



“ Successful investing is anticipating the anticipations of others. ”
– *John Maynard Keynes*

Interest rates are not expected to rise until 2014 and Europe's problems are not going to be solved quickly, therefore income generation is still the investment theme for the year. As recession takes hold in Europe, I expect Q1 to be challenging with pressure on the ECB and European authorities to act strongly. Recent Italian debt auctions may have completed successfully but a 7% yield remains a prohibitive cost. Ultimately, this will spark the urgency to implement the fiscal measures proposed at the last European summit. For 2012, I forecast a sovereign default within the Eurozone and a ratings downgrade for France but a narrow election victory for Sarkozy. The EURUSD will trade near 1.20, and Gold's recent correction will prove overdone. Emerging Markets will recover in the second half of the year, US GDP growth will hit 3%, and Obama will get re-elected (much to my disappointment).

Santa Claus rally is encouraging but the economy is still the Grinch

Last year was marked by Europe's repeated failure to address its sovereign debt crisis but the final quarter of the year saw stronger growth in the US and improvements in housing, employment and manufacturing. This fuelled an 11% rally in the S&P 500 in Q4 and the liquidity measures put in place by the European Central Bank (ECB) fed further into the impending year-end 'Santa Claus' rally. To think that we are out of the deep hole would be a mistake; inaction on the part of European authorities would dig us deeper. My prevailing sentiments are cautious, but not outrightly bearish. The gain for the S&P 500 in 2011 was a meagre -0.003% (the S&P 500 opened at 1257.64 and closed a year later at 1257.60, with 246 stocks ending the year lower and 254 higher), supplying the second lowest return in history. The flat finish belies the volatility we experienced (+8.9% and -14.6% at the peak and the trough respectively). More importantly while the index went nowhere, the EPS (earnings per share) rose 16% in 2011 to a record 97\$. With the S&P now trading at a multiple of thirteen times, it definitely looks cheap – relative to historic levels.

As debt migrated from the private to the public sector, growth has shrunk and refinancing costs have increased. It's going to be a slow recovery process and austerity alone is not the solution, as uber-austerity prescribers in Europe now realise. Just like eating spinach for breakfast, lunch and dinner is no sensible prescription, a diet of austerity alone is not a cure for excess debt. Any measure that ignores promoting and supporting growth will make things worse and prolong the crisis, and hence the recovery.

For Europe, Q1 is critical: no more quibbling and incompetence is allowed. Apparently, two months after the collapse of Lehman Brothers in 2008, a small group of European leaders set up a secret task force, one so secret, that they dubbed it "the group that doesn't exist." Its mission was to devise a plan to head off a default by a country in the Eurozone. Seriously? A full two years in preparation and given the response so far, maybe they should have called themselves 'the plan that doesn't exist'. I rather wish Ethan Hunt was offered this mission. How bad could he do? Not much worse.

2012 – Pessimist or Pollyanna?

We are about to enter the fourth year of the recovery that started in 2009. The S&P has doubled in this time but the gloom has not gone away. It will be some years before we are back to any semblance of pre-financial crisis normality. Plenty of negative press, bearish comments from strategists and general pessimism abound. It is hard to remain positive, however, this is what I advise. At the risk of sounding like Pollyanna – if we spend too much time looking for negative data, chances are we will miss the positive turn. Investment returns can be made even when the S&P finishes flat – as 2011 bears evidence to. This debt problem is not a natural disaster but a man-made one. It can and will be solved.

As recession takes hold in Europe, I expect Q1 to be challenging, with pressure on the ECB and European authorities to act, strongly. Recent Italian debt auctions may have completed successfully but a 7% yield remains a prohibitive cost. Ultimately, this will spark the urgency to implement the fiscal measures proposed at the last European summit.

As I have written before I do not see a Euro demise in the short term and any exit from the Eurozone will be 'managed' to prevent a disorderly event. Emerging market growth will no doubt be below trend, but not disastrous by any means. To sum it up, Q1 is going to be a challenge but following actions in Europe; Q2, and more so, the second half of this year, will be more positive for risk assets in general and equities in particular.

Just as orphaned Pollyanna, inspired by her father's views, learned to like what she got at the hands of her stern aunt; we have to accept what the conditions are and not wish them away. Pessimism may abound but in it lurks opportunities for an investor who is not a buy-and-hold type.

And now for some forecasts...

Samuel Goldwyn said "Never make forecasts, especially about the future" but everyone loves a forecast! The 2012 year end S&P 500 forecasts range from bearish 1,167 (-7%, Morgan Stanley) to extremely bullish 1,500 (+19%, Deutsche Bank).

As an investment philosophy, I am more 'direction' driven than 'target level' driven i.e. – do not worry about the target level. Identify the direction and buy/sell as long as the rationale for that decision holds and sell/buy as soon as the rationale changes. However, since tis the season for forecasting, here is mine. For reasons outlined in previous sections, I forecast the S&P 500 to finish the year at 1357 i.e. +8% with most of the rally coming in the second half of the year.

A few more predictions to make:

Likely outcome: Sovereign default within the Eurozone; France downgraded but Sarkozy ekes out re-election; EURUSD trades at 1.20; Gold correction proves to be overdone; Oil trades closer to 100\$ than 75\$. Emerging markets recover in the second half of the year, US GDP growth hits 3%, US unemployment falls below 8% and Obama gets re-elected (much to my disappointment). The S&P 500 ends the year above 1350.

Unlikely outcome: Breakup of the Eurozone; financials outperform, EUR trades 1.40, 100bn IPO (as is rumoured) Facebook to trade above its IPO price at the end of the year; Spain to win Euro 2012 and Great Britain to finish third in the medals tally surpassing Russia at the Olympics.

Two points to be mindful of Facebook and tech IPOs in general.

- Skyrocket valuations based on user growth which likely has 'peaked' makes it an expensive buy. The revenue of these businesses is no doubt going to grow as users are monetised but the high valuation which is based on 'peak' user numbers will be the spanner that potential late-round investors should be concerned about.
- Call me a cynic, but aren't tech IPO valuations today nothing more than a liquidity event for early round investors with little left on the table for the rest of us?

Social media is here to stay and I find Twitter very useful in following market developments. I just disagree with sky high valuations. Long existing companies such as Amazon and Google, at much lower multiples, offer better risk adjusted returns.

More specifically...

Interest rates are going to be near zero for some time: Europe's problems are not going to be solved quickly, and therefore income generation is still the theme for the year. Like last year, income structured products will continue to do well as volatility remains elevated. We saw 10-15% returns on some of the US equity indexed income products we launched even though the S&P 500 index finished flat. I expect this year to be more of the same.

For a long term investor and investor seeking capital gains however, stock picking remains the best bet.

Gold: If you are as strong a believer in central banks printing money, as the only way to inflate the debt away, as I am, then Gold is still your bet. A 10% gain on gold in 2011 was a good start and a fall from \$1900 to \$1600 should be seen as a second opportunity for this trade. Yet, printing money and the effects of inflation are not short term factors by any means, so a quick turn around on this investment is not what the Gold trade is about.

Equities: In Equities I still prefer the US to the rest of world. Let me share with you an interesting statistic from BIG Research. If you were to plot the relative strength chart of the S&P 500 versus the MSCI world (ex US) for 1995 to 2011, an interesting pattern emerges. For the first seven years, the US outperformed, then from 2002 until 2008, the US underperformed. The upswing in the US performance since 2008 has further strengthened in 2010 and 2011 and it may be that we see a few years of US outperformance again, should this pattern continue.

Continued weakness of Emerging Markets (EM) and a nearly 20% decline in EM equities in 2011 means that valuations have become attractive again. However in the near term, macro issues in Europe will continue to have an impact; as funding concerns add to growth concerns. The rate easing cycle should help, but EM is probably a long play for Q2 and H2 more than Q1.

Currencies: The deleveraging stress and flow into JPY is likely to continue; positive USD and JPY and bearish EUR will be the order for Q1; a dovish ECB and likely money printing will keep the EUR from appreciating. EM currencies will remain weak especially INR which has major challenges ahead.

Oil: Excess supply of Oil should keep prices in check, although a spike from unexpected events in Iran is the risk to the upside.

Bonds are the traditional home of an income/yield investor but over last two years it has been flooded by 'safety investors' as they seek a safe haven to park their cash. There is no immediate fear of an exit from this 'safe haven' status, but it is important to bear in mind that with every basis point decrease in the yield, the risk for a bond investor rises. Of course for an investor seeking yield alone and following a buy and hold strategy, the price movement is just a noise.

Government Bonds: Eurozone government bonds are the least preferred both for macro reasons and impending rating agency action. German Bunds look expensive too, as greater involvement of the German balance sheet in any European solution raises the risk of rewards not in line with the risks undertaken. US Treasury 10y yields should stay below 2% and UK Gilts will continue to provide good yield and capital gains.

Corporate Bonds: A low growth, low rate environment favours corporate bonds. US investment grade corporate credit will provide the yield with little risk of sell off.

Best wishes



Manish Singh, CFA

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