Henderson GLOBAL INVESTORS

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Economics & Strategy

Global Snapshot

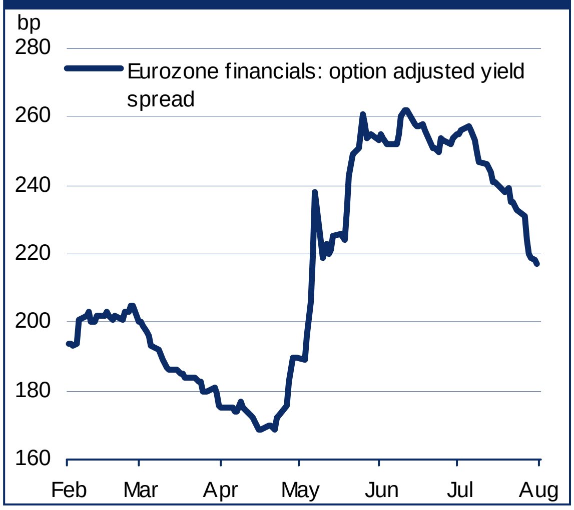
August 2010

- Positive sentiment returned to risky assets in July as corporate earnings releases and the Eurozone's bank stress tests were generally well received by investors.

- Peripheral Eurozone government bonds rallied sharply following the common currency zone's release of its bank stress test results, whilst German bunds sold off as the flight-to-quality bid reversed. The euro rallied sharply whilst the trade-weighted US dollar continued to slide in July. Generally positive risk sentiment also sent industrials, commodity prices, emerging market currencies and their external debt higher on the month.

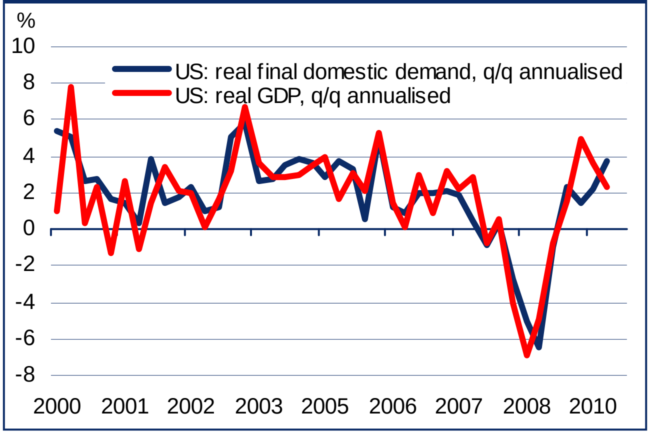
- Despite the better tone in risk assets, fears of a global slowdown continued to dominate press and financial market headlines in July. Though concerns over the sluggishness of the ongoing recovery and potential for a 'double dip' recession appear overdone, markets are likely to remain volatile over the summer months as global growth continues to downshift slightly.

Eurozone banks: not that (di)stressed



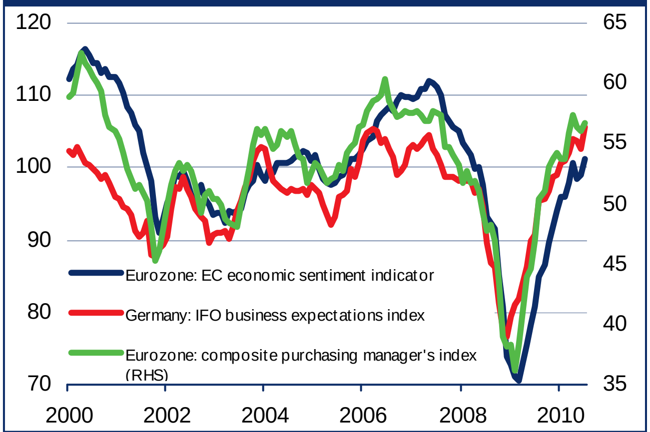
Source: Bloomberg, Henderson Global Investors, as at 31 July 2010
bp = basis points

US growth: not as bad as it seems



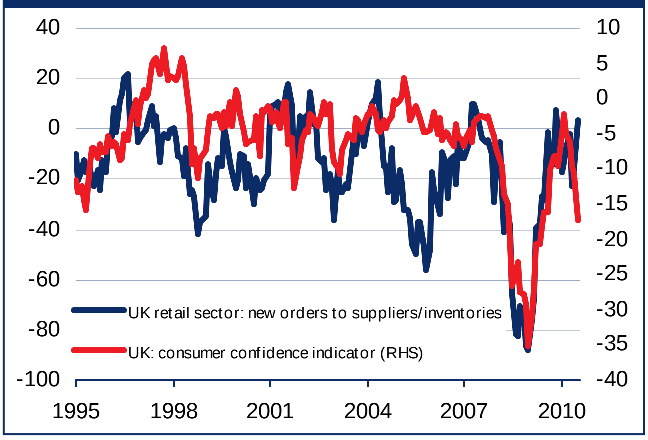
Source: Datastream, quarterly data as at Q2 2010
GDP = Gross Domestic Product

Companies remain upbeat on Eurozone economy



Source: Datastream, Henderson Global Investors, monthly data as at 15 July 2010

A divergence in UK consumer-related surveys



Source: Datastream, Henderson Global Investors, monthly data as at 15 July 2010

- The preliminary estimate of second quarter US GDP came in slightly lower than had been expected by market participants and prompted an initial negative response from risk assets.
- However, the details of the release show that the US economy appears to be shifting away from an 'inventory led' rebound to more sustainable 'growth led' by labour income growth and domestic demand.
- Though headline GDP expanded at a rather meek 2.4% annualised rate, domestic demand grew at a fairly robust 3.8% annualised rate. Labour income growth was also a fairly brisk 3.4% (annual rate) during the second quarter, a sizeable improvement on Q1's 1.2% pace.
- With most corporate surveys pointing to a continued labour market improvement, domestic demand should continue to expand at a healthy pace, which should be supportive for risk assets.

- Despite the recent high level of uncertainty surrounding European government finances and financial institutions' solvency, surveys show that business and consumer confidence in the Eurozone have increased in the intervening time period.

- The European Commission's surveys on business and consumer confidence, Germany's IFO survey, and the composite Purchasing Managers' Index all came in better than analysts had been expecting in July.

- Part of the strength can be attributed to the boost that Eurozone industries have received from a weaker euro, but the survey data also confirms that domestic demand appears to be gaining some traction.

- A number of UK consumer surveys have softened in recent months prompting concerns that the tepid recovery in UK household consumption has run its course and consumption could weaken again.
- However, most of the surveys that have weakened, such as the British Retail Consortium (BRC), Nationwide and European Commission indicators, do not exhibit consistent relationships with actual consumption spending as measured by national accounts data.
- One of the better indicators of UK consumption, the European Commission's survey of UK retailers opinions on orders and stock levels, has actually picked up in recent months and is pointing to annualised consumption growth of around 2-3% over the next two-to-three quarters.

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Consensus GDP growth estimates (%)	2009	2010*	2011*
US	-2.4	3.1	3.0
Japan	-5.3	3.2	1.6
Eurozone	-4.1	1.1	1.4
UK	-4.9	1.3	2.1
G7	-3.6	2.2	2.1
Asia ex Japan	5.7	8.5	7.5
World	-2.1	3.5	3.3

Source: Consensus economics, as at 12 July 2010. * Forecast
GDP – Gross Domestic Product

- Despite continued improvement in the labour market, economic growth has begun to ease. Going forward, growth is likely to ease further in the second half of 2010 as global fiscal policy tightens and some central banks normalise interest rates.
- Whilst a 'virtuous cycle' of falling unemployment, rising household income and improving household demand has begun, ongoing government and household sector deleveraging will likely subdue growth for the rest of 2010.
- Emerging market growth will probably downshift slightly, but global growth is likely to remain above trend for the rest of this year.

Consensus inflation (CPI %)	2009	2010*	2011*
US	-0.3	1.7	1.5
Japan	-1.4	-1.0	-0.2
Eurozone	0.3	1.5	1.5
UK	2.2	3.0	2.3
G7	0.0	1.4	1.3
Asia ex Japan	2.0	3.9	3.8
World	1.4	2.7	2.6

Source: Consensus economics, as at 12 July 2010. * Forecast
CPI – Consumer Price Index

- Given the recent strength in global commodity prices, headline inflation rates could surprise to the upside in the very near term.
- Though resource utilisation rates have bottomed, the still significant amount of slack within developed economies should continue to exert downward pressure on core inflation rates.
- Emerging market inflation rates are likely to continue to rise as those economies operate above their potential growth rates.

Interest rates (%)	31 July 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 July 2010
* Henderson Interest Rate Team forecast

- It is looking increasingly likely that interest rate hikes will be delayed until the first quarter of 2011 as a result of the broadening out in global government fiscal consolidation plans.
- The US Federal Reserve (the Fed) will probably employ other tools – including reserve management, reverse repos, and paying interest on excess reserves – to tighten monetary policy 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, given building inflationary pressures.

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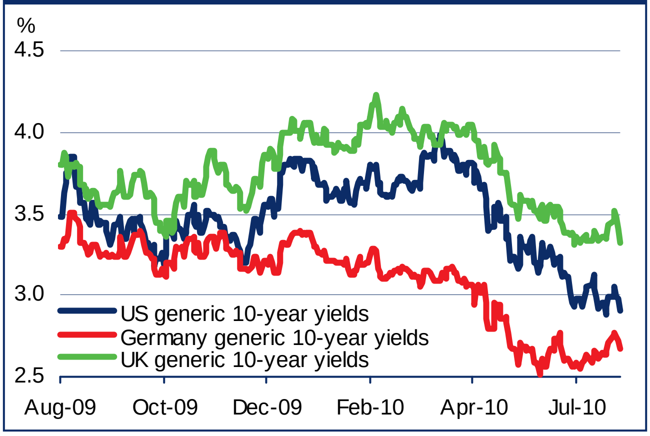
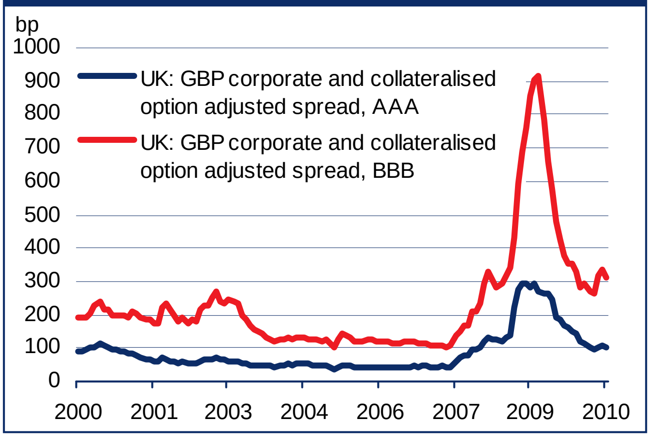
Government bonds trade in a fairly wide range



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

- Government bonds traded in a fairly wide 20 basis point range in July, initially selling off on the back of the Eurozone's bank stress test results before rallying on mixed US and Chinese economic data releases. Germany was the only one of the big markets to decline on the month (10-year yield +9bp) as the flight-to-quality trade reversed, whilst each of the UK, US and Japanese bond markets finished marginally higher on the month (10-year yields -2 to -3bp).
- The US dollar slid whilst the euro rallied against most currencies following an unwind in some sizable short positions and a return of better sentiment toward the common currency zone. Emerging market external bonds and currencies, and corporate credit also benefited from better risk sentiment.

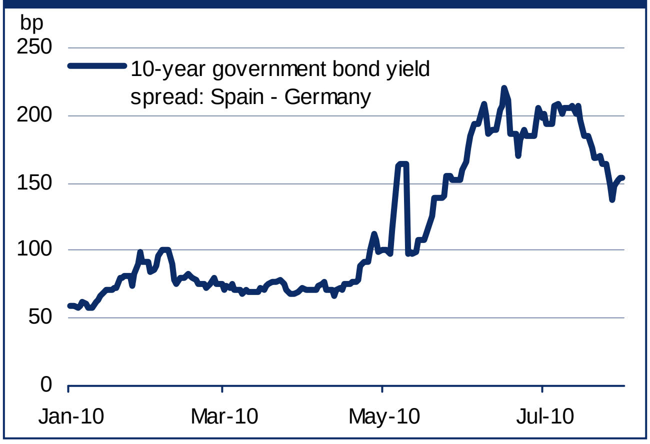
There's still value in UK investment grade credit



Source: Bloomberg, Henderson Global Investors, monthly data as at 31 July 2010

- Despite the recent run-up in inflation, the Bank of England continues to sound rather dovish as it attributes the inflation overshoot to 'temporary factors' and remains worried about downside risks to growth.
- Concurrently, indicators of economic growth, and indeed national accounts data itself, show that the economy continues to recover nicely.
- The combination of improving economic growth and a dovish central bank should be bullish for risk assets.
- To that end, there are sectors for the UK credit market that offer good value. Specifically, spreads on lower rated UK investment grade credit (BBB) still seem too high and should continue to benefit (compress) from the aforementioned environment.

Eurozone peripherals outperform following the stress tests



Source: Bloomberg, Henderson Global Investors, daily data as at 31 July 2010

- Global risk assets rallied following the Eurozone's announcement of its bank stress test results.
- In general, investors agreed that the stress tests were not stringent enough, but were comforted by the significant disclosure of individual banks' holdings of sovereign debt which, in turn, allowed analysts to perform their own 'stress tests'.
- With increased transparency on banks' balance sheets, fiscally distressed countries continuing to consolidate their finances, a Eurozone sovereign rescue fund in place if it is needed, loose monetary policy and a recovering economy, Eurozone risk assets should continue to recover. Implicit in this is a narrowing in Eurozone peripheral sovereign yield spreads to the core markets, through a fall in peripheral yields (as the risk premium recedes) and a rise in core yields (as the 'flight to quality' bid unwinds).

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Bond and currency outlook

10-year bond yields (%)	31 July 2010	2010*	2011*
US	2.93	↑	↑↑
Japan	1.09	↑	↑
Eurozone	2.58	↑	↑↑
UK	3.36	↑	↑↑

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

- Mixed macroeconomic data, ongoing government fiscal consolidation, low inflation and developed market interest rates, which will probably remain on hold until 2011, are likely to keep government bonds range-bound, with a weakening bias for the rest of this year.
- Core Eurozone government bonds are likely to continue to underperform their non-Eurozone peers as the flight-to-quality trade is unwound. Conversely, peripheral Eurozone government bonds should outperform the core in the near term as some further risk premium is removed from the yield spread.

Currencies	31 July 2010	2010*	2011*
Yen/$	86.5	↑	→
$/Euro	1.31	↓	→
Euro/£	1.20	↑	↑
$/£	1.57	↑	↑

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

- The US dollar is likely to continue to decline unless risk aversion flares up again.
- Sterling remains cheap and is likely to continue to rally as international investor confidence returns following the government's announcement of an aggressive fiscal consolidation plan.

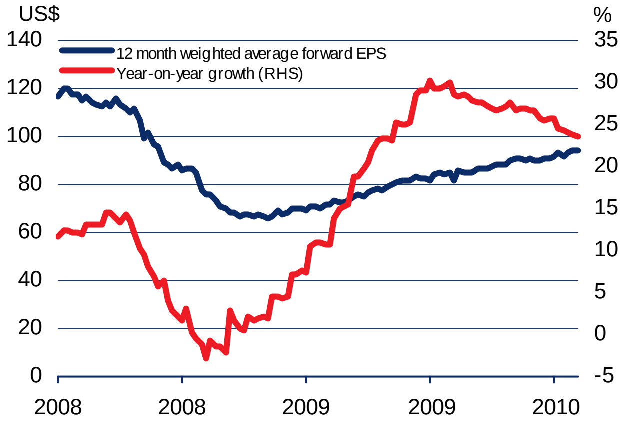
Emerging markets and commodities	2010*	2011*
G4/EMFX	↑	↑↑
Emerging market interest rates	↑	↑↑
Oil	↑	↑↑
Base metals	↑	↑↑
Precious metals	↑	↓↓
Agriculture	→	↑↑

Source: Datastream, Henderson Global Investors, as at 31 July 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 positive global growth and tight supply conditions.

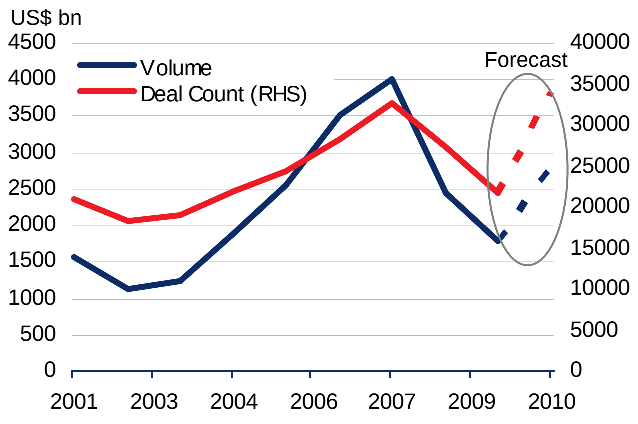
Global earnings growth is high but slowing



Source: Datastream, Henderson Global Investors, weekly data as at 2 August 2010 MSCI World Index, EPS = earnings per share, measured in US dollars

- One of the issues troubling equity markets has been the outlook for corporate earnings. As economic momentum has slowed, rhetoric about the likelihood of a 'double-dip' has increased and analysts have started to revise their forecasts downwards. Although year-on-year earnings growth expectations remain high, they have declined from their peak and broker downgrades are now exceeding upgrades.
- However, the current second quarter reporting season has surprised on the upside. So far, out of the 400 or so US companies that have reported, 78% have exceeded expectations. In turn, this has provided momentum to markets in July with the MSCI World gaining over 8% in US dollars terms.

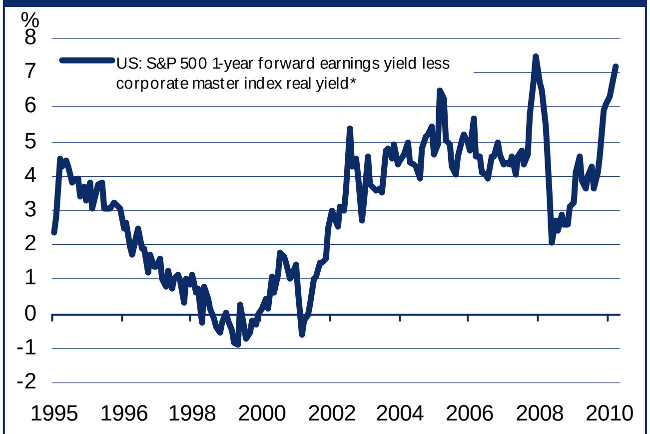
Global M&A activity expected to increase



Source: Bloomberg, Henderson Global Investors, annual data as at 31 December 2010. Forecast for 2010 based on year-to-end July figures, annualised

- Another sign that corporates are in good health is the noticeable pick-up in merger and acquisition (M&A) activity seen this year. After focusing on rebuilding their balance sheets in 2009, corporates are now sitting on high levels of cash, which we expect to either be used for capital expenditure or acquisitions.
- In the UK, Arriva, Chloride, Dimension Data and Tomkins, amongst others, have all been bid targets whilst Newscorp has announced its intention to buy the 61% of BSkyB it doesn't already own and Reckitt Benckiser has made a cash offer for SSL.

Equities are cheap



Source: Merrill Lynch, Henderson Global Investors, monthly data as at 1 July 2010. *Deflated by University of Michigan survey one-year forward mean expected inflation

- After the strong rebound seen in equity markets during July, can markets make further progress from here despite the uncertain macroeconomic environment? We think they can.
- The reason for this is that valuations do not look stretched, especially relative to bonds. The chart on the left shows that the US equity risk premium remains elevated and towards its recent highs.
- We believe the contrast between sluggish US economic growth and strong profit growth reflects three things: i) productivity gains; ii) lower wage growth; and iii) emerging market growth. Unit labour costs in the US manufacturing sector have fallen sharply and this has been extremely positive for profits.

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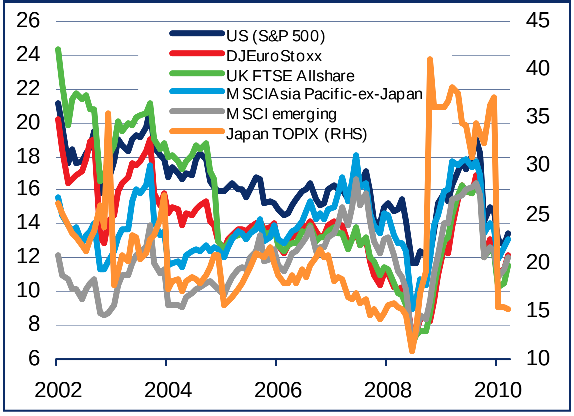
Equity outlook

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 July 2010
* Henderson Interest Rate Team view

Price-to-forward earnings ratio



Source: Datastream, Henderson Global Investors, monthly data as at 31 July 2010

Consensus EPS growth forecast	2010	2011	2012
US	38.3	15.4	14.2
Japan	89.7	22.0	14.2
Euro-area	33.2	19.8	14.5
UK	47.2	19.9	12.9
Asia ex Japan	31.2	14.2	11.6
MSCI Emerging Markets US$	33.0	18.3	14.8

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

- As long as the economy continues to expand, albeit at a slower rate, companies should be able to continue to grow their earnings in 2010.
- Forecast earnings growth rates for 2010 look high. This is partially due to base effects: earnings were so depressed in 2009 that small improvements can look dramatic in year-on-year terms.
- However, analysts may still be too optimistic given slowing economic momentum. And although earnings growth is likely to be strong, the rate of positive earnings surprises is likely to begin to fall.

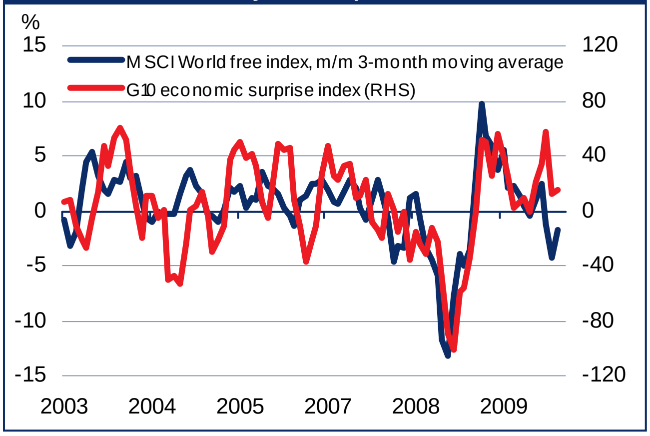
Equity market returns for July 2010 (%)	Local	Sterling	Dollar
US	6.9	1.8	6.9
Japan	1.0	-1.6	3.2
Euro-12	6.2	7.9	13.3
UK	6.8	6.8	12.1
MSCI Far East ex Jap (US$)		1.0	6.0
MSCI Emerging Markets US$		2.9	8.0

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

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

- With resource utilisation rates beginning to bottom out and unchallenging valuations, equities should be able to make some headway in coming months.
- However, a slowdown in the amount of positive earnings surprises and the expectation of more mixed economic data going forward is likely to lead to a more range-bound equity trading environment in the short term.

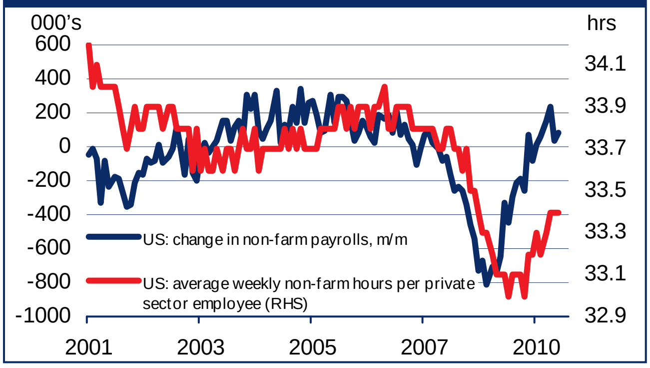
Government bond markets continue to be driven by data surprises



Source: Datastream, Bloomberg, Henderson Global Investors, monthly data as at 15 July 2010

- With the latest crisis over European peripherals and banks (seemingly) averted, markets are likely to turn to ongoing dataflow and macroeconomic policy changes for direction.
- To that end, the picture looks mixed. On the one hand, the expected easing in restocking is likely to lead to a number of months of softer data and negative surprises, which would be bad for risk assets and positive for government bonds.
- On the other hand, policymakers appear ready to counter any data weakness with dovish language and a further expansion in central bank balance sheets, if needed.
- The net result will likely mean that most asset classes remain broadly range bound, and rather volatile until investors are convinced that a more sustainable growth cycle is taking hold.

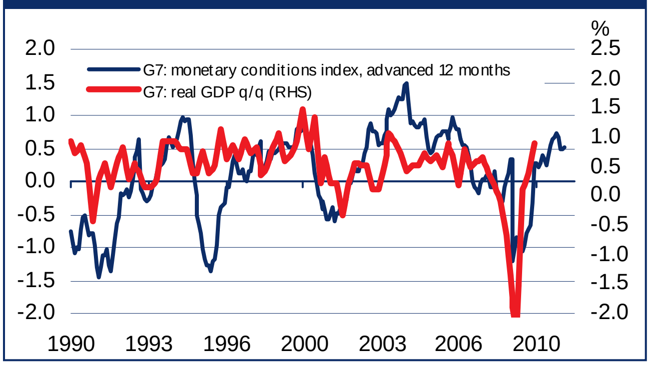
Continued improvement in labour market is key



Source: Datastream, Henderson Global Investors, monthly data as at 15 June 2010

- For a more sustainable growth cycle to take hold, job creation and labour income growth must continue to improve. To that end, leading and coincidental data suggest that this should be the case going forward.
- Our US payrolls model suggests average monthly payroll gains of 450,000 but these are likely to be closer to 150,000 to 175,000 in reality (as various adjustments are often revised in aggregate toward year end that should see the actual yearly aggregate move closer to our model).
- Additionally, a number of other developed and emerging economies' labour markets are in various stages of recovery.

Central banks can expand liquidity conditions further



Source: Datastream, Henderson Global investors, monthly data as at 31 March 2010

- Many pundits, economists and other market participants have recently stated that global central banks have run out of 'ammunition' to guard against a renewed slowdown. This view appears to be flawed.
- Financial markets continue to react to central banker's language and signalling, indicating that monetary policymakers still possess the ability to augment market expectations and behaviour – a very important aspect of setting monetary policy. In the case of Japan however, the Bank of Japan lost this ability two decades ago.
- Furthermore, central banks are able to further expand their balance sheets, including, in the Fed's case, directly lending to private companies, which, remains a powerful tool in the face of a potential deflationary shock. Thus, if a slowing in growth is on the cards, central banks should be able to set policy to accommodate this and avoid a second recession.