THOMAS
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INVESTMENT

Quarterly Economic Review

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Investment Strategy Overview

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Real GDP (qoq% saar)

	Q4 2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012	2011	2012
US	2.75	1.90	2.05	2.30	2.50	1.80	2.10
UK	1.00	0.55	0.55	0.55	0.80	0.90	0.60
Euro Zone	0.90	-0.10	-0.10	-0.20	0.20	1.60	-0.20

Unemployment (%)

	Q4 2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012	2011	2012
US	8.70	8.80	8.80	8.70	8.60	9.00	8.70
UK	8.40	8.60	8.70	8.70	8.65	8.00	8.70
Euro Zone	10.30	10.40	10.45	10.50	10.45	10.10	10.50

CPI (yoy %)

	Q4 2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012	2011	2012
US	3.40	2.50	2.10	1.80	2.00	3.20	2.10
UK	4.60	3.30	2.70	2.40	2.05	4.50	2.55
Euro Zone	2.80	2.35	2.00	1.95	1.80	2.70	1.90

Source: Bloomberg (as at 9th January 2012)

The Macroeconomic Backdrop

From a macroeconomic perspective, the last quarter was dominated by two divergent sets of economic reports. On one hand, recent reports on the US economy have shown a steady, albeit modest, uptick in the pace of economic activity; this has calmed investors' fears that another recession was imminent and provided bullish support for equity markets. On the other hand, the combination of the debt crisis and the stream of data pointing to a weakening economic outlook in Europe and the major Emerging Markets continued to undermine investor sentiment.

Focus on the US Economy

In the US, over the past few weeks, the labour market has shown signs of improvement. Data on the housing market have shown a pickup in prices and an increase in sales while consumer confidence has improved from severely depressed levels. Overall, economic releases have on balance exceeded consensus forecasts since the latter part of the second quarter. However, while these improvements are welcome, it is clear that investors have toned down expectations in recent months in response to the slowdown in the pace of growth during the first half of 2011. Besides, comparisons of month-on-month and quarter-on-quarter data benefit from prior soft data which make for easy relative gains. Viewed in absolute terms, the recent stream of more 'upbeat' data remains decidedly lacklustre.

2012 economic outlook: tepid growth with risks to the downside

The tables above present consensus forecasts for several macroeconomic variables.

The trend or direction of consensus forecasts is often more useful than the absolute numbers. For 2012, the direction of consensus estimates indicates expectations of a weak start to the year in the first quarter with progressive improvements in subsequent quarters. Overall, following an estimated 1.8% growth rate of US real GDP in 2011, real GDP is expected to grow by 2.1% in 2012. It is worth highlighting that this estimate is notably below the lower end of the central tendency of projections published by the Fed following its November 2011 meeting. The Fed's projections were for a central tendency range of 2.5%–2.9%. Moreover, in its Economic Outlook published in November 2011, the OECD estimated that the output gap across the OECD area would remain largely unchanged over the period between 2011 and 2013. Over that period, the output gap in the US is expected to narrow marginally from -3.8% to -3.7%. By the end of 2013, the output gaps for the UK and Euro-zone are forecast to have widened by about 42bp (to -4.1%) and 81bp (to -3.4%) respectively. In our view, while consensus forecasts have been revised considerably lower in recent months, the balance of evidence suggests that the risks remain firmly to the downside.

Central bank action

This macroeconomic backdrop is deflationary and we expect to see sharp declines in

headline inflation rates across both the developed markets and the major emerging markets. This will ensure that monetary policy remains particularly accommodative in 2012. In the US, further quantitative easing by the Fed is likely during the course of the year. Likewise, there is a strong case for further quantitative easing by the Bank of England. In the Euro-zone, in addition to cutting interest rates to 1%, following its meeting on December 8th, the ECB provided further support for banks by announcing two three-year repo operations. It also eased collateral requirements and reduced reserve requirements. There is no doubt that all of these steps by the ECB are helpful. The extended repo operations in particular represent significant changes in the ECB's approach to the crisis and have been widely seen as QE by the back door. In China, the PBOC is expected to embark on a policy of monetary loosening. Overall, central bank activity should help mitigate the downside risks in 2012.

"The outlook for the major developed economies remains very uncertain. For now, the consensus view is that the US economy has embarked on another upswing and should avoid a new recession in 2012. In our view, the evidence is not as clear cut and any hints to the contrary will cause a bout of risk aversion in the months ahead."

Financial Markets & Asset Allocation

Equity markets recovered some lost ground in the last quarter of 2011. Over the quarter, the S&P 500 index and the FTSE All-Share index delivered total returns of about 11.82% and 7.65% respectively in USD terms. For the S&P 500 index, that recovery was enough to ensure that the index finished the year up 2.11% (total returns). The FTSE All-Share index lost about 3.38% (total returns) for the year in USD terms. Concerns about the Euro-zone crisis and the implications of tighter monetary policies on economic growth in the Emerging markets ensured that the EuroSTOXX 50 and MSCI EM lost about 16.7% and 18.4% respectively (total returns in USD terms) in 2011.

Notably, despite the sharp rally in equity markets in the last quarter, investors' dual concerns about the Euro-zone crisis and the prospects for the global economy ensured that government bond yields declined in Q4. Yields on 10-year US Treasuries fell from 1.92% at the end of Q3 to 1.88% at the end of Q4. Yields on 10-year UK Gilts declined from 2.43% to 1.98% over the period and yields on 10-year German Bunds fell from 1.89% to 1.83% over the quarter. For the year, 7-10 year US Treasuries and 7-10 year UK Gilts gained about 15.54% and 15.21% respectively. Comparable German Bunds were up about 9% (in USD terms).

From a valuations perspective, it would seem a no-brainer that equities should deliver better returns than government bonds in 2012. However, despite the litany of valuation metrics that support that assertion, there remain significant risks to the economic outlook which could result in highly volatile equity markets this year. This should cause investors to temper their optimism in making judgements on the likely relative risk-adjusted performance of the major asset classes.

In the currency markets, the Euro should remain under pressure for obvious reasons. In light of the anticipated slowdown in economic growth in the Euro-zone and elsewhere (not to mention the existential threat facing the Union), the ECB is likely to remain in dovish mode, putting further downward pressure on the Euro. Likewise, weak economic performance, falling inflation and further quantitative easing by the Bank of England will also put pressure on Sterling.

Concluding comments

The outlook for the major developed economies remains very uncertain. For now, the consensus view is that the US economy has embarked on another upswing and should avoid a new recession in 2012. In our view, the evidence is not as clear cut and any hints to the contrary will cause a bout of risk aversion in the months ahead.

All other things equal even if the US economy was on course for above trend growth in 2012, there is no shortage of candidates for negative shocks to that growth path. Domestically, potential sources of shocks include political uncertainty given the Presidential elections in November and the related fiscal drag as Congress is unlikely to approve any new substantial stimulus programmes. Externally, there is as yet no decisive solution to the fiscal crisis in the Euro-zone, and the Emerging markets still face the challenge of adopting appropriate policy responses to waning economic prospects. These pose clear risks to the global economic and financial market outlook. The bottom line is that this economic backdrop is not consistent with either a sustained rally in risk assets or a protracted rise in yields on government bonds in the US and UK. Consequently, at this point, we continue to maintain a neutral allocation to both equities and bonds relative to respective client benchmarks.

Looking Back, it was not an easy year!

It is a fair assessment to say that many, if not most, investors will be glad to see the back of 2011. While returns were not generally speaking disastrous, investors on the whole will have been disappointed at the way the year developed. Looking back to the start of 2011, the anticipation – and it was a perfectly reasonable anticipation – was that the year would represent the 'expansion' phase of the cycle, where equity investors often make the best of their returns.

James Penn
Senior Portfolio Manager

It did not work out like that, of course, and by mid-year it looked very much as if the cycle was finishing prematurely, with another recession perhaps likely to kick in for developed economies within a mere two years after the last one. This would represent a devastating outcome, given that output for most western countries is still some way below its 2007 peak. In the UK it is still 4% below the peak, and the only two major economies where it has exceeded the previous peak are the US and Germany.

The few investors who will without question have enjoyed the year are government bonds investors, though this comes with a proviso: we mean government bond investors in countries with independent central banks, independent monetary policy, and free floating currencies. Yields have fallen from what looked like depressed levels to even bleaker levels, as modest expectations for economic progress were revised even lower. 'Quality' bond markets received a second kicker, as doubts over the Eurozone meant that several European bond markets were increasingly deemed uninvestable, and funds had to be directed to the increasingly few countries considered safe.

Doubts about the future of the Euro began to arise from June onwards, but grew progressively in July when the second Greek bail-out was announced. What was originally perceived as a problem with a single country began to develop into a full blown continent-wide crisis, and emergency summits started to spill over from one month to the next without any appearance of eventual resolution. The third quarter was thus an exceedingly difficult time for risk assets.

The fourth quarter again proved to be a particularly difficult one for investors, with volatility remaining at a relatively elevated level. The continued failure of European leaders to come up with a credible plan for tackling the burgeoning debt crisis, despite numerous meetings, kept the investment environment extremely tense and uncertain. The risk of contagion within the Eurozone also increased during the quarter, with 10-year rates in Italy breaching the 7% level in early December, whilst 10-year rates in Spain rose to 5.75% in mid-December before falling back to just over 5% by the quarter end. Even French rates came under pressure as concerns that their 'AAA' credit rating might be cut and this caused 10-year rates to rise to 3.14% by the end of the quarter, versus a yield of 2.60% as at the end of September 2011. Rates in other peripheral European markets also came under pressure, with Austria and Belgium also facing increased scrutiny from market participants. This left few countries able to provide the 'safe haven' status desired by investors but included in this increasingly select group were Germany, the UK and the US.

Given the above, and the continued 'safe haven' status awarded to the UK, the Gilt 0 to 5 year Index (total return) rose by 1.25% during the final quarter of 2011, thereby rounding off a full-year gain of 4.70%. The All Maturities Gilt Index (total return), the Gilt 0 to 15 Index (total return) and the Gilt 0 to 5 year Index Linked Index (total return) also rose during the quarter by 5.01%, 2.44% and 1.00% respectively. For the year as a whole, the gains were 15.6%, 9.4% and 2.0% respectively.

On the equity front, major developed markets continued to display high volatility illustrating the uncertain economic environment. However, towards the end of the review period markets gradually began to move higher, thereby erasing some of the dramatic losses seen in previous quarter. The FTSE 100, for example, rose by 8.7% over the quarter on a total return basis, whilst the Standard and Poor's Composite managed a US Dollar return of 11.2% over the same period. European bourses also saw some modest recovery during the quarter, with the German DAX and French CAC-40 indices, for example, rising by 7.2% and 6.0% respectively in Euro terms. However, the Euro remained weak throughout the quarter and so, on a Sterling adjusted basis, the gains were pared back to circa 4.2% and 3% respectively.

Despite the final quarter rebound in equities, for the year as a whole the FTSE-100, the Standard and Poor's Composite, German DAX and French CAC 40 recorded Sterling adjusted total returns of -1.5%; +2.6% ;-17.3% and -15.6% respectively.

In conjunction with this equity rebound, commodities also saw some recovery, with copper and oil rising by 8.5% and 24.8% respectively. Gold, however, bucked the general trend and declined by 3.2%, although it still managed to end the year some 11% higher in US Dollar terms.

“All that Glisters is not Gold”

William Shakespeare, The Merchant of Venice (Act II, scene vii)

Gold is a relatively rare commodity. It is estimated that, since the beginning of civilisation, there has only been approximately 170,000 tones of gold mined. If every single ounce of this gold were placed next to each other, the resulting cube of pure gold would only measure 20 metres in any direction.

David Thomas
Director

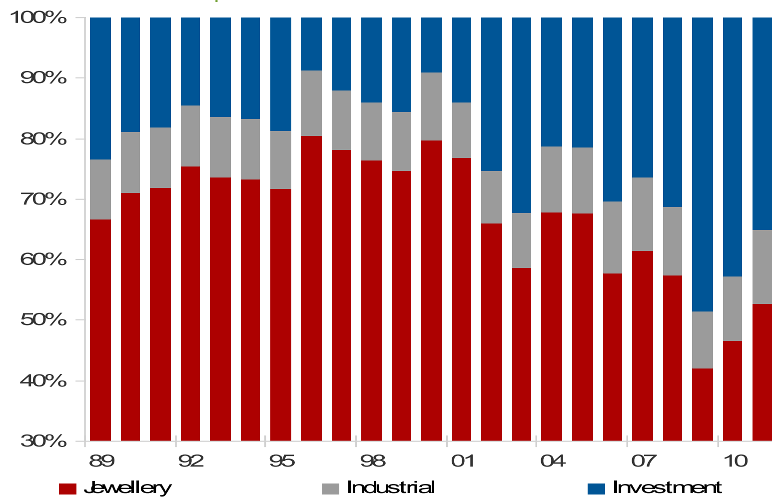
Gold – a few basic facts:

Jewellery remains an important area of demand for gold, with India and China at the forefront of consumption. However, in recent years, investment demand has increased substantially (largely through the growth of gold Exchange Traded Funds), so that jewellery demand in 2011 is now estimated to be around 50% of total production, versus nearer 60% in the 2002/2007 period.

To illustrate this, Table 1 to the right shows the split of demand for gold over the period 1989 to 2011. Please note that net Central Bank purchases are included under the ‘Investment’ category in the table.

Gold mining companies operate on every continent of the globe. Beyond mine production, recycling accounts for around a third of all current supply. In addition, Central Banks can also contribute to supply should they sell part of their gold reserves. It is worth noting that after 18 years of being net sellers collectively, Central Banks are now effectively net buyers, causing not only a significant decrease in supply but a corresponding, simultaneous increase in demand.

Table 1: Split of demand for Gold from 1989 - 2011



Source: AA&MR, GFMS

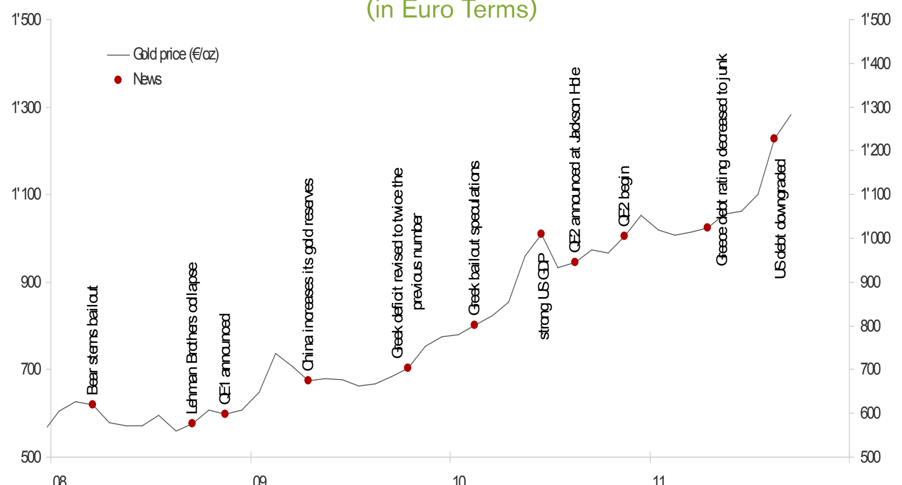
Gold – the ‘bull’ case:

Gold is in the midst of a secular bull market that has been going strong since 2000 and delivered more than a six-fold price increase. The main driver behind the rising gold price has come from investment demand, fuelled largely by:

1. Uncertain economic conditions.
2. Sovereign debt worries – basically an insurance against a financial meltdown.
3. Fears over currency debasement (the Euro is a prime case in point at the moment).
4. Desires to provide an inflation hedge.
5. As a *long term* store of value. It acts as a ‘currency of last resort’.

To illustrate some of the above factors at work, Chart 1 below shows the movement of gold since the financial crisis developed in 2008, highlighted against significant news events. Please note that the price is in Euros but the trend would be similar when equated to the US Dollar or Sterling.

Chart 1: Price movement of gold since the beginning of 2008 (in Euro Terms)



Source: AA&MR, Datastream

Gold – However, there are potential downsides:

The 'bull' case for gold appears strong, but, as with virtually all investment instruments, there are always potential pitfalls and disadvantages to investing in the metal. These include:

1. The costs associated with holding physical gold bullion.
2. The fact that gold provides no income.
3. It is priced in US Dollars and so, for Sterling investors the return may be less (or more, depending on the currency rate) than that achieved by US investors. In other words, there is an inherent currency risk.
4. Gold, in itself, does not have a readily definable value. The real value of gold lies in what it represents, namely a store of value given that it is relatively rare and cannot be easily produced. If interest wanes in gold, then it is difficult to determine an optimum price for the metal.
5. As investment demand increases, so does the potential volatility. If economic conditions stabilise, then the risk of significant selling increases.

Chart 2: Gold price performance in US Dollars
between 31/12/2010 and 31/12/2011

Source: Bloomberg

How is gold positioned currently?

During 2011 Gold rose 11.7% (11.1% US Dollar adjusted). However, the price peaked at $1,900 per oz on 5th September 2011 and has generally been on a downward path ever since, as shown in Chart 2 above.

Interestingly, as the Eurozone crisis has intensified towards the end of the year, gold has responded by retreating, rather than advancing. The reasons for this are not entirely clear, but a number of possible explanations can be put forward:

1. The US Dollar has been preferred as a "safe haven" recently.
2. Investors anticipated the bad news and were lightening positions ahead of the year end.
3. Demand from China and India has begun to decline as their economic conditions have deteriorated.
4. Central Bank buying has slowed.
5. Speculators and hedge funds have had to sell positions to fund margin calls, or losses in other asset classes.
6. Gold is now (possibly temporarily), being seen more as a commodity play. The relationship with Copper and Brent Crude, for example over the last few months is shown in Chart 3 below.

In reality, a number of the above factors may be at work currently, but it is clear that gold may not be solely the 'one way bet' that some commentators think it to be. Even if gold does continue to rise, the gains may now become more modest and the path far more volatile and so, even if investment is considered, careful entry points will need to be chosen to ensure the maximum potential return over the medium term.

Chart 3: Gold versus Copper and Brent Crude
from the 31st August 2011 to 30th Dec 2011

Source: Bloomberg

Conclusion:

Gold, arguably, has a place in portfolios as an insurance policy against economic catastrophe. Exposure to gold can be obtained via a number of different ways including:

1. Physical bullion – held in a safe storage facility. This will incur safe custody charges and pre-supposes no counter-party risk. Access to the physical metal may also be problematical.
2. The purchase via Exchange Traded Funds (ETFs). There are now a number of large and liquid ETFs that concentrate on gold. The best ones actually purchase the physical gold and hold it to order in a depository. This is far more preferable to those ETFs that use derivative instruments, where the counter-party risk is higher. There will be a cost for safe custody but this will be incorporated in the price of the fund. There is still a counter-party risk however, even for the physical gold ETFs.
3. The use of other collective funds, which may invest in gold directly, or via gold mining shares.
4. The purchase of individual mining shares that either are primarily gold producers, or have gold mining operations and facilities.

However, as mentioned earlier, gold has been in a 'bull' market for 11 years and has had a huge run and so is beginning to look somewhat overextended, at least in the short term. From an inflation perspective, whilst the inflationary statistics still look rather high, there is a distinct likelihood that these will begin to fall in 2012, especially as austerity measures and potential recession fears take hold. If inflationary expectations do, therefore, decline, then the inflationary argument for gold also diminishes.

Looking at the Euro crisis, gold could again become a safe haven should pressures intensify into 2012. The longer it takes for some form of acceptable solution to be worked out, the higher the risk that some form of Euro meltdown will occur. However, it is still likely that a solution of sorts will be hammered out in the first few months of 2012 and this could add further modest downside pressure to the gold price. Nevertheless, there are still many 'unknowns' and it will be important to maintain a heightened vigilance in these truly uncertain times.

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