



Most equity and bond markets rebounded strongly in the final quarter of 2011, although the problems surrounding Europe and general debt and growth concerns throughout the western world are far from resolved.

In this Quarterly Strategy report, we provide insight into what we believe could transpire in the New Year and how we are currently positioning portfolios.

## Our current investment strategy

We enter the New Year with portfolios **defensively positioned**, and will look to take profits in gilts and take advantage of attractive valuations elsewhere when we gain confidence that economies are stabilising.

We expect western economies to remain entrenched in a long-term deleveraging process, whereby banks, consumers and governments work off the debts they have accumulated. A lack of credit reduces the ability to use leverage for constructive purposes. It will take time to reduce unemployment; real wage growth will be muted; and consumers will be increasingly thrifty.

### We are cautious on equities ... for now

#### UK: currently, a negative outlook

- Largest drag is consumer weakness
- Equity valuations are currently low
- Confidence could improve before economy does

#### US: maintaining positive outlook

- Resuming a path of modest recovery
- Equity valuations reflect unwarranted pessimism

#### Europe: still negative, looking for stabilisation

- European sovereign debt crisis continues
- Double dip recession and bank deleveraging

#### Japan: still negative

- Long-term structural problems will continue

#### Asia ex Japan, Global Emerging Markets: neutral

- Long growth period led to broad-based inflation
- Concerns about China and India
- Positive on balanced Southeast Asia economies

### We are positive on bonds, but wary of valuation

#### Government bonds: positive on the US and UK

- Supported by slow economic growth
- Interest rates and bond yields low

#### Corporate bonds: negative for now

- Suffering from risk aversion
- Non-financial issuers are well positioned

### We have a positive view on alternatives

#### Gold: positive

- Negative real interest rates, central bank buying, European and global economic uncertainty

#### Hedge funds: positive on UCITS structures

- Diversification benefits

### We have a negative view on property

#### Non-Prime market: negative

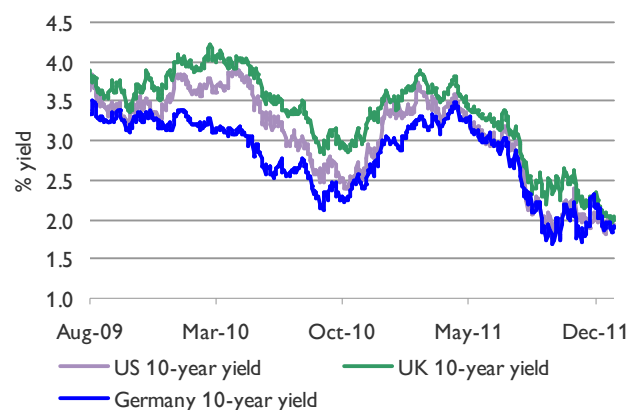
- Lack of credit and slowing rental growth

## Inflation, interest rates and bonds

Inflation in the developed world has peaked and is beginning to decline. Interest rates are likely to remain at their historically low levels for the foreseeable future.

The contagion of the European debt crisis to Spain and Italy resulted in their bond yields ballooning whilst Germany's collapsed. UK and US bonds also benefitted from this flight to safety. Valuations in key government bond markets are now expensive, as indicated in the following chart by the yields hovering around 2%.

### 'Safe haven' government bond yields are low

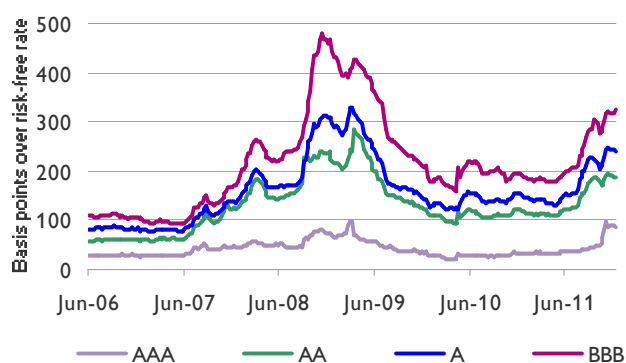


Source: Bloomberg (GBL052)

An amelioration of the debt crisis and return of risk appetite would see some correction in bond markets, but yields are likely to remain low.

While government bonds have flourished, corporate bond spreads have widened sharply, implying that investors demand higher yields in exchange for the greater risks perceived with corporate bonds.

### Corporate bond spreads have widened



Source: JP Morgan, Bloomberg (UK087)

Non-financial issuers, however, have become cheaper. They have strong balance sheets in aggregate, while profit margins, liquidity and interest cover have also improved in recent years.

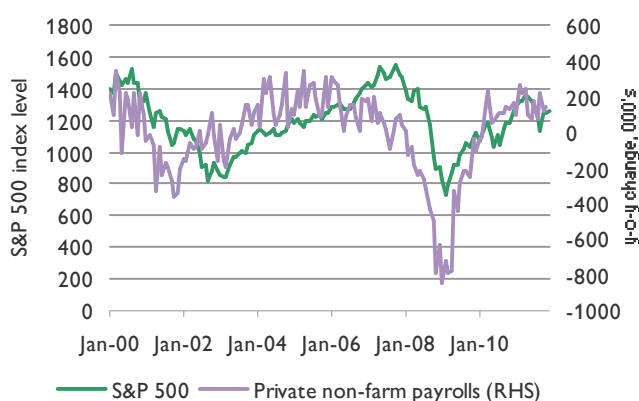
As European sovereign and banking issues clear, we would expect to become more constructive on corporate bonds, starting with non-financial issuers before considering financials and high yield bonds.

## Our view on equities

We noted in our October report that the final quarter of 2011 was likely to see downgrades to corporate profits, which would pressurise equity valuations and investor sentiment. As it happened, we were right.

A more optimistic tone is supported by current equity valuations. While the US is slightly expensive, it can be justified versus Europe, given short-term momentum and overall prospects for 2012. We are encouraged by improvements in the US employment market, as well as retail sales and economic activity.

### Employment and equity trend correlation

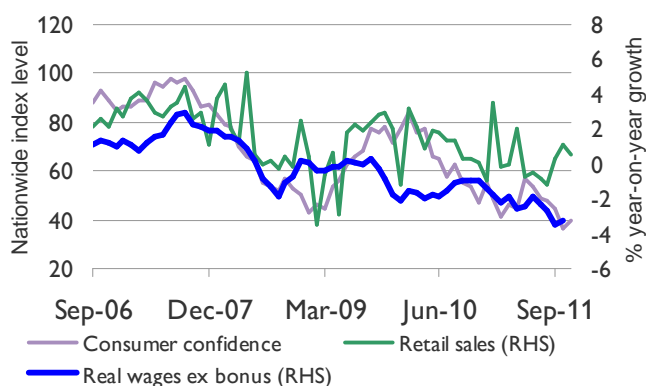


Source: Bloomberg (US041)

We are positive on US equities, but mindful of the risks associated with political wrangling in the run-up to November's presidential election, as well as risks of general disillusionment given that Americans have experienced a decline in their standard of living.

The consumer picture in the UK remains poor, with negative real wage growth resulting in a lack of confidence and sluggish retail sales. We are cautious on the UK, but with equity valuations currently low, markets could recover before the economy does.

### Negative real wage growth impacting consumers



Source: Bloomberg (UK092)

We are negative on Europe, as we cannot see a comprehensive solution to the debt crisis any time soon, and with Eurozone banks having to deleverage their balance sheets, the outlook for the economy is bleak. The weaker euro, however, may help exports.

In Asia, we favour the more balanced economies, but are cautious on China, given risks associated with its high property prices, and India because of inflation and corruption issues.

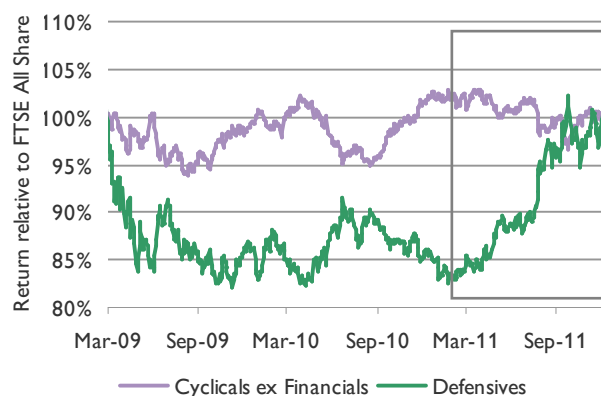
We remain negative on Japan, due to long-term structural issues that will prove difficult to overcome.

Overall, this environment should favour funds that can actively manage their allocations between cyclical and defensive sectors, and take advantage of the bottom-up opportunities that exist at this stage in the cycle.

## Sector view: Defensives versus Cyclical

Since March 2011, defensive sectors such as utilities, pharmaceuticals and consumer staples have significantly outperformed cyclical sectors excluding financials. This is due to the stability of earnings that companies in these defensive sectors offer, rather than superior earnings growth. They now look expensive versus equity markets as a whole.

### Defensive sectors have outperformed cyclicals



Source: Bloomberg (UK094)

We believe that, overall, cyclical sectors offer the most value in equity markets, and have attractive yields. They will look particularly cheap if the US maintains its recovery, Europe stabilises and China avoids a hard landing. Granted, those are big 'ifs'.

### What this means for our future strategy

If European sovereign and bank bond issuance succeed in the first quarter, and we see signs that economic conditions are stabilising, we expect to:

- increase equities and corporate bond exposure
- add to economically sensitive assets in general
- take advantage of depressed valuations
- take profits in government bonds

N.B. Any decision to go back into European equities is likely to reflect tactical investment opportunities, rather than Europe having resolved its difficulties.

For now, we remain defensive in preparation to change our stance when we believe the time is appropriate.

C. Hoare & Co.  
37 Fleet Street  
London EC4P 4DQ

T: +44 (0) 20 7353 4522  
F: +44 (0) 20 7353 4521

C. Hoare & Co.  
32 Lowndes Street  
London SW1X 9HZ

T: +44 (0) 20 7245 6033  
F: +44 (0) 20 7823 1975

[www.hoaresbank.co.uk](http://www.hoaresbank.co.uk)

For questions about this article, please contact your Portfolio Manager or:

David Crichton ([david.crichton@hoaresbank.co.uk](mailto:david.crichton@hoaresbank.co.uk))  
Head of Economics & Asset Allocation

Richard Garland ([richard.garland@hoaresbank.co.uk](mailto:richard.garland@hoaresbank.co.uk))  
Senior Investment Strategist

Michael Bell ([michael.bell@hoaresbank.co.uk](mailto:michael.bell@hoaresbank.co.uk))  
Investment Strategist

David Cavaye ([david.cavaye@hoaresbank.co.uk](mailto:david.cavaye@hoaresbank.co.uk))  
Chief Investment Officer

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