



January 2012

Currencies	ECB in reverse gear
Bonds	How low can we go
Equities	Risk on.... Risk off.... Again.
Oil/Commodities	Gold shines less brightly

GENERAL COMMENT

A VERY EUROPEAN CHRISTMAS

Six months, 22 months, 3 years and 5 years (x2); these are the ages of the children accumulated in my house over the holidays. It was loud and boisterous and quite a lot of food ended up on the floor. What does this have to do with the investment environment at the end of the year, you might ask? Think of the children's ages in terms of a parable for European countries and the now-monthly get together of European leaders and finance ministers. The six month old, represented by Portugal, only partially knew what was going on most of the time and more or less quietly acquiesced to the demands of the other children (read as countries, participants, members). The 22 month old, mostly incoherently yelling at the top of his lungs and demanding items at random should, of course represent Greece and their consistent message that they should have everything they please, without consequence. The three year old, caught in the middle and going about her business, should perhaps be represented by Holland or Austria, quite content to proceed with her daily routine as if nothing at all is amiss. The five year olds, the veterans of Ye Christmases of Olde, are of course Germany and France. Never quite content to let the smaller players work out on their own what they should do, invariably orders and admonitions are barked in between bouts of their own wrestling match to be the lead reindeer.

Absurd, one might say, but is it any more absurd than the daily market reactions to the headline

chasing small to middling global economic powers that comprise Europe? That the global financial markets are still listening to what the deputy education minister of Greece has to say about austerity on any given day 18 months after it was clear that Greece was going to need some "help" surely has to be more absurd. The powers of Europe have delayed and prevaricated for so long it is utterly awe-inspiring how well certain markets (and the Euro) actually performed over 2011 in the face of such uncertainty. In a world where all markets are supposedly correlated to each other and seem only to trade around the fortunes of Europe, the Dow Jones Industrial Average was up 5.53%. European equity bourses were by no means similar over this period with the French market down -16.95% and the Italian market -25.2%. Risk markets have differentiated themselves, despite overwhelming media attention to the contrary, and we are positioned to believe they will continue to do so in 2012.

With recession a certainty in Europe, the only true question will be whether the rest of the global economy can skirt its own growth downturn. Some of this question has to do with how deep and prolonged the European recession winds up being and whether it is able to envelop "out" countries like Denmark, Sweden, Norway and Switzerland.

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Evidence from the US economy supports a continuation of slow, boring growth in the coming year. The American consumer may be bowed, but is not yet broken and fixed investment by business continues to be relatively strong. While emerging market economies have slowed, they are currently tracking for a soft landing, rather than an extreme fall-off in growth, thanks to coherent monetary policy. What is certain is that there is one very good way to lower debt/GDP ratios and that is GROWTH. Equally certain is that with the IMF looking to be an increasingly important player in the denouement of the European debt

crisis, austerity seems to be winning the day in Europe and elsewhere. Even as we write this, Spain is raising taxes on income, savings and “high-value” homes; growth simply has no place to establish itself in Europe (even in Germany) and this may be more dangerous than the past policy of kicking the can down the road, so prevalent in 2011. We continue to be defensively positioned in this environment.

Andrew Baron, CFA, Head of Group Fixed Income.

MARKET COMMENT



CURRENCIES

The euro extended recent losses last month as currency investors disapproved of the ECB's latest measures to stem the crisis. A second consecutive interest rate cut of 0.25% unwound the year's prior hikes, but it was the less conventional form of intervention that precipitated the bulk of last month's decline. The announcement that unlimited three year loans would be made available to commercial banks speaks to a potential surge in liquidity within the financial system and is, in our opinion, tantamount to Europe's own version of 'quantitative easing.' Similar policies in the US and UK have caused the greenback and sterling to depreciate, suggesting that such monetary assistance may also act as a headwind for the single currency. The Euro finished the month almost 4% lower versus the dollar, moving below \$/€1.30 for the first time since September 2010.

In recent months, sterling has benefited from events in Europe, with last month's 3% gain against the Euro taking it to a 12 month high of €£1.20. However, we question how long this strength can persist with the UK economy on the verge of re-entering recession. It has already weakened against several other currencies, with last month's 1% loss against the dollar completing a miserable second half of the year for sterling.

The Aussie Dollar finished the month unchanged against the US Dollar, despite the Reserve Bank of Australia lowering the cost of borrowing for the second straight month. These moves have brought the target rate back to 4.25%, so there is still scope for further loosening should Europe's economic downturn prove contagious. The Aussie also finished the year flat against the greenback, but this masks the fact it has witnessed a number of swings of 10% or more since the summer. Such wild oscillations have been a feature of other commodity currencies, including the Canadian dollar and South Africa Rand.

Most 'growth' currencies were weaker last month, and the level of volatility experienced by emerging market currencies during the past six months has been extreme with markets caught between the negative impact of a return to looser monetary policies and the appeal of superior debt characteristics; few emerging economies have anything like the level of public or private sector indebtedness that has become the hallmark of developed economies.

Most Asian currencies were also weaker last month, with the Indian Rupee's 2% decline taking its annual drop against the US Dollar to 19%. Investors have evidently been perturbed by the damaging inflationary backdrop and a deterioration of the country's finances. Unlike many Asian peers, India has the dubious honour of running both a current account and budget

deficit, which leave the economy extremely vulnerable to weaker global growth, at a time when domestic growth has also started to decelerate.



BONDS

New Year predictions are normally an exercise in folly and amongst the seers in the industry few reach retirement with records

any better than the average astrologer. So with cap in hand and as humble as can be, we foolhardily launch ourselves into 2012 with a forecast made with a degree of conviction: 2011 was the final year of double digit returns in the great bond bull market that has spanned the last three decades.

10 year bonds in the UK, US and Germany all closed the year having generated returns of between 13% and 16%; a highly respectable gain from assets commencing the year on yields of a little over 3%. A further year of double digit gains would require yields to tumble to below 1%. This is not an impossibility since it would necessitate yields coming to rest where they have traded in Japan for many years. However, while the problems faced today in the West are huge, they are notably different to the great Japanese bubble of the 1980s. Few will forget, Japanese property prices scaling such heights that the grounds of the Imperial Palace were purportedly as valuable as all the real estate in California. At the same time, the stock market was trading on huge multiples, despite a corporate sector that was saturated with debt. Top heavy demographics only compounded the woes.

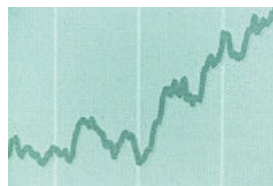
So, whilst many of these difficulties are reminiscent of the issues we face today, it is highly improbable that deflation will develop as it did in Japan whilst Central Bankers pursue current strategies. Maybe even more importantly for bond markets, a culture of saving meant that external funding was not a requirement in the way that it is for today's problem nations.

Current bond yields are well shy of nominal growth rates, and indeed even shy of the inflation rate. Such 'financial repression', or the manipulation of bond yields at low levels, was how Western Governments overcame post war debt burdens. Any immediate threat to capital

values may therefore remain modest for the time being. However, any asset trading on an effective p/e ratio of fifty times will always be vulnerable to downside shocks. More

importantly, however, we are nearing the moment when any tradition sources of 'upside' news for bond markets could act to work in reverse.

If the economic environment continues to deteriorate though 2012, budget deficits will swell and the likelihood of repayment will become the dominant factor in determining bond yields. We again stress that growth is essential to bring deficits under control. At some point, the need for external funding means that bad economic news can't indefinitely be considered good news for the bond markets, as the 2011 loss suffered in the Italian bond markets attests.



EQUITIES

Equity markets finished December broadly unchanged as trading volumes moderated in the

lead up to the holiday season; this completed a stellar quarter for most regional bourses, though annual returns were far less rewarding. Over the month, the MSCI World equity index appreciated by almost 1% in sterling terms, curtailing its annual loss to around 7%. After a strong 2010, last year will be one that most equity investors will want to forget.

The divergence between regional and sector returns over the calendar year has been stark. Despite the gloomy news headlines and the often nerve-racking levels of share price volatility, the US stock market managed a modest gain for 2011; on a total return basis the S&P 500 index inched 2% higher. The UK large-cap indices were not far behind, with a healthy dividend yield helping to offset the FTSE 100's 6% capital loss. It finished the year just 1.5% lower, having earlier experienced a number of meaningful corrections.

Significant losses were seen elsewhere, with most European markets experiencing double-digit percentage falls. Emerging markets also suffered from the general risk aversion with the Brazilian, Chinese, Russian and Indian headline markets all slumping by around 20% in local

currency terms. On a sector basis, last year saw defence as the best form of attack with the traditional defensive industries comfortably outperforming their more economically-sensitive counterparts.

Last month's lack of clear direction in markets may prove to be a snapshot of what is to come. Recent economic data releases imply positive, albeit modest global growth remains the most likely outcome. Importantly the US housing and labour markets are displaying tentative signs of recovery and self-sustaining US growth, coupled with continued progress in the developing nations, should be sufficient to offset the pending European recession.

With all but a very deep downturn in Europe already reflected in share prices, further signs that the global economy is still 'muddling through' are likely to lead to stock market gains. However, we remain cautious for the simple reason that the Eurozone's debt crisis is yet to be resolved. We anticipate there being renewed Europe-led 'wobbles' over the coming months, but are positioned to take advantage of any buying opportunities as they arise.



GOLD / COMMODITIES

Over the course of the month, headwinds from the European sovereign debt crisis and mounting concerns over economic slowdown in China led the Thompson Reuters/Jefferies CRB Index to decline by a further 2.71%. As a result, commodities markets posted their first annual fall since 2008.

Crude oil and oil products were amongst a handful of bright spots for 2011, supported by geopolitical uncertainty and generally firm demand, but sentiment over the health of major global economies has put a cap on prices. Disappointment over the lack of progress in Europe, along with speculation that US inventories have increased, led to the price of West Texas Intermediate crude oil for February delivery to decline 1.52% during December and finish the year trading around \$99/barrel.

Natural gas was among last year's most disappointing commodities, declining by more than 30%. Half that fall occurred during the

final month of the year, with natural gas futures declining below \$3 per million British thermal units for the first time since September 2009, on growing stocks and slack weather related demand.

Gold lost some of its lustre as a safe haven asset during December. Bullion prices have declined 17% from a record high of \$1,920/oz in September, as the US Dollar strengthened, traders liquidated holdings, and banks slimmed down gold trading books. Nonetheless, whilst the precious metal finished the month down 9.7% at \$1,576/oz, it remained 11% higher than its level at the start of 2010. The lack of a resolution to the long-term problems of the Eurozone has become an important factor in supporting the price of gold. Moreover, other shifts in the gold market that have underpinned the metal's decade-long bull-run remain in place. Central banks, mainly in Asia and the Middle East, have been stocking up, with net purchases this year expected to reach the highest level since before the 1970s, at more than 400 tonnes.

Prospects for a "soft landing" in the Chinese economy strongly influenced commodity prices throughout 2011, especially the likes of copper. By the end of December, copper for three-month delivery on the London Metals Exchange had declined 25% from a record \$10,160 a metric ton in February, also resulting in the first annual decline since 2008.

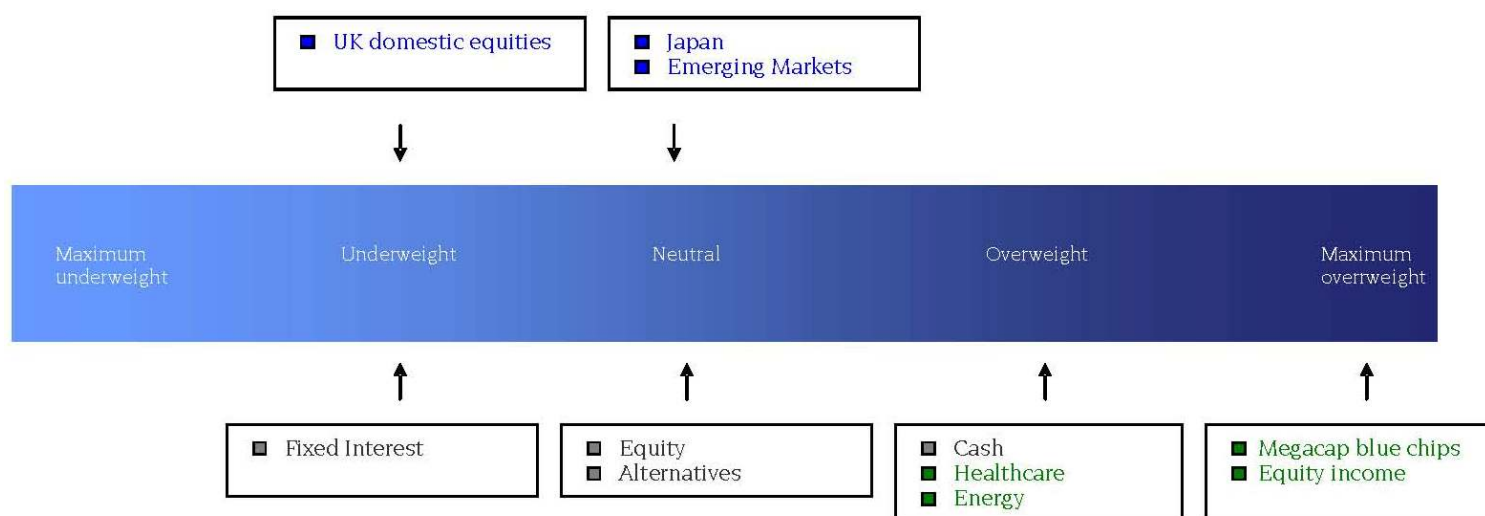
Soft commodity prices held up relatively well during the month, with wheat and corn leading rises. The price of wheat gained 9.5%, the biggest monthly advance since August, while corn rose 7.5%. A drier weather forecast for the Ukraine through to Argentina, plus a positive tilt to outside markets helped to support grain prices. General market consensus indicates that a drop in grain production from Argentina this year could spark increased end user buying, and tighten the supply outlook for the US and the world to a point where higher prices may result.

POLICY SUMMARY CHART

The chart set out below is a summary of our current policy stance on the various equity and bond markets which we monitor. It is not intended as anything other than a guide on where we stand and we will change the content as our views alter. Cash exposure is a residual and will tend to be high when negatives outweigh positives and vice versa.

Key

- Asset Class
- Regional Preferences
- Cross-sector themes/key industry opportunities



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MARKET PERFORMANCE

31st DECEMBER 2011

All performance numbers show % changes except for bond yields which show yield changes.

	Now	- 1 mth	- 3 mth	- YTD
CURRENCIES (VS USD)				
GBP	1.5543	-1.0	-0.3	-0.4
CHF	0.9381	-2.7	-3.2	-0.3
AUD	1.0209	-0.7	5.7	-0.2
JPY	76.91	0.9	0.2	5.5
EUR	1.2961	-3.6	-3.2	-3.2
BOND YIELDS (10 yr)				
UK	1.98	-0.34	-0.45	-1.42
US	1.88	-0.19	-0.04	-1.42
Germany	1.83	-0.45	-0.06	-1.14
Australia	3.67	-0.26	-0.55	-1.88
Japan	0.98	-0.08	-0.04	-0.15
EQUITIES				
UK. FTSE 100 (GBP)	5,572.28	1.2	8.7	-5.6
US. Dow Jones (USD)	12,217.56	1.4	12.0	5.5
Japan. Nikkei Dow (JPY)	8,455.35	0.2	-2.8	-17.3
Australia. All Ords (AUD)	4,111.00	-1.8	1.0	-15.2
MSCI Pac ex Jap (USD)	1,111.30	-1.1	5.2	-16.2
MSCI Eur ex UK (Local)	791.74	0.7	6.2	-15.3
MSCI Lat Am Free (USD)	3,602.29	-1.9	7.8	-21.9
MSCI World (USD)	1,182.60	-0.2	7.1	-7.6
MSCI World (GBP)	760.85	0.9	7.4	-7.2
MSCI World (AUD)	1,158.39	0.6	1.4	-7.4
COMMODITIES				
Oil (WTI)	98.83	-1.6	24.2	5.8
Gold	1563.70	-10.5	-3.7	10.1