

GLOBAL INVESTMENT STRATEGY – SUMMARY

Economic & Financial Market Background

A strong but variable recovery in global economic activity has been underway for the best part of a year. Over the twelve months to Q210 the world economy is generally estimated to have grown at a near 5% pace led in geographic terms by Asia, particularly China, and the US and by a vigorous 10% rebound in industrial production. Japan has also contributed meaningfully to the upturn but the recoveries in the UK and eurozone have proven very modest and patchy affairs.

In recent months all of the main international forecasting bodies have raised growth forecasts quite substantially with the latest, the OECD, now expecting global output to grow by 4¾% this year and next, a level well above trend. Although principally due to expected strength in the US economy, in aggregate, even the developed economies are forecast to expand at a 2½% to 3% pace, roughly one percent higher than forecast six months ago.

The global economy is projected to move from recovery to a sustained expansion phase with the developed economies at the stage at which 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 high given the difficulties of disentangling the effects of cyclical boosts from sustainable demand. In this particular business cycle, forecast risk is perhaps even greater due to the massive rise in government deficits producing instability in sovereign debt markets and overheating in some developing economies, notably China.

Perhaps the bigger problem globally is not necessarily eurozone growth per se but the potential impact on global debt markets and the banking system of any worsening in the euro debt crisis. Even so, it is important to place the growth issue in perspective. It is generally estimated that the fiscal consolidation measures outlined by Greece, Ireland, Portugal and Spain (GIPS) will subtract approximately 0.4% from eurozone GDP growth in 10 and 0.3% in 11. A weaker currency and a more accommodative ECB should act to cushion the effects of this fiscal tightening and, unless a further major financial shock occurs, the recovery in the eurozone seems unlikely to be derailed.

While financial market focus has centred on developments in Europe, with growing concern over the likely impact of economic contractions in the GIPS on eurozone growth, the key to the global economy shifting to its next gear is the success or otherwise of growth in the US economy becoming self-sustaining.

As yet, there is little evidence to suggest that recent turmoil in financial markets has seriously impeded progress in the US economy. Perhaps the key measures to monitor are confidence indicators for both the business and consumer sectors. For the former, the ISM's PMI manufacturing survey is generally perceived as an excellent lead indicator and the latest report for May showed manufacturing sentiment essentially holding steady at very high levels. The latest consumer confidence data also indicated little concern although actual retail sales in May were lacklustre, according to retailers' sales reports.

Indeed, nearly all the latest PMI's around the world published at month end, suggested that while global growth momentum may have peaked, a view shared by most economists, it is transitioning to a more steady state phase during which growth should remain fairly robust. It is interesting to note that one of the lagging components of the PMI surveys, employment, hit a new high in May suggesting further improvement in employment trends, one of the most important signposts for self-sustaining growth.

If forecasts for the global economy are to be achieved it is also essential for the Chinese economy to "soft-land". Signs of a slowdown are apparent, but most commentators believe that the downturn in parts of the housing market, an area targeted by the authorities, is a prerequisite to achieving more balanced, sustainable growth.

Overall, unless the euro debt crisis develops into a full-blown financial crisis, the composition of global growth should ensure a strong recovery this year. Global lead indicators may be in the process of peaking but this is natural for this stage of the business cycle. With the necessity of faster than previously expected fiscal consolidation, however, it is quite possible that H2 GDP forecasts could be subject to some downward revision, especially in Europe and the UK, over forthcoming months.

The by-products of the financial turmoil have included expectations of interest rates remaining unchanged for longer and ten-year bond yields falling to very low levels, both of which assist monetary accommodation at a time of fiscal consolidation. The wider implications of eurozone debt problems have also led to a substantial devaluation of the euro and very high levels of volatility in risk assets such as equity and commodity markets. Equity markets, as measured by the MSCI World Equity index, ended the month just over 10% below the April peak but have recently shown signs of stabilising.

Looking forward our asset allocation views are:

- it has long been noted that 10 would be a more difficult and unsettled year for equity markets, although positive returns were and still are expected. With global economic growth forecast to be above trend this year, the main issues centred on government and central banks exit strategies. The fact that the former is now so firmly in the financial market spotlight relegates the latter to an issue for next year. Equity markets have already priced in substantial uncertainties with regard to the likely transmission of economic and banking system frailties in Europe to a more global audience and indeed, may have over discounted the overall impact. At the moment it is too early for most investors to take this view and, in the near term, it may be difficult to disentangle the possible contagion effects to confidence from the industrial slowdown that was expected anyway over the summer months. While many investors will prefer to wait and see the rewards for the brave may now be more commensurate with the risks. As long as 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 still 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 and Emerging Markets, that benefit most from cyclical growth may stall somewhat. Currencies have been the key factor in relative returns and will likely remain so over the next several months. Investors need to be opportunistic, however, and should favour good value, defensive growth stocks, high yielders with exposure to growth markets. Any strong market recovery is likely to be led by resource stocks and probably financials, although both will underperform should financial and economic conditions worsen. 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 yields virtually nothing. For some time we had been fairly ambivalent about the level of yields over the next quarter to 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 a source of higher income rather than capital gain. Investment grade bonds 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 is beginning to calm down. The weight of money chasing high quality properties resulted in prime capital values rising by nearly 25% over the past year or so even as 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. With income in excess of nearly 3½% above ten-year gilts for even prime properties, however, the sector should comfortably outperform both cash and government bonds, at least this year. 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 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 substantial build up in inventories, especially in copper, remains a short-term concern that could lead to further pressure on prices but in general, industry “experts” remain sanguine about prices for the key industrial metals and crude oil. Valuations of the major diversified miners have fallen precipitously in recent weeks and look far better value on the assumption that both US and Chinese economic growth confirm expectations.
- the expected euro weakness and dollar strength came to pass. Sterling followed the euro lower while the yen even outperformed the dollar. It is generally expected that the euro could underperform for a longer period given weaker growth and ongoing peripheral debt and sentiment issues. The yen appears overbought and sterling oversold although as frequently noted the fundamentals look poor for all the major currencies. While many emerging and commodity currencies suffered in the flight to safety our long held conviction that these currencies will substantially outperform remains in place.

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