

Market view

Economic and investment
analysis in brief

April 2009

A quick summary

We thought at the beginning of this year that recovery would be a long, hard slog. And, in the first few months of this year, macroeconomic news was frequently worse than expected.

There are however now some signs that a bottom may be forming. Some economic news has been better than expected, particularly as regards consumer spending. And policymakers continue to grasp the nettle, with dramatic shifts in monetary and other policy.

A number of major risks remain, but we are increasingly confident that there will be a gradual recovery, starting in the US and China during the second half of the year. So, while we may not have any 'green shoots' of recovery just yet, at least a thaw has set in which should let the sap rise. In time, this will give investors a bit more spring in their steps.

Micheal Dicks, Head of Barclays Wealth,
April 2009

Signs of a thaw

- **It is too soon to talk of the 'green shoots' of a recovery**
- **But policymakers continue to work hard and there are reasons to hope**
- **Investors should turn up the 'risk dial' slightly**

uniformly bad to only the majority being bad. Some news has in fact turned out to be better than expected (for example on consumer spending).

A slump in industrial activity and declining external trade is to be expected. This, although unpleasant, is an important part of the economic adjustment process, reducing the flow of goods to bring it in line with the new, lower rate of demand. But this adjustment process sets off a second round of demand reduction – because, as workers lose jobs, those still in employment fear that they might be next and so raise their savings rate. So it remains very important that policymakers provide some support for demand. They are certainly becoming more aggressive on fiscal policy – even in Japan and Germany. Monetary policy shifts have also been dramatic.

Policymakers are also still trying hard to stabilise the world's financial system. They have not yet met with total success here. But the US's Public-Private Partnership Investment Programme – that buys 'toxic' assets from current holders, with the authorities providing loans to leverage up private investments – has a fair chance of lessening the risks associated with the financial system not functioning properly. There are therefore grounds for thinking that the latest proposals could mark the beginning of the end of the financial crisis.

We continue to believe that there will be a mild global economic recovery later this year, led by the US and China.

As far as the world's economies are concerned, it is too early to talk of the 'green shoots' of recovery. But it is encouraging that the tone of macroeconomic news has shifted – from



One is that the crisis could yet spill over into unexpected areas – as for example, the Fed’s surprise move to buy US Treasuries to push down the cost of borrowing had the side effect of pushing down the value of the dollar. The spectre of competitive devaluations is particularly disturbing.

Another is that “animal spirits” – or investors’ confidence in the economic system – tumble again. When that occurs, traditional instruments of demand management may well fail. Our demand models certainly over-predicted growth in the fourth quarter of last year, suggesting that something like this happened then.

Finally, one should always remember that problems can also appear from an unexpected source – and that this includes political risks. Unfortunately, what usually causes crises is something that wasn’t even on people’s radar screens before the event.

All in all, we put the chance of these problems derailing the recovery as something like one in ten. In other words, the risks of depression and (prolonged) deflation are not negligible – but neither are they near fifty-fifty.

All in all, we put the chance of these problems derailing the recovery as something like one in ten. The risks of depression and prolonged deflation are not negligible – but neither are they fifty-fifty.

So we think that investors should start to turn up the ‘risk dial’ slightly. As is discussed below, we are however keenest on credit, and remain somewhat cautious on equities – although we continue to expect that the stock markets will gradually find their feet during the second half of this year. The coming year holds much promise, albeit with some risk attached.

A large, bold, white, sans-serif word "OPTIMISM" is overlaid on a dark, blurred background. The background appears to be a close-up of a person's face, possibly a woman, looking slightly to the side. The lighting is warm and soft, creating a sense of optimism and focus.

Economic and market prospects – India and Asia

- A sharp fall in Indian growth is expected this year
- Inflation will turn briefly negative
- 2010 will be a better year for Asia

Indian GDP growth is forecast to contract from 6% in 2008 to just 4% this year, before only a slight recovery to 5% in 2010. The good news is consumer price inflation is predicted to fall from a 2008 average of 9.1% to -0.7% in 2009, recovering to 4% by end 2010. The benchmark repurchase interest rate is expected to fall from 6.5% at end 2008 to 3%, and stay there through next year.

Some Asian economies have suffered much worse from the current world economic downturn, particularly if they are heavily exposed to foreign trade. With global trade volumes possibly contracting by 30% this year, many countries' foreign trade data has been particularly depressing. The Asian economies are expected to contract by 0.1% overall this year, despite creditable performances by India and China. The Japanese economy is forecast to contract by 6% this year, with only slightly smaller falls in output in Taiwan (-4.9%), Singapore (-4.7%), Hong Kong and South Korea (both -3.5%).

However, faced by a sharp slowdown in expected growth, policymakers in most emerging market economies have plenty of room to ease monetary policy significantly. And in many, notably China, there can be a large fiscal boost administered too. So we expect emerging market rates of growth to

turn positive in 2010, although expansion will still be rather below 2009 levels. Emerging market equities are likely to anticipate real economic recovery, starting to rise before those in many developed market economies.



The Indian forecast in a nutshell*

% y-o-y except where stated

	2007	2008	2009	2010
GDP	9.0	6.0	4.0	5.0
CPI	4.8	9.1	-0.7	4.0
Repo rate (%)	7.75	5.00	3.00	3.00

* Note that all market variables are end-of-period rates.
Source: Barclays Wealth Research

Economic and market prospects – USA and Japan



USA

- Consumers will benefit from fiscal stimulus
- There will be modest GDP growth next year
- Policy intervention does carry the risk of higher inflation

US global forecasts

USA	2008	2009	2010
GDP	1.1	-3.0	0.8
CPI	3.8	-0.6	-0.1
Fed funds (%)	0-0.25	0-0.25	0-0.25
10-year yields (%)	2.07	3.00	3.40
MSCI US	-38.3	2.5	16.0
\$ index	-13.1	9.0	-5.4

Source: Barclays Wealth Research

The US economy should continue to shrink in the second quarter of this year, but more slowly. Consumers will begin to benefit from fiscal stimulus, with stabilising confidence also helping to prop up household spending. Fixed and residential investment should however keep declining throughout this year.

We expect the economy to recover in 2010, although GDP growth is likely to be modest that year. The battering of the financial sector, and the continuing increase in consumers' savings ratios, will limit the strength of the recovery.

We are also concerned about the way in which the current policy intervention will be reversed. There will be an understandable temptation for policymakers to main support as long as it is visibly needed, but the size of the intervention does raise the risk of higher inflation. Coordinating expectations at the time that the quantitative easing programme is wound up may prove tricky.

Japan

- A 6% fall in GDP this year
- Deflation will return
- Fiscal policy will prove important in shoring up demand

The Japanese economy has been the hardest hit of all the major economies. We expect real GDP to drop 6% this year, and for it not to bottom out until the fourth quarter of 2009 – when fiscal easing starts to have an impact on global demand.

Japan also looks set to return to deflation. The rapid economic contraction will result in large amounts of spare capacity, putting further downward pressure on prices. Deflation will also put further pressure on wages, and these are expected to fall further in the future, particularly after the next spring wage negotiations.

The Bank of Japan is likely to maintain its target interest rate of 0.1% until at least the second half of 2010. It has already introduced some unconventional monetary policy measures, and we think that it will cautiously step these up. But fiscal policy could be more important in shoring up demand.

Japan global forecasts

Japan	2008	2009	2010
GDP	-0.6	-6.0	0.8
Cons. prices (HICP)	1.4	-1.5	-1.1
BoJ rate (%)	0.1	0.1	0.1
10-year yields (%)	1.18	1.30	1.40
MSCI Japan	-42.5	-6.3	4.1
JPY index	158	147	137

Source: Barclays Wealth Research

Euro area

- **A 3.5% contraction in GDP is forecast for this year**
- **Speculation that the euro area could break up is overdone**
- **The ECB will not cut rates below 1%**

The euro area has been hard hit by the financial crisis. In some countries (for example Ireland and Spain) it has exposed some long-standing weaknesses. But speculation by some observers that the euro area could break up in consequence appears overdone, as the incentives for this are weak.

The clearest impact of the crisis is on investment and stocks. Firms, seeing demand fall away and access to finance becoming scarcer (and, in real terms, more expensive), are likely to cut back sharply on capital expenditure and on inventories. Alongside this, firms will cut back significantly on employment. Cycles in the labour market tend to lag those in GDP. So, we expect the euro area unemployment rate to hit double digits early next year for the first time since 1998. This mounting pool of unemployed should also have a clear negative impact on wages, weighing on the spending power of those households still in employment.

Towards the end of this year, we expect the euro area economy to start to emerge from recession as financial conditions improve and global growth picks up. But the recovery is likely to be relatively modest. We believe that inflation will fall further, but do not think that the euro area will be pushed into true deflation.

Fiscal policy will support growth, but to a lesser extent than in the US and UK. The European Central Bank (ECB) will not cut interest rates below 1%, but will use other unconventional policy stimulus measures.

Euro global forecasts

Euro area	2008	2009	2010
GDP	0.7	-3.5	1.2
CPI	3.3	0.0	0.8
Refi rate (%)	2.50	1.00	1.50
10-year yields (%)	2.95	3.40	3.50
MSCI euro area	-44.3	-5.7	26.1
€ index	4.1	-11.7	-2.3

Source: Barclays Wealth Research

Consumer price inflation

	2008	2009	2010
Germany	2.6	0.3	0.8
China	5.9	1.5	2.0
UK	3.6	0.6	1.3
France	2.8	0.3	0.9
Italy	3.3	0.7	1.1
Canada	2.4	0.6	1.9
Spain	4.1	0.3	1.4
Brazil	5.7	4.5	4.0
Russia	13.0	9.0	7.7

Source: Barclays Wealth Research

Other global forecasts

	2008	2009	2010
GDP growth			
Germany	1.0	-3.2	1.3
China	8.5	7.5	7.6
UK	0.7	-2.5	0.5
France	0.7	-2.1	1.2
Italy	-0.6	-3.4	0.5
Canada	0.6	-1.0	1.5
Spain	1.2	-2.7	0.7
Brazil	5.4	2.0	4.1
Russia	6.0	-1.0	4.1

Source: Barclays Wealth Research

Equities

- **Sentiment improves, although the rally may not last**
- **Tactical asset allocations reflect cautious optimism**
- **We move towards a more cyclical stance**

Sentiment towards equities has improved, with March's 6.4% rise in the MSCI World index proving to be the biggest monthly rise for nearly six years. Will this rally peter out, or can it be built on? At this stage, we don't know. But there are some good reasons to be optimistic, as discussed in the main article above.

Our cautiously optimistic mood is reflected in some new tactical asset allocations. Within equities, we suggest some over weighting to emerging market equities, as we believe that they will be at the forefront of the recovery. But we maintain that it is a little too early to be overweight equities as a whole.

Up to now, our sector recommendations have favoured a slight bias towards 'cyclical' stocks in anticipation of an economic recovery. The appeal of 'defensive' stocks (those thought better able to survive a downturn) had anyway been blunted by the fact that some sectors (e.g. consumer staples and utilities) were trading at 30-year highs in terms of relative valuation.

Increased risk appetite, coupled with the trends emerging in the earnings data, leads us to move towards a more cyclical stance. The approach is to go for sectors offering value and cyclical earnings exposure (i.e. earnings that will pick up relatively quickly as the economy improves). In contrast, we suggest avoiding 'expensive defensives'.

This leads us to prefer materials, consumer discretionary, IT and industrials. (We believe that the recent rundown in inventory levels stands to help this sector over the coming quarters). We are not quite 'out of the woods' yet in terms of the economy, so we are also keeping faith in telecoms, the only 'cheap defensive'. We remain least keen on the consumer staples and utilities sectors.



Bonds

Fixed income

- **Still an attractive asset class**
- **Some interesting anomalies on inflation pricing**
- **Corporate credit offers the potential for good returns**

Overall, we continue to think fixed income – both government bonds and corporate credit – an attractive asset class.

Government bonds remain a good port in a storm, although their pricing already reflects this. But there is one interesting anomaly here – the difference in price between inflation-linked bonds (e.g. those that pay a return linked to inflation) and those with a fixed nominal return. We believe that higher commodity prices do pose an imminent threat to the level of inflation in the UK (and other major economies) and that the existing differential between inflation-linked and nominal bonds does not properly reflect this. In other words, it is currently cheap to buy insurance against higher rates of inflation through inflation-linked bonds.

Corporate credit continues to offer the potential for good returns. Last year, a very gloomy market started to price in the prospect of large numbers of corporate defaults – the highest ratio since the 1930s. As a result, ‘spreads’ (i.e. the difference in yield between corporate debt and government debt of the same maturity) increased dramatically, to compensate investors for the perceived increased risk. As times get better, and the threat of large-scale defaults recedes, then

these spreads will narrow further, boosting the value of such bonds. The Bank of England’s programme of investment-grade corporate bond purchases (as a part of its quantitative easing programme, see below) should also provide some support in the UK.



Exchange rates

Exchange rate forecasts

End of period rates	2008	2009	2010
US\$/€	1.4	1.25	1.28
US\$/£	1.46	1.58	1.75
£/€	0.96	0.79	0.73

Source: Barclays Wealth Research

In addition to this principle, other factors are important too. Quantitative easing (QE) – as implemented by the UK, US and other governments – is a topical one. When a central bank has announced a QE programme, the immediate reaction has been for the currency of that country to weaken. This has been largely due to worries that QE will push up inflation. But we believe that QE, if properly implemented, and accompanied by a decent exit strategy, should benefit the country's currency – through restoring liquidity to the credit markets and through restoring economic growth.

Volatility and illiquidity have had a prominent market role in recent months. Low liquidity has affected the value of a number of currencies recently – even, at times, sterling. The euro has benefitted from this, as investors have been attracted by its large currency base and liquidity. But, as markets calm, liquidity should become less of an issue, benefitting a number of smaller currencies versus the euro.

Going forward, we expect that the US dollar will be supported by the US economy's improved fundamentals – although QE remains a risk. Sterling currently appears cheap, and its prospects are improving. The euro, in contrast, looks overvalued and is expected to weaken, assuming that investors don't turn against the dollar.

Investors' 'risk appetite' (their willingness to take risks) is key to future trends in the foreign exchange markets, as it is elsewhere. Higher risk appetite should mean that the riskier currencies perform better, and that the 'safe' currencies (e.g. the Swiss franc, Japanese yen and US dollar) do worse.

The Financial Prescription

In February, the Bank of England (BoE) unveiled a quantitative easing (QE) programme, intended to be its monetary policy instrument for the foreseeable future. An initial £75 billion has been allocated to the programme, which will primarily purchase medium- and long-maturity gilts across March, April and May from current private-sector buyers. (Smaller amounts of private sector assets will also be bought.)

The asset purchases are “unsterilised”. This means that the BoE will directly increase the supply of money to fund them, rather than borrowing to do so. This is how it works. The BoE purchases an asset from a private sector agent. The seller of the asset receives cash (new money). If he/she holds this in the form of a deposit at a commercial bank, then that bank in turn has a higher deposit base. Of course, if the bank then simply parks this cash in its reserves held at the Bank of England, then not much happens (beyond an increase in various measures of money supply).

But if, instead, the new money changes the behaviour of those concerned, the effects could be powerful. The seller of the asset could spend the cash, rather than depositing it. Or if the money is deposited in a bank, then the bank might lend the money out (as would normally be the case). At another level, if the Bank of England’s purchases push up prices in the targeted asset markets, pushing down yields in the process, this could also help boost activity.

There is no guarantee that quantitative easing will work. As mentioned above, the new money could just be parked in the financial system. But the Bank of England’ targeting of longer-term gilts (UK

government bonds) and private sector assets is a positive step. This is because these are less perfect substitutes for cash than short-dated gilts. Second, there is a greater scope for reducing yields and improving liquidity in these markets. The measure of the policy’s success is likely to be growth in the broad money supply to the household and financial corporate sectors, as many of the sellers will be the financial sector. And we reckon that £75 billion may not be enough. The Bank of England is assuming that an increase in the money supply translates 1:1 into additional spending. But in these difficult times, the ratio could be less, meaning that more gilts might have to be purchased to have the desired impact on the economy.



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