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VIEWPOINT

Newsflash

A new month and the 75th issue of Viewpoint from PPi.

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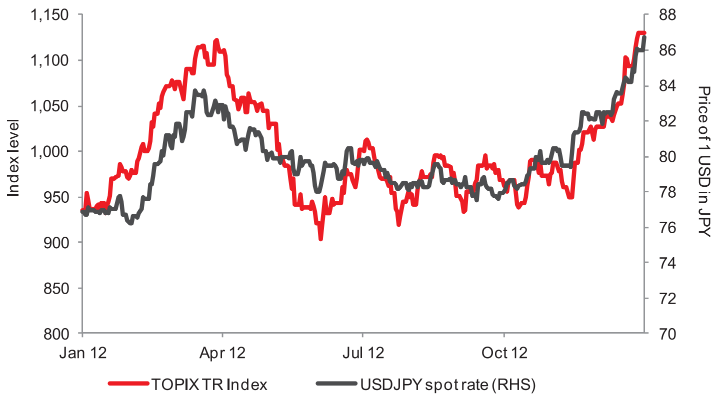
Market commentary

The final month of 2012 was dominated by two key themes: the US fiscal situation and the strong performance of Japanese equities. Starting with the latter, Japanese equities added 10.1% in local currency terms during December, whilst elsewhere markets traded sideways to marginally up (US 0.8%; Europe ex UK 1.8%; Asia ex Japan 2.5%). It was the best December for investors in Japan since at least 1989, and moved the Topix index ahead of peer markets for the year. Japan was the second best performing market in 2012 in local currency terms, although returns for US dollar-based investors remain anaemic due to the weakness of the yen.

Figure 1: Japanese equities bounce as the yen moves above 86



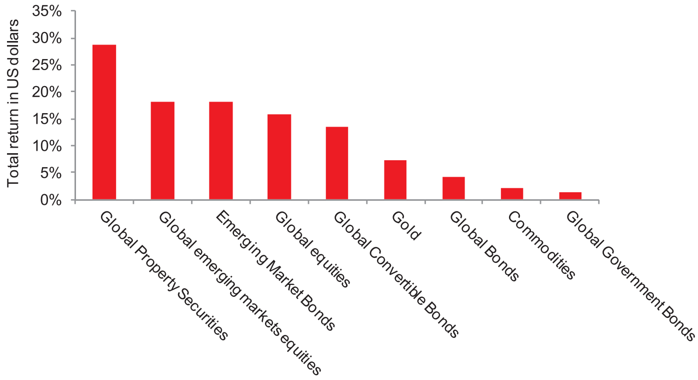
Whilst developed markets were relatively subdued (1.9%) during December, emerging markets rallied by 4.9%, as both Emerging Europe (6.4%) and Latin America (6.5%) posted strong gains.

Core government bonds lost ground last month (US treasuries -0.5%; UK gilts -0.5%; Japanese government bonds (JGBs) -0.3%), whilst investment grade credit and high yield continued to rally. European high yield bonds are now trading above par (in aggregate) for the first time since September 2007. The yield spread over government bonds of the same tenure has fallen to 5.6%, versus an average of 6.9% during the past 15 years (including an adjustment for the period of extreme risk aversion between 2008/09). This leaves some modest room for further price appreciation, but certainly less than there was earlier in the year. High yield bond prices are capped by embedded call options, which typically allow the issuer to redeem the bond at par plus any accrued interest; paying more than par (plus the interest) would expose the buyer to the risk of an immediate capital loss on their investment.

Global property securities rallied by 3.8% in December, to bring year to date returns to 28.7%. Asian property has added 45.5% over the past 12 months in US dollar terms, to cap its best year since 1993. The Japanese yen continued to weaken versus the US dollar over the month, down by 4.9%, whilst commodities sold off moderately, with gold spot prices declining by around 2%.

Looking at the performance of major asset classes during 2012, property securities provided the best returns last year, as investors adjusted their valuation of the sector from a price-to-earnings ratio of circa 11 times to 18 times. Emerging markets (18.2%) outperformed their developed counterparts (15.8%), as Emerging Europe rebounded by 24.3%. Latin America (8.7%) appears as the notable laggard amongst the set of emerging regions, after Brazil's stock market declined by 2.0%.

Figure 2: Performance of major asset classes in 2012



The key focus for markets during December was the US fiscal situation and the looming 'fiscal cliff'. Global equity markets rose steadily during the first three weeks of the month in anticipation of new legislation to reduce the effects of planned tax rises and cuts to government spending, before pulling back as it became clear that discussions were set to continue right up to the deadline. Several days of discussions concluded with an eleventh hour deal to stop tax rises on individuals earning less than USD 400,000 and married couples with combined incomes of up to USD 450,000. The so-called 'fiscal cliff' is more appropriately described as a 'fiscal slide': the widely-discussed headline reduction in US GDP – estimated to be around 4% – would only come to pass if tax breaks and government spending cuts were left untreated for the whole of 2013. Nonetheless, the total effect of planned measures is significantly larger than anything seen in Europe thus far. The deal does little to alter the current trajectory of US public debt, which is on course to hit the debt ceiling at the end of February. The US will soon be forced to introduce extraordinary measures in order to continue paying its bills.

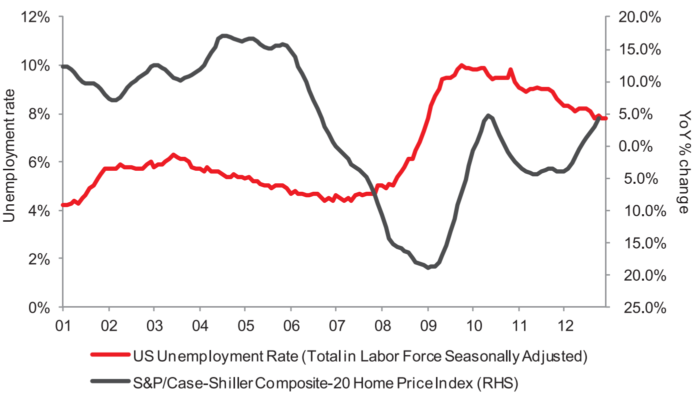
The Federal Reserve remains in accommodative mood, although the minutes of the Federal Open Market Committee's (FOMC) latest meeting showed a split amongst members on the question of whether to continue quantitative easing until the end of 2013, with several members making it clear that they consider an earlier exit appropriate in order to maintain

Source: Lipper Hindsight / Bloomberg. Returns in US dollars unless otherwise stated. December 2012.

financial stability. As expected, Governor Ben Bernanke unveiled a new asset purchase programme to replace 'Operation Twist' at the start of the month, ahead of the latter's phasing out at the end of the year.

On the data side, US employment figures continue to surprise on the upside, whilst house prices are now rising for the first time since 2010.

Figure 3: US unemployment falls whilst house prices rise



China remains the key influence in the East, with a growing consensus that Beijing has successfully engineered a soft landing for the economy. Chinese year-on-year demand for oil has come back strongly, whilst new orders amongst manufacturing firms are expanding at their fastest pace in eight months. Signs of fresh momentum in China have led to rapid moves in certain commodities, with iron ore prices rallying by over 50% since the start of September. Speaking at his company's fourth quarter earnings presentation, Alcoa's CEO Klaus Kleinfeld forecast aluminium prices would rebound in 2013, based on a resurgence in Chinese demand.

Overcapacity remains an issue in China, and new infrastructure spending is likely have a diminishing marginal effect on growth. Reform of the housing market continues, including the redrafting of rules on property ownership, which currently preclude migrant workers from purchasing housing units; this should help to bolster demand for property, which has appeared weak at times relative to new supply. Reports suggest that there is pent-up demand for IPOs in China, with regulators delaying the approval of applications in order to reduce the downward pressure on stock prices from this new wave of issuance into the market.

China has been outshone by Japan in recent months, with the Liberal Democratic Party's (LDP) election victory at the start of December catalysing strong gains for Japanese equities. The new government is pushing for stronger action to bring an end to Japan's period of low inflation/deflation. Prime Minister Shinzo Abe has kept up pressure on the Bank of Japan to raise its inflation target to 2%, and the central bank is believed to be on the verge of committing to unlimited asset purchases in pursuit of this target. Equally, the government is preparing a package of economic stimulus measures, which (according to local media reports) could reach as high as JPY 10 trillion. Whilst a weaker yen will benefit Japan, it has implications for competitors in the region, particularly ASEAN economies including Singapore and Indonesia.

Turning to Europe, the expectation appears to be that the Draghi 'put' on markets will hold. European Commission President Jose Barosso went as far as to say that the "existential threat to the euro is over". A huge amount still remains to be done, however, with banking reforms and moves towards greater fiscal integration at the top of politicians' agenda for 2013. Whilst there appears to be strong consensus amongst the political class, continued anaemic growth is likely to test voters' sense of solidarity. The European Central Bank (ECB) cut its forecast for Eurozone growth in 2013 to -0.3%, versus earlier forecasts for growth of 0.5%. At his regular monthly press conference, ECB President Mario Draghi said that a "gradual recovery should start later in 2013", whilst noting that the outlook for inflation was broadly unchanged despite the Central Bank's balance sheet expansion.

The passing of new budget laws in Italy was followed by the resignation of Mario Monti as Prime Minister on 21 December, after a little over a year in office. Mr. Monti is unlikely to disappear from the political spotlight, however, after announcing his willingness to play a role in a centrist coalition in the next election, scheduled to take place in

Source: Lipper Hindsight / Bloomberg. Returns in US dollars unless otherwise stated. December 2012.

February. Lingering questions over Greece's membership of the Eurozone appear to be contained, at least in the short term, although it appears premature to suggest that fears of a 'Grexit' are truly dead. The troika's latest report on Greece's progress stated that tax collection is falling behind target, whilst privatisations of state owned businesses have equally been disappointing.

There are clear obstacles for markets to navigate in the near term, beginning with the US debt debate, which will no doubt involve further rounds of political horse-trading. As ever these potential headwinds are balanced by opportunities. There has been a sizeable run-up in markets since the middle of the year, and a portion of the good news now appears to be priced into markets. Whilst this does not alter our broadly constructive view on equities for the coming year, it does raise a note of caution in the short term.

Source: Lipper Hindsight / Bloomberg.
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Market performance

Asset Class/Region	Index	Currency	To 31 December 2012 Month	Year to date
Developed Markets Equities				
United States	S&P 500 NR	**USD**	0.8%	15.2%
United Kingdom	FTSE All Share TR	**GBP**	1.0%	12.3%
Continental Europe	MSCI Europe ex UK NR	**EUR**	1.8%	19.4%
Japan	Topix TR	**JPY**	10.1%*	20.9%*
Asia Pacific (ex Japan)	MSCI AC Asia Pacific (ex Japan) TR	**USD**	2.5%	24.7%
Global	MSCI World NR	**USD**	1.9%	15.8%
Emerging Market Equities				
Emerging Europe	MSCI EM Europe NR	**USD**	6.4%	24.3%
Emerging Asia	MSCI EM Asia NR	**USD**	3.5%	20.8%
Emerging Latin America	MSCI EM Latin America NR	**USD**	6.5%	8.7%
BRICs	MSCI BRIC NR	**USD**	5.0%	14.5%
Global Emerging Market	MSCI EM (Emerging Markets) NR	**USD**	4.9%	18.2%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	**USD**	-0.5%	2.2%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	**USD**	-0.7%	7.3%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	**USD**	-0.1%	9.8%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	**USD**	1.6%	15.8%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	**GBP**	-0.5%	2.6%
UK Corporate (Investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	**GBP**	0.1%	13.3%
Euro Government Bonds	Citigroup EMU GBI TR	**EUR**	0.8%	10.7%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	**EUR**	1.0%	13.6%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	**EUR**	3.7%	29.4%
Japanese Government	JP Morgan Japan Government Bond Index TR	**JPY**	-0.3%	1.8%
Australian Government	JP Morgan Australia GBI TR	**AUD**	-0.2%	5.7%
Global Government Bonds	JP Morgan Global GBI	**USD**	-1.0%	1.3%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	**USD**	-0.2%	4.1%
Global Convertible Bonds	UBS Global Convertible Bond	**USD**	1.9%	13.3%
Emerging Market Bonds	JP Morgan EMBI +	**USD**	0.9%	18.0%

* estimate

Source: Bloomberg. December 2012.

Market performance

			To 31 December 2012	
Asset Class/Region	**Index**	**Currency**	**Month**	**Year to date**
Property				
US Property Securities	MSCI US REIT TR	**USD**	3.5%	16.5%
UK Property Securities	FTSE EPRA/NAREIT United Kingdom TR	**GBP**	2.3%	29.9%
Europe ex UK Property Securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	**EUR**	0.4%	25.9%
Australian Property Securities	FTSE EPRA/NAREIT Australia TR	**AUD**	2.4%	32.2%
Asia Property Securities	FTSE EPRA/NAREIT Developed Asia TR	**USD**	4.5%	45.5%
Global Property Securities	FTSE EPRA/NAREIT Developed TR	**USD**	3.8%	28.7%
Currencies				
Euro		**USD**	1.6%	1.8%
UK Pound Sterling		**USD**	1.5%	4.6%
Japanese Yen		**USD**	-4.9%	-11.3%
Australian Dollar		**USD**	-0.3%	1.8%
South African Rand		**USD**	5.1%	-4.5%
Commodities				
Commodities	RICI TR	**USD**	-0.9%	2.0%
Agricultural Commodities	RICI Agriculture TR	**USD**	-3.0%	1.8%
Oil	ICE Crude Oil CR	**USD**	-0.2%	2.8%
Gold	Gold index	**USD**	-2.3%	7.1%
Hedge Funds	HFRX Global Hedge Fund	**USD**	0.9%	3.5%
Interest Rates			**Current rate**	**Change at meeting**
United States	12 December 2012	**USD**	0.25%	-
United Kingdom	10 January 2013	**GBP**	0.50%	-
Eurozone	10 January 2013	**EUR**	0.75%	-
Japan	20 December 2012	**JPY**	0.10%	-
Australia	4 December 2012	**AUD**	3.00%	-0.25%
South Africa	22 November 2012	**ZAR**	5.00%	-

Source: Bloomberg. December 2012.

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Asset allocation dashboard

Positive	Neutral	Negative

Asset class	View
Equities	
Developed equities	Neutral
UK equities (relative to developed)	Positive
European equities (relative to developed)	Neutral
US equities (relative to developed)	Negative
Japan equities (relative to developed)	Neutral
Emerging market equities	Positive
Fixed Income	
Government	Negative
Index-linked (relative to government)	Neutral
Investment grade (relative to government)	Positive
High yield	Positive
Loans	Positive
Emerging market debt	Neutral
Convertible bonds	Neutral
Alternatives	
Commodities	Neutral
Hedge funds	Neutral
Property (UK)	Neutral
Currencies	
Dollar	Neutral
Euro	Negative
Yen	Negative
Emerging market currencies	Neutral

Source: Momentum Global Investment Management December 2012

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Under our multi-management arrangements, we selectively appoint underlying sub-investment managers and funds to actively manage underlying asset holdings in the pursuit of achieving mandated performance objectives. Annual investment management fees are payable both to the multimanager and the manager of the underlying assets at rates contained in the offering documents of the relevant portfolios (and may involve performance fees where expressly indicated therein).

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