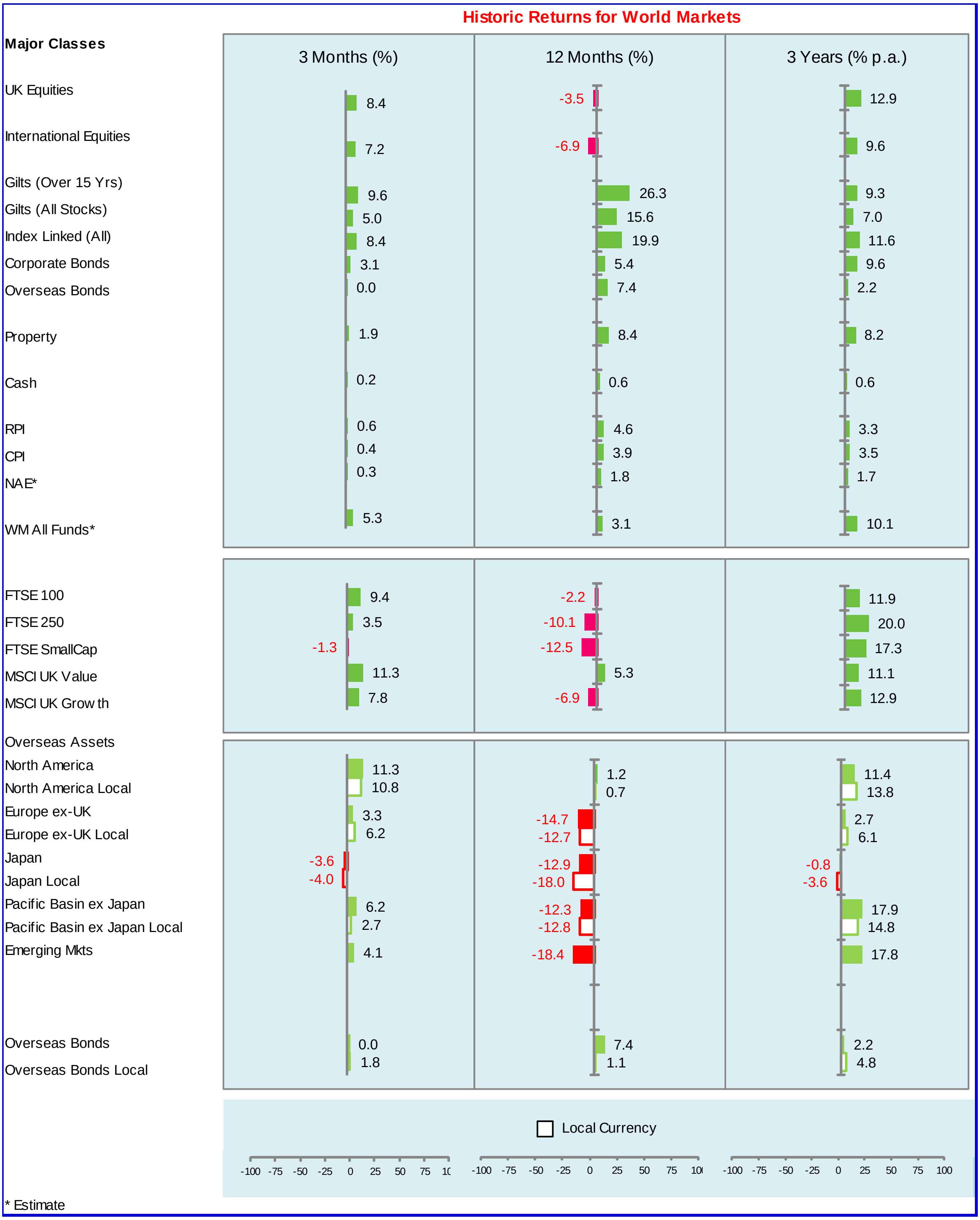
Market conditions – fourth quarter of 2011



Q4 Commentary

The European debt crisis was the dominant theme in financial markets during the final three months of 2011. The drama continued unabated. At times, it came close to stretching the credibility of the Euro project to its limit. Politicians struggled to agree a suitable policy response, as political priorities and allegiances clashed with the needs of monetary union. The Prime Ministers of Greece and Italy were casualties of the pressures placed on Euro member states struggling with substantial and unsustainable levels of debt.

In the UK, the Chancellor presented his autumn statement in November. As expected, the essential message was one of continuing ‘austerity’; sluggish economic growth, public sector pay restraint and painful spending cuts. The Chancellor also announced that it will take two years longer than first proposed to eliminate the structural deficit. The Office of Budget responsibility cut its forecast of economic growth for 2011, to just 0.9% (from 1.7% in March) and to 0.7% for 2012.

Despite all the negative news, equities and bonds each produced strongly positive returns. In the UK, the FTSE All Share index advanced 8.4% during the quarter; fixed interest government bonds returned 5.0% and index linked issues 8.4%. Of the major equity markets, only Japan produced negative returns.

Key events during the quarter were as follows:

Global Economy

- The Bank of England injected an additional £75bn into the economy through quantitative easing (after earlier stimulus of £200bn).
- The UK declined to participate in a plan for closer fiscal union across the European Union.
- Short-term interest rates unchanged in UK and US; reduced, in two stages, in the Euro zone.
- US central bank lowered the cost of short-term $ loans to European Central Bank, to ease liquidity concerns.
- Economic growth in major Asian markets impaired by weak external demand.

Equities

- Strong rebound after sharp falls during preceding quarter.
- The strongest sectors relative to ‘All World’ Index were Oil & Gas (+7.0%) and Industrials (+2.0%); the weakest were Utilities (-4.4%) and Telecoms (-3.5%).

Bonds

- Long dated UK bond yields fell to levels not seen for 60 years as investors sought ‘safety’.
- Italian ten year bond yield rose above 7% (highest level of Euro era) as debt concerns escalated.

High levels of debt in Europe and in the US threaten the stability of the global economy. Further tough and unpopular action is required to resolve the difficulties. In the meantime, no country is immune from the consequences of a failure to take decisive action.

Market Conditions

General

Following the sharp sell-off in equities in Q3, markets had a healthy rebound in Q4, although most delivered negative returns over the calendar year. At the same time, the rally in safe haven government bonds (principally US, Germany and UK) extended over Q4. Turmoil continued in the bonds of weaker Euro zone countries. The general tone was “risk on”, notwithstanding risks arising from the European debt crisis and the slowing pace of growth in Asian markets. Economic statistics in the US were ahead of expectations, providing some offset to other concerns. The Euro weakened over the period to the lower bound of its trading range.

Equities

North American equities delivered the strongest returns (+10.8% in local currency), followed by the UK (+8.4%). Only Japanese equities suffered a negative return (-4% in local currency) because of the enduring impact of the earthquake and slowing Asian growth. Over the calendar year, there was a substantial variance in returns. The only region in positive territory was North America (+0.7%). UK equities returned -3.5%. Europe and Asia Pacific both returned approximately -13% in local terms. Japan returned -18% in local terms but Yen strength improved the returns to a sterling based investor to -12%. The laggard was emerging market equities which has suffered an extended sell-off over 2011, returning -18.4% to a sterling-based investor.

At a sector level, Oil & Gas performed strongly (+7%) in Q4. Utilities (-4.4%) was the major underperforming sector. Over 2011, defensive sectors performed most strongly, lead by Health Care (+19%), Consumer Goods and Services (+8.2% and +9.4% respectively) and Telecoms (+8%). The weakest sectors were Basic Materials (-16.6%) and Financials (-11.9%). There was no strong bias to either growth or value styles.

UK equities

Large cap stocks (FTSE 100) returned 9.4%, significantly outpacing the FTSE 250 (mid cap stocks) which returned 3.5% and Small Cap returning -1.3%. Over the calendar year, large cap (-2.2%) is well ahead of mid cap (-10.1%) and small cap (-12.5%). Value stocks in the UK performed more strongly than growth, both in Q4 and over the year as a whole, which is at variance with global equities. At a sector level, the strongest sector over Q4 was Oil & Gas (+8.3% relative), driven particularly by the two Oil majors. The weakest sectors were Utilities (-7.4%) and Financials (-6.3%).

Royal Dutch Shell and BP both returned just over 10% over the quarter. Royal Dutch now comprises 9% of the entire FTSE All-Share index (for comparison purposes, this is over 4 times as large as the entire Small Cap (274 stocks) and not that much smaller than the entire FTSE 250 which comprises 12.5% of the FTSE All-Share. The star performers among FTSE 100 stocks were cyclical – Wolseley (+24.6%), Weir Group (+21.6%) and Antofagasta (+21%). The weakest performers included financials – Admiral (-37.8%), Lloyds (-31.4%) – and Essar Energy (-37%).

Bonds

Gilts performed strongly, viewed internationally as safe haven assets. Long dated (over 15 years) gilts returned 9.6% (26.3% over the calendar year). The All Stocks gilts index returned 5% over the quarter (15.6% over the year). Index linked gilts returned 8.4% (19.9% over the year) with longer-dated issues performing more strongly. Investment grade credit returned 3.1% (5.4% over the year), with AA-rated bonds delivering the best performance. Index-linked gilts have been the strongest performing major asset class over 5 and 10 years, closely followed by nominal gilts. Both were outpaced only by Asia Pacific and Emerging Market equities.

Property

Q4 performance data is not yet available. We are aware that capital values reduced modestly in November.