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Market view

Economic and investment analysis in brief

March 2009

A quick summary

A few months into 2009, and the going remains tough. Equity markets have been falling and much macroeconomic news makes for grim reading. But we continue to think that, although the downturn has been sharp, it is probably still best seen as a 'brutal' recession rather than a slump. And, whilst the sky is dark, there are already glimmers of hope. Recent macroeconomic data has not been wholly disastrous, firms are already unwinding excess stocks, and policymakers appear increasingly willing to explore new approaches to fixing economic problems. In addition, it is clear that some investors are considering how to move money into asset classes with more potential for gain, with many types of corporate credit (i.e. bonds) benefiting from this.

But the immediate outlook is not good. As is discussed in the following pages, it is clear that all major developed economies will suffer from a sharp decline in output this year. Any recovery in equities will have to wait until the second half of this year. Many commodity prices are likely to remain weak in the short term, although supply constraints will eventually begin to an upward influence. And investor fear will help bolster the US dollar, although we expect some eventual recovery in sterling.

Micheal Dicks, Head of Barclays Wealth,
March 2009

Glimmers of hope

- **Policymakers' efforts are gaining some traction**
- **But confidence and the financial system could prove fragile**
- **Equities suffer, but some other asset classes show signs of recovery**

Over the last few months, we have made some minor revisions to our growth, inflation and asset price forecasts here and there. But we have stuck that to the same basic story. We still believe that, whilst most economies will enter a deep and possibly protracted recession in 2009, policymakers' efforts will eventually succeed in getting recoveries going again. In other words, we are looking a "brutal" recession – rather than a full-blown depression.

From an investor's point of view, this underlined the importance in differentiating between short and long-term prospects. In the short-term, we have argued, investors should stayed be wary of equities, high-yield (i.e. high risk) credit, real estate and commodities, and instead looked towards cash and government bonds, amongst other things. But, as the situation starts to turn around, investors will clearly become more interested in the riskier asset classes, and eventually move towards an overweight in equities and investment grade bonds – and away from corporate bonds. The question, of course, is when this turnaround will happen.

As the macroeconomic backdrop has deteriorated, the efforts of policymakers to turn things around are turning out to be both conventional and unconventional, much as we had expected they would be – and again are, if anything, turning out to be a little more aggressive in their implementation than we had thought likely. Overall, we remain comfortable with our assessment that the moves should eventually set a floor to the contraction and, in time, help turns things around, providing a better climate for investors. But several things continue to cast a shadow.

First, this recession is clearly rather different from its predecessors. This slowdown has been driven largely by this crisis in financial markets, rather than some sort of real

structural imbalance in the world economy. Because of this, 'confidence' – or the lack of it – is very much to the fore. The dramatic fall-off in GDP at the end of last year was much greater than the fundamentals would suggest it should have been, suggesting that confidence had evaporated. Without it, the usual policy mechanisms at work – such as lower interest rates and tax cuts acting to boost economic activity might not work this time around. In other words, there is a clear risk that confidence stays so low that a slump develops.

Second, it is clear that the financial system could still implode. Just like a ship in a storm, the financial system is creaking – under vast pressures as it is buffeted by wave upon wave of bad news. Although policymakers have made clear that they do not want to let another major bankruptcy occur, and are so doing their utmost to support the main players, their handling of the crisis has been found to be wanting somewhat. There are fears that time is running out for policymakers to find, and implement, workable solutions to their problems. In such stormy seas, it is apparent that the risk of the ship 'losing its mast' is a significant one.

These risks have naturally led us to be a little more hesitant to call the bottom, as it were, of the market. But there are a number of glimmers of hope that maintain our hopes of a recovery, even if this may now have to wait until the second half of the year. There are three reasons to think that even if we are not yet at the end of the slowdown, we may be at the beginning of the end.

First, macro-economic news is not wholly bad – some is, in fact, proving rather better than expectations. Second, firms are already making great efforts to cut production; together with some evidence that demand is not falling so fast, this could lead to demand and supply being brought into balance. Third, policymakers are being increasingly innovative, with even the more conservative ones appearing increasingly radical. Progress on quantitative easing and has been particularly rapid.

All this has not stopped equity markets from having a rough time. But some asset classes are already showing signs of recovery, as very low interest rates encourage investors to look for higher yields apart from cash. We had expected that investment-grade credit would return to favour; what has been interesting has been increasing signs of enthusiasm about high-yield (i.e. higher risk) credit too. Of course, this may be a "dipping-one's-toes in the water" exercise, and we would suggest waiting a bit longer to push the boat out on, say, equities. This will be a story for later in the year. But there are glimmers of hope nonetheless.

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Economic and market prospects – India and Asia

- **A sharp fall in Indian growth is expected this year**
- **Inflation will fall sharply too**
- **Economic news across Asia remains bleak**

India will not survive the world downturn unscathed. We are now forecasting GDP growth to contract from 7.5% in 2009 to 5% this year, before only a slight recovery to 6.0% in 2010. The good news is consumer price inflation is predicted to fall from an end-2008 of 9.1% to just 2.5% by the end of this year, rising to 3.0% by end 2010. The benchmark repurchase interest rate is expected to fall from 6.5% at end 2008 to 4%, and stay there through next year.

The slowdown in India economic growth is, however, less severe than in many other Asian economies. In many, dismal trade data has proved to be a particular drag; the fall in Japan's exports has been particularly widely reported, but there have been other major falls elsewhere (for example, in Singapore, Taiwan and Hong Kong).

Stabilisation measures, in the form of rate cuts and fiscal boost, have continued across Asia, and these are expected to gain traction in the second half of this year. But, for the moment, the picture remains sombre.

The current crisis has refocused attention on the trend for many Asian economies to have high savings (and investment) rates, at the expense of private consumption. Particularly for China, there may be an argument for encouraging increased discretionary consumer spending, to help economic revival. But, with Indian private consumption already accounting for just over two-thirds of GDP, there is perhaps less scope for action here than in China, where the current share is only around 40%.

The Indian forecast in a nutshell*

% y-o-y except where stated	2007	2008	2009	2010
GDP	9.0	7.5	5.0	6.0
CPI	4.8	9.1	2.5	3.0
Repo rate (%)	7.75	6.50	4.00	4.00

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

Economic and market prospects – USA

- **Policymakers' efforts are centre stage**
- **Inflation target implies expansionary policies must continue**
- **Economic data remains poor**

Policymakers' efforts to stabilise financial markets and stave off fears about deflation have taken centre-stage over the past month. The $787 billion fiscal stimulus package was finally signed into law, and the US Treasury outlined the Financial Stability Plan (FSP) with which it hopes to stop the haemorrhage of capital from the banking sector.

On the monetary policy front, the Federal Reserve has reaffirmed its commitment to supporting the credit markets and has stated that inflation should be between 1.7 and 2.0% in the long run, thereby outlining its definition of price stability. If this target is to be met, expansionary policies will be needed for the foreseeable future.

Despite all this, poor economic data has further depressed expectations about 2009. We forecast a GDP contraction of 2% this year, followed by an anaemic 1.5% expansion in 2010.

US global forecasts

USA	2008	2009	2010
GDP	1.2	-2.0	1.5
CPI	3.9	-1.1	-0.9
Fed funds (%)	0-0.25	0-0.25	0-0.25
10-year yields (%)	2.98	3.0	3.5
S&P 500 index	-37	6.2	13.4
$ index	4.4	9.2	1.5

Source: Barclays Wealth Research

Consumer price inflation

	2008	2009	2010
Japan	1.4	-1.2	-0.5
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			
Japan	-0.3	-3.6	1.2
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 – sector strategy

- **Lack of detail on recent policies has sapped markets' strength.**
- **Pessimism is spreading from financials into other sectors.**
- **Defensive sectors look relatively expensive.**

Much was expected from policymakers in Feburary, but not very much has been delivered. Combined with continued gloomy macro news, equity markets have given up their recent gains. Most of the selling has taken place in financials, as markets worry about the sector's survival in the continued absence of a clear, detailed plan of action from policymakers.

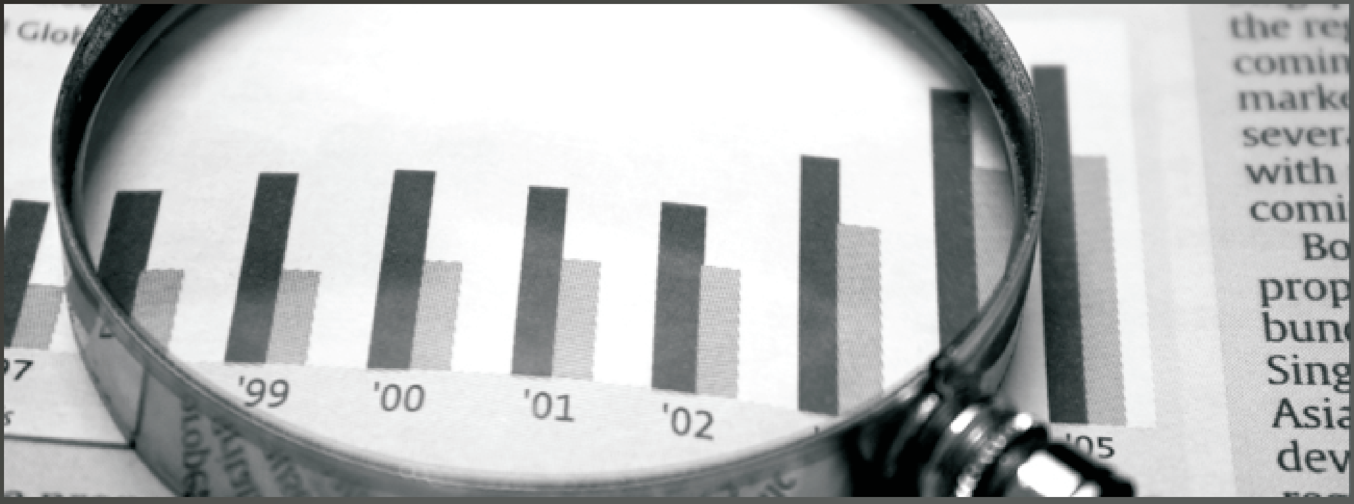
The news on earnings over the past month has not improved, with the fourth- quarter earnings season in the US disappointing. We continue to see the impact of the global recession being factored in to 2009 earnings – these are now expected to contract by 4% – with downward revisions in all major markets. Sector-wise, pessimism is spreading from financials into other sectors, with substantial downgrades seen in energy, materials and industrials.

Regular readers will be aware of our concerns about the relative valuation of the 'defensive' sectors. One thing that stands out to us is that the relative valuation of the health care and utilities sectors is higher than at any time in the past 28 years. Consequently, we continue to recommend that investors remain underweight equities (and overweight cash and fixed income). Only once the US economy starts to turn is it likely that equities can recover some of the lost ground.

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



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Bonds

- **Government bonds will continue to provide a safe haven.**
- **Some European government bonds look particularly good value.**
- **We continue to prefer high grade corporate credit.**

As February has demonstrated, the world remains a very risky place. Government bonds are the only true safe haven in this environment, and despite them being expensive, it still appears appropriate to prefer them over cash in a portfolio.

But it is increasingly important to distinguish between issuers. Markets reckon the risks associated with the European countries most exposed to the 'credit crunch' – Austria, Ireland, Portugal and Spain – have widened massively versus perceived low-risk issuers such as Germany. But it is possible that the markets have overreacted. These issuers (aside from Portugal) entered the crisis with low debt to GDP ratios and small fiscal deficits, and a co-ordinated EU bail out is plausible in a worst-case scenario.

Liquidity remains a major issue in the corporate credit market, despite large amounts of new issuance. This means that, in practice, the easiest way for investors to access the credit space in a prudently diversified manner is through Exchange Trade Funds (ETFs) and managed funds. We remain convinced that investment-grade credit is a key asset for investors to gain exposure to in 2009.

Further down the capital structure we note that junior subordinated debt and preferred shares continue to cheapen. But; while offering fundamental value, the risk associated with lower-tier paper means that we would only recommend it to very risk tolerant investors.

Commodities

- **Prices remain weak as recession dominates sentiment,**
- **Oil prices now appear below long-term 'fair value'**
- **We remain positive on gold**

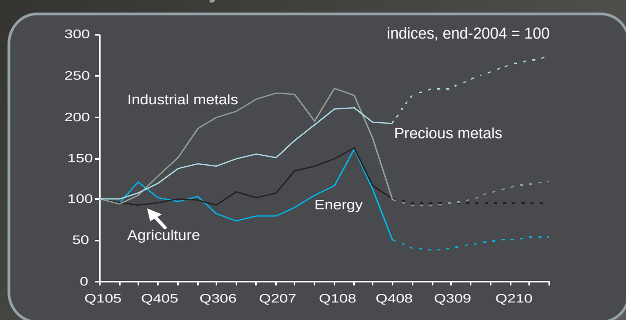
Commodity prices have continued to fall, not helped by poor market sentiment and weak economic prospects. But it is important to note the divergence between different groups of commodities. So while traditionally pro-cyclical commodities have been severely impacted by the economic slump, counter-cyclical ones (such as precious metals) have performed well and offer selected opportunities.

Energy, agriculture and industrial metals, which account for most of the index, have been badly hit by macro-economic and financial factors. World economic slowdown and, in particular the slump in Chinese demand, have hit prices hard, as have investors' attempts to move to other investments and reduce leveraging.

However, oil prices now seem to have stabilised somewhat, hovering around the $40/bbl mark in recent weeks. Our model of its long-run fair value (based on supply, demand, OPEC and refiners' utilisation rates and the futures market) points to a fair value for oil of about $60/bbl, suggesting that there will be a modest recovery by year-end.

Given the highly uncertain environment, investors have been turning to precious metals and in particular gold as a 'safe haven'. Gold price buoyancy is likely to continue. Physical investment demand in gold has surged of late and, with deflation likely in many countries soon, the status of gold as a safe haven is unlikely to be dented. But a strong US dollar has historically not helped gold prices, so there is a risk of this reversing.

GSCI Commodity Indices



Source: Barclays Wealth Research

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Exchange rates

- **The US dollar has benefited from high risk aversion.**
- **The euro will continue to weaken this year.**
- **The yen is undervalued and will recover.**

Investors' desire to reduce risk has been a major driving force of FX markets in recent months. This remained the case in February, as equity markets fell. The US dollar continued to be the main beneficiary from this drive to reduce risk, despite some bad economic news from the US. Paradoxically, bad news for the US economy is good news for the US dollar if it corresponds to a deteriorating global outlook and increases investors' appetite for 'safe haven' assets.

The Japanese yen weakened substantially at the end of February following the release of some dreadful Japanese GDP data. But we think that the currency is undervalued, and expect the yen to recover when market sentiment turns. In the short-term, the yen may also be supported by investors moving currency investments back into yen, and by Japanese firms adjusting their currency hedges. But in the long term, the deterioration of the Japanese economy may put a brake on appreciation.

Sterling was the best performing G10 currency in February, with policy actions from the Bank of England and government getting a good response from the markets. However, we expect the UK economy to remain weak and for investors to continue to avoid UK assets, limiting the potential for sterling rebounding further in the short term.

The euro has continued to weaken recently as the outlook for the euro-area economy has deteriorated. Concerns about the fundamental stability of the euro area have also increased. The euro is overvalued, so we expect further depreciation this year.

Exchange rate forecasts

	Now	End-May	End-August	End-November
£/$	1.42	1.42	1.45	1.53
€/£	0.90	0.88	0.85	0.78
$/€	1.27	1.25	1.23	1.19
¥/$	98	84	88	92
A$/$	0.65	0.58	0.55	0.55
C$/$	1.26	1.23	1.33	1.40

Source: Barclays Wealth Research, Barclays Capital

Three themes to ponder

Themes	Impact
The search for yield is just beginning	As rates fall – with the Fed already at zero and European Central Banks moving in the same direction, if not quite as far – and as Central Banks start purchasing bonds, so the yield on fixed income instruments will drop. Adding to the pressure, economic slowdown will lead to higher savings rates and reduced investment demand. So, long-term interest rates will also decline. Conservative investors will struggle to find alternative assets that offer risk-free returns anything close to those that they enjoyed last year. But in time they will likely take on private-sector risk. As the recovery bottoms and turns, expect to see a more forthright rotation into riskier asset classes, such as equities.
Deflation fears will be fanned by falling prices	Consumer prices are set to drop later in 2009 – i.e. inflation will soon turn negative. But, unlike many, we doubt very much that sustained deflation will occur. So, fears of it happening should provide investors with clear opportunities. Inflation-linked bonds look attractive relative to conventional bonds. However, it may well be that they get cheaper before they perform, thanks to inflation surprising on the downside for a while longer yet.
Real estate is really in a state	Both house prices and commercial property values soared above their 'fair values' during the 'noughties'. But they are now nose-diving. Some are already back to fair value. Undershooting is the norm in these markets. So, 'momentum' may well drive prices even lower in the short run. Nevertheless, long-horizon, risk tolerant investors are beginning to sniff opportunities in these markets rightly in our opinion.

More About Market View

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