



# Global Markets Update

International Investment Panel - House View  
August '08

## Global Outlook

*The macro economic outlook continues to deteriorate.*

Credit conditions remain tight, reflecting a preference for liquidity and reluctance to lend by global banks as they attempt to repair impaired balance sheets. The housing correction has gained traction across the world, although arguably the US is further through the cycle than other leading economies. Unemployment remains on the rise. Recent data releases suggest that recession or near-recessionary conditions are imminent for most Western markets. Current corporate earnings projections look too optimistic, particularly after stripping out any statistical rebound in bank numbers next year.

The deepening slowdown has led to a shift away from fears of stagflation (slower growth with rising unemployment) towards deflation, a process aided by the self-reinforcing reversal in energy costs and a broad spectrum of commodity prices in reaction to perceived demand destruction. Chinese exports remain under pressure as reflected in poor industrial production numbers and a drop off in GDP growth for the second quarter. India, along with the rest of Asia, is battling domestic inflationary pressures and a reversal in important portfolio flows. Although there remain sound structural reasons to support the argument for a long-term uptrend in these markets, near-term cyclical influences suggest further downside.

Of the leading Western economies, the USA looks best positioned. Policy reactions to the crisis, both fiscal and monetary, have been swift and necessarily aggressive. Housing numbers look to be losing downside momentum. Energy costs have come off sharply. Credit write-offs in the banking sector are arguably well ahead of the curve by comparison to say Europe. It would be unwise to bet against the resilience of the US consumer, although the extent of personal indebtedness has yet to be fully tested.

Elsewhere, the prognosis for the UK looks fairly grim as economic conditions appear to worsen daily. There is capacity for monetary relaxation, however, but the timing rests on short-term inflation concerns. However, the monetary stance is even more hawkish in Europe where inflation remains the sole target of the ECB and interest rates look even less likely to be lowered in the near-term. Japan remains a dangerous call due to previous disappointments but



has experienced extended low growth with moderate inflationary pressures resurfacing, potentially a good recipe.

Currency markets are shifting to reflect these views. Investors are beginning to favour the dollar and this view should gain traction in forthcoming weeks and months. The outlook for the pound seems very poor while the euro is likely to soften against the dollar. Australasian currencies could come under pressure as interest rates in those markets come off.

## Investment Implications

### Asset allocation

#### Equity

***The Panel favours a very cautious stance on equities.*** There are few grounds for optimism at present. Markets could weaken further in continued volatile trade. Market depth (turnover) and breadth (participating sectors) is extremely poor. During recessions, the typical bear market decline is -28% and lasts 13 months. In terms of style, a shift from style to value could be in the offing as valuations become more compelling. Investors will continue to remain focused on larger as opposed to smaller capitalization shares.

Given longer-term uncertainties, it is also anticipated that markets could range trade, that is, track sideways for an extended period of time. Significant relief rallies may eventuate in reaction to good news and hence significant trading opportunities will present themselves from time to time. Investors should remain aware of the attendant risk in the more active trading strategies required in this environment. Buying opportunities could be signaled by an improvement in credit spreads and ultimately, a turnaround in the housing markets.

#### Regional allocation

***Our macro view predicates a bias towards the US in terms of regional allocation.*** Europe and the UK are typically high beta plays on global recovery and hence remain marginally underweighted at present. The Panel also adopted a more cautious view on emerging markets due to their strong correlation to commodity prices and reduced what would have previously been an overweight call. We remain near full weight in Japan.

Middle East markets have suffered a significant setback due to what appears to be a dislocation of capital flows, linked to possible regulatory changes in the property market

## Fixed Income

*The Panel advocates an increased allocation to bonds.* Longer-dated government bonds look to offer value (over cash) as inflation concerns abate, short rates come off and growth concerns mount. The Panel expects to see yield curves steepen further. High grade credit prices are discounting an extremely pessimistic outcome to the crisis and therefore are starting to offer value in certain areas in the Panel's view.

In summary our short term interest rate view is as follows:

- US rates will remain flat with some upside risk as inflation moderates.
- UK rates are set to fall as growth concerns outweigh inflation fears.
- Europe rates could remain stubbornly flat but eventually could be lowered to counter growing demand destruction.
- Japanese and pan-Asian rates could rise further to counter supply-side inflation shocks.
- Australasian rates have begun to fall in reaction to the economic slowdown.

## Property and Alternative Strategies

*The Panel could not make a case for buying property at this stage* and is advocating a zero exposure to this asset class. Further fallout in the property market seems inevitable with commercial and retail sectors still under pressure.

Hedge funds have not lived up to their promise as a cash enhancer and are having a highly disappointing year, considering their absolute return mandates and high fee levels. *The Panel does not advocate adding further to this asset class*, thus reducing their effective exposure in the model.

## Currency

The anticipated reduction in current interest rate differentials and better growth prospects support the *Panel's bullish view on the US dollar over the short to medium term*. We advocate an underweight position in GBP due to poor fundamentals and remain neutral on the Euro and the Yen.

## Conclusion



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*Investors are cautioned to position defensively in what remain highly uncertain markets.* Other than in the fixed income and currency markets, sustainable trends remain difficult to identify and are compounding the difficulty of producing adequate returns. There is likely to be very little reward for taking extreme bets in such volatile times.

**Peter Bourne and Paul Clifford**

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