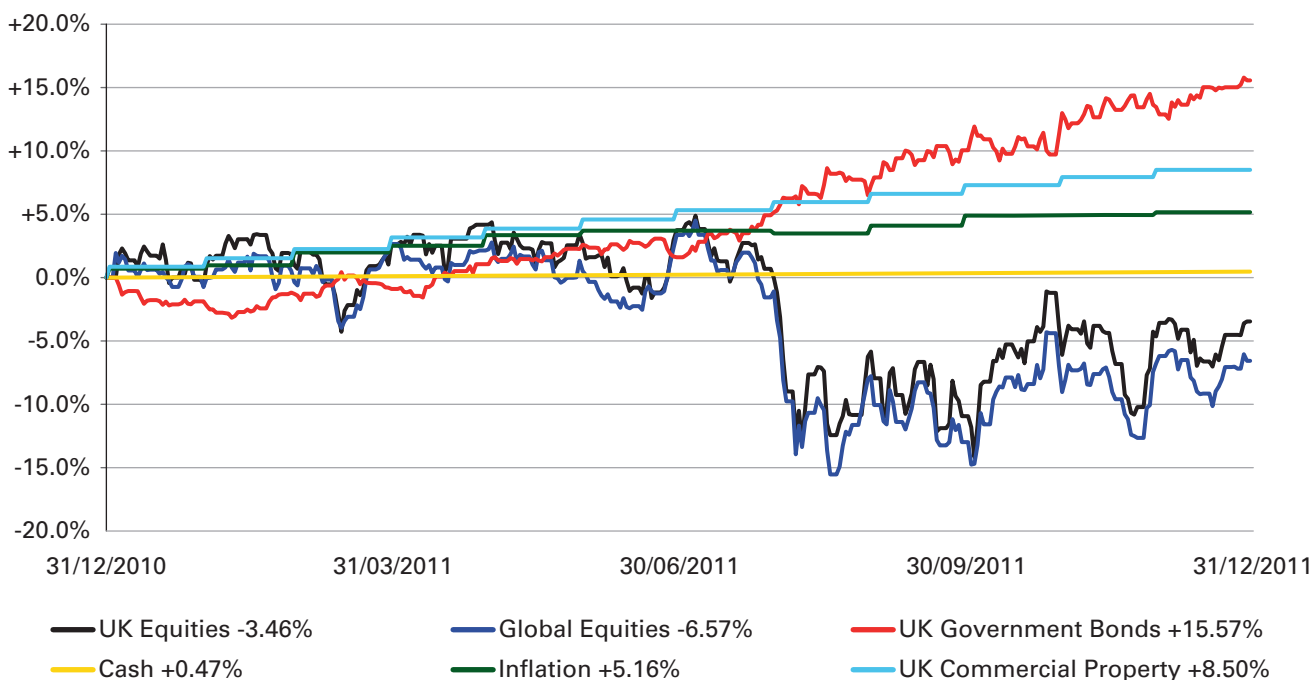


Headlines

- Global equity markets overall rose over the month with most regional markets moving higher.
- Fixed interest markets moved higher too and with investor risk appetites improved, corporate bonds outperformed gilts.
- Capital values declined slightly in the commercial property sector. Income remained solid however, leading once again to a modest positive overall return.
- In currency markets sterling rallied against a weak euro but lost ground against the dollar and yen.

Investment market returns over the past year



Sources: Bloomberg, IPD, FTSE All-Share Total Return Index, FTSE All-World Total Return Index, FTSE UK Govt All-Stocks Total Return Index, IPD Monthly Total Return Index*, 7 day LIBID, Retail Price Index* (*Lagged by 1 month).

Market review

Global equity markets rose over the final month of the year. The FTSE All-World Index gave a return of +0.96% to a sterling based investor, extending the rally enjoyed in the final quarter to an overall return of +7.37%, a reasonable gain but not sufficient to give a positive outcome to the year as a whole. The return over calendar 2011 was -6.57%. Of the major regional markets all but Europe made progress. Japan rose by +2.14%; the USA by +2.12% and Asia by +1.09%. Europe declined by -1.40%. The best performing individual markets over the month were Ireland (+4.15%) and some of the smaller Asian markets including the Philippines (+6.49%), Indonesia (+5.11%) and Malaysia (+5.59%). Of the markets which fell over the month India (-5.30%) and Pakistan (-5.61%) led the way in Asia, Greece (-6.09%), Germany (-5.45%) and Finland (-7.42%) were the weakest performers in Europe. The UK equity market performed in line with the international averages, rising by +0.84% as measured by the FTSE All – Share Index. Large companies were slightly stronger performers than the broad market allowing the FTSE-100 Index to rise by +1.25%. Lower rated ‘value’ companies outperformed the ‘growth’ alternatives.

In fixed interest markets government bonds (gilts) remained in good demand. The FTSE Government All-Stocks Index recorded a total return of +1.69% to bring the total return for the year to +15.57%. In contrast to recent months, when investor focus was on risk minimisation, there was a good appetite for the higher income that corporate bonds can provide and in general these outperformed gilts. The iBoxx sterling non-gilt 7-10 years Index returned +3.01%.

In the Commercial Property sector the IPD Index for November showed a modest decline in capital values due to weakness in the retail sector: poor general trading and the public difficulties of a number of retailers saw increased fears over future income

sustainability which pushed valuations lower. Despite this, overall returns remained in positive territory, sustained by the strong income flows that the sector provides.

In currency markets the dominant theme was the continued pressure on the euro which declined against all the major alternatives. Sterling rose by +2.65% against the European currency but lost ground against the dollar (-1.03%) and yen (-1.93%).

Economic developments

Probably the main development in the month and a prime reason for the improvement in sentiment was the decision by the European Central Bank to address the growing liquidity crisis in the region. It did this by providing banks with access to loans for up to 3 years whilst also reducing the minimum quality of collateral required. Eligible financial institutions were positively encouraged to take advantage of the new facility and some 500 did so. Of the €489 billion provided, €190 billion represented new loans whilst €230 billion was existing shorter dated loans which were rolled into more stable longer term arrangements. This initiative by the ECB provided a certainty of liquidity which the market was unable or unwilling to offer, particularly to banks in the peripheral economies which had effectively become excluded from conventional sources of finance. As well as providing immediate and necessary liquidity the ECB has effectively begun a back door quantitative easing programme because a good proportion of the new borrowings will inevitably be invested in government bonds, improving the demand in the sector and in so doing, pushing lower long term interest rates.

In the UK there were the first signs that inflation had peaked as November CPI data showed a rise of 4.8%, compared with 5.0% in October and 5.2% in September, the decline triggered by seasonal offers in clothing and lower food prices. Looking back at the surge in inflation during 2011 we can see that about half was caused by fuel and energy cost increases and about a quarter by the rise in VAT. As these two factors drop out of the comparative data so inflation should drop swiftly in the months ahead, to about 3% by mid-year. This should be a modest support to growth over coming months because one of the major causes of flat consumer activity in 2011 was that prices rose so much more quickly than incomes. As inflation falls back so this squeeze should reduce, although the benefit will be felt in the later months of the year.

Outlook

As the New Year begins so it is clear that the consensus view is that the economic outlook for 2012 is dull. Europe is expected to experience a recession which if severe could trigger a double dip in activity in the UK. The recent action by the ECB is very welcome, but the good news on liquidity and credit essentially addresses symptoms of the crisis rather than the causes and so needs to be matched by more fundamental action by governments. Until this is forthcoming there are clear risks that the recent improvement in sentiment reverses and, despite very attractive valuations, share prices spike lower. Short term volatility is expected to remain high.

We view fixed income markets as over-valued and have a below average weighting to the sector. Commercial property returns will remain dependent on income flows; we see no improvement in overall capital values until 2013. In equity markets we favour a high allocation to overseas economies where growth is stronger and more predictable.