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LOOKING TO 2012

An eventful period

This year has been an extremely eventful and difficult period for risk assets, taking in social unrest and uprisings in a number of Middle Eastern countries; a major earthquake and nuclear emergency in Japan; floods in Thailand; concerns about Chinese and global growth; riots in the UK and the small matter of the ongoing eurozone debt crisis. It is this latter crisis that has dominated investors' thoughts in the final quarter, leading to significant volatility and weakness in equities and higher-yielding fixed income assets while providing further support to core government bonds. Given 2011's event-heavy background, however, equities have actually held up relatively well over the course of the year. We believe that this is due in part to valuations, with markets already factoring in a significant slowdown in global economic and corporate earnings growth.

Invisible force of deleveraging

We have been below consensus in our economic forecasts for much of this year and we remain cautious on the outlook for the developed world today. The process of deleveraging will constrain growth for several years; we are forecasting growth of 1.5% in the US in 2012. Meanwhile, the challenge of addressing the structural problems in the eurozone is likely to lead to a period of economic contraction in that area. Conversely, we remain more optimistic about the prospects for emerging markets. In China, we believe that the authorities will succeed in engineering a "soft landing" and expect the economy to grow by around 8% in 2012. This will help to keep global growth in positive territory.

All eyes on the eurozone

The eurozone debt crisis continues to intensify and there now appear to be two possible outcomes. The first is that Greece and possibly other over-indebted nations are forced out of the single currency and have to endure a rapid re-adjustment through devaluation and a probable banking crisis. The second is that the ECB changes its current anti-inflationary stance, agrees to print money and guarantees all of the bonds of the troubled peripheral issuers. The adjustment in standards of living in this instance would take longer but would still be painful. Each of these outcomes has very different implications for markets and, at present, investors appear to be ascribing them equal probability. Whilst it is very difficult to predict the end game, our central case is that the ECB will eventually be forced down the route of printing money, but not before the crisis has intensified further. Thus, investors may get a chance to invest in risk assets at lower levels before the crisis comes to a conclusion.

Credit risk infects government bond markets

Core government bond markets have found support from their "safe haven" status, but the number of markets ascribed this status is steadily shrinking. Outside the US, Germany and the UK, most bond markets are now seen as carrying significant credit risk, and this has driven yields in the more troubled markets to unsustainably high levels. Conversely, "safe haven" markets now offer such low yields that there is limited scope for healthy positive total returns. Moreover, with yields below the rate of inflation in many areas, there is a heightened risk of losses in real terms. At the same time, the US and UK in particular are also struggling with very high debt levels which make their low yields hard to justify.

The search for yield

In light of the lacklustre growth outlook, and to balance the tight fiscal policies being run in many markets, interest rates are set to be kept at historically low levels over the medium term. With government bond yields also offering little value, the search for yield is set to be a major theme in 2012. A number of asset classes could benefit from this theme. For example, emerging market and corporate bonds continue to offer healthy yields, coupled in many areas with robust fundamentals. Company balance sheets are generally strong following several years of prudent cash management, while emerging market economies are benefiting from superior growth, relatively low debt and high FX reserves. As such, we continue to prefer these areas within fixed income.

Alternative sources of income

Elsewhere, the excess yield offered by UK commercial property over gilts is at historically wide levels and, although some areas of the property market are likely to suffer headwinds in 2012, the yield should be well underpinned. Meanwhile the dividend yield on many good quality companies' shares is higher than the corresponding corporate bonds. This, together with the scope for dividend and capital growth over the long term, is likely to see equity income products remain in favour.

Survival of the fittest

We have identified a number of other equity market themes in addition to the search for yield. The first is that we expect the strong to continue to get stronger in 2012. Poor management, flawed business models and weak franchises are likely to struggle in the tough economic conditions we foresee, while proven management teams with robust models will prosper. Many of these quality companies are inexpensively valued, affording them significant scope to outperform.

Growth in a low-growth world

Secondly, we continue to focus on businesses that offer growth in a low-growth world. For example, we favour companies selling into emerging markets; businesses with access to a secular theme such as the provision of healthcare services to ageing populations; or companies with superior products or intellectual property that will help to cushion them from the economic cycle. We are also finding good opportunities among companies that are undertaking "self-help" initiatives – where new management, cost cutting, share buybacks or other factors are creating potential value that is not yet reflected in the share price.

Asset allocation summary: overweight in equities...

Despite the ongoing eurozone crisis and the lacklustre economic outlook in the developed world, we remain overweight in equities. Company balance sheets are strong, many businesses are returning cash to shareholders via healthy dividends or share buybacks and valuations are very attractive on a range of measures relative to history and to most other assets. The current uncertainties make it hard to predict exactly when this value will be unlocked, but we remain confident that equities offer the best return potential over the medium term.

...and underweight in bonds

Government bonds appear particularly expensive to us and, given negative real yields and the high levels of debt facing many issuers, we see little scope for healthy total returns over the medium term. This leads us to be underweight in bonds in aggregate, although we do see good value among corporate, high yield and emerging market issues, where excess yields provide ample compensation for the modest additional risks. Elsewhere, tight supply/demand metrics make us positive on commodities. Meanwhile, the difficult UK economic background might cause commercial property vacancy rates to move higher but the asset class offers a very attractive yield relative to gilts. Finally, we remain underweight in cash as we believe that interest rates are likely to remain at historic lows and that, as a result, better opportunities exist in risk assets.

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