




Mark Burgess
Chief Investment Officer

MID-YEAR MARKETS OUTLOOK – JULY 2011

A turbulent year so far

Markets have had to contend with a number of unexpected adverse developments since the start of 2011. We have seen a significant Middle East uprising, which put upward pressure on the oil price; a Japanese tsunami and nuclear disaster, which gave the world a global manufacturing supply side shock; and significant sovereign risk concerns in the eurozone. Meanwhile, weaker economic readings from the US and other developed markets have led to downgrades to growth expectations. Predictably, these factors have resulted in a risk aversion trade that has driven treasury yields lower. More surprisingly, equities have risen.



Leigh Harrison
Head of Equities

Equity valuations are attractive

The resilience shown by equities can be partly attributed to their attractive valuations, and this is one of the key factors that support our positive views on the asset class. Indeed, most markets are below long-term averages on most valuation measures and are also cheaply valued relative to government bonds. Given the growth outlook that we foresee, we regard these valuations as supportive.

Policy outlook favourable

Recent policy tightening in economies such as China and Brazil is now nearing its conclusion and we believe that companies in a wide range of markets will continue to benefit from robust demand from these and other emerging markets. Meanwhile, although growth in developed markets is likely to be lacklustre it will still be positive, and the deflationary effects of deleveraging mean that interest rates are likely to be maintained at low levels for longer than some commentators are anticipating.



Jim Cielinski
Head of Fixed Income

Sovereign risk remains a worry

On the negative side, the European debt situation is likely to cause further volatility and periodic risk aversion. Despite the recent positive developments on Greece, investors will need to see evidence of progress in implementing austerity measures and cutting overall debt levels in Greece and elsewhere. As austerity and deleveraging take effect, not only in Greece but in much bigger economies such as the UK and eventually the US, growth in those markets will be constrained. Moreover, this is a multi-year phenomenon and equities will require strong growth in the emerging world to compensate for weak developed markets. Although companies have come through the credit crunch in generally good shape, there are some concerns that margins are not sustainable at their current, historically high levels. Any disappointment on global growth would exacerbate these concerns.

End of QE

Investors have had their appetite for risk stimulated by abundant liquidity arising from the quantitative easing programmes of the past three years. Policymakers are now moving away from this exceptional strategy for

maintaining confidence in markets, and there may be consequences for risk appetite and the valuation of equities in that process.

Equities – where to go?

Given the factors outlined above, our equity portfolios remain focused on emerging market growth. This is achieved via direct exposure and through companies domiciled in the developed world but meeting emerging market demand in areas such as luxury goods, natural resources and speciality engineering. In developed markets we are also finding selective opportunities among oversold domestic stocks and, in general, we have more of a value than a growth bias. Appetite for developed markets is likely to be driven more by risk appetite than by the economic outlook – for example, in times of risk aversion, developed world investors tend to revert to their home markets.

Is there any value in fixed income?

Government bonds in “safer” markets are yielding about 3% for a 10-year maturity; and in 5-year bonds it is even worse at 1.5-2%. More attractive yields are certainly out there, but they come with considerable credit risk. This is quite a dilemma in the bond markets and our answer is that there is not a lot of value left in the safer parts of fixed income: it is hard to make a 2-3% yield into a high total return. However, we do see value in corporate bonds, where spreads remain above where they should be for this time in the cycle and offer premiums far in excess of expected default losses. Combine that with the fact that sovereign balance sheets are being destroyed in an attempt to keep the private sector afloat, and we think the relative story for owning those assets relative to government bonds remains strong.

Old boundaries have disappeared

Looking at various countries with regard to government debt and interest payments as a percentage of GDP, fiscal balance and the percentage of debt held externally helps to reveal where the stresses are in the global government bond market. Charts show that emerging economies such as Russia, China and Brazil have lower fiscal deficits and lower debt to GDP ratios than most of the developed world. This, together with the healthy yields still on offer, is one reason why we continue to prefer emerging market bonds to developed world government issues.

Greece is an outlier

Greece shows up as an outlier on these measures, combining high debt and interest payments as a proportion of GDP, a large fiscal deficit and wide international bond ownership. As such, Greece is a significantly higher risk than the other peripheral European issuers. If the recent measures succeed in bringing the Greek situation to a satisfactory conclusion, and if appropriate austerity measures are put in place and economies such as Spain, Italy and Portugal manage to generate sufficient growth, contagion to other markets appears limited.

Scenario testing

We have modelled the likely total returns from various bond asset classes in a double-dip recession, an environment of ongoing slow growth and a more robust economic recovery. For each outcome we have assumed a different combination of movements in the government bond yield and the spread for the various sub-classes. Only in the double-dip scenario do government bonds outperform high yield, investment grade and emerging market bonds. We are not forecasting a double-dip recession.

Conclusion: asset allocation summary

We remain overweight in risk assets within equities and bonds as we believe they are attractively valued, even on our relatively cautious growth outlook. We particularly like emerging market assets, but we think some developed equity markets also look relatively attractive. For example, the UK stock market trades on a price to earnings ratio of about 9.5 times with a dividend yield that is above the 10-year bond yield. UK equities also offer good international diversification, with only about 35% of earnings coming from the domestic economy. As an example of developed markets, we think that looks quite interesting. Conversely we remain underweight in government bonds, where valuations are less attractive. As a hedge against inflation and currency debasement, and as a play on developing market growth, we are overweight commodities. We are neutral in UK property, where a high yield is balanced by limited growth potential. Finally, given our expectations of interest rates being kept low, we are underweight cash.

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