

View from PIM

“God Rest Ye Merry Gentlemen”

Tom Becket, Chief Investment Officer

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After the turbulence, trauma and topsy-turvy markets that investors have endured in 2011, it is no wonder that we are all tiredly gazing towards 2012 with some trepidation. Events over the last few weeks have encapsulated the perilous and punishing world that we now live in; question marks have appeared over both the future of the Eurozone and the sustainability of the economic recovery the world has enjoyed since the depths of the Great Recession that ended in 2009. Despite the cracks that have appeared in the global economic backdrop, financial markets have consolidated the gains that they have made since the misery of the late summer and seem poised to benefit from the now traditional “Santa Claus Rally” that we have all come to expect (and love). Should the seasonal festive cheer once again course through markets, it is conceivable that the UK and US equity markets, as well as various corporate credit markets, could push in to positive territory for the year. Clearly for many investors it is a case of “let nothing ye dismay” and this would be a remarkable achievement, given the level of uncertainty and fear that has been existent in markets this year. **It also should lead us to our first major question for the year ahead: if economies are slowing what will be the effect on corporate profits and equity markets?**

Before we look forward, it is necessary to take stock of the present situation we find ourselves in. Ferris Bueller said in the cult 1980’s film *Ferris Bueller’s Day Off* that “life moves pretty fast. If you don’t stop and look around once in a while, you might miss it”. Sadly life has rarely moved at quite the same frenetic pace that it is now. Both financial markets and our nerves have been battered over the last six months by a constant barrage of political uncertainty stirred up furiously across both sides of the Atlantic. **Political ignorance, ineptitude and immaturity have been the only certainties of a truly unpredictable year and with the Europeans unable to reach a conclusive agreement to their woes and a Presidential election in the US on the agenda for next year, we sadly expect more of the same to follow.** This crippling inability to create a constructive political backdrop to shore up economic growth has led to a crisis of confidence across the corporate world and intense volatility in financial markets. Corporate treasurers have spent the last few years tirelessly strengthening their companies’ balance sheets and are now rightly reticent to invest their cash piles in to an unpredictable world. This has meant that economic growth has slowed, as the private sector has been hitherto unwilling to take up the slack created by a public sector, which has been forced to draw in the purse-strings as question marks rightly appear over the solvency of governments across the developed world.

- Concerns over Europe still stalk markets
- Global economic growth is “patchy”
- Confidence throughout the world is brittle
- Markets have shown remarkable resilience
- 2012 themes are Quality, Yield, Recovery & Volatility

The European crisis has been repeatedly cited as the greatest impediment to global growth this year. Sadly this remains the status quo as we move in to the New Year. **To us, the latest solution to the Eurozone’s ills (announced with great fanfare and no small argument last week) looks woefully inadequate and is again designed to deal with the symptoms of the crisis (liquidity in bond markets), rather than its cause (too much debt and insolvent governments).** The European leaders have had opportunity after opportunity to draw a line under their issues and each time they have failed. Financial markets have called for a solution that is in part a concerted fiscal union and in part a transfer of wealth from the solvent and financially secure northern countries to those in the south that are bust. That unity is really the only way possible to secure a lasting union of European states. Last week’s impotent concoction of policies is still a long way away from the medicine that needs to be prescribed. Boringly, European concerns again seem set to continue to dictate once again the direction of financial markets at the start of next year.

All the while that the European leaders play their collective fiddle, the fires of uncertainty are burning around the world. There have been growing stresses in the financial system, such that the key central banks around the world were forced to inject yet more liquidity in to the system to prevent banking institutions from seizing up. This might well be necessary but it is not a good sign.

Signs that economic growth is faltering have been seen across the emerging market economies, proving that in a globalised world, with an inter-connected financial system, any hopes of decoupling regions and economies are illusory. **Recent trade data from some of the export-focussed economies have been suggestive of a more macabre economic slowdown than many had originally expected.** Indeed conditions have deteriorated sufficiently during recent months in China that the inflation-obsessed loosening their grips on credit creation, in order to try to allow economic growth to pick-up again.

In doing so, they have joined many other global central banks in loosening policy in an attempt to kick-start their faltering economies. Another vital question to be answered next year is whether we shall suffer the onset of another recession? Furthermore, the capability of emerging market economies to rebalance towards domestic consumption will also come under intense scrutiny in 2012. **For now we maintain our view that growth will be muted next year, rather than negative, which should be supportive of investment returns.** The key drivers of this positive growth will again be the emerging markets. However, we are aware that there are now an unprecedented number of risks to this forecast.

In stark contrast to other parts of the world, the US economy has picked up speed in recent months after a summer lull, justifying our current positive view on US equities and US high yield corporate credit. Given the insanely loose policy adopted by the US Federal Reserve and the profligacy of the US government, this growth spurt should come as no surprise. Whilst many other economies around the world, particularly those in the financially-stressed Eurozone, have decided to appease their creditors by cutting back their spending, the US has taken the opposite tack. "Spend, spend and spend some more" has been Uncle Sam's motto in 2011. Whilst that policy has clearly been fruitful in the short term, the US government has amassed a terrifying tower of debt and we remain extremely sceptical that bond market investors will allow the US government to borrow money at such paltry rates of interest for much longer. **We are surprised by the complacency shown by investors towards the US and UK bond markets, particularly given the attractive yields that investors can receive by focusing on other investments. As an example, the next addition to our portfolios will be the Legg Mason US Equity Income fund,** which is effectively a collection of extremely strong businesses, trading on low valuations and paying a dividend yield of 4%. When one compares that to the sub 1% yield you can currently receive for owning a 5 year US Treasury Bond, which has no growth potential, it is extremely attractive.

The four key themes for our investment strategy in 2012 are "Quality", "Yield", "Recovery" and "Volatility". Perhaps the two key decisions for our portfolios will be: when do we start to reduce the cash weighting we have been amassing since the early summer and when do we shift the balance from "Quality" to "Recovery"? At this time the core of our equity portfolios remains in high quality global franchises, with certain satellite positions in selective cyclically-focussed and recovery names. We are debating whether there is a sufficient valuation discount yet to recalibrate our equity positions in the UK away from the winners of 2011 towards the laggards. As yet, we are unconvinced that there is, given the potential for earnings downgrades in a bracing economic environment.

Amongst global equity markets we have maintained our preference for US and Japanese equity markets over Europe, as we feel that it is unnecessary to take the risk of investing in Europe at this present time. Indeed, our view is that were there to be a European solution, then it would be a case of a rising tide in equity markets floating all boats.

Our highest conviction in our portfolios remains in high yield corporate credit. Even though the asset class has managed to buck the negative trend of equity markets this year, **we feel that the yields on offer, particularly when compared to government bonds, should ensure healthy returns in the coming years, with significantly less risk than equities. Undoubtedly our greatest mistake in 2011 has been to hold too few high quality government bonds.** Rather than castigate ourselves again we have instead questioned whether such a stance could again be wrong in the years ahead. **Our view is that the paltry yields on offer neither compensate investors for the credit or the inflation risks that we foresee in the rest of the decade.** In our portfolios we have maintained an over-riding preference for index-linked bonds; particularly those in markets other than the UK, where we feel index-linked bonds are expensive.

I read in a recent piece of research that the only things now certain in life are "death, taxes and volatility". Sadly we fully expect the levels of extreme volatility that have plagued markets in 2011 to afflict us again next year. **That means that we will have to remain both diverse and hyperactive in our portfolios, ensuring that we adjust our investment strategy to reflect the evolving investment environment and maximise the opportunities as they present themselves.** Despite our expectation for another bumpy year ahead, we are optimistic about the potential returns on offer from asset markets in the coming years. Periods of deep uncertainty and high scepticism often lead to good returns and we are hopeful that this will be the case again. Our greatest concern remains that it is not merely our decisions that will dictate our clients' portfolio returns, but also those made by politicians and central bankers. Given their track record this year, we hope that they improve.

Merry Christmas and a Happy New Year.

Thomas Becket
Chief Investment Officer
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