



INCORPORATING



2012 Global Investment Strategy

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Foreword

2011 has proven another interesting year where the number of things in the 'problem pile' appears to have mounted. It is a long way back to the start of the year, but we have had a number of catastrophic natural disasters, the most high-profile of which was the earthquake and resultant tsunami that wreaked havoc at the Fukushima nuclear plant in Japan. We have had a 'changing of the guard' in much of North Africa and the Middle East with longstanding regimes disappearing under unprecedented popular protests; the Syrian regime's days may be numbered.

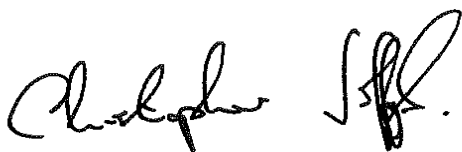
For the US and Europe, this has had a profound impact on foreign policy since close 'alliances' with these regimes were a cornerstone of policy in the region, something that may or may not handicap relations with subsequent regimes. At the beginning of 2011, the problems of Greece, Portugal and Ireland were rumbling along but there were at that point no signs that it was going to spread to 'core' Europe. During the summer however, Italy, Spain and to a lesser extent France have all been drawn in, and governments in both Italy and Spain have fallen; Monsieur Sarkozy's position cannot be described as solid.

Thus a crisis that back in 2008 was primarily focused on the consumer and corporate sectors of the economy has ultimately spread to sovereign nations. In the sense that rather than face a meltdown, governments chose to 'socialise' many of the private sector debts, this is perhaps not a surprising result. The desire to prevent pain amongst the electorate has ultimately called the solvency of nations into question and this is the primary cause of the turmoil in the government bond markets during 2011. Given the difficulty in managing 'self-help', the various European summits are attempting to pass this debt up the foodchain to supranational bodies such as the International Monetary Fund or European Central Bank or by establishing new vehicles such as the European Financial Stability Facility.

However, unless the troubled nations manage to pass on their debts to those countries with plentiful financial resources, they are ultimately still in the same boat; their debts are too high, they lack the monetary policy tools of, for example the UK, and the fiscal policy measures required to get their house in order remain unacceptable to the electorate.

Whilst many in the private client investment management world tend to focus primarily on picking individual investments for clients, whether shares, funds, bonds etc. in the current climate, it is the top level 'macro' issues that are dominating the movement in securities prices. As such, we devote a greater amount of space than usual to discussing many of these issues; whilst much of this tends to be fairly indigestible, we have tried to keep it as simple as possible. Later in the report we talk about some of the strategies we are using for clients in light of these broader macro issues and the key considerations for clients going forward.

I wish you all the best for 2012 and beyond

A handwritten signature in black ink, appearing to read 'Christopher Jeffreys', with a stylized flourish at the end.

Christopher Jeffreys

Director of Asset Management

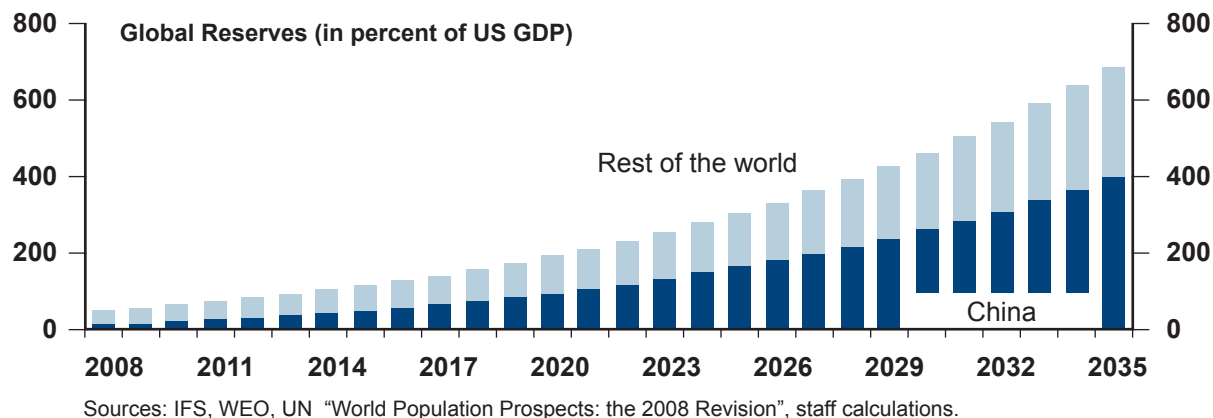
Global economic challenges: the real issues

The well publicised troubles of the Eurozone are merely a microcosm of the rest of the world. On the one hand for Germany you could easily substitute China or Japan. On the other, you could easily substitute Spain or Portugal for the UK or US. Thus to consider a resolution of Europe's problems we need to treat it as a global problem that is not the fault of any single party but where there is a prevailing 'equilibrium' that brings with it an increasing risk over time of instability. The current framework for the international monetary system (IMS) has stood for some 40 years or more with little adjustment but just as the Bretton Woods agreement and the Gold Standard that preceded it both ultimately collapsed, so too could the current IMS. The world is now a very different place compared with the 1970s and in the aftermath of the 2008 financial crisis and the current 'aftershocks' we thought this was an ideal opportunity to distil the key issues as simply as possible. Later on in the report we will discuss how this impacts on our overall investment strategy.

The US Dollar is undoubtedly the world's reserve currency, notwithstanding the ill-judged suggestions from some a few years ago about the Euro replacing it, and this is a situation that is likely to prevail for some time. In our view, a major contributory factor to the heightened volatility of capital flows internationally in recent years has been the build up globally of current account imbalances – primarily driven by a country's balance of trade. The existence of a single nation's currency acting as the reserve currency in addition to the existence of exchange rates of various countries of increasing global importance that are not fully flexible are the key factors in perpetuating these imbalances.

Fig. 1 is taken from a recent IMF report and forecasts future growth of global foreign currency reserves. The result is that they will swamp the size of the US economy within the next decade which is clearly not compatible with the US Dollar remaining the dominant reserve currency. Diversification into other currencies as well as for example, gold can play a minor role in alleviating this pressure but cannot prevent the inevitable.

Fig. 1



The challenge this creates for the US economy and by extraction the Dollar is known as the Triffin dilemma after the economist who first postulated this in the late 1950s. The crux of his argument was that where a single nation's currency is the reserve currency of choice for the rest of the world, that country must be willing to increase the supply of its currency to satisfy that demand and thus have a persistent trade deficit. However, over time the need to pursue measures designed to support that currency as a 'store of value' are likely to bring domestic and international policy goals into irreconcilable conflict with each other. There are two obvious solutions to this, long recognised but never acted on. The first is to have a new currency to act as a global reserve currency (suggested by Keynes in the 1940s), somewhat like a 'global euro', but this brings with it many of the problems the Eurozone now faces as it would require flexible adjustment in labour markets, fiscal discipline and cooperation amongst those using it. A 'halfway house' could be achieved by expanding the use of 'Special Drawing Rights' by the IMF, something advocated by Zhou Xiaochuan - the Head of the People's Bank of China - in a paper for the Bank of International Settlements back in March 2009. However, in magnitude, these are a long way from being able to become a major part of currency reserves.

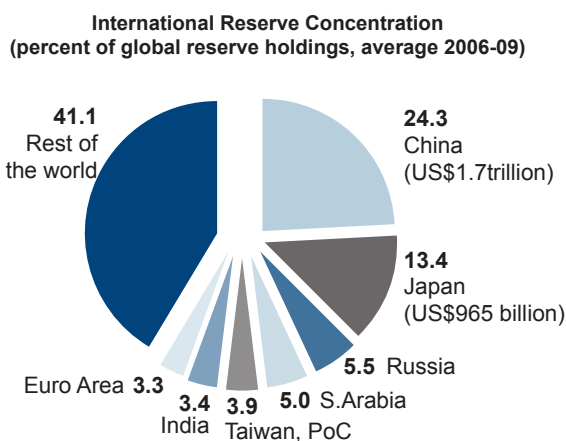
The second and perhaps more practical solution is to accumulate sufficient political consensus globally for nations to pursue policy agendas consistent with reducing the magnitude of current account imbalances and thus to slow the accumulation of foreign currency reserves as an interim measure whilst the first option is explored.

The burden of such policies is likely to fall on the 'surplus' nations such as China since it is arguably they who precipitate the 'deficit' nations problems rather than the other way round, even though it is the latter group currently under greater pressure.

Non-floating exchange rates are at the heart of the problem since the 'deficit' nations tend to have floating currencies whilst the 'surplus' nations tend to have fixed or quasi-fixed exchange rates. This prevents market forces doing their work properly as the currencies of the former group should fall in value whilst the latter group's rise. This would cause a rebalance of trade such that both surpluses and deficits narrow. Unfortunately, many emerging economies are pursuing policies domestically to suppress their currency to the detriment of global stability. Their artificially rapid accumulation of foreign currency reserves thus 'forces' the US to shoulder increasing current account deficits. Its status as the owner of the world's reserve currency enables it to continue on this path for longer than others can but as the debtor nations in the Eurozone are currently finding out, ultimately these things come home to roost and sooner or later (probably later), the US Dollar will lose its lustre.

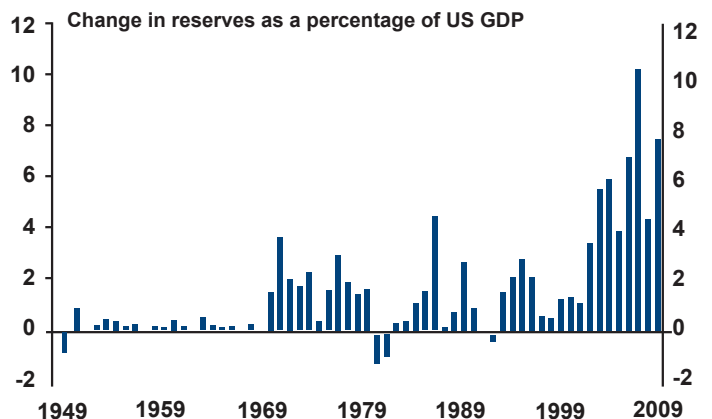
Fig. 2 shows that China is the dominant holder of US Dollar assets and in the absence of real change this will only increase to the point where it potentially has a quasi-veto over US economic policy. Already, China has chided the US over 'weak dollar' policies such as quantitative easing that inflict paper losses on China's US Dollar assets even though their own suppression of the Yuan essentially demands such policies. The increasing size of emerging economies is the primary reason for the accelerated increase in FX reserves and we believe plans need to be formulated to address this as a matter of urgency.

Fig. 2



Sources: IFS, WEO.

Fig. 3



Sources: IFS, WEO.

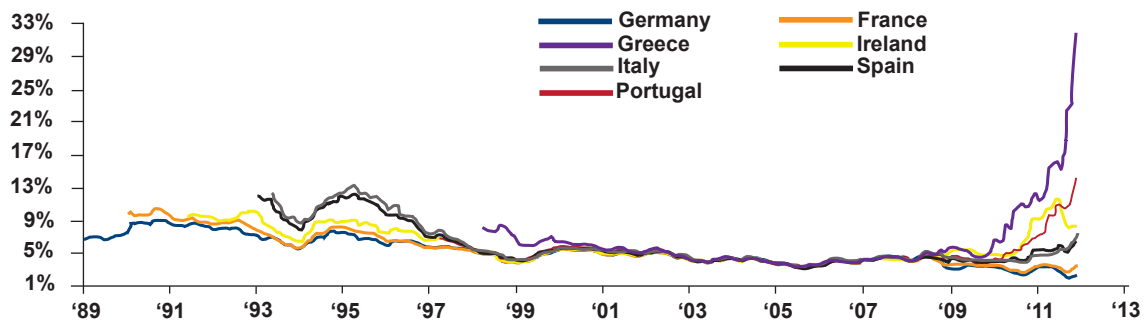
How to solve a problem like the Eurozone

In the previous section of this report we looked at the global economy in aggregate and sought to argue that it is the responsibility of the likes of China and Germany to make policy adjustments that over time will serve to reduce global imbalances. Such things take time to discuss, to agree and to implement. The Eurozone's issues are rather more immediate and thus the focus here will be on the debtor nations and what they can do to improve their circumstances in the near term.

- 1) A single currency with a single central bank and a single interest rate requires one rate of borrowing for member countries. This was recognised early on and thus you can see in Fig. 4 below the dramatic convergence during the late 1990s towards what was to all intents and purposes a single rate of borrowing. A Eurobond issued by any country but backed by all is the logical route but what happened instead is that all the individual sovereign bond markets remained. Whilst a Eurobond is now at least on the table for discussion we can't help but think that things will need to get a lot worse before they resort to this option. More practically, the European Central Bank is likely to have to continue acting as the 'buyer of last resort' for many Eurozone nations when they issue new debt. There is a substantial amount of issuance needed during Feb-Apr so that may bring things to a head.

Fig. 4

The biggest inflection point in 2012 will be the turn in sovereign European debt



Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg.

- 2) The countries with large deficits are being pressured by the so-called 'bond market vigilantes' to tackle them through increased taxation and reduced public expenditure. In the absence of a boost in exports or very 'easy' monetary policies, these are the perfect ingredients for a full-blown depression. The Eurozone as a whole has a broadly speaking balanced trade position and thus in the absence of a complete meltdown it is likely to prove more robust as a currency than popularly expected, thus closing off that route. The European Central Bank is still ideologically constrained by the German Bundesbank's hyper-inflation 'ghost' of the 1920s which prevents them replicating the dramatic action of the Federal Reserve in the US and the Bank of England here in the UK. Regrettably, this suggests that significant falls in wages are the 'best' remedy though it is one that could easily 'kill' the patient so isn't really the desired course.
- 3) Strong economic growth, not driven by increased leverage, would be the best solution all round but this seems unlikely. With developed market consumers generally increasing savings rates and governments under pressure to reduce borrowing this is simply rather difficult without a dramatic change in domestic policy in China and elsewhere in emerging economies.
- 4) One not widely discussed approach that could help those not in quite such a terrible state as Greece would be a clever approach to taxation. If Eurozone members cannot benefit from a depreciating currency to boost exports and reduce imports, and large drops in wages are undesirable then there is an unconventional 'third way'. What is needed is something, other than a currency move, that makes the country more competitive and should improve their trade balance. One way to achieve this would be to lower business costs by slashing payroll taxes e.g. National Insurance (which would make exports more competitive). To replenish the lost taxes you then significantly increase VAT (or equivalent). Domestic producers could use the lower costs to cushion the VAT rise whilst imported goods would see no benefit from payroll tax cuts but would be hit by the VAT rise.

The usual assumption of investors is that there is always a solution and everything will turn out OK but quite frankly it appears to us difficult to divine such a solution. The fact that we have seen so many European summits with very little, in tangible terms, to show for them suggests that we are not alone in this.

If politicians think that if they keep talking about doing something then the markets will just go away and leave them alone then we fear that they are badly mistaken. The political challenge of crafting consensus when their voter's domestic concerns run counter to the government's regional concerns is a difficult conundrum and it is in this situation that the weakness of democracy is most exposed. Who in the southern Mediterranean really want to support severe austerity measures that augur higher taxes, lower wages, delayed retirement, reduced public services etc? Equally, how many Germans want to see a meaningful drop in their standard of living to bail out what they see as their 'feckless' neighbours?

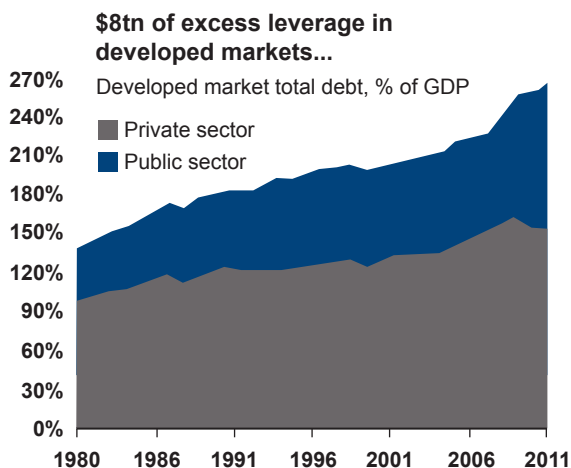
Without such measures, it seems that the only viable plan involves some kind of debt restructuring including extension of principal, lower interest costs and/or reduction of principal. Italy is the biggest problem but also potentially the easier solution as their issue is one more inspired by liquidity than solvency. With a new technocrat government in place and an underlying budget surplus (it is debt servicing costs that cause the deficit), restoring investor confidence and a stabilisation elsewhere in the Eurozone are key. As the largest bond market in Europe by far there is simply no room for error.

For the time being, many of the government bond auctions look only to be possible with the buying support of the European Central Bank. There are some that take comfort from this and it is indeed preferable to the alternative of failed bond auctions. However, until the Eurozone can stand on its own two feet and nations can fund themselves in the usual manner we remain firmly in the danger zone where the situation can escalate at short notice. Whilst that remains the case, we need to be mindful that any further unexpected stresses could be the final straw for the Eurozone; never before has it been so vulnerable.

Global economic outlook

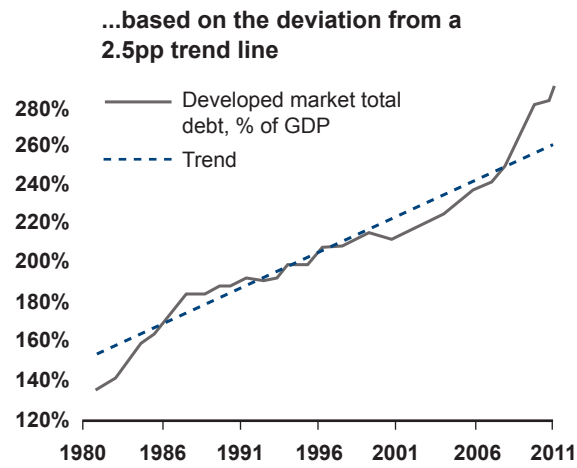
The need to deleverage was something of a theme in 2011 but as Fig. 5 shows there is still some way to go. Whilst the private sector, led by non-financial businesses, and to a lesser extent, consumers, has made good progress on this front, it can clearly be seen that governments have borrowed money at a faster rate than the private sector has been paying it. The result is that leverage in developed economies sits at an all time high. Fig. 6 shows how far above trend we remain and thus how much work still needs to be done to rectify this unsustainable driver of historic GDP growth. According to Credit Suisse, this excess leverage amounts to \$8 trillion which is significant in anyone's book.

Fig. 5



Sources: Thomson Reuters, IMF, OECD, Eurostat, Credit Suisse research

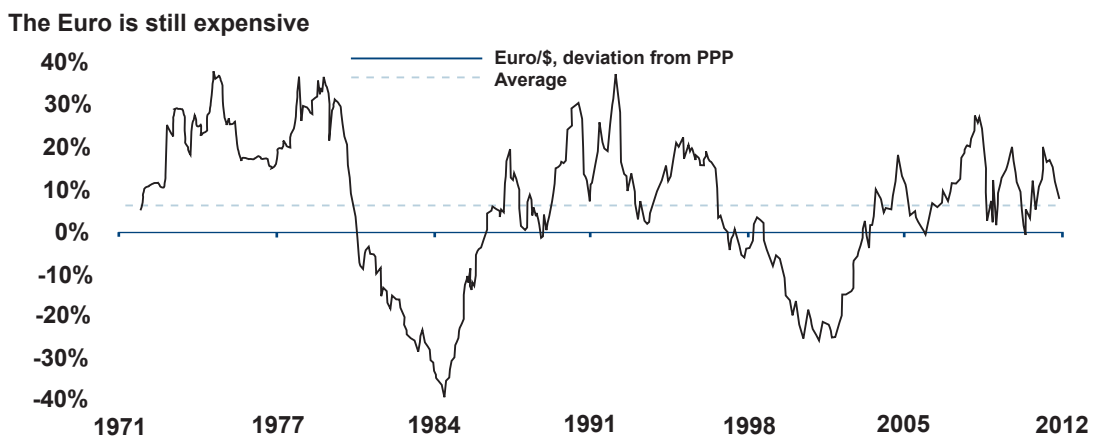
Fig. 6



Sources: Thomson Reuters, IMF, OECD, Eurostat, Credit Suisse research

Much of that need to deleverage comes from Europe but this is easier said than done and the impact of it could be felt far beyond Europe's shores. First and foremost there is the potential to have a negative impact on the US economy since European banks are demonstrating a clear preference for selling Dollar assets and repatriating them to Europe. In our view, this is undoubtedly one of the primary reasons why the Euro has remained curiously robust when on paper you would expect the Euro to be having a torrid time.

Fig. 7



Source: Thomson Reuters, Credit Suisse research

Fig. 7 illustrates how the Euro remains marginally expensive on longer term currency valuation measures such as purchasing power parity. This suggests that from current levels there is clearly the potential for a decisive weakening if the troubles in the Eurozone should take a dramatic turn for the worst.

The chief beneficiary of the Eurozone's troubles is Germany, at least in theory. Whilst many Germans may glance longingly in the rear-view mirror back to the days when they still had the Mark and didn't have to concern themselves with the financial indiscipline of Southern Europe, it is not quite so simple. Germany's economic revival

of the last decade has largely been driven by its powerhouse industrial base but this is no coincidence. It appears to us that this has been a function largely of two things; firstly that the Euro has been weaker than a standalone Mark would have been and has thus boosted German competitiveness at the expense of others. Secondly, with most major developed economies consistently living beyond their means, hence the previously discussed over-leverage, German export demand has obviously been much higher than it would have been if everyone had been running things more conservatively.

Hence the analysis that suggests that a Eurozone breakup would actually cost Germany far more than bailing out their incalcitrant neighbours, but this is likely to count for little with the average German voter and that is a view Mrs Merkel must be mindful of. Of course everyone cannot run a surplus since everything must net out somewhere along the line. The greater the surpluses on one side, and thus the deficits on the other, the more macroeconomic volatility we are likely to experience. To paraphrase our former Chancellor of the Exchequer Gordon Brown, this means 'boom and bust'. Interestingly, it is possible to argue that a period of boom and bust is likely to follow a period of steady growth and vice versa since one lays the groundwork for the other. The increase in leverage and the magnitude of country surplus/deficits (that helped drive above-trend growth) was a rational human response to a period of steady growth since if risks have diminished then you can borrow more. This dynamic can carry on until it becomes unstable which is what we have been experiencing in recent years. When that gets bad enough, and we are probably close to this point now, you get powerful forces that should act to stabilise matters with decreasing leverage and reduced deficits/surpluses resulting in another period of more stable growth.

Stephen Cacchetti, head of the Monetary and Economic department of the Bank of International Settlements has touched on this in recent speeches, including at the Jackson Hole Summit in Wyoming. He has referred to an "unhealthy co-dependency" created by 'surplus' countries that grow on the back of exports and 'deficit' countries that buy those exports by increasing leverage. The solution in his view is for the surplus countries to increase their domestic consumption and for deficit countries to increase their domestic savings and for this to happen in combination with exchange rate adjustments. He cautioned against surplus countries suddenly cutting off lending to deficit countries as this could trigger disorderly exchange rate adjustments. This is what we alluded to earlier in terms of the potential for the Euro to sharply devalue.

Interestingly, if the Eurozone was one country it would actually be in pretty good shape as the deficits and surpluses almost exactly net out, while borrowing is not too high. This would simply reflect at a European 'country' level what already happens within countries, namely that richer regions transfer part of their wealth to poorer regions. Whilst this is accepted within nations, it is much less politically palatable when other nations become involved. The logical conclusion of all of this is that the Eurozone needs to progress towards greater fiscal union to go with the monetary union, but also you effectively need Eurobonds where the stronger members are implicitly standing behind the debts of the weaker members. We do not appear to have reached the point where this is politically acceptable and given the implicit sacrifice of national sovereignty that this would involve, we may never get there.

Unfortunately we are in a situation where one side of the equation is subject to market forces but the other isn't. Deficit countries are being forced by investors to at least try and get to grips with their deteriorating financial situation and in tandem with this their currencies should be weakening to improve their competitive position. However, the major surplus countries are primarily considered 'emerging markets', generally have 'controlled' exchange rate regimes and are actively resisting the appreciation of their currencies, a process that would help to reconcile global current account imbalances. Within developed economies, Germany and Japan are the two major surplus nations. Thanks to its membership of the Euro, Germany is benefitting from a slowly weakening Euro as opposed to what should be a sharply appreciating Mark. Only Japan, despite its best efforts, is seeing meaningful currency appreciation. Demographic patterns in Japan mean a boost in domestic demand is rather unlikely but there are nonetheless signs that this currency adjustment is starting to have an impact with Japan's current account surplus averaging around 1 trillion Yen per year versus typical levels historically of 1.5-2 trillion Yen.

The implications of all of this for investors are complex to say the least and unfortunately the appropriate long-term strategy may prove very painful in the shorter term i.e. possibly missing out on a bull market, as it would be dangerous to underestimate the desire and ability of the world's central banks to keep throwing more money at the

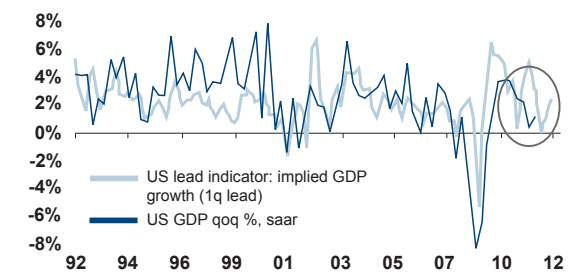
problem. Whilst this delays the day of reckoning, delay it, it does. The excess liquidity-induced stock market rally during 2009 and 2010 caught many off guard and there is no reason why the same could not happen in 2012 as many risk assets look very attractively priced if the global economy is 'jump started' again.

That leaves China, as so often these days, as the 'elephant in the room'. Options for the Chinese authorities are to stimulate domestic consumption and reduce the economy's reliance on export demand, accelerate its trend of adjusting its Yuan/Dollar peg or make strides towards fully floating the Yuan and letting international markets decide its true value. The first of these is the centrepiece of the latest 5-year plan and the middle option is happening, albeit more slowly than the Americans would like. The latter looks to be off the table for the time being at least. The trouble is whilst the current account surplus looks to have peaked as a % of GDP (back in 2007 at 10.1%), the US simply cannot support the deficit required for this to remain in the 6-7% area that the IMF forecasts for the next five years. This is because given the 10%+ nominal GDP growth rates that are likely, in money terms, this goes from 2011's forecast of \$360 billion to a 2016 forecast of \$850 billion. This is simply not compatible with the US reining in their deficit.

The need to deleverage in developed economies is clear but equally, most emerging economies have excess savings rates and a very 'under-leveraged' consumer. If they could 'leverage up' as the rest of the world is deleveraging then things could turn out fine with the imbalances ironed out in an orderly fashion. Regrettably, it looks like the deleveraging could be forced through before the increased domestic consumption in places like China has a sufficiently positive impact. This suggests to us that challenging times for the global economy lie ahead and that deflation in the West is a greater risk than inflation. For the time being, the biggest positive is the relative strength being shown by the US economy which just refuses to lie down and bow to its critics. This can be seen in Figs. 8 & 9 - there has been a definite bias towards better-than-expected economic data in recent months. The key imponderable is whether this can continue in early 2012.

Fig 8

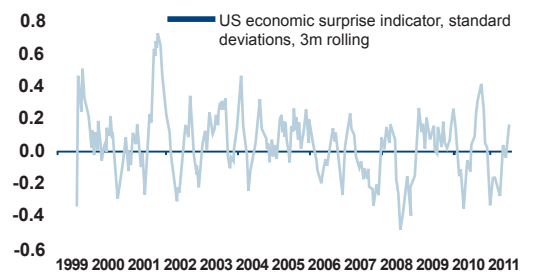
Our composite lead indicator is now consistent with 2.5% GDP growth, compared with 0% in late June



Source: Thomson Reuters, Credit Suisse research.

Fig 9

US macro surprise indicator has turned positive



Source: Thomson Reuters, Credit Suisse research. Surprise indicator based on deviation of actual data from consensus forecasts for 19 US major economic variables.

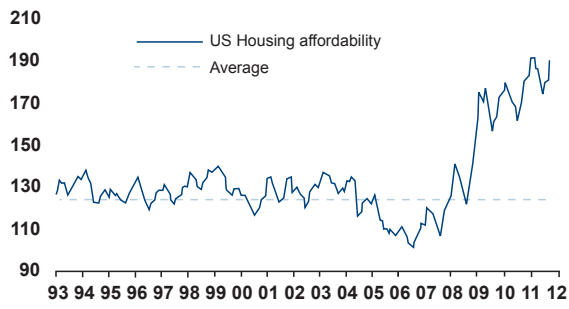
While the US housing market was at the epicentre of the financial crisis, Figs. 10 & 11 provide hope for those who believe it is not until the US housing market stabilises and then improves that the US can find a path to a durable economic expansion. In the sense that housing affordability is at an all-time high and that the cost of buying relative to renting has collapsed spectacularly, at least some of the ingredients are in place. What is now needed is for the better trends in the employment market to persist which in turn will boost consumer confidence, the return of which is surely a prerequisite.

Closer to home, the debate on whether the UK government should be cutting spending, and if so how quickly, continues to rage. Undoubtedly, the actions of the Coalition are depressing economic growth in the short-term but in our view that is a necessary evil. The extent of the cuts in truth is overly exaggerated but they are unavoidable if the UK is to retain control over its own financial situation. The plunge in Gilt yields means the government is being given credit by investors for these actions and there is a real beneficial impact through lower debt servicing costs. This contrasts for example with Italy where were it not for the cost of servicing all their debt they would actually have a budget surplus – the cost of issuing new debt is as important as the ability to issue it. The UK economy

certainly has a tough few years ahead, particularly if the troubles on the other side of the English Channel persist, but in our view there is the underlying strength for us to get through this and usher in a renewed period of prosperity, but this time on much sounder foundations; sometimes the best route is just the least worst route.

Fig 10

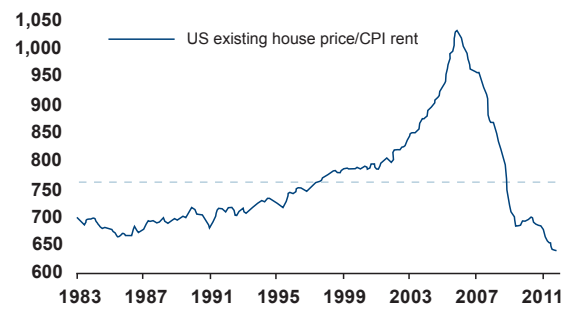
US housing affordability extremely high...



Source: Thomson Reuters, Credit Suisse research.

Fig 11

...and relative to rents, US housing is the cheapest on record



Source: Thomson Reuters, Credit Suisse research.

Investment outlook

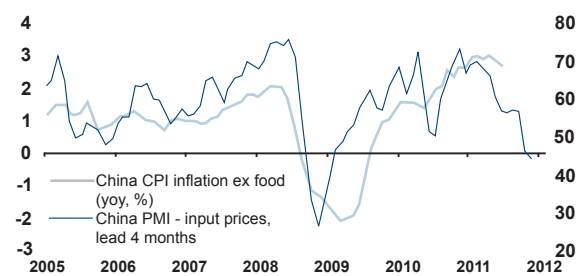
Hopefully you have survived the ‘brief’ economics overview but we believe it is essential to grasp the key issues here before moving on to individual asset class views and overall portfolio strategy. Given the current state of the global economy it really would be unwise to simply declare certain assets as attractive or unattractive, usually based on the recent past. Within this section, we will look to outline some of our key strategic views that we feel are consistent with what appears earlier in this report.

We have talked a lot about deflationary pressures and yet a glance at UK inflation measures such as the Consumer Prices Index (CPI) or Retail Prices Index (RPI), currently running around 4 to 5%, would suggest we are barking up the wrong tree. The forces driving us towards deflation in the UK are indeed powerful with rising savings rates, downward pressure on government spending and high unemployment. That headline inflation is running at a high level, certainly relative to the Bank of England’s 2% target for CPI, is a function of two things. Firstly, there have been one-off effects to reflect price adjustments because of taxation changes; principal amongst these is the 20% rate of VAT introduced in early 2011. Starting in January, these effects will start to fall out of the year-on-year comparisons.

Secondly, a weaker Sterling has resulted in imported inflation. Whilst this is no less a price rise for the ‘man on the street’ than other sources of inflation, it is nonetheless something that does not require policy action from the Bank of England. A weaker growth outlook globally, a tailing off in many commodity prices and attempts across an array of emerging markets to alleviate surging inflation, primarily through interest rate rises, means that such inflationary pressures should diminish and may even act to subdue inflation. Figs. 12 & 13 track the trends in input prices reported by a survey of Purchasing Managers as well as a headline value for the overall Purchasing Managers Index (PMI). These illustrate a diminution of inflationary pressure in China even amidst still robust economic growth; we could easily have chosen many other emerging economies.

Fig. 12

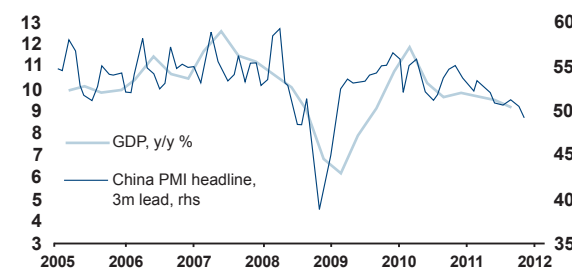
China’ PMI prices suggest core inflation will decelerate significantly ...



Source: Thomson Reuters, Credit Suisse research.

Fig. 13

...while China’s PMI is still consistent with 8.5% growth

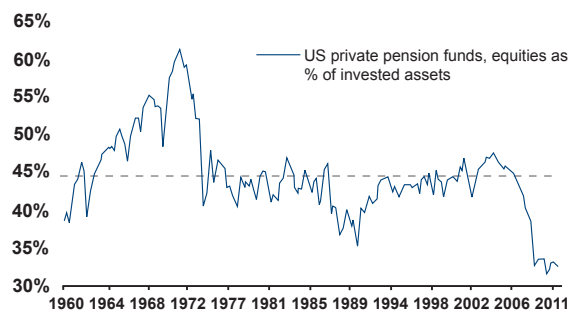


Source: Thomson Reuters, Credit Suisse research.

Hopefully that preamble leads us adroitly onto the issue of inflation-linked Gilts. Habitually seen as the best method of protecting one’s capital against the longer-term ravages of inflation, things are often not so simple. Whilst the capital payment at maturity does adjust over time according to the level of inflation, an investor needs to be mindful that the market price moves around according to expectations of future inflation. This means that it is possible to lose money in real terms if future inflation is not as high as expected. In our view, the current situation carries a risk of this with relatively high historic inflation being extrapolated out into the future. The investment case with 2% yields on 10 year Gilts doesn’t exactly look the most compelling but with considerable downside to future inflation expectations and economic forces conducive to lower inflation, the case for inflation-linked Gilts looks even weaker. They are not a safe haven and in our view look unattractive.

Fig. 14

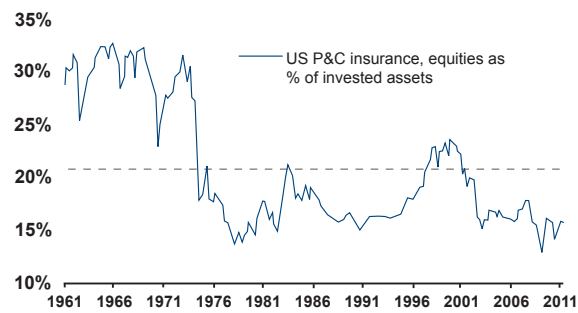
Equity weightings of US pension funds are well below average



Source: Thomson Reuters, Credit Suisse research.

Fig. 15

Equity weightings are close to all-time low for US P&C insurance companies



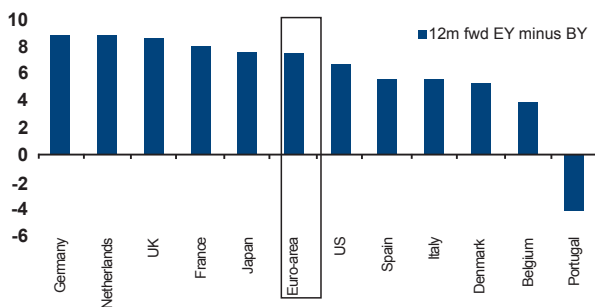
Source: Thomson Reuters, Credit Suisse research.

The bond market has, generally speaking, had a great decade or so as bond yields have fallen steadily. Notwithstanding the value that we see in the corporate bond market, it is virtually impossible for Gilts to match in the future the magnitude of past returns. The primary alternative for investors to bonds is equities and given that to the extent the investment in one is money that could be invested in the other, it is not necessarily surprising that equities generally have not had a great time during this period. Figs. 14 & 15 show how this has sapped institutional holdings of equities in the US but data elsewhere would reveal a similar pattern. The key question is what turns this round and genuinely attracts investors back to equities? The most obvious answer is a 'proper' bear market in bonds but this requires a significant rise in bond yields. In the absence of very strong economic growth, it is difficult to see how this can happen, particularly when the major central banks all appear committed to extended periods of very low interest rates. If bond yields stay 'low', even if they rise from here, fixed income returns are unlikely to be great but nor should they look too shabby in an environment of very low cash rates. Such returns appear unlikely to drive investors en masse back to equities and thus a period of relatively volatile but largely range bound trading for stock markets appears a distinct possibility.

Given the performance bloodbath in Europe during 2011, one might have expected European markets to look good value. In fact, as Figs. 16 & 17 show, whilst they do look cheap, they don't really look much cheaper than elsewhere in the world when looked at relative to their national bond markets. Fig. 17 shows that in absolute terms valuations relative to the rest of the world are in line with much of the last two decades suggesting not a great deal of pure 'Europe' risk has been priced in thus far.

Fig. 16

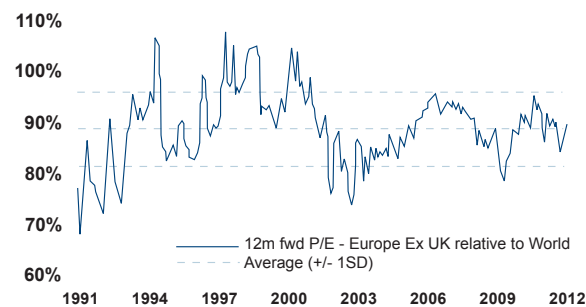
12-month forward earnings yield less bond is not abnormally high in the Euro-area



Source: Thomson Reuters, Credit Suisse research. For the Euro-area, we calculated the market cap weighted average of the Euro countries' earnings yield.

Fig. 17

Continental Europe trades at average levels on P/E relative to global markets



Source: Thomson Reuters, Credit Suisse research.

If cash and government bonds offer very little and we think inflation-linked Gilts are less appealing than the latter and possibly the former as well that leaves the corporate bond market standing out to us as the clear value on a risk-adjusted basis. Equities look cheap on a wide range of absolute and relative value metrics but this may not be enough. On balance there is appeal but it is still tough to feel very confident that markets can rise in 2012 much more than they could fall. Nowhere really stands out regionally from a valuation standpoint but the contrarian trade would be to favour Europe over the US since pretty much everyone is positioned the other way. Emerging markets remain the area of choice if risk appetite returns.

The area that we are allocating increasing proportions of client portfolios to is what we term 'Alternative Assets'. This covers a multitude of areas but below we will briefly highlight those areas that we are most favourably disposed towards.

With the inflation-linkage of inflation-linked Gilts coming at what we consider to be too high a price, an alternative source of income growth without the associated capital volatility of the stock market is the listed infrastructure sector. The sector continues to mature and broaden its offering both in terms of underlying assets and geographical focus. Broadly speaking, we are looking at 5%+ dividend yields that grow in line with inflation and a small amount of capital growth on a long-term basis. There are risks in terms of potential discount volatility, particularly if inflation falls but on a relative basis they should surely remain preferable to inflation-linked Gilts. Our favoured options are 3i Infrastructure, HICL and Bilfinger Berger.

Moving beyond listed infrastructure we get to the even hazier category of 'absolute return' funds. Before we go any further, let us be clear that absolute return doesn't mean they will make money in any market conditions but that it is possible for them to do so. We believe that it is this common misunderstanding that leads to the perennial disappointment every time one or more of these funds falls in value. Historically we have leaned towards those investment managers who we believe have sufficient skill to deliver over time but the key challenges here are that a) there is no way to determine whether a particular manager will get the 'big calls' right, b) the danger posed by this can be reduced by using multiple funds but then you increase the chances that in aggregate you are back to square one, c) they generally still need a backdrop of rising asset prices and d) for many of these managers, if and when they do get it wrong, there is a high likelihood that, from our point of view, it happens at the worst possible time i.e. during a market slump.

Bearing in mind these pitfalls, the funds that we now favour, whilst they have their own pitfalls and risks, don't suffer from any of these problems. That is because they are computer-driven so their (unemotional) behavioural characteristics can be relied upon more and you remove the unpredictability of human involvement. They may not be the sole solution but they are certainly highly complementary to portfolios largely composed of investments where emotion does play a part, whether ours or someone else's. Hopefully these funds will become a meaningful part of our client portfolios during the coming months and do an effective job at reducing portfolio risks and generating decent uncorrelated returns over time. One of the funds is specifically intended to act as an 'insurance policy' in the event that some of the more dire scenarios discussed in this report materialise. When all is said and done, our clients should experience a materially smoother ride.

Investment ideas for better times

Whilst much of this report may have a more cautious tone than usual, that doesn't mean we think there are no attractive opportunities out there. In fact, for an investor who is willing to look through short-term volatility and is comfortable seeing such investments fall further before ultimately profiting from them, the landscape is not that different to the first half of 2009. For many of our clients, trying not to lose money is of primary importance whilst making money comes second on the list of priorities. If we put aside concerns about downside risks for the moment and simply seek to identify those areas where, on balance, the risk/reward is attractive, then we believe these are good places to start for clients of a more risk-taking persuasion.

What makes them comparatively attractive is that we believe that the upside (in the event of a decisive move by the stock market to new highs) is a multiple of the potential downside (should the market fall materially). This can at least in part be attributed to the fact that such investments have generally fallen a long way already. So here are a few ideas.

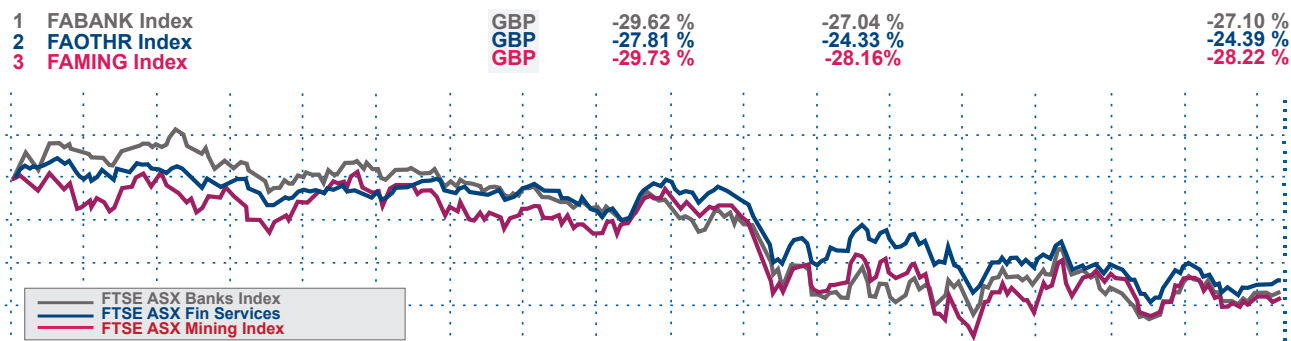
Emerging Markets

Irrespective of domestic economic fundamentals, emerging market debt and equity still tends to act like a more volatile version of their developed market peers. Structurally, it is possible to argue that developed world-based investors are 'underweight' emerging markets so there should be natural buying support for such markets except during periods of extreme turmoil. Based on the discussion earlier in this report, currency gains could be expected over the medium-term as emerging market currencies strengthen so having an unhedged currency exposure appears wisest. Additionally, if there is to be the accompanying rebalancing then exposure to domestically-focused investments would seem more sensible than exposure to the exporters who rely on the 'free ride' of an undervalued currency. Given the predominance in many emerging markets of export-led growth, the major stock market averages tend to be dominated by such companies. Thus, in order to pursue the domestic consumption theme, a range of diversified small company-oriented funds and/or funds oriented away from the dominant BRIC countries may reap the greatest rewards.

High Beta Equities – miners, industrials, financials

They do exactly what they say on the tin. If the market is having a rough ride then you can usually rely on these sectors to be leading the way down. They remain vulnerable in the event of any further market decline but they have already fallen a long way as the chart (covering miners, banks and financial services) below shows and if the market has either a short-term bounce or a longer-term bull market, these stocks are likely to be at the forefront.

Fig. 18



Subordinated bank debt and high yield non-financial bonds

Not too many years ago, bank debt was considered all but risk-free - oh, how things change! Whilst stock markets are sending relatively complacent signals, it is the complete opposite in bond markets where they are sounding alarm wherever you look. Whether government bond spreads within the Eurozone, gauges of bank sector liquidity, credit default swaps, implied default rates, without fail they are signalling virtual depression. From a risk/reward point of view, that means the corporate bond market looks pretty attractive to us given that such a pessimistic scenario is already priced in. Subordinated bank debt (that ranks lowly in the capital structure) though still above shareholders may be pretty racy by bond market standards but is still safer than the shares of these banks. With income yields of 10% or more generally on offer and the bonds at a large discount to their par value they have definite merit as an alternative to buying bank shares. Outside the financial sector, there looks to be a mismatch in yields between investment grade and so-called high yield bonds that is more than that justified by potential default rates. Again, the risks are greater but the potential rewards look to be proportionately greater still.

Small cap shares

Smaller company shares are usually a very good barometer of the stock market mood and the FTSE Smallcap index has been underperforming the FTSE 100 since early September 2011, or mid-January if you use the AIM Index. In the current market environment this is unlikely to change and there is certainly the potential for this underperformance to accelerate either in the teeth of a crisis, as was the case in 2008, or in the early stages of a liquidity-driven rally. However, the rewards can be comparably larger during strong market conditions and small caps outperformed substantially in the wake of the March 2009 market low. Access to small caps is easiest via high quality funds and one of our preferred routes is Blackrock Smaller Companies which is languishing on an almost 20% discount to net asset value. For those wanting something potentially more spectacular it is always possible to focus on a handful of individual small stock ideas but this carries greater stock-specific risk.

Listed private equity

The listed private equity sector in the UK has a very creditable long-term track record of value creation over and above the UK stock market. In spite of this the sector seems to oscillate between extremes of sentiment. During the financial crisis, one of our preferred holdings in the sector, Electra, fell from £17 to £6 but barely two years later was sitting at virtually an all-time high of just under £18. The recent dip in the share price to around £14 has been less extreme than in 2008 but value creation continues with recent deals taking net asset value above £22, putting the shares on around a 35% discount. Comparable value can be found elsewhere in the sector and for investors willing and able to risk capital, we believe the listed private equity sector should be high up on any shopping list.

Summary

That was a whistle stop tour of areas of the market that we feel offer the most potential in the event of a sustained rise in global asset prices. For us, the fact that the potential upside represents a multiple of the potential downside means that we view these areas as attractive in a purist sense but it is important that investors are willing and able to sustain paper losses in the meantime.

Conclusion

I trust that you haven't found this report too depressing but in writing it I have sought to strike a tone of realism in terms of where we are and the challenges we face. It would be foolish of us to be unbridled optimists in the circumstances but we have nonetheless still attempted to highlight areas of opportunity that inevitably arise when the future is as unclear as it is currently.

At the heart of the problems in the Eurozone is, we believe, the lack of a fundamental desire to understand what the problems are. Instead, politicians lean towards solutions that fit their ideological standpoint and are politically expedient. This will tend to prolong rather than solve the crisis and could do more harm than good if it leads to a false sense of security. Tough decisions need to be made in the Eurozone over the course of the next twelve months that will define its future path; whilst we hope that the right decisions are made, we fear they will not be and it is this occurrence that we need to plan for.

It is this fear that leads us to a somewhat more precautionary investment approach than usual. Although we have sought to still remain on the front foot, we equally have felt the need to introduce some measure of stability and protection to portfolios, even at the cost of sacrificing a proportion of any asset price increases. Make no mistake however, our portfolios remain dominated by corporate bonds and equities such that if, as has so often been the case in the past, things are not as bad as they seem then we are well-positioned to make some very respectable returns.

Central to this strategy is an appreciation of the difference between taking relative and absolute risks within portfolios. Often, investment managers such as us feel under such scrutiny in terms of relative performance that when the future appears so uncertain, the sensible thing is simply to mimic whatever benchmark is being used, whether it is the FTSE 100 or one of the APCIMS indices. However, on occasions this would require us to take more absolute risk than we think our clients want us to take and indeed that we think it is sensible to take. In such circumstances, we prefer to prioritise the consideration of absolute risk within portfolios; as before we try to make money we must first try not to lose any.

Hopefully, this report helps to explain why we are doing this and how we are looking to go about doing it. We are confident that with the recent strategy changes currently being implemented in portfolios, we are materially reducing the risk to our client's capital. We are mindful that there is likely to be an increased divergence in relative performance over the next 6-12 months. Should markets fall this is likely to be good news whereas if they rise strongly we are more likely to just capture a proportion of that rise. On balance we believe that this is a 'cost' worth bearing.

We are not trying to predict that the market will fall significantly; merely we acknowledge it could do. Even though it is in such an eventuality that our moves would appear most vindicated, we would not surprisingly rather see asset prices rise, as would you. So it is that we fervently hope for a prosperous 2012 but should it prove as tricky to navigate as 2011, or worse, we would hope to be relatively well placed.



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