Henderson GLOBAL INVESTORS

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Economics & Strategy

Global Snapshot

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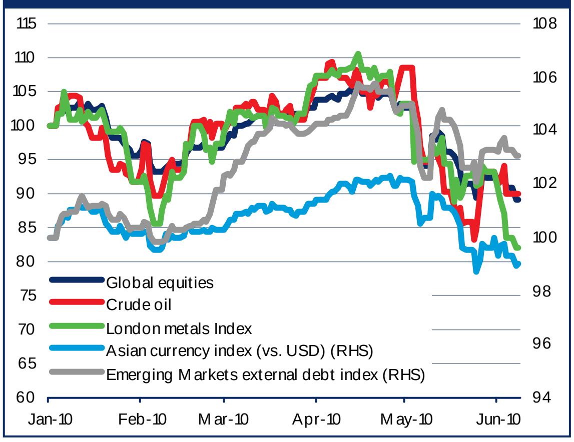
June 2010

- The global flight to quality, which began in April on the back of European sovereign default fears, gathered pace in May as the lack of coordination amongst Eurozone policymakers further unnerved investors.

- Government bonds in countries with healthy balance sheets, or those that have committed to fixing their balance sheets, rallied sharply. The trade-weighted US dollar continued to rally whilst the euro fell further due to the region's central role in the budgetary crisis. Commodity-producing and emerging market currencies were also hit hard as investors discounted a potential hit to global growth.

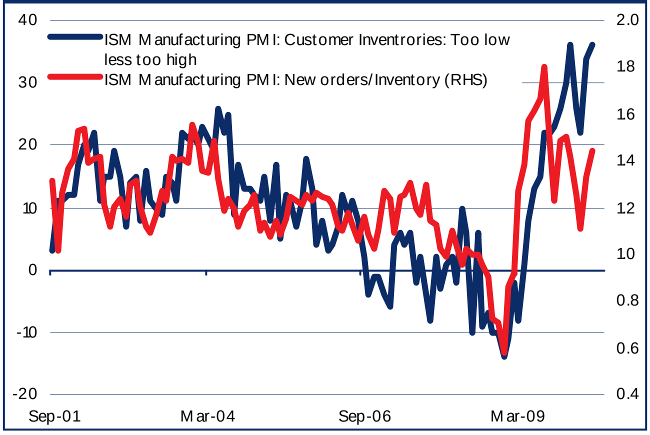
- Although economic dataflow during May remained positive, the potential for more broad-based financial market dislocation has elevated the risk to economic growth going forward. The prevailing environment presents a high level of uncertainty for risk assets in the weeks, and certainly the months, ahead.

The 'risk off' trade



Source: Bloomberg, Henderson Global Investors, as at 31 May 2010

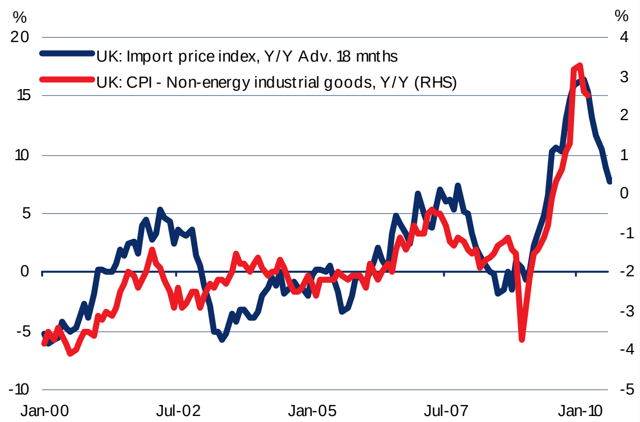
US: PMI shows consumer demand remains robust



Source: Bloomberg, latest data available as at 15 May 2010

- Leading indicators of US economic growth continue to point to solid underlying demand within the economy.
- The Institute of Supply Management's gauge on inventories suggest that they remain too low for the level of demand that end users are seeing.
- Indeed, our US payrolls model points to average private non-farm payroll gains of 440,000 per month over the next six months that should lead to continued gains in household income growth, which in turn, should help further support demand.
- However, some indicators have begun to reflect a tightening in financial conditions due to the ongoing market volatility which, if it persists or worsens, could derail the ongoing economic recovery.

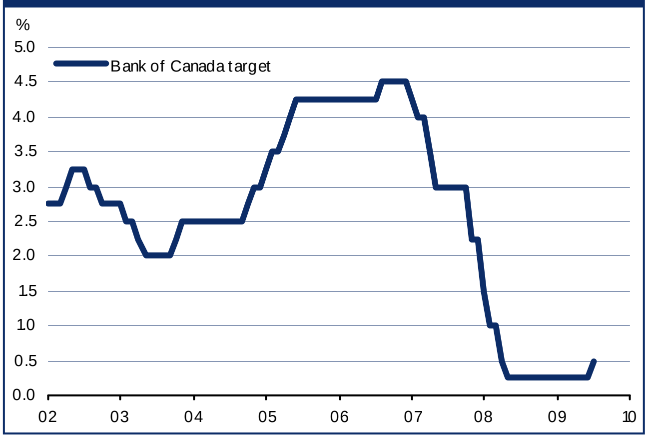
Has the UK growth/inflation trade-off worsened?



Source: Bloomberg, Henderson Global Investors, as at 15 March 2010

- Economists, analysts and even the Bank of England have consistently underestimated UK inflation for over a year.
- The predominant reason for the forecast errors has been a misjudgement of the inflationary impact of a 20% devaluation in trade-weighted sterling on final goods prices. However, recent trends in domestic service prices raise the question whether, in fact, inflation is more broad-based.
- There is no particular reason to believe that the inflation process has changed in the UK, indicating that, as inflationary pressures from sterling devaluation fade, inflation should begin to ease given the amount of excess slack which remains in the economy. However, with a recovering economy and base effects from the VAT cut unwind (on a year-on-year basis) still affecting data, inflation will remain volatile for the rest of this year.

Bank of Canada first to raise rates in G7



Source: Datastream, Henderson Global Investors, as at 6 June 2010

- The Bank of Canada (BoC) became the first G7 central bank to begin normalising interest rates as it hiked its target rate 25 basis points to 0.5% early in June.
- Canada's recession was relatively more mild than other G7 economies given lower household leverage, a sound banking system, and lack of a boom/bust cycle within the housing market.
- As a result, the significant fiscal and monetary stimulus injected into the economy at the height of the global financial crisis has resulted in a robust rebound in growth led by housing and household consumption.
- The BoC is likely to continue normalising interest rates as long as the global backdrop remains benign and the European debt crisis does not deteriorate further.

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Consensus GDP growth estimates (%)	2009	2010*	2011*
US	-2.4	3.3	3.1
Japan	-5.2	2.4	1.7
Eurozone	-4.0	1.1	1.5
UK	-4.9	1.3	2.3
G7	-3.5	2.2	2.2
Asia ex Japan	5.4	8.3	7.5
World	-2.1	3.4	3.4

Source: Consensus economics, as at 10 May 2010. GDP – Gross Domestic Product
* Forecast

- Despite continued improvement in the labour market, economic growth looks likely to ease in the second half of 2010 as global fiscal policy begins to tighten and some central banks normalise interest rates.
- Whilst a virtuous cycle of falling unemployment, rising household income and improving household demand is in train, the European fiscal crisis has the potential to derail this dynamic if it were to persist.
- Policymakers appear to be committed to avoiding such an outcome. To that end, central banks' ability to monetise government debt in a fiat money system is instrumental and is likely to occur if global deflationary pressures escalate.

Consensus inflation (CPI %)	2009	2010*	2011*
US	-0.3	2.0	1.9
Japan	-1.4	-1.0	-0.2
Eurozone	0.3	1.3	1.4
UK	2.2	2.9	1.8
G7	0.0	1.4	1.4
Asia ex Japan	1.9	4.0	3.9
World	1.4	2.7	2.7

Source: Consensus economics, as at 10 May 2010. CPI – Consumer Price Index
* Forecast

- With resource utilisation rates at very low levels and renewed commodity price weakness, developed market sequential headline inflation rates are likely to surprise to the downside in the very near term.
- Emerging market inflation rates are likely to continue to rise as those economies operate above their potential growth rates, although the recent declines in commodity prices should relieve some of the inflationary pressure.

Interest rates (%)	31 May 2010	Dec 2010*
US	0.25	0.25
Japan	0.1	0.1
Euro-area	1.0	1.0
UK	0.5	0.5

Source: Datastream, Henderson Global Investors, as at 31 May 2010
* Henderson Interest Rate Team forecast

- Eurozone, UK, and US interest rates could begin rising by the fourth quarter, although it is looking increasingly likely that rate hikes will be delayed by the ongoing European fiscal crisis and related market volatility.
- The US Federal Reserve (the Fed) will likely employ other tools – including reserve management, reverse repos, and paying interest on excess reserves – to tighten monetary policy this year and in 2011. In our view, the Federal Funds target interest rate may not be increased until the end of 2011, or possibly longer.
- A number of emerging market central banks have begun tightening monetary policy and more are expected to if Europe-related financial market dislocations do not escalate.

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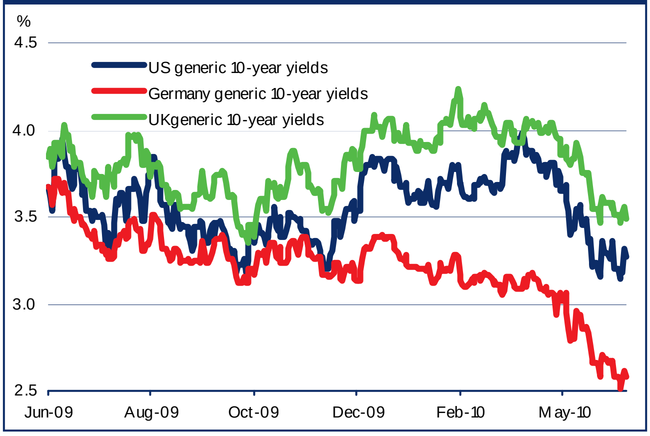
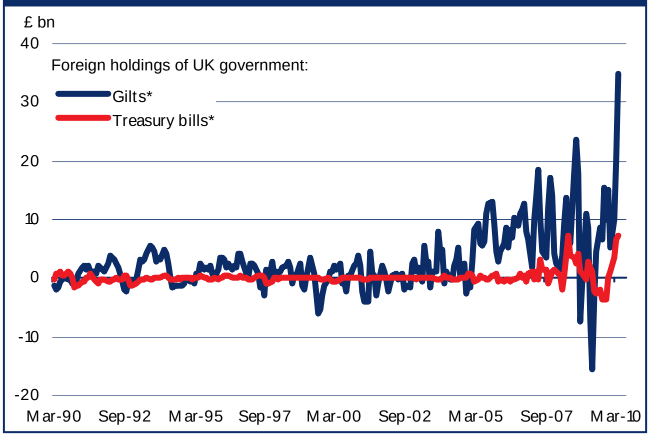
Performance divergence in government bonds



Source: Bloomberg, Henderson Global Investors, as at 31 May 2010

- Government bond performance varied widely in May. US and German government bonds, and those of developed and emerging economies with sound balance sheets rallied, whereas bonds of governments with weak balance sheets generally sold off.
- The spread between five-year and two-year yields fell (short end curves flattened) as bond investors speculated that interest rate increases would be delayed further by the ongoing financial market turbulence.
- The trade-weighted US dollar continued to rally, whilst the euro fell further on the back of the Eurozone's fiscal woes. Emerging market and commodity producers' currencies also fell as investors discounted a potential hit to growth.

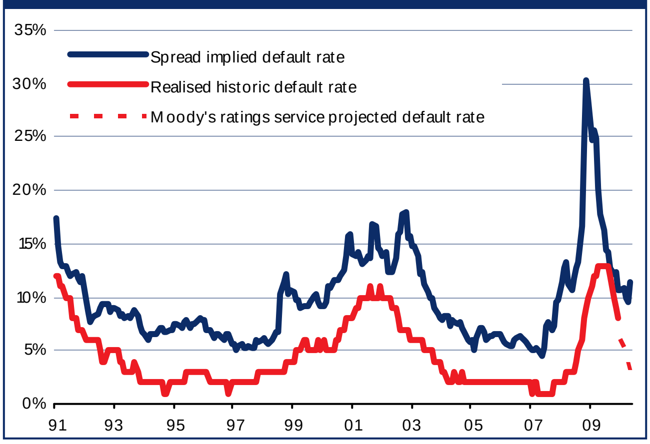
Foreigners have been supporting the gilt market



Source: Datastream, Henderson Global Investors, as at 15 April 2010
* 3m moving total

- UK government gilts performed well in May despite significant selling by UK-based institutional money managers.
- The reason for the positive performance was a strong pick-up in foreign inflows as global investors who were previously short/negative on the gilt market re-appraised their views.
- Broadly speaking, the three reasons for the re-appraisal were 1) the new UK government's seeming willingness to tackle the country's budget shortfall sooner than was expected 2) the deterioration in the UK's peers' budget/debt dynamics and 3) the 'cheap' level of sterling.
- With domestic investors caught offside by the move, gilts could continue to perform well as domestic investors continue to cover their net short position.

High yield credit still looks good value



Source: Bloomberg, Henderson Global Investors, as at 31 May 2010

- Credit spreads moved wider in May as liquidity dried up and investors were forced to mark their positions lower as a small minority of investors were forced to sell at depressed prices.
- Whilst the evolution of the sovereign budgetary crisis remains a key driver (see also *Key Issues* section), current spread levels are misaligned with underlying fundamentals.
- The developed market corporate sector has refinanced and now sits on a substantial financial surplus with the next major wave of refinancing not expected until after 2013.
- As a result, spread implied default rates – especially within high yield credit – look too elevated on even the most conservative recovery assumptions, indicating that spreads should tighten further going forward.

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Bond and currency outlook

10-year bond yields (%)	31 May 2010	2010*	2011*
US	3.29	↑↑	↑
Japan	1.27	↑	↑
Eurozone	2.66	↑↑	↑
UK	3.58	↑↑	↑

Source: Datastream, Henderson Global Investors, as at 31 May 2010
* Henderson Interest Rate Team view

- Improving economic growth, rising inflation, normalising interest rates and heavy issuance should send government bond yields higher during the second half of 2010.
- Discrepancies in government bond performance will become more pronounced going forward. In the second half of the year, we believe the bonds of those countries with strong balance sheets already in the midst of a hiking cycle (Australia, Canada, Norway) will outperform those of countries with weaker balance sheets (EU, UK, US), whose central banks will only be preparing to hike interest rates toward the end of the year.
- However, the European fiscal crisis has the potential to keep bond yields depressed and lead to core EU, UK, and US government bond outperformance if their central banks were to extend quantitative easing.

Currencies	31 May 2010	2010*	2011*
Yen/$	91.3	↑	→
$/Euro	1.23	↓	→
Euro/£	1.18	↑	↑
$/£	1.45	→	↑

Source: Datastream, Henderson Global Investors, as at 31 May 2010
* Henderson Interest Rate Team view

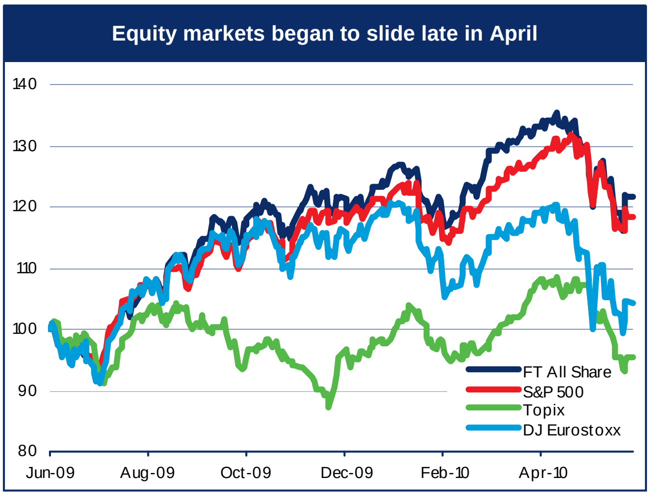
- The US dollar could continue to appreciate on the back of global risk aversion during the next few weeks, but the path of least resistance for the dollar remains down in the longer term.
- Sterling is likely to struggle against most G10 currencies until a new government puts forward a credible fiscal consolidation plan.

Emerging markets and commodities	2010*	2011*
G4/EMFX	↑	↑↑
Emerging market interest rates	↑	↑↑
Oil	↑	↑↑
Base metals	↑	↑↑
Precious metals	↑	↓↓
Agriculture	→	↑↑

Source: Datastream, Henderson Global Investors, as at 31 May 2010
* Henderson Interest Rate Team view
EMFX – Emerging Markets Foreign Currency

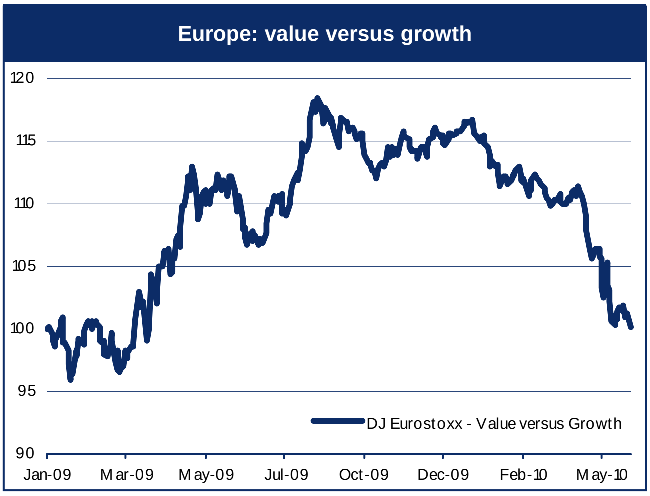
↑↑	Strong upward trend
↑	Upward trend
→	Little change
↓	Downward trend
↓↓	Strong downward trend

- Strong productivity growth, higher relative interest rates, positive demographics and, in some cases, an abundance of natural resources should ensure emerging market currency appreciation against the major, non-commodity producing developed markets.
- Gold has benefited from the spike in global risk aversion and flight to safety. However, as global liquidity is removed in the second half of 2010, gold will likely suffer.
- Oil and base metals should continue to benefit from an improving economy and tight supply conditions.
- An escalation of the Eurozone debt crisis has the potential to reverse these dynamics.



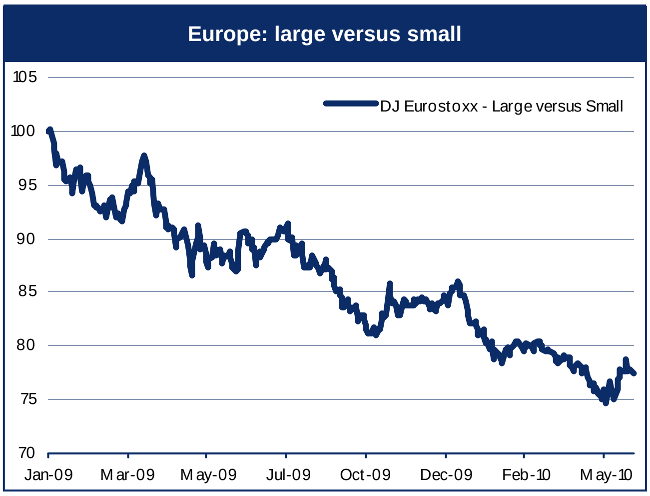
Source: Datastream, Henderson Global Investors, as at 31 May 2010

- Despite the continuation of a strong corporate results season and good economic data releases in the US and Far East, markets were preoccupied by continuing fears over the health of the Eurozone economies. The €750bn rescue package for the region could not stem the fears as markets eyed larger economies with significant budget deficits. Spain and Italy were in focus, both of whom announced strict austerity measures; however Spain was downgraded by Fitch.
- The UK market faced additional troubles following the unexpected collapse of BP's oil rig in the Gulf of Mexico, and in the US, the S&P 500 suffered its worst May return since 1962, triggered by growing fears that Europe's debt crisis and a slowing Chinese economy could place the US recovery in jeopardy.



Source: Datastream, Henderson Global Investors, as at 31 May 2010

- When equity markets enjoyed their tremendous run from March 2009, value outperformed growth by around 15% in Europe. This reflected how out of favour these value type of stocks had become in late 2008 and was also a sign that economy had started to recover.
- We have seen a shift however, as growth has dominated in 2010 so far. The outperformance of value in 2009 has more or less been wiped out in the first five months of this year.
- The elevated levels of some survey data suggests that although the economy will continue to grow, the pace of recovery may moderate, so investors have switched from value stocks to those companies that have good earnings growth potential.



Source: Datastream, Henderson Global Investors, as at 31 May 2010

- The performance differential between small and large-cap stocks in Europe in 2009 was similar – 'small' outperformed 'large' by around 15% as the signs of economic recovery drew investors back to the areas of the market that traditionally do well when the economic cycle picks up. However, unlike the value/growth relationship, smaller companies have continued to outperform their larger counterparts in 2010.
- Although investors have become nervous about sovereign risk, the underlying economy remains in reasonable health and is seeing signs of demand picking up - an environment in which small companies can still do well.

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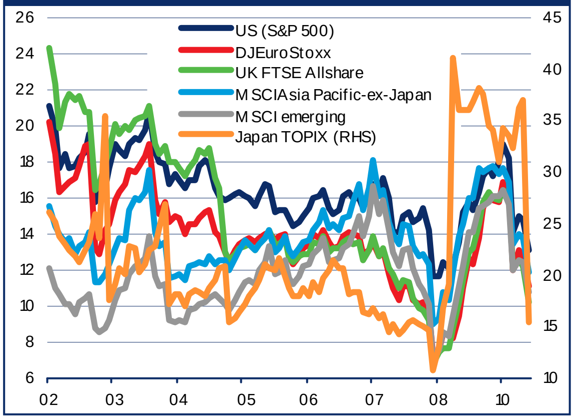
Equity outlook

Equity market levels	2010*	2011*	2012*
US	↑	↑	↑↑
Japan	↑	↑	↑
Euro-area	↑	↑	↑↑
UK	↑	↑	↑↑
Asia ex Japan	↑	↑	↑
MSCI Emerging Markets US$	↑	↑	↑

Source: Henderson Global Investors, as at 31 May 2010
* Henderson Interest Rate Team view

Price-to-forward earnings ratio



Source: Datastream, Henderson Global Investors, as at 31 May 2010

Consensus EPS growth forecast	2010	2011	2012
US	36.2	17.6	14.0
Japan	91.4	21.8	13.3
Euro-area	27.4	22.6	14.2
UK	47.2	21.3	12.4
Asia ex Japan	30.9	14.9	11.7
MSCI Emerging Markets US$	33.5	18.9	13.7

Source: Datastream, Henderson Global Investors, as at 31 May 2010
EPS – Earnings Per Share

- With 90% of S&P 500 companies having reported at the time of writing, 77% of companies had beaten their earnings estimates in the first quarter.
- Due to Japanese earnings estimate volatility, a valid growth rate for 2010 cannot be calculated.
- The rate of earnings surprises is likely to begin to fall as sequential analyst upgrades have begun to outpace sequential earnings growth.

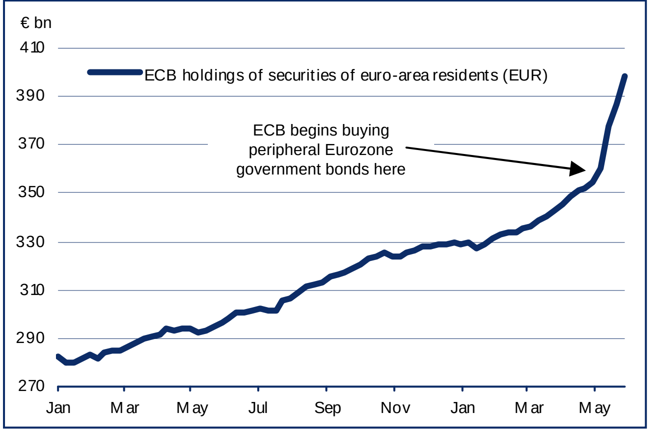
Equity market returns for May 2010 (%)	Local	Sterling	Dollar
US	-8.2	-3.6	-8.2
Japan	-10.8	-3.6	-8.3
Euro-12	-7.2	-9.8	-14.1
UK	-6.6	-6.6	-11.1
MSCI Far East ex Jap (US$)		-4.3	-8.9
MSCI Emerging Markets US$		-4.6	-9.2

Source: Bloomberg, Henderson Global Investors, as at 31 May 2010

- With resource utilisation rates beginning to bottom out, inventories at a low level, and valuations toward the bottom of their historic ranges, the prospect of multiple expansion remains.
- However, a decline in the amount of positive earnings surprises could somewhat curtail multiple expansion.

↑↑	Strong upward trend
↑	Upward trend
→	Little change
↓	Downward trend
↓↓	Strong downward trend

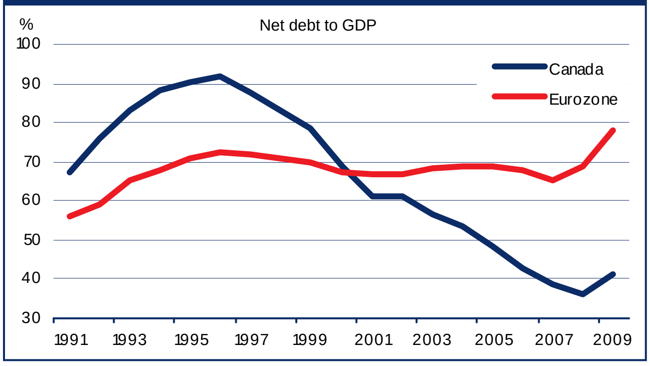
The European Union steps in



Source: Bloomberg, Henderson Global Investors, as at 28 May 2010

- Following an initial positive market reaction to the Eurozone's bailout package for the periphery, risk assets came under renewed, and more severe, selling pressure in May.
- The disorganised nature of European politicians' policy announcements (eg, the German naked short-selling ban) was a major catalyst for the renewed weakness.
- The ECB has committed to purchasing an unlimited amount of Eurozone government bonds and can continue to do so in an unsterilized fashion (quantitative easing) thereby financing governments and flooding the economy with liquidity, until reflationary forces firmly take hold.
- As such, it appears unlikely that the Eurozone will enter a deflationary spiral which – if the sell-off is sustained – is being priced in risk assets. As a result, the ongoing sell-off appears overdone and risk assets may experience a rather sharp relief rally in the near term.

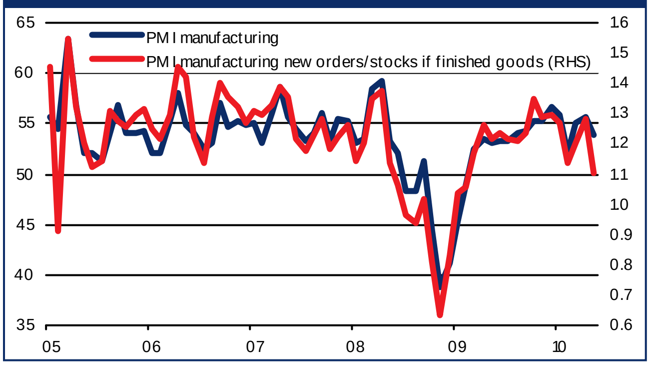
The Europeans have a lot of work to do



Source: Henderson Global Investors, as at FY2009

- The majority of the developed world's fiscal situation is unsustainable based on most measures of long-term solvency. One such measure equates long-term solvency as having a government net-debt-to-GDP ratio of 60%.
- When Canada encountered fiscal difficulties in the 1990s it used the 60% target, amongst others, as a benchmark for its fiscal consolidation. In doing so, the Canadian government cut its deficit by over 9%.
- Though a few plans are credible, most efforts by fiscally distressed countries to bring their finances in line come no where near to what is required to achieve fiscal sustainability. As such, financial markets are likely to further test the resolve of governments of the Eurozone, and eventually the US, to get their finances in order.

Chinese leading indicators rolling over?



Source: Henderson Global investors, as at 15 May 2010

- We mentioned in last month's issue of *Global Snapshot* that Chinese growth is more likely to accelerate over the next three quarters than decelerate.
- We still believe this to be the case, but signs have recently emerged that the targeted credit tightening and reserve requirement ratio hikes may be beginning to have an effect on the real economy.
- Loan growth has rolled over and some leading indicators appear to have begun to roll over. Whilst an economic hard landing is not our base case scenario, a broadening out of the slowing in LEIs (Leading Economic Indices) could present headline risk and the usual accompanying global asset price volatility