

Market view

Economic and investment
analysis in brief

September 2009

Introduction

Now that the risk of a depression is receding, we no longer believe that it is appropriate for investors only to be invested in low-risk investments such as cash or government bonds. It is true that equity markets have enjoyed a strong rally since early March, but for us the greater risk would be to avoid them altogether. In other words, we believe that investors who sat out the market downturn in 2008 by investing in cash or government bonds should now consider moving to a more normal investment posture – that is, investing in a wider range of asset classes rather than focusing solely on those that are perceived to be the safest.

On the economic front, it is pleasing that some economies already seem to be returning to growth, most notably in Asia. Doubts over the strength of the global economic recovery may worry markets in the short term, but in the longer term we would expect equities to build on their recent gains.

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Macroeconomic Outlook – Part 1

A multi-speed recovery

The initial “green shoots” of recovery have started to grow and branch out recently – much as many economists had expected. This was helped by the sheer passage of time, as inventory cutting has proceeded. But importantly, it also reflects supportive policy, which has fostered a return of confidence. In the phrase coined by economist John Maynard Keynes, “animal spirits” are back – and so the world has become a bit easier to understand, in that consensus economic forecasts of output for 2009 have now

stabilised in a number of markets and are even beginning to turn up for 2010 (see chart). Another positive development is that the majority of high-frequency macroeconomic numbers (such as industrial production data) are now turning out to be stronger than expected.

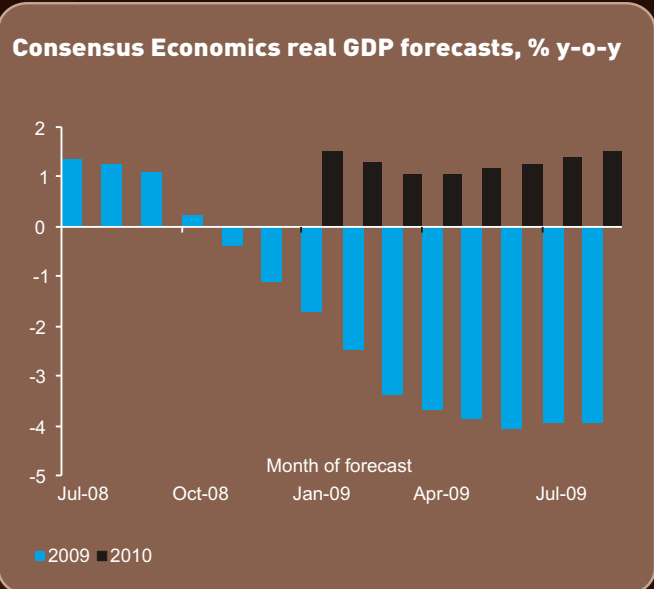
Developed countries are starting to break into a gentle jog...

However, the data from the major developed markets suggest only a slow turnaround. In the United States, the decline in Q2 GDP turned out a

little smaller than forecast, and Q3 growth now looks likely to be positive. The downward revisions to previous data were more important, however, as they suggest that the hole the economy is climbing out of is even deeper than seemed likely a quarter ago, and that future “potential” economic growth will likely be slower than what was achieved in the decade prior to this recession.

The UK economy’s second-quarter performance was disappointing relative to expectations. Some better news came from the euro area, where the German and French economies unexpectedly expanded in Q2, but the detailed statistics did not point towards an accelerating recovery. Altogether, a “slow grind” scenario still appears to us to be the most likely outcome for the major North Atlantic economies. Inflation, in this sort of environment, is likely to remain at bay, with high spare capacity and weak pricing power.

Consensus forecasts for the major economies are starting to turn up



Source: Consensus Economics, Barclays Wealth Research

Macroeconomic Outlook – Part 2

A multi-speed recovery (continued)

...but Asia is already sprinting

- Asia is returning to growth faster than the “advanced” economies
- In China the government appears to have been successful in boosting growth
- The tone of economic data from emerging Asia has also improved

In contrast to the developed world, there is mounting evidence that emerging markets, and especially those in Asia, are returning to growth much faster. Particularly noteworthy are developments in China. There, Q2 GDP growth ran at a rate of 7.9% year-on-year, according to official figures. Translating this into quarterly numbers is not straightforward, but private-sector estimates range from 4-5%, with our own estimate near the upper end of that range. Whatever the exact figure, it implies that the government has been successful in boosting growth.

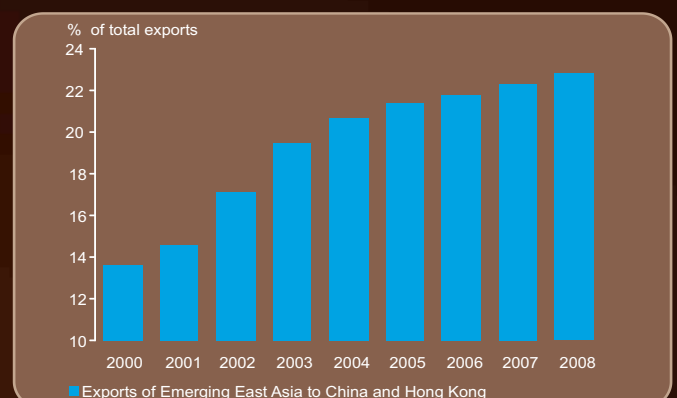
In the near term, we take comfort from the Chinese central bank’s commitment to maintain economic stimulus: the central bank pledged at the end of July to “unswervingly continue to apply appropriately loose monetary policy and consolidate the economic reform momentum”, countering speculation that monetary tightening will soon be used to rein in the expansion in credit growth.

In India, there are signs that ample fiscal and monetary stimulus is gaining traction: business confidence indicators have stood in expansionary territory for four months now, and the Reserve Bank of India has upped its estimate of economic growth in the 2009 financial year to 6% “with an upward bias”.

Elsewhere in emerging Asia, output declines have generally smaller than during the crisis of 1997/98, partly because domestic demand held up

better. As a rule of thumb, those economies most exposed to global trade performed the worst: Singapore, whose exports in 2008 were 186% of GDP, recorded a GDP plunge of 9.6% in Q1, compared to the 4.4% rise in Indonesia over the same period. Admittedly, much of the improved outlook for emerging Asia has been “made in China” (see chart) and the region’s economic integration with China has been proceeding apace. However, given that the bulk of trade in the region is in intermediate goods, and the final destination of the end products is still mainly the developed world, the strength of the whole region’s recovery will continue to depend on the continued rapid growth of Chinese domestic demand.

China has become an increasingly more important destination for Emerging Asia’s exports



Source: Barclays Wealth Research

Investment Outlook – Part 1

The first and last of our original investment themes for the third quarter – discussed in the July edition of Market View – were, in a sense, mutually contradictory. The first theme expresses the view that markets are fairly valued, with downside and upside risks around our base-case “unusually slow recovery” projection about equally balanced. The fifth and final theme was a reminder that investors should remain vigilant with respect to the risk of a “double-dip” recession. This apparent contradiction reflected our belief that a large majority of investors are more concerned with wealth preservation than with the creation of new wealth, especially so in the wake of the severe damage done by the global financial and economic crisis that began last September. This impression has been reinforced by our observation that many investors retain very defensive investment postures, holding much larger proportions of cash and government bonds than they normally would.

Since late June, when we formulated these investment themes, evidence has accumulated that the global economic recovery has begun. To date we haven’t seen any convincing signs that the recovery will be particularly, or even typically, robust. An initially weak, slowly accelerating period of economic growth remains the most likely outcome, and a double-dip remains a worrisome possibility. Nevertheless, the upside risk – the chance that the recovery could be surprisingly strong – has increased. Much slower job losses in the US, positive second-quarter economic growth in Germany and France, and healthy economic performance in emerging Asia, are among the indicators that could be consistent with either an unusually weak or a normal global recovery from recession.

Moving to a more normal investment posture

The emerging evidence leaves us uncomfortable with our fifth investment theme, and consequently we are dropping it. Dropping this investment theme does not involve changing any of our tactical asset allocation recommendations. These were at strategic norms in terms of both target risk levels and the proportions of the “headline” asset classes. But we no longer want to



leave the impression that we’re more worried about the potential pain of a double-dip than the opportunity cost of missing a continuing rally. Investors whose portfolios are still positioned defensively should move toward a normal or “neutral” risk posture.

Investment Outlook – Part 2

For the remainder of the third quarter – and indeed for the foreseeable future – there are four key considerations which we believe investors should keep in mind:

Financial markets appear close to fair value. At the broadest level – i.e. the valuation of equities and the general level of interest rates – market prices seem to reflect our most likely scenario: a weak recovery starting before the end of this year. This means that markets may struggle to make headway in the short term. It also means that investors should move their portfolios back into line with more normal strategic levels, rather than taking large bets on individual asset classes.

Asia is the most dynamic regional economy. The strong performance of Asian equity markets (excluding Japan) this year to date has brought valuations back to or above historical averages, but the region's relative growth prospects have, if anything, improved. Consequently, we continue to like Asia, but we would encourage investors to be more selective when investing in the region, focusing on the most attractively valued companies, sectors and countries, rather than adopting a "broad brush" approach. Alternatively, investors can consider "thematic" portfolios (e.g. a portfolio with a focus on Asian infrastructure companies) or Western companies with a significant presence in the region.

Short-term interest rates will remain low. Central banks are unlikely to raise rates at any time in the near term; this means that returns on "risk

free" investments such as cash deposits will remain very low – around 0% in most instances. Investors who need higher levels of income will need to take on a degree of credit risk to boost returns.

Inflation is not a problem, but inflation expectations could be. Given the huge amount of spare capacity in the global economy, we do not expect inflation to be a problem in the short term. But the worry that inflation could re-emerge at some point in the next two to three years could boost demand for investments that provide protection against inflation – such as inflation-linked bonds and commodities.



Equities – Part 1

Substantial but selective in Asia

- We continue to like Asian ex Japan equities
- However, the run up in valuations means that investors need to be much more selective
- Investors can consider “thematic” portfolios or Western companies with high levels of Asian exposure

One of our key investment ideas since early February has been to overweight Asia ex Japan markets. This idea has performed strongly, but as a result Asia is now trading at a premium to other global equity markets (see chart). Asia deserves some premium to reflect its better long-term growth prospects, but out performance could prove harder to sustain as Asia becomes more expensive in relative terms.

This has prompted us to change the focus of our view on Asian equities; we now believe it is time to be more selective. We believe that investors should look for ways to gain exposure to the Asian growth story that side-step the valuation concerns. Rather than just index exposure, we now prefer active managers who are able to allocate across different countries, sectors, and companies. Alternatively, investors could consider a thematic Asian portfolio, such as a selection of stocks of infrastructure suppliers. Another way to gain exposure is to consider investing in Western companies and economies that have high exposure to Asia. We still favour German equities within Europe, in part for its Asian exposure, and also expect that Japanese equities could see a period of catch-up relative to the rest of Asia. Indirect Asia exposure, such as a diversified allocation to commodities, can also make sense in an environment where local index stocks are getting expensive.

Although Asian equity valuations are no longer as appealing as they once were, we still remain optimistic on the outlook for the Asian economies,

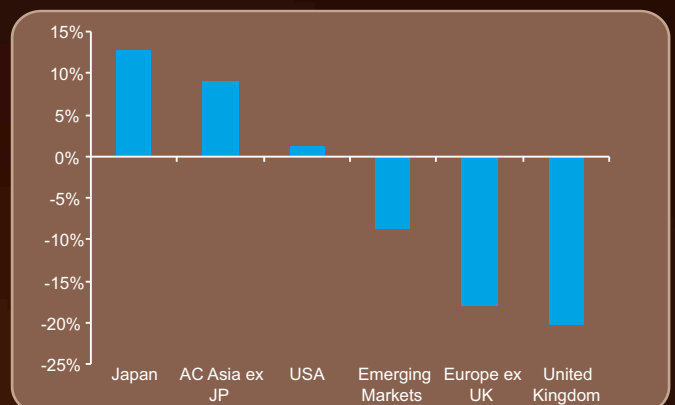
and our current investment theme “Asia is, and will remain the most economically dynamic region” is still firmly in place.

On the whole, equity valuations still look reasonable in our view – current valuations price in a recession, not a depression. As the economy and earnings continue



to recover over coming quarters we expect equities to make further gains, but in the near term there is a risk that Asian equity indices may lag developed markets in terms of relative performance.

Asian equity valuations are starting to look stretched



Source: IBES, FactSet, Barclays Wealth Strategy

Equities – Part 2

Sector strategy

- We would not recommend any major shifts in investment style at this time
- We continue to prefer cyclicals over defensives
- The materials sector is beginning to look expensive

The modest economically-sensitive or “cyclical” bias of our sector calls has performed well in recent months. These sectors have led equity markets around the world higher, while lower risk sectors with dependable earnings – the so-called “defensives” – have lagged.

With markets clearly in recovery mode, we re-iterate our previous view that we don’t have a strong conviction to make a shift in investment style bias at this time. We have, however, made a few changes to our sector views at the global and regional level (see table). The materials sector is beginning to look expensive following a period of strong performance and its positive earnings momentum is tailing off, so we are now neutral on this sector in all regions except the UK. In order to maintain exposure to commodities (which will

benefit from the Asian growth story, as discussed elsewhere in Market View), we have upgraded the energy sector to Moderate Outperform.

We continue to like industrials and IT, both of which give us cyclical exposure, but we are downgrading the telecoms sector back to Neutral. The sector’s attractive valuation is no longer justification for an Outperform recommendation following the sharp drop in price and earnings momentum. Our cyclical sector bias continues to be funded by modest underweight positions in the two most defensive sectors, consumer staples and utilities.



Sector recommendations by region

	ENERGY	MATERIALS	INDUSTRIALS	CONSUMER DISCRET.	CONSUMER STAPLES	HEALTH CARE	FINANCIALS	IT	TELECOMS	UTILITIES
Global	+	0	+	0	--	0	0	+	0	-
US	+	0	++	0	--	0	0	++	-	--
Euro area	+	0	+	0	--	0	0	+	0	-
UK	0	+	+	0	--	0	0	+	0	-

A plus (+) sign shows an expected outperformance relative to the market and a minus sign (-) an expected underperformance relative to the market. Double pluses and double minuses indicate strong conviction calls Source: Barclays Wealth Strategy, *Equities Weekly*, 7 August 2009.

Corporate credit

Risks remain for high-yield corporate bonds

- Corporate debt has enjoyed a strong rally this year
- Valuations are looking fuller for both investment-grade debt and high yield
- Sound credit selection is key as defaults are expected to rise



Much attention has been paid in recent months to the sustained recovery in the world's equity markets. Rather less attention has been given to the rebound in corporate credit (i.e. corporate bonds), even though this asset class has also enjoyed strong performance after a torrid 2008.

But is this a case of too much, too soon? One way of approaching this question is to look at changes in "spreads", i.e. the difference between yields on corporate bonds and government bonds with the same time to maturity.

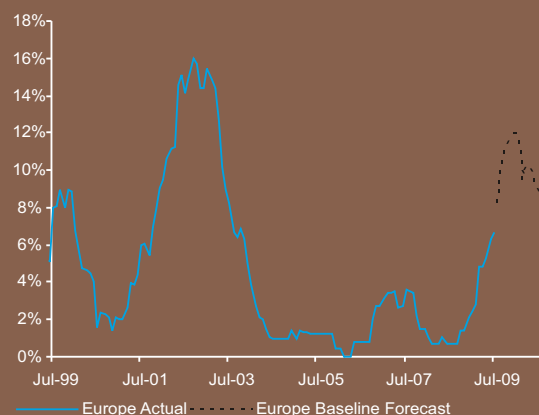
When calculated on a normalised basis, spreads can be used to assess the "richness" (i.e. expensiveness) or cheapness of corporate bonds in the context of how spreads have moved over the past twelve months. Normalised spreads are now close to the bottom of their normal trading range, suggesting that both investment-grade and high-yield debt are now

expensive. Of course, this does not necessarily mean that corporate bonds are about to retreat again – apparently rich valuations can be maintained for some time, especially if the economy is growing. But current valuations make adding to further corporate bond investments rather less appealing in our view.

Investors also need to be careful about credit selection, as the risk of default remains. Currently, the market still expects a default rate for high-yield debt of around 15-16%, while credit rating agency Moody's expects a level of 11-12% in the first quarter of 2010 (see chart). Default rates tend to lag crises, and it is still possible that default rates could pick up around the beginning of next year, even with a recovery in the global economy.

Of course, with average spreads for high-yield still almost two percentage points above their historic average, there is some scope for further gains. But, given the risks outlined above, demand for high-yield corporate bonds is likely to come from those investors with high risk appetite and high composure – and, even with this proviso, good credit selection is likely to be very important in the months ahead.

European high-yield credit default rates (actual & expected)



Source: Moody's Investor Service

FX

- We expect the euro to weaken in the long run, although it should enjoy some support in the short term as signs of economic recovery continue to emerge
- Rising risk appetite poses a near-term threat to the US dollar
- We remain bullish on sterling over the medium term

Below we provide a summary of our views on some of the key currencies, as well as our forecasts.

US dollar (USD)

A continued improvement in risk appetite poses a threat to the USD in the near term. That said, a rebound in the US economy, coupled with normalising monetary policy and improving current account balance, should provide support to the currency.

Euro (EUR)

We expect the euro to weaken in the long-run as less aggressive policy stimulus suggests that the euro-area recovery is likely to be anaemic and lagging. However, tentative signs of a recovery are likely to support the euro over the coming months.

Sterling (GBP)

We are bullish on GBP in the medium term, especially against the EUR. Sterling remains undervalued and will benefit from further improvements in risk appetite. But, short term, worries about the UK economic outlook could hinder appreciation.

Japanese yen (JPY)

We expect the yen to weaken against the dollar in the longer term due to Japan's deflation scenario requiring monetary policy to be kept loose for an extended period and the yen may return as a popular funding currency for carry trades.



Swiss franc (CHF)

Long-run fundamentals suggest that the currency will remain strong against the euro but weaken against the dollar. Possible intervention from the Swiss National Bank (SNB) will limit further gains to the Swiss franc whilst deflation risks remain.

FX Forecasts (Major currencies) ¹

	Forecasts					
	Spot	1 month	3 month	6 month	12 month	
EUR/USD	1.43	1.40	1.40	1.35	1.30	USD per EUR
USD/JPY	94	96	95	100	103	JPY per USD
GBP/USD	1.65	1.62	1.65	1.65	1.70	USD per GBP
USD/CHF	1.06	1.10	1.11	1.13	1.14	CHF per USD
USD/CAD	1.08	1.10	1.10	1.10	1.10	CAD per USD
AUD/USD	0.83	0.80	0.82	0.83	0.84	USD per AUD
NZD/USD	0.68	0.64	0.66	0.67	0.71	USD per NZD
EUR/JPY	134	134	133	135	134	JPY per EUR
EUR/GBP	0.87	0.86	0.85	0.82	0.76	GBP per EUR
EUR/CHF	1.52	1.54	1.56	1.53	1.48	CHF per EUR
EUR/SEK	10.19	10.50	10.30	10.10	9.70	SEK per EUR
EUR/NOK	8.59	8.50	8.20	8.20	8.00	NOK per EUR
GBP/JPY	155	156	157	165	175	JPY per GBP
GBP/AUD	1.99	2.03	2.01	1.99	2.02	AUD per GBP
GBP/NZD	2.44	2.53	2.50	2.46	2.39	NZD per GBP
GBP/CAD	1.79	1.78	1.82	1.82	1.87	CAD per GBP
GBP/CHF	1.75	1.78	1.84	1.87	1.94	CHF per GBP

Notes: ¹ We utilise our colleagues at Barclays Capital for the 1 month and, generally, 3 month forecasts. The 6 month+ forecasts are Barclays Wealth forecasts in line with our economic and market outlook.

Focus

Cash: Don't settle for 0%, but understand the risks

With interest rates at close to zero in many of the key economies, it's understandable that many investors have sought to boost the level of return on their savings via investment in short-dated bonds or cash alternatives such as certificates of deposit. Whilst we believe such an approach is laudable – and indeed necessary for those who don't want to settle for 0% returns – it is important to be aware of some of the risks.

Liquidity risk

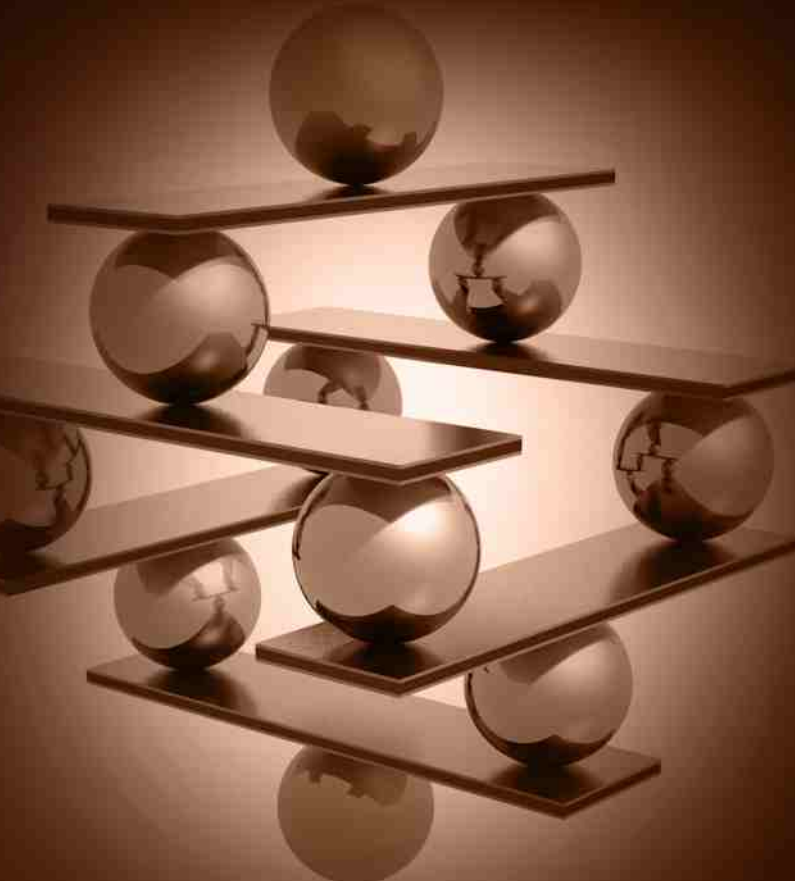
This is the risk that you may not be able to access your cash when you need it. For funds that can be safely locked away for 6-24 months, it may be worth considering short-term bonds or certificates of deposit. But be aware that if you require your funds before the term is up you may have to pay an early withdrawal penalty. You could also be penalised by a wide bid/offer spread (the difference between the buying and selling price of the investment).

Interest-rate risk

When holding government bonds of the highest quality, investors will receive an enhanced yield relative to cash and receive their principal back in full at maturity. However, for investors with shorter investment horizons, there is a risk of loss associated with selling securities before maturity if interest rates rise. For example, a 1% increase in the market yield of a two-year US Treasury Note over a three-month period would result in about a 1.4% loss to an investor who sold at the end of the three months – although the likelihood of a 1% increase over such a three-month period (based on historical movements in yields) is very small.

Credit risk

This is essentially the risk that a borrower won't be able to meet any outstanding debt repayments – this could be for interest or capital payments, or both. However, for those willing to take on some credit risk, the pick up in yield can be substantial. For example, as of mid-August, the yield on three-month US Treasury bills was 0.18%, while the yield on the Barclays Capital one- to three-year Investment Grade Credit Index was 3.54%. "Investment grade" bonds are those judged by credit rating agencies to be of good quality, and thus likely to meet their debt obligations.



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