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**Investment Letter: 9th February 2012**

At the beginning of the year, wary of the multiple uncertainties facing investment portfolios, we suggested investors audit their portfolios to ensure they did not overly favour deflationary (and therefore defensive) outcomes over inflationary outcomes, and vice versa. This process should, at least, have prevented defensively biased portfolios becoming more so in the first weeks of 2012.

January's synchronised rise in all major risk assets has been nothing less than an eruption that gathered force, as it became clear how much investor cash was parked in the sidelines. Being cautious often seems the appropriate response, up until it has become the overwhelmingly majority response, at which point it is decisively the wrong response. We hold our hands up as being guilty of being too cautious in the latter part of 2011.

Looking to the macro backdrop, we observe that the US economic data continues to be helpful and January was an unusually light month for bond maturities and rolls in Europe - defraying some of the solvency issues. Markets also obtained succour from Central Bank actions: the Fed extending its commitment to keeping short term rates low into 2014 and the ECB shoring up the funding side of many European banks' balance sheets via its LTRO programme. Again and again, the key central banking authorities are sending out the message that they stand ready to provide liquidity on demand. Relaxing, where required, collateral requirements, flattening bond yield curves, taxing savers for years on end and - by extension of these measures - take a supersized risk on longerterm inflation.

The Fed's messaging has been commendably clear for some time; the bigger scene shift is the more recent conviction that the ECB will chime-in to a greater extent than anybody dared believe under the Trichet era. Given their optimistic mien, markets are now happy to gloss over the political controversy of central bank stimulus. In particular, it has begun to matter a lot less that QE3 is a dead duck in US Republican politics, which has extracted mileage in being anti-Federal Reserve, as the gaining strength of employment numbers relegate its immediate prospect to the sidelines.

We live in a world where investors and savers are being frog marched to their own financial repression. Expression might be a better term than repression, as savers are being expressed out of cash. The asset management industry has noted this, hence the growing popularity of equity income funds.

When you have such a dramatic move in markets, the appropriate question is: What has changed ?

Price momentum is, of itself, a fundamental factor, and should not be dismissed. Sustained price momentum is prone to change investor-saver psychology and is an express aim of the Fed in the equity asset class. Whereas deflationary fears were the mark of autumn of last year, these have been quelled by price momentum. It has been a perilous environment for market timers, most of whom will have struggled.

Whether January's swallows will stay airborne until the end of June and beyond will depend on a certain confluence of factors: sustenance of thermal lift from US data, China fulfilling the required notion of a soft landing and Europe to further elongate its rolling crises so that the consequent events (and the contagion risks of these events) are sufficiently spread out so that markets fail to interpolate a Greek crisis into a Portuguese crisis and thence to Spain and Italy and ultimately to the creditors of last resort: Germany and the ECB.

Whereas Brussels-Frankfurt-Paris-Cannes summiteering was the spectator sport of choice in the second half of 2011, we have clearly grown tired of the *ronde* and its exigent personalities. Six weeks to save the euro, they cried, and the six weeks passed and *biere pression* still flows, Toulouse has its *saucisson*, Alsace its *sauerkraut*.

Among these heady, perfumed airs of exuberance we should not, however, lose sight of the fact that Europe is broadly following the wrong policies and wrong policies at a time of crisis risk turning recessions into depressions. What the world needs now, unwholesome as it may sound, is a gradually expanding aggregate credit balance and Europe is doing a good deal less than its part. Neither should we ignore the truly alarming credit data emanating from private sources within China. Apparently, RMB3tn was pumped back into the credit system in 4Q alone in a dramatic loss of nerve on the part of the authorities who reopened the spigots to "re-up" its dysfunctional, regional property systems that were going bad, fast. Whilst this sudden turn of direction may have been helpful in numerous ways, it is a trick that cannot be performed again and again. As some of the more fundamental of the managers with which we invest have pointed out, the scale of fixed asset investment as a percentage of GDP that has been recorded in China is of the order that has *always* elsewhere resulted in a meaningful downturn.

For the US, final confirmations needed to deem the recovery robust and sustainable will need to come from three sources: a meaningful up-tick in US credit aggregates, confirmation that the apparent value in US housing will be met by rising prices and a filling out of the upward trends in US employment.

We have added equity with a strong quality bias to client portfolios: in the form of quality *per se* through the US manager Montag & Caldwell who invest only in US large capitalisation shares, buying those with sustainable earnings at a discount to their intrinsic value. We have also begun to add quality via equity income in Overstone Equity Income Fund, a new portfolio from an established global equity manager that invests in a concentrated portfolio of global shares (yield 4.2%) and the Trojan Income Fund (yield 4.3%), a well established income fund with a bias to UK sources of income.

Elsewhere within portfolios, whilst we cannot reasonably expect macro managers to record as good a year as 2011, we remain invested here, and our thesis is as follows. Either i) bond markets will continue to do what their masters require of them and this provides opportunity for macro managers to profit from the gap between communication and action or (ii) growth really gets going and there will be opportunity to profit whilst bond yields rise or (iii) sovereign credit issues really come home to roost and yields rise for another reason entirely, also a potential source of profit. When gold begins to express too much personality, recently behaving more akin to a pro-cyclical

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industrial metal, we are tempted to reduce. Given our starting position was around 10% of assets in many portfolios, we have taken January's strength as an excuse to reduce to closer to 7%, but replace all of that capital with income yielding equities. If a broad recovery does take hold, longer term rates will rise and we will want no part of gold.

Although our own currency overlay activities have not added value in January - a month in which beta currencies rose and the US dollar fell - we are invested in some managers that have benefited: many of the themes that confounded GAM Star Global Rates in 2H11 are playing out better in the past quarter. Autonomy, a macro manager suitable only for non UK tax sensitive portfolios, invested heavily in Asian currencies post their 3Q11 swoon, accounting for the large part of this manager's positive return in January 2011.

If January's lesson was to compel us to behave more like investors than economists, then we must continue in this fashion.

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