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Investment Strategy

September 2010

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Economic and market commentary

Economic data released over the past month has reinforced our below consensus growth forecast for the United States. Unemployment remains disappointingly high, the housing market is still weak, consumers continue to deleverage and business investment is being held back by economic uncertainty. We have, however, seen stronger than expected Q2 GDP numbers from Germany, leading us to increase our European growth estimates for this year. German growth was surprisingly well balanced between exports, capital investment and domestic consumption. Strength in core-Europe will be clearly positive for the region despite continued weakness in the periphery. In the UK, Q2 GDP numbers were also better than anticipated, but we are still concerned as to the impact of the fiscal austerity measures due to be announced in Q3. Public sector cuts will have an inevitable impact on unemployment, consumer spending, and the revenues of domestically-oriented companies.

In all, we still think we will see a prolonged period of low growth in developed economies, but see little chance of a significant "double dip" in economic activity. Should US economic data continue to be weak the US Federal Reserve will almost certainly take additional policy action before the end of the year. Further substantive quantitative easing should be helpful for risk asset prices. Many companies have held back on both hiring and investment and at some point in the near future will need to loosen the purse strings. Emerging market countries – now approximately half of the world economy – continue to grow strongly and are less dependent than previously on exports.

Looking forwards, we think that dividend yields will become increasingly important, as low economic growth sends investors in search of reliable income. We have seen strong performance year to date from corporate, high yield and emerging market bonds which has primarily been driven by the sharp decline in government bond yields. In many equity markets, an increasing number of companies now yield more than local corporate bonds. Equally, in the face of economic uncertainty companies with strong cash flows and good capital deployment should perform well. We are already seeing an up-tick in mergers and acquisitions which should be supportive of returns. M&A will also be essential in allowing some industries to reduce capacity and improve utilisation.

Over the last month, confidence and risk appetite have taken a knock with all major equity markets taking a step down in the face of weaker US economic data. Although there are areas where earnings expectations are probably still too high, valuations are modest and dividend yields supportive. We would look to add to existing positions on any further weakness.

Economic forecasts

US

	2008	2009	Current	(T) End 2010	(Cons) End 2010	(T) End 2011	(Cons) End 2011
GDP (year/year)	0.4	-2.4		**2.5 ↓**	2.9	**2.0**	2.8
Headline Inflation (year end)	0.1	2.7	**1.2**	**1.0**	1.2	**2.0**	2.0
Core Inflation (year end)	1.8	1.8	**0.9**	**1.0**		**1.5**	
Official Rates[1] (year end)	0.25	0.25	**0.25**	**0.25**	0.25	**0.25**	0.70
10-year bond yield	2.21	3.84	**2.50**	**2.75 ↓**	3.3/4.5[2]		3.9/4.5[2]
EUR/USD (year end)	1.40	1.43	**1.27**	**1.13-1.23**	1.20		1.20
USD/JPY (year end)	91	93	**85**	**85-98**	93		97

Updated 25 August

Notes: (T) = Threadneedle forecast, (cons) = consensus forecast, [1]consensus = derived from market expectations, [2]first bond yield consensus number represents economists' views, second represents TAM's measure of 'Fair Value'.

Changes to Threadneedle forecasts: 2010 GDP changed from 2.7% to 2.5%. 2010 10-year bond yield changed to 2.75% from 3.5%.

Slip sliding away...

Revisions to GDP data for last year and this Q1 have given us a more sensible makeup of growth. We were scratching our heads to understand where the strength in consumption was coming from, and why the stimulus package was not boosting government spending. The revised data reverses the inputs and confirms our view from late last year. Consumption has actually been 1% lower over the 12 months to the end of June. Government spending has been significantly higher. The stimulus will start to work as a drag, as most data is pointing to slower growth still going forward. Our forecast for 1% through the remainder of the year is still lower than consensus, but for how long? We must also recognise that when the economy is so close to stalling, a negative quarter becomes more likely.

Growth forecasts for 2011 are edging to our 2% call. At this stage, we would be inclined to edge our forecast lower still, but for our growing confidence that further stimulus measures will be implemented, both monetary and (hopefully) fiscally. One may not produce the desired result without the other. Another round of QE from the Fed looks a near certainty, and we would favour a 'sledge hammer' approach in the $2trn range, or a doubling of the balance sheet, concentrating the action in longer-dated Treasuries. (A weaker dollar would be a by-product of the programme). This action, coupled with a dramatic move to aid struggling home owners (possibly through mass refinancing), will give the economy another shot in the arm. Neither will be a quick fix to a long-term problem, but we hope they will reduce the chance of further deterioration.

Economic forecasts

Euro Area

	2008	2009	Current	(T) End 2010	(Cons) End 2010	(T) End 2011	(Cons) End 2011
GDP (year/year)	0.55	-4.0		**1.5** ↑	1.2	**1.5** ↑	1.4
Headline Inflation (year end)	1.6	0.9	**1.4**	**1.0**	1.6	**1.0**	1.5
Official Rates[1] (year end)	2.5	1.0	**1.0**	**1.0**	1.0	**1.0**	1.2
10-year bond yield	2.95	3.39	**2.19**	**2.50** ↓	3.0/4.0[2]		3.3/4.0[2]
EUR/USD (year end)	1.40	1.43	**1.27**	**1.13-1.23**	1.20		1.20
EUR/JPY (year end)	127	134	**107**	**110-140**	112		116

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Notes: (T) = Threadneedle forecast, (cons) = consensus forecast, [1]consensus = derived from market expectations, [2]first bond yield consensus number represents economists' views, second represents TAM's measure of 'Fair Value'.

Changes to Threadneedle forecasts: 2010 and 2011 GDP changed from 1.0% to 1.5%. 2010 10-year bond yield reduced to 2.5% from 3.0%.

The strong prosper while others struggle

Our growth forecast for Europe has been upgraded, primarily off the back of extremely robust German GDP. What initially looked to be an export story, now appears to be a well-balanced expansion, with capital investment and domestic consumption playing a larger role than many expected. While the strength of Q2 may be a tall order to repeat, momentum into Q3 means that we now see 1.5% growth this year and next.

Germany will remain the powerhouse, while most of the PIIGS will continue to struggle under austerity measures. For nations such as Greece, this imposes very clear hardships on the population and the immediate concern is for social and political stability. The divergence between the strong and the weak will increase, but some of the prosperity of Germany will trickle down to other countries. The ECB will continue to hold rates low, while intervening in the peripheral bond markets as and when it feels required.

Economic forecasts

Japan

	2008	2009	Current	(T) End 2010	(Cons) End 2010	(T) End 2011	(Cons) End 2011
GDP (year/year)	-1.2	-5.2		**2.75 ↑**	3.2	**1.0 ↓**	1.5
Headline Inflation (year end)	0.4	-1.7	**-0.9**	**-0.5**	-0.5		-0.1
Official Rates[1] (year end)	0.1	0.1	**0.1**	**0.1**	0.1		0.1
10-year bond yield	1.17	1.30	**1.06**	**1.2**	1.2/2.0[2]		1.4/2.0[2]
USD/JPY (year end)	91	93	**88**	**85-98**	93		97
EUR/JPY (year end)	127	134	**114**	**110-140**	112		116

Updated 25 August

Notes: (T) = Threadneedle forecast, (cons) = consensus forecast, [1]consensus = derived from market expectations, [2]first bond yield consensus number represents economists' views, second represents TAM's measure of 'Fair Value'.

Changes to Threadneedle forecasts: 2010 GDP changed from 2.0% to 2.75%. 2011 GDP changed from 1.5% to 1.0%.

The Land of Deflation

Given the growth momentum in Asia, Japan is well placed to meet some of this demand irrespective of the fact that the yen looks uncomfortably strong from an export perspective. However, we note that China's abandonment of a dollar peg in favour of a flexible exchange rate policy, did not do much to weaken the yen. The deflationary forces present in the economy remain very strong.

Looking further ahead, we reiterate our view that Japan is mired in long-term structural problems: ageing demographics; falling household savings; and a colossal amount of outstanding public debt. Recent policy discussion from the government has ignited consideration of an inflation target but understandably the BoJ is reluctant to engage in expansionary policy when fiscal policy is so loose. Furthermore, the risk to the Japanese government bond market of such a policy would be considerable if yields had to rise to compensate investors for higher inflation expectations – refinancing costs on the government debt stock could increase materially. With these policy challenges, and a lack of genuine free market capitalism that contrasts with the way companies merge and reform in the west, things point towards an in-built sclerosis. At least the improvement in the economic performance of the Asian region has bought Japan a bit of time.

Economic forecasts

UK

	2008	2009	Current	(T) End 2010	(Cons) End 2010	(T) End 2011	(Cons) End 2011
GDP (year/year)	0.6	-5.0		**1.25 ↑**	1.5	**1.25**	2.0
Headline Inflation (year end)	3.1	2.9	**3.1**	**2.5**	2.6	**2.0**	2.3
Official Rates[1] (year end)	2.0	0.5	**0.5**	**0.5**	0.5	**0.5**	1.25
10-year bond yield	3.02	4.02	**2.85**	**3.0 ↓**	3.6/4.5[2]		3.9/4.5[2]
USD/GBP (year end)	1.45	1.61	**1.54**	**1.50-1.70**	1.46		1.49
EUR/GBP (year end)	0.96	0.89	**0.82**	**0.80-0.95**	0.82		0.81

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Changes to Threadneedle forecasts: 2010 GDP changed from 1.0% to 1.25%. 2010 10-year bond yield reduced to 3.0% from 3.5%.

Those were the days...

With GDP for Q2 confirmed at 1.1%, we have marked our 2010 growth forecast up to 1.25%. We are comfortable to remain at 1.25% for next year. The effect of Britain's new course of fiscal austerity is yet to be felt and requires 80% of the tightening to be found from lower spending. Achieving this will be very difficult and implies massive budget deflation for most government departments, especially as the National Health Service is being ring-fenced.

At least a public sector wage freeze is not as draconian as the outright cuts being seen in countries like Spain and Greece. Our concern must be that unemployment will be very slow to fall as the public sector sheds jobs to balance the budget whilst the private sector can only grow slowly. Large headwinds exist for the consumer – including a VAT hike to 20%.

On balance, the gilt market looks safer than it did before the election but investors will be looking for those PSNCR numbers to prove the government's plans; we have lowered our end 2010 forecast for gilt yields to 3.0%. And overall we think we are right to maintain a lower growth projection for the UK than that of the government or, come to that, the new Office for Budget Responsibility.

Economic forecasts

Far East

	GDP yoy						Inflation					
	2008	2009	2010 (T)	2010 (cons)	2011 (T)	2010 (cons)	2008	2009	2010 (T)	2010 (cons)	2011 (T)	2011 (cons)
China	9.0	9.1	**9.9↓**	9.9	**9.0↓**	9.0	5.9	-0.7	**2.9↓**	2.9	**3.0↓**	3.0
Hong Kong	2.7	-2.8	**5.6↑**	5.6	**4.6↑**	4.6	4.3	0.6	**2.6↑**	2.6	**2.9↓**	2.9
India*	6.6	7.4	**8.4↑**	8.4	**8.4↑**	8.4	8.1	12.4	**9.6↑**	9.6	**7.3↑**	7.3
Taiwan	1.2	-1.9	**6.8↑**	6.8	**4.3↓**	4.3	3.5	-0.9	**1.3↓**	1.3	**1.7↓**	1.7
Korea	2.5	0.2	**6.0↑**	6.0	**4.3**	4.3	4.7	2.8	**2.9**	2.9	**3.1↓**	3.1
Australia	2.2	1.3	**3.0↓**	3.0	**3.4**	3.4	4.4	1.8	**3.0↑**	3.0	**3.0↑**	3.0

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Notes: (T) = Threadneedle Forecasts (cons) = Consensus Forecasts * = Fiscal Year.

Changes to Threadneedle forecasts: In line with consensus.

Off the brake

Chinese growth has slowed a little and we think the authorities will be pleased. Indeed, there is talk that the recent period of policy tightening is now drawing to a close. This will be good news for global growth especially as China is clearly pursuing policies aimed at improving the flexibility of the RMB – via Hong Kong money markets RMB usage for general clearing and transactions is rising sharply. Ultimately, a convertible yuan will address global macro imbalances and mark the fact that the G7 share of global GDP is set to fall below 50%.

Overall growth rates across the Asian region are robust and we have no reason to disagree as the medium to long-term growth drivers in this region have much more potential than in the debt-burdened west. We note that intra-region trade stimulated by China is also having an important positive effect on countries like Korea, Taiwan and Singapore. Indeed, our optimism now extends into 2011 where we expect the domestic resilience of these economies to be underpinned.

Economic forecasts

Emerging Markets

	GDP yoy						Inflation					
	2008	2009	2010 (T)	2010 (cons)	2011 (T)	2011 (cons)	2008	2009	2010 (T)	2010 (cons)	2011 (T)	2011 (cons)
Brazil	5.1	-0.1	**7.5**	6.5	**4.5↑**	4.5	5.7	4.9	**5.2↓**	5.5	**4.5**	4.6
Mexico	1.5	-6.5	**4.4↓**	4.6	**3.5**	3.6	5.1	5.3	**5.1↑**	4.5	**4.0**	3.9
Russia	5.6	-7.9	**4.7↓**	4.0	**4.9↓**	4.5	14.1	11.8	**7.0↓**	6.5	**7.0**	7.3
South Africa	3.7	-1.8	**3.0**	3.1	**3.5**	3.6	11.5	7.1	**5.0↓**	5.4	**5.7**	5.8
Turkey	1.2	-5.8	**5.7↑**	6.4	**4.0↓**	4.3	10.4	14.1	**7.5↑**	8.0	**6.4**	6.8

Updated 25 August

Notes: (T) = Threadneedle Forecasts (cons) = Consensus Forecasts.

Changes to Threadneedle forecasts: A number of revisions to growth and inflation forecasts.

Adjusting expectations

Growth consensus forecasts continue to be revised up across much of the emerging market region. These adjustments are mostly reflective of a stronger than expected first half and merely bring consensus closer to our expectations.

Activity data is beginning to show a clear deceleration and forward-looking indicators across the region have been generally softer in July. This is consistent with the peak in the manufacturing cycle and prospects of weaker global growth in the second half of 2010. Although we expect growth in emerging markets to slow down in the second half, we expect it to remain on a strong footing in the medium term. Robust domestic demand and improving employment should help shift growth dynamics away from purely export-driven growth.

Global uncertainty is allowing many central banks to go easy on normalisation, keeping real rates much below pre-crises levels. Countries that are more exposed to external demand, such as Mexico or those in CEEMEA (Central and Eastern Europe, Middle East and Africa), are able to push normalisation further into the future. Even economies that have seen strong growth such as Brazil have become less aggressive with respect to policy tightening in response to a deceleration of activity data and softer inflation prints. This should be supportive for domestic growth and provide a cushion, should global growth decelerate more rapidly than expected.

Sector views

June 2010	July 2010	August 2010
Overweight	***Overweight***	***Overweight***
Healthcare	Healthcare	Healthcare
IT: Software	IT: Software	IT: Software
IT: Hardware	IT: Hardware	IT: Hardware
Insurance	Insurance	Insurance
Industrials	Industrials	Industrials
Minerals	Minerals	Minerals
Neutral	***Neutral***	***Neutral***
Media	Media	Media
Energy	Energy	Energy
Telecoms	Telecoms	Telecoms
Basic Industries	Basic Industries	Basic Industries
Consumer Staples	Consumer Staples	Consumer Staples
Autos	Autos	Autos
Financials	Financials	Financials
Retail	Retail	Retail
Underweight	***Underweight***	***Underweight***
Utilities	Utilities	Utilities

"No changes in sector views"

Asset allocation

	Equities Overweight	**Bonds** Overweight	**Property** Neutral	**Cash** Underweight
Overweight	US Asia (ex Japan) Latin America	High Yield Emerging Market Investment Grade Corporate		
Neutral	UK Europe		UK Property	
Underweight	Japan	Government		Cash

↑ and ↓ arrows indicate changes since last Investment Strategy.

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