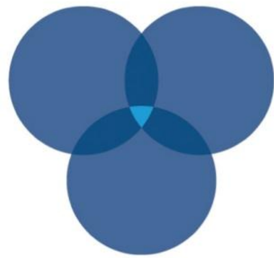

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Quarterly Investment Bulletin

January 2013

General Overview – Quarter Four 2012

We started the quarter with more concerns about the outcome of debt negotiations in Europe and further uncertainty about regime change in the US, China and Japan, yet despite all this, the performance of stock markets around the world was broadly positive. This has been mainly driven by the recent release of political pressure in Europe following Greek debt restructuring and the ECB supporting the bond markets in the rest of peripheral Europe. In the US economic data has been encouraging and political uncertainty has been settled, even the fiscal cliff has been resolved in the first few days 0f 2013. Lastly the Chinese hard landing and regime change has come through its critical phases without damaging market confidence significantly.

The last quarter of the year was much less volatile than the first half of the year because of the reduction in what have been termed as tail risks – those risks that have a small probability of occurring but if they did would drive markets significantly downwards. Political statements and central bank action in September and October helped to stabilise market levels around the world and in particular those that had been operating on very weak valuations such as Europe. Europe has had a very strong year despite fundamental data not being significantly better than earlier in the year.

Economic opinion on the next year or so leads us to the consensus view of a slower growth world although this is not constant across either countries or sectors. The world can be broadly split between two groups, the first where de-leveraging pressures are intense including European sovereigns and their banks. The second group, which is not so challenged, includes much of the corporate sector, US banks, the US consumer and emerging economies. This means that although overall growth may be muted there will be areas which continue to push the global economy forward.

Looking at this in a longer term context, we can consider how our economic environment has changed over the last few decades and how this now affects the current investor's mind set. The financial environment or investment regime typically drives returns from the different asset classes. Much of the seventies were dominated by stagflation which was a poor environment for both equities and bonds. The eighties and nineties, now often referred to as the 'Great Moderation' was a disinflationary environment positive for both equities and bonds. From 2000 increased levels of leverage drove returns until the bubble burst with the financial crisis. Since 2009 the world has been in de-leveraging mode. The world, as noted, has been dominated by event risk due to this deleveraging. This is a difficult environment in which to invest. To succeed, investors need to understand the financial environment on a longer term basis, in other words in today's volatile world it is necessary to understand the regime investors are in to provide coherence to decision making. Furthermore a more active approach to asset allocation and stock selection than was the case in the 'Great Moderation' is necessary to deliver above average returns.

Equity Markets

Equity markets in 2012 have performed better than many investors had expected. Whilst economic conditions have remained tough overall the cyclical outlook has turned out to be better than expected. In the UK for example the FTSE All Share finished the year up 8.24% thanks mainly to the end of year market rallies. Longer term reflection however suggests that we should not get too

optimistic as markets have moved very little in the five years since the beginning of the financial crisis in 2007. The S&P 500 for example was up just 3.3% in local currency terms from January 2007 to 21 December 2012.

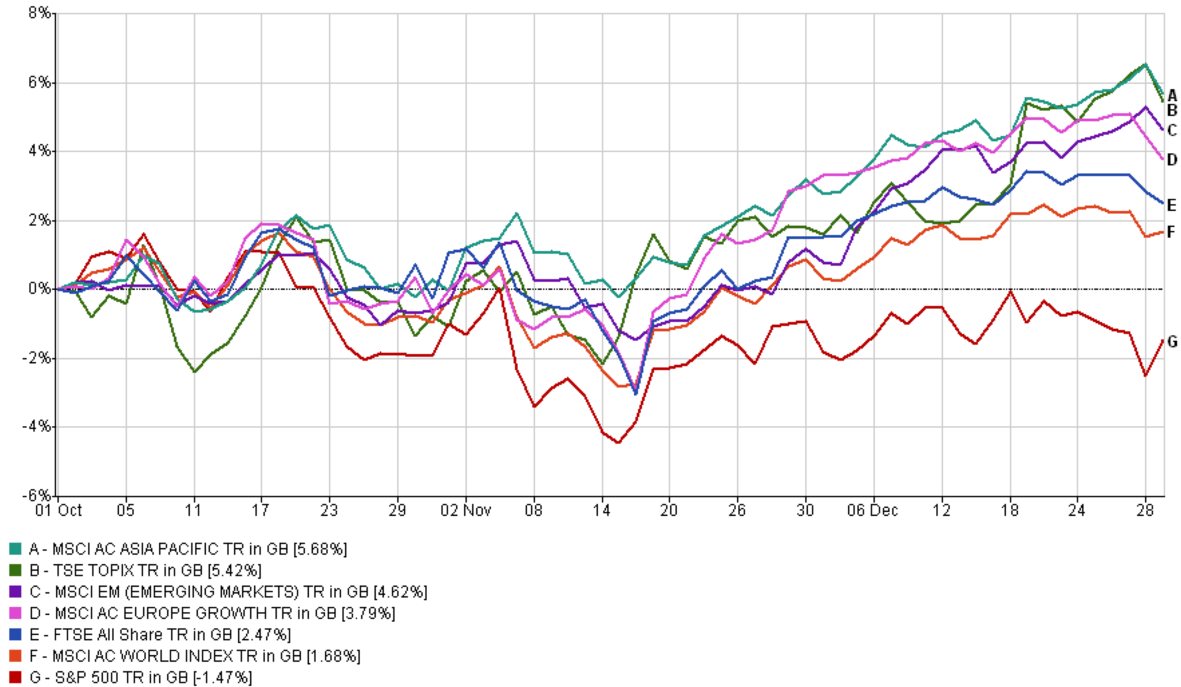
At the start of 2012 there was concern as to whether the US recovery would continue or falter. It now appears that US economic recovery looks likely to be sustained, especially with the recovery in the housing market. Whilst China has undoubtedly slowed, a hard landing has been successfully avoided. In Europe the debt crisis has been contained at the very least, with the actions by new ECB President Draghi ensuring that liquidity issues will not be a problem for peripheral European governments or their financial institutions in the short term.

Markets in 2012 have benefitted from the attractive valuation or entry point available to investors at the start of the year. So, although company earnings have been under pressure in many regions, progress has been made as the resolution of tail risks has allowed equity markets to re-rate positively. Even after this upward move valuations are still not stretched and are attractive in many parts of the world. Perhaps the only market to contract is the Chinese local market which has few foreign investors.

Markets will need to see an improvement in earnings for the current rally to be sustained in 2013. With the improvement in both the US and Chinese economies and some degree of stabilisation in Europe a positive outlook for equity markets remains justified.

Chart showing 2012 returns for major market indices:

Chart showing Quarter Four returns for major market indices:



Sector Review

UK

The UK economy has fluctuated in the year between small levels of growth and flirting with recession. The third quarter data showed growth of 1% although Mervyn King (Governor of the Bank of England) stated that this may have been primarily due to one-off factors, that GDP may contract again in the fourth quarter and that recovery may start later than previously forecast. The OECD predicted growth for 2013 of 0.9% and the National Institute for Economic and Social Research reduced their 2013 forecast down from 1.3% to 1.1% - there seems to be a consensus building around the 1% figure. Weak export to Europe, sluggish business spending, government spending cuts along with the on-going hangover of household debt have all impeded growth. Modest improvement in some of these areas and in particular improving employment statistics indicate that we should see more positive growth next year in 2013. The UK housing market edged lower in 2012 with strength in London offset by weakness in other regions. Although interest rates remain low, activity is not improving with mortgages harder to get and buyers reluctant to climb onto a stagnant property ladder.

Despite the current economic situation and outlook, companies remain in a relatively healthy financial position with dividends to investors remaining strong due to good cash generation. Dividends are likely to be a relatively significant part of investor returns over the shorter-term and companies that are able to show growing dividends are likely to be well received by the stock market – medium-sized and smaller companies have significantly outperformed larger companies over the

last twelve months due to their performance during the 'risk on' rallies making larger companies look more attractive with their relatively safe haven status during 'risk off' periods.

In stock market terms we should not forget that only 20% of earnings from the FTSE 100 companies comes from the UK so an upturn in the global market will have a strong boost to company profitability even if the domestic economy struggles.

Europe

The most sensitive issues in Europe remain around the Euro and peripheral Europe although this pressure has abated since the announcement by the ECB that they would support the bond markets of Italy, Spain and Portugal.

Whilst we have probably moved away from the bottom of the crisis, any backsliding on structural reform in the periphery or a rejection of unpopular austerity policies could lead to renewed fears of sustainability of sovereign debt pushing markets into testing the ECB's resolve. This may well lead to a stronger administrative union although any closer political union will take time to construct. The ECB has definitely stepped up to support the various governments showing it will not bow to market pressure. It is likely this will be tested in 2013 if Spain or others request further support.

Overall economic growth in Europe is likely to remain subdued with southern Europe staying in recession for much of the year. As in the UK there are some very good, very strong companies operating from Europe and any upturn in world growth will directly benefit them, lifting corporate profits with a knock on for the domestic economy. The West cannot grow in the same way as Eastern economies but they can benefit significantly from their growth with China's continued expansion being at the forefront of this demand.

Fixed Interest

Unlike a number of previous reviews, for once we can report on the returns from fixed interest being fairly stable with the best returns coming from corporate debt both investment grade and high yield. As we suggested last quarter, government debt has little margin for capital growth given current yields but equally investors are still not prepared to relinquish this debt for potentially higher returns maintaining a low risk low yield environment.

Quantitative easing (QE) has played a huge part in the current positioning of debt markets across the world with the very supportive action of central banks being a positive for markets in recent months. Some commentators are concerned that QE or money printing will soon lead to a pick-up in inflation, however, the usual drivers of inflation remain absent meaning that the normal upward price pressures that lead an inflationary pickup are not there. So, although QE should be inflationary, there may not be enough of it to counteract deflationary forces such as de-leveraging by the banks, and unless central banks radically alter current inflation targets an imminent pickup in inflation is unlikely as a more general global economic recovery is necessary before inflation returns.

In this environment an immediate upward jump in government bond yields seems unlikely. Central banks have pledged to keep rates close to zero for a long time and the latest announcement by the US Federal Reserve to maintain current levels of interest rates until unemployment falls to 6.5% is the boldest move yet, ensuring long term interest rates are pegged at low levels. Whilst the catalyst

for a bond bear market will be tighter monetary policy in the western world, this is still some way off.

Prospects for corporate credit remain more positive than for government bonds, with low but positive growth retaining an environment in which credit spreads can tighten further. Investor thirst for yield means corporates are having little difficulty refinancing and in this environment default rates look unlikely to rise significantly next year.

US

The US had more encouraging economic news over 2012 and the stock market had performed better than others up to the final quarter of the year. Investors however felt that given the valuation levels in US equities had reached post Lehman highs, there were better bargains elsewhere, in particular in Europe. This meant that in the last quarter US equities did not respond as well to the wider global market rallies.

Underlying data, such as employment, has been picking up and wages rising as well as stronger signs from the US housing market which was the epicentre of the financial crisis that engulfed markets in 2007-08. At that time, the US had over-supply in the housing market and this overhang, when combined with unemployment and falling incomes, led to falling house prices and recession. The US banking system was under huge stress and large numbers of construction jobs were lost with the whole economy suffering as the negative multiplier effects spread through the economy. With the current positive signs the reverse might be true next year. Available housing inventory has now fallen sharply to the point where house building should resume. Furthermore, in general it makes more sense to buy than rent due to historically low levels of mortgage rates. The multiplier effects of a recovering housing market could be very powerful for the US economy. House prices are 30% below their peak and 30 year mortgage rates are around record lows of 3.3%. This all bodes well for a continued recovery in house prices.

Other structural changes which will have a positive longer term effect on the economy include the emerging growth of the shale gas and oil production. The importance of shale gas / oil for the US and indeed global economy should not be underestimated. It has already started a renaissance in US manufacturing due to lower energy costs and in Asia there are hopes that US shale gas imports will be half the price of Australian LNG and so cheap US energy has global ramifications as it will increase disposable incomes around the world. Although there will be some fiscal tightening in the States, the US economy appears robust enough to continue to grow in 2013.

Asia and Emerging Markets

The themes in Asia that are driving growth remain in place, the main ones being the expanding population and the rise of the middle class element. Central Asian economies have strong domestic growth potential and this is insulating them from the worst of the western economic problems. In particular the banking system is in a much stronger position, particularly with not having to improve their capital adequacy and balance sheets. Governments in countries such as Brazil and Mexico can use their strong balance of payments position to stimulate areas of their economy that show weakness without massively increasing government debt. There is greater control of the public finances and of control instruments such as interest rates and inflation.

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China is the key economy that drives the region's, and increasingly the world's demand and after a period of uncertainty surrounding slowing economic growth and a change of leadership, it has perhaps come through one of its most challenging periods. Whilst the summer may have seen a bumpy landing, economic growth has at least stabilised and in many sectors it is picking up. A growth rate of around 7.5% now looks certain to be achieved for 2012. The strong growth in China contrasts with the subdued levels of economic activity in the West. At first sight this seems to justify high levels of investor interest in the region. Investing in Chinese companies however is not straight forward, as many industries suffer from an oversupply problem. To be successful in China there is a necessity for differentiation. Many companies may actually find life tough in China over the next couple of years, due to oversupply resulting in a squeeze on margins but over the longer term this will help larger national champions to emerge in many Chinese industries, providing a sound basis for stronger profit growth over the medium or longer term.

The new leadership look to be leaning towards a pro- reform stance which is a definite positive given recent uncertainty, but is unlikely to sponsor large stimulus packages with them preferring to see monetary easing and wage growth drive the domestic economy through the rising middle classes. Housing remains a problem but rising wages are helping to bridge the gaps.

Growth rates in China look likely to be maintained around the 7% to 7.5% level for the next few years and inflation has come down significantly over the last 12 months and at 2% is under control.

The main expansion in Asia and Latin America is through domestic markets and the increasing and wealthier middle classes which is a theme for many global portfolios.

Japan

Japan remains the world's third largest economy but is still weighed down by two decades of stagnation. Sitting most uneasily in this data is the changing demographics with a declining population a drag on economic growth.

Japan still holds some of the world's largest companies and brands and earns significant profits from overseas markets. These companies have struggled in recent years with the strength of the Yen but this is beginning to change as the currency weakens and may get further support from the newly elected LDP and returning Prime Minister Abe. The new leader has committed to escape the deflationary environment and a large increase in QE may weaken the Yen to more competitive rates whilst also adding liquidity to markets. Japanese equities are cheap on a number of measures and may prove to be the surprise package in 2013 if reforms progress.

Property

There has been little change in the views of most experts watching the commercial property market in the UK with valuations falling by varying degrees depending where in the country the properties are located and whether they are prime or secondary assets. The prime end of the market, particularly in the south east and London, remains more robust and, as many commentators have noted, is supported by foreign investors. Sales of offices shops and hotels in London rose to £13.6bn during the year up 25% on 2011 (source FT) thanks largely to Asian Governments (45%) looking for long term investments.

The main source of return is still income and provided falls in capital values do not erase this, should provide a substantial yield pick-up to that of gilts and cash at current levels. The decline in UK commercial property capital values continued to gather pace in 2012, with all three main UK commercial property sectors (retail, office and industrial), continuing to decline. The decline was particularly marked in retail, especially retail warehouses.
In general property investors expect companies to remain defensive, reducing costs and not making expansionary acquisitions, and as such rental growth will remain weak with short to medium term returns expected to be around 5-6% with yields drifting slightly upwards.

In Europe the transaction levels have remained reasonable but investment has been focused in areas such as France, Germany and the Nordics where risk is seen as the lowest.

Most direct property funds hold reasonable levels of residual cash which makes keeping up with the IPD index difficult in this environment but this is needed to support the liquidity required in the current volatile investment environment.

Summary

The fourth quarter saw further consolidation of equity markets as investors felt more confident in the longer term viability of the European Economic Union and the likely survival of the Euro. This aligned to the resolution of political uncertainty in the US, China and Japan has helped to remove some of the volatility in markets as well as the so termed 'risk on risk off' environment faced for the previous twelve months.

The environment remains favourable for risk assets generally, although it must be remembered that the uncertain and low growth world of today means market volatility will continue to occur from time to time. The developed world remains in a deleveraging mode, so growth rates will stay relatively low but Central Bank actions have resulted in buoyant liquidity which is always a positive for risk assets.

In areas where economic growth is robust such as China and the emerging world, many better quality consumer names currently trade at high valuations. Managers' skill in stock selection in these markets will remain crucial.

Overall risk assets look attractively valued compared to safe low risk alternatives. Central Banks continue to respond to the current economic slow down by increasing monetary stimulus to the global economy and so, despite the gains seen in equities in 2012, valuations remain attractive for longer term investors.

Ken Rayner
Director
Rayner Spencer Mills
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