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ASSET MANAGEMENT (C.I.) LIMITED

## Investment Memorandum

International equity markets have staged a partial recovery in the fourth quarter and, given the extraordinary economic and financial conditions of 2011, the overall performance for the year, although negative, has been quite resilient. The divergence of performance in sovereign bond markets has reflected the countries' underlying fundamentals and an artificial situation prevails in bond markets. Currency movements were generally unremarkable in the final quarter. Gold was relatively subdued whilst the oil price, as measured by Brent crude, fell slightly.

The tables below detail relevant movements in markets:

### International Equities 30.09.11 - 30.12.11

| Total Return Performances (%) | | | | |
|---|---|---|---|---|
| **Country** | **Local Currency** | **£** | **US$** | **€** |
| Australia | +1.9 | +7.8 | +7.5 | +11.1 |
| Finland | +1.8 | -1.3 | -1.5 | +1.8 |
| France | +5.8 | +2.6 | +2.3 | +5.8 |
| Germany | +7.4 | +4.1 | +3.9 | +7.4 |
| Hong Kong, China | +5.4 | +5.9 | +5.6 | +9.2 |
| Italy | +4.4 | +1.2 | +1.0 | +4.4 |
| Japan | -4.0 | -3.6 | -3.8 | -0.6 |
| Netherlands | +10.5 | +7.2 | +6.9 | +10.5 |
| Spain | +1.9 | -1.2 | -1.4 | +1.9 |
| Switzerland | +7.1 | +4.3 | +4.0 | +7.5 |
| UK | +9.3 | +9.3 | +9.0 | +12.7 |
| USA | +11.6 | +11.9 | +11.6 | +15.4 |
| Europe ex UK | +6.2 | +3.3 | +3.0 | +6.5 |
| Asia Pacific ex Japan | +2.7 | +5.6 | +5.3 | +8.9 |
| Asia Pacific | -0.4 | +1.3 | +1.1 | +4.5 |
| Latin America | +9.5 | +9.4 | +9.1 | +12.8 |
| All World All Emerging | +5.1 | +4.2 | +3.9 | +7.4 |
| The World | +7.6 | +7.7 | +7.4 | +11.0 |

*Source* FTSE World Indices

FT Government Securities Index All Stocks (total return): +5.1%

### International Bonds - Benchmark Ten Year Government Bond Yields (%)

| Currency | 30.09.11 | 30.12.11 |
|---|---|---|
| Sterling | 2.42 | 1.98 |
| US Dollar | 1.93 | 1.88 |
| Yen | 1.03 | 0.98 |
| Germany (Euro) | 1.89 | 1.83 |

### Sterling's performance during the quarter ending 30.12.11 (%)

| Currency | Quarter Ending 30.12.11 |
|---|---|
| US Dollar | -0.9 |
| Canadian Dollar | -3.1 |
| Yen | -1.1 |
| Euro | +2.9 |
| Swiss Franc | +2.9 |
| Australian dollar | -6.0 |

### Other currency movements during the quarter ending 30.12.11 (%)

| Currency | Quarter Ending 30.12.11 |
|---|---|
| US Dollar/Canadian Dollar | -2.2 |
| US Dollar/Yen | -0.2 |
| US Dollar/Euro | +3.8 |
| Swiss Franc/Euro | N/C |
| Euro/Yen | -3.8 |

### Significant Commodities (US dollar terms) 30.09.11 - 30.12.11 (%)

| Currency | Quarter Ending 30.12.11 |
|---|---|
| Oil | +4.5 |
| Gold | -4.3 |

## Performance During 2011

### International Equities 31.12.10 - 30.12.11

| Total Return Performances (%) | | | | |
|---|---|---|---|---|
| **Country** | **Local Currency** | **£** | **US$** | **€** |
| Australia | -10.8 | -10.1 | -10.8 | -7.8 |
| Finland | -29.2 | -31.0 | -31.5 | -29.2 |
| France | -12.3 | -14.5 | -15.2 | -12.3 |
| Germany | -15.3 | -17.4 | -18.0 | -15.3 |
| Hong Kong, China | -17.4 | -16.7 | -17.4 | -14.6 |
| Italy | -20.3 | -22.3 | -22.9 | -20.3 |
| Japan | -18.0 | -12.9 | -13.5 | -10.7 |
| Netherlands | -14.7 | -16.9 | -17.5 | -14.7 |
| Spain | -7.3 | -9.6 | -10.3 | -7.3 |
| Switzerland | -6.1 | -5.7 | -6.3 | -3.2 |
| UK | -2.3 | -2.3 | -3.0 | +0.3 |
| USA | +1.7 | +2.5 | +1.7 | +5.1 |
| Europe ex UK | -12.7 | -14.7 | -15.3 | -12.5 |
| Asia Pacific ex Japan | -12.8 | -12.9 | -13.6 | -10.7 |
| Asia Pacific | -15.2 | -13.0 | -13.7 | -10.8 |
| Latin America | -9.6 | -18.4 | -19.0 | -16.3 |
| All World All Emerging | -12.1 | -18.4 | -19.0 | -16.2 |
| The World | -5.7 | -5.8 | -6.5 | -3.4 |

*Source* FTSE World Indices

FT Government Securities Index All Stocks (total return): +15.6%

### International Bonds - Benchmark Ten Year Government Bond Yields (%)

| Currency | 31.12.10 | 30.12.11 |
|---|---|---|
| Sterling | 3.40 | 1.98 |
| US Dollar | 3.29 | 1.88 |
| Yen | 1.12 | 0.98 |
| Germany (Euro) | 2.96 | 1.83 |

### Sterling's performance during the year ending 30.12.11 (%)

| Currency | Year Ending 30.12.11 |
|---|---|
| US Dollar | -0.5 |
| Canadian Dollar | +1.7 |
| Yen | -5.7 |
| Euro | +2.8 |
| Swiss Franc | N/C |
| Australian Dollar | -0.8 |

### Other currency movements during the year ending 30.12.11 (%)

| Currency | Year Ending 30.12.11 |
|---|---|
| US Dollar/Canadian Dollar | +2.2 |
| US Dollar/Yen | -5.2 |
| US Dollar/Euro | +3.1 |
| Swiss Franc/Euro | +2.6 |
| Euro/Yen | -8.1 |

### Significant Commodities (US dollar terms) 31.12.10 - 30.12.11 (%)

| Significant Commodities | Year Ending 30.12.11 |
|---|---|
| Oil | +13.3 |
| Gold | +9.0 |

### Markets

International equity markets recovered some of their poise in the final quarter of 2011 following a very poor third quarter. In total return and in local currency terms, the FTSE World Index gained 7.6%, in sterling terms 7.7%, in US dollar terms 7.4% and in euro terms 11.0%. The stand out market was the USA where the FTSE USA Index returned 11.6% in local currency terms. The UK also performed well with the FTSE UK index returning 9.3%. Latin America showed a good recovery with the FTSE Latin American index returning 9.5% in local currency terms. There was a slightly below average performance from the FTSE Europe ex UK Index which returned 6.2% in local currency terms. Within this area, the Netherlands was a particularly good performer, with the local FTSE index returning 10.5%. On the other hand, Finland and Spain underperformed, with returns of 1.8% and 1.9% respectively. In local currency terms, the FTSE Australia index also underperformed, returning 1.9%. Japan was the most disappointing market, with the FTSE Japanese index returning -4.0% in local currency terms. In sterling terms, there are only modest differences except in Australia where a strong Australian dollar propelled the sterling return on the FTSE Australia index to 7.8%, slightly above the return on the FTSE World Index in sterling adjusted terms. The FTSE USA index's sterling adjusted return was a very good 11.9%, reflecting the marginal increase in value of the US dollar against sterling. With the euro and Swiss Franc weakening against sterling, the return on the FTSE Europe ex UK index in sterling adjusted terms fell to 3.3%.

Bond markets have put in extraordinary performances. Whilst some of the bond performances of eurozone countries, measured in terms of the ten year benchmark government bond yield, have been bad to disastrous over the last quarter (countries like Greece, Portugal, Italy, Belgium, Ireland and France, for example), other countries which are regarded as a safe haven, either because they are considered financially more robust or because they can print their own money and are therefore less likely to default, have performed well. Our table above detailing the ten year government bond yields of the UK, USA, Japan and Germany, shows, except in the case of Japan, scarcely credible levels of yield. We will be discussing this phenomenon later on in this review.

In the currency markets, moves were not as substantial as we have witnessed earlier in the year. The woes of the eurozone have weighed on the euro whilst the weakness of the Swiss franc is a function of the Swiss Central Bank's decision to peg the currency to the euro through heavy market intervention following extraordinary flows of money into the Swiss Franc in 2011 which posed a threat to many Swiss companies. The feature of this table was the strength of the Australian dollar against which sterling fell by 6.0%.

In the commodity markets, oil rose by 4.5% as weakness in parts of the world economy failed to dent its price, whilst gold encountered a sell off at the end of the quarter, perhaps as investors sought some liquidity.

Despite everything which has been thrown at markets during the year, international equity markets, although modestly lower, have performed creditably, testament, we think, to the underlying attraction of this asset class even in these extraordinary times. Looking back at the performance in total return terms in 2011 of the FTSE World Index, the return was -5.7% in local currency terms, -5.8% in sterling terms, -6.5% in US dollar terms and -3.4% in euro terms. Following two strong years in 2009 and 2010, the setback is therefore relatively mild. If we look at individual countries and regions in local currency terms, the stand out performer, as we noted just now in the final quarter, has been the USA which, as measured by the FTSE USA Index, ended up in positive territory returning 1.7%. At the other end of the spectrum was Japan, affected by the devastating earthquake and tsunami in March. The FTSE Japanese index returned -18.0%. Elsewhere, the FTSE Europe ex UK index suffered a relatively poor year, returning -12.7%, as did Asia Pacific ex Japan (-12.8%), emerging markets (-12.1%), Latin America (-9.6%) and Australia (-10.8%). The UK held up relatively well with the FTSE UK index returning -2.3%. The only area where currency movements made a significant difference is Japan where a negative local currency return on the FTSE Japanese index (-18.0%) was reduced to -12.9% in sterling terms. On the other hand, local currency returns on the FTSE Latin American index and FTSE All World All Emerging Markets indices of -9.6% and -12.1% deteriorated to -18.4% in both cases in sterling terms.

In the international bond markets, the features noted in the comments above on the last quarter are magnified for the year as a whole, both for the perceived strong and the perceived weak sovereign credits.

Remarkably, given all that has happened in 2011, except, as noted above, for some Latin American and emerging market currencies and, to some extent, Japan, currency movements, as our table shows, have been very modest overall. Of the major currencies, the yen has been the strongest and the euro the weakest, with sterling falling against the yen by 5.7% and rising against the euro by 2.8%.

Political turmoil amongst some of the oil producing countries, notably Libya, and continuing strong Chinese and Indian demand resulted in a 13.3% increase in the price of Brent crude over the year, whilst gold, although well off its peak, ended the year 9.0% higher with worries about paper currencies and inflation partly offset by investors' liquidity raising measures at the end of the year.

## Economics

At the end of the year when looking at the unremarkable performance of international equities, down a modest amount but not substantially, one would be forgiven for thinking that it had been a fairly uneventful affair on the economic side. Of course, nothing could be further from the truth. 2011 was an extraordinary year and 2012 promises more of the same. 2011 saw a spate of terrible natural disasters such as those in Japan, New Zealand and Thailand as well as elsewhere, and extraordinary political events starting with the Arab Spring and culminating in the toppling of Colonel Gaddafi in Libya. Whilst, unfortunately, natural disasters will always occur, the ramifications of the Arab Spring may be profound. Economically, the importance of the area from an oil production point of view points to possible serious risks if it spreads further to currently stable countries. On the other hand, the outcome may be benign. We just cannot tell at present.

What we will talk about is the economic background, usually the most important one for investors and there is no doubt about the major story of 2011, the continuing and increasing woes of the eurozone. We have written so much and so often about this in the past that we do not wish to go over old ground unnecessarily so perhaps we can look at where we are as we enter 2012. Of one thing we are certain, which is that the eurozone cannot go on as it is. The profound contradictions of establishing a currency union in a disparate group of countries without a fiscal transfer union and suffering from a "one size fits all" monetary policy make the present set up of the eurozone unsustainable. Whilst the founders of the eurozone said they expected economic convergence, in fact, it has only been economic divergence and the one size fits all monetary policy has turned into disaster, as one sees if one looks at the range of eurozone bond yields. Five years ago, there was scarcely any meaningful difference in the yields on benchmark ten year government bonds, now they vary enormously. What happened, amongst other things, was that the interest rate set by the ECB was not correct for a number of countries in the eurozone, notably those in southern Europe and Ireland, and too much money was borrowed at too low rates of interest. So, in countries like Ireland Spain, an unsustainable property bubble developed whilst Greece felt that it could borrow with impunity only to find that this is not actually the case. As we enter 2012, there are serious solvency issues with certain of the eurozone countries, of which Greece is the prime example, and there is also a liquidity crisis as some governments are finding it difficult to borrow money and the banking system is seizing up. With enormous refinancing of debt by some of the vulnerable eurozone countries like Italy and Spain in 2012, the moment of truth is approaching. Whilst the politicians hope that they help to solve the problem by encouraging banks, fed on cheap cash by the ECB, to buy much higher yielding sovereign bonds and therefore make a turn, some of the sovereign bonds in the eurozone have proved to be anything but good investments and it is difficult to see banks putting good money after bad.

Early on, the Stability and Growth Pact was supposed to be the guardian of eurozone stability. Eurozone countries were limited to a budget deficit of 3% of GDP and outstanding public debt as a percentage of GDP was not supposed to exceed 60%. But politicians generally only look at their own electoral prospects and, so, when these restraints became inconvenient, they were ignored. France and Germany were both guilty of this at an early stage, so it is no wonder that others felt they could follow. To be an optimal currency area, countries in it have to have strong economic similarities. So, from an early stage, Germany worked hard to keep down its costs and remain competitive but, in other countries, particularly the southern eurozone countries, but also France, costs relative to Germany rose and a number of these countries became uncompetitive resulting in current accounts deficits and slow growth which impacted on their budgetary position. But, if there is no mechanism for transferring funds to countries in trouble, these countries will suffer both a liquidity and ultimately a solvency crisis and we are now at this stage with several of the eurozone members. The politicians have shown themselves to be completely behind events in the eurozone, with a number of summits resulting in claims of success, but, in fact, they were nothing of the sort, and there are bound to be more in 2012. Politicians, whilst espousing the bigger EU picture and, perhaps, particularly the eurozone picture, are interested in their own electoral prospects and what is required to stabilise the eurozone position and ultimately resolve it, does not sit easily with being re-elected in the near term. There are only two outcomes of the present situation but the politicians are trying for a third outcome. The first outcome would be a fiscal and transfer union, effectively a eurozone government which would decide tax policy and transfers so that, as in the USA, money could be transferred to where it is needed. This is quite clearly a non starter politically. One only has to see the problems that Mrs Merkel in Germany is facing to know that creditor countries' electorates would never countenance such transfers. Both creditor and debtor eurozone countries' electorates would recoil at this. In the creditor countries like Germany, voters are clearly unwilling to help out other countries where they believe the policies have been reckless and, whilst the European ideal may be very strong in the mainstream German parties, there comes a limit for the electorate as they see their money being transferred to other countries. One of the problems of the EU has been the lack of democratic accountability with so many decisions being made that were not taken to the electorates for confirmation and so we can expect severe opposition in the creditor countries. In the debtor countries, on the other hand, it will look as if they are being dictated to by other countries and their sovereignty is being compromised as a result. Having tax increases, public expenditure cuts and other policies, such as supply side reforms, imposed from outside on an affected country will almost uncertainly lead to social unrest and what is happening in Greece is a harbinger of what could happen elsewhere. Whilst the most ardent supporters of the EU and eurozone might believe this to be the ultimate destination for their policies, such a move is unlikely to get past electorates and these are decisions that cannot realistically be made by politicians and eurocrats alone. Public opposition would be too great. The other outcome, which we have always believed to be the more likely one, is that the eurozone will fragment partially, at first, or totally, later on. The fundamental flaws in the construction of the eurozone are so profound that no amount of sticking plaster can keep it together. Politicians, of course, will fiercely deny this but it is interesting that the possibility of a country leaving the eurozone has started to be mentioned in the context of Greece and this was a subject which was completely taboo before. There is going to be no happy ending to the saga of the eurozone but, if we look for the least bad solution, we think it would be a total or partial break up. The reasoning is this. The loss of competitiveness in countries like Greece, Portugal, Italy and Spain and others to some extent, including France, against Germany is so great that the only realistic way of restoring it is through internal devaluation. This means that countries have to try to get their relative costs back to where they started at the time of the founding of the euro or when they joined it after the start, in the case of countries like Greece. The only way realistically of reducing costs is to reduce pay, and perhaps pensions as well, and the difficulty of getting these measures through in democracies are, we think, insuperable. It may work for a time but, if we look at the reaction of Greece where there are regular strikes and demonstrations, which make the economic situation even worse, we can see that it is a non starter over any period of time. However, if one or more countries leave the eurozone, their new currencies will be significantly devalued against what is left of the euro and their competitiveness will be enhanced immediately. So, if we take a country like Greece, where tourism is an important part of the economy, it could become very competitive again and the economy could be boosted in this way, amongst others. This all sounds very easy. In fact, the consequences will be horrific whichever of these two outcomes occurs. But, we think the latter is the less bad one because it does provide some hope for future economic growth, whereas an internal devaluation condemns countries to years of no growth or perhaps contraction as we are seeing with Greece at present and with the prospect of others to follow. There will be significant defaults for countries, businesses and individuals with liabilities in euros and the consequences will be dramatic. But when a mistake has been made, and the euro is a huge mistake, it is usually better to face up to it immediately. Although the politicians at the heart of the euro project were repeatedly warned about its inherent flaws, such warnings were ignored and we now have a man made currency that is out of control. It is to be hoped that, somewhere within the eurozone's establishment, work is being done on a break up of the single currency, although no word could be allowed to get out. However, we do know that companies are making contingency plans and multinational companies are probably better placed than most to respond to the situation in an appropriate manner. We also know that governments, like those of the UK, are making contingency plans, as are the banks. The truly disappointing fact about this whole matter is that it need never have happened. Often, we can talk with the benefit of hindsight but this is not hindsight and the woes of the eurozone are threatening to impose terrible hardship on many of its inhabitants.

At present, there is simply not enough money to bail out eurozone countries which may get into trouble. The European Financial Stability Facility which has been arranged is far too small if a country like Italy, which is having to pay around 7% for ten year money, an unsustainable rate of interest, finds it impossible to refinance its debt in 2012. Whilst defaults by Greece, Portugal and Ireland may just about be manageable in the short term, if Italy or Spain were to become insolvent, the situation would be beyond critical. None of the fine words of the politicians are in any way convincing and it does not appear that any of them have an idea of how to stabilise the situation.

In the absence of any meaningful leadership, we see the only short term measure which can stabilise the situation, but not solve it or put off the ultimate result, is through action by the European Central Bank. In our table of bond yields at the beginning of this review, we noted the extraordinarily low levels of yield, using ten year government bonds as a benchmark for the USA, UK, Germany and Japan. The only member of the eurozone in that table is, of course, Germany, which is regarded as the strongest credit in the currency union and therefore has been a haven for investors in the eurozone area seeking safety, albeit that the rate of interest that they are being offered on the bonds is derisory. Of the major eurozone countries, Germany is in the least bad situation, having grown very strongly in 2010 and at the start of 2011, although growth is now tailing off. The other three countries have two important things in common. The first is that they have a huge borrowing requirement which might have been expected to push yields up, but has not, but their important advantage is that they have their own currencies and, in extremis, and we are in this position now, they are able to print money. Thus, we have seen quantitative easing whereby the central bank effectively prints money to buy in assets to provide liquidity for the banks, keep interest rates down below what they would otherwise have been and hope to get the economy moving through banks lending more money at these relatively low interest rates. None of the members of the eurozone can issue their own currencies so they do not have any access to this economic tool unless the European Central Bank takes it upon itself to take these measures. Printing money is an extreme measure because of the dangers of inflation later on as more money chases a finite amount of goods and pushes up prices. But times are desperate and quantitative easing is an unorthodox aspect of monetary policy that can be used. Japan is a special situation. It normally has very low interest rates so, although it has an extremely high level of public debt, over 200% of GDP at the gross level, it is not regarded in immediate danger, although it will have to act later on. Italy, with public debt at around 120% of GDP, is a much more immediate problem. The UK's budgetary position, when the coalition government came into office in 2010, was very serious and one of the worst around, but the coalition's policy of eliminating the structural deficit over the life of this parliament has been well received abroad and the UK has maintained its AAA credit rating, although it cannot be sure that it will continue to hold on to that. Problems in the eurozone have reduced UK growth prospects so that the target has now slipped by a couple of years, but the UK does have some credibility, whereas many members of the eurozone do not. The USA, which also has horrific problems and is beset by serious political infighting, which makes economic management all but impossible, has not only the advantage of being able to print its own money but also having the world's largest reserve currency. Therefore, for the many foreign governments and sovereign wealth funds which hold US dollar bills and bonds, the risk of bailing out of US dollars risks degrading the value of the rest of their dollar assets if they start to sell, given that they would not be able to get out of them completely. Both the UK and the USA, not to mention Japan, have to put their house in order, but investors can only concentrate on one issue at a time, it seems and, bad though the problems of these three countries are, they are nothing compared with the existential crisis facing the euro.

The policy prescriptions in the eurozone for those countries which have required bailouts, Greece, Portugal and Ireland and for those whose borrowing is too large, is a package of austerity measures. So tax increases and public spending cuts have been prescribed as policy tools in order to restore order to public finances. It is, of course, true that a number of these countries got into severe problems because they overspent and did not have proper budget disciplines and, in countries like Greece and Italy, tax collection is very lax and the black economy very large so that revenue gathering prospects are not good. Additionally, many EU countries have structural rigidities which limit the possibilities for economic growth and one of the ways to improve present economic conditions for countries is to try to raise economic growth levels which will increase employment and raise more taxation among other benefits. But the policy prescription is nearly all the other way and the austerity measures risk a vicious spiral of economic contraction, such as we are seeing in Greece, in particular, but will also see elsewhere in the eurozone. So, what we think will happen, is that the ECB will have to become even more engaged. The ECB is the only organisation that we think can do anything meaningful at the moment. It is taking two actions. Firstly, because banks are fearful of lending to each other, it has been providing liquidity to the banking system in vast quantities, against pledged collateral, so that the banking system does not seize up completely. This is, in a way, its own type of quantitative easing and should help to stabilise the situation in the banking sector in the short term. However, in order to strengthen their balance sheets, deleveraging will take place by banks which might involve lending less to businesses, not a desirable state of affairs at present. We think the ECB has the tools to deal with the seizing up of the banking system but, ultimately, banks have to be able to attract funds in their own right. However, because the wholesale deposit market has seized up, only the very best credits are able to secure funds at present. This situation cannot go on forever because the amount of desirable collateral which the ECB can have will be shrunk and the ECB is having to lower its standards. The second thing is that the ECB has been buying in bonds of troubled sovereigns and it has bought over €200 billion so far. The ECB is not allowed to fund directly countries in trouble so it cannot, for example, buy new issues of bonds and can only deal in the secondary market. Although the ECB is orthodox in its policies and has set its face against various measures, it is already doing things of which it would not have dreamed and we think that it will have to monetise the debt of countries by creating money to buy debt, otherwise there is the risk of a major sovereign failure, which will bring down banks all over the world, not just in the eurozone. We see no other mechanism for stabilising the situation in the short term and even the word "stabilisation" is far too strong a term.

So, as this is written at the beginning of 2012, it is difficult to imagine any other story which will be bigger than the eurozone sovereign debt crisis. If we had to make a guess at this stage as to how the crisis will develop in 2012 it is that one or more members of the eurozone will leave the currency and, as that happens, investors will be speculating on the next weakest link. We think that the ECB will monetise the weakest countries' sovereign debt, creating money to buy troubled eurozone sovereign bonds and even to finance deficits, something that is absolutely not allowed at present but, with the currency facing an existential crisis, it is difficult to see any other option. It may be that, as the crisis worsens, even the most ardent supporters of the euro will begin to realise that they have to look at life beyond the single currency.

All things are relative, however, and, were it not for the eurozone sovereign debt crisis, focus would undoubtedly be trained on the USA. Here, the lack of leadership is almost as dispiriting as that shown in the eurozone and, again, it is all about politics, 2012 being election year. As we have mentioned in a number of previous reviews, the political system in the USA, as now constituted, militates against decisive policy action. In this instance, the Westminster model is undoubtedly superior because a government, which can command a majority in the House of Commons, can implement its policies quickly and, therefore, in the case of an issue like that facing the USA's on its deficit, can act more quickly. In the USA, the checks and balances built into the constitution both within Congress and between the executive and legislature at the moment ensure almost complete paralysis in policy making. The atmosphere at the top of the USA's political set up is dangerously poisonous with hardly any politicians seeming to take the national interest into account, preferring instead to engage in partisan politics and, with the centre ground vacated, the more extreme members of both main parties make the running. It is a question of Nero fiddling while Rome burns and it is difficult to see anything sensible happening this side of the Presidential election. As we have said, the USA is fortunate in some respects with the dollar being the world's largest reserve currency and because it has its ability to print its own money, which can stave off default even if it does debase the currency. Were it not for these "advantages", the USA would be under much more attention and the downgrading by Standard & Poors of its long term debt to AA+ in 2011 would have been a more decisive moment for investors. The long term outlook for the USA's public finances is truly awful but, at this stage, the ideological divide between Republicans and Democrats is so wide that there seems to be hardly any meeting of minds at all. The December 2010 Report of The National Commission On Fiscal Responsibility And Reform, which was a bipartisan report, was the most compelling document presented in this crisis but was effectively ignored by the Administration. It is worth quoting the second paragraph of the preamble of the report which reads "our challenge is clear and inescapable : America cannot be great if we go broke. Our businesses will not be able to grow and create jobs, and our workers will not be able to compete successfully for the jobs of the future without a plan to get this crushing debt burden off our backs". During 2011, the divide between the two parties has widened even further. It has become hugely ideological with the big state/high taxes stance of many Democrats against the small state/low tax stance of most Republicans and it has been almost impossible to reach any middle ground. The problem is from an economic perspective that, as long as Congress raises the debt ceiling and, of course, Republicans have used this weapon to try to press home their policy prescriptions, the USA cannot really default. It can print money and even though printing money debases the currency, it does avoid formal defaults. These "advantages" merely put off the day of reckoning because once investors lose confidence in a country or its currency, interest rates can be expected to rise very substantially, thus creating recessionary or depression conditions. At the moment, the USA is benefiting from its situation looking less critical than that of the eurozone and investors can only focus on the latter at the moment. We therefore see, as 2011 ends and 2012 begins, a stronger dollar and, as our table at the beginning of this review shows, extraordinarily low government bond yields, which can only be explained by the exceptional circumstances prevailing in markets at present. Indeed, as 2011 drew to a close, the economic news improved and this was reflected in the relatively good performance by US shares over 2011 as a whole. So, what will happen in 2012 in the USA? The big political event will obviously be the elections. From an economic perspective, decision making, whether it is ultimately the right decisions which are made or not, is best taken when the Administration and Congress are controlled by one party. This makes it nearer the Westminster model of decision making. However, as things look at present, this is very unlikely to happen, with different parties controlling the Administration and Congress, and one can only imagine that they will continue to be at each other's throats unless some truly catastrophic event brings them to their senses. Politicians do not generally like making hard decisions and it is an inescapable fact that the entitlement situation in the USA, as elsewhere, will have to be addressed because, as the years go by, the costs will get out of control.

Because we see the eurozone sovereign debt crisis as continuing to be the main economic issue in 2012, we think that the USA can get by in 2012 without all of its economic problems coming to the fore, but it is only a postponement of the day of reckoning.

What about the UK? The positive news is that, although the structural deficit elimination plan has slipped because of deteriorating external economic conditions impacting on the UK, there is still a plan which has been well received by foreign investors, enabling gilt yields to fall to unbelievably low levels and for the currency to hold up reasonably well. Now, the reason for ultra low gilt yields is not just the confidence issue, it also reflects poor short term growth prospects and the effects of quantitative easing with vast amounts of money having been printed to buy government debt which has kept bond yields below what they would otherwise have been. These are hardly the best reasons for UK government bond yields to be where they are but, at least, the UK is in a better place than much of the eurozone. As the austerity measures continue to kick in, confidence will remain low in the UK, but, in our view, it is absolutely essential that the coalition keeps to its structural deficit elimination programme because, if it does not, it will also almost certainly pay a very heavy price in terms of the currency and yields on government bonds. Siren voices still call for the government to go more slowly. These voices suggest that by borrowing more in the short term they will borrow less later on as consumer confidence rises, businesses become more confident and growth recovers thus helping the tax take. In our view, this sort of thinking betrays no understanding of markets. The effect of out of control finances in some of the eurozone countries has been rocketing bond yields which will exacerbate the recession. What governments, including the UK one, must do is to try to encourage economic growth by whatever means they can, apart from spending money which they do not have. This means being aggressive with supply side reforms to free up the economies to grow more quickly. Labour and product markets must therefore be deregulated as far as prudently possible whereas, unfortunately, the trend, certainly in Europe, is for more beaurocracy, red tape and regulations which are growth destroying measures. In eurozone countries such as Greece and Italy, the lack of liberalisation in labour, products and services markets is a serious impediment to growth, yet vested interests are fighting the supply side reforms tooth and nail. One big test will be how Italy fares in the face of plans to introduce supply side reforms very shortly.

As economic growth forecasts continue to be downgraded in the UK, it is very easy to feel pessimistic about prospects. However, the UK does have some advantages, notably being outside the eurozone and therefore having a flexible currency which can be the catalyst for some growth if it engenders a more competitive exchange rate. Similarly, the authorities can engage in quantitative easing and it will be no surprise if yet more quantitative easing occurs in 2012. Assuming the coalition holds together, the UK is likely to be one of the more stable countries economically in 2012, albeit at a level of activity which is much lower than would be desirable.

For Japan, the problems remain very severe although the economy has recovered more quickly than expected following the natural disasters of March 2011. Despite having the largest level of outstanding public debt in relation to GDP of any major economy, over 200%, the Japanese currency remains popular with overseas investors. Japan has traditionally had very low interest rates, more appropriate in an economy which has suffered from deflation, and it has meant that debt servicing issues have not arisen. However, Japan's public finances are in such a serious state of imbalance that serious efforts will have to be made to address the problem. Unfortunately, political wrangling and vested interests militate against the type of reforms which Japan needs, namely strong supply side reforms and making changes to the tax system which give a much better basis for tax collection, almost certainly meaning a significant rise in consumption tax, a tax which is difficult to avoid and easy to collect. Most of Japan's debt is funded internally so Japan has not suffered from any external concerns which have affected other countries but it, too, like the USA will have to address its serious public finances' crisis.

China faces a very delicate balancing act in 2012. China must always maintain a strong growth rate in order to absorb people coming in from rural areas. This growth helps to maintain social cohesion for the last thing which China can afford is social unrest. There has been a significant rise in the number of strikes in China, mostly in foreign owned companies, perhaps a sign of the difficulties to come and China is not as cheap a source of production as it was once was with some business going to cheaper countries in Asia. One of China's major problems in 2011 was inflation with food prices rising in double percentage figures. The situation does seem to be improving but China will want to continue to put downward pressure on inflation. In this connection, property prices have been a major concern and one of the authorities' main tasks has been to try to subdue property prices and they are having some success in this respect. This has meant regular increases in bank reserve requirements and interest rates but now the policy is gradually being reversed as house prices are contained and the danger in 2012 will be to stop the economy's growth rate and house prices from plunging too rapidly. Of course, China's growth rate is one that western countries can only dream of but China has to keep this strong rate of growth continuing to keep social cohesion. Of course, industrialised economies continue to benefit from China's fast growth and it will be one of the helpful issues in 2012 in stopping industrialised countries from going into recession overall, although a number of economies obviously will. China will continue to be under pressure from the USA, in particular, over its exchange rate, and one of the worries for 2012 is the growth of protectionist sentiment, particularly in the USA as it faces an election and with politicians unable to see the big picture. The USA needs foreign countries to fund their deficit and trying to put quotas or tariffs on Chinese imports risks cutting off its nose to spite its face. In 2012, we expect China to continue to have a positive influence on the world economy even though it cannot completely offset the recessionary forces in a number of eurozone countries.

The other very large economy which has shown strong growth rates in the past, and continues to do so, is India, but 2011 has been a very disappointing experience for followers of India. The government appears to have seized up and to be in a state of paralysis. The country desperately needs supply side reforms to make it more efficient yet the government has been mired in corruption scandals and, at the end of the year, an important supply side reform which was proposed by the governments, notably the liberalisation of foreign ownership of supermarkets, had to be abandoned temporarily at least in face of opposition.

As we look at the performances of the emerging markets in 2012, although their economies continue to prosper relative to those of many industrialised ones, the markets underperformed in 2011 as investors took money out of them. But, although many of them faced problems, as they always have, these countries are going to show far superior growth compared with most industrialised ones and many of them have financial positions which are much stronger. The emerging market story has not gone away, in our view. Emerging market economies are becoming more and more important relative to the world economy and, at the moment, exert a positive influence by means of their superior growth which does provide some support for the industrialised economies. So, investors should certainly not give up on these markets. It is true that they have performed very well over the last few years but their economic prospects have not suddenly worsened relative to those of the industrialised economies.

Because events are moving so quickly, particularly in the eurozone, it is inevitable that investors must consider the big picture, in which the fate of the eurozone is the biggest issue. Economic data can quickly become obsolete and, in the current circumstances, a poor predictor of the future. If we look at the latest quarterly GDP data, we see that the eurozone was already struggling. Annualised growth in the third quarter was just 0.6%, with even Germany struggling after its strong growth record in 2010. Although at a 2.0% annualised growth rate in the third quarter, it was still at the top of the list of eurozone countries. The eurozone countries in the most financial trouble were, unsurprisingly, at the most depressed end of the spectrum. Annualised third quarter growth for the USA was 2.0%, though the evidence is of some pick up in the economy at present, with the news surprisingly good. Japan, recovering from a bounce in economic activity after March's earthquake and tsunami, showed annualised growth of 5.6% in the third quarter but this would not be a representative picture as GDP is 0.7% lower than a year earlier. Although the UK's annualised third quarter growth rate at 2.3% does not compare too badly with what is happening in the eurozone, activity is only very modestly up on a year earlier and very little growth is expected for 2011 overall as the eurozone's woes weigh heavily on the UK economy. All of these growth rates pale into insignificance compared to that of China where third quarter annualised growth, year on year growth and the expected outcome for 2011, all exceed 9%.

Forecasting for 2012 carries an enormous degree of uncertainty, mainly because of the eurozone's problems. If the currency union breaks up, then the shock will undoubtedly cause a sharp but possibly short recession in not just the eurozone but Europe as a whole and the ripple effects will be substantial. As the eurozone's problems have grown, so economic growth forecasts have been reduced. The austerity packages being imposed overtly on some eurozone countries and covertly on others will reduce economic activity.

If we look at the USA, there have been a number of encouraging items of news covering the housing market, employment, the ISM manufacturing index and new orders. Compared with, say, the UK and individual EU members, the USA is a relatively closed economy, so internal dynamics can be more powerful. It cannot escape what is happening elsewhere, but the general belief is that the USA might, under the right circumstances, show growth of about 2% in 2012. The eurozone's outlook for 2012 is anybody's guess. All we do know is that it is not going to be good. Germany may show some modest growth depending on how its export markets hold up, but it is quite possible that the eurozone as a whole will go into recession as a result of the results of the crisis. If there is any overall growth, it will certainly be very modest. Some, if not all, of the particularly troubled eurozone countries will move into recession. The UK, too, could go into recession. The OBR has had to reduce its growth estimates on a regular basis. We know that conditions in the UK will be tough because of the need to tackle the structural element of the budget deficit but the eurozone's problems will cast a baleful influence on the UK's economy because of its importance as a trading partner. For Japan, there will be further catching up from the after effects of last year's earthquake and tsunami and the benefit of its trade links with the rest of Asia, the most buoyant economic area at present. The consensus forecast for Japan's growth rate in 2012 is about 2% at the moment. What should stop the world economy overall from falling into recession in 2012 is the strength of many parts of Asia, crucially China, parts of Latin America and the Middle East and some emerging markets, some of which form parts of these areas. We can be sure that China will continue to grow rapidly in 2012, if not at the pace of 2011, expected to be just over 9%. We have explained the delicate balance which the Chinese authorities have to maintain between growth, inflation, the housing market and fixed asset investment. China will, we believe, continue to exert a positive influence on the world economy in these most testing of times.

Amongst all the economic uncertainties, a negative development would be an increase in protectionism which often occurs in times of economic difficulties. We have talked about the short term horizons of politicians, and protectionism is often a populist measure to curry favour with various economic constituencies. Its economic consequences are malign, reducing economic welfare and the level of world trade and, through these effects, economic growth. The US/China situation is the most important one to watch but countries like Brazil have also become more active in imposing higher tariffs on some imported cars having had to take earlier action to try to limit the strength of its currency in the face of large capital inflows.

The economic outlook overall is undoubtedly poor for 2012 but not uniformly so. From a stock market point of view, it is possible to see markets performing well when economies are doing badly and vice versa. Looking at the various asset classes, we believe that bonds are offering very poor value. The sovereigns which have been in favour show gross redemption yields which are out of line with fundamentals. We have explained why this is so but it does not alter the fact that prices are very vulnerable to a change in sentiment, in which case large losses could be seen which may take a very long time to recover. Even though some corporate borrowers are far stronger fundamentally than their governments, we think that they have to sell off their sovereign yields although margins obviously move. Cash is only for the extremely risk averse, if held as a main asset class, rather than a modest part of an overall asset allocation. We can be almost sure that even when taking interest earned into account, which will be very little, a negative real return will be earned. Shares, we believe, offer the best value. The "negative" reason is that other classes look unappealing. The more important positive reason is that they look good value if measured in terms of earnings multiples and dividend yield. We appreciate that this would not be the case if corporate earnings collapsed this year but this would not be our central case. Non financial corporate balance sheets are strong which should mean that dividend levels are fairly safe. With short term interest rates likely to remain very low for the foreseeable future and bond yields very unattractive, the appeal of dividends is strong. But volatility is bound to occur and the state of the eurozone is so severe that there are bound to be nasty shocks which affect markets badly as they did on occasions in 2011. For medium and long term investors, quality companies with broad international exposure are our preferred way to deal with the current extraordinary economic circumstances.