Market view

Economic and investment analysis in brief

April 2010

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Introduction

As we begin the second quarter of 2010, we again suggest to clients that they continue to position their portfolios towards structural growth – i.e. the corporate sector – whether this is through investments in equity or corporate credit. But we also restate our view that this is the time for selectivity and active management, particularly as equity market returns are likely to be more modest in 2010 than they were in 2009.

At a broader level, the path to full economic recovery will be a long one and will often run uphill, but we expect the recovery to remain on track, even though the ride may be a bumpy one at times.

Although we are encouraged by recent economic data, we also anticipate a continued gradual deterioration in many governments' finances in the coming years, as fiscal imbalances will take time to reduce. In the interim, worries about the health of governments' finances are likely to continue to affect market sentiment and investor behaviour.

Arnaud de Servigny
Head of Research Analytics
14 April 2010

Investment outlook

- **We still prefer equities to cash or bonds**
- **But investors need to be mindful of greater economic risks in the second half of the year**
- **Risk-averse investors may want to add some short-term protection against a worse-than-expected economic outturn**

While the macroeconomic picture may not be completely clear, one thing that is clear is that equity markets have continued to make good headway so far in 2010. However, while we are encouraged by stock markets' strong first-quarter performance, we do not think returns will be quite as strong as they were in 2009. For that reason, we think active investment management approaches could be important this year, as skilled managers should be able to exploit valuation anomalies within their respective markets.

In the second quarter, some investors may be worried about economic turbulence, particularly given the recent fiscal crisis in Greece. One traditional way of defending a portfolio against the risk of an economic downturn is to increase the average maturity (or "duration") of its government bond holdings. We had recommended a stance that was focused on shorter-dated bonds, but holding some longer-dated bonds on a short-term or "tactical" basis could prove useful if economic conditions do deteriorate.

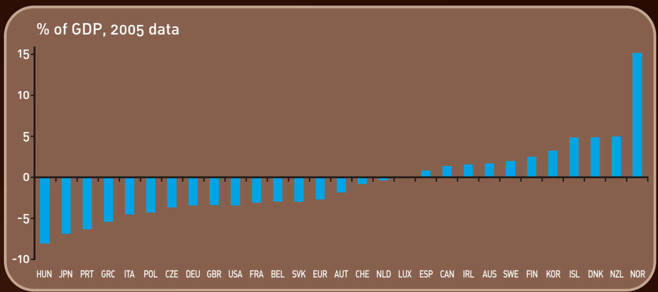
So, in essence, investors face something of a dilemma at the moment: equities have risen in value and should perform well relative to bonds and cash as long as our benign economic scenario continues to play out. For that reason, we still prefer equities over cash and bonds. Equities also continue to look attractive relative to their long-term valuation averages, which should provide further support to the asset class. But, in the short-term, risk-averse investors may want to add some short-term protection against a worse-than-expected economic outcome, and all investors need to be mindful of potentially greater macroeconomic risks in the second half of the year.

A further theme for the second quarter is that we still believe that is worthwhile maintaining selective and indirect exposure to emerging market economic growth, most notably in Asia. In the media, concerns have been voiced that "bubbles" are starting to develop in some emerging markets and that growth may stumble as central banks begin withdrawing the special measures introduced in 2008-9 to deal with the financial crisis. We are not particularly worried by these concerns – not every overvalued asset is a harbinger of crisis, and policy developments have looked both reasonable and timely. What we would say is that emerging markets do look expensive relative to Western markets, so we think it is best for exposure in the region to be indirect – e.g. via Western companies with a strong presence in the region.

Finally, and perhaps most importantly, it seems to us that political risks are beginning to grow. Aside from the broader fiscal issues highlighted above, specific risks also seem to be emerging – it is not impossible, for example, that the US and China may fall out over currency policy this year.

Political risks are difficult to protect against, but one thing that is for certain is for that the future will involve higher taxes. Investors should therefore make their portfolios as tax-efficient as possible and even non-taxpayers need to consider how tax increases could affect specific asset classes or investments. Local fiscal issues could play a key role here, so the size of a country's budget deficit – as shown below, with 2005 chosen as the comparison year because the global economy was still very strong back then – may prove to be particularly important.

Fiscal balances may emerge as an important investment consideration



Source: Barclays Wealth Strategy

Macroeconomics – US, Euro area

US outlook

- The US economy appears to be humming along, despite slowing from the hectic pace registered in the fourth quarter of last year, which was largely inventory driven.
- In the second quarter, we expect the three-quarter old economic recovery to finally produce job growth. But, with growth unlikely to move up another gear, unemployment is likely to remain elevated all year.
- On the monetary policy front, the Federal Reserve should be in no rush to lift interest rates, given that core inflation is hovering at 1% and expected to remain muted.

US forecasts in a nutshell

% y-o-y except where stated

	2008	2009	2010F	2011F
GDP	0.4	-2.5	3.0	3.1
CPI	3.8	-0.4	1.4	0.5
Official interest rate (%)	0-0.25	0-0.25	0.75	4.00
10-year yields (%)	2.22	3.84	4.50	5.50
S&P 500	-38.5	23.5	10.3	4.00
Trade-weighted $ index	4.4	-5.7	1.6	-0.4

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

Euro-area outlook

- After a disappointing end to 2009 and a fairly feeble start to 2010, we expect the recovery in the euro area to continue but at a weaker pace than previously thought.
- While the agreement over a last-resort solution for Greece should reassure markets that a default is unlikely to occur, such concerns are unlikely to recede quickly.
- In terms of monetary policy, we expect inflation to remain subdued and under the ECB's target throughout 2010 – due to large excess capacity and muted wage growth – so we do not expect any rises in interest rates until the beginning of next year.

Euro-area forecasts in a nutshell

% y-o-y except where stated

	2008	2009	2010F	2011F
GDP	0.5	-4.1	1.3	1.8
CPI	3.3	0.3	1.0	1.5
Official interest rate (%)	2.50	1.00	1.00	2.00
10-year yields (%)	2.94	3.40	3.75	4.30
Euro STOXX 50 index	-44.4	21.1	5.3	3.6
Trade-weighted € index	4.1	-2.2	-5.4	-2.3

Note that all market variables are end-of-period rates.
1Germany
Source: Barclays Wealth Economics

Macroeconomics – UK, Japan, emerging markets

UK

- Despite the benefit stemming from a sharp depreciation of sterling, the UK has been the last of the G7 economies to turn the corner.
- This poor performance reflects in part a reassessment of the UK as a place to invest: the volume of fixed investment has dropped by 22% since end-2007. Meanwhile, households are still hampered by high debt levels.
- We judge that the structural budget deficit is rather bigger than the Treasury has estimated. Accordingly, we expect further fiscal tightening will be necessary, whoever wins the election. If so, then the Bank of England is likely to do nothing for quite some time, both in terms of interest rates and quantitative easing.

UK forecasts in a nutshell

% y-o-y except where stated

	2008	2009	2010F	2011F
GDP	0.5	-4.9	1.5	2.7
CPI	3.6	2.2	2.1	1.0
Official interest rate (%)	2.00	0.50	0.50	3.00
10-year yields (%)	3.02	4.01	4.75	5.75
FTSE 100 index	-31.3	22.1	7.6	4.00
Trade-weighted £ index	-24.6	8.8	5.0	6.5

Note that all market variables are end-of-period rates.

Japan outlook

- The recovery gained momentum in the last quarter of 2009 and at the start of 2010. While the pace of recovery should slow by mid-year, we have raised our GDP forecast for 2010 to 2.0%.
- Despite this, deflation remains deep-rooted in Japan. With high spare capacity still weighing on the underlying inflation trend, prices are likely to fall further – probably until 2011.
- With the government caught between the need to keep stimulating the economy and the necessity of reducing Japan's ballooning debt, we think the Bank of Japan could come under more pressure to do more to tackle deflation.

Japan forecasts in a nutshell

% y-o-y except where stated

	2008	2009	2010F	2011F
GDP	-1.2	-5.2	2.0	1.7
CPI	1.4	-1.4	-1.2	-0.6
Official interest rate (%)	0.10	0.10	0.10	0.10
10-year yields (%)	1.18	1.30	1.50	1.70
Nikkei 225 index	-42.1	19.0	12.2	2.4
Trade-weighted ¥ index	29.9	-5.7	-4.2	-6.4

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

Emerging markets

- **Emerging markets are again expanding fast, and are still being assisted by counter-cyclical measures designed to help many through the financial crisis. Emerging markets are now rapidly increasing their share of global GDP.**
- **Fiscal policy is being reined in, particularly by the bigger emerging markets. Both India and China have also raised bank reserve requirements, a first stage in tightening monetary policy.**
- **The strength of the recovery is leading to a rise in inflationary pressures, particularly in the major emerging markets. Headline inflation is increasing as food and commodity prices rise.**

Emerging markets forecasts in a nutshell

% y-o-y, except for first column, which is $bn for 2008

	GDP	2008	2009	2010F	2011F
Brazil	1573	5.1	-0.2	4.5	4.6
Mexico	1088	1.3	-6.5	4.2	3.7
Argentina	326	5.8	-2.2	3.8	2.6
Russia	1677	5.6	-7.7	4.5	4.7
Turkey	729	0.6	-5.5	4.6	4.5
Poland	526	4.8	1.6	2.5	3.6
China	4402	9.0	8.7	9.9	9.3
India	1210	6.7	6.4	7.8	8.4
Indonesia	512	6.1	4.5	5.8	6.3
Saudi Arabia	482	4.7	0.2	3.5	4.3
South Africa	277	3.1	-1.8	2.8	3.9
All EMs	12802	6.1	1.8	6.5	6.4

Source: Barclays Wealth Economics

Focus: Sitting tight – Still favouring stocks

Investors' risk appetite seems, if anything, to be gradually returning.

- **The valuation of equity markets in particular remains undemanding, in our view. Upgrades to consensus expectations of profits growth mean that valuations below relevant long-term averages.**
- **We believe that equities will be the best performing of the traditional asset classes in the second quarter and we remain overweight.**
- **Tactically, we continue to favour developed over emerging markets. Within the developed bloc, we have an overweight on the UK, due in part to sterling weakness.**

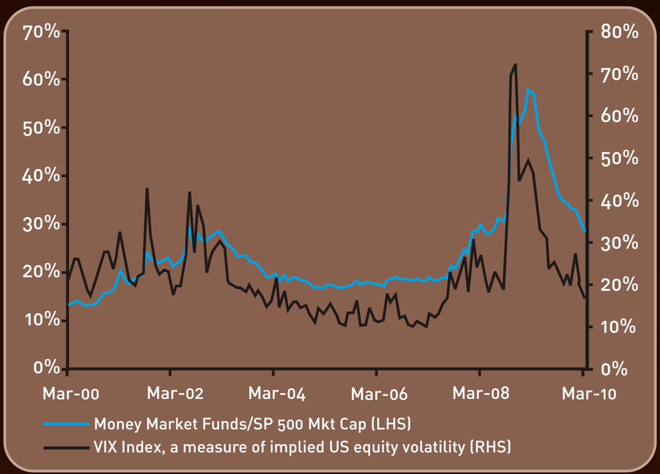
As we enter the second quarter, the global economy still faces a number of risks. Consumer confidence remains fragile, overshadowed by weak labour markets, yet interest rates – and probably taxes too – have to rise at some stage. And in Europe, the precarious nature of some government budgets has been brought to investors' attention by the turmoil in Greece and the slide in the euro.

These risks may be at least partly priced in, however. Indeed, very slowly, investors' risk appetite seems if anything to be gradually returning – encouraged perhaps by the decline in implied equity volatility (see chart). It can be seen indirectly at least in continuing outflows from "safe haven" money market funds in the US (also shown in the chart). On this front, there is potentially much more to follow: there is still $3 trillion, equivalent to about 30% of the S&P 500 market cap, sheltering in such funds, an amount well above pre-crisis norms (and indeed above the earlier peak seen in 2002).

Meanwhile, economists' and investors' worst fears of six months ago – of an abrupt reversal in the incipient recovery in the global economy and financial markets – have not come to pass. Even in the hard-pressed eurozone, where we think the risks of monetary disintegration have been overstated, the weaker euro will help support exports and overseas earnings.

For good measure, the valuation of equity markets in particular remains undemanding, in our view. The additional rally in 2010 to date has been associated with further – plausible – upgrades to consensus expectations of profits growth, and as a result, prospective valuations remain below what we think are the relevant long-term averages.

Amounts held in money market funds are now falling, as equity volatility declines



Source: Datastream, Barclays Wealth Strategy

On balance, then, as in Q1 and Q4, we think that equities are likely to remain the best-performing of the traditional asset classes, and we stay overweight. We'd re-iterate that a repeat of 2009's stellar performance is not in store. But our index targets have not been ambitious, and the prospective level of earnings may be a little higher than we thought at the start of the year, suggesting a bit more headroom for stocks.

Within equities, we continue tactically to favour developed markets over global emerging markets (GEMs). In 2010 at least, developed market profits will grow just as quickly (around 30%) as GEMs'; and it is in the GEMs that monetary policy is being tightened first; it also looks likely that GEMS will tighten a lot further than developed markets. Emerging markets have indeed underperformed the developed bloc in 2010 to date, as measured by the MSCI indices: we think this trend could run further and therefore recommend concentrating an overall equity overweight in developed markets.

In the developed bloc, we are retaining an overweight stance on the UK. This may surprise some readers, given the UK's feeble domestic recovery and its fiscal and political risks – but those very same risks have already brought with them some renewed weakness in sterling, which is underpinning the profits of companies quoted on the UK stock market, which is by some way the most international of the larger markets. The UK also benefits from some of the fastest earnings growth, and lone of the least expensive valuations, in the developed Western bloc.

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Fixed income: Continue to prefer corporate to sovereign debt

- **The fiscal crisis in Greece has unsettled markets, and we think that at current yields, exposure to the majority of sovereign debt issues is simply not a risk worth taking.**
- **Within the corporate bond market, there are attractive opportunities in all regions but at present we would focus our search among UK and Asian issuers.**
- **Investors should have a blend of both investment-grade and high-yield exposure in their portfolios, favouring financials and high-yield credit.**

At present, we continue to recommend that investors concentrate credit risk in the corporate rather than the government sector.

The fiscal crisis in Greece has undoubtedly unsettled sovereign bond markets, and despite EU support for the country, we think that at current yields, exposure to the majority of sovereign debt issues is simply not a risk worth taking. We suggest that investors who want to shelter in sovereign debt investments should confine their exposure to the highest-quality government debt, even if it may mean slightly lower income (in the form lower yields). In Europe, this would mean allocating to what are known as the "core" sovereigns – Germany and France, for example.

Any credit risk that investors do take in their portfolios – and we believe they should be taking a normal amount currently – should be focussed on the corporate bond market. There are attractive opportunities in all regions, but at present we'd focus our search among US and Asian issuers. Our positive view on corporate debt is underpinned by our view that corporate finances are in better health than those of many governments.

Specifically, we believe that investors should have a blend of both investment-grade and high-yield exposure in their portfolios, favouring financials and high-yield credit versus investment grade non-financial issues, which look more expensive. Regionally, we prefer US and Asian issuers over European. However, even within these broad sector and regional preferences, we would re-iterate the importance of active investment management given the ongoing risks to our "benign" central scenario.

- **Industrial metals prices fell in early 2010, but this weakness should prove only temporary as Chinese economic growth revives.**
- **Improving global economic prospects have braked the rise in gold prices, and fading inflation fears should led to a gradual fall in gold price by the end of 2010.**
- **Oil prices have remained close to the $80/bbl mark in early 2010, but should drift higher as global oil demand gradually improves.**

Concerns over China's monetary policy actions and fresh worries about the strength of the Chinese economy clouded the market's broadly positive view on metals demand briefly, causing prices to fall at the start of the year before picking up later in the first quarter. We expect any weakness in industrial metals to prove to be temporary, as we expect that Chinese economic growth will undergo only a mild and short-lived deceleration.

Gold prices surged by 25% in 2009, on the back of demand for safe haven assets and inflation concerns (gold acts as an inflation hedge). Since then, global economic prospects have improved causing gold price returns to become more muted, with only a 2% rise in the first quarter. Looking ahead, as long-term drivers such as global activity – in particular in Asia – continue to pick up, and with inflation fears looking to fade further as disinflation becomes more evident, prices should fall gradually by the end of 2010.

After the initial recovery of energy prices early last year, oil prices ended 2009 with a rather insipid range-bound performance. This sluggish momentum has continued into 2010 with oil prices still remaining tightly bound around the $80/bbl mark. A bout of extremely cold weather hit the northern hemisphere in January, modestly boosting energy demand. Although natural gas prices rallied and energy price momentum picked up, oil prices only nudged higher temporarily. As global oil demand gradually improves alongside the global recovery, oil prices should drift higher.

Commodity forecasts in a nutshell

% changes[1]

	2008	2009	2010F	2011F
Agriculture	-27.5	13.7	-1.0	8.0
Industrial metals	-48.3	80.0	14.4	6.4
Precious metals	-4.1	29.2	-6.9	0.0
Oil ($/bbl, year-end)	36	78	88	91
All energy	-47.3	-5.3	13.1	14.6
All commodities	-35.7	18.9	6.9	9.1

[1]From 31 December to 31 December

- **US dollar:** The US dollar has strengthened recently as the Federal Reserve (Fed) has begun to normalise its monetary policy. We expect the currency to remain supported as the US economy recovers at a strong pace and the Fed starts to reduce the size of its balance sheet.

- **Euro:** Although concerns about Greece caused the euro to lose some of its overvaluation at the beginning of the year, the currency still appears expensive. We expect the euro to depreciate further as the euro area's recovery looks set to remain sluggish, with the ECB keeping interest rates on hold until the beginning of 2011.

- **Sterling:** Fiscal concerns have weighed on the sterling of late, but we judge that it has been oversold. Even if the election results in a hung parliament, fiscal tightening is likely to be agreed upon, providing a boost to the currency. However, the currency may fall further ahead of the election, especially if the polls remain tight.

- **Other G10 currencies:** Within the remaining G10 currencies, we expect the yen to weaken as monetary policy is eased further, while low interest rates in Switzerland should cause the franc to weaken a little. Meanwhile, we judge there to be limited scope for further appreciation of the commodity currencies – although our commodity price and interest rate outlook are supportive for these currencies, this has almost entirely been priced in.

Exchange rate forecasts

	Spot	3 mth	6 mth	12 mth	End 2011
EUR/USD	1.35	1.30	1.35	1.35	1.35
GBP/USD	1.52	1.48	1.58	1.70	1.75
USD/JPY	93	96	98	100	105
USD/CAD	1.01	1.05	1.02	1.00	0.98
AUD/USD	0.92	0.86	0.84	0.88	0.88
NZD/USD	0.71	0.70	0.69	0.70	0.70
EUR/GBP	0.89	0.88	0.85	0.79	0.77
EUR/CHF	1.42	1.47	1.50	1.55	1.55
EUR/SEK	9.74	9.60	9.50	9.30	9.00
EUR/NOK	8.01	8.05	7.90	7.70	7.40

Source: Barclays Wealth Economics

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