

### Economic and political news

Investor sentiment in the final quarter of 2011 was dominated by the European debt crisis and, to a lesser extent, the US economic recovery. In Europe, there were fears emerging that the debt funding difficulties had spread to the core economies of Italy and France. This was evidenced by a lack of demand in bond auctions and, in turn, rising yields.

European politicians gathered for a summit in December and eventually agreed, in principle, to a pact enforcing limits on government spending and further austerity. Once again, however, they fell short of delivering a comprehensive solution.

The European Central Bank (ECB) announced the provision of three-year loans, which eased fears of a banking collapse. The Bank of England announced a further £75 billion of asset purchases, recognising the need to support the flagging British economy.

China, meanwhile, responded to signs that its own economy might be slowing by lifting the reserve requirement ratio enforced on banks.

The most positive signs emanated from the US, with improving employment and economic activity data. There was some disappointment during the quarter, however, when the budget 'Super Committee' failed to reach agreement on how to reduce the government's debt.

### Currencies and interest rates

The ECB reacted to deteriorating growth prospects and softening inflation by cutting rates by a total of 50 basis points during this quarter. The euro weakened in this environment, while the US dollar strengthened on the back of positive economic data and a flight to safety.

### Three-month returns (%)

Index	Local currency	Sterling return
FTSE All Share		8.39
S&P 500	11.82	12.16
FT Europe ex UK	6.51	3.30
Topix (Japan)	-4.17	-3.78
FT Pacific ex Japan		4.38
FT Emerging Markets		4.17
FT World ex UK		7.51
FT Gilt All Stocks		5.01

Source: Bloomberg, as at 31st December 2011.

### Equity markets

All major markets except for Japan produced positive returns in the quarter. The rally was driven by a gradual improvement in the economic data out of the US, and defensive stocks generally outperformed those in the cyclical sectors. This was partly a reflection of the deteriorating economic growth outlook, but also because of their attractive yields relative to bonds.

### Bond markets

It was also a positive quarter for UK government bonds, in sharp contrast to Greek, Portuguese, Italian and French government bonds, which lost significant value. We believe that the continued increase in European government bond yields relative to 'safe' German bunds emphasises that the Euro-crisis is far from over.

Corporate bonds also gained ground, but returns still lagged those of gilts.

### Commodities

The gold price declined modestly, due largely to a stronger US dollar. Crude oil was also volatile, but finished the period higher. Prices of both commodities are likely to be driven by fear in 2012, particularly regarding the situations in the Eurozone and in Iran.

### Outlook

We headed into the New Year with a defensive stance in portfolios. During the first quarter and probably throughout 2012, we expect markets to continue focussing on several key issues, particularly on progress made to resolve the European debt crisis. Other issues include whether the US can maintain its economic recovery and if China can avoid a 'hard landing'. We would consider increasing risk in portfolios, as appropriate, if we see these areas begin to stabilise.

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