

Market view

Economic and investment
analysis in brief

May 2009



Introduction

The outlook for investment now appears better than for some time. However, substantial risks remain and some investments could still disappoint.

Although we believe that the world economy will start pulling out of recession later this year, there remains a small but significant chance of a prolonged recession or depression. And, while we believe that market volatility will diminish gradually, it will stay above normal levels for sometime.

In this environment, government bonds, fixed rate or index-linked, form an important part of an

investment portfolio. We are keen too on corporate credit, which will gain first from a recovery, but continue to be somewhat cautious about equities holding certain geographic and sectoral preferences, as discussed below. Overall, we suggest increasing portfolio risk but only modestly.

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Macroeconomic Outlook – Part 1

Not quite so bad

- **We are now in the second stage of a classic inventory cycle**
- **The US is likely to be the first developed economy to start growing again**
- **Unemployment rates will rise further**


outlook for unemployment is grim. Inflationary pressures will remain low.

Over the winter months, the macroeconomic news was almost universally gloomy, with new record lows on a wide range of indicators, right across the globe. But recently there has been something of an improvement. Economic data have not been strong but there have been a number of better than expected outcomes, amongst the bad news.

In the first stage of a recession, firms typically find demand for their products falling away rapidly, causing inventories to build up in warehouses. But because firms find it difficult to distinguish between a temporary and a sustained fall in demand, production remains close to its previous rate for a while, buffering the fall in GDP. However, once it's clear that demand will stay low for some time, firms cut back on output – reducing it by more than the fall in demand, in an attempt to clear inventories.

We appear to be in this second stage of this classic inventory cycle now, judging from the weakness in industrial production relative to retail sales. But once inventories are cleared, the rate of economic contraction should slow.

We also draw hope from policymakers' actions. It may not have been a smooth ride, but the fiscal stimulus now pledged, including automatic stabilisers (such as rising unemployment benefits) now adds up to a substantial sum, including many from some countries (such as Germany and Japan) that were initially reluctant to pitch in.



Macroeconomic news has been somewhat less disastrous, and once inventory adjustment is complete, the pace of contraction will slow. Policymakers are making progress, but the

Macroeconomic Outlook – Part 2

The monetary big guns have also been rolled out, with the Bank of England, Federal Reserve and Bank of Japan all engaged in quantitative easing, and the European Central Bank (ECB) considering steps of its own. Policy makers also seem to be making progress on stabilising the world financial system, with action too (through the IMF and others) on avoiding large-scale defaults and crises in emerging countries.

At a country level, we expect those countries that are taking the most decisive policy action to fare the best, in relative terms, this year. So the US will contract by less than the euro area, UK and especially Japan. The US economy could start growing again in the second half. But, while the end of the recession may be moving closer into sight, the end of the downturn in the labour market is not. The US, UK and euro area will have unemployment rates in or close to double-digits by end year. Mounting competition for jobs, and spare capacity, should keep inflationary pressures low.

Emerging markets should still, in aggregate, manage to grow a little this year. Within this group, we are most optimistic on the prospects for countries such as China, which can boost domestic demand to counteract some of slump in global demand.

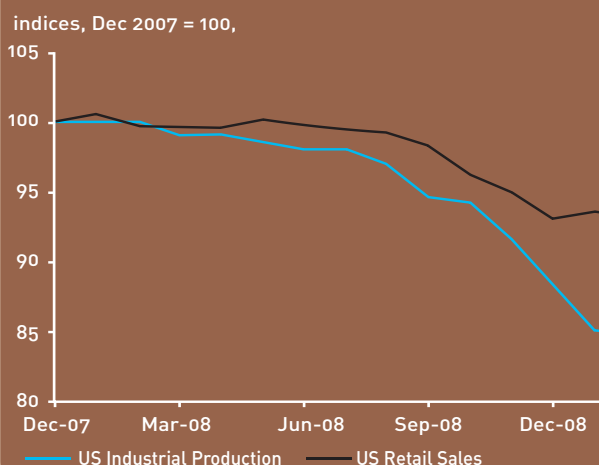
GDP growth & inflation in the major countries

% y-o-y			
Real GDP	2008	2009	2010
United States	1.1	-3.0	0.8
Euro area	0.7	-3.5	1.2
United Kingdom	0.7	-3.3	0.6
Japan	-0.6	-6.0	0.8
Inflation	2008	2009	2010
United States	3.8	-0.6	-0.1
Euro area	3.3	0.0	0.8
United Kingdom	3.6	1.7	1.2
Japan	1.4	-1.5	-1.1

Source: Barclays Wealth Research



Inventory adjustment is proceeding rapidly



Source: Barclays Wealth Research

Investment Outlook – Part 1

- **Investors should increase risk only gradually**
- **Under our main scenario, the favoured investment is corporate bonds**
- **We remain slightly hesitant on equities**

As discussed in the previous pages, we are now seeing clear evidence that the current severe global economic downturn will not turn into a depression. Ordinarily, if we were as confident of recovery as we are now, we would strongly recommend equities. But we are not doing so now.

Instead, we are suggesting that investors play it carefully, and only increase risk gradually. This is because we think that there remains a small but significant risk that the recession does not end this year, and is prolonged or turns into a depression. The world in this second scenario would be a grim place. The psychological impact of policy failure on consumers, businesspeople and investors could be devastating. Under these circumstances, prolonged depression and a lost decade in the global economy would be a possible outcome. We assign only a 10% chance of this happening.

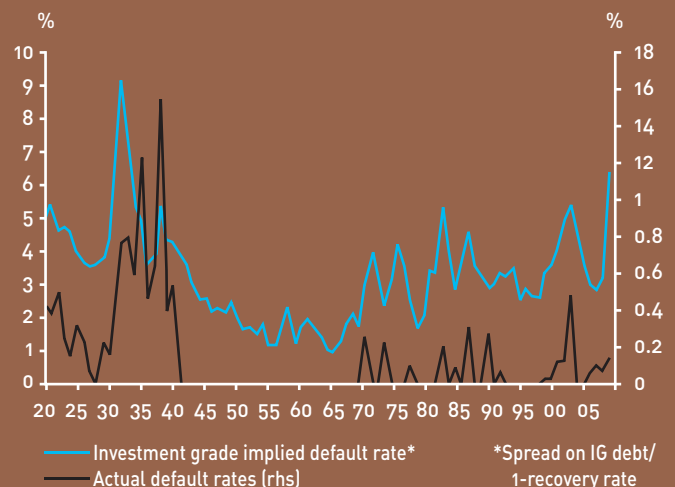
The base case scenario remains that there is a mild recovery in global growth later in 2009. Under this scenario, our favoured investment is corporate bonds, where markets appear to be assuming a gloomier economic outlook than appears justified. And while cash has been an excellent place to be invested in over the past few quarters, future returns on cash are likely to be paltry, with global central banks expected to keep interest rates low for some time.

We remain keen on government bonds, with a distinct preference for inflation-protected bonds over their conventional peers. But we are still

slightly hesitant on equities, until we are sure that a meltdown scenario will not materialise. As explained below, we have adopted a cyclical bias on equity sectors, and think that Asia (excluding Japan) is the most attractive geographic region.



FCredit is pricing in too gloomy an economic outlook



Source: Moody's, Barclays Wealth Strategy

Investment Outlook – Part 2

Assuming that depression can be avoided – our central scenario – we would highlight the five following points.

- Continued aggressive, creative global public policy intervention – along with early signs that this will work – makes us confident enough to suggest beginning a process of adding more risk. So now might be the time to move from the defensive, to the tactical offensive.
- Asia is likely to lead the global economic revival. The current crisis has proved a catalyst, encouraging China to shift its development strategy from growth driven by exports, to growth driven by expanding domestic demand. There are early signs that this shift, backed by substantial fiscal stimulus and an aggressive promotion of bank lending, is already having an impact within China and amongst its Asian trading partners.
- Credit (i.e. corporate bond) markets will outperform, as investors' appetite for risk increases. There is a strong argument for believing that credit markets must recover before the general economy can. And corporate credit currently appears to offer better value than equities. This is because corporate yield spreads (the difference in yield with government bonds of equivalent maturity) currently assume a much more pessimistic economic outlook than equity valuations.
- Volatility will ease back only gradually. Macroeconomic and financial market conditions will stabilise over the course of 2009, but only very slowly. In other words, we expect volatility to remain above normal levels for many months to come.
- Don't ignore the risks. We suggest that one should increase risk only gradually, from a securely defensive position. For many investors, the 'risk free' position will be cash or very short-term government bonds. But with the risk of a downturn still significant, longer-term government bonds – either fixed-rate or inflation-indexed – could be important too.



Equities – Part 1

‘Cyclicals’ explained

- **Cyclicals are sectors that can recover more dramatically in an upturn**
- **Cyclicals are tending to trade towards the bottom of their historic P/E ranges.**
- **During past recessions, cyclicals have tended to lead the recovery**

Certain sectors prove relatively resilient to the effects of economic downturn. Others benefit disproportionately from an upturn. The first group is often labelled as ‘defensive’, and includes sectors such as healthcare, consumer staples and utilities, where it is presumed that a fall in spending will be limited. The second group, the ‘cyclicals’, contains sectors such as industrials, materials and technology. Spending here can be cut much more sharply in the event of a recession – but can recover much more dramatically in an upturn too.

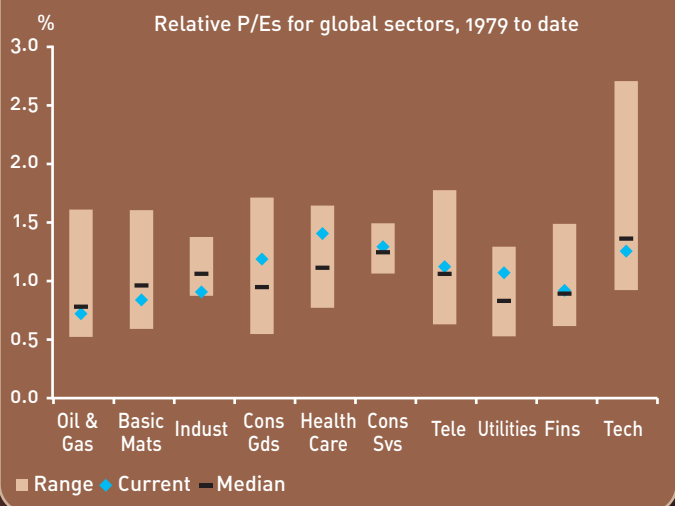
During the current downturn, the decline in share prices has not evenly matched the fall in corporate earnings. As a result, price earnings (P/E) ratios for each sector have moved, sometimes quite dramatically. Many ‘defensive’ sectors are trading at P/E ratios at the top of their historic trading ranges; in contrast, ‘cyclicals’ are trading towards the bottom.

As economic recovery takes hold, we would expect these sectoral P/E ratios to move back towards more normal levels. The implication is that there will be a prolonged period of under performance by the ‘defensives’. ‘Cyclicals’ are already showing sentiment turning in their favour.

History also suggests that in previous recessions ‘cyclicals’ have tended to lead the market higher in a recovery. So this might be a good time to invest in them – we would point to materials, industrials, IT and consumer discretionary stocks. And it might be a good time to avoid ‘defensives’ such as utilities or consumer staples.



Valuations favour cyclical sectors



Source: Datastream, Barclays Wealth Strategy

Equities – Part 2

Why Asian equities appeal

- **Economic improvement in China is already spilling into the rest of Asia ex Japan**
- **The crisis has forced a change in China's economic direction**
- **Asian markets remain attractively valued**

Certain geographical equities markets will do better in a recovery than others. Asia (excluding Japan) appears particularly well-placed to outperform. As noted above, we have seen signs already that the improving economic backdrop in China has begun to spill-over into the rest of non-Japan Asia, through exports. Much of the Chinese 'bounce' is of course being led by government spending, and government-induced extra lending, but we think that this will eventually lead to sustained recovery.

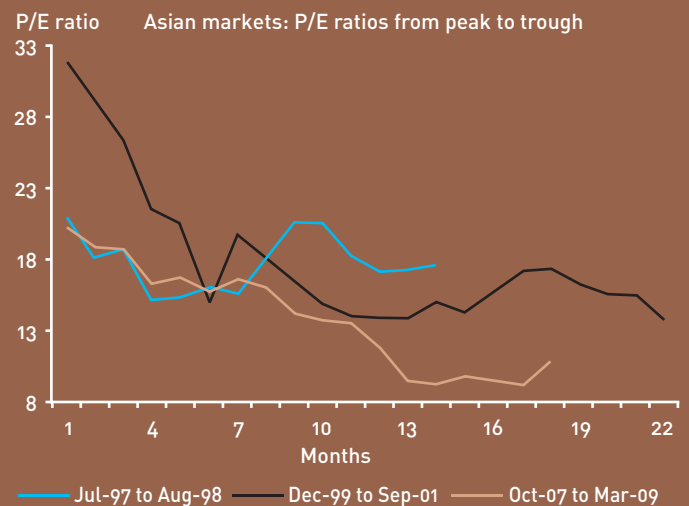
At present, the ratio of domestic consumer spending to GDP is very low in China – making the country very dependent on export growth. The crisis could however force a change in direction. A permanent increase in the US savings rates will reduce demand for Chinese exports, meaning that policies to encourage greater domestic spending will be increasingly needed. The Chinese have a well-earned reputation for being able to restructure radically over short periods of time. Interestingly, India already has much less export exposure.

Not only is Asia ex-Japan likely to lead other markets out of recession, but most Asian markets remain attractively valued. Price/earnings (P/E) ratios remain well below their long-term levels – and are even much lower than during the 1997-98 Asian crisis.

There are various ways to get exposure to Asian market. One way to do this is through an exchange traded fund (ETF) tracking the MSCI Asia ex-Japan index. Those feeling more adventurous could look at specific markets.



Asian valuations lower than in past downturns



Source: Bloomberg, Barclays Wealth Strategy

Corporate credit

The case for credit

- **A recovery in credit is certain to lead the economic recovery overall**
- **Bond yields more than compensate investors for an increased risk of default**
- **Bond portfolios need to be diversified**

As the current crisis has underlined, corporate bonds are far from being a risk-free investment. But they are less volatile than equity returns. A recovery in the credit markets is also certain to lead the economic recovery overall.

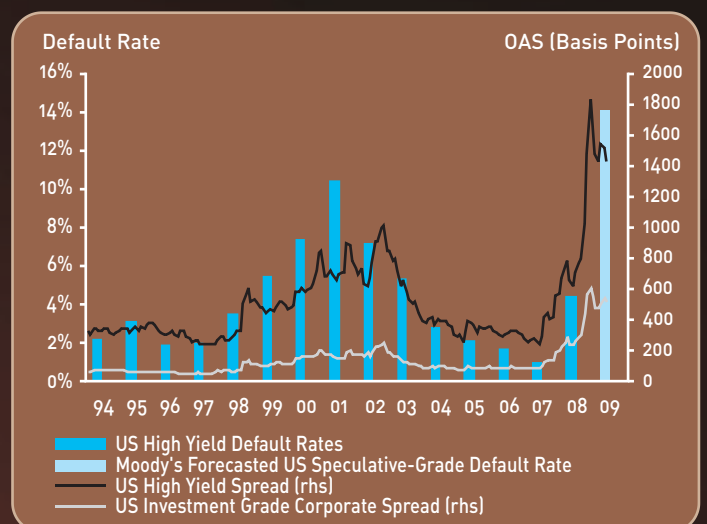
We expect increasing credit defaults. But we also believe that both speculative- and high-grade bond yields more than compensate investors for this risk. This belief is based on a relatively simple calculation. The question can be simply put: what percentage of bonds need to default, before a diversified portfolio of corporate bonds equals underperforms government bonds of the same maturity?

To work this out, one must make an assumption on what an investor might recover after a default. Assuming a recovery rate of around 40%, we reckon that 23.9% of speculative-grade bonds, and 8.6% of corporate-grade bonds, would have to default before corporate bonds would underperform. These default levels are much higher than forecast. For example, Moody's forecasts a speculative-grade default rate of 14.1% in 2009. This is very high by historical standards, but still well below the implied rate given above.

Bond portfolios still need to be diversified. The best performing sectors have considerably outperformed the worst this year, highlighting the importance of individual name selection too. But, overall, corporate bonds still appear very attractively priced.



Yields on corporate bonds imply an unreasonably high level of defaults



Source: Bloomberg, Barclays Wealth Strategy

Sterling sterling?

- **The scope for further sterling falls is limited**
- **But the outlook for the euro is worsening**
- **So sterling could now put in a strong performance**

already 'priced in' all this doom of gloom. (In other words, sterling's value already reflects the worries outlined above). And the Bank of England doesn't have scope to cut interest rates any further, removing this potential source of currency weakness.

At the same time, the outlook for the euro is worsening. Until now, the ECB's relative reluctance to cut rates has supported the euro. But this also poses a risk that in future the ECB could cut rates sharply, or be forced engage in some form of quantitative easing – both of which would weaken the euro.

Moreover, it's now clear that the euro area economy is no more insulated from the global slowdown or financial crisis than the UK. The euro area has substantial export and financial sector exposure to Eastern Europe, and to overheated property markets in Greece and Spain.

Falling export demand is also a big problem for many euro area countries. This has undermined German industrial production growth in particular. The fall in German industrial output is currently showing only faint signs of bottoming out, while the UK manufacturing sector may now be showing a more meaningful bounce.

Our conclusion is that the euro now looks much more vulnerable than sterling. And we expect sterling to benefit much more from a recovery in the financial sector and the global economy. So sterling could now put in a strong performance.

Sterling has had a tough time recently. Worries about the UK economy – for example, over the level of dependence on financial services, over private and public sector debt levels, and over the vulnerability of the property market – have undermined the currency. And the Bank of England's aggressive interest rate easing, compared with the more moderate approach of the European Central Bank (ECB), has fuelled the currency's weakness.

But it may now be time to step back and reconsider. The financial markets appear to have

Exchange rate forecasts	Spot	6 month	12 months
\$/€	1.34	1.30	1.20
¥/\$	99	99	102
\$/£	1.50	1.55	1.57
£/€	0.89	0.83	0.75
CHF/€	1.51	1.56	1.48

Source: Barclays Wealth

Focus: Inflation

We're worried because you're worried

Inflation forecasts are very divergent. Some economists are forecasting high levels of future inflation. But others are still very concerned about a prolonged period of deflation – or falling prices.

This is a subject where perception may matter as much as reality. If investors believe that massive monetary stimulus and huge government borrowing will inevitably lead to a period of very high inflation in the future, then we have a problem – these inflation expectations will cause market difficulties, whether or not the economic realities support it.

In fact, while inflation could become a problem in a few years' time, this is far from inevitable. It will be challenging for central banks to reabsorb the liquidity that they're currently providing at the right pace. They might err in a way that leads their economies to overheat slightly, and to inflation rising above target levels (currently between 1% and 2% in most countries, either explicitly or implicitly). And they might also get it wrong in the same way as the Bank of Japan did in 2000, when a premature rise in rates led to five more years of deflation. But, on balance, we think that their efforts to contain inflation will be generally successful.

Nonetheless, higher inflation expectations – particularly as the global economy begins to mend – could still prove a problem. The first impact would be a steeper yield curve – in other words, interest rates paid on longer-term bonds would rise significantly, as investors shy away from them. This, in turn, would push up mortgage rates – possibly aborting incipient recoveries in housing markets.

Many sorts of investment have a degree of 'inflation proofing' – in a moderately inflationary environment, if not in a period of hyperinflation. Investments in real estate, commodities, and the stocks of companies which can influence the price at which they sell their products all fall into this category. And, in a world where central banks will push up interest rates to fight inflation, cash may also appeal. Another way to deal with the possibility of higher inflation is to buy inflation-linked government bonds.



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