bonds, strong corporates through to long-term strategic investments in undervalued currencies.
- **High Yield** bonds offer one of the best risk-adjusted returns profiles for 2012.
- Key positives include return to pre-crisis operating margins, lower debt ratios, and extended maturity profile.
- **Equity exposure** via large cap stocks, high and steady dividends, with high free cash flow, low debt levels and global footprints will remain the key focus.
- We favour **Commodities** with tight supply, despite a subdued demand outlook.
- **Gold** will continue to play a role as a relatively safe haven investment, on the basis of its 'alternative currency' status in the face of turmoil.
- **Hedge Fund Strategy** will be focused on global macro and with protection from CTA exposure given asymmetrical outlook.



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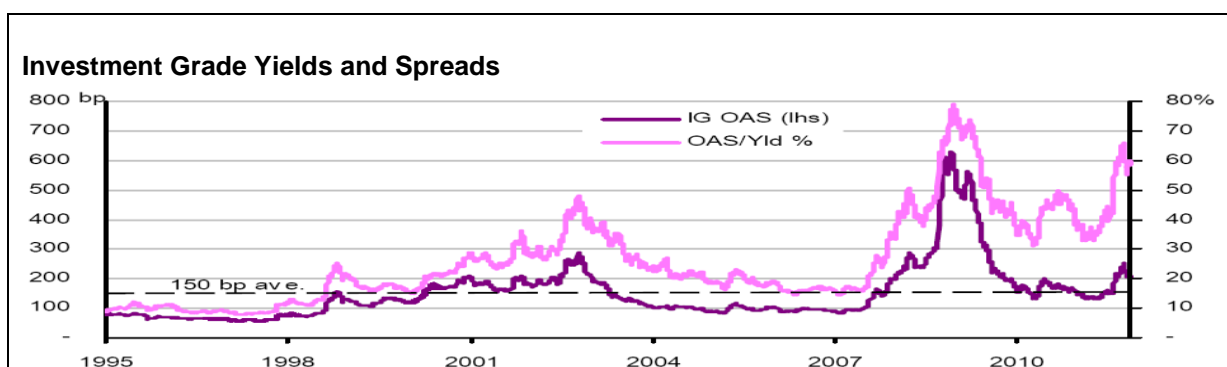
Investment Grade Bond Outlook

Investment Themes

- The outlook for Investment Grade is constructive as the US remains on a positive growth trajectory, supported by lax monetary policy and QE. Changing expectations of growth prospects however are expected to keep volatility levels elevated.
- Investment Grade borrowers are expected to hold and possibly strengthen their enhanced credit profile through 2012.
- Wide credit spreads have made valuations more attractive, albeit absolute yields are close to post-war lows suggesting periodic valuation challenges.
- Positioning between defensive and the more cyclical sectors will vary depending upon risk budgets, but holding large, liquid issues will be important so strategy changes can be implemented as the investment climate evolves.

Overview

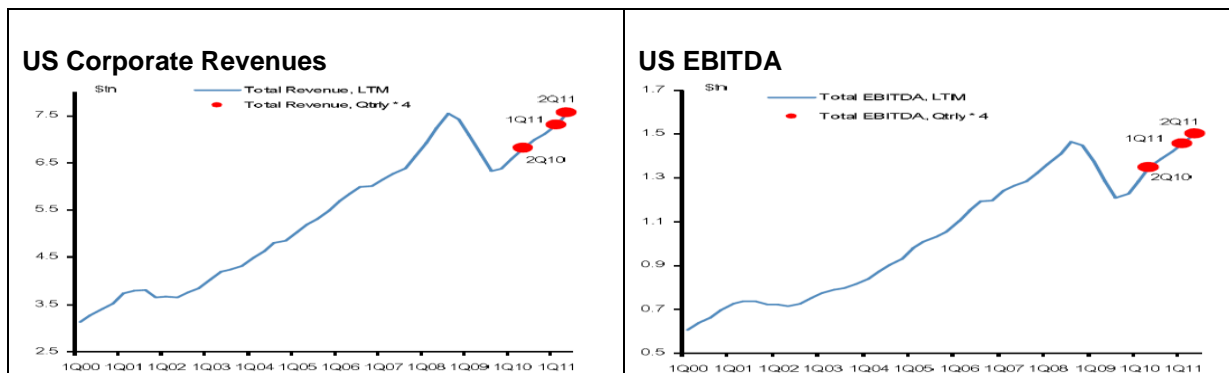
The general background for Investment Grade bonds remains constructive while there is still economic growth in the developed world. But growth prospects can change quickly, in turn impacting the credit valuations. These rapidly changing fortunes have contributed to elevated credit market volatility in recent months, and this is expected to continue well into the New Year.



Source: UBS, Yield Book

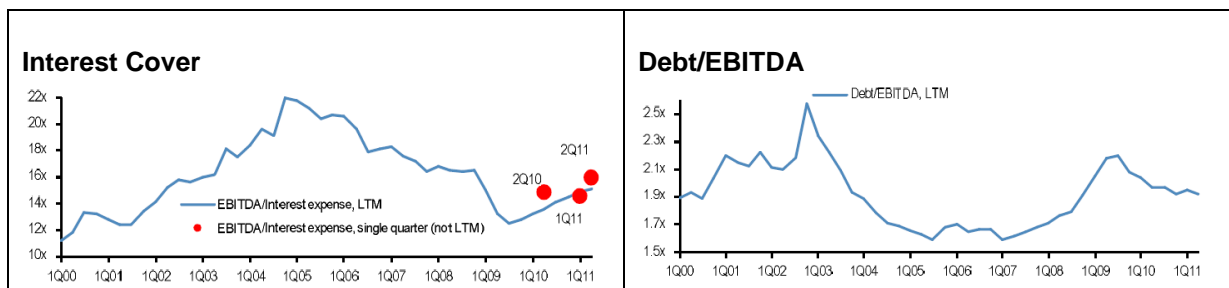
Compelling Credit Fundamentals

With the US economy expected to grow around 1½% in the coming year, the starting point for credit is reasonably constructive. This is complemented by extremely accommodative monetary policy, including most developed world official rates anchored near zero and central bank buying of government bonds. Further Quantitative Easing remains in prospect for 2012. Credit quality has improved steadily over the past 2½ years, and Investment Grade borrowers are expected to hold and possibly strengthen this enhanced profile through 2012.



Source: JPM

Having fallen dramatically after the credit crisis broke, corporate revenues and profits have recovered steadily, returning to earlier peaks. During this period, corporates have become more risk-averse, largely shunning opportunistic development and making sure their debt obligations are fully honoured, often at the expense of equity holders. CAPEX has picked up, but in a controlled manner, and cash has risen to record levels. This more cautious business model operated by many borrowers has been a positive for bond holders, and this is expected to continue. Nonetheless, this is occurring at a time when the solvency of sovereigns is being questioned increasingly, especially in Europe, and unless reversed will ultimately add to the cost of capital for corporates.



Source: JPM

With the rise in revenues and profits, the ability of the corporate sector to service its debt obligations has improved markedly, albeit interest cover (EBITDA/interest expense) still lies some way below the best levels of 2005 (largely because the stock of outstanding debt is significantly higher). Looking ahead, interest cover is expected to rise modestly/stabilise in the coming year as the tough operating climate persists. Leverage (debt/EBITDA) has declined since early 2009, but in recent quarters the progress has rather stalled. The amount of leveraging varies quite significantly between sectors, for instance it is falling in chemicals and rising in capital goods. Companies are expected to make tough decisions going forward, ensuring leverage remains controlled, which in turn means embarking on further rounds of cost consolidation if necessary.

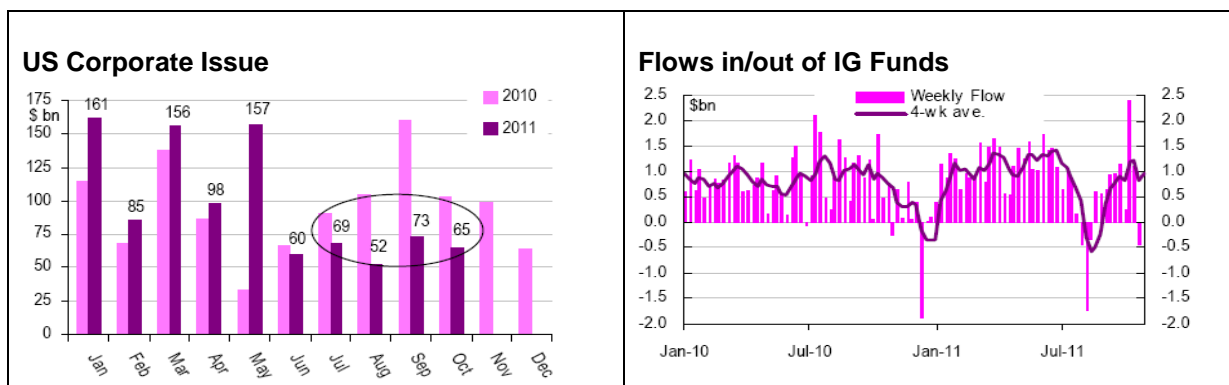
Overall, the improved credit quality of corporates is expected to remain in place through 2012. The macro climate will remain hesitant, curbing the scope for significant improvement, but no significant deterioration is seen either unless a demand shock emerges from the Euro crisis.

Market Dynamics, Funding and Positioning

Corporates made good progress on reducing re-financing risk, having been shut out of capital markets at the peak of the financial crisis. This has considerably reduced their need to raise capital in 2012 and

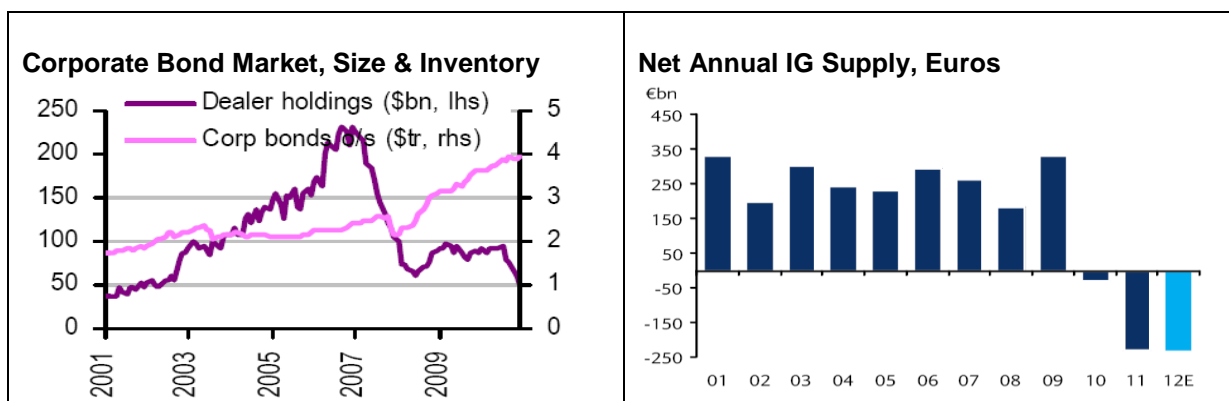


2013. Primary bond market activity has tailed off sharply since the summer, serving a timely reminder to corporates that there is no quick end to the credit crunch, which in turn is expected to promote good credit behaviour. Net issuance in the Euro credit market is projected to be negative in 2012 for a second year running, at minus €220bn.



Source: UBS, Bloomberg, Lipper

Although the flow of funds into Investment Grade has moderated from the heady levels of 2009-10, it remained positive in H2 2011. This is expected to continue going forward, with investors attracted to the security of bonds over equities, and the allure of scheduled coupon payments. Nonetheless, while the size of the bond market is at a record level, dealer inventory is low; suggesting that the recent high levels of volatility will remain a market feature well into 2012.



Source: UBS, Bloomberg, Federal Reserve, Barclays Capital, Dealogic

Attractive Credit Valuations

Credit spreads widened sharply in H2 2011 as the European sovereign debt crisis escalated. This made valuations more attractive given the robust underlying corporate business models and credit qualities. Credit spreads versus governments are some 50bps wide of their 150bps long term average. Absolute yields remain close to post-war lows, however, providing periodic valuation challenges. As the low-interest climate endures, the sectors' inherent qualities are expected to attract fresh buyers.

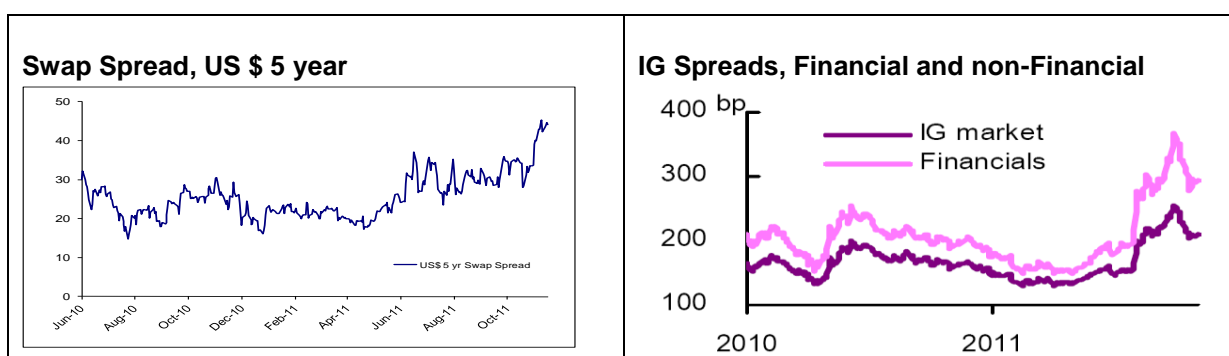
Within sectors, financials are cheap on an historic basis, on a swap spread basis (i.e. they are wide), and versus non-bank borrowers. Much of this can be explained by expectations of significant losses arising



from the Euro debt crisis. Nonetheless, careful analysis of individual banks and different types of bonds can offer very attractive risk/reward return profiles. We stick to bonds issued by the largest systemically

important banks, which are considered to have an implicit government guarantee, and expected to be redeemed at the call dates.¹

Investment Grade sectors offer value for the medium term investor. Positioning between defensive and the more cyclical sectors will vary depending upon a funds' risk budget. Holding large, liquid issues will be important given market conditions, giving maximum flexibility to switch between sectors/individual bonds, taking advantage of opportunities as the investment climate evolves.



Source: Bloomberg, UBS, Yield Book

¹ The Financial Stability Board listed officially some 29 global systemically important banks.



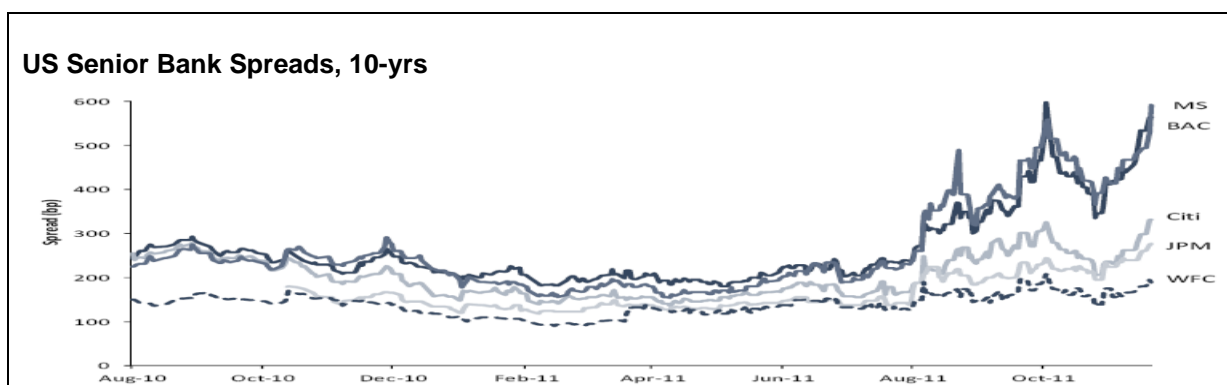
Financial Bond Outlook

Investment Themes

- Financial bonds offer a wide range of prospective returns for 2012, highly dependent on the overall investment climate, the issuer, and where a particular issue sits in the capital structure.
- Fortunes of the European financial sector and sovereigns are integrally entwined; financials will benefit from any credible plans to restore the fortunes of Euro sovereigns.
- On-going de-leveraging, the evolving new regulatory structure, and economic growth (albeit slow) are combining to make banking much safer on a 5-year horizon, strengthening credit-worthiness significantly, and building a strong case for strategic exposure.
- Financials are cheap by many valuation metrics, providing an interesting variety of investment opportunities.

Background

Financials have been at the centre of the Euro Zone sovereign debt crisis, with bond prices falling abruptly in H2 2011 as the turmoil escalated. The fortunes of European sovereigns and financials are integrally entwined, with any credible plans to restore the fortunes of the former positively benefitting the latter. The inter-connectedness of the global economy has meant these forces have been felt in the US and elsewhere, and have not purely been restricted to Europe. This has left financials heavily discounted, and offers some extremely interesting opportunities for 2012.



Source: Goldman Sachs

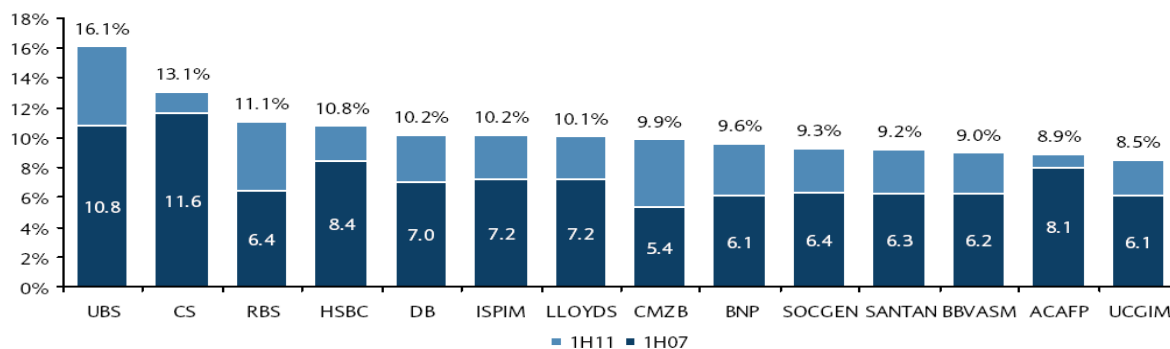
Credit Fundamentals and the Changing Regulatory regime

The global banking system remains in the midst of the de-leveraging process, which still has some years to run. At the same time the sector is undergoing major regulatory reform at a global level. In short, this is designed to strengthen balance sheets markedly from the pre-crisis 2007 era.



Selected European Tier 1 Ratios, Present vs H1 2007

Figure 3: Core Tier 1 capital ratios (%), H1 11

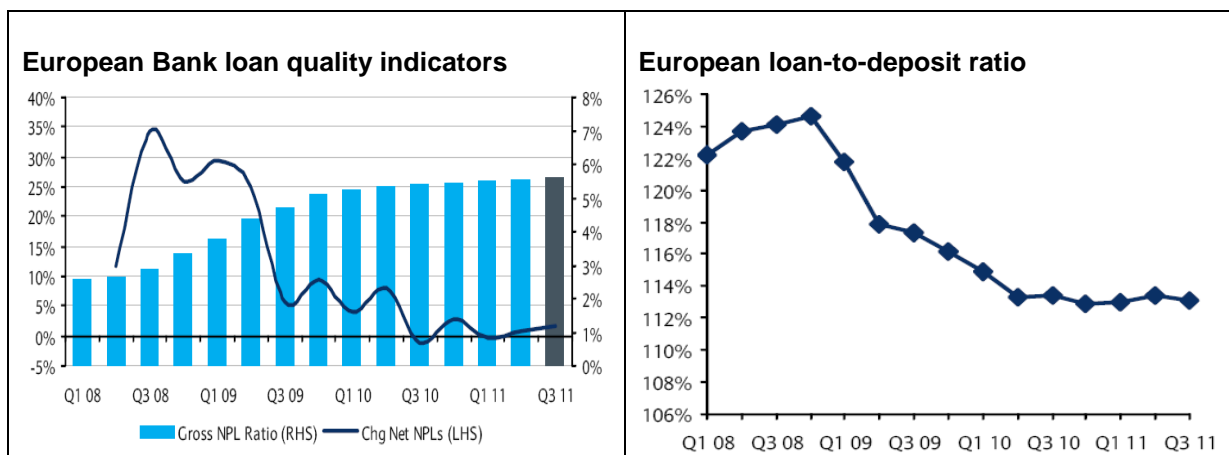


Source: SNL, Barclays Capital

In the US, this reform has been mainly driven by the Dodd-Frank legislation, which restricts greatly bank proprietary trading activity, strengthens derivative regulation, enhances transparency of bank activity, and bolsters depositor security. In Europe, Basle III determined banks must increase common tangible equity capital to 6% of (risk weighted) assets, and in Autumn 2011 the EU went further by agreeing to increase this to 9% (meaning European banks need to raise an additional €105bn of such capital by mid-2012). In addition, under Basle III, banks require further loss-absorbing 'contingent' capital, which will raise the capital to assets ratio to 14.5%. Rules in the UK are even more stringent following the recommendations of the Vickers Commission report where the assets of retail banking operations will be ring-fenced, and 'core plus contingent' capital ratios of 10% and near 20% will be adopted (similar to the Swiss regime). Banks are already moving towards adopting these regimes, which come into force between 2013 and 2019. Old-style hybrid Tier1 subordinated bonds will be phased-out and will not count towards regulatory capital, becoming progressively more expensive bank capital.

As occurred in the wake of the Lehman's crisis, central banks have taken bold steps to provide near unlimited access to (short term) funding for banks. A global co-ordinated response saw the opening up of US dollar swap lines, and the ECB providing c€0.5trn in 3-year loans. Policy is now designed to provide adequate liquidity to banks, limiting the chance of an accidental bank failure.

This will make banking much safer on a 5-year horizon, strengthening credit-worthiness significantly, with the flip-side invoking equity dilution and lower return on equity employed. This builds a powerful case for building strategic long term bank exposure. Selection of bank names and where an individual issue will lie in the capital structure will play a vital role in determining allocation.

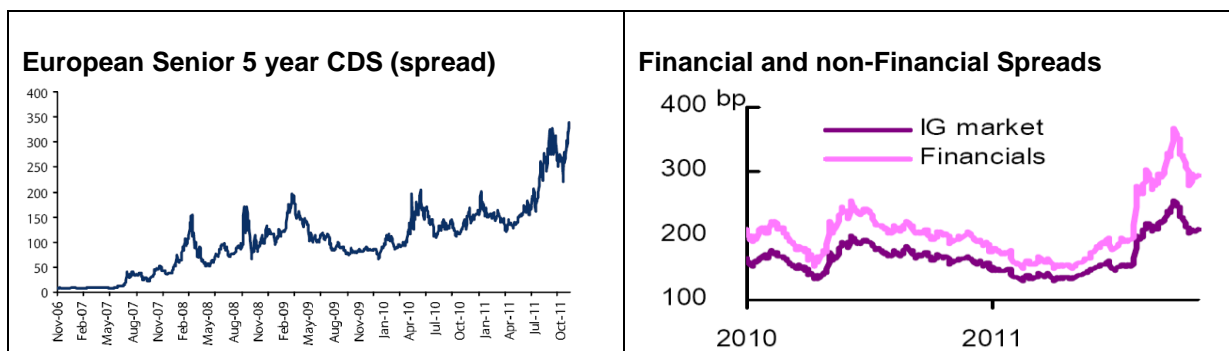


Source: Barclays Capital, bank annual accounts

Attractive Credit Valuations and Investment Strategy

Financials were sold-off abruptly, and in an across-the-board manner in H2 2011. This has left the entire sector cheap by recent historical standards, and versus the major government bond markets and corporates. Particular attention needs to be paid to investor risk appetite, i.e. how much volatility can be tolerated. Holdings should be focused on the global significantly important financial institutions (G-SIFIs) as documented by BIS, in other words those that are 'too big to fail' and enjoy an implicit government guarantee.

Senior bonds from such issuers presently run with relatively high yields, c5%. Much higher returns can be garnered by holding subordinated issues. Lower Tier II issues presently yield c13% to the call, and enjoy a final legal maturity (with lower c9% yields). Legacy subordinated Tier 1 issues are presently deeply discounted commonly priced at 75-85c in the dollar. Detailed analysis reveals issues that in all probability will be called, giving very attractive returns of c11%, before such issues turn into expensive bank funding. This will prove a very interesting sector providing a variety of diverse opportunities for investors in 2012.



Source: Barclays Capital, Bloomberg, UBS, Yield Book

Insurance valuations have moved broadly in line with financials. While the sector has not been subject to the same scrutiny as the banking sector, EU insurers now fall under the EU Solvency II directive, which goes live in 2013-14. This initiative serves to strengthen the solvency and capital positions of insurers by embracing a risk-adjusted return framework, which again over time will enhance overall credit worthiness. The risk/return profile for issues across the capital structure is similar to banks. Only the largest, non-Euro Zone insurers are considered suitable investment opportunities.



Emerging Market Bond Outlook

Summary

Emerging markets provide significant income and long-term capital growth opportunities capturing the credit upgrade cycle. However, EM is not a homogenous grouping and it is important to differentiate between the stronger and weaker sovereigns and credits, a characteristic this asset class shares with developed nations.

There are three main medium-term EM centric investment strategies:

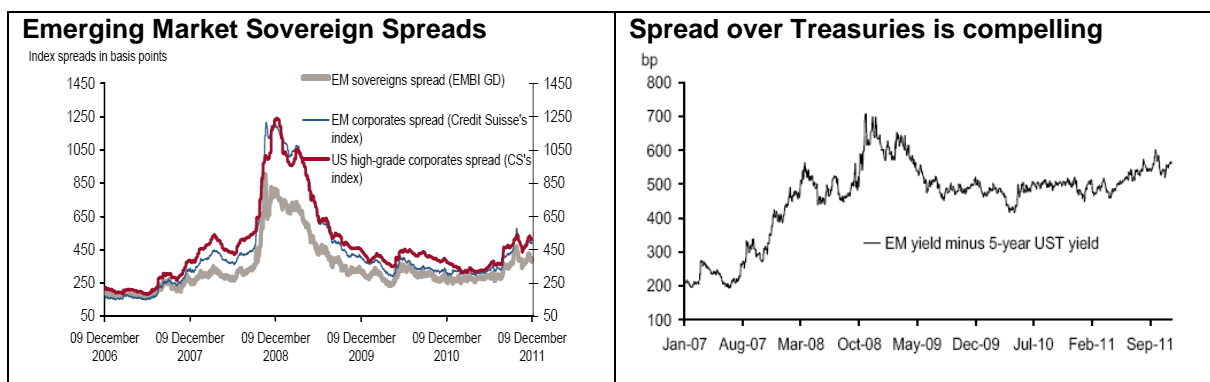
- **Sovereign and quasi sovereign bonds** – focus on the strongest countries with credit upgrades, a well-defined financial sector and industrial policy
- **Corporate Bonds (hard currency)** – focus on national champions, global conglomerates and resource orientated companies
- **Local currency sovereigns and supranationals** – capture long-term currency revaluation via short-duration low credit risk entities.

Background

The general background for emerging market bonds remains constructive with still robust economic activity and strong balance sheets. However, there are also reasons to be cautious due to the risks to growth in Europe and the political morass in the United States, given that for a number of countries, exports remain a key driver of activity. Nevertheless, the longer-term strong internal credit dynamics and the rebalancing of the global economy in favour of the EM will lead to significant credit upgrades.

As with the developed world it is important to differentiate between the stronger sovereign credits and the weaker ones in constructing portfolios. **The stronger credits such as Singapore and China** generally have lower yields and lower volatility whereas the weaker credits such as Egypt and Turkey have significantly higher yields and hence higher volatility. The same applies to the corporate sector with global conglomerates such as Noble Group, Tata and a diverse range of financial institutions.

Overall, on a relative and on an absolute basis, EM remains a compelling story. The asset class has displayed far greater resilience in the recent Euro led financial market turmoil than in 2008 reflecting concrete steps undertaken to improve the internal credit dynamics.



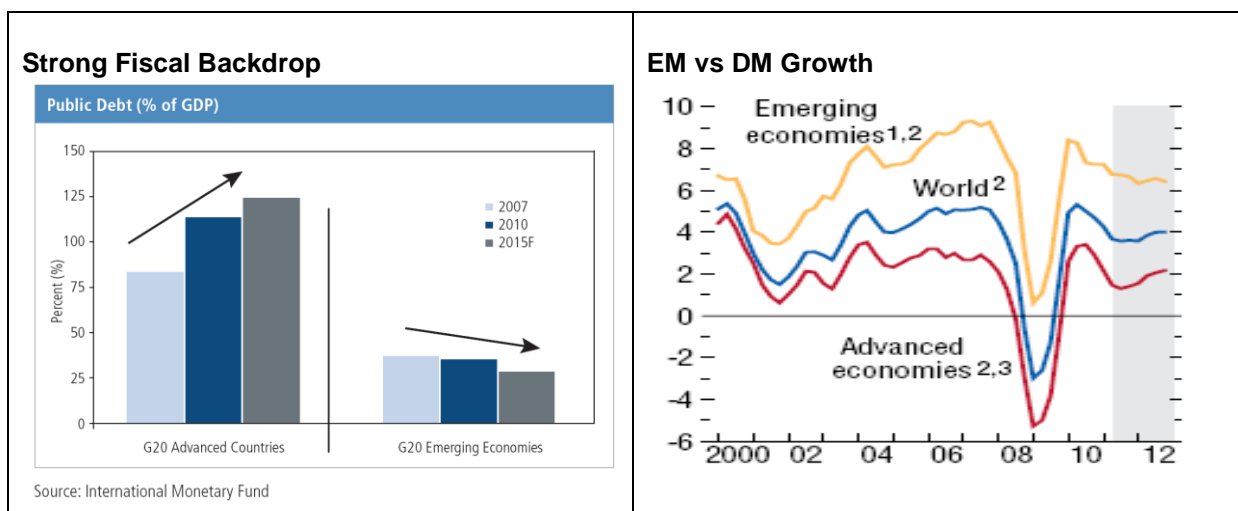
Source: Morgan Stanley

Source: JP Morgan



Sovereign Credit Fundamentals

The starting point for emerging markets is extremely constructive as inherent credit quality has steadily improved over the past 3 years. This also provides an extremely supportive backdrop for corporate credits. **On balance, the credit upgrade cycle should remain intact particularly for the Asian and Latin American countries.** Eastern Europe and Northern Africa will initially face a very challenging environment but in the medium-term will overcome these issues.



Source: JPM

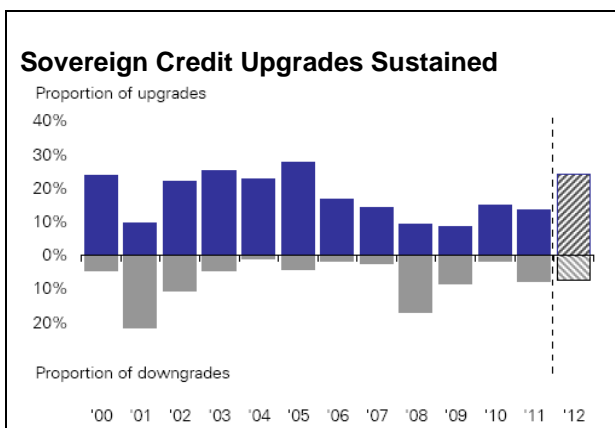
Source: IMF Economic Outlook

The EM group has moved into a faster growth trajectory comfortably surpassing the developed world. Encouragingly, domestic demand has played an important role particularly for the larger economies and this trend should be sustained over the next few years. EM Asia continues to lead the way and is projected to grow between 5-7% and is likely to get stronger beyond that. Many commentators continue to cry wolf on China waiting for the hard landing that would de-stabilise the rest of Asia and beyond. Of course there should never be any complacency but there is a widespread misunderstanding of the internal political, economic and financial dynamics. Policymakers make use of a much wider range of tools to either indirectly fine-tune the economy or directly change the growth patterns. This is most notable in the financial sector where reserve requirements can be moved significantly and acts as a constraint both on the way up and on the way down.

Emerging Europe faces the biggest potential risk due to the economic and banking links with the Euro Zone. There are already signs of strain in a number of these countries, with outright recessions already underway in Hungary and the Czech Republic. It is widely expected that the main Euro Zone banks will curtail lending to this region as a part of their efforts to increase capital buffers and reduce riskier loans. In tandem with lower demand and capital expenditure, the outlook is not rosy, even though in many countries there is room to support growth via fiscal and monetary policy.

There are shorter term challenges for the whole of EM as the Euro Zone crisis continues to rumble on, with potentially a significant credit crunch ahead. Additionally, the private sector (households and companies) deleveraging that is underway across much of the developed nations will also constrain potential economic growth.

The positive news is that the major EM countries have room for manoeuvre both in terms of cutting nominal and real interest rates and in terms of loosening fiscal policy. They start from a much stronger fiscal position with lower debt levels and the capacity to act pro-cyclically.



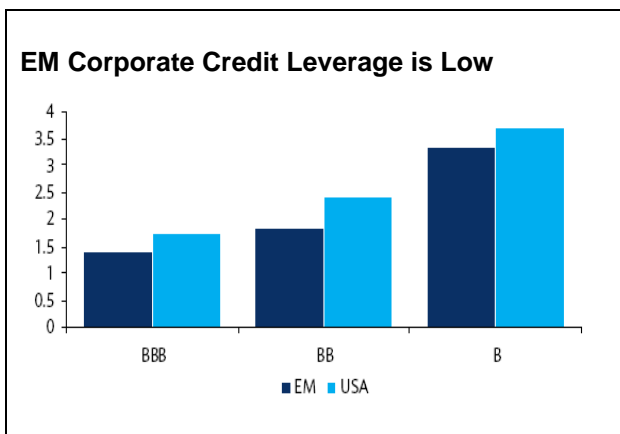
Sovereign EM FX Reserves Rising

	FX reserves (eop)	
	2008	current
Emerging Markets	4,148	6,392
Latin America	447	690
EMEA EM	715	929
EM Asia	2,986	4,773

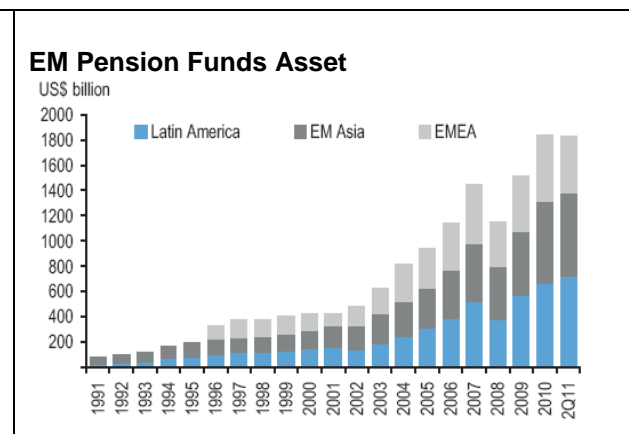
Source: JPM

Corporate Credit

The fortunes of corporate credit are entwined with sovereign debt as it provides a basis for an upgrade cycle particularly for emerging markets and it is essential to get the sovereign analysis right. The corporate backdrop is in essence positive with the negatives connected to the Euro Zone and the potential credit contraction related to the banking sector. The risk from this particular area is most acute for Emerging Europe and less so for Asia and Latin America as there has been a re-orientation in these regions towards American and Japanese banks.



Source: Deutsche Bank



Source: JP Morgan

EM credit leverage is relatively low across the rating spectrum underpinning the prospects for credit upgrades. Looking ahead, interest cover (EBITDA/interest expense) is expected to improve modestly/stabilise in the coming year as monetary policy is loosened and the cost of capital is lowered by government action. Leverage (debt/EBITDA) has declined since early 2009, but in recent quarters the progress has rather stalled.

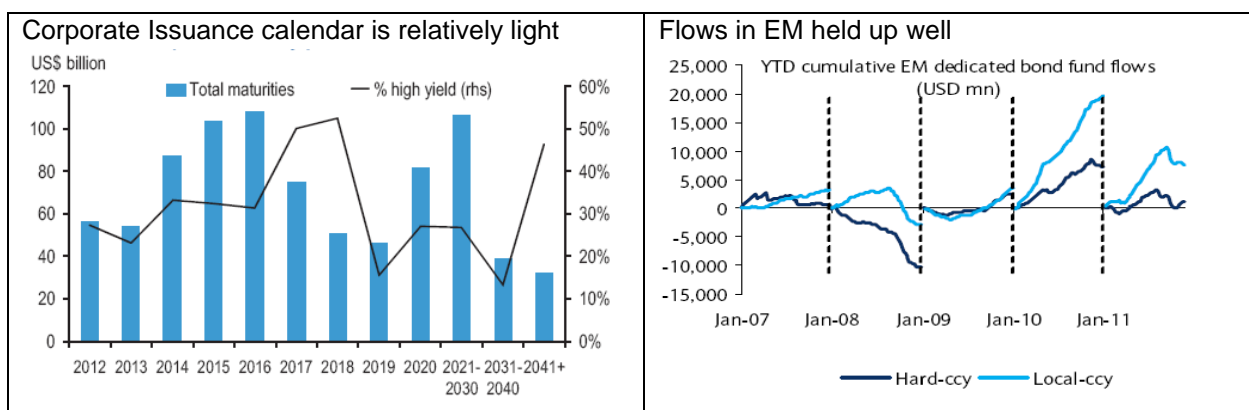
Overall, the improved credit worthiness of corporates is expected to remain in place during 2012. The macro climate is expected to remain hesitant, curbing the scope for significant improvement, but no significant deterioration is seen unless a demand shock emerges from the Euro crisis.



Market Dynamics, funding and positioning

Both EM sovereigns and corporates face little re-financing risk. The new issue market was not as poor as for other markets. Looking ahead sovereign cash flows will exceed the financing need for 2012. EM net corporate issuance will also be manageable as the calendar is relatively light. The high yield component of new issuance will remain low and maturities will only be a quarter of total maturities over the next two years.

Flow of funds in EM have been far more resilient unlike previous risk-off phases partially reflecting the more supportive credit dynamics but also the changing investor landscape that has more of a strategic approach. EM based pension funds and sovereign wealth funds will undoubtedly increase allocation as well.



Source: JP Morgan

Source: Barclays/EPFR Global

Credit Valuations

Credit spreads widened recently as the European Sovereign debt crisis escalated but the sell-off was less pronounced than in 2008, underlining the greater resilience, reflecting a deeper investor base and superior credit fundamentals. Nevertheless, valuations are more attractive as the underlying corporate business models and their credit metrics are largely unchanged. Spreads are relatively wide against risk-free rates and also bank funding costs (i.e. swap rates). Absolute yields are also attractive.

Within sectors, financials have been far less volatile than their OECD counterparts as they have a very different credit profile and were not as leveraged. A number of banks have majority/significant government stake holdings which allows for far greater control. Careful analysis of individual banks and different types of bonds can offer very attractive risk/reward returns.

Investment Grade sectors offer value for the medium term investor. Positioning between defensive and the more cyclical sectors will vary depending upon a funds' risk budget.

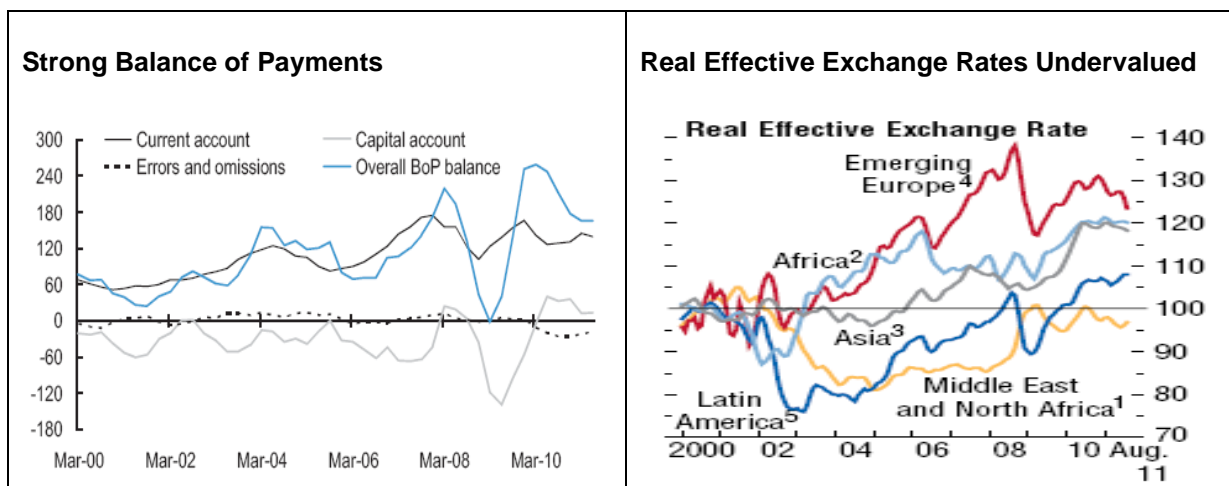


Local Currency Bonds

As part of the global economic rebalancing, emerging market currencies are likely to continue to appreciate both in nominal and real terms. This asset class is extremely volatile as it is more vulnerable to foreign capital flows. This was seen over the past few months as positions were cut in the face of a deepening Euro debt crisis. Additionally, changing EM political priorities and threats of capital controls also undermined confidence.

Currency revaluation in the medium-term will be driven by a number of factors:

- Strong external balance sheets coupled with low debt levels
- Rising FX reserves
- Widening growth differential versus the developed world



Source: IMF Economic Outlook

The local currency performance varies across the EM regions and by country. The stronger credits such as Singapore and China generally exhibit lower volatility whereas India and Brazil have had higher volatility. A constrained exposure to local currency EM bonds (via AA rated short duration EIB/World Bank and some sovereign bonds) is recommended with a mix of low and higher volatility names.



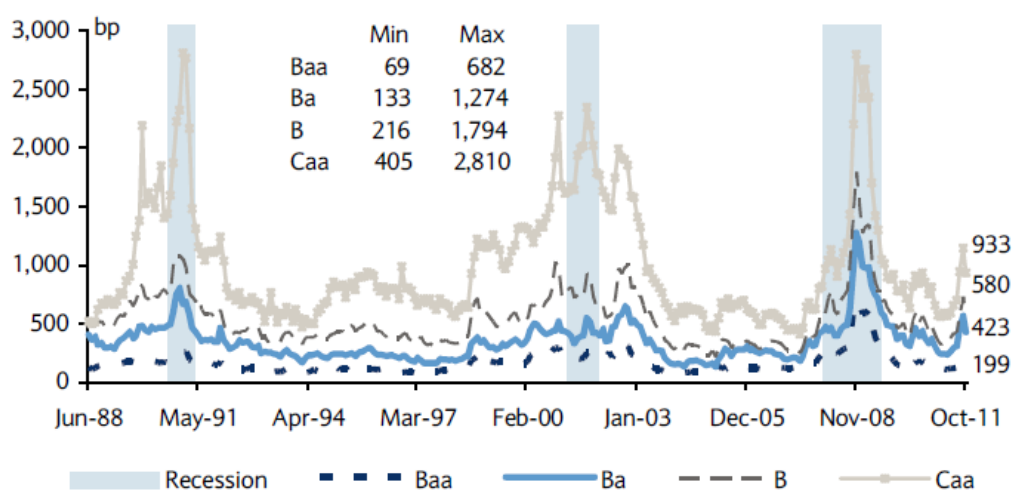
High Yield Bond Outlook

Overview

- The central case is that HY offers one of the best risk-adjusted returns profiles for 2012
- Key positives include return to pre-crisis operating margins, lower debt ratios, and extended maturity profile
- Specific exposure themes:
 - Overweight USD holdings vs. EUR
 - Highest quality preferred

Background

High Yield Spreads* by Credit Quality



Note: *Spread to the 10y bellwether (not OAS). Source: Barclays Capital

High yield spreads backed up sharply during August & September 2011, not through deteriorating balance sheets, but more due to illiquidity and broad-based risk aversion. This can be seen in the chart above, showing Caa rated yield spreads almost doubling from the July lows.

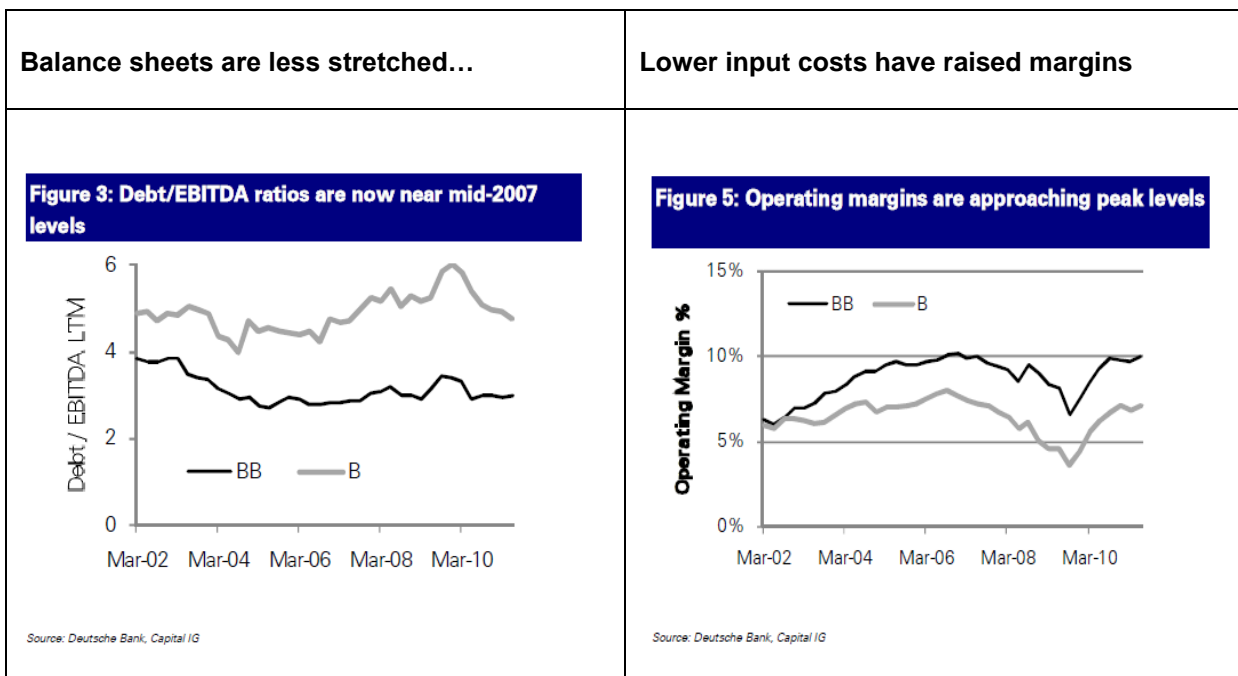
The overall credit curve, spanning sovereigns to HY, has steepened to 2-year wides, driven by both lower US Treasury bond yields and increasing HY yields, creating an attractive opportunity. Low-end IG spreads (Baa in the chart) did not widen significantly. The main concern expressed by HY investors was that a materially softer global growth profile would ultimately hit the revenue stream of corporates.

As action is taken to stabilise global growth, investors are expected to return to this asset class.

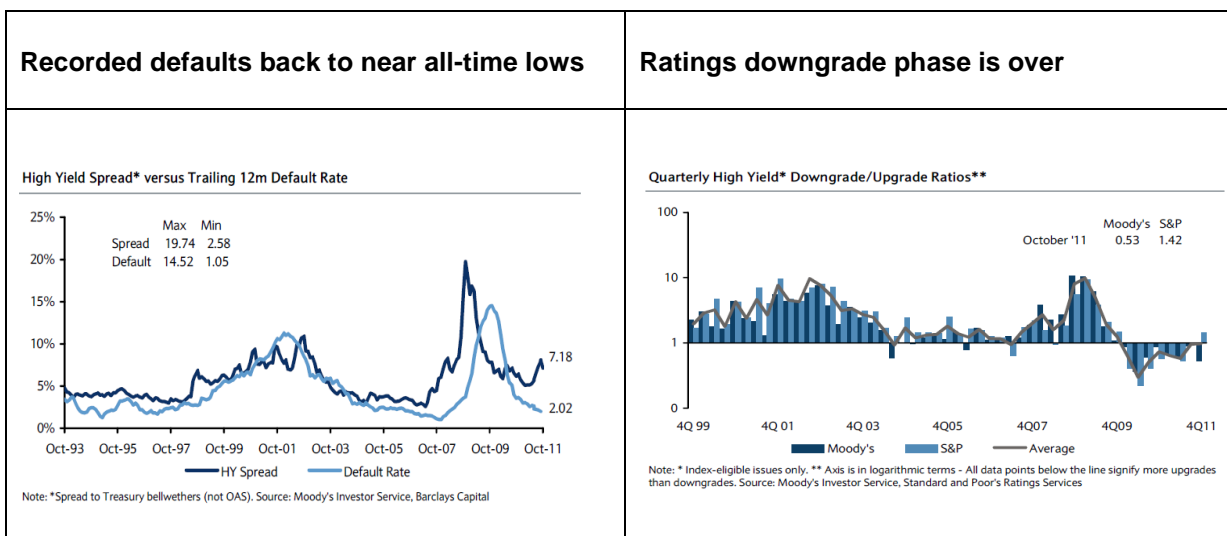


Credit Fundamentals

Balance sheets have been repaired, through the strong combination of lower debt leverage, as well as securing lower interest costs through maturity extensions.

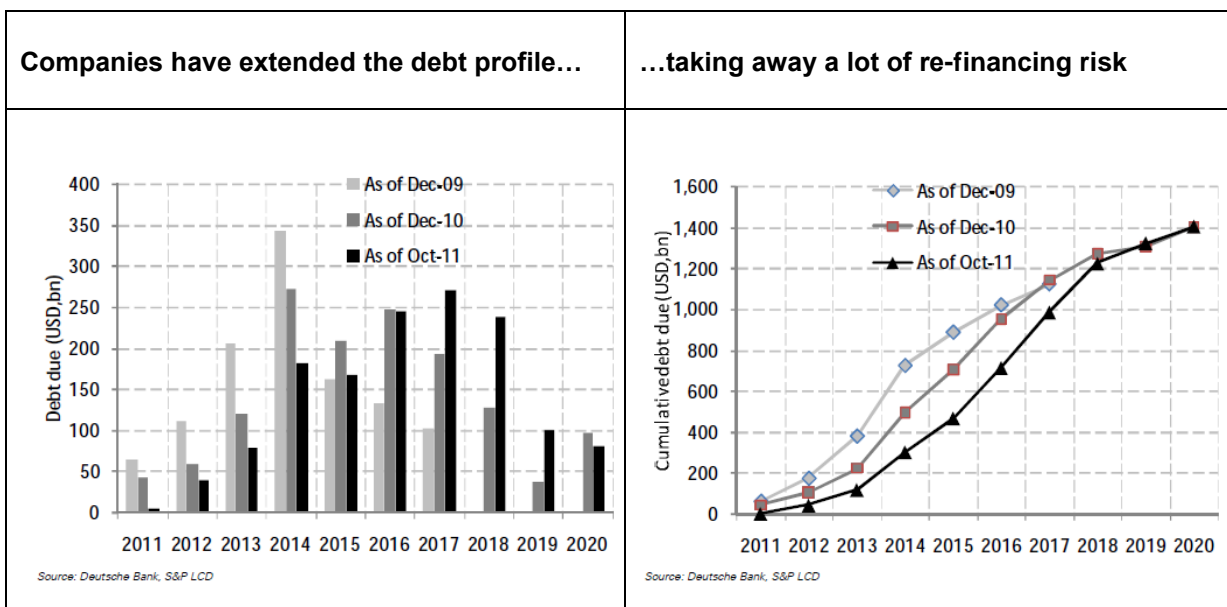


The level of observed defaults has plummeted to near all-time lows (see first chart below), and forecasts are that during the next 24 months it may pick up but to only c.4%. Absolute yields and spreads to UST's look very much out of the observed correlation zone, unless companies are on the verge of entering into a spike in recorded defaults similar to 2008/09. We would assign a very low probability to this recurring, especially as the ratings downgrade/upgrade cycle is now likely to side-track (see below).





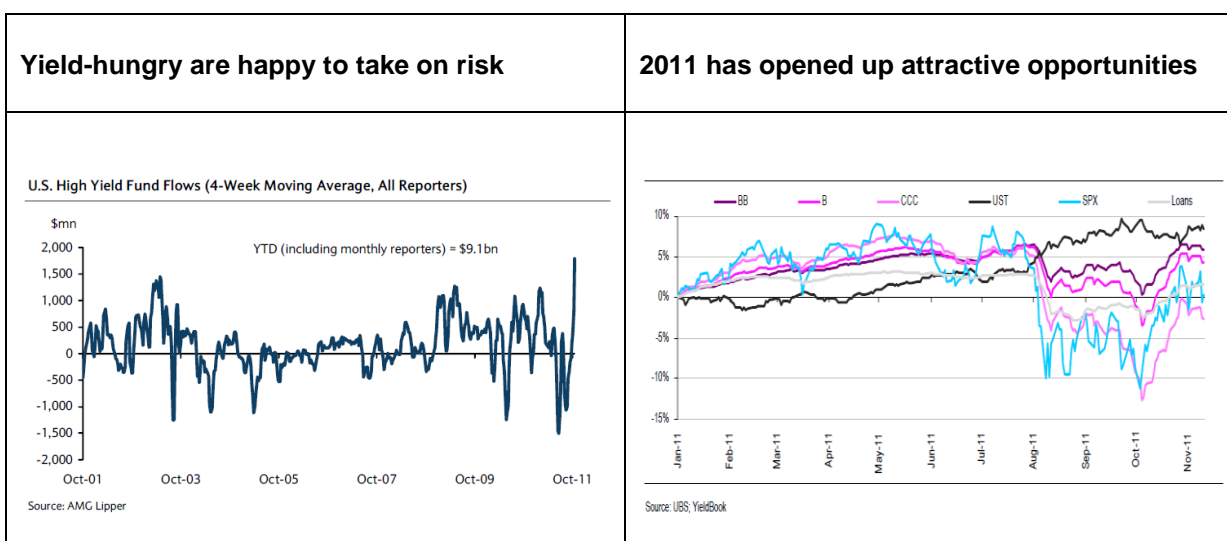
Alongside the relatively high level of cash on the balance sheets, the other factor that has taken pressure off a surge in new issuance is the extended maturity profile, which has effectively reduced refinancing risk (see below charts).



Market Dynamics

Domestic investors know that official rates globally will be kept at abnormally low levels for the next 18-24 months. Savings rates will most likely stay high, very supportive of the HY sector.

2011 returns remained positive in US HY, with BB grades the best performer. This segment continues to be our most favoured allocation to HY on a risk-adjusted basis.





Addendum: Cross Asset Correlation Analysis

High Yield Returns versus Other Asset Classes (%)

	High Yield	X-Over	U.S. Credit	S&P 500	EM**	Govt	U.S. Agg	Ba	B	Caa
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Monthly Return Correlations (since 1984)

Crossover	0.91									
Credit	0.50	0.63								
S&P 500	0.58	0.56	0.29							
EM	0.58	0.58	0.47	0.55						
Govt	0.07	0.11	0.83	0.04	0.12					
Agg	0.28	0.39	0.93	0.17	0.30	0.96				
Ba	0.93	0.98	0.61	0.55	0.59	0.20	0.41			
B	0.98	0.86	0.47	0.57	0.57	0.05	0.26	0.90		
Caa	0.91	0.78	0.31	0.52	0.49	-0.08	0.10	0.78	0.87	
Lev. Loans	0.77	0.74	0.27	0.43	0.39	-0.34	-0.04	0.75	0.72	0.78

* The Time Series for the Loan Index includes the S&P/LSTA Leveraged Loan Index prior to 2006 and the Lehman High Yield Loan Index beginning in January 2006

**EM since 1994

*** All average returns, standard deviations and Sharpe Ratios are annualized.

Source: Bloomberg, Barclays Capital



Equity Outlook

Macro-economic backdrop for Equities

The European debt crisis is dominating the economic environment, which has caused uncertainty across the globe. The Americans are alarmed about what a European default would do to their economy, let alone their financial system. The Fed has ordered another stress test that would incorporate such defaults. Barack Obama is tracking developments in real time and is imploring Europeans to save the Euro. In the meantime, the Bank of England has said the lack of visibility in Europe is preventing it producing its usual forecasts. Activity is slowing almost everywhere and investment decisions are being postponed.

Clearly, a compromise has to be found that imposes fresh financial discipline on Member States in return for refinancing. If a European Institution is set up to act as a lender of last resort without any corresponding disciplinary arrangements, budgetary slippage could simply persist.

As the Eurozone continues to burn down, the problem remains that even if agreed, amendments take an awfully long time to obtain approval from national parliaments. We may have to settle for an agreement from the heads of government, which may be a step towards putting the fire out.

In the period before constitutional amendments take effect, financial orthodoxy will probably be assured by constraints on high-debt countries. The purchase of new issues could be subject to a limit expressed as a proportion of GDP, for example. That would mean countries borrowing on favourable terms up to that limit and on extremely unfavourable terms beyond it.

In any case, as economic growth rates are expected to be depressed in the next few years, the ECB will copy the Fed by keeping its main interest rate very low for a considerable period.

The two main dangers and how to deal with them

Throughout 2012, there will be two main dangers that equity investors will have to deal with:

A) Impact of Low Economic Growth on Earnings

Economic growth in Developed Economies will continue to be anaemic at best. It is likely that Eurozone's continuous flirting with recession will end up translating in negative growth for the region.

Unsurprisingly, company profits are being revised down aggressively for all but the most defensive of companies. MSCI World earnings estimates have been pruned by 8.2% over the past three months, led by Europe and Japan. The biggest revisions concern the financial sector, followed by cyclicals. America is holding up relatively well, with adjustments limited to 4.3% overall. All in all, Earnings Per Share (EPS) is now expected to rise 10.8% in the USA in 2012 and by 10% in Europe. These expectations are likely to be trimmed even more in subsequent months.

Emerging countries are suffering from weakening activity in developed economies; 2012 EPS for the MSCI Emerging Markets index has been revised down 13% in dollars.



Since 2008, we have maintained our 'capital preservation' approach to investing through the volatile markets and we continue to prefer specific equity sectors, including defensive companies with the strongest brands and market positions: these companies will be the ones able to deliver sustainable profits and cash flows in tough environments.

B) Impact of Bank Deleveraging on Credit Availability

One of the most dramatic developments to take place in 2012 will be the widespread reduction in credit availability for corporations. There is deep uncertainty around how and when the European crisis will unfold. However, under all possible scenarios a collateral consequence will be continued reduction in credit availability. When this happens, any corporation with high refinancing needs will, at best, do it at more onerous terms.

The best way to address this issue will be to concentrate in companies with low financial leverage (i.e. strong balance sheets).

What are Equities discounting?

For Wall Street, and under our baseline soft landing scenario, we have reduced consensus EPS forecasts by 20% for the next five quarters. That leaves us with a 2% EPS decline in 2012. Our resulting S&P 500 objective is 1,326 points with long rates at 3%, or 14% upside potential. Under the double-dip hypothesis, we reduce consensus estimates by 25%, leaving us with -12% in 2012. This scenario prices the S&P 500 at 1,025, although the fear factor could drive it much lower than that in the meantime.

Our scenario for Europe integrates a 10% EPS drop in 2012 (compared with a 10% gain for consensus). This means that currently, European equities are trading on 11x P/E. If we were to go back to a conservative 8x multiple (as in 2008), there is currently a 25% maximum downside.

Sector Outlook

Consumer Staples

The sector will continue to be a beneficiary of investment demand as a hedge in the current economic environment. It is the only sector that manages to combine a defensive profile and growth appeal. We have entered a low-growth environment and in this context we think investors should favour resilient growth sectors like Staples. Furthermore, soft commodities used as raw materials are likely to moderate their upward trend and give some relief in margins within the sector.

Healthcare

Healthcare is another defensive sector (low sensitivity to the domestic OECD growth cycle) which manages to generate very healthy levels of internal and external income generation. Expect the sector to suffer earnings volatility as Obama's healthcare reform is likely to be reviewed by the Supreme Court ahead of the 2012 presidential election. However, fears of generic threats to their business model appear somewhat overblown: big pharma companies are weathering the storm quite well using branded generics.



Financials

Monetary policy and sovereign debt remain the main catalysts for the Bank sector's performance. In effect, the increase in government bond yields is driving up the banks' borrowing costs. Banks are generally unable to issue long-term bonds at interest rates lower than those paid by their governments. This means higher borrowing costs for the banks which will force them to rely more on the ECB to keep credit flowing. It also means scarcer loans for non-financial companies, which in turn could put a drag on economic growth and hamper debt repayment. Inherently high leverage of the sector and the possibility of dilution (come bail outs) makes it a sector to avoid except for aggressive punters.

Industrials & Consumer Cyclicals

We are not terribly excited about either sector. If we were pressed to choose, we prefer consumer cyclicals for the following reasons: 1) expected deterioration in GDP and industrial production should put further pressure on industry-related sectors, 2) early signs of easing inflation, particularly in the UK, could revive depressed consumer confidence and 3) as emerging markets are expected to decelerate, consumer-related sectors should prove more resilient than Industrials, as the case has been in the past.

Information Technology

Hardware and Communications Equipment firms will continue having restrictions in terms of supply as the Thailand flood consequences are still echoing. Regarding Software and IT Services, prospects for 2012 are significantly positive and backed up by the last good earnings season in the industry. Nonetheless, we are due to witness further EPS downgrades within the first half of 2012 as figures are rather optimistic in both industries: 18% the former and 15% the latter, but especially in Hardware manufacturers.

Metals & Mining

One of the key catalysts for Metals & Mining's performance will be China's growth prospects. With roughly 40% of global commodity demand coming from China, we believe the sector is set to underperform until the risk of a hard landing scenario disappears. Considering that the Metals & Mining sector has the highest cyclical and low growth prospects, we expect consensus estimates to be revised sharply down: IBES consensus figures point to 40% growth for 2011 and 11.2% for 2012.

The dawning era of higher dividends

Amidst global uncertainty, corporations will keep receiving pressure to maintain elevated levels of return on Equity. This will translate into higher dividend pay-outs to shareholders for high quality, cash rich companies.

As interest rates in Western Economies remain low, the need to harness yield through secure and high dividend payers will intensify. This will increase the appeal of companies able to generate good levels of internal and external income.



With interest rates unlikely to rise anytime soon, stocks with healthy dividend yields will continue to be an attractive option to investors seeking income. Some large-cap stocks have dividend yields approaching or even exceeding the company's bond yield, effectively giving you an income stream similar to that of the bond with an equity kicker on top. Even though equities clearly have downside risk, the attractive free cash flow yields of many companies offer investors comfort that they are paying a reasonable price for those companies' future cash flows.

Given the severity of the financial crisis, it is probably not surprising that companies are hesitant to part with their cash piles. We have already seen a number of companies increasing their dividend payments. In fact, the number of S&P 500 companies that increased dividends last year (in 2011) exceeded pre-financial-crisis levels. However, companies clearly have a lot more room to increase their dividends going forward. Pay-out ratios are still at historical lows (26% versus an average of 37% during the last 20 years) while cash on corporate balance sheets is exceptionally high.

As companies gain confidence in the macroeconomic backdrop, and as we get more clarity around regulatory and tax changes, they will increase their dividends in greater numbers.

Of course, an exception to this will be the banking sector. Given the need that many of these companies have to meet increased capital requirements and regulatory oversight that dictates how they return capital to shareholders, it could be a long time before some of these companies are allowed to restore their dividends to normal levels.

How to play EM growth?

One of the universal truths will be that emerging markets will continue to lead the global economy in the next few years. There are a number of reasons for this, but clearly the most developed economies are debt ridden and fiscally weak, as well as being over-reliant on consumer spending and housing markets. Conversely, many emerging markets enjoy robust finances supported by the growing affluence of their populations, albeit from very low bases. The overall outlook remains positive but these markets will remain extremely volatile going ahead as they deal with domestic overheating and inflationary pressures, so the best way to access local markets is through global multinationals with growing exports into EM regions. Within Emerging Markets, Asia Pacific continues to offer the best growth perspectives.



Commodities Outlook

Introduction

After the worst price volatility since the 1970s, emanating from politics to natural disasters, there is a clear nervousness about the 2012 outlook for commodities. The world looks set to remain in a difficult environment with risks coming from a possible EU breakup, a China hard landing, geopolitical conflict and natural disasters. We expect low global growth in 2012, Europe GDP contraction in 2012 with Euro area recession to formally commence in Q4 11, and debt anxiety to continue. The Eurozone recession will likely hit the neighbouring EMEA region the hardest but could also pressure China (17% of China's exports go to Europe). The US and Japan should suffer less from a European recession. The US could surprise expectations in 2012 with lower energy, labour, housing and other costs.

Global policy responses remain pivotal to commodity demand outcomes. The resolution of the European debt crisis, China easing and more favourable cycle/positioning are necessary but not sufficient conditions for a stronger commodity market. In our view a commodity bull market would need the US Federal Reserve to embark on a substantial QE3 programme. The hurdle rate for QE3 is higher than for QE2 but once deflationary pressures are showing in the US, QE3 will become more likely and a significant catalyst for commodities.

Supply constraints are still the key differentiator of commodity prices: constraints in global commodity supply include volatile weather, disruptions from operational, industrial and social problems, rising capital and operating costs, diminishing access to natural resources due to competing environment needs, growing geopolitical risk and Asian resource competition.

Energy

We see an inevitable deceleration of global growth in H1 12 after the multiple crises of H2 11; this is likely to put downward and volatile pressure on commodity prices until improved conditions prevail in H2 12. The Energy sector embodies the many contradictions facing most commodities. These include potential supply disruptions, with Middle East tension balancing the demand erosion associated with developed markets deleveraging (Europe comprises 17% of global oil demand). Saudi Arabia's spending, in response to the Arab spring uprising in 2011, has effectively raised the OPEC floor to US\$80-\$90/bbl. Non-OPEC supply, including non-conventional shale oil, however, could surprise on the upside in 2012.

In the short term, risks for Crude Oil are still primarily on the downside: demand growth may turn out weaker and/or Saudi Arabia could refrain from lowering supplies as we believe it will in Q1 12. Furthermore, the weekly CFTC data indicates that the market has speculative long positions in oil. If these positions are unwound it could temporarily push oil lower. On the other hand, the market is pricing in a pretty downbeat outlook for the global economy, so there is margin for positive surprises.

Overall, we see USD105-115/bl as fundamentally justified and expect an oil price in this range for the next six months. However, in the second part of 2012 we expect to see a renewed tightening of the market balance and expect prices to close the year at USD120/bl.



Base Metals

While current metal prices in general imply poor to no recovery in 2012, risks remain on the downside. With 2008 price experiences – when copper prices plummeted an astounding 60% in the final quarter of the year and aluminium fell over 40% – fresh in the memory, the probability of a much larger and steeper correction in base metals in the event of a further escalation of the Eurozone crisis will rise. Having said this, our baseline macro scenario for China and the US look likely to produce respectable growth in 2012. In this light, while base metals forecasts have been reduced for the near future (chiefly Q4 of 11 and Q1 12) on the back of continued European worries we remain upbeat and continue to see prices edging cautiously higher during the remainder of 2012.

Copper prices are set to be supported by steady demand from China, globally the biggest user of the red metal. While for most of this year, Chinese users have been observed to be operating in a de-stocking mode, there are now signs that this may have come to an end and that the Chinese are again beginning to restock, also encouraged by lower prices. From a global perspective and according to CRU reports, global copper consumption has grown by about 1.3% y/y in Q3 from the same period last year and projected expectations for the final quarter are for stable sequential growth, which would imply about 3% y/y growth. Given that these numbers have significant growth slowdown embedded in them, we remain positive in terms of 2012 consumption levels.

Aluminium is less supported by the market balance dynamics than copper, as for much of 2011; world production has tended to exceed world consumption.

Overall, the most significant risk to our base metals forecasts lies in a prolonged and potentially escalating European debt crisis and the failure of American and Asian led growth to materialise. While the former could potentially cause very steep and rapid corrections in the short to medium term and can be expected to keep market volatility levels elevated, the latter risks a more structural and longer term downward revision for global base metals demand.

Precious Metals

In the precious metals sector, gold prices will continue to rise, albeit with increased volatility throughout the period. Investment demand continues to be the key determinant of prices. This in turn has been driven by on-going concerns about inflation, currency weakness, political turmoil in the MENA region and Eurozone sovereign debt. Central bank activity has also been supportive, with Mexico recently announcing a purchase. We continue to see gold more as a 'safe haven' rather than a 'risk-on' asset in 2012, as the European sovereign debt crisis, exacerbated by recession, and the US debt concerns, returning in Q1 12 when its US\$15.2trn debt ceiling is likely reached, are expected to dominate investor sentiment again.

We expect the Eurozone crisis to intensify to the point of a 'big bang', namely when the clear alternatives are breaking up the Eurozone or systemic collapse will EU politicians be compelled to accelerate fiscal convergence, that should ultimately change sentiment significantly. We view the risk of European CB gold sales as extremely limited. A modestly stronger US dollar for 2012 could cap gold's advance. In short we expect a volatile but an active trading market that should continue to attract good liquidity and investment flows throughout the year.



Elsewhere in precious metals markets, palladium prices could rise as Japanese auto manufacturing continues to recover and supply-side constraints continue.

Agriculture

Agriculture (and specifically grains) is an area that will benefit from secular, thematic tailwinds from the demand side, i.e. increased consumption of higher value added foods from fruits and vegetables to dairy and meats in the developing world which will put strains on existing global capacity. Increased demand will be met via intensification of agricultural practices, which means mechanization, irrigation infrastructure, fertilizers, herbicides and pesticides and genetically improved seeds. At the same time, the drive towards more ecological agricultural practices is creating profitable niches for farmers and distributors, a fact that simply adds pricing pressures throughout the chain.

Within the space, we are most bullish on Corn; especially if/when we see the added tailwinds from increased ethanol consumption in a Beyond-\$100/crude barrel environment: more US corn is used for ethanol production in the US than for feed, while 56% of Brazil's total sugar goes into ethanol.

We are structurally bearish on wheat and cotton. However, these positions could reverse late 2012 with conditions becoming more bullish on soybeans and sugar and more bearish on corn. Timing in trading will likely be important in 2012. We expect relative outperformance by commodities that continue to face tight supply, despite a softer demand outlook.

To conclude, we favour commodities with tight supply, despite a subdued demand outlook. Corn, copper and crude oil are supply shortage stories. We consider Gold as a relatively safe haven investment, on the basis of its 'alternative currency' status in the face of continuing turmoil. We are negative on wheat, nickel, cotton and uranium - all on the grounds of rising supply or imperilled demand.



Hedge Fund Outlook

2011 Summary

Last year entailed a rollercoaster ride: 2011 started with an inflation scare and expectations of rate rises and ended with a deflation scare. 2011 experienced The Great East Japan Earthquake and Tsunami, US Debt Issues resulting in US downgrade, China crash landing scare and European contagion emanating out of Greece, which resulted in flight to safety towards the downgraded US Treasuries and a de-risking from EM.

The incessant switch between Boom and Doom has been injurious to multiple strategies – whilst the S&P, as an example, finished the year flat; it was up 8.5% by the end of April, and suffered a 20% drop by September, only to recover in October. These wild swings, were amplified intra month. Co-dependencies between asset markets resulted in effective transmission of this phenomenon – rendering asset diversification less efficient.

As a result of increased asset class volatility, most discretionary portfolio processes (being risk constrained) typically cut risk prior to the fateful reversal. While systematic strategies were subjected to signal switches caused by sharp reversal, in particular the short and medium term strategies. Counter intuitively, a wider risk (volatility) tolerance, in tune with increased volatility of the safest of securities (US Treasuries) would have resulted in better performance.

2012 Outlook

We expect more of the same over the first half of the year, although with increased sensitivity to policy developments in Europe. In short, remaining bearish is as risky, as marginal positive developments from European policy or ECB stance can trigger a massive 'risk-on' environment; despite a deflationary medium term outlook driven by austerity and lower growth.

On the flip side, a populace rejecting austerity in any of the insolvent countries could have a disastrous effect leading to a crisis. A policy mistake is likely to have a similar outcome, as is an exogenous event or a problematic bank. Based on the potential macro outcome and the near equal probability of either, has lead us to a cautious mindset.

In general, having a reduced gross exposure and asymmetric bets on both outcomes will turn out to be the key to success, allowing for the ability to profit from either wing outcome, while attempting to remain flat to marginally negative in a status quo scenario.

Discretionary Macro

The largest profit contributor of 2011, remains the most promising investment style for 2012 on account of the following features:

- a) Extremely liquid and nimble
- b) No Tail Risk
- c) Balanced between positioning for positive wing out come and the ability to profit from trading on-going incremental news.



Managed Futures

We remain positive, driven by a central view that an end to the status quo will lead to powerful trends. Within this, we favour the longer term trend strategies to others. The style is extremely liquid, and whilst inherently levered, leverage is tightly controlled and predictable and does not suffer from financing risk, and thus offers no tail risk.

High Frequency Traders

The investment styles exemplified and cemented its potential portfolio protection ability over 2011 (and previously in 2008). We remain confident of this style providing the best negative tail hedge and profit potential in a mildly trending environment. The style is extremely liquid, and whilst inherently levered, leverage is tightly controlled and predictable and does not suffer from financing risk, and thus offers no tail risk.

Equity L/S

We remain neutral to positive on the asset class, but primarily to managers who have a proven ability to dynamically manage gross and net exposures over 2011. Lower net exposures are expected to provide no downside beta, whilst allowing for periodic alpha capture through the year. Preference is given to the more liquid and less levered managers. We are cautious on managers who have a longer net bias and those with a catalyst or value bias, and have therefore implemented appropriate changes.

Relative Value

Our outlook is qualified to specific sub-styles within this bucket. In particular, we have a neutral bias towards Micro RV strategies that seek specific anomalies in highly liquid asset classes. These remain perpetual alpha generators. The strategy is nonetheless levered and faces tail risk, which is mitigated by manager selection and tested through 2008.

Credit L/S

A neutral bias qualified to specific sub-styles which are targeted towards liquidity, trading, and active risk management.

Other Strategies

Negative outlook is maintained on investment styles that are either exposed to structured securities (counterparty and documentation risk), illiquidity (tail risk), leverage (tail risk), directional bias (gap risk) or where primary securities traded have transient liquidity or are lower in the capital structure. These include: Structured Credit Arbitrage, Convertible Arbitrage, MBS Arbitrage, Value Equity and/or Special Situations/Catalyst Driven and Distressed Securities Investing.