

Schroders Outlook



2012: A year in global equities

Virginie Maisonneuve, Head of Global & International Equities, looks ahead into 2012



It has been a momentous year for the world economy with events moving at a remarkable pace. Fragmentations in the world order have emerged along social and economic fault lines, and the economic and political landscape looks markedly different from this time last year. At the same time, the long-term trends that are shaping the global economy are as important as ever heading into 2012. In Chinese 'Wei Ji' means both challenge and opportunity. 2012 will most likely be a 'Wei Ji' year!

- 2011 was the year when the European 'party' ended; whatever the outcome of the most immediate crisis facing the region, there is likely to be fundamental change
- Global markets will continue to adjust to the 'new normal' where global growth is shaped by deleveraging in many parts of the developed world and the impact of emerging market growth
- The US election cycle in 2012 and the ability of China to manage its slowdown in growth will also be key to the global economy.

2011: a year of sovereign weakness

2011 was the year when the European 'party' ended. The problems created by having a monetary union without a fiscal union, compounded by strong structural divergence in the region, have unravelled. What was hoped to be an isolated problem in Europe's 'periphery' has spread to engulf the entire region in a crisis that threatens the Eurozone's very existence – in its current form at least.

The burden of sovereign debt has not been confined to Europe. In July, political gridlock about raising the US debt ceiling almost forced the world's largest economy into a technical default and prompted S&P to strip the country of its coveted AAA rating. Although a deal was struck in time, the difficulty for politicians to lead in such an environment on both sides of the Atlantic triggered a damaging crisis of confidence in the fragile markets.

This crisis of confidence has developed despite the fact that, as we move into 2012, the corporate world is in relatively good shape. Balance sheets are generally healthy among the large companies and cash flows are strong. Unlike in 2008, 2011 has very much been a year of sovereign weakness, not corporate weakness. However, because of the leadership problems on the global stage and with markets pricing in a weak economic scenario, companies are reluctant to increase spending and start hiring. With companies postponing business decisions, the risk of a recession in Europe next year increases.

Adjusting to the 'new normal'

One of the underlying causes of the crisis of confidence has been a reduction in global growth expectations. Tighter fiscal policies in the developed world are being employed to help deal with excessive debt and facilitate deleveraging. This is very much in line with the 'new normal' environment, in which developed world growth is muted and emerging market growth is robust. This theme ('Supercycle') continued to influence the global operating environment this year and, along with our other two key themes of climate change and demographics, will be just as instrumental next year.



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Looking into 2012, we believe volatility will remain going into the first quarter of next year as the markets gauge the resilience of the European and global financial system, and how it will cope with potential additional shocks. There will be three main causes for the continuing volatility: first, the future of Europe; second, the US elections; and third, the nature and effect of the slowdown in Chinese growth.

A new age for Europe?

Clearly, what happens in Europe will be key. The inefficiency of the political structures and implementation tools at the leaders' disposal, as evidenced by several attempts by the EU to promote bail-out packages, makes visibility extremely poor. Nevertheless, it is time for Europe to 'find its way' and deal with the economic consequences of unclear leadership.

Whatever the outcome of the most immediate crisis facing the region, there is likely to be fundamental change, and possibly a new age for Europe. In Italy, at the time of writing as the new government under Mario Monti is established, the yield on the government's 10 year notes is fluctuating around the critical 7% mark. If the situation in Italy deteriorates further, given its size it will be a very strong test of the willingness and ability of EU nations to remain united and moving – or not – towards a more integrated fiscal and political union. This will be the true test of the 'faith' that Europe has in itself.

We cautiously expect Europe to carve a new path for itself: our assumption is that it will be a continuous effort and that it will take time. We believe at this point that core-Europe has more interest in keeping the shape of Europe close to what it is today, although we do not exclude the possibility of a 'two-gear' Europe. At this stage, though, there are no easy options.

In any case, the path Europe takes will be paved with the consequences of deleveraging banks' balance sheets and slow, if any, economic growth. This deleveraging will limit the ability for many corporations to access capital, especially for small and medium sized companies. While many European corporations are cash rich, the medium-term impact could lead to additional economic retrenchment if it persists. As banks delever in response to regulatory pressures to bolster their capital positions, this task becomes all the more difficult.

Ultimately, a European solution should include quantitative easing, which might in turn invite a third round of quantitative easing in the USA and add to currency weakness in key developed markets versus a benchmark like gold. If inflation remains tame, this is not a bad environment to 'debase' one's debt and 'invite' a revaluation of some key emerging market currencies.

Political gridlock in the US

While US elections are generally entertaining, the split between Democrats and Republicans (by which we mean the Tea Party movement) has rarely been so sharp. This, in the run up to the November 2012 presidential election, could create a political gridlock and bring further volatility to the market. We can expect to see discussions about the size of the budget deficit intensify as the election season gets going in full. The economic environment in the US, after a strong adjustment since the 2008 financial crisis, is faring better than in Europe, with growing competitiveness and unemployment plateauing. While consumer demand remains sluggish, inflationary pressures abating are marginally helping.

China: when to turn the tap back on?

Looking outside Europe, with global growth increasingly relying on emerging market momentum, China's ability to manage its slowdown at a time of political transition will be as important for the wider global economy next year as ever.

The pace of growth in China has slowed, but not rapidly. While we are cautious about the short term, we do not think its economy will suffer a 'hard landing'. The overall slowdown comes in response to the recent sustained tightening measures that the government has used to cool the politically-sensitive rate of inflation. Inflation has now started to fall which should clear the way for carefully targeted easing – especially in the areas of lending to small and medium sized companies as they have suffered the most from the tightening measures.



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Virginie joined Schroders in 2004 as Head of EAFE and became Head of the Global and International Equities Team in 2007. For the last few years, including in 2011, she has been selected as one of the 100 most influential women in the European capital markets (Financial News). She began her career as a Consultant with the French Ministry of Foreign Affairs in China. Her investment career commenced in 1987 at Martin Currie in Scotland where she managed Continental European equity funds. In 1990 she joined Batterymarch Financial Management in Boston as a portfolio manager for EAFE and Asia funds. She moved to State Street Research and Management in San Francisco in 1996 where she managed Asian equities. In 1998 she joined Clay Finlay in New York where she became Co-CIO and was a Director and a member of the Executive Committee and Investment Policy Committee Meeting. Virginie is a CFA charterholder and holds an MBA from the Ecole Supérieure Libre des Sciences Commerciales Appliquées (ESLSCA). She also has an MA in Mandarin Chinese, Dauphine University, Paris, France. BA in Political Economy, People's University (ren da), Beijing, China.

Although the tightening has cooled down part of the economy, it has not had a significant impact on property prices which have skyrocketed since the January 2009 stimulus plan. This has led to strong discontent among many in the country. Furthermore, small and medium sized companies are feeling the crunch of the tightening policies. Finally, with Europe as its largest trading partner, China is concerned about the potential impact of the European crisis. With a new leadership team coming in 2013, the current government has the delicate task of fine tuning the shift away from tightening policies but not re-igniting property price increases.

In the developed world, by comparison, the tension between the need to promote growth and the pressure to reduce debt, both at a sovereign level and a corporate level, will intensify. For example, in Europe, which is in danger of edging back into recession, the need for growth is clearly urgent but somewhat in contradiction with the spirit of the current European bailout package targeting fiscal austerity.

Bright spots will emerge

Over the last few months, fear has gripped the markets, as evidenced by a strong switch into low beta stocks in September. Given the headwinds and uncertainties facing the global economy, the volatility in the global equity markets will continue. But amid the challenges, there are important bright spots that we expect to emerge in 2012.

We see many exciting opportunities for investors in global equities next year. Stocks are currently under-owned and attractively valued. Furthermore, market volatility will create a stock-picker's environment: investors with a medium to long-term focus will be able to find quality companies at very cheap prices.

Japan is now coming back 'on line' as it recovers from the devastating earthquake and tsunami in March this year. This will be a boost to global GDP in itself, but equally importantly, it will ease the global supply chain – the disruption of which has been a significant dent to US GDP.

The environment of slower growth over the next 12 to 18 months should also bode well for inflationary pressures overall. It will ease political pressures in countries, especially in emerging markets, that had to maintain tight monetary policies over the past 12 months. This should support our Supercycle theme.

Long-term trends are more important than ever

One trend we see developing that will create investment opportunities is in the area of global competitiveness. Some of our work is showing that the US is becoming increasingly competitive: large US corporations have emerged from the financial crisis leaner, more productive and globally competitive, with some US multinationals increasing production in the US.

Given the pace with which macro events are moving currently, and in a world where social and economic fragmentation is high, having a long-term focus becomes all the more important to ride out the short-term market fluctuations and take advantage of them.

In our global and international equity portfolios, we maintain our focus on high-quality growth companies, with visible and sustainable earnings, sound balance sheets and business models, as well as strong management teams. We continue to pursue companies which, irrespective of the short-term market uncertainties discussed above, are benefiting from longer-term global trends and show strong global competitiveness. These include companies benefiting from the mitigation of climate change, growth in emerging market demand and demographic trends. These trends will continue to shape the global economy throughout 2012.

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