GLOBAL INVESTMENT STRATEGY - Summary

Economic & Financial Market Background

The manufacturing-led rebound in global economic activity appears to be gradually morphing into something more concrete and sustainable. Cyclical recovery in the emerging world has been a reality for some time but the key transition of the US economy into self-sustaining growth mode, the prerequisite for a durable global economic upturn, may now be underway.

There is still considerable debate about the ability of a US business cycle to be sustained once policy support wanes. Recent data, however, is pointing to the expansion developing in a fairly typical way with improving financial market/financial conditions, growing confidence and income gains. Corporates have joined consumers in spending at a faster pace than many of the economic bears believed

likely and, while it is still early days, both the March ISM survey (suggesting production growth should stay strong in coming months) and the March employment report indicate the rising probability of a sustainable business cycle.

Japanese economic data has also surprised positively over the past month or so and led to some substantial GDP forecast upgrades for the current year. The newsflow in the UK and Europe remains more mixed although economic activity, as measured by manufacturing and services confidence surveys, continues to improve and suggests an economic rebound has begun.

China and much of the rest of the Asian region is forecast to grow very strongly this year and next. With accelerating domestic demand and inventory restocking replacing inventory destocking, industrial production, exports and GDP could all surprise positively in Q1 even after the surge in Q4.

Nearly all commentators expect the recoveries in the developed world to result in only limited inflationary pressures in 10 and indeed, many expect output gaps and low wage growth to continue through next year as well. Conditions are obviously different in the emerging world with recovery so much further advanced and inflation accelerating.

In the main developed economies money markets are forecasting little change in interest rates until later in the year, probably Q4 at the earliest. In the meantime, as the functioning of financial markets has improved, central banks are unwinding numerous special liquidity schemes and lending programmes and in the US and UK asset purchase programmes have ended. Both, of course, could be reinstated should economic conditions dictate.

A number of developing economies have experienced strong recoveries, significant capital inflows and a pick up in credit growth. This has led to policy tightening, in China, for example, where the central bank, the People's Bank of China, was the first to initiate meaningful moves. In order to reduce the risk of inflation elsewhere in Asia, policy normalisation is beginning with the unwinding of emergency liquidity measures. In some countries this is likely to be augmented by some small hikes in policy rates during Q2/Q3. As expected last month India and Malaysia both raised rates by 25bp in mid-March with further hikes to come. S.Korea could also raise rates during Q2.

Ten year government bond yields in both the US and Germany continue to trade broadly within the ranges established over the past ten months or so. Unsurprisingly, given the relative economic performance, treasuries are trading towards the top of their 3.20% to 4.00% band while bunds are at the bottom of their 3.00% to 3.70% range.

At the moment US treasury demand is still running high with overseas buying still strong, increasing interest from banks, safe-haven demand and a more attractive level of yields. Gradual upward pressure on US yields is expected as the year progresses, however, given massive ongoing government issuance, an eventual pick up in private sector credit demands and the end of Fed government/agency purchases.

UK gilts look an even worse bet and having broken above 4.00% look set to trend higher as the year progresses. Growing political risk, rating risk, currency risk and the end of the temporary support provided by the BOE's gilt purchases are all negatives.

In recent days, the EU has announced a support programme for Greece that reduces short term funding pressures but still leaves unanswered concerns over Greece's long term debt sustainability. This will also be a challenge for many other countries. For most, however, the severe fiscal challenges remain a medium term problem rather than an immediate one as reflected by current and forecast bond yields. Longer run, however, yields are heading higher as all the current supports unwind.

Stockmarkets will obviously be affected by fiscal deficit news, indeed, the risks are crystal clear but markets are unlikely to riot until they believe fiscal trends are out of control, as with Greece. A background of better than expected economic newsflow, strongly rising corporate profits, very low interest rates and reasonable valuations has continued to provide support for the ongoing rally in equity markets.

Looking forward our asset allocation views are:

- It has been noted that 10 would be a more difficult year than last with the likelihood of more unsettled stockmarkets, although positive returns were and still are expected. Some of the major issues centre on government and central bank exit strategies both of which have the potential to cause substantial volatility. Early evidence of this occurred with Chinese monetary policy tightening, the inability of Greece to convince investors to buy its debt and growing concerns about global fiscal debt sustainability. Given these risks, equities need to be attractive to investors and as long as economic and profit expectations are met, then valuations remain reasonable, especially relative to cash and bonds. Short rates are set to stay low for the next six months or so and global economic news should still surprise on the upside. Near term there is little to choose between the main geographic areas although currencies may play a larger role in returns. Investors will need to be opportunistic, however, and should favour a barbell of good value, defensive growth stocks, high yielders and industrials all with exposure to growth markets. From today's levels, long-term gains this year should still outpace those for most other asset classes.

- Government bond markets, particularly in the US and UK, have been massively supported by central bank bond purchases but, with heavy issuance for the foreseeable future, longer run upward pressure on yields is virtually guaranteed. In the near term, however, overseas central banks remain buyers as well as banks playing the steep yield curve while core inflation is low and falling in most countries. A more palpable rise in yields is expected late this year and next. Relatively, corporate bonds are better value and should continue to outperform governments but should be considered a source of higher income rather than capital gain. Investment grade bonds offer the potential for reasonable returns going forward with a further narrowing in spreads. A medium term overweight in high yield also continues to be recommended.

- Newsflow in UK commercial property continues to improve. Industry specialists have been joined by investors reinvesting in a sector where the yield pick up is still 3.0% above 10-year gilts. A shortage of prime property is squeezing prices sharply higher at the moment but as 10 progresses higher capital values should encourage involuntary holders, such as banks, to boost supply. Even so, with in excess of double-digit total returns forecast for 10, property should comfortably outperform cash and government bonds. Property shares have underperformed since last summer and there could now be some relative upside on a longer-term perspective.

- Predicting commodity returns is always a difficult call given the very broad spread, high volatility and problems associated with rolling over future contracts on returns. As long as the economic background develops as we anticipate, however, the favoured commodities, such as oil and copper, where there are clear long-term demand/supply imbalances, should perform well. A substantial build up in inventories, especially copper, is a short-term concern that could lead to pressure on prices but in general, industry "experts" continue to raise forecasts for many industrial metals and oil prices. Valuations of the major diversified miners appear up with events, although still reasonable if earnings reflect commodity prices marked to market.

- The key features in foreign exchange markets in Q1 was not dollar strength (+1.7% trade weighted) but euro and sterling weakness (both 4% lower trade weighted). Fundamentals look poor for all the major currencies but on balance Japan needs a weaker currency more than most. The euro is oversold while sterling could drift higher although election uncertainty is unlikely to foster a sizeable move from here. The US still has a large current account deficit and is unlikely to rally too far on a trade-weighted basis. Our long held conviction that many emerging and commodity currencies will substantially outperform remains in place.

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