

January 2012



In our first communication of the year we felt it appropriate to start with the close of 2011. It was an incredible year for worldwide events: the New Zealand earthquake, Japanese tsunami, Arab Spring uprisings, the Royal Wedding, London riots and the ever present European crisis, to name a few. They ensured the media were never short of a story.

Proving a difficult and volatile year in the markets, 2011 will certainly go down as an important chapter in economic history. It is widely recognised that rules are being rewritten and much of the economic structure and relationships we have become accustomed to will have to change...

From the perspective of the PFM Group, it was a year in which we reviewed our investment process. In light of the changing economic climate we made some fundamental changes that will lay the foundations for our future portfolio performance.

As you will be aware, we moved out of equities last August due to the excessive level of volatility within global markets. This decision was not taken lightly and whilst we have not seen the dramatic fall that looked highly likely, uncertainty still remains within the markets. We believe the current equity run is short term and not sustainable given present economic conditions.

We continue to monitor the situation in the markets and have made a decision to increase the fixed income exposure through our portfolios. This reflects the 'risk off' nature of the current environment.

The New Year

Markets

Our anticipation for the year ahead is that it will again prove a difficult period for the economy. The European crisis continues to rumble along and there is no indication that any solution will be found swiftly. Clearly, it is in President Sarkozy's interest to find a resolution, but he is running out of time.

Our worry for this year is that the investment environment will be pulled into a 'Perfect Storm'...

The three critical ingredients that we believe will produce this storm are:

- European Union crisis
- Public sector austerity measures
- Increasing social tension

These factors will leave no nation untouched. Surpassing 2011, this could become the most pivotal year since the global financial crisis of 2008.

We do believe that there are some positive stories at the moment and economic indicators from the US are continuing to improve. That said, areas such as unemployment figures and the infamous 'Obama accounting wrinkle', which moved all capital expenditure from 2012 to 2011 (by allowing 100% tax relief), do mean that the US market may be buoyed only for the short term.

It is key to differentiate between a long term upward trend and market sentiment instigated by state spending and stimulus packages. The economy, stretched profit margins and unattractive valuations from a historical standpoint, suggest the market may struggle more than in 2011 and may indeed fall through 2012.

And then there is China. Will the economy see the rate of growth experienced in recent years, or will it have a 'hard landing'? We don't believe either of these will fully play out and we anticipate just a much slower level of growth. It will remain a positive contributor to the world economy but is unlikely to be its saviour.

In addition to China, other Asian countries are expected to regain strong economic growth. Asia is very well positioned to bounce back before other regions, even more so than in 2009-10. The biggest driver of Asia's V-shaped recovery would be a massive resurgence of net capital inflows to the region, likely even dwarfing the inflows after the global financial crisis.

As we have indicated, we foresee a tough environment for the majority of the major, developed equity markets. The possibility of the break-up of the European Monetary Union is becoming more likely. If Greece defaults then this

will weigh particularly hard on share prices in Europe. If a break-up does take place then this should further strengthen the yen and keep Japan's stock market on the defensive.

Emerging equity markets will also struggle against developed equity markets as risk appetite wanes, with Emerging Europe bearing the brunt of a sell-off due to its close ties to the Eurozone.

In spite of this somewhat negative outlook, the optimists believe that the solution is for the Eurozone to muddle through, ie. a wholesale, forced write-down being used to reset the system and kick-start the global economy.

“the impending lights of an oncoming crisis may prove constructive”

There is always the possibility that the impending lights of an oncoming crisis will prove constructive in the sense that it forces the hands of policy-makers and politicians. Indeed, 2012 may be the year in which we fundamentally alter our assumptions, not only regarding economics and monetary policy, but also about the way we live.

The hope must be that it ushers us quickly towards that turning point at which we begin planning for the future, rather than pretending that we can pay for all of our past mistakes.

Portfolio Asset Allocations

In terms of the asset allocations of our portfolios, we believe that gold will continue to be a store of value in volatile times. In turn, equity markets will show high volatility and are likely to offer opportunities once trends are identified.

Inflation will continue to be higher than generally anticipated with the recent dip being a result of technical factors being eliminated from the index. We expect interest rates in the UK and US to remain at historically low levels, and, as a result, are investing into inflation-linked instruments issued by these governments.

We remain invested in property with our largest exposure being to Central London which is still yielding positive returns as the rental market and foreign investment increase.

The outcome of these decisions is that we will initially be holding a greater deal of assets that are considered as being lower risk. However, in these current markets there is of course the possibility of the unexpected. Consequently, diversification across these assets is imperative.

The PFM Group Investment Panel



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