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GLOBAL INVESTMENT STRATEGY – SUMMARY

Economic & Financial Market Background

Over the past month nearly all of the leading investment houses have reduced their global growth forecasts for both this year and next. So far cuts are generally just a few tenths and 4.0%+ growth is still forecast for both 10 and 11.

That economic activity would slow in the second half has been long expected and its timing is fairly typical of business cycles. The global economy is moving from recovery to hopefully sustained expansion with the developed economies at the stage when temporary and cyclical factors, such as the bounce-back in world trade, the upturn in the inventory cycle and policy-induced demand, begin to fade and private domestic demand takes up the reins. Risks to estimates at this point are naturally high given the difficulties of disentangling the effects of cyclical boosts from sustainable demand. In this particular business cycle, the forecast risks are perhaps even greater due to the massive rise in government deficits, which have produced instability in sovereign debt markets, together with overheating in some developing economies.

In recent months leading indicators have begun to rollover, the rate of industrial production growth is now downshifting and a number of economic reports in both the US and China have disappointed somewhat. Even so, none of this suggests a global "double dip" recession is on the horizon. Overall, some slowdown in global output is forecast for H2 to be followed by a period of relatively modest growth in industrial economies but still robust but slowing activity in emerging markets.

In the US, as yet there is no real evidence to indicate that this is anything worse than a "soft patch", i.e. a slowdown that typically follows the initial recovery surge. Some of the more recent data has allayed fears somewhat with improving weekly retail sales, a sizeable pick up in new home sales, house prices continue to recover while capital goods orders are still growing strongly. Corporate profits, an often forgotten but key indicator, continue to surge, while, in general, CEO reports have remained upbeat. For the recovery to be sustained at trend pace, however, continuing job growth/rising workweeks are essential to improve income growth and consumption while a pick up in small business optimism would certainly help cement hopes for a sustained expansion.

After seemingly endless disappointments in Europe and the UK, more recent economic reports provided some pleasant surprises. This was particularly true of the UK Q2 GDP release with grow annualising at 4.5%, while July PMI's were indicative of recent strength spilling over through Q3. The German economy is the key driver of Europe and currently more than offsetting weakness in the periphery.

Japan's growth rate is forecast to slow markedly in H2 while the pace of China's advance is also slowing to an 8% p.a. or so quarterly rate as the authorities' tightening programmes bear fruit. Forecasts have been revised down in recent weeks but are not expected to fall much below the Q2 rate before accelerating again. If necessary, policy could well turn more supportive again later in the year, given the moderation in growth and receding inflationary pressures. The economy is rebalancing from excessive fixed asset investment to greater domestic retail spending and although industrial production growth has moderated, consumer spending and exports should cushion the slowdown.

While a global slowdown, rather than anything more serious, is expected there is little doubt that there are significant economic and financial challenges ahead. Risks to growth have risen in recent months, with increased financial market volatility and greater than forecast fiscal tightening, but Asia and the US should provide sufficient support to generate at least trend global growth. A reduction in policy uncertainty has also recently contributed to stabilising financial markets and at this stage the possibility of a global double-dip looks slim.

Although growth is slowing investor anxiety that a recession redux is near lessened over the month. This was accompanied by reduced worries of bank regulatory overkill and a considerable easing of sovereign risk concerns in Europe following the publication of “stress tests” on European banks. This enabled risk assets to shine once more with commodities and equities rising very strongly over the month. In the UK, for example, the FTSE100 has now recouped some 600 of the 1000 index points lost between 15/4 and 1/7 while sterling was also positively targeted by investors. Against the dollar, for example, the pound ended July some 10% above the 18/5 low. With worries over European sovereign debt and the banking system fading, the euro also recorded similar sized gains.

In this environment bond yields might have been expected to back up but weaker growth, short rates likely to stay lower for longer as fiscal tightening begins and falling core inflation combined to keep yields fairly steady over the month. This provided an ideal background for corporate bonds, with spreads narrowing as risk positions were reinstated.

Our asset allocation views are:

- it has long been forecast that 10 would prove to be a much more difficult year for **equity** markets, although positive returns were and still are forecast. The main issues centred on government fiscal policies and the transition, in principally the US economy, from the recovery phase to sustainable expansion. Attempts to tackle government deficits have dominated most of the past few months but in recent weeks it is the economic recovery that is being questioned. It is far too early to determine whether deteriorating confidence will have a lasting economic or profit impact but for many equity investors discretion has been the better part of valour. For those who believe as we do that a double dip is unlikely, equity prices are now at very reasonable valuation levels but in the near term this may not prohibit them from further downdrafts over the summer. It may well take several months to disentangle the contagion effects on confidence from the cyclical slowdown now underway and many investors will prefer to wait and see how this develops. For those of a braver disposition at least the potential rewards are now more commensurate with the risks. As long as reduced economic and profit expectations are met then current valuations would suggest very reasonable upside over the next six months but, even if they falter, there are some very decent dividend yields around. There is still little to choose between the main geographic areas although Europe’s period of underperformance could be over while those, such as Japan, that benefit most from cyclical growth, may stall somewhat near term. Currencies have been the key factor in relative returns and will likely remain so over the next several months. Investors should favour good value defensive growth stocks, high yielders and exposure to growth markets. From today’s levels, gains this year should handily outpace those for most other asset classes but an ability to withstand volatility is essential.

- the scale of the move in the main government **bond** markets has come as a surprise but reflects the deep unease felt by investors when hit by financial crises and perhaps the fact that cash returns virtually nothing. For some time we had been fairly ambivalent about the level of yields over the next quarter or two (the very steep yield curve, falling core inflation and bank and overseas central bank buying), but noted that “a more palpable rise in yields is expected late this year and next”. From today’s levels this is still the view. Relatively, corporate bonds are better value and should outperform governments but they are now more a source of higher income than capital gain. Investment grade bonds and riskier credits still offer the potential for reasonable returns going forward with some further narrowing in spreads.

- after such a strong yield impact-led recovery in capital values the **property** market has slowed down considerably over the past few months. The weight of money chasing high quality properties resulted in prime capital values rising by nearly 25% yoy even as All Property rentals continued to fall. With banks now becoming keener to supply the market with portfolios of properties from their involuntarily built stockpiles, this and waning natural enthusiasm should impinge on further capital gains. Selectivity is important and central London, especially offices, is a favoured area. With income in excess of 3½% above ten-year gilts for even prime properties, however, the sector should outperform both cash and government bonds, but returns will be far lower than those achieved over the past twelve months.

- predicting **commodity** returns is always a difficult call given the very broad spread, high volatility and problems associated with rolling over futures contracts on returns. As long as the global economic background develops as anticipated, however, the favoured commodities, such as oil and copper where there are clear long-term demand/supply imbalances, should hold up. A build up in inventories, remains a short-term concern that could lead to further pressure on prices but, in general, industry "experts" remain relatively sanguine about medium term prices for the key industrial metals and crude oil. Valuations of the major diversified miners are still way below April highs and look better value on the now admittedly more debatable assumption that both US and Chinese economic growth confirm even lowered expectations.

- as ever **currencies** present all sorts of conundrums for investors. Will sterling continue to benefit from the UK's newly found fiscal rectitude or will this be overridden by a deleterious impact on economic growth? Alternatively, will lower shorter term rates, e.g. 2 year gilts now yield 0.8%, prove sustainable in the light of rising inflation that will ensure substantial negative real returns over the next year? The best guess is that sterling may have some further upside on a trade weighted basis, given the scale of its prior collapse, but gains will be fairly limited. While the euro could rally further, as the global economic slowdown replaces the focus on Europe, it is interesting to note that the dollar missed out on the latest "safe-haven" rally and again the squaring of growth needs with huge fiscal and growing current account deficits provides ammunition for both bulls and bears.

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