

Schroders

talkingpoint



2012 Crystal Ball

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Introduction

It is almost tempting to re-issue last year's Crystal Ball with a few updated numbers. Here's what we said in our Crystal Ball in December last year:



.... consider the possibility of a double dip recession.
.... think about the difficulties faced by the peripheral Eurozone countries.

Both of these issues have the potential to upset markets and drive asset class returns....”



Alan Brown

Group Chief
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We argued that the range of possible outcomes was unusually wide and that there was a need for the industry to adopt a more dynamic approach to asset allocation. Crucially, we concluded that:



....The odds are stacked against Government bonds in most of the developed world (but not Australia). Timing remains uncertain, but strategically this does not look like a good time to be long duration.

.... Equity assets are attractively priced as long as we can avoid Double Dip.”

The view on equities looked quite reasonable through the middle of the year, but clearly has unraveled since in the face of the acute problems facing the Eurozone and the chronic lack of growth in the developed world. We certainly did not expect the 10-year bond yield in the US to fall from 3.3% at the start of the year to 2.0% at the time of writing, and that after the summer's credit downgrade to AA.

We were correct in thinking that big picture, macro items would drive returns, but we were too sanguine about the outlook.

Where do we stand today?

The themes of last year continue to be highly relevant today and will once again be the main drivers of returns in 2012. The investment environment is therefore likely to remain highly challenging with a continuation, at least for a time, of the current environment. The market has had no breadth. All stocks rise and fall on the same piece of news: risk on or risk off, depending on the latest twist in the Eurozone story. While markets have been extremely volatile there has been no material increase in portfolio tracking error to benchmarks. That is simply because the correlation between individual daily stock returns and the broad market has been extremely high. Everything goes up or down by 2%. The only way to deliver returns in that kind of environment is to make macro calls, and few, if any of us, can sensibly forecast European politics on a daily basis. Markets could also continue to exhibit the high degree of daily and indeed intra-day volatility which has characterized so much of the second half of 2011.



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Once again, this is likely to be an environment in which diversification and a willingness to be flexible in asset allocation, as events unfold, will be the key to success.

But there is likely to be one key difference between 2011 and 2012. 2011 was the year when the market lurched from risk on to risk off as optimism and pessimism traded punches over the key themes of the Eurozone and Double Dip.

2012 is likely to be the year where both of these issues will be resolved for better or worse. And there is an awful lot riding on the outcome. A favorable resolution - and we need to think about what constitutes a favorable resolution - could set markets up for a very decent rally on the basis of favorable valuations.

An adverse outcome has the potential, in the most extreme scenarios of a domino collapse in the Eurozone, to put the developed world back into a severe recession. And with few effective policy levers left, we would be up the proverbial creek without a paddle, hoping against hope to avoid going over the edge of the falls.

So I want to devote this year's Crystal Ball to considering:

- Valuation arguments
- What constitutes a favorable outcome
- Where the main risks to that outcome lie (a.k.a. - The Eurozone)

Valuations

In the absence of a major change in the economic outlook (Double Dip), equities are very attractively priced, particularly against developed world government bond markets (ex-Australia). Continuing declines in bond yields and equity markets have simply further improved relative valuations from the attractive levels we already noted last year.

In an environment of such uncertainty it is perhaps unsurprising that risk assets are priced cheaply. Nobody buys government bonds on yields of 2% out of greed. Fear dominates.

Consider, though, what would happen if we were fortunate enough to get back to business-as-usual. In normal conditions, short-term interest rates might typically average nominal GDP growth rates, say 4.5% for the US (2% inflation + 2.5% trend growth). Add 1% for the curve and the 10-year Treasury might trade on a yield of say 5.5%, compared to just 2% today. For a five-year duration bond, an increase in yields of 3.5% implies a capital loss of some 17.5% or nearly nine years' income!

Or consider the UK, where today 10-year gilts yield 2%. Marks and Spencer's dividend yield is 5.3%. That dividend is covered over 2 X and likely will increase over time. The coupon on the government bond is fixed! The stock is on a P/E of 8.3. Arguably M & S has better visibility over its revenues and earnings than the UK government. Oh, and unlike the UK government, M & S revenues exceed its expenses.

These valuations, both of government bonds and equities, are at historic extremes. This strongly suggests that over the course of the next year, either valuations will begin to return to something closer to historic norms or the fundamentals will be seen to have changed. Historically, equity markets have not been very good at forecasting changes in fundamentals.

What constitutes a favorable outcome?

Put in the starkest terms, a favorable outcome means getting the Eurozone off the front pages and seeing evidence that at least weak economic growth is being maintained in the developed world. Of course, growth in the developed world and the fortunes of the Eurozone are closely linked. It is hard to imagine that we will be reassured on growth prospects without seeing some kind of satisfactory resolution to the Eurozone's woes.

At the moment, economics and politics are at odds with one another and the numbers are simply not adding up. Even with the proposed 50% write-off of Greek debt, the debt/GDP ratio will still be around 120% at the end of the decade. That is the same level as Italy today.

If economic growth predictions for Greece prove optimistic (as is highly likely) well then the ratio could be significantly higher still. On top of that, nothing will have been done to improve Greek competitiveness, which lies at the heart of the problem.

The fundamental issue for Greece, Italy and others is that moves to make their economies more competitive, in the absence of exchange rate depreciation, take a great deal of time. More time than markets will give.

It is often claimed that the economic costs, let alone the political costs, of a country leaving the Eurozone would be catastrophic. It is certainly possible to envisage a scenario where that would be the case, but it is not a given. Everything depends on whether a change in membership is “orderly” or “disorderly”.

No fewer than 69 currency unions (on the narrowest definition) have come to an end since World War IIⁱ. The fact that that this is little known strongly suggests that the sun still rises in the morning! And that number does not include Sterling's exit from the ERM in September 1992 (not a formal currency union, but economically similar) or the Czech/Slovak currency union that broke up in January 1993.

An argument is often made that any competitiveness gains from nominal exchange rate depreciation are often transitory and are quickly eroded through rapid growth in nominal wages. Certainly there were many occasions in the past where countries such as Italy experienced multiple devaluations without a sustained improvement in competitiveness.

However, given the current high level of unemployment and very weak economic conditions in Greece, it is difficult to see wage growth accelerating any time soon. Those of us in the UK at the time of the ERM exit experienced a 25% drop in the pound overnight. But we remember that it ushered in 15 years of low inflationary growth. We have quite forgotten that our Greek holidays became much more expensive!

Arguably the most interesting example of the end of a currency union is the Czech/Slovak case. This involved a Euro-style currency union where two countries shared (albeit briefly) a single currency and a single central bank.

At the end of January 1993 Slovakia had lost 60% of its foreign exchange reserves and the game was clearly up. Both parliaments voted on February 2nd to introduce two new currencies just six days later on February 8th. On February 17th commercial banks quoted the Slovak unit down around 20%.

What is clear is that there are no “costless”, pain-free solutions. Correcting the structural imbalances that have built up in the Eurozone will require some difficult adjustments, but continuing with the status quo is not an option.

Writing down bank exposures to the peripheral countries will be painful. But allowing these exposures to continue to grow (as they inevitably will if the periphery continues to run a large deficit with Northern Europe) only postpones the day of judgment and makes the problem ultimately worse.

The difference between an “orderly” or “disorderly” change is critical. As there is no provision for a country to leave the Eurozone, any departure will require negotiation. The technical issues of introducing a new currency are well rehearsed and not that complicated. Clearly though there would be a need for temporary capital controls for a short period of time to avoid massive capital flight.

New notes can actually be introduced quite quickly by over-stamping existing currency. In today's modern world, there are far more ATMs and other machines that will need recalibrating, but again that is a technical issue, not a major political or economic issue.

Writing off sovereign debt is one thing, but a more material issue is the redenomination of private sector contracts where there has to be a loser at one end of the deal or the other. Either the Greek entity continues to carry Euro obligations, which in extremis could easily drive them to bankruptcy, or the other party takes a write-off as contracts are redenominated into New Drachma. Either way there will be losses to be realized. Once again though, there is precedent.

ⁱ Andrew K. Rose, Checking Out Exits from Currency Unions, MAS, April 2007

In an “orderly” exit losses will be borne. There is no escaping that. Banks may well need additional capital and in some circumstances, if the private sector is unwilling to provide capital at a reasonable price, banks could require public support. A condition of public support will likely be that both equity and unsecured debt holders will bear significant, possibly 100%, losses.

The difference between an “orderly” and “disorderly” exit depends fundamentally upon whether a robust firewall can be created to avoid a domino effect hitting other countries, Portugal, Ireland, and most critically Italy. Italy’s stock of debt is €1.9 trillion which goes well beyond the existing resources available for support. A sensible approach would be to make a Greek debt write-off also conditional on exiting the Euro. Other indebted nations would then know that the price for debt relief was exit, reducing the temptation to seek similar forgiveness.

The Key Risk – A “Disorderly” Exit

The great fear is that it will be impossible to create a firewall between Greece and the rest of the peripheral countries. Failure to do so means that as Greece’s exit is announced contagion spreads.

Depositors flee other peripheral countries perceived to be the next in line. Banks are forced to close their doors and a major credit crunch engulfs the Eurozone. Economic activity takes a nosedive. Recession spreads well beyond the Eurozone to engulf the rest of Europe and then the United States.

It is impossible to predict how much output might fall in such a scenario. However, an analysis of past crises (Argentina etc.) suggests that Eurozone output could fall by as much as 10, 20% or even more. And in those circumstances, equity assets, which might appear historically cheap today, could prove vulnerable to yet further very significant falls.

Watching the Eurozone’s tortured political process, it would be easy to be extremely negative about likely outcomes. After all, Italian bond yields have flirted with 7.5% (although they are back down to 6.9% at the time of writing), a level widely regarded as being catastrophic if maintained for any length of time. That may be too pessimistic a view.

It may well be that politicians are not able to get ahead of this problem before the crisis is staring us all in the face. But that does not mean that they cannot make contingency plans for the time when the train wreck is apparent to all.

What might those plans be? Any rescue plan would need to be bold and VERY convincing. There is only one country and one institution that could together have the clout to stop the dominoes collapsing once contagion really starts: Germany and the ECB.

Germany at the moment is seeking to achieve three incompatible goals:

- Preserve the Euro with its current membership;
- Avoid picking up the bill;
- Refuse to allow the ECB to print money.

Once contagion starts the only way to stop it would be to take the brakes off and allow the ECB to print money without limit. Rather as the Swiss have done, saying that they will sell Swiss Francs without limit to hold an exchange rate above 1.20 to the Euro. So too could the ECB stand there with a bid without limit for peripheral debt. However, not only would this go against all German instincts, it would also be in direct breach of the Lisbon Treaty (Article 123). Such actions would represent a clear re-writing of existing “rules” and that’s exactly why they won’t or can’t occur until the very last moment before the train is wrecked.

All of this argues for an extraordinarily uncomfortable period ahead of us with a wide range of possible outcomes, many of them extremely unpleasant.

Conclusion

What then are the views we would like to express today? Unashamedly, they are remarkably similar to last year!

- The odds are even more stacked against Government bonds in most of the developed world (with the notable exception of Australia). Timing remains uncertain, but strategically this does not look like a good time to be long duration. And we face significant tail risk credit exposures in a number of weaker sovereigns.
- Equity assets are attractively priced **as long as** we can avoid Double Dip. However, any material increase in the likelihood of Double Dip should be treated extremely seriously indeed.
- Strains within the Eurozone are unlikely to be resolved without some kind of restructuring or change in membership. The all-important question is whether a restructuring is “orderly” or “disorderly”.

The last few years have certainly been eventful. There is every possibility that the next years will be equally so.

Sticking with a strategic asset allocation model is the equivalent of setting sail from Boston to Bermuda and not changing course or trimming sails irrespective of the weather on the way.

That is not the way I would want to navigate the Bermuda triangle. If you are persuaded that you need to be more responsive to a rapidly changing world, then the first thing you are likely to have to do is to invest in your Fund’s internal governance structure to enable the Fund to take timely and considered decisions. Diversification and flexibility remain key.

If it is not too much to hope for, we trust that 2011 has been rewarding for you and your Fund, and here’s to a prosperous New Year! Even if all the omens suggest otherwise.

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