



SIGNPOST ESSENTIALS

A long, hard slog

ANNUAL OUTLOOK 2009

Signpost Essentials

Welcome to *Signpost Essentials*, a new publication that previews the key content of our annual edition of *Signpost*. Here you will find, in an easily accessible form, our central macroeconomic forecasts and asset allocation recommendations.

Signpost Essentials will be published in electronic-only form. Electronic and then printed versions of the main *Signpost* and *Signpost Lite* will follow in the next few days.

Michael Dicks, Head of Research, 1 December 2008

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A long, hard slog

- ◆ The global economy has entered a recession, which may well prove to be deep, and could prove to be protracted too.
- ◆ Policymakers are responding with deep interest rate cuts and substantial fiscal easing. Further support for the financial system is inevitable too.
- ◆ By the second half of 2009, the US may well be growing again, albeit feebly so. Equities, being a leading indicator, should recover somewhat.

Recession, not depression

The ice shatters

In last year's 'Annual Outlook' version of *Signpost*, we described the global economy as skating on thin ice – potentially able to avoid recession if only policymakers could steer their way through a hazardous environment. For much of the year, that seemed the right sort of analogy to have drawn, with for example the US economy managing to eke out growth at close to a 2% pace during the first half of the year. The decision to let Lehman Brothers go bankrupt in mid-September, however, changed everything – letting rip forces which completely changed the economic landscape. Now, it is clear that policymakers cannot avoid a recession (Figure 1). The only question is how bad will things be and, in particular, whether the same sort of processes develop which led in the 1930s to the Great Depression.

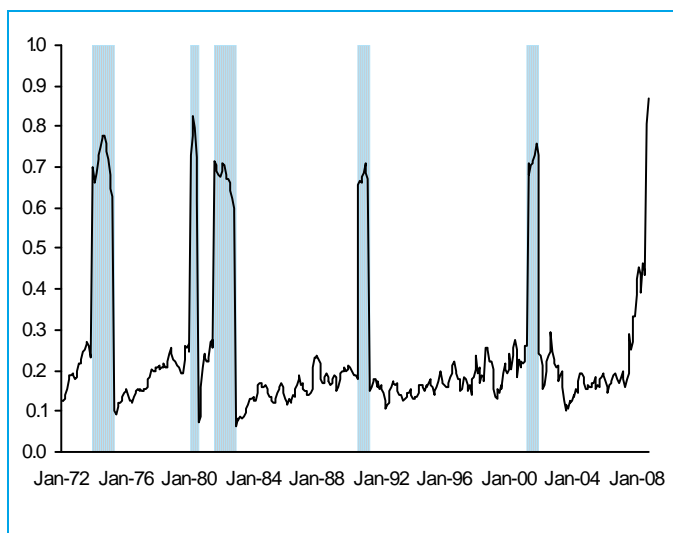
Saving the world's financial system

Faced with a potential complete financial meltdown, policymakers moved quickly to try to undo some of the damage done by the Lehman's' bankruptcy. The new measures involved massive liquidity injections to try to unfreeze credit and money markets, attempts to boost bank capital (in some cases involving the public sector becoming majority stakeholders in the banks), the guaranteeing of deposits; and coordinated fiscal and monetary easing.

Catastrophe averted, just

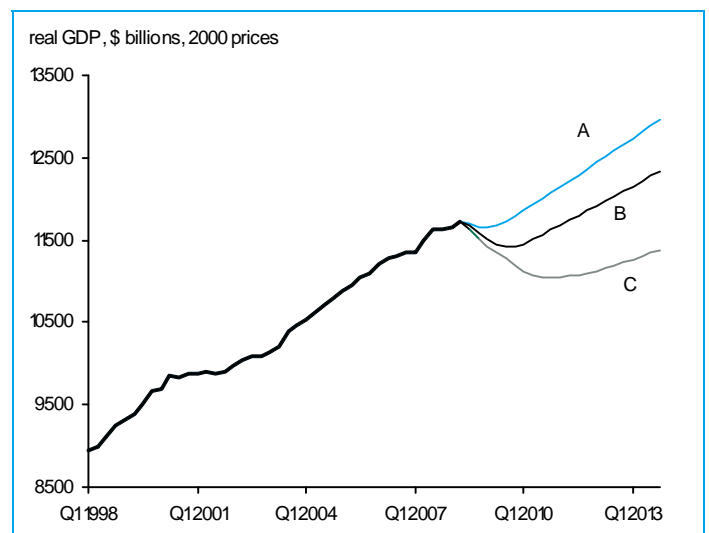
The less conventional of these measures did not prevent a sharp ratcheting up of the credit crunch – i.e. a reduction in the willingness of banks to supply credit to potential borrowers. But, we judge that it did bring to a stop the vicious circle that would otherwise have developed in which one after another of the world's major financial players went belly up. For that reason, we deem

Figure 1 – Recession probabilities in the US



Source: Barclays Wealth Research

Figure 2 – Three possible paths for global GDP



Source: Barclays Wealth Research

the measures as sufficient to avoid a ‘catastrophic’ scenario, which might well have been the story for 2009 otherwise – of a depression-type scenario developing in which the decline in global GDP was double-digit or more (shown as scenario C in Figure 2). Instead, the question in our minds now is what sort of recession should we expect – just an ‘awful’ outcome or a ‘brutally’ deep slowdown (shown as lines A and B respectively in Figure 2).

How deep will the recession be?

In other words, we are having to ask ourselves just how deep will the recession be. Will it be something like the typical post-second world war one, in which the peak-to-trough fall in output is only 2% or so? Or perhaps something more like the post-first-oil-shock one, in which many countries experienced declines in economic activity of 3% to 4%? Once we have an answer to that question, we can compare it with what is generally expected – and thus likely to be what is priced in by markets. Then, that should provide us with a guide regarding whether or not riskier asset classes, such as equities, will soon start performing again or not.

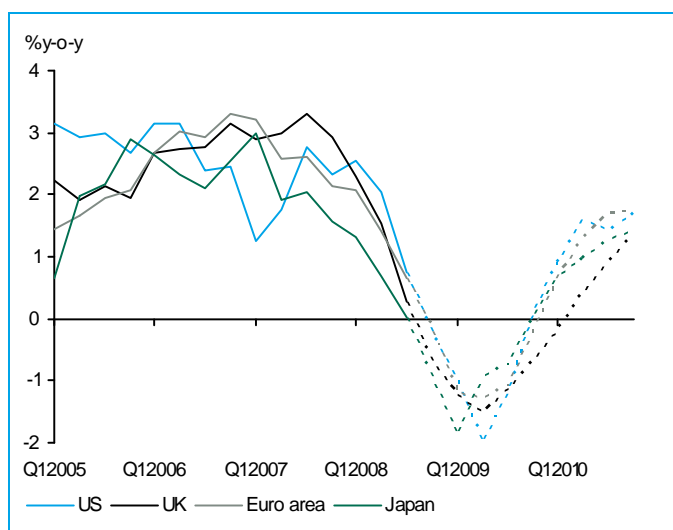
Recession to turn out deeper than generally expected

The rest of this publication details our responses to these questions. (See, in particular, the following country sections. And for detailed forecast tables, see the ‘Prospects sections in the Appendix.) First, we consider macroeconomic prospects, concluding that:

US and Europe contract by around 1% in 2009

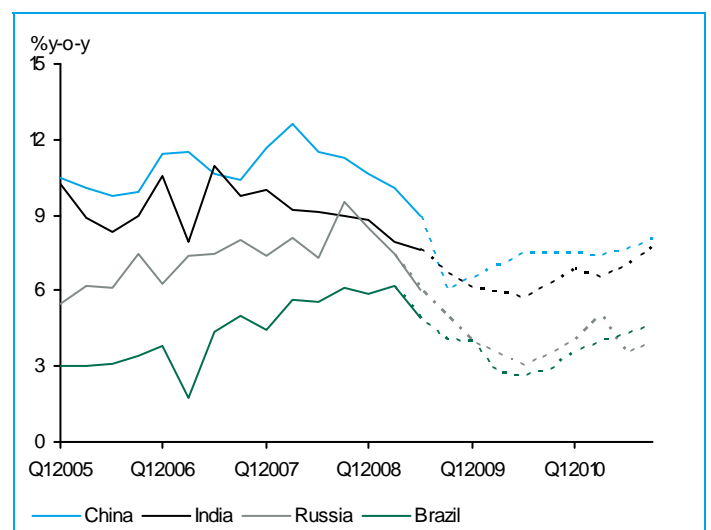
- **The US economy will likely contract 1% or so in 2009.** The collapse in the housing market remains the main drag on households, entailing as it does such massive wealth destruction. But the halving of the equity market is doing lots of damage too. Eventually, the combination of falling inflation (and, in turn, falling prices); zero official interest rates; and fiscal relaxation – perhaps to the tune of 4% of GDP – will foster a pickup in households’ real take-home pay sufficient to get them starting to spend again. But, that is likely to be a story for the second half of the year at the earliest, and perhaps even one for 2010 (Figure 3). Firms too are in contraction mode, looking to cut back their investment and employment. Only the government sector is set to grow in the short term.
- **Europe will slow about as much.** Much the same story holds in Europe – and in spades for the UK (which also faces a housing market crash, albeit one which started after the US’s). On the continent, the picture is more

Figure 3 – Real GDP growth in the developed economies



Source: Barclays Wealth Research

Figure 4 – Real GDP growth in the BRICs



Source: Barclays Wealth Research

mixed, with for example Spain having closer parallels with the Anglo Saxon economies' problems than does Germany. But a drop in real GDP of the order of 1% looks to be on the cards for Western Europe. Inflation looks set to turn negative too in most economies. And the ECB and BoE look set to push rates down to close to 1-1.5%. Most governments either have, or are intending to, loosen their fiscal stances to the tune of 1% of GDP. Partly due to this more muted reaction than that of the US authorities, the recoveries in Europe are likely to take longer to be forthcoming and be more gentle in their gradients.

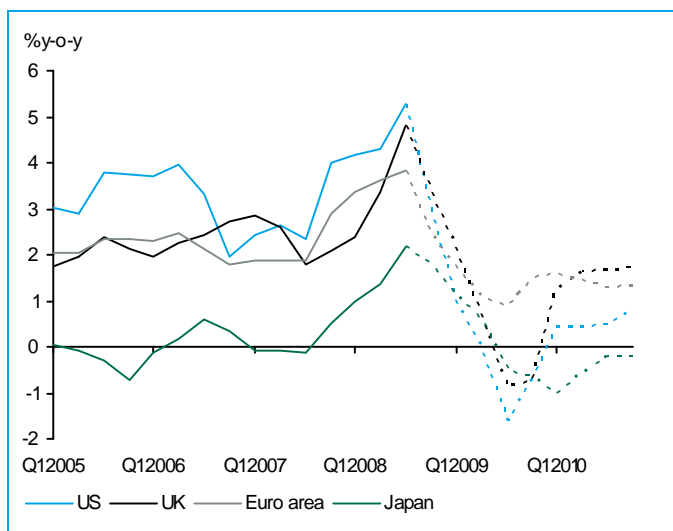
Emerging markets slowdown may exceed expectations

- Emerging markets are not immune.** We were never believers in 'resilience' – i.e. emerging markets being able to plough their own furrow in the face of a decline in developed world demand. That is now turning out to be a key issue for the globe, as country after country discovers that its own consumers and firms are suffering from the same sort of decline in 'animal spirits' that has affected the US and Europe. On top of that, the global nature of the credit crunch means that prospective borrowers everywhere are faced with tougher lending criteria and a higher cost of borrowing. In many cases, policymakers have plenty of room for manoeuvre, if they want to try to limit the pain. In the case of China, the government is acting forcefully to help bolster demand (via fiscal injections and rate cuts). In India, given that its public finances are in a less healthy state, more of the policy shift is coming via monetary policy. All in all, we suspect that the slowdown in emerging markets will be greater than generally expected (Figure 4). Nevertheless, the slowdown will be fairly muted. For Asia-Pacific excluding Japan (which like the US and Europe is likely to be in recession much of next year), it looks to us as if GDP growth will slow from 7% in 2008 to 5% in 2009. For Latin America, the comparable figures are likely to be close to 4.5% and 2.5% respectively. For Eastern Europe, a move down from 5.5% to 3.5% seems plausible. **All in all, that would mean that global growth next year ends up around the 1% mark – the lowest rate of expansion since the second world war.**

Inflation to turn to deflation

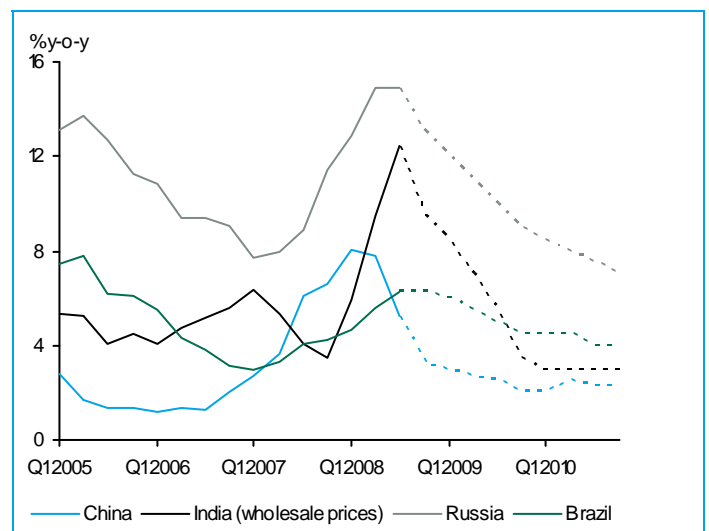
Such feeble growth, with 2009 being a year of two halves – i.e. declines in the first half, followed by a gradual pick-up during the second – ought to entail some further downward pressure on commodity prices. Oil prices, for example,

Figure 5 – Inflation in the majors



Source: Barclays Wealth Research

Figure 6 – Inflation in the BRICs



Source: Barclays Wealth Research

may well drift lower during the first half of 2009 – even though they now appear to be lower than their equilibrium ‘fair’ value according to our oil price model (developed along much the same lines as that used by the ECB to support their conjecture earlier this year that oil prices were being driven well above a sustainable level partly by speculation). Updating our earlier analysis, and taking into account the projected slowdown we are pencilling in for aggregate demand, it appears that the equilibrium oil price is around \$64/bbl (See Box 1 for details.) Most likely, prices will only regain that sort of level again once the US economy begins to expand again – perhaps in the third quarter of next year.

Huge downward pressure on headline inflation

Such a profile for oil (and for many other commodity) prices will engender huge downward pressure on headline inflation. This will be aided by the impact of weaker growth, and rising unemployment on wages and, in time, ‘core’ (i.e. ex food and energy) prices. In many developed countries, headline inflation is going to be negative by the spring as illustrated by Figure 4. Core inflation, however, is likely to be much more sticky, staying above zero in all the major economies. Consequently, although fears of outright deflation taking root again – as it did during the 1930s – are bound to be fanned by consumer prices registering outright falls, we doubt that the process will actually gather momentum: by 2010 most countries will be registering positive rates of inflation again.

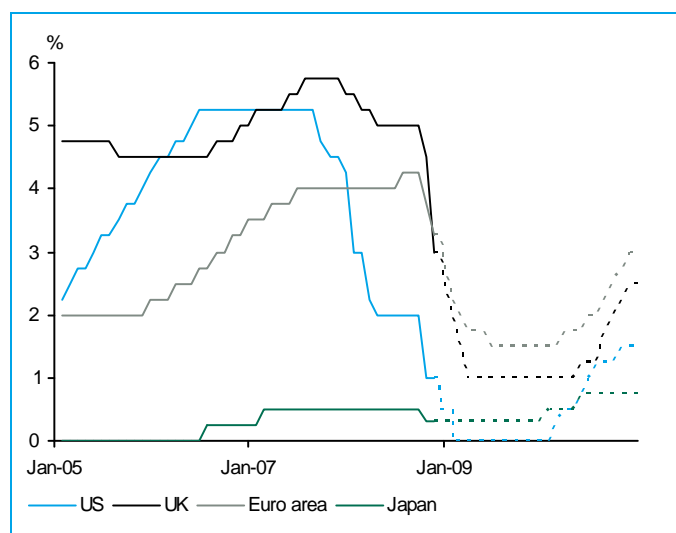
Policymakers have much more work to do

Rate cuts will beat market market expectations

What lower inflation will mean is that central banks that got hung up on higher commodity prices fuelling a wage-price spiral in spring 2008– with, for example, the ECB hiking as recently as July – ought to start back-peddalling at a rate of knots. In other words, rate cuts will happen almost everywhere, and we suspect on a bigger scale than is currently priced in. When it comes to the Fed, a zero official interest rate looks to be in prospect very soon. And, we suspect, the FOMC will not stop there. Rather, it will print money in order to help ensure that longer-term maturity government assets yield zero too. As for the ECB and BoE, official rates with a one handle look to be in prospect by the spring: a more aggressive easing than is priced in (Figure 7).

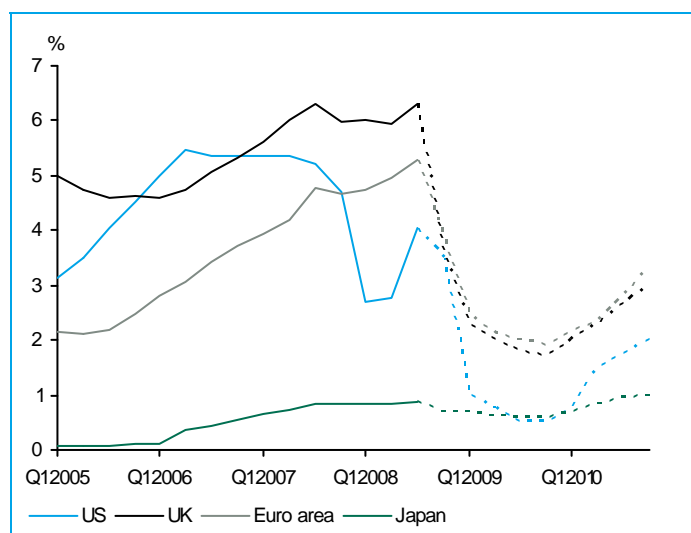
Fiscal relaxation is also happening big-time and universally. In time, this policy easing will work. And, once that becomes apparent, fears of a depression (and of deflation) should begin to disperse. As spirits lift, so ought riskier asset

Figure 7 – Official interest rates in the majors



Source: Barclays Wealth Research

Figure 8 – 3-month interbank rates



Source: Barclays Wealth Research

classes, such as equities. Perhaps slightly ahead of that happening, credit spreads can narrow – with this process being driven by reduced tail-risk (as people realise that the authorities are focussed on avoiding further large-scale bankruptcies in the financial sector). In other words, it may well be that, even while financial market participants are still focussed on the depth and longevity of the recession – and thus concerned about the ability of firms to deliver a decent stream of earnings – they have nevertheless already reduced significantly the risk, in their minds, of firms going belly up.

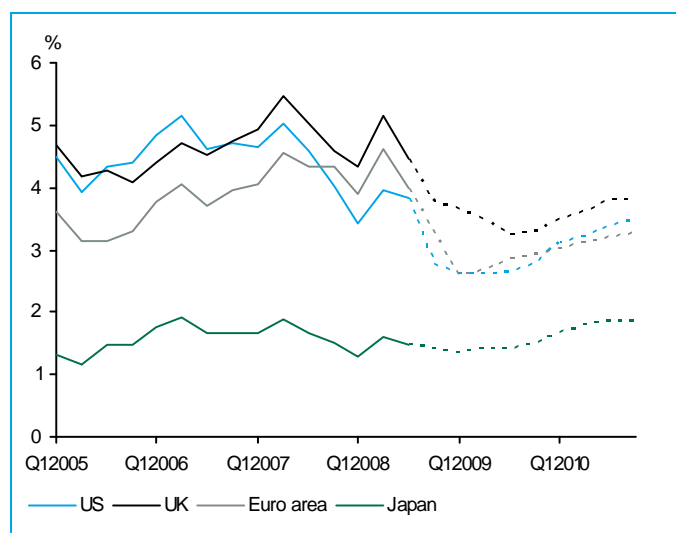
Lots of opportunities for investors

This sort of outturn – a quarter or two of economic decline, followed by a gradual pickup in activity, and a sustained period of downward pressure on inflation – ought to provide a number of opportunities for investors. (These we briefly run through here, but detail in the main edition of *Signpost*.) In particular, we would highlight:

- **Get long, or stay long, the interest rate futures strip until spring is here.** With global growth likely to disappoint consensus expectations for a while yet, and disinflation to exhibit greater force than generally expected, central banks will have to work harder than is priced in to bolster demand and, eventually, turn things around. Interbank rates will follow official rates down (Figure 8). Only once evidence builds that policy is working will markets begin to worry about rate hikes. The pull down in short-term rates should also exert downward pressure on longer-term maturity government bonds, although burgeoning fiscal deficits will no doubt limit the impact (Figure 9).
- **Stay overweight bonds and long-duration fixed income assets for another quarter or so, before looking to move back to neutral and then shift into equities.** Our duration scorecard has been registering close to maximum scores in recent weeks – i.e. telling us to get long duration. That reflects momentum, risk appetite, economic activity and inflation, *and* the term slope. We suspect that the signal strength will gradually fade, as the US economy bottoms and investors grow a little less fearful for the future. But, that may well be a story for the spring/early summer. Meantime, it looks reasonable to continue with what has been a winning strategy of late – i.e. staying in bonds rather than equities.

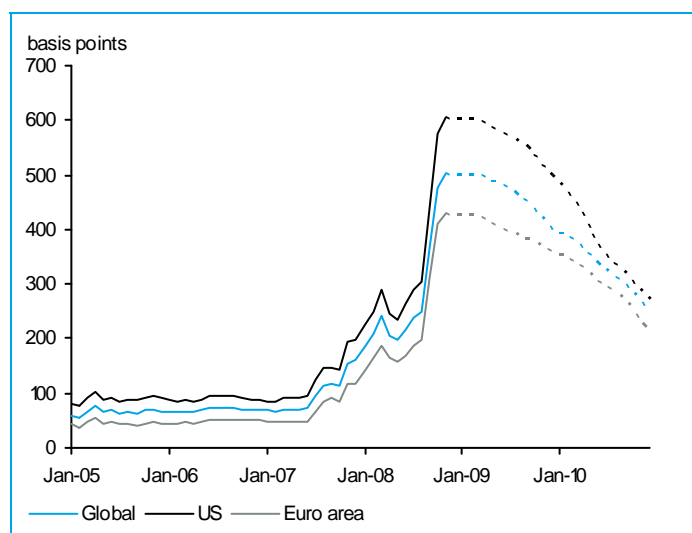
Go long fixed income – for now

Figure 9 – 10-year yields



Source: Barclays Wealth Research

Figure 10 – Investment-grade credit spreads

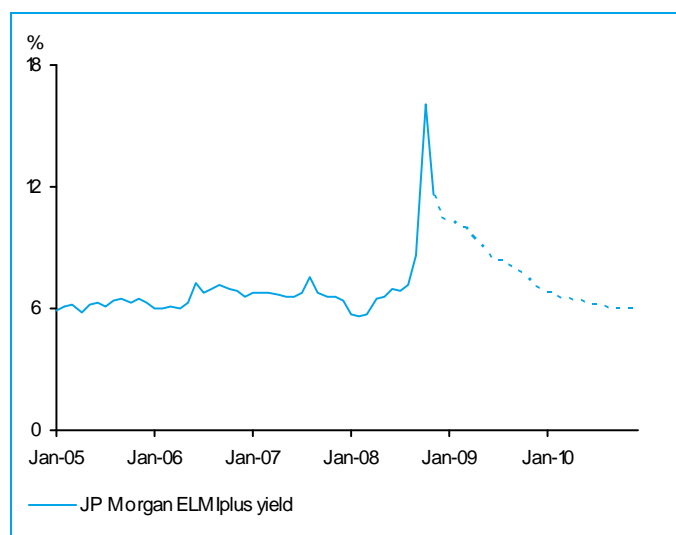


Source: Barclays Wealth Research

- Look to get long investment-grade credit quite soon.** The big step down in economic activity has, unsurprisingly, raised fears that corporate defaults will shoot higher. And that has caused credit spreads to widen (Figure 10). In the short term, that move may continue. However, as yields on government bonds drop back, so the search for higher returns will encourage investors to take on private-sector credit risk, most likely initially at the low-end of the risk spectrum – i.e. high grade as opposed to high yield credit. With many economies set to contract during the first quarter, the search for yield is likely to be a story for the second quarter at the earliest, and perhaps even only the second half of the year. Nevertheless, we very much expect that, over the next 12 months, investment grade credit will perform well.
- Expect further improvement in emerging markets, after the recent blow out in spreads.** Both foreign currency-denominated and local debt spreads have widened sharply of late, as deleveraging and the global slowdown led to perceptions that some emerging markets would struggle to meet their obligations. Already, however, local markets have begun to do better, with the ELMI spread coming in smartly (Figure 11). We suspect that that can improve further in the months ahead, and recommend overweights to take advantage of that happening. We are more cautious regarding sovereign, foreign currency debt, reckoning that the EMBI spread will come in 2009, but it could widen a little further first.
- Equity turnaround may have to wait until mid-year.** Throughout 2008 we have been overly optimistic about stock markets – reckoning that investors would put more weight on valuations than they have. Given that failing, we have devoted a lot of time and resources looking at how momentum-based strategies perform, both in asset allocation and equity country and sector selection. (A piece in the main version of *Signpost* summarises the signals coming from these automatic trading strategies.) At both an asset allocation and equity selection level, these sorts of strategies suggested adopting a defensive posture during the summer. (This was one reason why we shifted our short-term TAA to neutral in October.) Looking to 2009, we suspect that the worse-than-consensus outcomes for growth

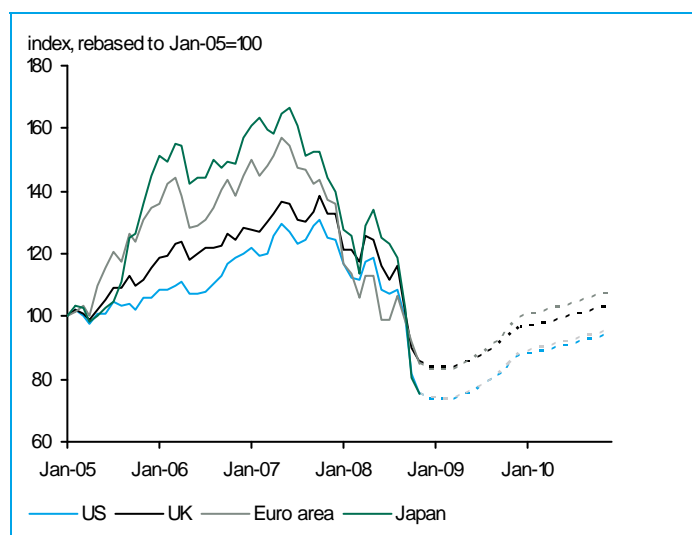
Don't expect an early equities revival

Figure 11 – Emerging local market (ELMI) spreads



Source: Barclays Wealth Research

Figure 12 – Equities



Source: Barclays Wealth Research

and inflation (and hence rising fears of deflation) may well push equities down a little during the early part of the year, despite their undoubted cheapness. As the global economy begins to bottom out, however, it may well be that stock markets recover somewhat (Figure 12). In previous ‘big’ bear markets, it has typically taken about eighteen months before equities trough. On that basis a mid-year turnaround would look to be plausible. By year-end, we expect equities to have made substantial progress.

- Stay defensive on countries and sectors for now.** In much the same spirit as our equities-bond call, we are happy staying long ‘defensive’ countries – such as the United States and Switzerland – in our short-term focussed recommended portfolios, and hence short the more aggressive ones, such as the BRICs. Likewise, with sectors, we prefer to hold healthcare and telecoms in our one-quarter-ahead focussed TAA, and short energy and materials. Looking out a year, however, we expect to rotate into the sectors which usually benefit from a cyclical pickup and which appear to be beaten up currently, such as financials and industrials. In other words, our year-ahead sector calls are very different from our one-quarter ahead ones. And we expect to make changes to the latter if not at end-Q1 then mid-year.
- Foreign exchange to be dominated by risk appetite.** This year the combination of fundamental- and trend-based analyses have worked very well for us. Currencies that were cheap on both measures – such as the dollar, the yen and the Swiss franc – have appreciated, while those that looked expensive – such as sterling, the Australian, Canadian and New Zealand dollars – have all dropped sharply in value. Now the signals from these models are rather less clear, with many in close accord with their ‘fair’ or ‘sustainable’ values. Thus, most of our forecasts are now momentum-based, assuming that the adjustment processes overshoot, as they have typically done in the past (Figure 13). Accordingly, we recommend adopting much smaller positions than formerly. Nevertheless, we expect there to be opportunities still for investors to trade much the same trends that have worked through 2008. One thing to watch out for within emerging markets is a likely growing distinction between ‘creditor’ and ‘debtor’ currencies (with these terms defined in terms of different countries’ net foreign asset and current account positions).

FX analysis shifts to a momentum-based approach

Figure 13 – Currencies

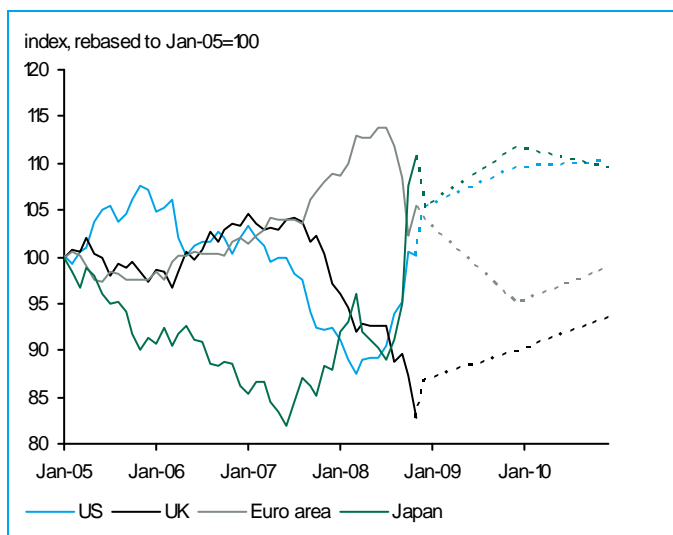
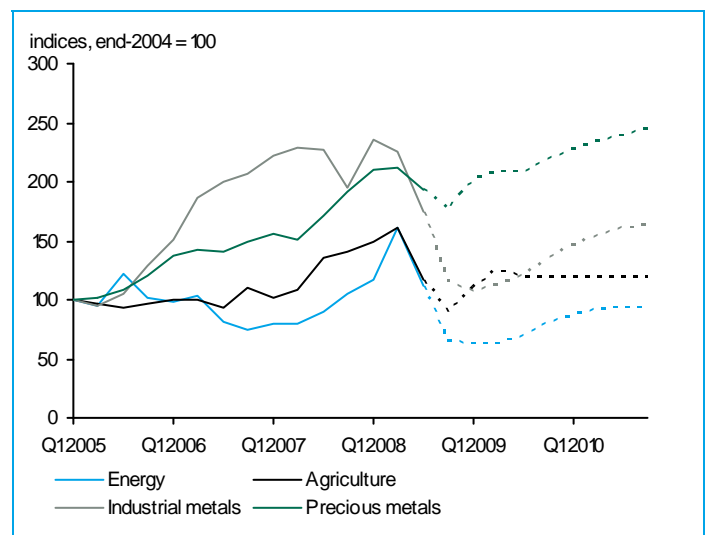


Figure 14 – Commodities



We doubt that the commodities euphoria will return

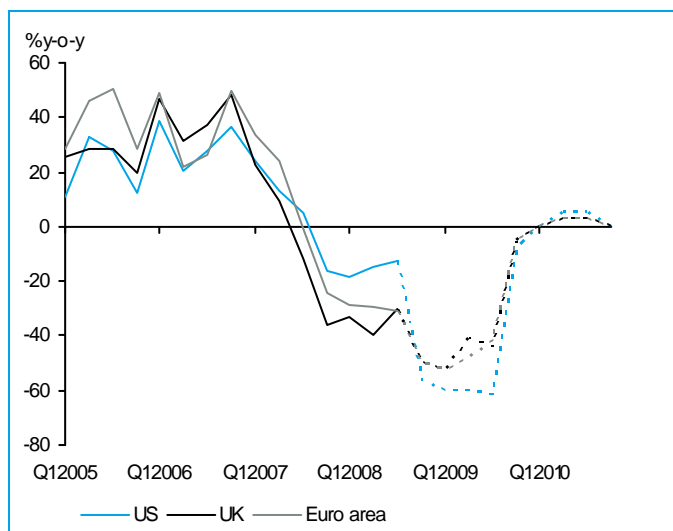
Real estate recovery will lag the global economy

- **Commodities to follow the economic cycle.** Most commodities have been driven of late by the gloom and doom around investors' perceptions concerning global demand. (Talk of a 'super cycle' is rare these days.) We suspect that little will change in the short term. Thus, we would not be surprised if oil prices fell a little further before finding a floor, but then rebounded somewhat once the global economy shows some signs of life again. A year from now, we expect most commodity prices to have risen somewhat, but we doubt very much that we will go back to the euphoria of this spring: commodities will rise but not shoot higher (Figure 14).
- **Real estate has quite a bit further to fall.** One asset class we called well this year has been real estate – covering both the price of housing and commercial property (Figures 15 and 16). As with our projections for US, European and UK housing (detailed in the pieces in the main *Signpost* on these countries' prospects), our models of commercial property suggest that, having been well above fair value at the peak, now prices are going to head well into overshoot territory. So, although the global economy may well recover during the second half of 2009, we doubt that commercial property (or housing) markets will do so. At best, they may be troughing as winter approaches.

Conclusions

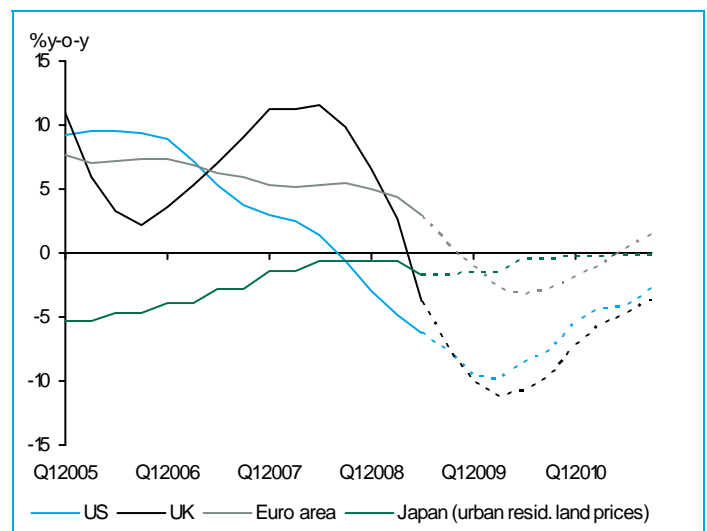
Our mission statement is to try to be holistic in our analysis, rather than merely providing a sweet shop of goodies for investors to pick from. After all, that way investors should benefit from diversification, whereas the 'list of trade ideas' approach runs the risk of generating very concentrated portfolios. Our TAA recommendations, detailed in the following pages, tries to bring all of our investment recommendations together in one place, and in a coherent fashion. To better emphasise the holistic nature of these calls, however, we have decided to run a model portfolio based on our recommended tilts, in which position size is related to the success of our past trading strategies (and their correlations). In this approach we try to take advantage both of momentum strategies and value/fundamental analysis, as detailed in the next section. We hope that this will provide more insightful analysis to help readers formulate their own investment strategies. As always, we very much appreciate feedback from our readers. And we hope that this new digest of what we call *Signpost Essentials* doesn't prove to be as hard a slog to read through as 2009 is likely to be for policymakers, and for the global economy.

Figure 15 – Commercial property



Source: Barclays Wealth Research

Figure 16 – House prices



Source: Barclays Wealth Research

Updating our 'fair value' analysis of oil prices

Back in August, we presented some analysis, based on extending some ECB research published earlier in the year, which attempted to come up with a 'fair value' for oil prices. The model took into account a number of key drivers of oil prices:

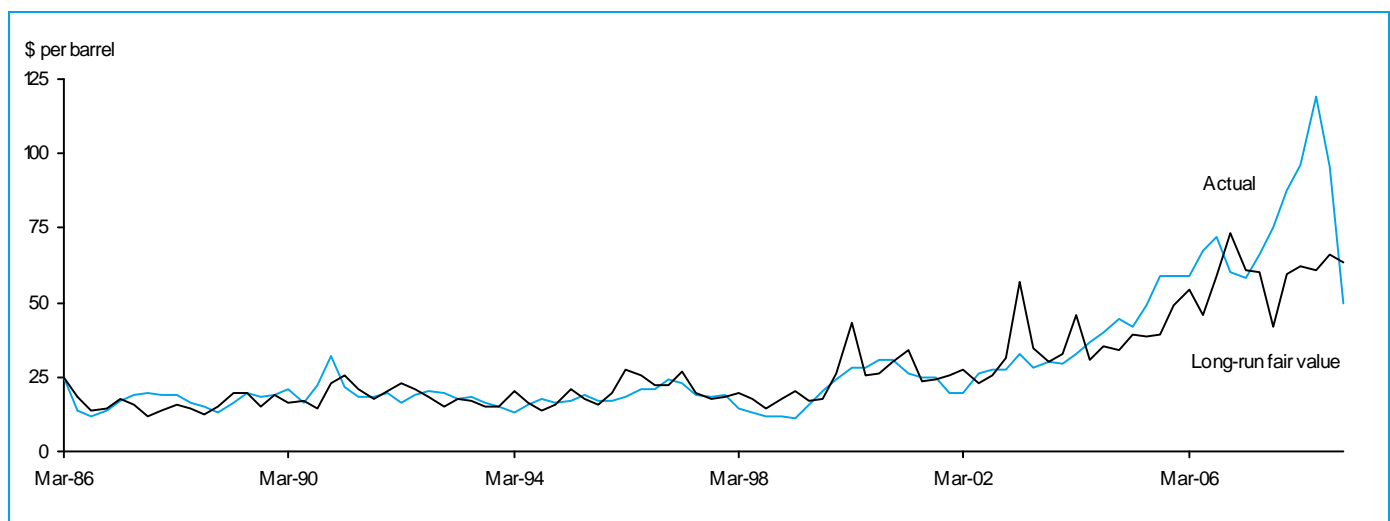
- **Supply and demand.** Whenever the global economy grows fast, and the demand for oil exceeds the ability of producers to boost supply, the inventory of oil stocks gets run down. So, shifts in these stocks help explain, statistically speaking, changes in oil prices.
- **OPEC capacity utilisation.** In addition to the short-term impact of shifts in stocks, a big driver of longer-term trends in oil prices is OPEC's capacity to produce measured in such a way as to take into account the fact that OPEC member countries sometimes cheat on their quotas (promising to curb production but not actually doing so, or at least not to the extent that they promised).
- **Refiners' utilisation rates.** Sometimes there is plenty of oil coming out of the ground but it is not in the right place or refiners are struggling to convert it into final products at a sufficient rate to meet demand. Hence we find refiners' utilisation rates help explain fluctuations in the oil price.
- **The futures market.** Depending on whether the futures market is in a state of backwardation or contango, the incentive to build stocks is very different. This helps explain why oil prices tend to rise faster when futures markets are priced for oil prices to rise – i.e. when the market is in a state of contango.

The model that we came up with suggested, back in summer 2008, that a long-run sustainable value for the oil price was of the order of \$80/bbl – i.e. way below where the oil price was trading at the time (\$145/bbl). A dynamic specification, built to give a feel for how long it might take for actual prices to return to normality, suggested that it would not take long for the mood of the market to turn around. Thus we predicted in August at least a period of "less upward pressure on the oil price [over the rest of 2008] – and perhaps even some downward pressure on it". That, of course, we now know turned out to be right, although much of the reason why was no doubt the collapse of Lehman Brothers and the huge demand shock that resulted – a way bigger contraction in demand than we had pencilled in to our forecast.

Conclusions

As 2009 approaches, we thought it pertinent to return to our oil model to see what it now suggests is a fair value for oil prices, and what it suggests will happen in 2009 if our demand- and supply-forecasts pan out correctly. The answer to the first question is shown in Figure 1 – with a long-run fair value estimated at \$64/bbl. When it comes to the dynamic equation, it suggests that it will take a good year or more to return to this sort of level. Indeed, in the short run, as demand continues to contract, it suggest that oil prices may drop a little further, before eking their way back to the low \$50s by mid-year.

Figure 1 – A long-run 'fair value' estimate for the Brent oil price



Source: Barclays Wealth Research

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TAA recommendations for a global portfolio

- ♦ Automatic momentum-based strategies help guide us when making Tactical Asset Allocation (TAA) suggestions.
- ♦ On top of that, however, we need to consider fundamentals – or ‘value-based’ analysis, as it is often referred to.
- ♦ Combining the two, we recommend adopting fairly defensive positions short term, but look to add risk in the spring.

We used automatic momentum-based rules...

...to drive two long-only portfolios...

...which performed well to mid-2008...

Earlier in 2008, given the rather limited success that our fundamental approach to asset allocation had enjoyed, we decided to examine using automatic momentum-based rules to help both in considering which asset classes might perform well going ahead and, within these asset classes, which components would be worth overweighting.

In terms of the asset allocation exercise, we followed an approach that others have used with some success, not just in an academic exercise but out of sample – in the real world. (For details, see the July edition of *Signpost*.) This entailed us assuming that past performance would be a useful guide to future developments. Hence, the Automatic Momentum-Based Asset Allocation (AMBAA) tool was based on constructing two long-only portfolios comprising half of the asset classes examined, with equal weights on each, and with the decision taken whether or not to include an asset based on how well it had performed over the previous six months. The rule was simple: include an asset if it had performed better than half of the asset classes considered over the look-back period. And only rebalance and reconstruct the portfolio once every six months. We ran two such portfolios – one based on look-back periods which ended at year-end and mid-year and one which ended at the end of the first and third quarters – in order to create a quarterly version of AMBAA.

Such a simple trading strategy performed remarkably well – with a Sharpe ratio of 1.2 between 1994 and mid-2008. Accordingly, we decided to use it as a tool to help guide us when we were trying to come up with a recommended asset

Figure 1 – Automatic Momentum-Based Asset Allocation (AMBAA) recommendations

Asset class	Benchmark weights (%)	2008				2009				Forecast return (3-mths)	Forecast return (12-mths)	TAA tilts (3-mths)	TAA tilts (12-mths)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Cash	8.3	0	8	17	17	17	17	8	0	2.2	1.1	8	2
Global Bonds	8.3	8	17	17	17	17	17	8	0	2.7	2.5	8	2
IG credit	8.3	8	17	17	8	8	8	17	8	8.7	11.1	0	2
HY credit	8.3	0	0	0	0	0	0	8	8	1.1	17.7	-8	-4
US equities	8.3	8	0	0	0	0	0	8	17	-24.0	22.1	-8	-2
Other dev. equities	8.3	8	0	0	0	0	0	8	17	-21.3	21.7	-8	-2
EM equities	8.3	17	8	0	0	0	0	8	17	-23.5	26.1	-8	-2
EMBI	8.3	8	17	17	17	17	17	8	8	-18.4	8.6	8	4
ELMI	8.3	17	17	17	17	17	17	17	17	-18.1	11.3	8	8
NAREIT	8.3	0	0	0	0	8	8	0	0	-56.4	-5.2	0	-4
GSCI	8.3	17	17	17	8	0	0	0	8	-36.5	21.4	-8	-6
Hedge funds	8.3	8	0	0	8	17	17	8	0	-15.0	15.0	8	2
	100	100	100	100	100	100	100	100	100	-16.5	12.8	0	0

Source: Barclays Wealth Research

...and its increasingly conservative stance...

...can be married to our forecast asset returns

In addition, we now link macro-economic forecasts to asset returns predictions...

allocation for clients. Figure 1 shows how it has performed of late, with the weights on an asset class at 1/6 if both of the rules suggested being long an asset class; at 1/12 if only one did so; and at zero if neither did so.

At the end of 2007, AMBAA recommended a fairly aggressive portfolio – with maximum overweights on all three equity asset classes, hedge funds, commodities and local market instruments in emerging markets. By the end of the first quarter, however, it suggested spreading risk more broadly – putting (small) allocations to government bonds, emerging market sovereign bonds and investment grade corporates (with reduced emphasis on two of the three equity classes and hedge funds), as shown in the second column of Figure 1. Its posture became still more conservative through the summer, to the point that, by end-Q3 it was maximum overweight on cash, government and emerging local market and sovereign bonds, investment grade credit and (to its cost) commodities. Based on the assumption that the ranking of assets is not changed during the course of December (from what has gone before during Q4), AMBAA looks set to continue recommending avoiding equity market exposure, although it may well point to small long positions in real estate for the first time in a long while, and in hedge funds.

Looking ahead, we can include our forecast returns for each asset class and see how AMBAA's recommendations will shift if those forecasts prove to be accurate. What this suggests is that 2009 will be a year of two halves – with equity exposure building during H2, and cash and bond exposure falling away.

...and a red light to using value alone

The momentum-based approach to investing is unlikely to work day-in day-out. After all, there must be some correspondence between fundamentals and investment performance in the long run. To complement our AMBAA approach, we therefore incorporate in our macro-economic models a number of 'link' equations, to translate growth, inflation and interest rate predictions into forecasts for bond and equity market returns; credit and sovereign spreads; changes in real estate prices; commodity return forecasts etc... Likewise, we ask our colleagues in Alternatives to give us their thoughts regarding what it might be reasonable to expect in terms of hedge fund performance over the coming year.

Figure 2 – Value-based TAA recommendations

Asset class	Benchmark weights (%)	2008				2009				Forecast return (3-mths)	Forecast return (12-mths)	TAA tilts (3-mths)	TAA tilts (12-mths)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Cash	5	5	5	5	5	9	6	4	0	1.0	1.1	4	0
Global Bonds	20	20	20	20	20	25	21	15	10	2.5	2.5	5	-2
IG credit	10	10	10	10	10	11	12	13	14	3.3	10.7	1	3
HY credit	5	5	5	5	5	4	4	5	6	1.1	17.8	-1	0
US equities	15	15	15	15	15	15	17	19	19	0.3	22.1	0	3
Other dev. equities	15	15	15	15	15	14	16	17	18	0.3	21.7	-1	1
EM equities	5	5	5	5	5	4	4	6	8	0.2	26.1	-1	1
EMBI	5	5	5	5	5	3	3	3	4	-4.4	8.6	-2	-2
ELMI	5	5	5	5	5	5	5	3	4	1.1	11.3	0	-1
NAREIT	5	5	5	5	5	0	0	0	0	-5.0	-5.2	-5	-5
GSCI	5	5	5	5	5	5	6	7	9	-0.5	21.4	0	2
Hedge funds	5	5	5	5	5	5	6	8	8	3.0	15.0	0	3
	100	100	100	100	100	100	100	100	100	0.7	13.0	0	0

Source: Barclays Wealth Research

...to present 'value-based' strategies...

...which are more effective when combined with AMBAA...

...particularly if their relative weights vary according to the investment horizon

A defensive portfolio is suggested for the first quarter

Using these forecasts, we can also come up with a number of recommendations concerning asset allocation. Figure 2 illustrates. Rather than consider an equally-weighted portfolio as the benchmark – as is appropriate to the AMBAA analysis – we nudge the benchmarks in this case so that they more closely accord with those used in typical offerings to HNW clients. These 'value-based' – or some would say 'fundamental-based' – recommendations are less easy to back-test, although some work has been published recently to suggest that such an approach to TAA has worked reasonably well over the past two decades, with an information ratio of close to 0.6.¹

Combination strategies is the new green

What this latest research really shows, however, is that using such strategies in isolation is much less effective than if they are combined with momentum-based investing. For example, using momentum alone delivers an information ratio of close to 0.6 – i.e. the same as the value approach. But, using both momentum and value-based approaches simultaneously results in an information ratio of 1.2. For this reason, rather than rely on Figure 2's recommendations, rather than Figure 1's, we actually prefer to weight the two together when coming up with our preferred tilts for the various asset classes.

Figure 3 illustrates our final, preferred, TAA. Because we believe that momentum pays greater dividends in the short term, and value more in the long run, we let the weights on the two sets of recommendations be a function of the investment horizon. So, for example, we use weights of 0.8 on momentum and 0.2 on value for a one-quarter ahead recommendation, but weights of 0.2 and 0.8 respectively on a four-quarter one. Gradually, value takes over from momentum.

Conclusions

Using this approach, we suggest adopting a pretty defensive portfolio for the first quarter of 2009 – recommending overweights on cash and bonds. As 2009 progresses, however, we expect to shift into credit and equities, most likely starting around the spring. And we expect to build risk positions more forcefully during the second half of the year.

¹ For further details, see "Global Tactical Cross-Asset Allocation: Applying Value and Momentum Across Asset Classes", by Blitz, D., and Van Vliet, P., The Journal of Portfolio Management, vol .35 no.1, Fall 2008.

Figure 3 – Overall TAA recommendations

Asset class	Benchmark weights (%)	2008				2009				Forecast return (3-mths)	Forecast return (12-mths)	TAA tilts (3-mths)	TAA tilts (12-mths)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Cash	5	4	6	8	8	10	8	4	0	1.2	1.1	5	1
Global Bonds	20	17	19	19	19	23	20	14	10	2.6	2.5	3	-3
IG credit	10	10	12	12	10	10	11	13	14	4.4	10.8	0	2
HY credit	5	4	4	4	4	3	3	5	6	1.1	17.8	-2	0
US equities	15	13	11	11	11	12	15	18	18	-4.4	22.1	-3	1
Other dev. equities	15	13	11	11	11	11	14	16	18	-3.8	21.7	-4	0
EM equities	5	8	6	4	4	3	3	6	8	-4.4	26.1	-2	0
EMBI	5	6	8	8	8	6	5	4	4	-7.1	8.6	1	0
ELMI	5	8	8	8	8	7	7	4	5	-2.6	11.3	2	1
NAREIT	5	4	4	4	6	2	1	0	0	-14.9	-5.2	-3	-4
GSCI	5	8	8	8	6	4	5	6	9	-7.4	21.4	-1	1
Hedge funds	5	6	4	4	6	7	8	8	8	-0.5	15.0	2	3
	100	100	100	100	100	100	100	100	100	-2.0	13.0	0	0

Source: Barclays Wealth Research

Global Overview

Cash*	Weights (%)	2008				2009				Forecast return (12-mths)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	9	3.00	2.50	2.25	2.15	1.00	0.75	0.50	0.50	1.1
UK	12	6.01	5.95	6.30	3.60	2.30	2.00	1.80	1.70	2.4
Euro area	38	4.45	4.83	4.95	3.90	2.45	2.10	2.00	1.90	2.6
Japan	23	0.91	0.93	1.02	0.90	0.85	0.70	0.70	0.80	0.8
Emerging	18	5.70	7.00	8.60	12.00	13.00	12.50	12.50	11.50	11.33
Global	100	3.94	4.28	4.66	4.51	3.87	3.55	3.46	3.25	3.8

* 3-month interbank rates, % end-of-period, weighted by M1, except for emerging, which is an M1-weighted average of the main constituents of the ELMI index.

Bonds*	Weights (%)	2008				2009				Forecast return (12-mths)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	28	3.41	3.97	3.83	2.98	2.75	2.60	2.60	2.65	5.4
UK	6	4.35	5.13	4.45	3.77	3.65	3.50	3.25	3.30	7.2
Euro area	39	3.90	4.62	4.02	3.29	3.00	2.90	2.85	2.80	6.9
Japan	26	1.30	1.76	1.49	1.40	1.35	1.40	1.40	1.50	0.5
Emerging	1	3.16	2.98	4.30	7.50	8.30	8.30	7.50	6.50	8.63
Global	100	3.11	3.72	3.33	2.74	2.54	2.46	2.42	2.45	2.5

* 10-year bond yields, %, end-of-period, except for emerging markets, which is the EMBIG spread, in % points.

Investment grade credit*	Weights (%)	2008				2009				Forecast return (12-mths)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	50	2.55	2.47	4.11	5.77	5.75	5.70	5.50	5.25	10.72
UK	11	2.83	2.37	3.93	5.11	5.10	5.00	4.95	4.70	11.09
Euro area	32	1.77	1.74	2.94	3.75	3.75	3.70	3.60	3.40	9.06
Japan	7	0.15	0.20	0.30	0.33	0.35	0.30	0.25	0.25	0.63
Rest-of-world	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Global	100	2.16	2.06	3.44	3.32	3.32	3.24	3.18	3.02	7.4

* Spread over 10-year bond yields in basis points, end-of-period.

High yield credit*	Weights (%)	2008				2009				Forecast return (12-mths)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	87	7.80	7.07	10.20	15.4	15.4	15.4	15.4	15.4	17.7
UK	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Euro area	12	7.06	6.73	10.65	15.1	15.1	15.1	15.1	15.1	18.8
Japan	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Emerging	1	4.35	4.35	6.12	9.0	8.9	8.9	8.9	8.9	10.2
Global	100	7.7	7.0	10.2	15.3	15.3	15.3	15.3	15.3	17.8

* Spread over 10-year bond yields in basis points, end-of-period

Equities*	Weights (%)	2008				2009				Forecast return (12-mths)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	42	-9.3	-2.1	-9.0	-24.0	0.3	4.8	6.8	8.8	22.1
UK	10	-10.4	-0.9	-11.8	-14.7	0.4	4.0	5.6	7.2	18.1
Euro area	16	-15.5	-4.1	-11.1	-22.5	0.3	5.0	7.1	9.2	23.1
Japan	9	-17.8	9.1	-17.5	-26.3	0.3	5.0	7.1	9.3	23.3
Rest of world	25	-12.4	-1.1	-11.6	-23.5	0.2	5.6	8.0	10.4	26.1
Global	100	-11.7	-0.9	-12.4	-23.5	0.3	5.0	7.0	9.1	23.0

* MSCI total return indices in local currency, % changes during period

Currencies*	Weights (%)	2008				2009				Forecast return (12-mths)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Dollar	43	-5.3	1.9	6.6	5.0	1.5	1.5	-1.0	2.0	4.0
Sterling	10	-5.3	0.6	-3.1	-9.0	-2.0	-0.5	2.0	4.0	3.4
Euro	19	3.7	0.8	-4.7	-3.0	-1.0	-3.0	-2.5	-2.5	-8.7
Yen	11	9.1	-6.0	5.2	17.0	1.5	1.5	1.5	1.5	6.1
Swiss franc	2	7.0	-2.1	0.1	1.0	1.0	1.0	1.0	0.0	3.0
Rest of world	14	7.0	-2.5	-15.5	-17.8	-3.0	-1.4	3.8	-6.8	-7.5

* Bank of England effective exchange rate indices, % changes during period. Weights use Barclays Wealth SAA by region. Rest-of-world is calculated by residual.

Commodities*	Weights (%)	2008				2009				Forecast return (12-mths)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Energy	70	10.0	38.0	-30.0	-42.0	-4.0	0.0	10.0	15.0	21.4
Agriculture	12	6.0	9.0	-28.0	-23.0	22.0	14.0	-6.0	0.0	30.7
Livestock	5	-14.6	7.0	-7.0	-10.0	2.0	0.0	2.0	2.0	6.1
Industrials metals	11	20.7	-4.0	-23.0	-34.0	-8.0	5.0	8.0	12.0	16.8
Precious metals	2	9.9	1.0	-9.0	-9.0	15.1	3.0	0.0	5.0	24.5
Global	100	9.5	27.5	-27.4	-36.5	-0.5	2.3	7.2	12.0	21.4

* GSCI indices in dollars, % changes during period

Real estate/commercial property*	Weights (%)	2008				2009				Forecast return (12-mths)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	30	1.4	-5.5	4.5	-56.4	-5.0	-5.0	0.0	5.0	-5.2
UK	10	1.3	-22.6	4.7	-39.0	-5.0	-3.0	0.0	3.0	-5.1
Euro area	25	1.7	-13.0	-10.4	-37.1	-5.0	-3.0	0.0	3.0	-5.1
Japan	20	-19.9	5.1	-15.0	-26.2	-3.8	-2.5	0.0	2.5	-3.8
Rest of world	15	-14.0	-5.5	-2.6	-29.3	-4.0	-2.0	0.0	2.0	-4.0
Global	100	-5.1	-7.0	-4.2	-39.7	-4.6	-3.4	0.0	3.4	-4.7

* EPRA/NAREIT indices in local currency, % changes during period

Key Tactical Asset Allocation (TAA) themes

Theme	Thesis	Investment strategies
1. Don't get too depressed about depression.	Markets appear to be putting a significant probability on the next few years playing out just like the Great Depression. We suspect, however, that policymakers' efforts to save the financial system, and avoid repeating the mistakes made in the 1930s, will be successful – in which case we will have a recession, but not a complete meltdown.	The equity market has performed much as it did during the run in to the Great Depression. And credit spreads are priced much like they were 80 years ago. Accordingly, if we avoid a depression, these asset classes should outperform over the next year, as investors grow more positive about prospects.
2. The recession will be deeper and more protracted than its predecessor. Policymakers will have their work cut out turning things around.	Although we see less 'tail risk' than most, we suspect that the slowdown will be sharper than the consensus's best guess – thus requiring a more forthright policy response, both from central banks and from governments.	The equity market may not recover for a while if growth data continue to turn out worse than the consensus is forecasting, as we suspect will happen during the rest of 2008 and early part of 2009. Likewise, credit markets may get spooked by rising arrears and defaults. Hence our TAA looks to put risk into these asset classes only in the spring. However, we also suspect that the combination of worse-than-expected growth and lower-than-expected inflation figures will lead the major central banks to cut rates more forcefully than is priced in. Thus we advise getting long the interest rate futures strip.
3. The stretch for yield is just beginning.	As rates fall – with the Fed likely to go to zero and European banks to a one-handle on official rates – so the yield on fixed income instruments will drop. Adding to the pressure, economic slowdown will lead to higher savings rates and reduced investment demand. So, long-term interest rates will also decline, even though some (such as the US 10-year treasury yield) are already at 50-year lows.	In retrospect, it is clear that the best asset classes to have held in 2008 have been cash and government bonds. That may not be true for long, as the returns on both are on the slide. Conservative investors will struggle to find alternative assets that offer risk-free returns anything close to those that they have enjoyed this year. But, in time they will likely take on private-sector risk – say by buying corporate credit. Expect high-quality (investment-grade) credit to benefit before high yield does. Capital-protected equity investments should benefit too from this money seeking a new home. As the recovery bottoms and turns, expect to see a more forthright rotation into riskier asset classes, such as equities.
4. Deflation fears will be fanned by falling prices.	The combination of the commodity price bubble bursting; the deep recession; and (in the UK) policymakers' decision to cut VAT means that consumer prices are set to drop in 2009 – i.e. inflation will turn negative. As this becomes apparent, people will grow more concerned about a proper deflation occurring – as in a protracted period of price falls, causing consumers to postpone purchases as they expect to be able to buy cheaper down the line and debtors to suffer real problems meeting obligations, as real debt-service burdens soar. We doubt very much that deflation will occur. So, fears of it happening should provide investors with real opportunities.	Inflation-linked bonds have already moved big-time – with, for example, TIPS now reckoning that US inflation will average less than 0.5% per annum over the next decade. That suggests to us that there is a great opportunity for investors who get long inflation bonds. However, it may well be that they get cheaper before they perform, thanks to inflation surprising on the downside for a while longer yet.

Key Tactical Asset Allocation (TAA) themes – continued

Theme	Thesis	Investment strategies
<p>5. The emerging world is not resilient. But it will re-emerge.</p>	<p>Much of the emerging world acts as the ‘workshop of the west’ – producing goods for sale in the so-called developed world. We always thought that, if ‘Anglo’ consumers cut back their spending, and started saving again, then the rest of the world would suffer as a consequence – and especially Asia (including Japan). Although catch-up means that policymakers in countries like China and India have more ability to promote domestic demand to help offset the hit to export prospects, there are still limits to what can be achieved through this route. However, once global demand begins to pick up again, emerging economies – and their markets – will turn out to be leverage plays on the recovery.</p>	<p>Emerging equities is the easiest way to play the ‘leverage’ theme. However, many emerging markets have also seen their currencies suffer and their sovereign debt spreads widen dramatically. So, both the ELMI and EMBI indices have suffered big losses of late. We suspect that there is more pain due before these indices recover. But, investors should still look for opportunities in 2009 as risk appetite returns and economic fundamentals turn around. Importantly, there has been little differentiation between ‘good’ and ‘bad’ emerging markets thus far. But, creditor countries stand to do better, and sooner, than debtor ones. That goes for their currencies as well as their debt.</p>
<p>6. Another sterling crisis?</p>	<p>The pound has already taken a pounding in 2008. But, with the UK facing a tougher macro environment than most other developed countries, and policymakers’ reactions to date far from perfect, there has to be a reasonable chance that sterling takes another big hit in 2009. In other words, instead of just being cheap, it is possible that the pound falls so fast and so far, that international investors completely recalibrate their ranking of the UK. Then the currency’s value isn’t so much a boon for exporters, as currently, but a real problem in itself – and for everyone faced with picking up the bill.</p>	<p>Avoid home bias if you are a UK investor. Treat currencies as an asset class – and get long some which will look likely to continue appreciating in 2009 (such as the yen and the Swiss franc).</p>
<p>7. Volatility will drop back – thanks in part to asset price targeting</p>	<p>In the ‘new world’ that policymakers are designing, asset price fluctuations will be accorded a more prominent part: policymakers will react to them, rather than dismiss them as something that is not of their concern or making. Regulatory reform is likely to help limit the cyclical liquidity provision and leverage. So might a new breed of central banker, focussed as they will be on trying to avoid repeating the mistakes made by their predecessors. By keeping asset prices in a ‘cone’, policymakers will help limit their degree of fluctuation. And that should help permit volatility to gradually return to more normal levels, albeit higher than those seen before the credit crunch.</p>	<p>It will take time. But equity volatility should trend lower during 2009 and into 2010. And that will help stock markets recover. Likewise, once housing and commercial property markets find a floor – perhaps towards the end of 2009 – they should be able to start the laborious climb back to something close to sustainable values. Lowered volatility should help these asset classes recover some sort of reputation. But it may well be more a 2010 story than a 2009 one.</p>

Forecast summary

GDP (real change, %)	2007	2008	2009	2010
US	2.2	1.3	-1.0	1.5
Japan	2.1	0.3	-0.9	1.1
Euro area	2.6	1.0	-1.0	1.3
UK	3.0	0.8	-1.2	0.5
Canada	2.7	0.4	-0.6	1.9
China	11.4	8.5	7.5	7.6
India	9.0	7.8	6.0	7.0
Russia	8.1	6.0	3.0	4.1
Brazil	5.4	5.2	3.0	4.1

Inflation (%)	2007	2008	2009	2010
US	2.9	3.9	0.3	0.5
Japan	0.1	1.6	0.1	-0.5
Euro area	2.1	3.3	1.3	1.4
UK	2.3	3.5	0.5	1.9
Canada	2.1	2.5	1.4	1.7
China	4.8	3.2	2.0	2.3
India	4.8	9.5	6.0	3.0
Russia	10.7	13.0	9.0	7.7
Brazil	3.6	5.7	5.0	4.3

Interest rates (%)	2007	2008	2009	2010
US (Fed funds)	4.25	0.50	0.00	2.00
Japan (Call rate)	0.5	0.3	0.3	0.8
Euro area (Refi rate)	4.0	2.75	1.50	3.00
UK (Bank rate)	5.5	2.5	1.0	2.5
Canada (Call rate)	4.25	1.75	1.25	2.75
China (Lending rate)	6.73	6.39	4.5	5.0
India (Repo rate)	7.75	7.0	5.5	5.5
Russia (Repo rate)	10.0	13.0	14.5	13.0
Brazil (SELIC rate)	11.25	13.75	13.0	11.0

Source: Barclays Wealth Research

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