

Investment Outlook and Review – Winter 2011



JLT INVESTMENT MANAGEMENT



Index	Performance 2011 (Sterling)
S&P 500	0.74%
FTSE 100	-2.18%
MSCI Europe	-11.10%
Nikkei	-12.22%
MSCI Asia Ex Japan	-16.69%
MSCI Emerging Markets	-17.82%

1st January 2011 - 31st December 2011 © Data Provided by Financial Express

It has been a turbulent twelve months that has seen natural disasters, economic upheaval, revolutions and, not surprisingly, severe market volatility – including a very sharp fall in prices over the summer.

We will discuss in more detail below our thoughts for 2012 but suffice to say at this stage the problems markets have been experiencing throughout 2011 are far from being solved, and may deteriorate further. But the most difficult question then to answer is how much has already been discounted by investors.

What do markets seem to be expecting in 2012? Economically, commentators forecast a return to recession in the eurozone, a possible return in the UK and the US (depending again on what happens in the eurozone), and a slowdown in China. Emerging markets' growth will continue, but at what rate? Interest rates are not predicted to rise anywhere in the developed world, and inflation is expected to be subdued – even in the UK.

But, as mentioned above, all of this is dependent on a satisfactory resolution of the eurozone crisis – satisfactory both to the politicians and the markets (and – eventually – to the European electorates). The last few weeks and months have seen some progress – mainly in the politicians' perceptions of the problem – but a lasting solution to the underlying causes of the crisis still appears a long way off. And the short-term could prove very messy if recent 'agreements' begin to unravel.

So market forecasts have to be treated with even more caution than usually. There are reasons to be optimistic, and these are discussed further below, but in the short-term at least the outlook is very clouded and it may take many months for any clarity to appear.

FIXED INCOME

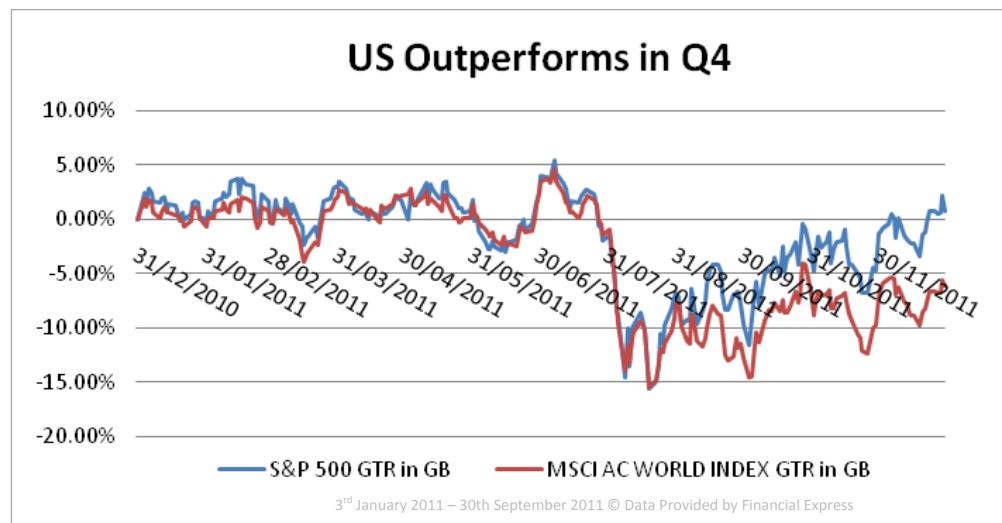
Throughout the year investors have poured their surplus liquidity into the government bonds of perceived 'safe havens' – the US (despite Treasuries being downgraded in the summer), the UK, Germany, Switzerland and Japan. It is hard to believe they can appreciate much further (although the same was said a year ago), as there is little more room for manoeuvre on interest rates. However, more quantitative easing is possible, especially in the eurozone.

But until investors regain confidence in other, riskier, assets the safe-haven status is likely to remain. This is conventional wisdom, but the view of German bunds is weakening. Whatever long-term solution of the eurozone debt crisis is eventually agreed Germany will be, directly or indirectly, the biggest monetary contributor. This implies a credit risk to German government debt that is slowly being appreciated by investors and, as a result, yields are edging upwards – and could go higher.

Good quality non-financial corporate bonds have largely performed in line with government issues, and we would expect that to continue. There is, however, some risk to capital values as the year progresses if yields on government bonds begin to reverse. Bonds issued by financial companies, principally banks, have proved far more volatile, causing severe losses for some managers and there seems little chance of this changing in the near future.

We are happy to stay invested in bond funds, for the income, but appreciate there is some risk to capital later in the year. Our preference is to invest in strategic bond funds, where the manager has the flexibility to attempt to reduce this downside.

U.S.A.



Investors' concerns that the US was slipping back into recession in the early summer was one of the primary causes of the sharp fall in the markets over the period. Economic statistics at the time were very mixed, giving plenty of ammunition to gloomier commentators in the media and on Wall Street.

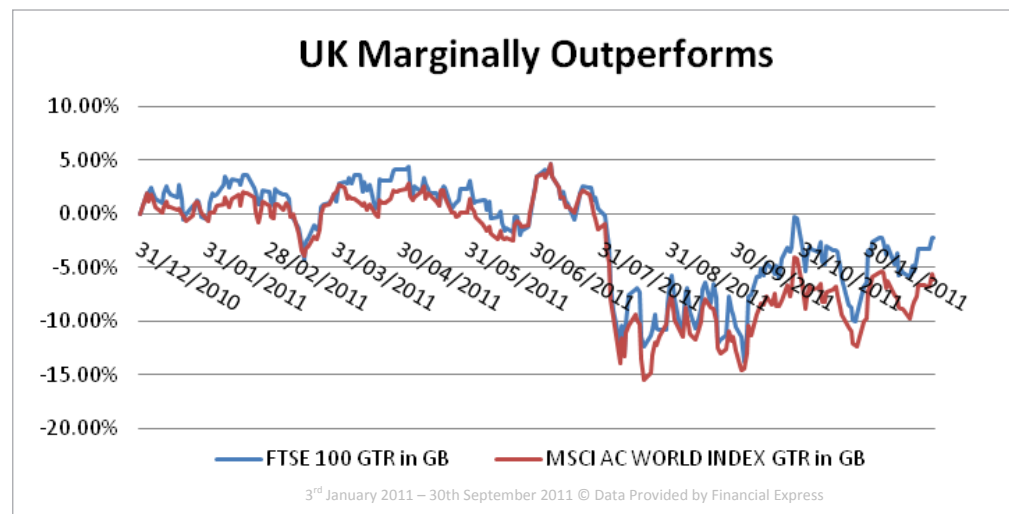
In the event, the economy has performed better than expected in the last few months, with the poor numbers in the summer being recognised as a temporary 'blip' caused by the spike in the oil price, and the knock-on effects of the Japanese tsunami (and the resulting short-term disruption to supplies).

Hopes for better-than-forecast growth in 2012 (importantly, an election year) have been rising recently and the equity market has been one of the better performers as a result. The US market outperformed by 7.8% in Q4 as can be seen from the above chart. Monetary policy remains loose (and presumably will not be markedly tightened this side of the election in November). However fiscal policy is another matter. The deficit, long a major concern for overseas investors, has now become a domestic political issue, one that will weigh heavily on the campaign for the Presidency and Congress in the autumn. Spending cuts (and cancelled tax breaks) will begin to bite this year and into 2013, potentially holding back growth prospects in the overall economy.

Whilst the US authorities have much more freedom of manoeuvre than many of their contemporaries, the US economy has never been fully immune to events elsewhere. If the eurozone falls back into recession and growth elsewhere slows down confidence in the US – already under pressure – will decline. It still seems likely that the US will avoid a double-dip recession, but the odds are lengthening and growth might not prove as robust as many forecasts would currently suggest.

US equities, taking 2011 as a whole, are little changed, although extremely volatile during the year. Corporate profits have exceeded many expectations, and companies' balance sheets are in a far healthier shape than in 2008, with many very cash-rich. In an election year the Administration will do everything in its power to promote growth, and, despite all the potential problems mentioned above (which will have to be resolved sooner rather than later), we believe holdings in US equities should be maintained.

UNITED KINGDOM



The UK's economy has been weak for several quarters, experiencing stagflation (low growth and high inflation) as a combination of lower-than-expected growth elsewhere, and squeezed consumer income at home has led to declining confidence and a resulting unwillingness to spend.

The Coalition's austerity programme to reduce the deficit has led to plaudits from abroad (except in France!) but at home consumers have chosen, where possible, to increase their savings at the expense of consumption. This has exacerbated the overall weakness of the economy.

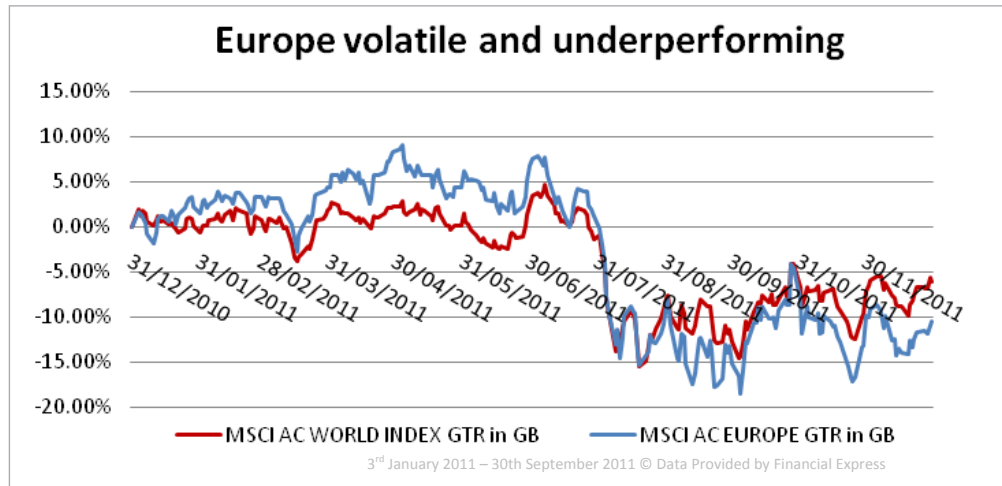
However the biggest threat to the UK in 2012 is almost entirely out of its control – the ongoing debt crisis in the eurozone. As is constantly stressed by the government and the Bank of England, the eurozone is the UK's largest trading partner. It now seems almost certain that Europe as a whole will fall back into recession in the near future and this will increase the pressure on an already fragile economy here in the UK.

Will this lead to a change in government policy? There are no signs yet of a more expansionary policy being considered (Plan 'B'), but some sort of fiscal stimulus and more quantitative easing cannot be ruled out, especially if the Bank of England is right and the rate of inflation falls in the first quarter and the economy looks to be weakening further.

But all is not lost in the equity market. UK gilts may look incredibly expensive but UK equities are not (unless the eurozone implodes, in which case all markets will fall). Despite all the volatility we have seen during the year the FTSE 100 has fallen only 2.18%. Profits have continued to grow at companies with a significant contribution from overseas (as we have often said, many of the constituents of the index), as growth has not yet disappeared around the world. But, more importantly, dividends have risen and should continue to do so, providing a yield support to the market largely unavailable elsewhere.

Unless world growth turns negative, leading to corporate profits in the UK coming under severe pressure, UK equities (or more specifically the UK index) should continue to show relative value. They will remain volatile, especially more domestic-related issues, for instance retailers, but at least should give a reasonable income return until the outlook improves.

CONTINENTAL EUROPE



‘Nations have no permanent friends or allies, they only have permanent interests’.

Lord Palmerston’s apt warning in the 19th century is just as relevant today and should be plastered on the walls in Paris and Berlin (and Brussels).

What can be said about the situation in Europe that has not been covered ad nauseam by all the media already? In the last few months there are at least a few signs the politicians on the Continent now appreciate the gravity of the problems facing them, even if they still show little inclination to make the basic changes apparently needed to solve them. Each ‘solution’, including the most recent, has still avoided the fundamental problems of the lack of competitiveness of the peripheral nations of the eurozone and the chronic weakness of many of the continent’s banks.

Just before Christmas the European Central Bank released nearly half a trillion euros of loans to the banking system at ultra-low interest rates (1%), hoping the banks would then buy government debt, especially in Spain and Italy, paying them a higher yield and thus providing a profitable ‘carry-trade’. Markets responded positively to the first indication of a bending of the ECB’s rigid rules on any form of quantitative easing or of taking on the role of a ‘lender of last resort’.

In practice, most of this cash injection into the banking system is being parked for safety back with the ECB, earning 0.25% and thus making a loss. Which has rather defeated the object of the exercise! Only time will tell whether this will change in the New Year.

Most commentators outside the eurozone, and increasingly some inside, now see only two possible long-term solutions to the crisis – either full fiscal union or the break-up of the euro in its present form. Even avid Europhiles are now accepting that something fundamental has to change, and that a succession of short-term ‘solutions’ will not work. The ECB could postpone this fundamental change by finally becoming a true central bank (similar to the Federal Reserve or the Bank of England) – which would lead to a very sharp rally in financial markets – but eventually one of the two outcomes above would have to occur.

Germany is in favour of full fiscal union, with all the checks and balances that implies. However it seems the loss of economic sovereignty this would entail is likely to be unacceptable elsewhere in the eurozone (and the existing checks and controls are regularly flouted, so what would change?). The odds are low that full union – with the resulting monetary transfers from richer to poorer members – could ever be achieved.

So will the euro change? Such a suggestion was anathema even a few months ago, but is now being much more widely discussed and seriously considered by policymakers. Whether this eventually results in a core, ‘hard’ euro centred on Germany or something more complicated is the major problem markets – and companies – may have to face during the coming months.

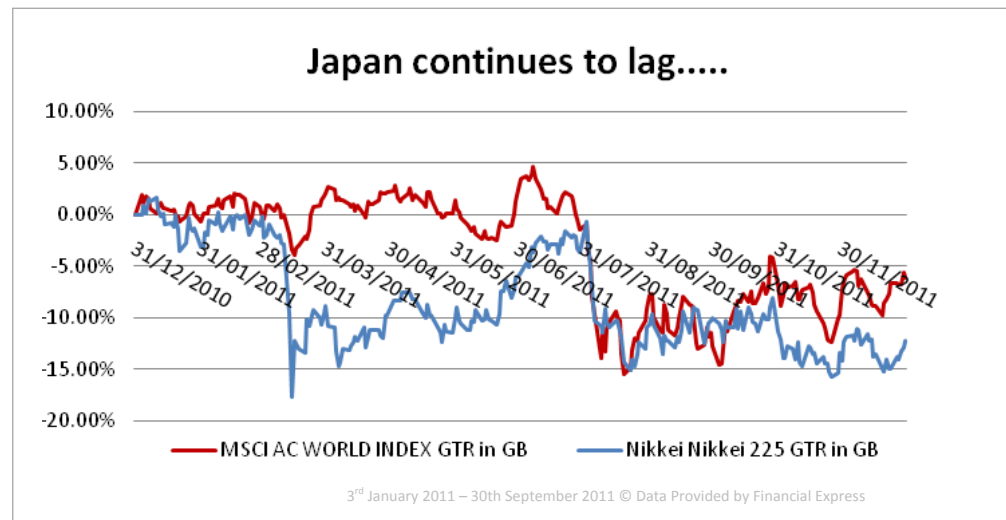
How to achieve a lasting solution without precipitating another major financial crisis is a challenge that could prove beyond the capabilities of the politicians involved. Additionally most seem still to be in denial about the health of their national financial systems, where massive amounts of capital need to be raised in the near future, and markets may force the issue on this and the bigger picture sooner than they would like.

According to Bloomberg the European Banking Authority has concluded that European banks need to raise an extra 114.7 billion euros (\$152.5 billion) in the coming months.

Where does this leave Continental European equities? Corporate profits have so far held up remarkably well, and forecasts are still optimistic in many areas. But as the likelihood of a Europe-wide return to recession increases, forecasts will be cut back. One bright area has been dividends, which have been increasing to such an extent that many companies can now be bought for the income they provide.

We have reduced positions in the more growth-oriented areas of the European markets whilst retaining those with a decent income – a stance we will maintain until something concrete is decided. Unless the ECB changes course – in which case all bets are off – markets in aggregate are unlikely to make much headway in the short-term.

JAPAN

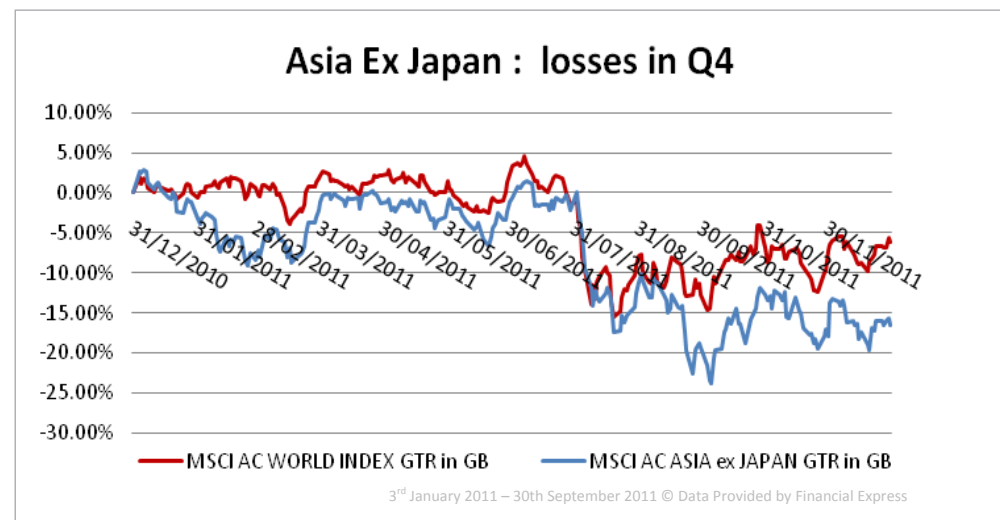


The Japanese market has not been immune from events elsewhere with the threat of sovereign defaults in Europe unsettling investors. Also many companies when announcing their half-yearly profits have also lowered expectations for the full year, based on a deteriorating global outlook.

However the economy as a whole has, as expected, recovered strongly from the decline caused by the effects of March's tsunami and exceeded forecasts in the third quarter. This was reflected in the stock market with a huge fall followed by steady recovery. This is despite the yen appreciating to record levels as Japan is a member of the 'safe-haven' club in investors' eyes. The Bank of Japan has tried, so far fruitlessly, to reverse this rising trend, which shows no signs of abating in the short-term.

There are many world-class companies based in Japan, with exposure to growth in developing markets, especially China. They have adapted to changing circumstances with more speed and efficiency than they are often given credit for. Eventually (when the currency finally begins to weaken?) this will be reflected in stock prices and the seemingly never-ending bear market will finally come to an end.

ASIA ex JAPAN



China is now the world's second largest economy after the US (the eurozone as a single entity is still bigger), and as a result obviously has a significant effect on the overall global economy. It is the key to the rest of the Pacific Region and, increasingly, to other developing markets. That is why forecasts for growth, and the actions of the Chinese authorities, are so eagerly watched and analysed.

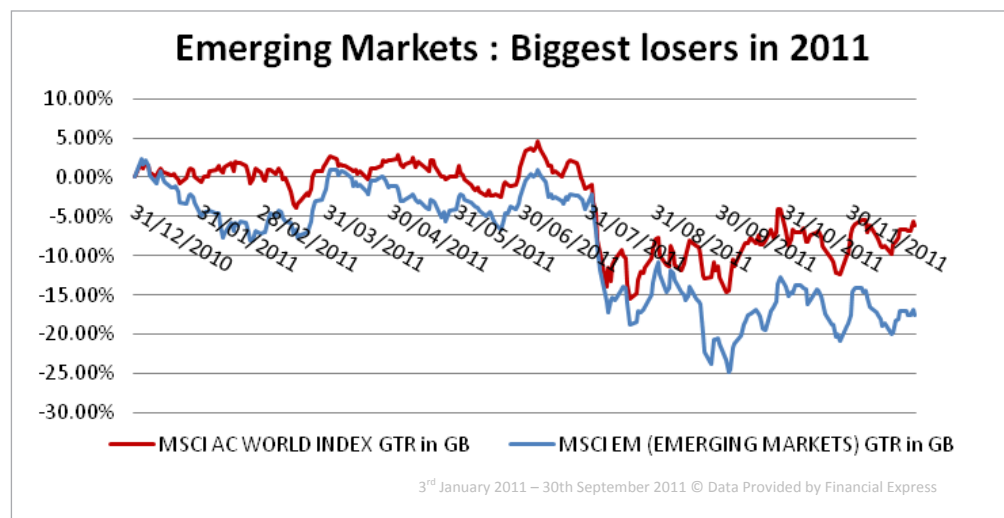
And here the picture is cloudier than investors would ideally like. Most forecasters expect the Chinese economy to grow by 8 to 9% in 2012, slightly lower than originally thought – but still a very large number!

But this optimistic figure is under question. If most of the developed world experiences very low growth or even recession, and demand in other developing markets slows down, where does this leave Chinese exports? And internally, with a property market seemingly heading for a major crisis in many areas, with a knock-on effect on many banks, are consumers likely to spend more?

If growth is slower than expected this has implications for the rest of the region. For example, any slowdown in activity will have an effect on commodities such as coal, iron and copper, and those nations that export them.

As we have often mentioned before, we remain very positive in the long-term on the Pacific region, based on above-average growth prospects and the rise in consumer wealth and demand. 2012 may, however, present rather more difficult challenges in the short-term. There will be opportunities, especially in those equities with some yield support, but the volatility we have seen in 2011 could well continue for several months yet.

EMERGING MARKETS



Since the summer emerging market equities have underperformed the US and other developed areas, largely due to economic concerns. The eurozone crisis, rising inflationary pressures in many countries (leading to interest rate increases), worries over Chinese growth, and the lack of any meaningful recovery in the US have all taken their toll.

Events elsewhere will be the key. If investors' confidence in 'risk-assets' returns – probably after some workable solution in Europe is resolved – the relatively low valuations of emerging market equities and an above-average growth outlook should return to the fore and re-coup the underperformance in 2011. If, however, the developed world slips back into recession, or the eurozone crisis deepens (possibly both), this could be postponed for some time. As elsewhere the long-term very positive view would be heavily outweighed by the short-term problems.

We want to move to higher weightings in Emerging Markets for our clients but with so much uncertainty, we do not yet believe that now is the right moment.

CONCLUSION

Given everything above it is easy to be gloomy about prospects for equity markets in both the developed and developing world during 2012. But we must be careful not to overdo the pessimism.

Yes, growth is anaemic at best – but many companies continue to prosper, grow, and, importantly, increase their dividends. Corporate balance sheets (for non-financial companies) are in much better shape than before and during the crisis of 2008 with an abundance of cash and, in many cases, very little debt. Banks, of course, especially in Europe are a different matter!

Interest rates are at record low levels and are not expected to rise. Cash earns little to nothing, so investors spend much time and effort trying to find homes for their liquidity that can provide a safe return, hopefully in real terms. This is where many equities, with relatively high, and often rising, yields can become attractive.

It is a truism to say income is the key. In current markets it is as true as it has ever been.

BUT – and it is an enormous but – everything depends on an orderly resolution to the eurozone debt crisis. The emphasis is on 'orderly'. If markets force the issue, the resulting break-up of the euro, if that happens, could trigger a financial crisis far greater than that seen in 2008.

Something must happen sooner rather than later. Time is running out for short-term solutions and the markets are demanding more radical, long-term changes. As a result we remain very cautious for the early part of the year, but subject to something positive arising out of Europe, believe the second half could see some recovery as a pick-up in economic activity begins to be discounted by investors.

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