Aureus Asset Management
Investment Perspectives: January 2012

Europe, China, the US: How 2012 Might be Different

Introduction

Many investors found that 2011 was both more volatile and less rewarding than past years, as shown in the table below. However, the US market easily surpassed other areas of the world:

	Total Return		
Period	S&P 500	MSCI Europe	MSCI Asia ex-Japan
2011	+2.1%	-13.8%	-19.2%
2010	+15.1%	+1.0%	+17.0%
2009	+26.5%	+31.2%	+68.3%

The gain in the US equity index was slight, but it was also far ahead of the performance of other geographies, quite different from the recovery year of 2009. Actually, the only solid results last year came from high quality bonds, as investors fled from what they felt were riskier assets.

This year, Europe, China and the US continue to face challenges requiring unique policy responses. For reasons described below, Europe and China may alter economic and political policies more quickly than the US.

Because of continued improvement in corporate profits and balance sheets, valuations of equities and other "risk" assets look reasonably cheap for much of the world. When the outlook for economic growth improves, these valuations should prove attractive.

2011 Review

After several inadequate attempts at a cohesive response to sovereign debt issues, European politicians finally adopted a proposal in November to amend European treaties, making it both harder and costlier to run significant budget deficits. Even more recently, the new President of the European Central Bank ("ECB") aggressively loosened monetary conditions in December, by taking actions similar to those by our Federal Reserve in late 2008 and early 2009. At least temporarily, the ECB has helped to calm markets and signal a possible way out of crisis.

China moved decisively last year to reduce the threats of inflation and real estate speculation. As a result, China's growth slowed. More recently, China has begun to relax certain measures, reminding us that they have the flexibility to implement well understood counter-cyclical fiscal and monetary policies. Substantial increases in the country's domestic wage levels should boost the purchasing power of the Chinese middle class, while also reducing export competiveness. The country has made a clear choice to emphasize domestic growth, recognizing that exports will assume less importance.

In the US, press headlines all year focused on political dysfunction. Despite the gridlock in Washington, the economy displayed signs of improvement in late 2011, with jobs rising and unemployment down slightly.

One Winthrop Square, Boston, Massachusetts 02110 | 617.728.8900 | info@aureus-asset.com | www.aureus-asset.com

Expectations for 2012

While Europe struggles with painful spending decisions to reduce some social benefits, the ECB will try to stabilize sovereign bond markets. Both monetary easing and real fiscal discipline are essential. We believe that Europe will undergo a recession in 2012, which will make the adjustment more painful. However, we hope that Europe's leaders will remain committed to the path agreed upon in late 2011.

As for China and Asia in general, we expect different policies than those of 2011. With inflation less of a threat, the spigots of growth will be slowly opened. Asian economies may well reach a cyclical low in the first quarter, which could worry investors in the near term but which should be understood as a delayed reaction to the pressures of 2011. Led by China, Asia has the financial resources to boost domestic growth rates, even while its exports to the developed world reflect reduced opportunities, especially in Europe.

Because of the US presidential election in November, it seems unlikely that Congress will pass any meaningful legislation to attach our budget deficit problem. We require a political compromise to address, once and for all, this very large challenge. That compromise will inevitably involve both entitlement cuts and revenue increases, programs which Congress cannot touch in an election year. In the meantime, we expect slow improvement in the economy, with modest but continuing gains in corporate profits. We expect the US will continue to be viewed as a safe haven in a very uncertain world.

Conclusion

In 2012, there should be signs of further improvement in the US, as well as of halting but eventual progress in both Europe and Asia. Therefore, investors may once again respond to opportunities outside the safest and most risk-averse assets.

With valuations of many asset classes and geographies well below historic means, we see a large number of potentially rewarding long-term investments.