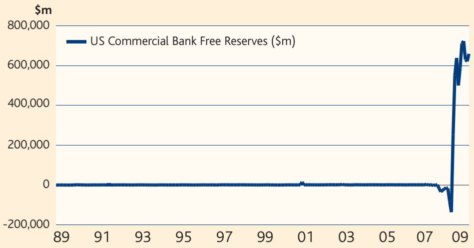
Global Investment Outlook

The monthly investment outlook from Aberdeen's multi-asset team

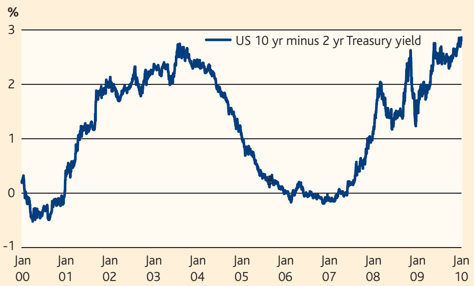
Aberdeen

Excess liquidity will be a key focus of the exit from accomodative policy in the US



Source: Factset, 11 Jan '10

US yield curve steepness is entering unchartered territory



Source: Factset, 11 Jan '10

Key forecasts	US	Japan	Euro-zone	UK	China	Global
GDP rolling 12m forecast	2.2	1.5	1.3	1.4	9.4	2.5
Consensus	2.7	1.5	1.3	1.4	9.4	2.7
CPI rolling 12m forecast[A]	1.6	(1.0)	0.7	2.3	3.3	1.1
Consensus	2.1	(1.0)	1.2	2.3	2.8	1.4
Current Base Rates	0 - 0.25	0.10	1.00	0.50	5.31[B]	–
Monetary Policy (3m)	0 - 0.25	0.10	1.00	0.50	5.31[B]	–
Monetary Policy (12m)	0.50	0.10	1.00	1.00	5.58[B]	–
10 Yr bond Yields (12m)	4.00	1.66	3.50	4.50	n/a	–

[A] core rate [B] PBOC 1 year Yuan Lending Rate
Source: Aberdeen Asset Managers Ltd, 11 Jan '10

Asset allocation	Deviation[C] (%)
Equities	5.0
- UK	(1.0)
- US	0.0
- Japan	1.0
- Europe ex UK	1.0
- Asia	2.0
- Emerging Markets	2.0
Fixed Income	(5.0)
- Conventional	(4.0)
- Index Linked	(1.0)
Property	0.0
Cash	0.0

[C] Deviation refers to a % over or underweight vs. our core multi-asset benchmark.
Source: Aberdeen Asset Managers Ltd, 11 Jan '10.

Executive Summary

- G7 fiscal policy remains expansionary but focus is now on the size of budget deficits
- Recovering US consumer demand may sustain above trend output growth for longer
- Abundant liquidity may prompt further revaluation in emerging markets

Global growth is now on a more even keel, but for the G7 countries fiscal policy is the main support and activity would not be sustained without it. A revival in consumer demand in the US, and to a much lesser degree the UK and elsewhere, has postponed companies' ability to rebuild inventory. The implication is that global industrial output growth may remain 'stronger for longer', as evidenced by renewed vigour in forward looking output indicators. However much of the consumer rebound has been the result of tax incentives and sustained expenditure on employment in the public sector. The resultant budget deficits have prompted massive borrowing requirements bringing into question the length of time this can continue. Budget deficits in the major countries will therefore be an increasing influence on financial market performance.

This is less relevant for the emerging countries where fiscal expansion has been more contained, and good growth dynamics should enable deficits to be filled more quickly. Indeed abundant global liquidity should enable these regions to outperform once again in at least the first part of the year.

Inflation continues to be contained at the core level, but investors should remain vigilant for signs that this may change.

2009 proved an exceptional year for the performance of riskier assets, and 2010 should prove to be a year of consolidation, with returns still reasonable but more muted than before. Yield will be a constant focus for investors as cash rates sustain their lack of competitiveness.

Mike Turner
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Economic and Market Outlook

Fiscal policy a necessary prop to G7 growth

The global economy is entering 2010 in a more upbeat fashion, especially within the less developed regions, implying better growth this calendar year. However for developed countries, the foundations for recovery are not particularly solid. Fiscal policy is still a necessary prop to promote self sustaining activity.

US

US output indicators showing renewed vigour

This is amply demonstrated by the US housing market. A big drop in November pending home sales implies that tax credits are a very important incentive to purchase despite good affordability, and these have now been extended. Prior buoyant sales benefited consumption, so if sales are boosted again consumption may recover further. So far this expenditure has thwarted firms' attempts to fully restock, leading to a renewed rise in indicators such as the Purchasing Managers Survey (ISM). In sum we feel growth may be 'stronger for longer' before moderating in H2 2010.

Europe including UK

UK consumption potentially weak in Q1

UK growth meanwhile has yet to officially emerge from recession. Anecdotal evidence suggests that retail sales over the holiday period were not as poor as feared. However the re-introduction of a higher sales tax (17.5%) in January, and the impending increase in the top rate of income tax, could still suppress growth in the first quarter. The incumbent government's decision not to tighten fiscal policy sooner is probably beneficial for growth, in what is an otherwise lacklustre environment, despite evidence of a modest revival in housing.

Euro-zone growth is set to be characterised by a stronger 'core Euro' group consisting of Germany, France, and the Netherlands, whilst the peripheral countries, such as Ireland, Greece, Spain, and even Italy may be significantly weaker. This implies a moderate recovery for 2010/11 with Euro16 growth below that of the US. Fiscal policy will be key in determining growth differentials within the currency bloc.

Japan

Excess capacity in Japan discouraging investment

It is hard to see how the Japanese economy can grow sustainably without a strong global environment in light of the strong yen, although a supplementary fiscal package will boost aggregate demand temporarily. Excess capacity is resulting in sluggish corporate investment whilst a relatively weak labour market is depressing consumption.

Asia and Emerging Economies

Within non-Japan Asia, China is set to grow faster in 2010 than in 2009 driven substantially by exports as developed countries (US) continue to re-stock. India too should experience a similar uplift. In Latin America, domestic demand should power Brazil's economy out of recession in 2010, growing at between 4% and 5%, with countries such as Chile, Peru and Argentina achieving similar results.

Commodities

Some commodity markets in contango

Energy prices continue to embody a large speculative element. Recent cold weather has pushed oil up to $82pb. Despite current excess supply in certain commodity markets, the view is that a weak dollar, and loose monetary and fiscal policies is re-flationary, will continue to drive prices higher led by precious metals. We remain wary of those markets that are in contango, particularly in energy and some base metals.

We identified that headline rates of inflation would rise in the final quarter of 2009, but that core rates would remain low or fall further. This is particularly true in the US where the rental component of inflation measures is depressing overall price indices. This should continue for some time, but we are alert to the risk that this reverses course.

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Bond Yields, Currencies and Monetary Policy

Fed exploring methods of liquidity extraction

The Federal Reserve still advocates low rates for an extended period. One significant development has been the creation of term deposits for reserves. The authorities emphasised that this was not a change in monetary policy, although the December FOMC minutes revealed suggestions that the central bank start selling (QE) assets back to the market.

Whichever route the authorities take, it seems clear that the absorption of excess liquidity will be a primary focus in any 'exit strategy'. Whether this is accompanied by an increase in the Fed funds rate is debatable.

The Bank of England is refraining from quantitatively easing beyond the £200bn set by the UK Treasury. More economic data is required to convince the Monetary Policy Committee to seek an extension to this limit. We believe the UK will be one of the last of the G7 to shift base rates.

The European Central Bank staff forecast in December projected inflation at 1.4% over the next two years and growth below trend. This implies that policy will remain unchanged for the foreseeable future if not all of 2010. However the decision to reduce one year 'repo' operations indicates that financial institutions will increasingly rely on the market rather than the authorities for liquidity, which could create funding pressures.

Yen strength an unwelcome aspect of monetary conditions

Japanese Finance Minister Kan has expressed his desire for a weaker yen, despite rebukes from PM Hatoyama. The implication is that the 0.1% policy target rate of the Bank of Japan (BOJ) is unlikely to change. Indeed the futures market is not pricing in any policy move until 2011.

Chinese monetary policy is tightening further with 3 month bill rates now four basis points higher than at the end of 2009. This move may be accompanied by guidance surrounding bank credit extension as well as an increase in reserve ratios. Elsewhere in the emerging world, Brazil may institute pre-emptive tightening, something which is reflected in the currency.

Steeper yield curve developing in government bonds

Government bond investors have greeted the new year with worries over supply and credit rating status. This is most relevant for the UK and US and some peripheral Euro-zone countries such as Greece.

Sovereign bond spreads have mostly factored in the credit deterioration but there have also been impacts on yield curves. The spread between US two and ten year notes broke above its highs in late December to reach a record. This could represent a new trend although further movement may be slow as steeper curves benefit bank balance sheets encouraging them to buy bonds. Any rise in ten year yields above 4% represents a buying opportunity.

Investors search for yield in bond markets

Within credit markets, technical factors remain influential, with the ongoing search for yield resulting in further compression between stronger and weaker credits. We are broadly positive on credit given this backdrop (lack of supply) and companies' focus on rebuilding financial strength.

There are still many risks, including the removal of market liquidity enhancing measures (the sale of credit assets) or the intermittent impact of weaker sovereigns' credit quality, such as in the case of Dubai. Nevertheless we find value in financial bonds, but within industrials remain focussed on less cyclical sectors.

We remain constructive on Emerging Market Debt but conditions may be more challenging as the focus shifts to 'exit strategies'. The region's growth outlook should be positive for risk appetite with high yield sovereigns and some smaller sovereign issuers performing well. Local currency debt will also offer some appeal, but performance here may be mixed if the US dollar remains firm.

Medium term US dollar outlook still uncertain

Closing of short dollar positions, amidst uncertainty about Greece's debt burden on the euro, bolstered the dollar at year end. A final move lower in €/$ is possible, but the medium term still beckons a weaker US currency due to its new found 'funding' status. In a similar vein sterling will suffer from the UK's anaemic recovery and uncertainty over the outcome of forthcoming elections.

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Equity and real estate

Risk appetite will be influenced by monetary policy

Progress of riskier assets in general and equities in particular this year, will be heavily influenced by the stance of monetary policy and expectations of that policy. Our base case is that policy rates amongst the major countries will be static for much of the year. The low yield of cash should therefore promote a natural attrition and movement towards higher yielding riskier assets as the year progresses.

The current competitiveness of dividend yields and the increasing certainty of dividend payments, thus affords greater attraction for stocks. This is particularly relevant as companies' free cash flow also continues to improve, prompting more merger and acquisition activity if not the return of more capital to shareholders via increased dividend payments.

The obvious question surrounding all this is the impact this may have on valuations. Whilst there is still much more uncertainty surrounding the sustainability of growth in the developed regions, and we are not starting from a particularly cheap valuation level, we don't believe that earnings multiples (PEs) will expand much in these markets. Additionally we suspect that if growth does surprise on the stronger side, it may be accompanied by worries over the withdrawal of stimulus and the tightening of short rates. Most importantly any resulting upwards movement in government bond yields in these circumstances would likely be big, dramatically improving their competitiveness and undermining the attractiveness of riskier stocks thereby limiting any revaluation.

However the better foundations of growth in Asian and emerging economies could allow a greater element of PE expansion, even though similar arguments surrounding monetary policy apply. Indeed industry surveys indicate that the strategic allocation towards these areas by western pension schemes will continue in 2010, which may be the catalyst for it. We should not be surprised if more bubbles develop, such as that which appeared in China last summer.

Decline in rents for real estate slowing

Investor sentiment in the global commercial real estate market has strengthened considerably in recent months, underpinned by a better climate in the financial markets. In the case of the UK, property values rose sharply in Q4 on intense competitive bidding by institutional, foreign and private investors as pricing has become very attractive relative to other asset classes.

Direct investment into commercial real estate in Europe during the first nine months of 2009 amounted to a still low €43bn, but we expect Q4 volumes to be the highest for the year as there is evidence of more deals being closed for good quality assets.

The prime property markets should show an ongoing recovery into 2010, but assets considered secondary in terms of both location and quality will take longer to recover from steep falls in values of the last 12-18 months. Fundamental support for the real estate market is elusive in most regions with rents still in decline and vacancy rates rising. We don't expect a turnaround in the occupier market for another 12-18 months, though declines in rents are slowing across all major economies as demand stabilises, while isolated rental increases have been recorded, such as for prime rentals in the City of London. With the development pipeline at a complete standstill (as banks withdraw funding for speculative schemes), a recovery in rental values could be sharp across many major markets.

In sum we would characterise our outlook for equities in 2010 as one of consolidation. We don't expect correlations between markets to change at all, so we continue to look towards the S&P500 as the bellwether, and we identify a broad trading range for this index of 950 to 1250 during much of the year. This scenario is one where real estate yields will become progressively more attractive as rental growth stabilises.

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