Driven to extremes!

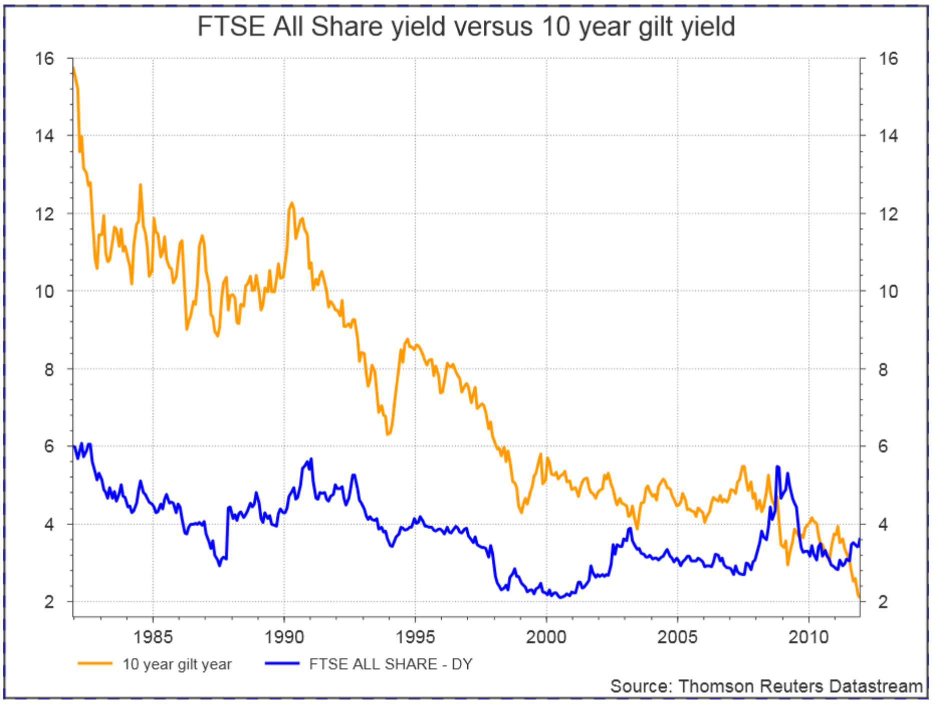
We may well look back on 2011 as a year that forever changed the economic and political landscape of the world. At the very least, it will be a case study year for students of both economics and politics long into the future. For this year has proven no less eventful than 2008, with a bombardment of sensationalist headlines causing unprecedented volatility across the financial markets. Indeed, during one tumultuous week in August, the S&P 500 Index gyrated by more than 4% on four consecutive trading days – movements of such magnitude have never been seen before. We witnessed several sovereign states in the Eurozone being forced to count the cost of many years of living the high life through soaring interest rates and further bailouts for Greece and Portugal. With tough austerity measures being thrust upon the heavily indebted nations we saw a change of government in Greece, Italy and Spain as financial markets flexed their power over political leadership. However, the Eurozone debt crisis was far from the only macro-economic event clouding the decision making process of investors. The United States suffered the embarrassment of being stripped of its AAA credit rating, whilst a knife was taken to growth forecasts across the globe. With this deluge of macro headlines dominating the fundamentals, correlations between asset classes and intra-asset class rose sharply. It was a year where valuations clearly counted for very little and certain markets were driven to extreme levels.

Investors started the year in an optimistic mood as risk assets marched higher in the first quarter on the back of strong earnings growth, with around 70% of companies in the S&P 500 Index reporting profits ahead of expectations. There was a continued belief that, following his speech at Jackson Hole, Federal Reserve Chairman Ben Bernanke would support asset markets at any cost including devaluing the US Dollar. Whilst developed market equities were able to make good progress, one notable trend was the underperformance of emerging market equities. With major commodities being priced in US Dollars, the price of metals, foods and energy spiked causing high inflation in those economies. Combined with little spare capacity and rising wage inflation, policy makers were forced to take action and stamp on the brakes by tightening monetary policy. Subsequently, the MSCI EM Emerging Market Index lagged the S&P 500 Index by nearly 6% over the first quarter.

By April, the relative calm of the first quarter was a distant memory and the so called 'Arab Spring,' which had been triggered by food price inflation, intensified. Peaceful demonstrations for change were replaced with a revolutionary tone turning into all out civil war in Libya. This led to a further spike in the oil price to above $120 a barrel, a level which was to hinder global economic growth in the second half of the year. As fears that the global economy may tumble back into recession investors optimism morphed rapidly into pessimism.

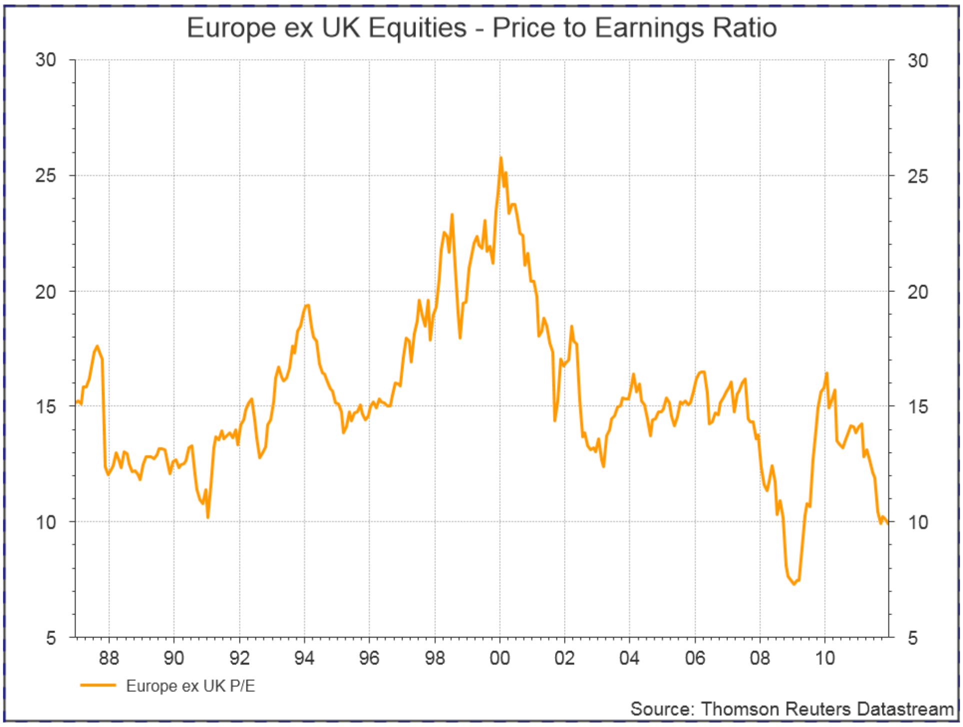
Bond markets were quick to react to the changing macro picture with sovereign bond yields in the perceived safe havens of the UK Gilts, US Treasuries and German Bunds plunging to historical lows. On any normal valuations metrics these securities looked widely overvalued, offering negative real yields for much of the year. However, we live in unprecedented times, where policy measures and fear often override fundamentals. In the UK, the Monetary Policy Committee (MPC) appeared to have largely abandoned their dual mandate of price stability and growth in favour of simply the addressing the latter. They unleashed a further round of quantitative easing, a policy measure which has heavily distorted the price of UK Gilts over the past two years. Furthermore, price insensitive buyers in the form of banks and pension funds also distorted the market. These factors and the general unprecedented fear of the future still felt by many goes a long way to explaining why UK Gilts, US Treasuries and German Bunds trade as such extreme valuations.

Gilts – all time low yields.



Meanwhile, equity investors appeared to have their head in the sand during the second quarter, taking comfort from continuing positive earnings momentum rather than paying attention to the deteriorating macro news. This all changed in August in what turned out to be a brutal month for risk assets. Finally equity investors could appreciate bond investors' fears as rapidly weakening US economic data coincided with credit downgrade and soaring government bond yields in Spain and Italy. With the Eurozone sovereign debt issues at the epicentre of global risk, the first eight trading days of August saw Germany's Dax index tumble 15%, with many other global equity markets posting similar double digit losses.

European equities – approaching attractive levels.



Heightened levels of volatility have persisted. After two big down months in August and September, the October return represented the best monthly gain in the S&P 500 Index in 20 years. As we moved towards the year end, the Eurozone debt crisis further intensified and despite a number of 'rescue' packages announced by Eurozone leaders, the contagion continues to spread from the periphery towards the core. In the latest EU Summit, concluded on 9th December 2011, there was an agreement to move towards greater fiscal union between member states, however it once again lacked detail. What does appeared to have worked, at least in the short term, is the provision of 'unlimited' three year loans at 1% to Eurozone banks. This is the main reason behind the dramatic fall in short term funding rates for Spain. At a recent auction, Spain was able to sell 3 month paper at 1.735% and 6 month at 2.435%, versus 5.110% and 5.227% respectively they were being forced to pay for the same maturity bonds at the previous auction in November. As the European Central Bank (ECB) will lend at 1% and accept a far wider range of securities as collateral, banks are likely to exploit the natural carry trade to repair their balance sheets, i.e. borrow heavily at 1% and re-invest the proceeds in higher yielding Spanish and Italian debt. This is a positive development, and if it can have a similar impact on the longer term funding rates of Italy and Spain then it would be an important step toward a final solution. However, this is a big 'if' and the underlying issues that caused this mess in the first place are far harder to fix. The huge disparity in competitiveness between the likes of Germany and Greece will not be solved overnight and it is likely that politicians will have to be pushed to the very edge of the abyss before they commit to providing the financial "Big Bazooka" so desperately sought by markets. What would this "Big Bazooka" look like? It would probably consist of much tighter fiscal union between member states, issuance of Eurozone bonds, quantitative easing and a commitment by the ECB to make unlimited purchases of sovereign debt.

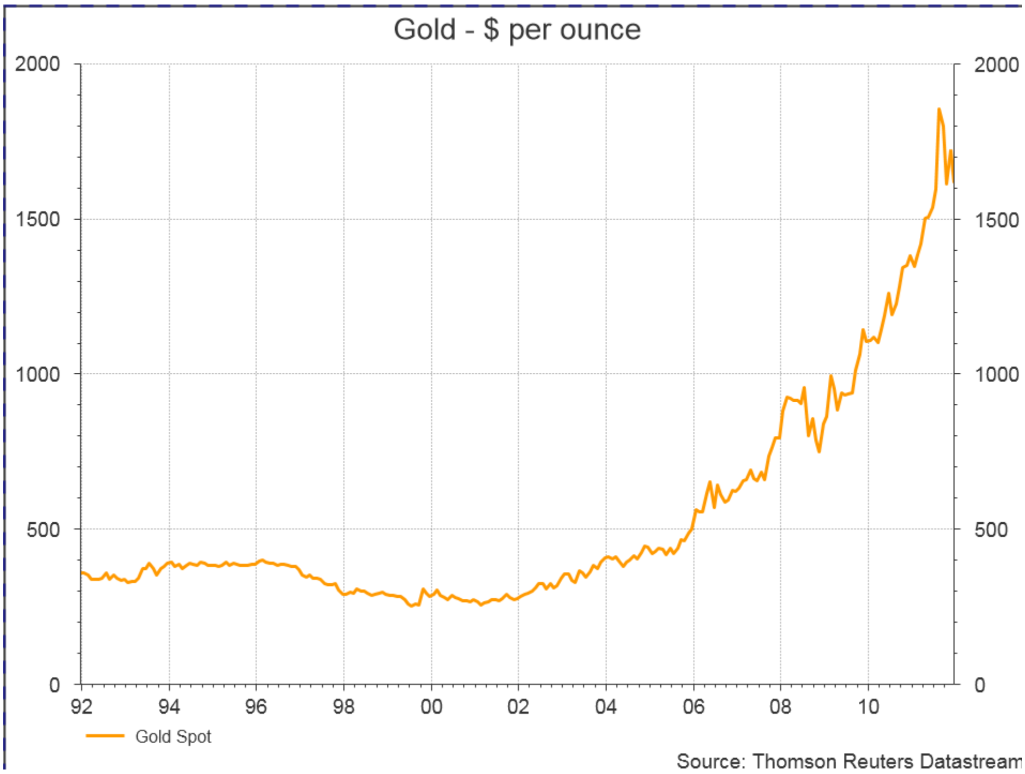
The performance of different asset classes in local currency over the year is shown in the table below:

Name	% Growth Cum TR ExD LC
	31/12/2010 to 20/12/2011
	Value
Cust Index Gold Spot $/Oz	20.4
Index Linked Gilts (FTSE A British Govt All Stocks I/L TR)	19.5
U.K. Gilts (BofA Merrill Lynch TR)	16.01
Investment Grade Coporates (Markit iBoxx Sterling Corporates TR)	4.57
Japanese Yen	4.09
S&P 500 TR	0.73
IMA Absolute Return	-1.52
High Yield (BofA ML Sterling High Yield TR)	-3.32
FTSE All-Share TR	-6.07
MSCI EM (Emerging Markets) TR LC	-14.01
MSCI Europe ex UK TR LC	-14.07
MSCI AC Asia Pacific ex Japan TR LC	-15.43
Topix TR	-18.24

Source: Lipper. Total return data expressed in local currency.

There are some clear observations here. Gold and UK Gilts have been the asset classes of choice in 2011. For those unwilling to buy non yielding Gold or the negative yields offered by UK Gilts, life was undoubtedly tough as almost everything else lost value. Equities, despite trading on undemanding valuations, declined as the overall market swiftly de-rated from moderate growth to recession in the face of the fierce macro headwinds. Although many funds within the absolute return sector delivered a positive return, the average posted negative returns, highlighting the need for good fund and strategy selection when considering investment in the sector.

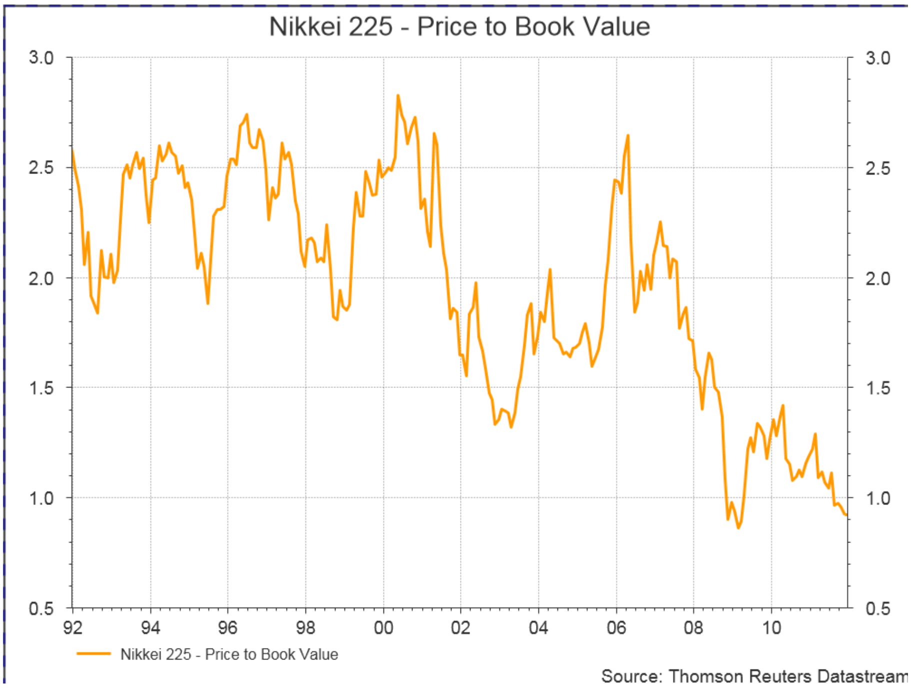
Gold – new nominal highs in 2011



As we write today, the opposing forces acting on asset classes are probably as great as they have ever been. On the one hand we have corporates in fairly good health, receding inflation allowing a loosening of monetary policy in the emerging economies and finally a significant fall in the yields of Spanish and Italian bonds. Conversely, de-leveraging by consumers and governments will continue to weigh on economic growth in the developed world for years to come. In addition, corporate profit margins are at historically high levels and are likely to fall back, whilst the longer the Eurozone worries continue to more likely we are to see credit markets seize up and impact the real economy.

We move into 2012 with a fairly cautious outlook, although we are also excited by some of the opportunities this year's events have created. Whilst the core of our equity strategy remains broadly defensive, with a focus on larger companies with strong balance sheets and a presence in the emerging world, we recognise this has become somewhat of a consensus view and are sensitive to just how out of favour some value stocks have become. As such, we have allocated some capital toward 'deep value' companies, where the potentially upside is very significant. We have also taken notable positions in Japan, where we find exceptional opportunities. Valuations sit near record lows, whilst companies are generating record levels of cash and becoming increasingly shareholder friendly.

Japan – back to 2008/09 valuations



Within fixed income markets we view gilts, treasuries and bunds as exceptionally poor value and have minimal exposure to sovereign bonds across the portfolios. Whilst yields may head lower on any further deterioration in the global economic outlook, the scope for capital appreciation from current levels is limited. Conversely, given the shocking underlying fundamentals we would not be surprised by a significant rise in yields. From such low yields, it would potentially take several years the recoup the capital loss. As such, we see the risks of holding sovereign debt lying firmly to the downside. Elsewhere within fixed income, parts of the investment grade market look highly attractive, whilst short duration strategies within high yield continue to offer some of the most compelling risk return characteristics across any asset class.

Whilst on valuation grounds we are comfortable not owning gilts, it leaves us with the conundrum of having to unearth other non-correlated assets to ensure sufficient diversification within portfolios. We have identified a number of hedge fund strategies which provide non-correlated returns, whilst also have investments in less traditional markets such as the re-insurance sector. Gold enjoyed its 11th year in a row of positive gains and whilst we would be nervous to increase our exposure at current levels, it continues to provide much needed diversification.

So with the outlook finely in the balance, the performance of financial markets in 2012 will once again be heavily influenced by policy rather than fundamentals. However, it is unlikely to be such an influence as this year with much of the uncertainty already priced into markets. There will come a point when the fundamental argument of valuation will reassert, when asset prices are no longer driven solely by global macro-economic news. We are not there yet, but with many asset classes reaching valuation extremes, we may not be far off.

Nick Roberts
Fund Manager, North
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