

## Global Investment Review

First Quarter 2010

### Introduction

Equities continued to rally through the end of September, but paused in October before pushing on further through November and December. Recent economic indicators have shown a broad return of economic global growth during the fourth quarter of the year. This has led to improved confidence in a sustainable economic recovery. Combined with the continued support of global monetary policy, this has created an environment in which growing numbers of previously sceptical investors, unsatisfied with continued low cash yields, have demonstrated the confidence to return to risky assets.

As we start the new year, the focus remains firmly on the strength and sustainability of the incipient global economic recovery, as well as the ability of markets to price in further gains, which we have seen toward the end of 2009. Will the road to recovery still face yet more fierce head-winds? As we write, Dubai's imminent debt defaults and sovereign risk downgrades have injected a more sober note into the pre-Christmas cheer.

This report comprises two elements. In the first part, we share some relevant aspects of Ashburton's economic outlook for 2010. In the second part, we hone down into specific asset views for the next few months, as derived from our recent International Investment Panel meeting.

### Key Global Market Indicators - 2009

Asset Class Performance	YTD
USD 3m LIBOR cash returns	0.80%
MSCI World Equity (local currency terms)	22.82%
Citigroup World Global Bond Index (local currency terms)	1.00%
CRB Commodity Index	34.14%
GBP/USD	10.81%
EUR/USD	2.50%
USD/JPY	2.63%

\*Data source: Bloomberg as at 31 December 2009

### Ashburton's Economic Outlook - 2010

- The economic recovery may be stronger than expected
- Policy and country-specific risks are rising in both developed and emerging markets

Only a year ago, global financial collapse and the onset of an economic ice-age seemed an all too likely possibility. Thankfully, our worst economic nightmares have been avoided – so far at least. However, while our perception of possible outcomes is less extreme today, by the standards of most years, the outlook for 2010 seems decidedly uncertain.

The most prevalent view on the economic outlook is that a subdued recovery is underway. Growth will be slow in the West on a trend basis, constrained by high unemployment, weak credit growth and the efforts of governments to reduce public debt. Inflation will be low in the

near term but may rise a couple of years down the line. Against this backdrop, the developed world's major central banks are expected to keep interest rates extremely low for a prolonged period. Rate hikes by the Federal Reserve, ECB, BoJ or BoE will be delayed until late 2010 at the earliest and the tightening cycle will be modest. Another widely held view is that emerging market economies – especially China, India and Brazil (enthusiasm for the other BRIC nation, Russia, has tempered somewhat) – will outperform developed nations.

Are these consensus views right? While we share some of the concerns about G7 economic growth on a structural basis, we believe there is a major risk at present of ignoring the importance of cyclical dynamics. Even Japan managed brief periods of 4% growth in the past 15 years, a period widely regarded as a prolonged recession. Our bias is to expect a stronger global economic recovery in 2010 to the consensus view. There are several reasons why this might be the case:

- (1) China and other emerging markets are now growing rapidly;
- (2) a very large inventory cycle has only recently turned positive in the West;
- (3) lagged effects of the unprecedented stimulus efforts are still to come through and
- (4) business confidence and corporate profits are improving.

The latter point is crucial to a revival in business spending and hiring. Like everyone else this time last year, chief executives feared a repeat of the Great Depression and acted accordingly. The government-led turnaround in economic activity and financial markets has since surprised positively. This could lead to a much quicker return to jobs growth than occurred after the previous two recessions.

We are not yet overly concerned about high inflation on a multi-year basis, but we think markets may worry about inflation again in early 2010. Our experience has been that financial markets and related media pay excessive attention to the latest month's inflation figures. As a result of the increase in commodity prices (and VAT increases in the UK), headline inflation is forecast by Barclays Capital to approach 3% in the US and UK respectively by early 2010. Although core inflation (ex-food and energy) should keep on falling, in light of the increase in base money supply, rising headline inflation and the prospective monetary policy response (or lack thereof) is likely to become a focus of attention.

Together, our expectation of upside surprises for GDP growth and rising headline inflation would suggest that concerns over tighter monetary policy (reduced liquidity in other words) may intensify. The consensus expectation of continued low interest rates into 2011 is perhaps the most likely outcome in the US or Europe, but we believe there is a good chance that the market doubts this view sometime in the first half of 2010.

Policy challenges are also rising in emerging markets and fears of tightening are likely to intensify, especially in countries that are growing rapidly and experiencing rising inflationary pressures (such as India). Some countries that wish to maintain weak exchange rates may also look to Brazil's example of taxing capital inflows (or other heterodox measures) to dampen pressure on exchange rate appreciation. As policy risk increases, country-specific effects are likely to become more important than they were in 2009, a year in which the decline in required risk premia at the asset class level was the dominant driver of returns.

(The full version of this report is available on request from Ashburton)

### The International Investment Panel

#### Equity Market Outlook

The broader view of the International Investment Panel continues to be positive towards equities. They remain the preferred asset class over the following 12 months. The base case view of returns in equities in 2010 is approximately 15%, with one member of the Panel tending towards a more bearish view of 5%. This is an expression of the Panel's majority view that the economic environment will be stronger than anticipated and profit growth could be robust. Subsequently, the Panel remains strategically bullish whilst acknowledging the risks of a short-term drawback on any form of economic or political disappointment.

- The Panel is of the opinion that equities need to be carefully managed through the next 12 months as volatility remains at elevated levels. An active approach is likely to out-perform a passive management style. Markets are likely to be highly responsive to negative news-flow and thus investors should retain the flexibility to move quickly to adjust weightings.
- The Panel was unanimous in its long-term positive view of Asia and emerging markets in general, although valuations do look a little overdone in the short-term.
- Developed markets such as the USA and Europe are in neutral value territory and the Panel's outlook remains largely unchanged, as do holdings at around benchmark weights. While the UK remains stubbornly in recession, there continues to be a dearth of positive news to justify an increase in weight here.

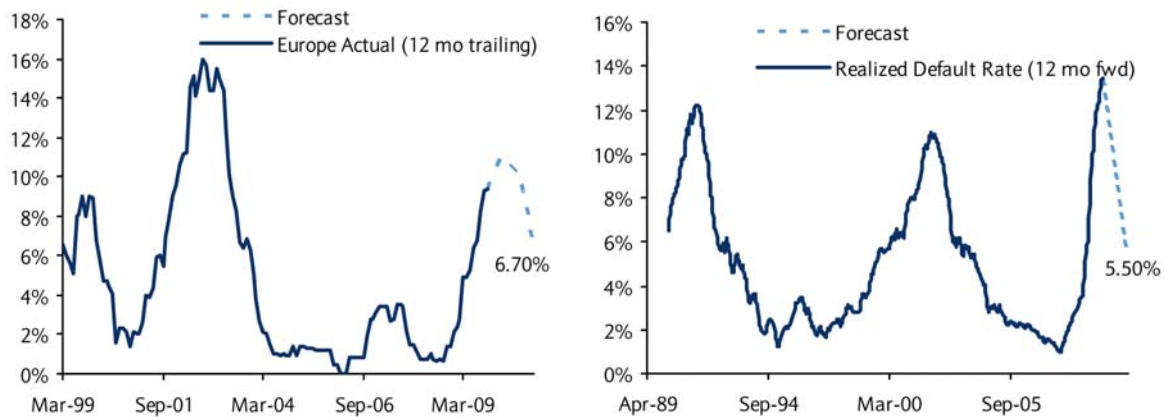
#### Fixed Interest Outlook

The Panel was unanimous that government bond markets are now beginning to look expensive and the risks of underperformance have increased markedly. It would take an extreme shock and flight from risk assets to generate meaningful returns from these elevated levels. There is a risk of a gradual withdrawal of what were highly supportive monetary policies, albeit unlikely in the short-term, plus the possibility of inflation scare stories emerging in the New Year. The Panel believes that at best returns are likely to match coupon levels only (ex-growth).

As a result, it was decided to underweight this asset class in favour of equities and within the asset class to favour credit issues over government debt.

- The Panel highlights the potential for a shock to corporate credit (should monetary policy change) now that spreads have narrowed back to more normal levels at this point in the cycle. However, it was felt that monetary tightening was unlikely in the short-term and there remains little noise on this front from policy-makers.
- The Panel sees some value in US and European High-Yield debt. Expectations are that US defaults will peak near 14% in early 2010, before falling back to more typical levels of 4 - 5% (source: Barclays Capital - see charts overleaf). However, we caution that this would not form a significant portion of client portfolios.
- A position in Emerging Market debt was generally supported by the Panel, with further consideration toward carefully selected issues in local currencies.

**US and EUR High Yield Default forecast**



**Currency Outlook**

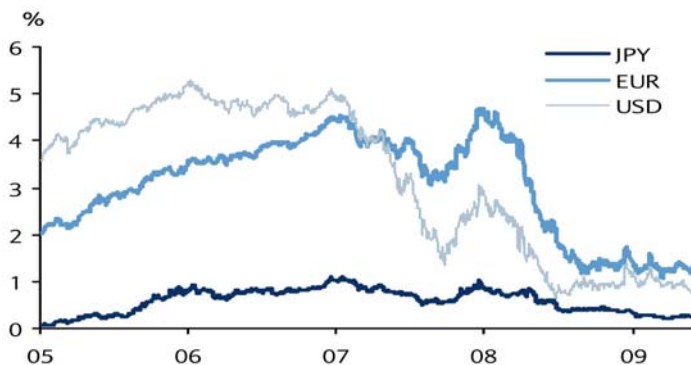
The Panel's views on currency remain largely neutral with no significant positions adopted.

- There remains some bias towards emerging market currencies, which is supported by the lack of structural problems which have been endemic in the developed nation peer-group. Commodity currencies continue to be favoured although there are clearly some specific country issues mitigating this view. The actions of Brazil and the increasing rhetoric of others with respect to the need for weaker currencies are relevant here.
- The Dollar still faces continued strong headwinds in high unemployment, large negative output gaps in production capacity and dovish statements on monetary policy. Looking further forward, these factors could begin to reverse during 2010, giving rise to a change in direction for the Dollar from what is already a very cheap level.

**Alternative Assets**

The Panel increased weightings in this asset class, advocating increased exposure through selective diversified multi-strategy vehicles. Some improvement in transparency and liquidity within the sector has assisted this decision.

**G3 2yr Treasury Yields**



Source: Bloomberg

- It was also

recognized that this asset class offers a reasonable alternative to other low yielding fixed interest assets particularly cash and government bond yields (see above).

- It was agreed that opportunities in property should be considered with a view to introducing some exposure. The investment case in the asset class was primarily based on strong yields of 6 - 8%, some early signs of recovery which suggest stabilising capital values and possible growth upside in select sectors of the market.
- On balance, a small exposure to a basket of commodities looks justified at these levels. Speculative upside remains and further improvement in the global economic recovery could see strengthening in consumption demand.

## Strategic and Tactical Allocation

Asset Class	Strategic Weight	Tactical Weight	Directional move	Comment
<b>Equities</b>	50	60	↑	Tactically Overweight taken from Bonds
			→	Unchanged
			→	Unchanged
			→	Unchanged
			↓	Short-term risk on strong yen
			↑	Increase on positive outlook for BRIC's
<b>Bonds</b>	25	15	↓	Reduce on poor outlook
<b>Cash</b>	25	5	→	Reduced on low yields and increased attraction to other asset classes
<b>Alternatives</b>		20	↑	
(taken from cash)				
		15	↑	Increased weight taken from cash based on improved liquidity and transparency
		0	↑	Looking to increase with right opportunity
		5	→	Exposure via emerging market equity
<b>Total</b>		<b>100</b>		

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