

Market view

Economic and investment
analysis in brief

May 2010

Introduction

Despite the problems in Greece, there is some good news at the moment. Macroeconomic data, particularly in the US, has generally been better than expected. Corporate earnings for the first quarter have also been very strong.

Set against this, there is a realization that the current economic recovery owes much to policy stimulus, so there are concerns about the likely effects of scaling back or withdrawing this stimulus. Shifting to fiscal contraction too quickly risks derailing recovery. Conversely, tightening too slowly risks a loss of market confidence and an even more daunting fiscal challenge, as Greece

and southern European economies are learning to their sorrow.

Whatever the timing of this move to fiscal contraction, higher taxes look certain. The burden of this looks likely to fall on corporations, investments and investors, as governments will be unwilling to raise taxation of low and middle income households. We start this issue of Market View by considering the implications of this.

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6 May 2010

Investment outlook

- We still think that global economic recovery will continue
- But taxes look set to increase
- This will affect both post and pre-tax investment returns

We continue to argue that investors should position their portfolios for what we regard as the most likely outcome – a continued global economic recovery that is broadly supportive for riskier asset classes, for example equities.

However, we do think that it's worth highlighting four themes that will remain important over the next few months.

- The first is to “mind the gap” between the base-case scenario and other less benign outcomes – the Greek debacle has reminded us just how real the risks are.
- The second is to look to use more active management – that is, to attempt to select individual stocks and sectors that you think will outperform, rather than rely on overall market movements to generate returns.
- The third is to maintain selective and indirect exposure to emerging markets economic growth, particularly in Asia. (Although we think that emerging market equities, overall, now seem fairly priced.)
- And, fourthly, we would suggest that you attempt to build some defences against public policy risks.

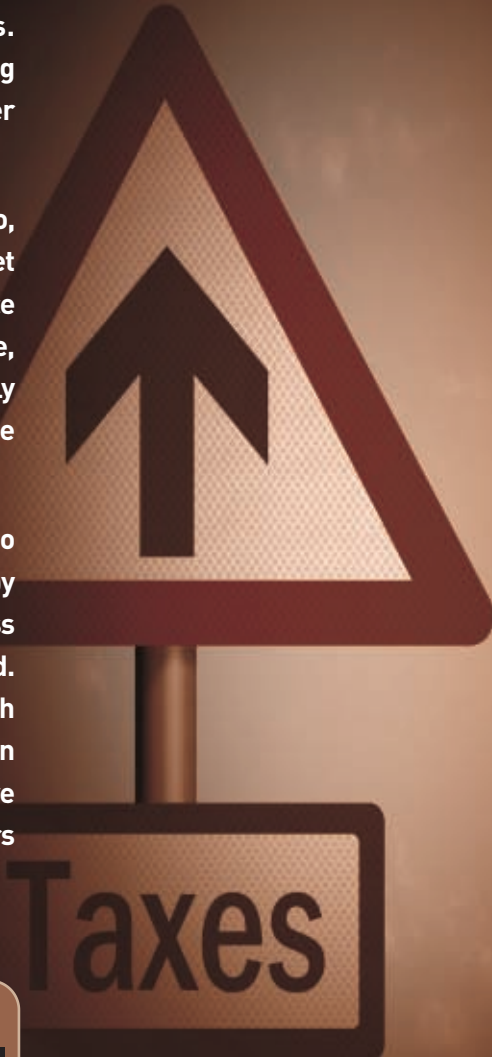
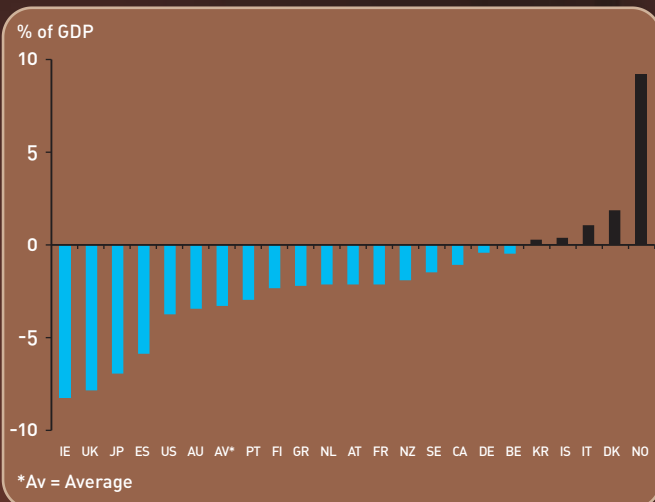
Rising taxes are one obvious public policy risk. Governments need to reduce their structural fiscal deficits and it seems very unlikely that the entire adjustment can be managed by cutting government spending.

Higher taxes will affect investors' investment returns, most obviously through the difference between before-tax and after-tax investment returns. Investors can mitigate the effect by reallocating portfolios into more tax-efficient investments – after having taken advice from their own tax advisers.

But tax increases can also affect pre-tax returns too, both in absolute terms and relative to other asset classes. One positive affect should be that they reduce the volume of government bond issuance in future, meaning that government bond yields may be slightly lower (i.e. prices will be higher) than would otherwise be the case.

For the most part, however, higher taxes will tend to suppress pre-tax investment returns, although not by as much as many fear, and probably by much less than a severe fiscal crisis in a large economy would. The effect may be largest in those countries with largest structural primary fiscal deficits, as shown in the chart below. Tax rises will also affect the relative pre-tax performance of different assets, as taxpayers respond to new sets of incentives.

Primary structural fiscal deficits



Macroeconomics



- **Data on economic activity have been increasingly robust, as have corporate earnings**
- **But the recovery is underpinned by massive policy intervention**
- **The Greek crisis will also continue to affect market sentiment**

Much macroeconomic data continued to improve in the first half of 2010, particularly in the US. Employment levels have started to grow again in the US, there have been signs of stability in the housing market, and US retail sales increased sharply over the previous three months. Both business and investor confidence has risen sharply.

But the shape and nature of the current recovery has been determined by massive policy intervention. So it is still worth asking what might happen when this policy stimulus is withdrawn or scaled back.

The US is a case in point. Here there has been a particularly forceful application of both fiscal and monetary policy. The results have been impressive: the IMF reckons that fiscal stimulus boosted US GDP growth in 2009 by around 1 percentage point. But the impact of last year's fiscal package is expected to peak in 2010, with its effects starting to wane later this year.

Our forecasts summarised

Year-on-year % change			
Real GDP	2009	2010F	2011F
United States	-2.5	3.0	3.1
Euro area	-4.1	1.3	1.8
United Kingdom	-4.9	1.5	2.7
Japan	-5.2	2.0	1.7
China	8.7	9.9	9.3
Inflation	2009	2010F	2011F
United States	-0.4	1.4	0.5
Euro area	0.3	1.0	1.5
United Kingdom	2.2	2.1	1.0
Japan	-1.4	-1.2	-0.6
China	-0.7	3.4	3.5

Source: Barclays Wealth Economics

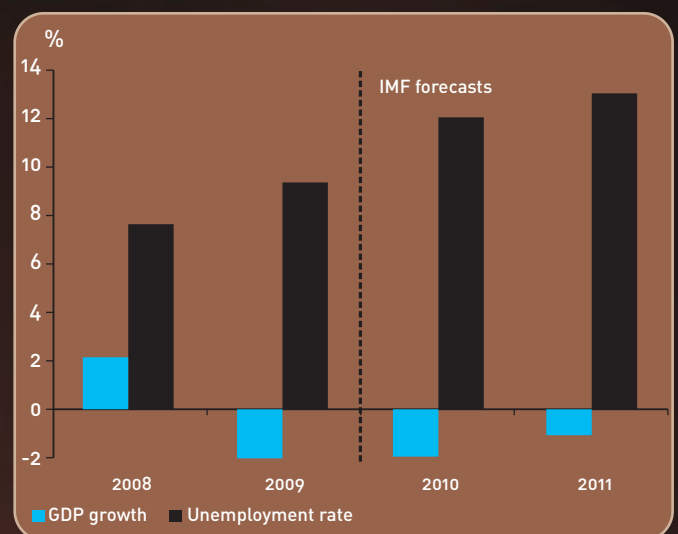
In other parts of the world, the legacy of the recent recession is more evident. The euro, and some European asset prices, remain at the mercy of fears about sovereign risk, as the rapidly-evolving developments in Greece undermined the standing of some European institutions.

The sheer size of the problem seems to preclude straightforward solutions. Starting from a negative fiscal balance of 13.6% of GDP in 2009, the Greek government says that it wants to reduce this to deficit to 5.6% of GDP next year, a herculean effort. It would be challenging enough to do this at a time of healthy economic expansion – but this is not such a time. As shown in the chart below, the Greek economy is expected to keep contracting, with unemployment probably soaring in the next 18 months or so. And as history suggests, even when multilateral investors and external investors agree with governments on a course of action, domestic audiences may find the pill too bitter to swallow. The interplay between domestic politics and budget cuts is a big unknown.

More immediate problems can be caused by the chess game between market expectations and European policymakers. The hesitant reactions of EU policymakers to the Greek crisis have encouraged market participants to consider previously unthinkable outcomes, increasing the likelihood that they will happen. So the bond markets are now pricing in the likelihood a Greek default; some other European economies are already under fire.



The IMF's forecasts for Greece



The case for equities and high-yield credit

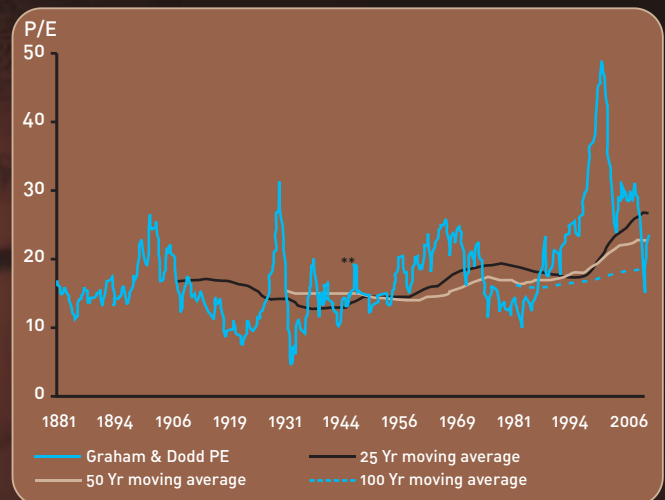
- We still take a positive view on corporate assets – both equities and bonds
- Valuations here still look relatively cheap in the case of high-yield credit and equities
- But valuations are less attractive in the case of investment grade corporate bonds.

The valuation case for equities is complex, partly because of uncertainties surrounding the interpretation of earnings data. We think that the US market (still the bellwether) is trading on a plausible price/earnings (P/E) ratio for 2010 of around 15, which around 10-15% below where we think it should be.

But earnings can be volatile, and historical comparisons pose more questions than answers. The current P/E ratio looks low in the context of the last quarter-century; but high (i.e. expensive) if you take a hundred year view, as is suggested by the chart below. There must also be a question mark over the older earnings data used in these long-term comparisons, due to laxer accounting conventions in the past and also a rather different industrial mix.

The valuation case for high-yield credit is simpler. Spreads (the difference in yields between high-yield bonds and government bonds on equivalent maturity) are narrower than before, but are still above pre-crisis levels. With a vigorous sell-off in government bonds unlikely, these spreads look set to narrow further – in other words, the value of high-yield credit should increase.

Equities price/earnings ratios



What goes into a good equity portfolio?

- **Equities remain our favoured asset class, but it seems likely that the pace of gains will slow and there will be setbacks along the way**
- **We think that it's worth focusing on developed market equities in the short-term, concentrating more on the US than on Europe.**
- **Consider stocks that can gain from the resumption in mergers and acquisition activity, or increased corporate investment**

Equity remains our favoured asset class. Corporate earnings have been recovering with vigour, liquidity is good, and equity valuations will look relatively inexpensive. But it seems likely that the pace of gains will slow, and (as demonstrated by the reaction to the Greek crisis) there will be some setbacks along the way. Structural uncertainties in Europe may impact valuations in the near term.

We remain keener on developed markets than emerging markets. In the short term, profits growth of companies in the developed markets will probably be as vigorous as those in the emerging markets – recovery will be steeper. Longer term, emerging markets will deliver higher returns than developed markets, on the back of faster economic growth – but prices already reflect this.

Returns from overall market movements will be lower than in the recent past. So there is an argument for selecting individual stocks that you believe will outperform. Look to stocks that may gain from the expected resumption in merger and acquisitions (M&A) activity, or from a sharp increase in capital spending.

As the recovery settles down, one would normally angle a portfolio towards non-cyclical stocks (i.e. away from stocks and sectors that benefit disproportionately from the early stages of a recovery). But non-cyclical stocks have not done particularly well so far, and we prefer to remain focused on the M&A and capital spending themes identified above.



Coping with inflation

- Many investors are worried by a possible pick up in inflation.
- But inflation-linked government bonds and gold may not offer protection against this.
- Instead, you may need to take a portfolio approach.

Recent increases in inflation have led to concerns that we might be about to enter a period of runaway inflation. In fact, we don't think that this is likely: unemployment and spare capacity in the economy is likely to keep the lid on prices for some time, and we also have faith in the ability of central banks to keep matters under control.

But, if you are concerned about inflation, it is worth thinking carefully about what you can do to protect your investments against it.

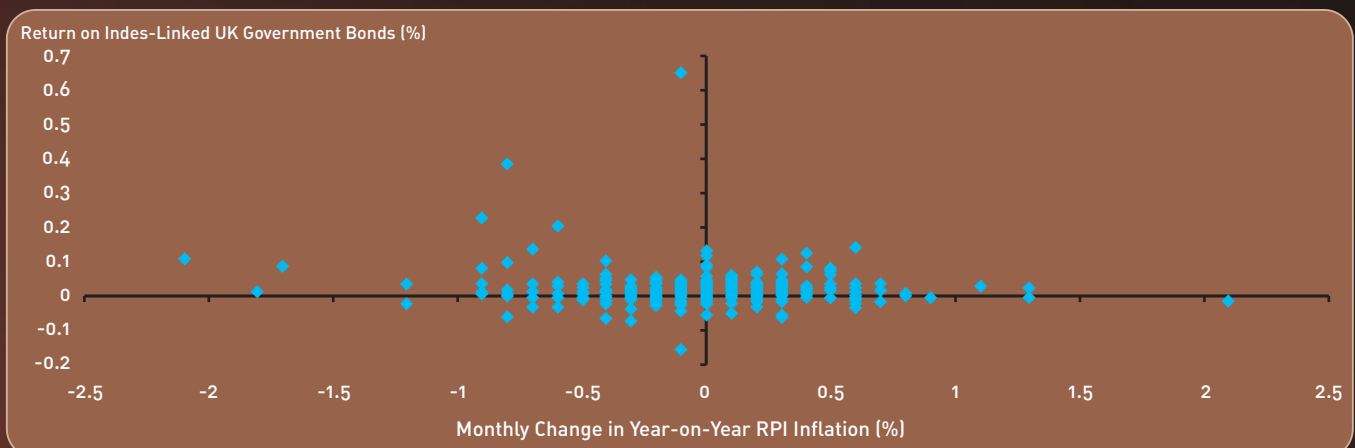
For most investors, the two most obvious "inflation hedges" (investments that should do relatively well in a period of rapidly rising prices) are inflation-linked government bonds (often referred to as "linkers") and gold.

Inflation-linked bonds pay a coupon (or return) that is linked to a measure of inflation. So, if



inflation rises, then the coupon increases. But this does not necessarily make them a good hedge against inflation, if you don't plan to hold them for the full term. This is because the price at which you can sell the bond will vary too, because it is influenced by the level of real interest rates. In fact, if you look at the history of UK inflation-linked bonds, their best monthly performances have often been recorded when inflation is going down.

The monthly performance of UK inflation-linked bonds: 1982 to present





Gold is another “obvious” inflation hedge that really isn’t one. The metal has performed well during financial markets crises, and during periods in the past when monetary policy has been too loose for a sustained period of time. But inflation becomes a problem when a “wage price spiral” develops and, looking back at the late 1970s and early 1980s when inflation was out of control, the correlation between gold prices and inflation was unstable. At present, we believe that – unless inflation turns out to be much worse than we anticipate – then gold prices are more likely to decline than rise.

So, in the absence of a single, perfect hedge, what should the investor do? A portfolio, rather than single-bullet approach may be best way. There are a number of investments that may provide some protection – for example, investment in diversified basket of commodities and in certain sorts of real estate.

It may also be worth looking at stocks of companies with what could be dubbed “pricing power” – in other words, those that are more able to pass on higher input costs to their customers. Individual companies in almost any industry can exercise “pricing power” but our analysis suggests that these often occur in two broad stock market sectors: regulated utilities and companies that own well-established brand names.

FX Focus

US dollar: Although the US economy is recovering at a strong pace, we expect risk appetite, high oil prices and Asian currency appreciation to limit the dollar's future rise.

Euro: The euro is likely to remain sensitive over the next few months to the perceived likelihood of success or failure of the Greek rescue package. Beyond this, we think that scope for a further fall in the euro is limited.

Sterling: The currency provided resilient to fears about a hung parliament in the run up to the UK general election, but an inconclusive election result could still hold down the currency in the short term. However the currency is fundamentally cheap and is expected to appreciate in the second half of the year.

Other G10 currencies. We still expect the yen to weaken against the dollar in the longer term, due to deflation keeping Japanese monetary loose for an extended period. The Swiss franc may weaken over the next year, as Swiss interest rates are kept low. There is limited scope for further appreciation of the Canadian dollar, after a strong recent performance.

Australian and New Zealand dollars. The likelihood of strong future growth and interest rate rises has already been priced into the Australian dollar, limiting the scope for future gains. But the New Zealand dollar could rise, particularly against the Australian dollar.



Exchange rate forecasts

	Spot	1 mth	3 mth	6 mth	12 mth
EUR/USD	1.33	1.35	1.30	1.35	1.35
GBP/USD	1.54	1.50	1.48	1.59	1.70
USD/JPY	94	95	96	98	100
USD/CAD	1.00	0.99	0.97	1.00	1.00
AUD/USD	0.93	0.90	0.88	0.84	0.88
NZD/USD	0.73	0.70	0.70	0.69	0.70
EUR/GBP	0.87	0.90	0.88	0.85	0.79
EUR/CHF	1.73	1.44	1.47	1.50	1.55
EUR/SEK	9.61	9.75	9.60	9.50	9.40
EUR/NOK	7.85	8.10	8.05	7.90	7.70

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