Asset Values and Prospects
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London & Capital
intelligent investors

Prospects for Q1 2012

- **Currencies –** There is little to choose between the major developed currencies in the current environment of abnormally low interest rates and Quantitative Easing (QE). The US Dollar however, continued to benefit from safe haven flows in Q4 2011. The Euro is expected to remain under pressure in Q1 2012, however, with the positive, albeit diminished interest rate differential affording little support. FX volatility is expected to remain elevated.

Relative to USD over a year (%)		Relative to GBP (%)	
GBP	-1	**USD**	+1
EUR	-1	**EUR**	0
Yen	0	**Yen**	-1

- **Inflation –** Higher commodity prices including crude oil lifted measures of inflation last year. These pricing pressures are proving transitory, with limited chance of triggering second round effects. Major economies are operating with excess capacity, and corporate pricing power is limited. OECD inflation rates are expected to fall now that the large food and energy price hikes are largely played out.

	Changes in CPI inflation (% pts)	Taking inflation to:
US	-0.60	2.80%
UK	-0.80	4.00%
EUR	-0.50	2.50%
Jap	-0.10	-0.60%

- **Interest rates –** The global authorities remain firmly in easing mode. The Fed indicated that rates would remain unchanged until mid-2013, and possibly beyond, and in the UK the Bank of England has re-started the QE programme. On the continent the ECB is buying covered bonds and has introduced 3-year fixed rate loans and other short term measures for banks. Overall, global central banks are providing ample liquidity; ensuring banks have plenty of access to funds. The approach reflects concerns over the hesitant recovery, the ongoing Euro debt crisis, private sector deleveraging and the drag on consumption from higher commodity prices and fiscal tightening.

	Actual rates	Changes in rates (% pts)	Taking interest rates to:
US	0.25%	0.00	0.25%
UK	0.50%	+0.0	0.50%
EUR	1.00%	-0.5	0.50%
Jap	0.10%	+0.0	0.10%

- **Bond yields** – The key government bond markets have been major beneficiaries of the flight to quality, with yields falling to historic lows. They will continue to benefit from a period of sluggish growth, low inflation, low interest rates and central bank asset purchases. Some reversal of the rally is likely, but the move is not expected to go too far given actual/prospective QE; a re-run of Japanese style yield levels is on the cards.

	Changes in yields (% pts)	Taking 10 yr yields to:	Real yield
US	+0.25	2.15%	-0.65%
UK	+0.20	2.20%	-1.80%
EUR	+0.15	2.50%	0.00%
Jap	+0.10	1.10%	+1.70%

- **Total Return** – from 10-year Bonds (in GBP, % p.a.)

	Income	Capital Gain	Currency	Total
US	1.9	-2.1	1.0	0.8
UK	2.0	-1.7	0.0	0.3
EUR	1.8	-1.2	0.0	0.6
Jap	1.0	-0.9	-1.0	-0.9

- **Potential Equity Gains** – (potential rise in share prices as %) taking into account the relative cheapness of stocks and bonds.

	Earnings[1]	Bond Yield	Bond: Stock**	Total
US	10.7	-2.1	10.5	19.1
UK	4.1	-1.7	10.0	12.4
EUR	14.2	-1.2	11.0	24.0
Jap	3.6	-0.9	11.0	13.7

- **Total Return from Equities** - (in GBP, % p.a.) driven by earnings and dividend yield. Taking into account the stock:bond ratio returns may be higher over the medium-term.

	Income	Capital Gain	Currency	Total*
US	2.5	19.1	1	22.6
UK	3.0	12.4	-	15.4
EUR	2.5	24.0	0	26.5
Jap	1.5	13.7	-1	14.2

**Total figures are rounded/consensus EPS estimates are looking too optimistic*

Equity positions in portfolios must be tempered by the higher volatility.

- **Portfolios**

Equity **–** Bond differential expected returns (in GBP, % p.a.).

US	21.8
UK	15.1
EUR	25.9
Jap	15.1

[1] Source: IBES earnings forecast for the year to December 2012. ER consensus EPS estimates adjusted down by 25%

** Earnings yields are calculated based on P/E ratios from Bloomberg. Equity sentiment can take a long time to repair.10-year bond yields used for ratio calculation. Japan neutral ratio assumed to be 0.80.

Conclusions:

- Elevated volatility will remain a feature of financial markets this year. Investors continue to be buffeted by global growth prospects and the unfolding European sovereign debt crisis.

- Central banks remain firmly in accommodative mode. The Fed is holding the official rate near zero until at least mid-2013 and the ECB cut rates twice last quarter, returning the refinancing rate to a record low. Central banks have re-introduced many initiatives introduced early on in the financial crisis, and are acting to ensure banks have ample liquidity.

- Bond purchases by the Fed, UK MPC and the ECB are all aimed at lowering long term rates, attempting to keep the cost of borrowing low. Recent research suggests QE contributed positively to growth during the 2008-09 downturn, and authorities are pinning hopes of a repeat act.

- Fiscal austerity is increasingly weighing on developed world growth, especially in the UK and periphery Europe. This will continue to act as a drag on growth going forward, especially with the US now adopting a long-term fiscal consolidation package.

- Corporate earnings are expected to continue to grow, albeit the pace of growth has moderated sharply. The slower growth environment and higher commodity prices have squeezed margins, which in turn have placed pressure on equity valuations recently. We look for defensive, well diversified entities with global franchises, including exposure to Emerging Markets.

- Government bond yields fell sharply in Q4. They are now at such low levels; some reversal is to be expected. However, yields are expected to remain fairly low given the high level of global political and economic uncertainty, and the Central Bank buy-back programmes.

- Some hedge fund strategies are benefitting from the current trading environment, particularly global macro (i.e. those employing macroeconomic based strategies). We favour liquid strategies, such as global macro, and long/short equity. Managing tail risk will remain key.

Asset Values and Prospects for Q1 2012

Currencies

Currency volatility remains elevated, influenced principally by developed world growth prospects and the unfolding European sovereign debt crisis. The US dollar benefitted from flight to safety in Q4 11 as the Euro crisis escalated. Looking forward, the Euro is expected to remain under pressure, with no quick resolution to the crisis. The Euro's modest interest rate differential in its favour is not expected to offer meaningful support. Emerging Market currencies experienced heightened volatility in Q4 11 as flight to safety spread across all asset markets. Over the medium term, the outlook for Emerging Market (EM) currencies remains favourable. They continue to draw benefit from superior growth prospects, strong government balance sheets, favourable demographics, and an inflow of investor funds.

Inflation

Market inflation expectations were well behaved in Q4 11; 10-year break-evens (nominal less real yields) showed little change. Global commodity prices such as food, raw materials, and energy have all fallen back from their 2011 peaks, easing pricing pressures. At the same time, the US and developed world growth slow-down also moderated demand for such commodities, helping ease inflationary pressures. The US Federal Reserve, UK's MPC, and the ECB have looked through these pressures, regarding them as transient and eased policy accordingly. Acutely aware of Japan's 'lost decade,' global central bankers remain wary of ending the accommodative policy measures prematurely.

Interest Rates

Interest rates in the developed world are set to remain at record low levels for a prolonged period, and this was underscored with the Fed indicating official rates would remain low until mid-2013, or longer. In the US, the beleaguered housing market, lack of jobs growth, bank weakness, and upcoming presidential election underpins this view. Anaemic growth and progressive fiscal tightening will keep UK rates pinned close to zero, while in Europe; the ECB is expected to lower rates again, albeit after a pause following two back-to-back reductions in Q4. Developed world central banks are operating in concert to ensure banks have sufficient recourse to funding, re-opening US dollar swap lines and the ECB offering 3-year fixed rate loans in Q4. The official rates in the emerging world are at a plateau, amid signs of slowing economic growth.

Bond Yields

Government bond yields remain at record lows, albeit their absolute level is raising total return volatility sharply. Volatility will remain elevated reflecting economic and financial market uncertainty. These low yield levels are set to be supported for some time on account of the following official central bank operations, 1) Fed buying of longer-term Treasuries and selling of short dates (known as operation twist), 2) Bank of England's £75bn gilt buying programme, and 3) €40bn of covered bond buying by the ECB and purchase of sovereign debt through its securities market's programme (SMP).

Equities' Capital Gains

The backdrop for equities remains challenging. Equity markets were highly volatile last year as the European crisis continued, although this tailed off towards the year-end. Economic growth momentum has slowed, corporate income growth has slowed, and there is some compression of margins. More constructively, interest rates remain low and there has generally been ample liquidity. Equity markets in part appear to be discounting the onset of a European recession. Emerging markets have been volatile despite the strength of the underlying economies. Tighter monetary policy and the withdrawal of liquidity particularly in China and India has had an impact; there was some involuntary liquidation as investors needed to raise cash as the crisis in the developed world markets intensified.

Bond:Stock

This measures the relative relationship of equities to bonds. The historical very low government bond yields have increased the attractiveness of equity markets. Current price to earnings ratios make **equity markets cheap relative to bonds**. The level of under-valuation can take a long time to unwind. We assume a ratio of 1 as a neutral level, with the exception of Japan where we've chosen 0.80.

Volatilities: (Updated Dec 2011)

Asset	Long Term Volatility (%)	Current Volatility (%)	Forecast Volatility Short Term:	Forecast Volatility Long Term:
US 7 – 10 yr Bond	7.1	7.7	Ease from high levels	To remain elevated
UK 7 – 10 yr Bond	5.9	6.7	Ease from high levels	To remain elevated
German 7 – 10 yr Bond	5.2	5.9	Ease from high levels	To remain elevated
Japanese 7-10 yr Bond	4.3	4.4	Ease further	To remain elevated
S&P500	18.1	20.2	Ease from high levels	To remain elevated
FTSE100	16.7	17.1	Ease from high levels	To remain elevated
DAX	27.0	28.1	Ease from high levels	To remain elevated
Nikkei 225	21.2	21.8	Ease from high levels	To remain elevated

Long Term Volatility: 15yrs (quarterly data) / Current Volatility: 3yrs (monthly data)

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