

# Market view

Economic and investment  
analysis in brief

February 2009

# A quick summary

So far in 2009, the world has turned out much as we suspected it would – a ‘brutal’ recession, that will entail a contraction of GDP in the first half of the year, at a minimum, and associated downward pressure on prices. Policymakers will have to use every tool in their toolbox to turn things around (and perhaps invent a few new ones). But, ultimately, they should manage to get the global economy back off its knees again. Once the shoots of economic recovery appear, risky asset classes should recover somewhat. But that may be a story more for the second half of the year, or perhaps if we are lucky, the second quarter.

After our main article, ‘About as bad as expected’, we set out our individual forecasts

for the UK, US and Euro area, which suggest that while things may get better in 2010, the going will still be tough. A revival in equities markets typically precedes a recovery in the ‘real’ economy by a few quarters, but equities could still disappoint over the next quarter or so. And, while corporate bond valuations could look attractive, investors should approach with care. Commodity prices will tend to follow the economic cycle, although there should be a few bright spots. Exchange rates will prove volatile, but we see some hope for sterling.

Michael Dicks, Head of Research,  
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# Essay

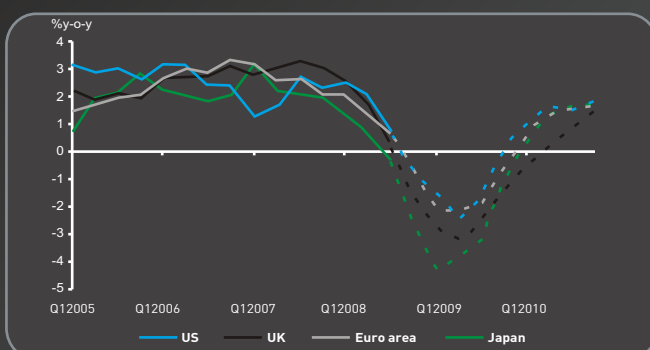
## About as bad as expected

- **Almost everywhere, economies are contracting and inflation nose-diving.**
- **President Obama's new administration must deliver real change quickly.**
- **Policy efforts are being delivered along three broad fronts**

The hit to economic growth towards the end of last year was bigger than we had pencilled in. And it looks to have been more synchronous in nature than expected, with no significant economy remaining unscathed. Asia – and particularly those of its economies that are heavily dependent on global trade – has been especially hard hit.

All in all, we have found it necessary to trim our GDP growth forecasts for 2009. As a result, it now looks fairly likely that the global economy will shrink a little this year. (We had previously forecast an expansion of just under 1%.) Nevertheless, we still feel that a recovery can begin as soon as the second half of 2009 in the United States, although it may well be 2010 before the United Kingdom or Japan join in.

**Developed World GDP growth estimates**



Source: Datastream, FactSet, Barclays Wealth Research

Alongside the gloomy economic news, many of the world's major financial institutions have reported big hits to their earnings from the slowdown and associated declines in the market values of hard-to-value financial instruments, such as mortgage-backed securities. This 'profits crunch', and perhaps too the recognition that housing market declines have reaccelerated in many countries (including, importantly, the United States), has led to concerns that the authorities' attempts to bail out the financial system, and put the banks back on the road to recovery, could prove inadequate.

We never saw the bank bail-outs as a total solution to the crisis, but have still been somewhat surprised at the scale of the moves down in stock prices for many financials. This risks becoming a self-fulfilling process. Accordingly, we are watching especially closely President Obama's new administration's efforts to deal with the situation, especially given the poor reception that the UK's recent efforts were greeted with.

Any US approach involving the creation of 'bad banks' (in which to hold the troubled assets) might well be more successful, as it would likely be perceived to be a more durable solution to the problem and bring more transparency to the situation. (At the moment, it is fear of the unknown which appears to be driving markets. So, adding some more 'knowns' may well help.) But, as so often in such situations, the devil will be in the details. Especially important, in our estimation, will be the split between public and private sectors of any future upside revaluations.

Although policymakers are still struggling with the implications of the credit crunch for their banking systems, they are yanking on plenty of policy levers to help bolster demand, and set the stage for an eventual recovery in economic activity. So it seems likely that official interest rates will end up being slashed further, and that many central banks will go further than that – by finding less conventional methods to support activity. More generally, policy efforts are being directed on three broad fronts:

**Monetary easing.** Some central banks are now employing forms of ‘quantitative easing’. Having driven short-term interest rates down to close to zero, they are using public funds to help lower yields (i.e. rates) on other instruments. To do this, they may print money and use it to buy government bonds of longer maturity. Or, as in the USA, buy other assets (such as mortgage-backed securities, so that mortgage rates for borrowers start to decline). In theory, the central banks around the world could drive borrowing costs down to any level they so desired, and for just about any type of borrower.

**Fiscal easing.** Before Christmas, several large countries were lukewarm about joining in the large-scale fiscal easing planned by the US, UK, France, China and others. But now everyone has joined the party. In effect, after subtracting the hit to public finances from the slowdown, governments are intending to throw another couple of per cent of GDP at the problem, either by cutting taxes or spending more money themselves, or both.

**Non-traditional policy shifts.** These include giving households vouchers to spend; providing them with financial incentives to replace household durables sooner than they would have otherwise done – along with government’s lending directly to the non-financial sector; and providing credit guarantees to companies.

But, as the following individual country forecasts demonstrate, recovery will still take time.



# Economic and market prospects – India

- **Slower GDP growth in 2009.**
- **Inflation will fall sharply in 2009, before picking up modestly next year.**
- **Indian equities offer an interesting valuation story.**

In common with other economies, GDP growth in India will slow in 2009, reflecting the ongoing adverse impact of the global credit crunch on both companies and consumers. Nonetheless, in a global context, Indian GDP growth of 5.0% in 2009 should look attractive when compared to the contraction evident in many of the Western economies. Indeed, India (along with China) will play a key role in allowing the world as a whole to generate some very modest growth in aggregate in 2009.

Given the backdrop of weaker global demand and falling commodity prices, we expect inflation to fall markedly in 2009 before picking up modestly in 2010. One major plus for India is that the Reserve Bank of India still has plenty of room to cut rates should economic conditions dictate; the same cannot be said of the US, UK, or Japan.

In terms of equity markets, one of our key themes for 2009 is the differentiation between the larger Asian economies of China and India, which have sizeable internal markets that provide some cushion against a global demand slowdown, and the small, open economies like Hong Kong and Singapore that are considerably more at the mercy of global demand.

In terms of regional valuations, this theme is very clear. On a price-to-earnings basis (both trailing and estimated), Chinese and Indian (Nifty) equities are trading at higher multiples than the Hang Seng and Straits Times. Intuitively, this makes sense: in today's environment of weak global demand and lack of visibility of a recovery, these markets will probably be hardest hit. Conversely, when there is greater certainty of the trough in growth and equities begin to recover, these markets could see some of the largest gains.

Within this theme, Indian equities offer an interesting valuation story. Until recently, Nifty valuations tended to be close to those of Chinese equities, in line with higher long-term growth expectations. However, the recent corporate scandal led to a sell-off that pushed the Nifty much further down the relative valuation scale. Fundamentally, however, we do not see a big shift in relative growth expectations. So, for investors with a longer-term time horizon, current Indian equity valuations may offer an attractive entry point.

## The India forecast in a nutshell\*

	% y-o-y except where stated			
	2007	2008	2009	2010
GDP	9.0	7.5	5.0	6.0
WPI	4.8	9.1	2.5	3.0
Repo rate (%)	7.75	7.0	4.0	4.0
Current account (% of GDP)	-1.1	-2.5	-2.8	-2.6
Budget balance (% of GDP)	-6.5	-7.0	-7.5	-8.0
Earnings growth	19.4	0.0	12.0	10.4

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

# Economic and market prospects – US, Global

## US

The ongoing recession is still gathering momentum. GDP shrank forcefully in the fourth quarter – driven by depressed business investment and consumer spending – and this is likely to be followed by another contraction in the current quarter. US manufacturing is reducing its stock levels sharply, and US consumers are facing up to double-digit falls in house prices and rising unemployment.

The effectiveness of the US fiscal stimulus would be enhanced, if the pressing issue of financial market stability can be resolved. At the time of writing, the Treasury appeared to be leaning towards an ‘aggregator’ bank (‘bad bank’) solution, whereby banks’ toxic assets could be taken into one institution and ring-fenced.

Recent data supports the Fed’s fears about deflation. ‘Core’ inflation (excluding food and energy) continues to ebb, and we expect it be hovering between 0.5% and 1% before the end of the year.

### US global forecasts

	2007	2008	2009	2010
US				
GDP	2.2	1.2	-1.4	1.5
CPI	2.9	3.9	-0.1	0.5
Fed funds (%)	4.25	0-0.25	0-0.25	0.75
10-year yields (%)	4.1	2.98	3.00	3.9
S&P 500 index	3.5	-37.	15.1	9.3
\$ index	-9.3	4.4	9.2	1.5

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

### Consumer price inflation

	2008	2009	2010
Japan	1.5	-1.0	-0.2
Germany	2.6	0.4	1.1
China	5.9	1.5	2.0
France	2.9	0.6	1.3
Italy	3.3	0.9	1.3
Canada	2.4	0.9	1.8
Spain	4.1	0.7	1.8
Brazil	5.7	4.5	4.0
Russia	13.0	9.0	7.7
India	9.1	2.5	3.0

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

### Other global forecasts

	2008	2009	2010
GDP growth			
Japan	-0.3	-3.2	1.3
Germany	1.0	-2.3	1.5
China	8.5	7.5	7.6
France	0.7	-1.3	1.6
Italy	-0.6	-2.4	1.0
Canada	0.6	-0.8	2.0
Spain	1.2	-1.8	1.2
Brazil	5.4	2.0	4.1
Russia	6.0	1.5	4.1
India	7.5	5.0	6.0

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



# Global equities – sector strategy

- **Markets have struggled to hold on to gains from the end-2008 rally.**
- **Earnings growth expectations for 2009 are turning negative.**
- **We recommend staying defensive in the short term.**

Markets staged an impressive rally towards the end of last year from their November lows, with the US and emerging indices gaining nearly 25%. However, New Year optimism was soon wiped out, not helped by further write-downs and concerns about capital adequacy in the banking sector.

The news on earnings over the past month has deteriorated markedly, partly due to huge unexpected losses announced in the US fourth-quarter earnings reported season. Global earnings are now expected to contract in 2009, with downward revisions in all major markets. The US and the UK currently have the largest falls pencilled in, but we expect the situation to deteriorate further over the coming months as other regions follow the same downwards trend.

Looking ahead, we expect the backdrop for equity markets to remain tough for the foreseeable future. As well as the earnings revisions, the economic news is likely to stay poor and there are few catalysts for improvement on the horizon. In our mind, it is not the time to be heading in to riskier assets – although that should change as we enter the second quarter.

In sector terms, we emphasise our defensive short-term calls, with overweights in healthcare and telecoms. In the medium term, we see the most value in materials, industrials, and to a lesser extent financials.

## Medium-term global sector recommendations

Energy	3 – Neutral
Materials	2 – Moderate Outperform
Industrials	2 – Moderate Outperform
Consumer discretionary	2 – Moderate Outperform
Consumer staples	5 – Strong Underperform
Healthcare	3 – Neutral
Financials	2 – Moderate Outperform
IT	3 – Neutral
Telecoms	3 – Neutral
Utilities	5 – Strong Underperform

Source: Barclays Wealth Research



# Global bonds

- **Economic and corporate fundamentals still suggest caution.**
- **We recommend government-guaranteed and 'senior' paper.**
- **Inflation-linkers may be an attractive option for the medium term.**

Economic turmoil has raised credit spreads (the difference between the yields on corporate and government bonds) to such an extent that corporate bonds may look attractive from a valuation perspective, but economic and corporate fundamentals still weigh heavily on the market, suggesting that caution is appropriate.

We recommend government-guaranteed and 'senior' corporate paper, because of the increasingly robust government policy response to defend financial or non-financial companies seen as systemically important for their markets. ('Senior debt' has priority for repayment, if the company is wound up.)

But, overall, corporate bond default rates are expected to reach record levels. (Moody's expects the default rate for US speculative-grade issuers to exceed 15% and that for European speculative-grade issuers to rise to 18.3%.) So it would be premature to invest in high-yield bonds.

We believe that investment-grade bond spreads already price in the bad economic environment, and could offer attractive long-term returns versus government bonds, but investors need to be aware of default and downgrade risk.

Inflation-linked government bonds are still an attractive option for investors prepared to take a longer term view. These are still pricing in sustained deflation in the US, UK and euro area economies over the next three to five years, which seems overly pessimistic: while we think inflation will drop sharply in the first half of 2009, it is likely to pick up again 2010. But in the short-term, these inflation-linked bonds may be less attractive.



# Commodities

- **Prices remain weak, but volatile**
- **Crude oil prices could start rising by late 2009.**
- **Base metal price weakness will continue for at least two quarters.**

Commodity prices remain depressed, but volatile. With expectations that the global economy will slow, and continued market turmoil, investors have continued to try and reduce risk and reduce borrowings. This has affected commodities as an asset class, as we have expectations of lower demand.

Crude oil prices are weaker, with the price of Brent crude oil moving below \$50/bbl. OPEC's announcement of production cuts has not offset expectations of softening global demand, and concerns about high crude and product inventory levels. But over the medium term, supply constraints from both non-OPEC and OPEC sources of oil could still cause a sharp rebound in prices.

Metals prices have proved particularly volatile with price direction and sentiment driven by broader macroeconomic and financial factors rather than industry-specific news.

Metals prices are likely to remain weak over the next two quarters but are likely to recover thereafter, propped by recent mine shutdowns and project postponements.

Gold prices, currently around \$900/oz, have benefited recently at times from the metal's status as a 'safe-haven' investment but at other times have suffered from expectations of dollar strength. This two-way pull will continue but we are fundamentally bullish on gold over the medium term.

In agricultural commodities, prices for most products remain weak but much of this has been due to seasonal factors. We continue to expect a rebound in agricultural commodity prices, helped by tight supply and demand balances, favourable market dynamics and low customer inventories.

## Commodity price forecasts

	2008	2009	2010
Crude oil (Brent, \$/bbl)	98	65-70	80
Copper (\$/mt)	6,955	4,500	5,500
Aluminium (\$/mt)	2,580	2,300	2,700
Gold (\$/oz)	860	850	850
Platinum (\$/oz)	1,600	1,275	1,500
Wheat (\$/bushel)	570	600	650
Corn (\$/bushel)	400	435	480

Source: Barclays Wealth Research



# Exchange rates

- **Risk aversion continues to be a strong factor in the markets.**
- **So we continue to favour the US dollar, yen and Swiss franc.**
- **The Euro is expected to depreciate further in 2009.**

Risk aversion remains the primary driver of FX markets, with 'safe haven' currencies (e.g. the US dollar) generally outperforming risky ones. We expect this trend to continue over at least the next three months.

Sterling has fallen further against the dollar, to about \$1.40/£1 at the time of writing, but has strengthened slightly against the euro. Weak sentiment towards the UK economy in general, and the banking sector in particular, led to the cross-rate to drop as far as \$1.35/£1 before rebounding. With UK's economic outlook certain to remain poor, sterling is likely to remain weak in coming months. In fact, as we expect the UK economy to continue

to contract during much of 2009 and, accordingly, any recovery will probably have to wait until close to the end of this year.

The US dollar has now regained most of the strength that it lost at the end of 2008. We expect the currency to remain supported by investors' risk aversion over the coming months; looking forward further into 2009, US economic recovery will then lead to further US dollar appreciation – although risks remain.

In contrast, the euro has weakened since the beginning of the year, after having appreciated sharply at the end of 2008. We believe that the euro will continue to depreciate throughout 2009, as the Euro area economy turns down.

## Exchange rate forecasts

	Now	End-April	End-July	End-October
£/\$	1.42	1.42	1.5	1.55
/£	0.92	0.88	0.81	0.73
\$/	1.31	1.25	1.21	1.16
¥/\$	90	84	82	84
A\$/	0.66	0.58	0.55	0.55
C\$/	1.22	1.28	1.37	1.40

Source: Barclays Wealth, Barclays Capital



# Three themes to ponder

## Themes

## Impact

Deflation – worries will increase.

The combination of the commodity price bubble bursting, the deep recession and (in the UK) policymakers' decision to cut VAT means that consumer prices are set to drop later in 2009 – i.e. inflation will soon turn negative. As this becomes apparent, people will grow more concerned about a proper deflation occurring – as in a protracted period of price falls. Deflation would cause consumers to postpone purchases, as they expect to be able to buy more cheaply later, and would cause debtors to suffer real problems meeting obligations, as real debt-service burdens soar. But we doubt very much that deflation will occur, and think that overdone fears of it happening could provide investors with some clear opportunities.

Volatility – set to reduce?

In the 'new world' that policymakers are designing, asset price fluctuations will be accorded a more prominent role: policymakers will react to them, rather than dismiss them as something that is not of their concern or making. Regulatory reform is likely to help limit the cyclicity of liquidity provision and leverage (i.e. borrowing for investment). So might a new breed of central banker, focused as they will be on trying to avoid repeating the mistakes made by their predecessors. All this should permit volatility to gradually return to more normal levels, albeit higher than those seen before the credit crunch.

Asian attraction?

Higher-risk equity markets (such as those in Asia) were the main victim of 2008's sharp equity market sell-off – despite the fact that the macroeconomic fundamentals in many of the Asian and emerging markets are better than those in the developed world. Given that Asia and the emerging markets basically offer geared exposure to global stock market returns, they could be attractive for investors who can take a long-term view. Higher-risk assets could be good performers in the second half of 2009 on the assumption that a major global economic downturn is avoided.

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