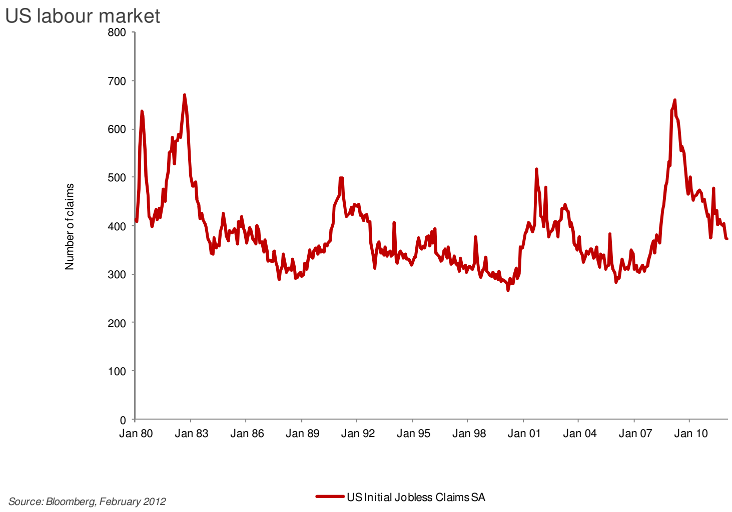
2012: light at the end of the tunnel?

2011 was a very tough year for investors. Although markets did not quite experience a Lehman's type event we saw a return of high volatility and uncertainty; exacerbated by the fact that the risks, most notably of course the European crisis, were low probability but very high impact. Active managers struggled in this environment; 75% of global equity managers underperformed their benchmark while in bonds 90% of active managers underperformed.

Going in to 2012 investor sentiment was weak, expectations low and uncertainty high. But what a difference a few weeks makes. Now 5 years into the post credit crisis world, can we see some light at the end of the tunnel?

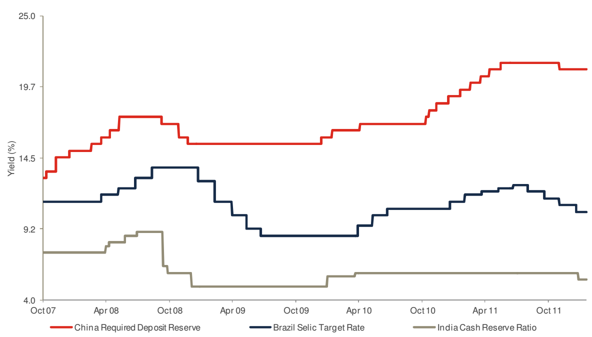
Let's look at what has driven markets higher in the past couple of months, the sustainability of these factors and the key issues that will drive markets and hence portfolio construction in the year ahead.

Three developments have been critical to the turn in markets. First the US economy has pulled through its soft patch in mid year, fears of a double dip recession have been unfounded and the economy has performed better than most expectations. Second the cycle of monetary tightening in the developing world has come to an end; as economies have slowed and inflation peaked policy in China, Brazil, India and other emerging countries has been eased. Third, and probably by some margin the most important factor, there has been a distinct thawing of the European crisis.



Source: Bloomberg, February 2012

Monetary easing in emerging markets



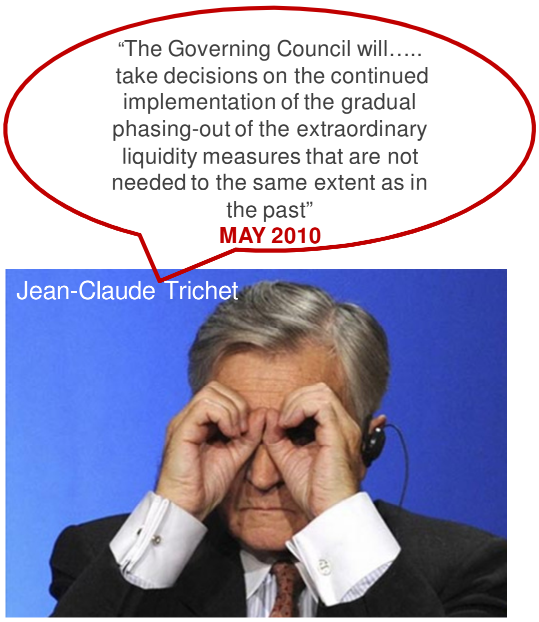
Source: Bloomberg, February 2012

How sustainable are these trends? The US looks set to sustain growth of 2 to 2.5% this year. The economy is highly competitive, they have a central bank committed to do whatever is necessary to maintain growth and key sectors such as housing are arguably bumping along the bottom. There is the little matter of a presidential election later this year but I don't think the outcome makes much difference. I suspect Obama will win, due in large part to the fact that the GOP is fielding second rate candidates, but whoever gets in faces a long period of fiscal restraint to rein in the deficit. The headwinds to growth remain and will keep this recovery at well below normal post recession growth levels but there will at least be some growth.

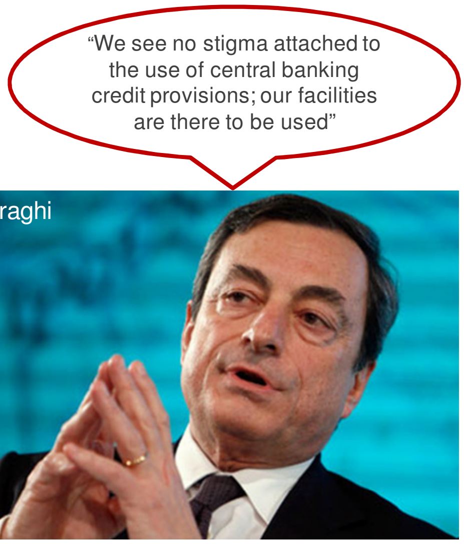
In the emerging world the easing stage of the monetary cycle has some way to run. Economies have slowed, food and commodity price inflation is waning and authorities will be keen to ensure growth does not slip too far. They have considerable policy flexibility given the tightening of the last couple of years. Longer term growth must surely depend increasingly on domestic consumption, especially in the key economy China, and the necessary rebalancing of the economy entails risks and uncertainties but even with slower growth we are still expecting 6-8% from China.

The European debt crisis remains the major threat to the stability of financial markets and the European economy seems certain to slip into recession this year. Lots of things could still go badly wrong. But there is a case for saying that the point of greatest risk has passed. Europe's political leaders just might have finally 'got it'; having been pushed to the brink by the spectre of the whole European project effectively going up in smoke, they are now in the process of putting in place a much more robust and credible solution. There are lots of concerns about the new 'Fiscal Compact' but it certainly has greater substance and bite than the failed Stability and Growth Pact. Similarly the agreed boost to the rescue funds might be seen as too little, too late, but again it is a very substantial shift from the early days of the crisis and the previous history of the EU. The Eurozone, a region of 17 sovereign states, is not likely overnight to move to full fiscal union; these latest measures could be seen as further steps on the long road to full fiscal and monetary union (probably one with fewer than 17 members).

Source: Matt, The Telegraph,, November 2011



Then there is the European Central Bank. Here there is no doubt that there has been a huge shift in approach under Mario Draghi. The disastrous interest rate increases implemented by Trichet in mid 2011 have already been reversed and it would be no surprise if the ECB moved to the effective zero interest rate policy of the Fed and Bank of England; there is certainly no prospect of short term interest rates going up anytime in the foreseeable future. And make no mistake, the extension of the ECB's Long Term Refinancing Operation in December from one year to three year funding for Eurozone banks was a critical step in preventing a banking collapse. Liquidity pressures have eased, banks' funding costs have fallen and they have been given greater clarity and stability in their funding through the next 3 years. The ECB has moved to the forefront of the major central banks in terms of size of unconventional monetary policy measures. Whatever the politicians and bureaucrats might say, this is quantitative easing on a gigantic scale, albeit through the backdoor.



These measures are vital in preventing a full blown banking crisis and buying time but for a long term sustainable solution Europe needs structural reforms. In this respect progress remains painful. But it is easy to overlook the fact that debt and structural problems can be solved. Ireland is perhaps the best recent example. The austerity packages are obviously biting in terms of impact on growth but Irish competitiveness is rapidly being restored and the country is seeing significant inward investment to take advantage of its flexibility and reduced labour costs. Unit labour costs are almost 20% lower than peak levels and the trade surplus now represents well over 20% of GDP. Ten year bond yields in Ireland have almost halved since peaking at close to 14% in July last year.

There are reasons why Ireland might be viewed as the exception in the current crisis, it was after all an open and dynamic economy before the crisis, and expectations for a similar recovery in other peripheral countries and in Spain and Italy are low. But history shows us that recoveries from similar crises can come surprisingly quickly, borne out of necessity and enabling implementation of structural reforms that politically would otherwise have been near impossible. Often the recoveries are extended, leading to a long period of superior economic performance. Witness the turnarounds elsewhere: the UK after 1981, Scandinavia after the banking crisis in the early 1990's, Canada after 1994 and Asia after 1998. Unexpectedly sharp turnarounds are possible and usually unexpected; they always surprise investors on the upside.

In the current crisis the first steps to reform have been taken, fiscal austerity is well underway and the chances of implementing structural reforms are better than they have been in decades. When faced with the alternative, a long term decline in living standards, painful measures are finally being adopted. The process will undoubtedly be long and tortuous with plenty of bumps on the way but the reality of the situation has dawned, leadership is evolving and the political will to preserve the Eurozone is overcoming the resistance to painful change. While much of the focus of policy action to date has been to stabilise the current liquidity crisis (and in the case of Greece a solvency crisis), there is a clear recognition that structural reforms are also a prerequisite to create long term sustainable growth. Mario Monti's Grow Italy programme is introducing labour reforms and liberalisation of services, Portugal, Spain and France are also introducing reforms to labour laws and over generous social welfare programmes; more will follow as the rest of Europe moves towards catching up with German competitiveness and following the same path of labour reform and liberalisation that has so successfully rejuvenated the German economy over the past decade.

In large part because of the austerity measures, there is a broad consensus that Europe is either in or soon heading into recession. Yet aside from the peripheral countries most exposed to the debt crisis, there is no evidence of a severe contraction in activity levels. Germany continues to benefit from the weak euro and is enjoying strong export trade; its economy is slowing but some growth is still anticipated for 2012. Other Northern European countries are also performing relatively well. Europe in aggregate is highly unlikely to suffer a severe recession and could even show very modest expansion over 2012 as a whole.

None of us can predict with confidence the eventual outcome of the European debt crisis. Many of the decisions required to resolve the crisis are political and European political leadership does not have a history that inspires confidence. It is quite conceivable that the Euro will not exist in its current form in a few years time. There are very tough times ahead whatever the outcome, as the process of deleveraging, necessary fiscal retrenchment and structural reforms will provide severe headwinds to growth for some years. None of the alternatives to the current policy approach offer any more palatable solution. The risks of a disorderly sovereign default, banking collapse and euro break up are low probability but very high impact. It is therefore important to retain some insurance against these events in portfolios.

40 of the top 100 global brands are European

Source: Interbrand Top 100 Global Brands, December 2011. Third party trademark, copyright and other intellectual property rights are and remain the property of their respective owners.

But it is easy to overlook the positives and the opportunities. Financial markets are surrounded by a sea of money as all the major central banks inject massive liquidity into the system and will continue to do so. Short term interest rates here in the UK as well as the US, Europe and Japan will remain at close to zero for years to come. Inflation is falling as the surge in commodity prices falls out of the annual figures; in the UK I think inflation will hit and probably fall below the Bank of England 2% target this year. The global economy is not buoyant but it is still growing, perhaps by 3% or more this year. And in the UK the economy is flat lining even though the deleveraging process and fiscal retrenchment provide a very stiff headwind to growth. Under the circumstances that seems to me to be a reasonably good outcome. The entry point into equities in particular is reasonably low by historical standards, dividend yields are high and generally well backed by strong corporate balance sheets and cash flows. To an extent investors are being paid to wait, earning dividend yields that are well above interest rates on cash and high quality government bonds. At some stage, the valuation of equities will be tested by a rise in yields on government bonds, which must surely be expensive on anything other than a short term view, but that is probably some time off.

Equity market valuations

	Price/ Consensus earnings estimates	Dividend yield	10-year Government bond yields
United States	11.6	2.0%	2.0%
Eurozone	8.8	4.6%	1.9%
United Kingdom	9.5	3.6%	2.2%
Germany	9.5	3.7%	1.9%
Japan	14.8	2.1%	0.9%
Hong Kong	9.7	3.0%	1.4%
Australia	10.7	4.6%	4.0%

Source: Bloomberg, February 2012

The crisis will eventually be resolved: Europe has come through much bigger crises before and will do so this time. Investors have been focusing on the negative news flow, and of course there is plenty of that. But sooner or later the news flow will turn and will become impossible to ignore. By then it will be too late, the best opportunities will have been missed. Remember, history suggests that buying during crises and being patient has produced outsize rewards; we might just be close to that position today. I think that 2012 will surpass expectations and be a good year for investors.

Glyn Owen
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February/March 2012

MSCI World Price/Earnings ratio since 1995

Source: Bloomberg, February 2012

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