OLD BROAD STREET RESEARCH LTD

GLOBAL INVESTMENT STRATEGY

Summary

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Economic & Financial Market Background

Most countries have now produced at least an initial estimate of economic progress in Q4 with two, the UK and US, recently releasing first revisions. Overall, the figures confirm very strong growth in Asia, a healthy rebound in the US and a stretched definition of a "recovery" in the UK and Europe. Japan's underlying growth remains relatively weak despite a higher than expected Q4 outturn.

Background details of the Q4 GDP figures for the main economies is gradually becoming available and shows the still relatively modest contribution from the private sector. Inventories were the key to the strength in the US and exports in Japan. Domestic demand has yet to contribute positively in Europe while the UK is still suffering from very weak business investment expenditure offset by a modest pick up in household spending and a reduced drawdown in inventories.

From a global economic perspective there is no real change to the outlook, all the major economies have exited recession and nearly all commentators expect a sustained global expansion through 11. There are some signs of weaker data, in the early part of the year, although much of this could well be due to the very poor weather hitting the US, the UK and Europe.

Despite this, consensus US forecasts have risen again, to 3.0% for 10 from 2.7% according to Bloomberg, while Japan has seen some upward revisions and a vigorous expansion remains in train in the developing world. There is no doubt that European data has disappointed but as yet it is not clear whether this is pointing to just a slow recovery or a return to negative growth. Over many months it has been pointed out that domestic demand growth in both the UK and Europe would remain muted throughout 10 and therefore a fall back into technical recession is always quite possible should expected contributions from net exports/inventories be worse than expected.

The money markets are forecasting little change in short-term 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 both in the US and UK asset purchase programmes are either at or close to an end. Both, of course, could be reinstated should economic conditions dictate.

Generating an economic recovery in the developed world has entailed considerable cost, not least from the ballooning central banks' balance sheets and accumulation of massive fiscal deficits. While the unwinding of these is likely to be gradual and carefully planned their execution only adds to the risks of successfully transitioning from recovery to sustainable expansion, especially against a background of deficient final domestic demand that is common to most of the developed world.

The smaller European economies have provided the first example of financial markets being unwilling to support government financings unless accompanied by fiscal probity. Greece is the immediate problem and, although qualified and implicit support of EU ministers has provided a short term breathing space (Greek 10 year bond yields declined during February to 6.36% from 7.16%), until some solution is found that avoids default, probably requiring an EU supported bilateral loan programme to buy/guarantee Greek debt, this is a sore that will continue to fester.

The main conduit for concern regarding these fiscal developments and a weaker growth outlook in Europe is via the foreign exchange markets with both the euro and sterling under severe pressure versus the dollar and yen. The pound has also suffered from concern that the growing possibility of a hung parliament could further delay necessary reductions in government debt.

Equity markets initially reacted poorly to both these fiscal developments and monetary tightening in China but essentially this was an overdue correction albeit one that has highlighted to investors the problems posed by the sheer scale of government debt, an issue that is likely to haunt financial markets for some considerable time to come.

Looking forward our asset allocation views are:

- After such strong gains global equity markets had been vulnerable to a correction. It has been consistently noted that 10 would be a difficult year with the likelihood of much more unsettled markets, although positive returns were and still are expected. The major issues centred on government and central bank exit strategies both of which have the potential to cause substantial volatility. Early evidence of this has occurred with Chinese monetary policy tightening, the inability of Greece to effect a credible debt reduction programme and growing concerns about fiscal sustainability. Given these risks, equities need to be attractive to investors and as long as economic and profit expectations are met, then valuations are very reasonable, especially relative to cash and bonds. Interest rates are set to stay low for some time to come and global economic news could 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 some industrials all with exposure to growth markets. It should be a better environment for good stock pickers following the "recovery" rally for most of 09. 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 remains. 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 later in the year. Given the UK's longer-term economic problems and the ending of QE purchases this month, the gilt spread relative to treasuries, but particularly bunds, is still unrealistically tight and could widen further. Relatively, corporate bonds are better value and should continue to outperform governments but should now 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 higher quality high yield also continues to be recommended but there are near term risks of a widening in spreads.

- 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 forecasts of double-digit total returns for 10, property should comfortably outperform cash and government bonds. Property shares have rallied strongly and valuations now appear well up with events, although there could be some further 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 anticipated, 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" have raised forecasts for many industrial metals and oil prices. After a steep fall valuations of the major diversified miners now appear better value.

- A dollar rally had been anticipated through the early part of 10 but it has been augmented by recent moves towards safe-haven assets and the unwinding of the dollar carry trade. With the eurozone and Japanese economies recovering only modestly companies in both would appreciate a cheaper currency. The former is suffering currently from "euro" concerns driven by the peripheral counties, although Spain is now increasingly lumped in, while for the latter a move to safe haven currencies tends to result in yen strength. This is a trend that is anathema to the current thinking of the Japanese authorities and further quantitative easing may be initiated to alleviate it. The outlook for sterling even after its recent sharp fall is hardly propitious. On a medium and long term view the commodity and selected emerging market currencies continue to be favoured.

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