INVESTMENT VIEWS

No. 2 of 2012 FEBRUARY 2012

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Investment

* Currencies	The weak and the volatile
* Bonds	Still priced for perfection
* Equities	Wall of money drives a wall of worry
* Oil/Commodities	Oil floats higher. Gold and silver shine

GENERAL COMMENT

THE LAW OF DIMINISHING RETURNS

Wikipedia gives a good example of the law of diminishing returns when it uses the analogy of adding fertilizer to a crop. The use of fertilizer improves output to a point, but adding more and more improves crop yields by ever smaller increments and excessive quantities can eventually even reduce the yield. On January 25, The US Federal Open Market Committee, led by Chairman Bernanke, began its latest exercise in what it calls "transparency". It is our view that the FOMC, far from having many tools at its disposal to address weakness in the US economy, has little spare capacity to influence the growth path in the US, the trend in long-term interest rates or the direction of risk assets.

First of all, we should address what we believe the Fed's release actually said in late January and what it means for policy. Press reports and many analysts have simply stated "the Fed is on hold until late 2014". The actual text and press conference wording show a different result and therefore a different interpretation. The timeframe of late 2014 was actually the median tendency of Fed Governors, not a commitment to zero rates until that time, nor was it a unanimous conclusion. Several Governors had earlier tightening in mind and several had a view that

tightening was even further off in the future, with a range of outcomes for the Fed Funds rate in 2014 between 0.25% and 2.75%! Our interpretation of this is that there is a huge distribution of potential possibilities, between near-term normalisation of base rates and a Japanese scenario of zero policy rates ad infinitum. This neither gives us confidence in interest rate market direction, nor does it give us a clearer picture that the Fed has many tools at its disposal, which they unanimously believe will actually work to stimulate growth.

Secondly, if one wanted to interpret the new information as a forecast we would argue that it is impossible to forecast economic growth with any accuracy past one year and is therefore meaningless. The Fed, being comprised of professional, if academic, economists knows this. If they clearly know that this is the case, releasing the range of rate predictions does nothing to increase transparency, it simply adds more to the verbal suasion that the Fed has been fond of since Greenspan's famous "irrational exuberance" speech. Each layer of "increased transparency" has introduced a new variant of the same theme. Through words, they are attempting to influence an ever-expanding range of market behaviour.

The sum total of the words, actions, deeds, hints, and testimony shows a decided taste for experimental government intervention in financial markets with the following stated goals: push investors into riskier assets by severely punishing them to choose a risk-free asset - this punishment comes through a deeply negative real rate of return - and secondarily, make every attempt to control the long-term portion of the interest rate curve in order to bring about the hoped for recovery in mortgage lending that would serve to boost output in the US. By virtue of the uncertainty created by Europe, their first goal is not working (yet). There is still a preference for a negative real return in the US and judging by the rest of the G-7 bond markets, that preference has expanded its global reach, not lessened it. As for the second goal, despite some commentators calling for the "turn" in US housing and the US Administration all but begging Congress to throw yet more money at the situation, housing markets are nowhere near recovery and that means they are failing on that policy goal as well. If QE1 had a measurable impact (debatable) and QE2, somewhat less, we believe that we are at an exhaustion point in Fed tools, both in word and deed. Unquestionably, should growth falter in the first quarter, the markets will scream for QE3, QE4, QE "buy High Yield", etc, but at what cost to the correct functioning of Capital markets?

THEY SAID IT THIS MONTH

Despite very tentative signs of an improvement in the Euro-crisis, we believe it is still appropriate to highlight evidence of some 'creative-accounting' occurring within the region:

"According to Italian tax authorities, 66% of taxpayers have an annual income

of €20k or less. Of these taxpayers 42,000 own yachts, 518 own private jets or helicopters and 188,000 own luxury sports cars."

And Niels Jensen, writing in the Absolute Return letter, points out a slight amendment in the annual accounts for one of Spain's regional banks (which no longer exists):

"A 2010 profit of about €50 million in Caja de Ahorros del Mediterraneo turned into a loss of €1.7 billion by June 2011 after its property book was marked to market to reflect the actual prices of Spanish homes."

Meanwhile, like the markets, Nic's Golfing Corner is suffering from 'euro fatigue':

A guy stood over his tee shot for what seemed an eternity; looking up, looking down, measuring the distance, figuring the wind direction and speed and driving his partner nuts.

Finally his exasperated partner says, "What's taking so long? Hit the blasted ball."

The guy answers, "My wife is up there watching me from the clubhouse. I want to make this a perfect shot."

"Forget it. You don't stand a chance of hitting her from here."

And finally....

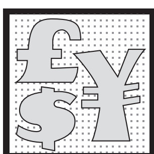
The schoolteacher was taking her first golfing lesson.

During the putting session, she innocently asked, "Is it spelled p-u-t or p-u-t-t?"

"P-u-t-t is correct", he replied, and then went on to explain....

"Put means to place a thing where you want it. Putt typically means a vain attempt to do the same thing."

MARKET COMMENT



CURRENCIES

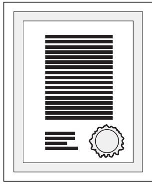
The US dollar was on course to start the year strongly; however investors incorrect assumption that the Federal Reserve's mid-month report suggested that to keep interest rates exceptionally low until at least 2014 sparked a sharp sell-off in the currency. The DXY index,

which measures the dollar's value against its main counterparts, fell by 1% over the month. For several years now, the US authorities appear to have been using both conventional and innovative monetary tools in a bid to lower the dollar's value and 'reflate' the economy. Irrespective of their likely effectiveness, the fact that policymakers remain fully committed to an aggressively accommodative approach, even in the face of reasonably sound economic data, suggests the US dollar will continue to face strong headwinds going forward.

The backdrop is further complicated for currency investors by the fact that the European Central Bank (ECB) is now participating in its own quantitative easing program in all bar name. The three-year unlimited loan facility being provided to European banks appears to have a number of merits, including a material boost to euro-based liquidity within the region's financial system. The sheer scale of the lending, which amounted to almost €500bn in the first auction, has alleviated the constraints the banks were facing in gaining access to euros, and suggests they will be able to 'roll-over' their debts that expire during the next few years. However, a side-effect of the supply-boost is likely to be downward pressure on the single currency's value. A second facility is scheduled to be offered later this month and whilst the euro has firmed a little in recent weeks, benefiting from improved risk appetite and the general dollar weakness, we do not expect this trend to last. Whatever the outcome of the crisis, a weaker euro seems a distinct possibility.

Sterling was little changed against the euro and Japanese Yen in January, but inched a little higher against the dollar; its 1% gain to $1.57 reversing the prior month's decline. Recent strength can be partly attributed to the actions of the US and European monetary authorities. The Bank of England's own £75bn 'QE2' package pales into insignificance when compared to the sums being deployed in the US and Europe. That said, the UK economy expanded by a miserly 0.9% in 2011 and with activity likely to remain stagnant this year, we expect an extension of the BoE's asset purchase program to be announced soon. Governor King has already alluded to another return to the printing presses and this does little to increase the pound's appeal.

Last month's spike in risk appetite propelled many of the emerging market currencies higher. These moves come despite the fact that interest rates are being lowered in many of the growth regions, which merely underlines the influence of sentiment-based investor flows. After a torrid 2011, the Indian Rupee rallied by 7% as the Reserve Bank of India stated its rate-hiking cycle was over; the policymakers have evidently capitulated after thirteen increases in the same number of months failed to quash stubborn inflationary pressures. The Brazilian real and Russian ruble also moved higher with 6% gains against the dollar, though the Chinese renminbi only moved sideways. Over time, we expect many emerging market and commodity currencies to benefit from the aggressive intervention being conducted by the monetary authorities in the more mature nations, but last month's moves suggest volatility in foreign exchange markets is likely to remain elevated.



BONDS

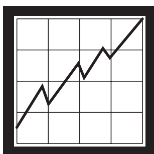
Bond markets in the Eurozone have again taken the centre stage with the key sovereign markets of Italy, Spain and France posting strong returns, despite downgrades to their credit ratings by Standard & Poor's. Positive reaction to the injection of €489bn of 3-year loans by the ECB into the European banking system at the end of the year has allayed market fears over the upcoming re-financing that is required by Banks and Sovereigns alike. Furthermore, it has highlighted that the ECB is not prepared to just sit on the sidelines and watch the Eurozone crumble.

Whether the introduction of the Long Term Refinancing Option by the ECB is a 'game changer' is yet to be seen. Again, the program is focused upon liquidity issues rather than the more thorny issues of solvency and productivity within Europe and, as such, we fear it may do little more than provide short term relief. This is perhaps best highlighted by the divergence in bond market performance between those with (most likely) liquidity issues - France, Spain, Italy - and those who are insolvent - Greece and (most likely) Portugal. However, three years is a long time, and further rounds of the LTRO potentially buys time for the Eurozone Governments to implement change.

Elsewhere, the first month of 2012 has seen bond markets in the US, UK and Germany continue the rally witnessed in 2011. Despite some relatively positive economic data through much of the month, the realisation that economic growth in the US and UK was weaker than anticipated through the final quarter of 2011 was enough to push yields a little lower. This was further compounded by the markets' interpretation that the Federal Reserve has also extended the timeframe over which it would likely keep interest rate at almost zero.

With nominal bond yields already at historical lows and inflation-adjusted yields in negative territory, we question what could continue to drive bond markets through the coming months. In the near-term, the weak economic environment, falling inflation expectations, ongoing concerns over Europe and loose Central Bank policy should be reasonably supportive of current yield levels, but upside in bond market performance is capped by how low bond yields could realistically go from here. In this regard, it should be remembered that not even Japan has experienced a period of negative real yields similar to that presently priced into the major Western Bond Markets.

We are therefore mindful of bonds at present. Markets appeared priced for perfection - a low growth, low inflation, muddle through environment, supported by easy monetary policy and a gradual de-leveraging of sovereign balance sheets. A failure of Governments and Central Bank's to deliver such an outcome could, at some point, start to weigh on even the safest of the safe.



EQUITIES

Global stock markets witnessed their best start to a calendar year since 1997 last month, with the MSCI World Equity index appreciating by a little over 3% in sterling terms. At the headline level the gain appears somewhat modest, but it conceals the stellar outperformance of those stocks that are more reliant on a robust economic recovery. In contrast, the more defensive areas lagged, but we are encouraged by the marked divergence in returns at both sector and regional levels as it suggests markets are returning to a more rational state. However, we note that the returns have been built on lower than average trading volumes.

After a turbulent 2011 the emerging markets started the year strongly; the FTSE 'BRIC' index surged by almost 11% in January. Whilst the economic outlook for developing nations compares favourably to most countries in the West, a notable deceleration in activity has been underway for some time. Official figures are starting to reflect this development, as evidenced by easing inflationary pressures and China's shift from double-digit gains in GDP growth to a little less than 9% annualised in the fourth-quarter. Given last year's emerging market equity falls, the economic slowdown appears to have largely been accounted for and with interest rate cuts already underway in many of the 'growth' regions, monetary policy looks set to become more supportive during the course of this year.

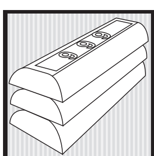
The strong gains in the more cyclically-oriented sectors contributed to solid advances for the vast majority of regional headline bourses. The S&P 500 and MSCI Europe ex-UK indices registered 5% gains, in local currency terms. Whilst the FTSE 100 was amongst the laggards it still managed a 2% rally. We also note that small and mid-cap stocks tended to generate better returns than their large-cap counterparts last month as is often the case during 'risk on' periods.

A dominant feature of the past few weeks has been the strong gains made by financial stocks. Many European banking names, for instance, have posted double-digit percentage gains since the start of the year following stronger than anticipated results from US banks. However, we would caution against reading too much into this. The turmoil of the financial crisis has caused a number of listed banks to become 'penny stocks,' meaning even small nominal price shifts can create outsized percentage moves. Furthermore, anecdotal evidence implies a significant portion of the gains can be attributed to 'short covering,' whereby speculators buy back shares that they had previously sold in a bid to profit from price falls. Unless fundamental buying power returns, the recent recovery may prove short lived.

We believe the 'short squeeze' prevalent within the banking sector may also be a feature of the broader market rally as the majority of investors have been positioned for further downside and the recent dovish actions of the monetary authorities in both the US and Europe are likely to have spooked the bears.

Despite news headlines to the contrary, the global financial system is awash with cheap money that is looking for a more profitable home; not only does this significantly lower the risk of a Lehman Brother's style liquidity freeze unfolding in Europe, the excess reserves should provide a formidable prop for income-paying stocks as yield-hungry investors look to eschew the paltry returns offered by cash and bonds.

So far, markets have started the New Year as they did in 2011. Twelve months ago, equity prices were being driven higher by reasonable economic news flow and the 'wall of money' created by the Federal Reserve's 'QE2' program. Looking back, it proved essential not to ignore what remains a vulnerable economic recovery and we believe the same will be true this time round. Whilst there is growing evidence that investors have 'euro fatigue,' the crisis still has the potential to create the occasional hiccup; we are likely to use any price weakness to increase exposures to our favoured holdings.



GOLD/COMMODITIES

A combination of better-than-expected economic growth from China and the assumption that the US Federal Reserve signalled plans to maintain near-zero interest rates through to 2014, gave a lift to commodities markets over the month. China's economy grew by 8.9% during the last quarter of 2011 from the year-earlier period, which provided some relief towards the view that Europe's debt-related problems would significantly slow the Chinese economy. As a result, the Thompson Reuters/Jefferies CRB Index gained 2.3%.

Crude oil proved resilient over the course of the month despite early concerns over weak European growth, as continued expansion in the Chinese economy again helped to ease concerns about an oil demand slowdown. In addition to emerging market demand, prices remained supported by anxiety over the effects of the Iran oil embargo. With Iran's parliament expected to pre-empt EU sanctions by voting for a ban on oil exports to Europe, the market firmed, with ICE March Brent trading at $111/barrel, up almost 4% on the month. The supply concerns surrounding the volatile situation in Iran, as well as Sudan halting oil production over a transportation fee, also offered support in maintaining West Texas Intermediate (WTI) prices at their current level. As a result, the price of WTI crude oil for March delivery remained largely unchanged, posting a decline of 0.35% during January to finish the month trading around $98/barrel.

Over recent weeks, gold has been one of the standout performers. The US Dollar's weakness and signs of an extended period of low interest rates in the US have helped drive the metal back above $1,700/oz. Increased liquidity and easier monetary policy, which led to declines in the US currency, are seen as a positive for bullion. The metal is also regarded by many investors as protection against rising inflation.

While gold has risen almost 10% since the start of the year, silver, which was in the doldrums during the latter half of last year, has gained even greater ground. The price of silver climbed 18% over the month, as investors attempt to diversify from equities and currencies.

After declining 21% in 2011, copper prices have risen by more than 9% year-to-date as concerns over Eurozone debt issues eased and stabilisation in Chinese manufacturing brightened the outlook for the metal. In China, imports of refined copper rose 18% in December, to a record high due to improved arbitrage and increased use of copper for financing purposes. Their imports of refined copper rose to 407,000 tonnes in December, up 78% from a year earlier and exceeding the previous monthly record of 379,000 tonnes in June 2009. From a European stance, rising optimism towards a positive conclusion for the ongoing Greek debt negotiations has help lift an overhang on the metals market, at least in the short term.

The majority of soft commodities prices also increased during the month, with wheat and cotton leading the gains. Wheat futures rose to levels not seen since late September on speculation that persistent dry weather in the US and low temperatures in parts of Russia and Ukraine will damage crops as they emerge from winter dormancy in the next two months. Russia, which lifted a ban on grain shipments in July after crops recovered from the 2010 drought, has recently been indicating the possibility of introducing an export tax to secure domestic supplies. The potential for this to occur comes after Russia announced back in October that it would impose a duty if shipments exceeded 24 million to 25 million metric tons. Currently this looks likely to be the case, as exports have topped 20 million tons to date.

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POLICY SUMMARY MATRIX

The matrix set out below is a summary of our current policy stance on the various equity and bond markets which we monitor. It is not intended as anything other than a guide on where we stand and we will change the content as our views alter. Cash exposure is a residual and will tend to be high when negatives outweigh positives and vice versa.

6-12 Month View	Strongly Negative	Negative	Neutral	Positive	Strongly Positive
EQUITIES					
US			■		
UK		■			
EUROPEAN		■			
JAPANESE			■		
AUSTRALIAN			■		
DEVELOPING			■		
RESOURCES			■		
GOLD			■		
GLOBAL INCOME				■	
BONDS					
US		■			
UK		■			
EUROPEAN		■			
JAPANESE		■			
AUSTRALIAN			■		
CORPORATE				■	
OTHER			■		

MARKET PERFORMANCE — 31st JANUARY 2012

All performance numbers show % changes except for bond yields which show yield changes.

	Now	1 mth	3 mth	12 mth
CURRENCIES (VS USD)				
GBP	1.5760	+1.4	-2.0	-1.6
CHF	0.9202	+1.9	-4.7	+2.6
AUD	1.0621	+4.0	+0.9	+6.5
JPY	76.27	+0.8	+2.5	+7.6
EUR	1.3084	+0.9	-5.6	-4.5
BOND YIELDS (10 yr)				
UK	1.97	-0.0	-0.5	-1.7
US	1.80	-0.1	-0.3	-1.6
Germany	1.79	-0.0	-0.2	-1.4
Australia	3.72	+0.1	-0.8	-1.8
Japan	0.96	-0.0	-0.1	-0.3
EQUITIES				
UK. FTSE 100 (GBP)	5681.61	+2.0	+2.5	+3.1
US. Dow Jones (USD)	12632.91	+3.4	+5.7	+6.2
Japan. Nikkei Dow (JPY)	8802.51	+4.1	-2.1	-14.0
Australia. All Ords (AUD)	4325.71	+5.2	-0.8	-10.8
MSCI Pacific ex Japan (USD)	1218.42	+9.6	+0.2	-7.1
MSCI Europe ex UK (Local Currencies)	824.41	+4.1	+2.8	-14.4
MSCI Latin America (Free) (USD)	4051.44	+12.5	+3.6	-8.0
MSCI World Index (USD)	1240.89	+4.9	+1.9	-5.1
MSCI World Index (GBP)	787.37	+3.5	+4.1	-3.6
MSCI World Index (AUD)	1168.34	+0.9	+1.1	-10.9
COMMODITIES				
Oil (WTI)	US$ 98.48	-0.5	+6.0	-1.3
Gold	US$ 1737.60	+11.1	+1.3	+30.4