

Global Investment Outlook

The monthly investment outlook from Aberdeen's multi-asset team

January 2012

Executive Summary

No resolution yet for the euro's woes

- Markets likely to be range bound but volatile, absent further shocks
- Whilst global central bank policy provides a cushion to markets, political risk remains elevated
- Risk assets could move higher on decisive ECB action, lower on any euro debilitation

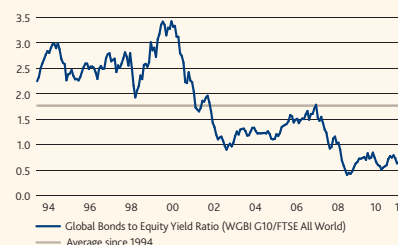
Despite much trumpeting of a breakthrough at the latest European gathering in December, in reality there was no new, comprehensive solution to the euro-zone crisis. Rhetoric was not backed up with meaningful action, with neither the support nor impetus required for the European Central Bank to begin to monetise debt. Whilst markets are somewhat calmer, to wit the rally in some peripheral European yields, we remain concerned that measures to address the crisis are half-hearted and continue to fall far short of solving the fundamental problems of competitiveness and disjointed fiscal policy.

Investors are still acutely aware that they are, quite deliberately, not being rewarded for holding cash, with central banks holding official short term rates at historically low levels. The ECB has now reversed its interest rate hikes of earlier in the year, returning to the all-time low level in place since mid-2009. The US Federal Reserve continues to signal rates staying on hold through to the middle of 2013, adding further unconventional liquidity through Operation Twist. The Bank of England is in no hurry to start raising base rates, having recently increased the size of its asset purchases. Other central banks have provided further liquidity provision, as worries spread over disappointing growth and risks of recession rise. All this should provide a cushion to markets, particularly with current valuations.

Yet, significant risks remain. If European politicians and monetary authorities can get their collective acts together and deliver an extensive package, then risk markets should rally. However we continue to believe this will not happen without another dramatic stage to the crisis. Markets could move sharply lower on a worsening outlook for the single currency. This could force the ECB's hand and be the trigger for far-reaching and ultimately positive action, but the intervening period would be one of potential discomfort and dislocation.

The S&P 500 is in the upper half of our range of 1,100-1,300 expected through 2012. Positive sentiment might stretch this to 1,350 on the upside, whilst bad news from Europe may push this down towards 1,000. Political risk remains a dominant and as yet unresolved theme, and has the potential to move markets significantly in either direction.

Valuations are supportive of equities



Source: Thomson Reuters Datastream, Jan 12

Concerns remain over euro-zone debt



Source: Thomson Reuters Datastream, Jan 12

Key forecasts	US	Japan	Euro-zone	UK	China	Global
GDP rolling 12m						
forecast	2.6	1.5	-0.1	0.2	8.4	2.3
Consensus	2.1	2.0	-0.1	0.7	8.4	2.2
CPI rolling 12m						
forecast ^A	2.1	0.3	0.8	3.2	3.5	1.7
Consensus	2.1	-0.2	1.8	3.2	3.5	2.0
Current Base Rates						
Monetary Policy (3m)	0.25	0.10	0.50	0.50	6.56 ^B	-
Monetary Policy (12m)	0.25	0.10	0.50	0.50	6.56 ^B	-

^A headline rate ^B PBOC 1 year Yuan Lending Rate
Source: Aberdeen Asset Managers Ltd, Jan 12

Economic and monetary policy outlook

Policy makers globally face the challenge of supporting growth whilst managing debt levels, and still remaining aware of inflation. The euro-zone crisis is a further complication to authorities, and has the potential to make matters even more difficult. That being said, there is still growth in the world economy, though perhaps more disparate than in previous cycles. Given the inter-connected nature of countries in the globalised world, there are few areas truly insulated from turmoil. However, there are safer-havens where clearer policy frameworks and the ability to enact solutions more robustly are helpful. Likewise, countries somewhat removed from the euro-zone and with better fiscal starting points may be able to withstand external pressures better. However, it is important to stress once more that nowhere is immune given albeit varying degrees of correlation across the globe. Volatility is likely to remain a feature as we move into 2012.

US

Whilst there are some positive signs in the US economy, risks remain. Although the level is still too high for policymakers, unemployment has nonetheless fallen to a two and a half year low of 8.6%. Business activity, as measured by the Chicago Fed Index, expanded at the fastest pace in seven months in November. It is important to note that recoveries are not driven by sentiment alone, and any pick up in diffusion indices would need to be followed through by improvements in underlying activity. Retailers reported the highest sales on record for the post-Thanksgiving shopping period, though it is uncertain how much of this was merely pent-up demand released by price competition. Overall, economic clouds remain. The housing market is still a concern, government has issues to resolve and will need to address expenditure at some point, employment is not growing fast enough and, for the Federal Reserve at least, there is not enough inflation. The Fed has been explicit in stating official rates will stay at their current, historically low levels into 2013 and might extend this period at their next meeting. Whilst there is growth, which is encouraging, it remains muted and is vulnerable, though perhaps less so than elsewhere, to any dislocations overseas.

Europe

The key question for the euro-zone is one of political will, just as the creation and subsequent expansion of the euro was. The first officially recorded mention of a single European currency was at the League of Nations on the 9th September 1929, when the German foreign minister Gustav Stresemann asked "Where are the European currency and the European stamp that we need?" Given that long gestation, it is unlikely that the European political elite are ready to ditch it at the first sign of trouble. However the challenge in convincing a diverse range of now sceptical voters of the benefit of the euro remains, and is a key reason why there has yet to be a solution to the short-term crisis in markets. A lasting solution for the euro's woes would be some form of fiscal integration, addressing the fundamental, structural challenges ignored at the inception of the currency. The timescale for that to take effect may be beyond that of many investors' patience. With such a diverging timeline, and political risk remaining a dominant and as yet unresolved theme, there is the potential for significant, further volatility into 2012.

UK

Britain is of course exposed to the euro-zone, which accounts for some 40% of its exports. Given the structure of the UK economy this translates into a still significant, but less overwhelming, 8% of GDP. However, whilst these external risks remain, they are not the overriding area of concern. The domestic headwinds are already significant without any further potential negative impact from Europe. The recovery has been hampered by disappointing consumption. Whilst there has, understandably, been much focus on retail activity over the Christmas period, the longer-term picture is not positive. Household incomes remain under pressure and credit conditions are not easing. The Bank of England's annual survey of households reported that household income had fallen, continuing the trend of the last four years. Around half had been affected by the fiscal consolidation, mainly through lower income and higher taxes. A higher proportion expected a negative impact on their situation in the future - showing the risks that may lie ahead.

There are a few areas truly insulated from turmoil

Recoveries are not driven by sentiment alone

The key question for the eurozone is one of political will

Domestic headwinds are already significant

Japan

Policy stimulus in Japan remains supportive for growth and should be further bolstered by high levels of consumption as labour income remains healthy. Disinflation is therefore likely to ease and 'good' inflation would be a welcome visitor to Japanese shores.

Looking further ahead though, the debt dynamics in Japan remain very poor as the population continues to age, leaving an increasingly small working population to fund those in retirement. However, the domestic nature of the bond market will likely support Japanese government bonds for some time to come.

It is also possible that the current strength of the yen will result in further intervention from Japanese policymakers.

Asia and emerging economies

Much has been made of Asia's apparently resilient growth. However, emerging markets are not isolated and remain exposed to global trade, as well as changes in European capital flows. Faced with rising risks, central banks in Brazil, Indonesia, Thailand, and Australia have cut benchmark interest rates as growth slows. China's central bank has cut reserve requirements. India faces a slowdown in investment, but with a weakening rupee boosting inflation will make it harder for the Reserve Bank to cut rates. However, given the different starting point compared to the developed world, central banks across Asia and emerging markets do have greater potential for further policy easing as inflation begins to slow. Whilst a sustained recovery in the US would be welcome news for emerging market economies, Asia's saving grace is likely to be the relative health of public, corporate, and personal balance sheets. This in turn should leave room for future fiscal stimulus should it be required, providing a further support for growth.

Equities

Whilst there is plenty to concern us with regards to structural, economic and political issues, it should be noted with a certain amount of optimism that the corporate sector, in general, remains in a strong financial position with robust balance sheets and record margins in some sectors. After years of cutting costs and generally not investing heavily in capital expenditures, company margins have, on the whole, risen to lofty levels, allowing operational leverage to kick in and propel earnings and profitability levels upwards. Alas, here too we have some concerns, not that we disagree with the margins or earnings that are occurring but more the sustainability of profits at these levels. If the costs of raw materials that companies use to produce goods are rising, then in order to maintain record margins, companies will have to either cut costs or increase prices.

Companies exposed to emerging markets are likely to see good growth, which hopefully should be reflected in positive company earnings. Valuations are not as stretched in these economies and we think, through our bottom-up approach to investment, there will be opportunities here to produce positive returns within a diversified global equity portfolio.

With interest rates at a 50-year low and savings income plummeting, many savers need to look beyond cash deposits to generate the income they require. We believe there are opportunities to earn an attractive income from equity investment in global equity markets, particularly in places like Europe, Asia and Latin America. Many companies are now focusing on using their earnings to return value to their shareholders and we believe this will continue in the future. From a diversified portfolio of high quality companies, we believe it is possible to achieve a steady income stream, even in difficult markets.

Bonds & currencies

The European balance of payments crisis is set to continue this year, with peripheral euro-zone members having to refinance large amounts of debt - Italy alone has to roll over €400 billion in 2012. The yields they will have to pay are seemingly at the whim of policy makers at the ECB and various political institutions.

Policy stimulus in Japan remains supportive for growth

Asia and emerging markets do have greater potential for further policy easing

The corporate sector, in general, remains in a strong financial position

The volume of euro-zone debt refinancing in 2012 is significant

Debt mutualisation is what markets are looking for from policy makers, as in aggregate the euro-zone fiscal position is not disastrous. This could include action by the European Financial Stability Facility in the form of loans to governments or bond purchases in the secondary market, or effective mutualisation by the ECB.

Significant obstacles to broader debt mutualisation and fiscal union are present, primarily the German constitutional limit on guarantees (around €200bn) and the European Treaty with respect to debt monetisation by the ECB. Similarly, moral hazard is playing a major role, and has underpinned most of the German response so far. Certainly it is behind the attempt to strengthen the Maastricht criteria at the December summit – an unworkable pro-cyclical policy – and the reluctance of the ECB to increase purchases. It is in essence a game of political arbitrage: currently the political cost of bailing out supposedly “profligate” southern Europeans is greater than the cost of failing to solve the crisis for German politicians, and even if the politicians fully understood what is in Germany’s best interest, explaining to the voter is a major challenge. This suggests it has to get “worse before better”.

The market is seemingly relying on the ECB to purchase peripheral bonds as the short term resolution, preferably without sterilisation. Once the ECB rate hits the zero bound, policy will have to become more creative in the face of likely recession, deflationary fears and a shrinking money supply. Quantitative easing is possible, which would have dual benefits of allowing purchases of government bonds and hopefully higher inflation and wage increases in the core to re-balance intra-EMU competitiveness to rebalance. The Germans would have to accept that this is necessary for the euro to hold together, and consequently is for their own benefit. This also requires “worse before better”.

A growing number of commentators are warning about the prospect of defaults this year, and a risk that the euro itself could break up. While a break up is certainly not our main scenario, this is a not insignificant risk. Consequently, ‘safe haven’ bonds like gilts, Treasuries, and bunds continue to be well bid, pricing participants’ expectations of further capital gains rather than reasonable yield levels. We consider both gilts and Treasuries to be grossly overvalued and vulnerable to an unwinding of risk aversion and therefore yields are likely to rise from current levels over the medium term. Moreover, while the UK’s coalition government has built up enough credibility with the market to keep the bond vigilantes happy for now, this could change should disappointing growth make fiscal targets harder to meet. Bunds could also suffer from a rapid deterioration in Germany’s fiscal position should concrete steps be taken towards debt mutualisation and fiscal transfer – a true fiscal union unlike that envisaged at the December summit.

A weaker euro is fairly essential for the euro-zone as a whole to regain competitiveness, and certainly the currency faces numerous headwinds. However, the market has built up short positions and bearish sentiment to the extent that we feel it is more appropriate to look to oppose the consensus at extremes.

In the credit markets, underneath all the macro uncertainty, for now, corporate fundamentals remain strong and credit offers attractive returns. But, as with all risk assets, it risks being overwhelmed by macro developments. Similarly, emerging market debt continues to be volatile. The surprise injection of cheaper dollar liquidity by six major central banks prompted a healthy rally, with local currency debt the notable outperformer. With the market’s focus remaining on the euro-zone, and with no resolution in sight, risk assets will continue to be choppy. However, the fundamental health of most emerging markets, and our view that Chinese growth will be sustained, means that Asian currencies and bond markets should remain supported.

We are wary of over bullish arguments for commodities

Commodities

2011 was broadly a year of two parts for commodities. Prices continued to rise during the first four months but then gave way to weakness since May. Over the year as a whole only gold and oil strengthened significantly and even then they both ended off their 12 month highs.

While proponents of the commodity super cycle will argue that 2011 is merely a blip, it is perhaps more in accordance with the historic commodity rollercoaster. With problems in the euro-zone and weak demand in the US likely to remain into 2012, we see little reason to be bullish. Demand from China and other emerging markets will offer a degree of support but an overall sluggish global economy will mean continued downward pressure on prices.

Real Estate

Concerns regarding Europe's economic outlook mean investors need to be increasingly selective when investing in property across the region. Business sentiment is weakening and the outlook for growth into 2012 is subdued as economic growth slows and widespread cuts in government spending take effect. For some time now, we have viewed European office markets as overpriced, and we would advocate the removal of as much of the asset related risk as possible for office investments. There are better opportunities in retail property, with its defensive qualities, and industrial property, which offers income. Over the short-term capital values are likely to dip most significantly within secondary property. Meanwhile prime, well leased assets are most likely to outperform as investors continue to focus on quality. For the more courageous investor the turbulence surrounding the euro and substantial retrenchment by lenders is starting to create opportunities to buy high quality core assets at substantial discounts to current valuations in Ireland and Spain in particular. For the majority of investors that risk may still be a step too far.

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