

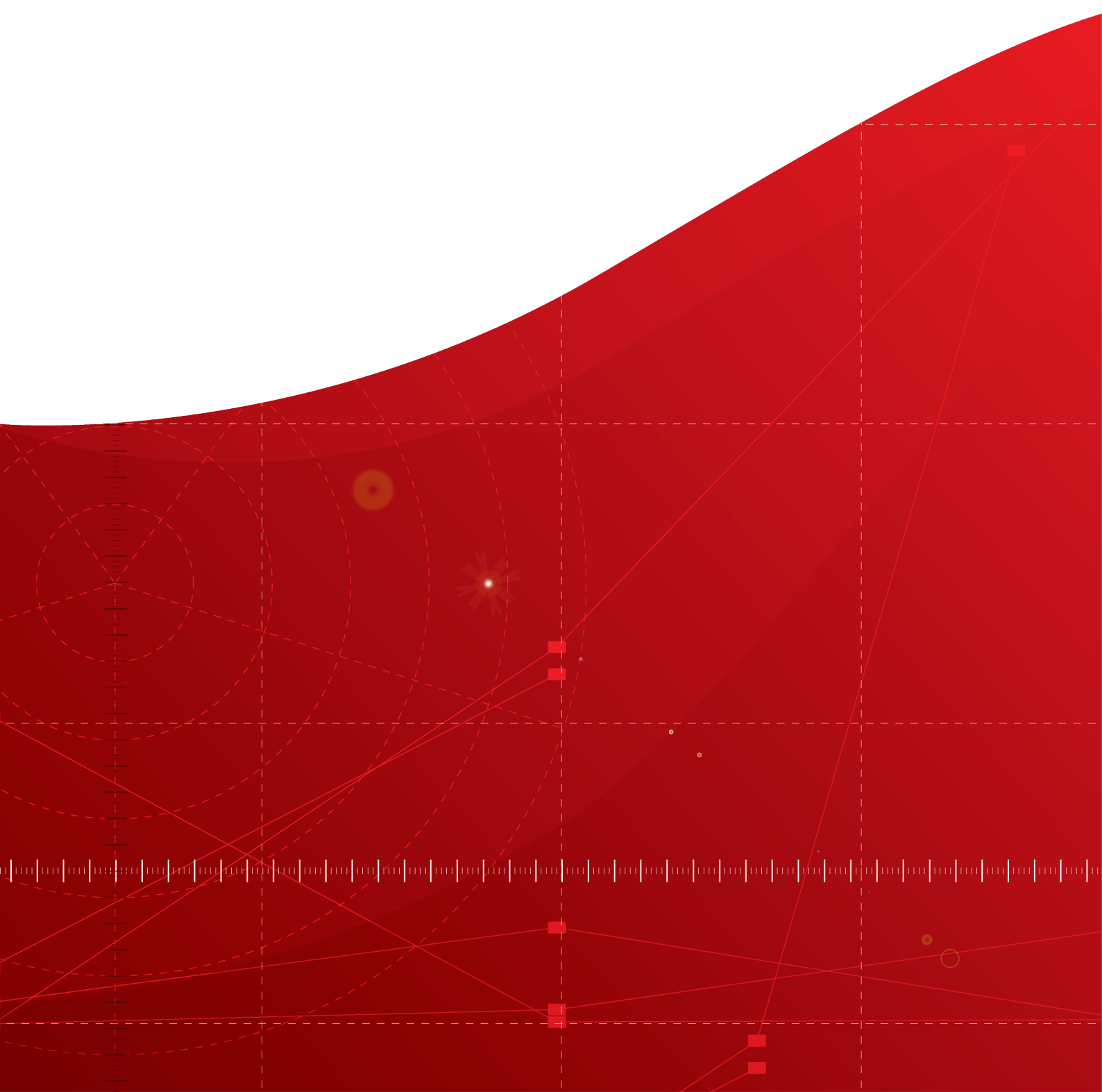


---

# A Look into 2011

A Review of 2010 & Outlook for 2011

By Neal Kelly



## 01.01

Investment Commentary

---

**Investment Commentary**

---

The global economic recovery story has become more firmly established over the past year.

The developing world led by China is growing at a vigorous pace. The US economy is recovering at a modest rather than a vigorous pace, against a background of weak consumer spending and business capital investment. The Euro Zone is in aggregate doing well, led by Germany, but roughly 20 per cent of the zone is struggling with weak growth, rising unemployment, large fiscal deficits and serious sovereign debt issues. The UK economy has shown surprising vibrancy. In general the outlook for the global economy is positive, but a nervous US consumer sector, a requirement to reduce government borrowing in many developed countries and currency volatility will act to restrain recovery in the developed world.

The main central banks are under no pressure to start taking official interest rates up from current historically low levels. Despite the recovery, central bankers are still more concerned about the threat of deflation than inflation and this is likely to result in unchanged official interest rates for some time to come.

The dollar has come under renewed downward pressure in recent months. This is primarily due to the fresh programme of quantitative easing. On the other hand, the markets like the Euro at the moment on the basis of the strong German recovery. Further dollar weakness looks possible over the coming months. Sterling looks well supported in its own right, but could be vulnerable to limited weakness due to its relationship with the dollar.

Global equity markets are doing well. This reflects the fact that the global economy is gradually returning to health and corporate earnings are now generally growing strongly. Despite concerns about global growth, the Euro Zone sovereign debt crisis and currency uncertainty, the background for equity markets looks reasonably good and further gains can be made over the remainder of this year and into 2011. Prospects for the ISEQ are not good as the banks will continue to struggle badly as will companies with a predominant exposure to the beleaguered Irish economy.

The fundamentals of the housing and mortgage market are still weak and are unlikely to get significantly better any time soon. In 2010 completions are likely to be around 13,000 and average prices look set to fall by around 10 per cent in the year to December. The market looks set to remain weak in 2011. Average prices could fall by around 4 per cent and completions could be as low as 9,000.

The Irish economic backdrop remains very challenging. Exports and manufacturing are doing well, but consumer spending, construction activity and business investment spending remain challenged. The key issues that must be addressed include restoring order to the public finances, getting credit flowing in the economy, continued progress in improving the competitiveness of the economy, the restoration of confidence to bond markets and addressing personal debt problems.

## 01.02

# Investment Commentary

---

### Investment Commentary (continued)

---

The issue of mortgage arrears cannot be allowed to persist, as the economic implications of this are very negative. However, there is no easy or straightforward solution. Debt write-off appears like a viable solution, but there are serious complications. Moral hazard is one issue, but the cost to the banks and ultimately to the taxpayer of debt write-off is potentially too costly to contemplate. It is quickly becoming the next biggest challenge facing the economy, the banking system and ultimately the public finances.

Ireland's economic and financial outlook is clearly very challenging and it will undoubtedly take serious political will, popular acceptance of very difficult measures, considerable domestic pain and a lot of luck in the shape of a stronger international recovery, to lift the economy out of the current very difficult situation.

GNP is forecast to decline by 1.5 per cent in 2010 and GDP is likely to be flat. Looking ahead to 2011, GNP is expected to increase by just 1 per cent and GDP by 1.8 per cent. This forecast represents a marked downward revision. This reflects the escalating cost of the bank bailout and the larger than anticipated fiscal correction.

The key task facing Government now is to convince bond markets of Ireland's future. If markets are not convinced of Ireland's future viability, there is no guarantee that the country could even access funds at current elevated rates. It is clear that there will be significant fiscal austerity over the next four years and this will dampen the economic recovery. However, there is a growing recognition amongst sensible people that there is little choice other than to restore order to the public finances. The big worry and real possibility is that c15 billion may not be enough, because growth could easily turn out weaker than anticipated and even more likely the cost of the bank bailout will rise as the extent of the personal debt default starts to become clearer.

From an economic perspective, it would be more desirable to have a bias towards cuts in inefficient expenditure rather than through tax increases that would further undermine effort and initiative in the struggling economy. If risk takers and entrepreneurs are demonised and taxed out of existence, then it is not clear where job creation will come from in the future and the tax revenues will not be generated to fund expenditure on social welfare and public sector pay.

## 01.03

# Investment Commentary

### Overall Economic Assessment

It is clear that the Irish economy is continuing to experience very difficult economic times.

From the perspective of consumers, personal disposable incomes have declined over the past two years due to a combination of wage cuts, tax increases and government expenditure cuts. Disposable incomes will remain under pressure for at least the next couple of years and this will undermine consumer spending. Consumer confidence is currently very fragile and consumers are more interested in saving and paying down debt, rather than spending. Personal savings have grown strongly over the past couple of years and there is now a pool of savings of close to c97 billion in the system, but consumers do not feel confident enough about the future to spend. Policy makers need to instil confidence in the population as soon as possible.

The manufacturing side of the economy is now doing well, driven by an improved export performance. Provided external demand continues to gradually improve and that competitiveness continues to improve this trend can continue and Ireland should experience an export-led recovery, but this will have limited impact on employment and tax revenues. To climb out of the current deep morass, a number of issues will have to be addressed;

- Correction of the public finances has to continue. Government cannot succumb to union pressures and has to at work towards the 3 per cent deficit target by 2014. It is highly unlikely that this target will be achieved, but we have to work towards it;
- The banking crisis has to be sorted and credit flow needs to resume in the economy. This will be a slow, painful and laborious process and it may be necessary to set up a state-funded bank to specifically target the SME sector.
- The competitiveness agenda needs to be pushed further. While some improvement in external competitiveness has occurred over the past year, more work is required. Consumer prices and all business costs need to fall further. The list of business costs includes professional fees, local authority charges, commercial rates, commercial rents, energy costs and wages. Ireland simply has no choice other than to pursue an aggressive competitiveness restoring agenda.
- The personal debt issue will have to be addressed, particularly the mortgage component. Data from the Financial Regulator suggested that at the end of June 2010 36,438 mortgage accounts, equivalent to 4.6 per cent of total mortgages were in arrears for more than 90 days, with 24,797 in arrears for more than 180 days. In value terms, this means that c6.9 billion was owed on accounts more than 90 days in arrears. It is likely that this figure has increased subsequently and looks set to increase further over the coming year, given the continued squeeze on disposable incomes. The issue of mortgage arrears cannot be allowed persist, as the economic implications of this are very negative. However, there is no easy or straightforward solution. Debt write-off appears like a viable solution, but there are serious complications. Moral hazard is one issue, but the cost to the banks and ultimately to the taxpayer of debt write-off is potentially too costly to contemplate. It is quickly becoming the next biggest challenge facing the economy, the banking system and ultimately the public finances.

## 02.01

# A Look Back at 2010

---

### A Year in Three Acts

---

A year ago at this time, we made the forecast that cyclical stimulus would beat out structural problems. This turned out to be a good representation of what actually happened, and over the course of the year, risk assets continued the choppy advance they began in 2009. In some sense, there were three parts to 2010. The early months saw risk assets move higher as they continued the 2009 asset recovery story, helped by preliminary signs of employment improvements in the US and very strong fourth quarter 2009 and first quarter 2010 earnings. The middle months of 2010 saw a double-digit percentage correction on the back of the Greek sovereign debt crisis and a stalling in jobs growth, leading to fears of a double-dip recession. Investors were also unnerved by the May “flash crash” and the uncertainty surrounding the financial reform bill in the US. Nevertheless, after touching a late summer low, the market experienced a very strong finish to the year (US stocks advanced more than 20% from their August lows through the end of the year) as double-dip fears receded, jobs growth resumed and the US midterm elections results were perceived to be capital markets friendly. Additionally, Federal Reserve President Ben Bernanke delivered his famous Jackson Hole speech, leading to a second round of quantitative easing measures (QE2) and, perhaps most importantly, the Bush-era tax cuts were extended and supplemented with some fiscal sweeteners.

Regarding the economic backdrop, debt and deflationary risks remained present throughout 2010, causing central banks (especially the US Fed) to respond with unprecedented actions. Real gross domestic product (GDP) growth continued in a positive direction but remained subpar compared to most recoveries on the historic record. In the United States, jobs growth was not strong enough to reduce the unemployment rate. Corporations, however, managed to notch fantastic earnings gains despite mediocre economic growth. Inflation remained a non-issue in the developed world, but began to rear its ugly head in some emerging economies. Government deficit spending and debt levels continued to haunt investors, but corporate financial health remained remarkably strong in both balance sheet and income statement terms.

US stocks ended the year up double-digit percentages, and the S&P 500 closed at close to our 1,250 target, outpacing most developed markets and many important emerging markets. Still, the year saw investor assets flow out of equity funds (especially US equities) and into bond funds as the insatiable thirst for income continued. Overall, equity market movements were choppy in 2010, but ultimately a double-digit percentage gain goes into the history books.

## 02.02

# A Look Back at 2010

---

### From Deflation to Inflation (Eventually)

---

One of the main themes that dominated the global economy in 2009 was the competing forces of deflation and inflation, and 2010 saw a continuation of that battle. Over the past few years, deflationary risks have obviously dominated, but there has been evidence of inflationary pressures in some markets (most obviously in China), and we have seen inflation in the form of rising commodities prices. With the high degree of excess capacity in labor and manufacturing, however, it is almost impossible to imagine widespread inflation taking hold any time soon. Recent data shows inflation remains muted, and the US Federal Reserve's launch of QE2 demonstrated that, if anything, the Fed is trying to promote higher levels of asset price inflation.

Over the longer term, the combination of easy monetary policy, further injections of quantitative easing and high deficits has led many to worry about the prospects for inflation. In our view, the worst of the deleveraging situation is now in the past and the impact of deleveraging on future growth will be less than it was over the past two years. Along with the easing of deflationary pressures, the falling dollar, higher commodity prices and the addition of more quantitative easing should prime the pump for inflationary pressures to begin increasing. As such, we believe the shift from a deflationary to an inflationary environment may be on the horizon over the next couple of years.

### 2010 By the Numbers

---

Although the course of the year was uneven and high levels of market volatility remained a constant for stocks, 2010 ended strongly, marking the second consecutive year in which US stocks recorded double-digit percentage gains. For the year as a whole, the Dow Jones Industrial Average gained 14.1% to close at 11,577 and, in the process, moved past the levels last seen before the collapse of Lehman Brothers in late 2008. For its part, the S&P 500 Index advanced 15.1% to 1,257, while the Nasdaq Composite moved up 18.2% to 2,662. Small cap stocks experienced even stronger gains for the year as investors began to move into higher-risk assets. For all of 2010, the small cap Russell 2000 Index climbed 26.9%.

Worldwide, stocks generally performed well, but in a noticeable change from previous years, the United States was one of the best-performing markets around the world. Europe was plagued with sovereign debt problems throughout the year, and many emerging European markets posted negative results for 2010. Among developed European markets, however, German stocks rose 16.1% and UK markets advanced 13.0%. Japan, which has long been suffering from anemic economic growth and deflationary problems, lost ground in 2010, with Japanese stocks declining 1.5%. China, which is combating inflation and is in the process of tightening monetary policy, saw market declines of 11.3% for the year. Despite problems in areas of emerging Europe and in China, however, emerging markets as a whole posted respectable returns, with the MSCI Emerging Markets Index advancing 18.9% for the year.

In bond markets, the theme for almost all of 2010 was one of yields trending lower as investors continued to move into the relative safety of fixed income investments. That theme turned around abruptly in the fourth quarter of the year as investors began to seek out higher-risk assets, prompting bond yields to rise sharply as the year drew to a close.

## 02.03

## A Look Back at 2010

## The 2010 Scorecard

Economic data fluctuated strongly throughout 2010 as the global economy continued to emerge from the "Great Recession." Likewise, financial market volatility remained elevated, but equity markets finished the year with strong gains. Against this backdrop, most of the predictions we made one year ago came to pass, we didn't get them all exactly right, but most of our predictions were on track:

**1. The US economy grows above 3% in 2010 and outpaces the G-7.**

Although final fourth-quarter growth numbers will not be available for a while yet, economists are currently revising their estimates upward, and it looks like GDP will have grown in the fourth quarter by around 3%. Also, it is looking like US growth for all of 2010 should just clear the 3% hurdle. Among other G-7 countries, other than Canada, no other country's growth level will surpass that of the United States.

**2. Earnings rise significantly despite mediocre economic growth.**

When we made this prediction at the beginning of the year, our point was that earnings improvements would outpace the broader improvements in the overall economy, and that is exactly what came to pass. Corporations as a whole did an excellent job at generating earnings in 2010, despite a lackluster economic backdrop.

**3. Inflation remains a non-issue in the developed world.**

While there have been some inflationary concerns in areas of the developing world, for the developed markets, deflationary pressures persisted through 2010. We acknowledge that in the years ahead, inflation may become a concern given high deficits and some of the structural problems, but such an environment is not likely to develop in the near future.

**4. US stocks outperform cash and Treasuries, and most developed markets.**

Our broad asset class call we made at the beginning of the year has come to pass. With year-to-date returns over 10%, US stocks have outperformed cash and Treasuries so far for 2010. With few exceptions, US stocks also outperformed other developed markets.

**5. Emerging markets outperform as emerging economies grow significantly faster than developed regions.**

Economic growth in emerging markets has been much stronger than in the developed world, and emerging markets on balance have outperformed. The degree of outperformance, however, was narrower than we expected.

**6. Healthcare, information technology and telecommunications outperform**

**financials, utilities and materials.** This prediction was correct, but just barely so, as a basket of healthcare, information technology and telecommunications stocks has very slightly outperformed a basket of financials, utilities and materials stocks.

## Funds We liked

## 2010 Return

— Zurich 5*5 Americas Fund	15.9%
— Threadneedle American Select Fund	19.03%
— Zurich Top Tech 100	29.78%
— Zurich India Equity Fund	26.28%
— Friends First Protected Equity 2	6.89% (to September 10)

(Source: Zurich Life & Pensions & Friends First)

## 03.01

# Our Predictions for 2011

---

### A Look into the Crystal Ball

---

In an economic environment likely to be characterised by a modest cyclical recovery combined with ongoing structural problems, we expect equity markets to remain volatile, but to see continued gains. With this backdrop, we venture forward with our predictions for 2011.

- Not only is US growth likely to be stronger in 2011 than it was in 2010, but more importantly, the quality of growth will improve. Economic activity in 2010 was based heavily on government stimulus and inventory rebuilding. Both of these factors will be less significant in 2011 than they were in 2010, meaning final demand is going to pick up the slack. In particular, we believe real final sales will increase from around 2% to almost 4%. This sort of growth is healthier for the economy and more sustainable. Additionally, we believe economic growth in 2011 will be supported by an increase in money growth, a steeper yield curve and easing of credit conditions in the US. Nominal GDP in the United States already reached a new all-time high in 2010, and we expect real GDP to also reach a new high at some point during the first half of 2011. Despite this outlook, however, we would caution that growth levels are still likely to remain below trend.

The last time the stock market posted three consecutive years of double-digit percentage gains was in the late 1990s. We believe a double-digit percentage total return is certainly possible for 2011. We expect earnings growth to continue to be better than economic growth, stocks are reasonably inexpensive and confidence levels are improving. Our view is that the risks in 2011 are more to the upside when compared with the downside risks of 2010. Should business and consumer confidence levels continue to improve, if credit problems remain manageable and if US politicians remain reasonably capital markets friendly, then we could see some valuation improvements, which could push market prices even higher.

- While stocks did ultimately outperform bonds and cash in 2010, it wasn't until the fourth quarter that stocks pulled ahead of bonds for the year. We expect stocks' leading edge to continue in 2011. Assuming stocks have any sort of positive return in 2011, they will outperform cash investments. The bigger question is bonds; Eurozone interest rates are not expected to rise until Q1 2012, with peripheral weakness offsetting core economy strength. The current view is that UK and eurozone base rates are not expected to rise until Q1 2012. The US is expected to move on rates during Q4 2011. In peripheral eurozone countries fiscal challenges remain acute. This has been reflected in dramatic yield spread widening over core country bonds, a situation that is unlikely to resolve itself in the near-term. Yields in core eurozone bond markets, especially Germany, and the US Treasury market have risen recently, reflecting improving economic data. This is a trend that could continue should the economic recovery momentum be sustained. Inflation pressures overall remain modest, reflecting weaker data in developed economies, while stronger readings in emerging economies and Asia, especially China, have led to interest rate rises.

## 03.02

# Our Predictions for 2011

---

### A Look into the Crystal Ball (continued)

---

- 2010 was a year in which geographic allocations played an important role in determining investors' overall portfolio returns, and we think 2011 will see a continuation of this trend. We favor markets that have evidence of accelerating economic momentum and low levels of inflationary threats. We also prefer to avoid markets that are facing significant credit risks. As a result, we are predicting that a basket of US, German and Brazilian stocks should outperform a basket of Japanese, Spanish and Chinese stocks. There are a host of reasons to favor US stocks, including improving quality and quantity of US economic growth. Germany is exhibiting strength in manufacturing and exports and Brazil is benefitting from a rapidly growing middle class and solid consumer spending levels. On the other side of our equation, Japan is suffering from persistently slow growth and Spain has a troubled banking system and ongoing credit woes. Regarding China, we expect economic growth will remain strong, but that market is in the midst of a tightening cycle designed to combat inflation — an environment that does not bode especially well for equity market performance.
- As long as global growth is at least reasonably strong (as it was in 2010), commodities prices should appreciate in 2011. Oil could top \$100 per barrel at some point during the year due to better macro demand and continued inventory declines. At the same time, since gold is "the only currency without debt," gold prices are likely to move higher over the course of the year, albeit at a slower pace and more irregularly than they have over the past couple of years. Additionally, industrial commodities such as copper should benefit from continued global growth and urbanization in emerging markets. As indicated earlier, we expect the growth differential between emerging market countries and developed markets will narrow in 2011, but we remain preferential toward emerging market currencies over a basket of the dollar, euro and yen. The US dollar strengthened versus the euro during 2010, despite the US pursuing a weaker dollar policy through quantitative easing. It closed the year quite a distance from the perceived equilibrium level, versus the euro, of 1.18. Expectations would be for the dollar to trade towards this equilibrium level in 2011.
- Should the economic and market backdrop play out as we expect, we should see fixed income flows slow and equity fund flows pick up materially in 2011. This would reverse a multi-year trend in which investors have been embracing bond funds and shunning equity funds. Indeed, this reversal appeared to kick off in the fourth quarter of 2010 when equities began to noticeably outperform fixed income. Flows tend to follow prices, and we would expect that during the course of this year, we will see a noticeable slowdown in bond fund flows and the switch into equity funds.

## 04.01

# What's an Investor to do?

---

### What's an Investor to do?

---

The start of a new year is always a good time to review your investment goals and asset allocation, and to make portfolio changes where necessary. With that in mind, we suggest some ideas investors may wish to consider:

- Retain equity overweights: A combination of supportive fiscal and monetary policy, decent economic growth, low inflation, strong corporate earnings and decent valuations should be a recipe for stock price appreciation in 2011. As such, we would recommend retaining overweight positions in equities relative to cash and bonds.
- Think about geography: As indicated by our overall market outlook and our specific predictions, we expect US stocks to continue to outperform most other global markets. Economic growth should be stronger in the United States than in almost any other developed market, as should corporate earnings growth. At the same time, it is important to maintain a diversified portfolio with some allocation to better-positioned international markets, including emerging markets.
- Stay with commodities: Gains will likely be uneven, and volatility in the commodities markets is likely to remain high, but long-term investments in commodities continue to make sense.
- Remember that gains will be harder to come by: In many ways, the "easy money" in this bull market has already been made. The year ahead will likely see ongoing volatility and heightened dispersion between the winners and the losers. In this sort of environment, selectivity will be critical.

## 05.01

## Disclaimer

---

### Disclaimer

---

**This outlook** does not constitute an offer and should not be taken as a recommendation from Thomond Asset Management. Advice should always be sought from an appropriately qualified professional.

**Warning:**

- The income you get from an investment may go down as well as up.
- The value of your investment may go down as well as up.
- Benefits may be affected by changes in currency exchange rates.
- Past performance is not a reliable guide to future performance

