THE YEAR AHEAD

Seven Investment Management

2012

INTRODUCTION

As we enter 2012, the only thing we can say with any degree of certainty is that, given the countless open questions confronting the global economy, the markets and policy makers, 2012 looks set to be as challenging as 2011. The very nature of these challenges is uncertain, hence difficult investing conditions are likely to continue. The sentiment has changed immensely from a year ago, where there was a degree of cautious optimism from policy makers and investors alike that the worst effects of the Great Recession were subsiding and whilst we weren't looking at a reversion to the status-quo, we were at least grinding slowly upwards on the steep road home. Then 2011 delivered (metaphorically) a series of short, sharp jabs to a woozy boxer only just climbing back into the ring. Economic fault lines exposed by the Credit Crunch were almost immediately subject to pressure from exogenous shocks. The Arab Spring saw the oil price rocket and the Japanese Tsunami impacted supply chains around the world. In an unsteady world, the traditional bedrocks of Western governments offered little stability – as fears over the US Debt Ceiling and the Eurozone sovereign debt crisis focussed markets' attention on vulnerabilities rather than strengths.

The US economy underperformed, particularly as unemployment remained high, whilst the UK economy ground to a halt as fiscal austerity began to bite. The Eurozone crisis took on a life of its own as sovereign debt sustainability, bank solvencies and political indecision all overlapped to create a serious threat to the very existence of the monetary union. The markets were (and still remain) unconvinced regarding the credibility of the solutions so far put forward by Europe's leaders but one ray of hope rests on the belief that the aforementioned politicians have finally acknowledged the serious prospects of an economic depression. Having outperformed in 2010, China and other emerging economies disappointed as worries over excessive inflation gave way to concerns of slowing growth.

The major issues of 2011 were not magically resolved at midnight on December 31st. It's a fairly safe assumption that their continuation into 2012 could lead to a severe recession in the Eurozone, at best a mild recession in the UK, modest growth in the US and below trend growth in the emerging market economies. The most concerning aspect of the global outlook is the expanse of the downside risks, particularly if the threats to the Eurozone crystallise in accordance with the dire predictions.

ECONOMICS AND POLITICS

In 2011 we saw a formation of a somewhat symbiotic relationship between policy makers and markets, whereby markets moved from 'risk-on' to 'risk-off' on the back of apparently inconclusive political statements. Similarly, we saw politicians and central bankers adjust their stances and decisions based on superficial market movements, as opposed to economic fundamentals. This stems from the economic and financial climate developed countries find themselves in:

- interest rates are at near zero,
- central banks have taken huge amounts of financial assets on their books,
- budget deficits are stretched,
- public debts are at peace-time highs and
- strong GDP growth seems like a faded dream.

This has meant that policy makers have been heavily constrained in their responses to deal with unforeseen natural disasters, economic weakness and large, destabilising market movements. In an environment where short term strong policy actions are limited or non-existent, words become the only recourse for policy makers, with the promise of policy action to follow. However, the more often words are spoken the less useful they become. This has been demonstrated almost daily by European leaders; their claims to commit to resolving the crisis are given less and less credence.

Europe

In Europe, the uncertainty by and large stems from the failed promises of the last decade to stick to previous agreements and from a failure to stem the crisis at the periphery. The debt crisis has become more complex as political interests have taken hold and it starts to be clear how difficult it is to change the legal structure of governing treaties to address the problems. Even if we could ignore the politics and empty talk of fiscal reform, there are still structural imbalances which have received far less attention than merited. The monetary union has left huge imbalances of payments between countries. If the Eurozone is to achieve fiscal, economic and financial stability going forward, these imbalances need to be addressed. There are two ways this can be achieved; through a rise in German imports, (from stronger German domestic demand) or from a collapse in German exports. The likely outcome is a combination of the two but an emphasis on the former would be a far more attractive option. Despite the overwhelming challenges and their apparent ineptitude, we believe that the Eurozone policy makers do recognise the severity of the problem and will eventually develop a credible long term solution. Violent market movements are almost inevitable, as the most likely solution will not come in one fell swoop but rather as a murky and indistinct muddle through. However, summit by summit, meeting by meeting, the European leaders will slowly build a strong and long lasting economic, political and legal framework to deal with the crisis, at the heart of which will be a fiscal union.

Greece & Spain

The past year has already seen a dramatic political change across southern Europe with the installation of technocratic governments in Italy and Greece and a change of political parties in Spain. Over the next year we see the Greek situation stabilising as reforms are introduced and as the spotlight moves to the bigger peripheral countries such as Italy and Spain. The other key player is, obviously, the European Central Bank (ECB), which we believe must take up the role of the final buyer of government debt to stabilise the markets and the economy. It is likely that the ECB will undertake this role on the basis of rapid structural reform and a credible road map to fiscal integration which, as we argue above, is on its way to happening.

USA

The US also faces a political crisis of sorts as the acrimonious and inconclusive debate over reducing the deficit and the debt ceiling limits has impacted business and consumer confidence. The lack of political will culminated in the ratings agency Standard & Poor's downgrading the creditworthiness of US Treasury bonds from AAA to AA+, and singling out the policy makers for particular blame saying *'The downgrade reflects our opinion that the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics'*. With the US elections in November, it seems that this political paralysis will continue as each side of the political spectrum becomes ever more entrenched in their own irreconcilable positions. With unemployment at 8.6% and a falling labour participation rate, Obama and the Democrats will be unlikely to commit to any Federal spending cuts which could potentially derail the US recovery before the election. Similarly, the Republican candidates looking to

line up against Obama are promising to cut spending ferociously in order to avoid raising taxes, an anathema to the Republican Party faithful. This political uncertainty could impact further on consumers and businesses but we do not see it yet being strong enough to tip the economy into recession in 2012.

Emerging Markets

Whilst Emerging Markets (EM) underperformed in 2011, there is a hope that 2012 will see Emerging economies decouple from the West and may even drag the stagnating economies through the worst of the problems. Despite the worsening outlook for the global economy we believe that the current economic fundamentals are supportive of growth in the emerging economies and in addition their policy makers have for the most part more room to implement stimulus policies. There is also increasing intra-EM trade, particularly between Asian countries which should help limit the effects of a severe downturn in Europe.

The popular distrust and lack of belief in politicians is likely to be a continuing theme throughout 2012. In the developed world, it is likely to manifest itself in political paralysis – as economic weakness leads to polarised opinion and political division. In Japan, this has been the norm for nearly a decade, and the USA seems to be heading for a similar governing stalemate. In the developing world, we've already seen the ideal of the "Arab Spring" foster revolutions in the Middle East and North Africa – it could well spread further and deeper.

ASSET CLASS VIEWS

Fixed Income

The climate of uncertainty has meant an extremely good year for the few fixed-income instruments lucky enough to retain their 'safe-haven' status. As the Eurozone crisis spiralled out of control, it became clear that some 'safe' bonds such as Greek government debt had been misclassified. The peripheral European nations have seen yields soar as the price of their debt plummeted – in turn reducing their ability to sustainably repay the debt. UK Gilts have been one of the small number of securities which have benefited from their perception as secure, along with the government bonds of the US, Japan and some of the Nordic nations. For this select group, yields will remain low as global uncertainty continues, inflation is set to fall, growth slows and interest rates are likely to remain near-zero in the foreseeable future.

Just as in 2011, the Eurozone crisis will remain the key driver for bond markets in 2012. The uncertainty surrounding the crisis has led to the yield on corporate bonds diverging significantly from yields on safe haven government bonds. In Q3 2011, we saw a significant re-pricing that took credit spreads (the difference between corporate bond yields and government bond yields) to levels usually seen immediately prior to a recessionary period - pricing in record levels of corporate default. Non-financial corporates have managed their debt relatively successfully since 2008, leaving their balance sheets in fairly good shape. All this indicates that corporate bonds are underpriced, but the fact remains that it is difficult to ignore that corporate bond markets will be heavily influenced by the macro-economic environment and the business cycle. This is important to consider given the lack of immediate growth prospects in the Eurozone and the absence of quick fixes to the crisis. As earnings decline, corporate bond yields could increase their spreads over government bond yields.

Equities

2011 saw losses across the world's main equity markets, bar the US which ended the year ever so slightly higher. As we enter 2012, the macroeconomic uncertainty remains and is likely to keep volatility quite high. However, there are reasons to be cautiously optimistic, particularly if US growth picks up and if the required steps are taken by the Eurozone leaders to resolve the crisis.

The US market is likely to trade at less than fair value, as the European debt crisis and financial sector deleveraging suppress US equity levels in spite of good fundamentals. US business and consumer confidence seems certain to take a hit due to government policy uncertainty, however we believe that a US recession is unlikely: recovery from the last recession is far from complete and there are few reasons for companies to cut back further and tip the economy into recession. On top of this, we are unlikely to see further substantial declines in the labour market and housing market as both are showing signs of bottoming out. It has been well noted that US companies remain cheap on the basis of strong cash

flows and strong balance sheets. As such, rising dividends could act as a support for US equities.

UK and European equities are following a similar path to the US apart from the fact that they are relatively cheaper on the whole than their US counterparts – hardly surprising given the proximity of UK and European companies to the Eurozone debt crisis. Earnings expectations have not been priced into the market due to the concern over the sovereign debt crisis. Furthermore, the debt levels of many UK and European companies are low and cash flows are strong, which means there is more scope for increased dividends and buybacks even if margins continue to remain flat or modestly lower. The risk of recession in key Eurozone countries is much higher than in the US as austerity and weak intra-union exports choke growth. In unison with the lack of employment growth, these factors weaken the consumer base upon which many European and UK corporates depend. Although the balance sheets are healthier, prospects for future earnings may not be.

Last year saw Emerging Market (EM) equities underperform developed market equities – scotching the accepted wisdom that EM countries were independent engines of growth, destined to save the West. Expect more of the same in 2012, as EM equities are still a long way from ‘de-coupling’ from equity markets in developed market economies – which as discussed above are facing a gloomy 12 months. However, due to the rise in solely intra-EM trade, China is starting to play a significant and increasing role in the performance of EM equities irrespective of the developed world. With scope for monetary easing in China, a soft landing is looking more believable - however unresolved problems in the banking and property sector pose downside risks.

Property

Overall, house prices in the UK were broadly flat in 2011. The Nationwide house price index rose 1% year on year while the latest Halifax house price index showed a year on year seasonally adjusted fall of 1%. Supply remained very limited but demand was also low, partly as a result of the lack of available mortgage credit but also because banks and building societies demanded higher deposits than previously required during the housing boom. The Bank of England statistics show mortgage approvals bumping along at around 50,000, far below the 120,000 per month level seen at the beginning of 2007. For existing homeowners, the very low level of interest rates has helped to keep the cost of servicing existing mortgages down and the default rate remained fairly low.

As we go into 2012 the economic outlook remains challenging for homeowners, with the prospect of job losses adding to the woes possibly forcing some home sales. Interest rates are expected to remain low this year and this should give some support to the housing market, if only to help prevent a disorderly market price correction. The latest commercial property returns from the Investment Property Databank (IPD) showed a 7.2% return for the 11 months to November but only 1.3% of that was capital growth as caution about economic prospects feeds through to business decisions about buying commercial property.

However, the higher end of the market continues to defy gravity with house prices continuing to rise faster in London than any other area in the UK. Yields on City and West End properties are much lower on strong demand from overseas buyers, particularly those who see London as a safe haven. Looking at overall prospects for property in 2012, although the yield on commercial property remains significantly above the risk free rate, concerns about the European crisis and economic growth are going to be the dominant influences and will keep yields up. The housing market faces a tough year. Commentators suggest that a more gloomy outlook for the economy and a persistent lack of mortgage availability (especially for first time buyers) points to a gradual decline in nominal house prices, perhaps taking them down by around 4% over the next 12 months

Commodities

Over the past three years, near zero interest rates and quantitative easing spurred hope of a sustainable global recovery and thus pushed commodity prices higher. However, the feasibility of commodity prices rising further in 2012 is in serious doubt, depending as it does on decisive and credible action from Eurozone policy makers, robust US growth and a soft landing for the Chinese economy. It is clear that the Eurozone sovereign debt crisis will pose the greatest threat to the commodity markets, particularly to copper and Brent crude oil. However, if the global economy was to underperform, particularly if negative real rates (when inflation is greater than interest rates) remain, then gold could remain an appealing prospect despite falling nearly 20% from its record high. That said there always remains huge upside risks to commodity prices even in an economic slowdown, especially oil, the consistent supply of which depends on geopolitics.

Last year saw significant political upheaval in the Middle-East and the chance of further disruption remains as many of the region’s states attempt to transform from autocracies to democracies. Autocratic

rulers in the Middle East have relied on paying for peace for decades – subsidising their citizens in order to quell unrest. The funds for this come from oil production – and in such an environment it is in the interest of OPEC to cut oil supply and therefore increase oil prices. It is estimated that the break-even oil price for the Gulf Cooperation Council (GCC) to maintain fiscal and trade balance is around $86.5 per barrel. If the Arab Spring continues in any form, the breakeven price will rise further – and short of a discovery of a vast reservoir of oil somewhere other than the Middle East, prices are not likely to fall below it.

Currencies

Despite the market volatility throughout the year, Sterling has remained essentially unchanged (only slightly stronger) against the Dollar and the Euro. Weak Sterling is in the interest of the UK and is often touted as one of the potential drivers for economic growth, as exports become cheaper. It is likely to remain weak over the course of the coming year as we see the Eurozone crisis slowly being resolved. That said, if the worst case scenario were to transpire, the UK could see a much stronger Pound on the back of *'safe-haven'* flows as nervous investors move away from German Bunds to UK Gilts. Alternatively, nervous investors may see a deteriorating Eurozone economy translate into a deteriorating UK economy and so avoid Sterling altogether and flee to the Dollar or Yen instead.
As global uncertainty has taken hold in 2011, the Dollar has remained strong due to its safe-haven status and the Euro has remained surprisingly strong despite the crisis. One of the reasons given for this is that European banks have cut international lending and brought the money back to the domestic economy – again, something likely to continue in 2012.

The strongest currencies beyond the traditional safe-havens tend to be the ones with strong trade balances and low government debt. As such, the Canadian Dollar, Norwegian Kroner and Australian Dollar are viewed as safe investments although these currencies are less available, and commodity linked.

CONCLUSIONS

Overall, considering the likelihood of volatility in the coming year we are slightly underweight equities in our portfolios. However, given that equity markets have already priced in a large amount of negative news, we are cautious of cutting allocations further. Though US equity valuations seem more expensive compared to European equities, we believe that US companies are currently in a stronger position to weather the impending challenges, both domestically and globally.

We remain underweight government bonds as we see very little upside to returns relative to the chance that yields could rise. Reciprocally, we stay overweight corporate and high yield bonds which are currently pricing in a far bleaker view of the economy than is likely to occur – a position with minimal downside, and a lot of potential to capitalise on the upside. The volatility in markets has also encouraged us to hold a large overweight in cash to maintain liquidity and flexibility in an uncertain market.

Given the over-arching uncertainty surrounding the global economy, it is likely that the volatility seen in 2011 will continue to blur the story in 2012, but perhaps with a turning point in the Eurozone debt crisis and a sustainable US recovery offering a glimmer of hope as the year progresses.

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Registered office: 125 Old Broad Street, London EC2N 1AR. Registered in England and Wales number 4092911.