Quarterly Strategy

As we near the start of the London Olympics, the global economy remains under the heavy weight of the European crisis and a recent dip in business confidence. Financial flows to emerging markets have declined, impacting growth, commodities and US manufacturing.

We believe the ingredients could be in place for a better second half of the year, with lower inflation, policy easing and stable household consumption in the US, Germany and Japan. The risk of disappointment remains high, however, and we will require confirmation of a positive outcome before investing further.

C. Hoare & Co.
PRIVATE BANKERS SINCE 1672

Our current investment strategy

Financial market performance has been negative over the quarter due to a combination of worries over Europe and a more generalised slowing of global economic activity. While our client portfolios have been underweight European equities for some time compared to their benchmark positions, we sold out of the one European equity fund as uncertainties rose.

In respect of portfolios for clients with suitable risk profiles, we initiated a holding in a Japanese equities fund, and made several changes to our alternative assets. We are hopeful of a modest improvement in consumer and business confidence worldwide, which will allow us to invest further in economic recovery.

We are broadly neutral in equities

UK: recovery potential

- Lower inflation helps consumption
- Further policy easing expected

US: remaining positive

- Consumer outlook and housing market supportive
- Fiscal cutbacks a risk for 2013
- Global exposure denting earnings growth

Europe: no exposure

- Credit contagion ongoing
- Uncertainty over extent of political union

Japan: positive

- Exposure to recovering US
- Reconstruction spend; better domestic confidence
- Proactive Bank of Japan to ameliorate deflation

Asia ex Japan, Global Emerging Markets: negative

- China to remain sluggish
- Remainder impacted by falling financial flows

We are positive overall in bonds

Government bonds: uninspiring valuations

- Gilts and US Treasuries supported by safe haven status and central bank easing, but valuations poor

Corporate bonds: positive

- Credit benefits from more careful corporates

We retain a positive view on alternatives

Gold: positive

- Supported by uncertainties and central bank easing

Hedge funds: positive

- Diversification from returns of traditional assets

We are negative in property

Overall property market: negative

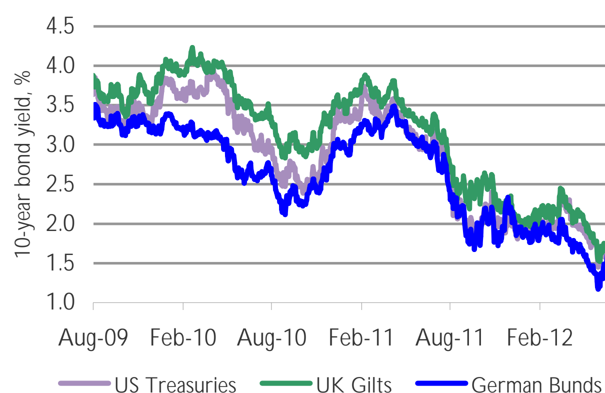
- Expecting total returns to be flat

Inflation, interest rates and bonds

In European government bond markets, the difference between most sovereign bond yields and those of German Bunds widened considerably in the second quarter. This was in contrast to the previous quarter, when the success of the European Central Bank's bank refinancing operations caused spreads to narrow.

The main beneficiaries of investors reducing their risk have been Germany, the US and the UK. German Bund yields reached all-time lows, but as safe haven assets, we continue to favour US Treasuries and UK Gilts.

'Safe haven' yields remain exceptionally low



Source: Bloomberg, to 4th July 2012

We think the likelihood of further Quantitative Easing in the UK, a biasing toward easing in the US and China, and the requirement for further liquidity measures in Europe could support bonds with greater sensitivity to a falling interest rate environment.

On inflation positioning, we repeat our view that the overall global dynamic is deflationary for the time being. In the developed world, this is essentially due to ongoing bank deleveraging and poor growth dynamics, although the two are to an extent intertwined. One area where this may not hold true is in Germany, where the risks of inflation are higher than elsewhere.

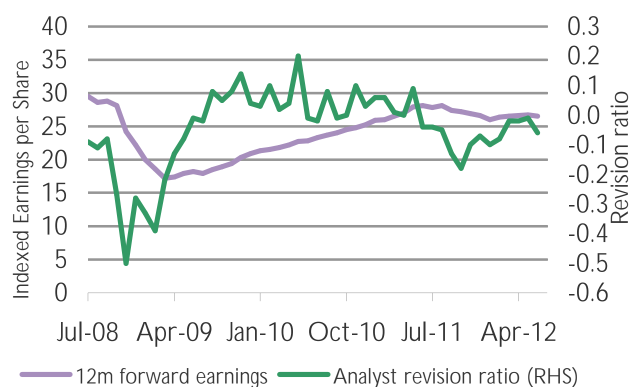
With government bonds at extremely low yields, we favour corporate credit whilst acknowledging the risk of further spread widening in the event of a severe negative economic outcome emanating from Europe. Spreads are attractive if the 'worst case' scenario can be avoided. Nevertheless, we believe the sizable difference between the yields of financial issuers and those of non-financial issuers are justifiable given the current risks facing the financial system.

European defaults are likely to rise on the weakening macro environment and bank deleveraging. The default rate in the US should rise more modestly, but absent an extremely negative event, we believe US credit spreads look relatively attractive.

Our view on equities

Earnings forecasts across the world were downgraded in the second quarter. This was due to the European crisis, moderation in Chinese growth and concerns that at the end of the year, we could see $600 billion in fiscal restraint imposed on the US economy, as tax cuts and emergency benefits are due to end at the same time that new tax increases begin. Commodity producers were downgraded the most, followed by companies supplying economically sensitive industries.

Recent downgrades to earnings forecasts



Source: Deutsche Bank Consensus Earnings

Consumer sectors tend to be more domestic in orientation and should offer a degree of stability. We are conscious, however, that a more sizeable economic deterioration would lead to vulnerability across discretionary, staples and possibly technology sectors.

We nevertheless maintain a positive view on the technology sector, which is undergoing structural change with the movement to smart phones and tablets. This, as well as cloud computing and storage, remain attractive growth areas.

MSCI World sectors	Earnings growth		Price/Earnings	
	2012e	2013e	2012e	2013e
Cons. discretionary	39.1%	16.6%	12.9	11.1
Consumer staples	7.2%	10.1%	15.9	14.4
Energy	-2.6%	8.2%	9.1	8.4
Financials	12.6%	12.5%	9.9	8.8
Healthcare	3.3%	8.2%	12.6	11.6
Industrials	12.8%	13.3%	11.9	10.5
Technology	17.8%	16.5%	12.7	10.9
Materials	0.5%	17.8%	10.6	9.0
Telecoms	2.6%	8.9%	12.4	11.3
Utilities	20.1%	14.7%	15.3	13.4
MSCI World	**10.2%**	**12.6%**	**11.7**	**10.3**

Source: Deutsche Bank's June 2012 report

Overall in equities, we could see a quick stabilisation of earnings prospects if there were a resolution to fiscal problems, monetary easing or a return of business confidence. On the other hand, we are concerned that if there are no resolutions, we could be in store for a prolonged period of earnings downgrades, as companies would be reluctant to take risks and would allow their cash balances to build.

We are struck by how negative sentiment is among investors worldwide, as evidenced by modestly higher equity volatility and little consistent momentum. Investors remain sceptical of earnings growth prospects, and valuations continue to condense around the current low levels. Large US companies have higher margins and returns on equity, justifying higher valuations, but the US has also benefited from being a safe haven. Valuations could rise quicker in Europe and Asia in a more positive environment.

Equity fund flows highlight that major developed markets see only minor positive or negative flows, although this could change if markets deteriorated markedly. Japan is noticeable in having seen flows pick up on the back of better economic data, while Asia and emerging markets show modest outflows.

In the financial sector, the leading US banks are generally better capitalised than in Europe although we remain aware of negative legacy exposures on both sides of the Atlantic. For UK domestic focussed banks, we believe the weak economy and need for continued deleveraging are significant headwinds despite the progress that has been made on rebuilding capital and improving funding positions. As for the rest of Europe, we are concerned by the low levels of capital relative to total assets at some large banks and continued excessive reliance on wholesale or central bank funding. European banks also have large exposures to their national sovereign debt.

Our view on alternative assets

Gold has held up well on expectations of more easing by central banks. The uncertain nature of any resolution to the growing US budget deficit issue and ongoing external deficit may hit the dollar and further sustain the gold price.

The fall in the oil price has reflected the recovery in supply from Libya, previous increases in production following the spike in prices in March and decrease in expected demand due to the economic slowdown. We would expect some consolidation from here, and if economies begin to stabilise and improve, we could see an advance in oil prices later in the year.

Hedge funds have endured a disappointing two years, but we believe well-controlled market neutral strategy funds continue to be attractive until such a time as markets begin to establish more predictable trends.

We remain negative on property. Transaction volumes remain depressed and investors cautious. Declining capital values in the UK are likely to persist for the next couple of years, offset largely by income, which we think will result in total returns being flat.

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