

COMPASS

Summertime blues: a setback, not a reversal

JULY 2011



- Economics: growth to stabilise and rebound in H2
- Asset allocation for Q3: risk trimmed, but still positive
- Current investment ideas summarised

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Dear Clients and Colleagues:

By the time we get to October, we expect to have some clear answers to the questions that have been disturbing global investors over the past few weeks and have brought global equity markets down by 7.5% from their cyclical highs on 2 May. We also believe that most of the answers we get will be the ones we want to hear. By the Northern Hemisphere autumn, it should be clear that the global recovery remains on track despite the recent US and UK softening, that politicians in Europe and the US have agreed to adequate temporary resolutions to their respective fiscal policy conundrums, that policy makers in the large emerging economies have managed to bring their growth rates down to still robust but sustainable levels, and that public companies have delivered another quarter of eye-popping earnings growth.

Our reasons for optimism are set out in this edition of *Compass*. But right now, it isn't obvious that everything will work out for the best. Indeed, the economic news from the US may stay relatively bad before it gets better, the political rhetoric in the US and Europe may border on the histrionic, Chinese inflation may not have peaked yet, and the height of earnings season is still many weeks in the future. So our basic optimism is tempered by what we expect will be a period of continued downside volatility in the global equity markets.

Nevertheless, our investment advice for the third quarter of 2011 remains focused on our constructive three- to 12-month view. We recommend maintaining risk above strategic norms, albeit a bit less so than in the previous quarter. In our view, the transaction and opportunity cost of trying to dodge what might be a bumpy road in early July won't have been worth paying when viewed in retrospect from late September.

Sincerely yours,

Aaron S. Gurwitz, Chief Investment Officer

Asset classes and outlook in brief (Q3 TAA positions)

		Tactical position ¹	Change on Q2 ²	Key headwinds	Key tailwinds
1	Cash & Short-maturity Bonds	Up to overweight	↑	Low yields; inert	Rates slowly firming; near-term risk aversion
2	Developed Government Bonds	Neutral	↔	Low yields; vulnerable to growth	Insurance against geopolitical risk
3	Investment Grade Bonds	Underweight	↔	Expensive; inert; M&A cycle	Higher yields than Treasuries
4	High Yield & Emerging Markets Bonds	Down to underweight	↓	Fully-priced; global emerging markets inflation	Highest yields; corporate recovery
5	Developed Markets Equities	Overweight	↔	MENA unrest and oil prices; rising rates	Profits recovery to continue; cheapest asset class
6	Emerging Markets Equities	Neutral	↔	Inflation; geopolitics; overbought; capital controls	Inexpensive; structural attraction intact
7	Commodities	Neutral	↔	Valuation; supply response	Geopolitics; global emerging markets demand; diversification
8	Real Estate	Underweight	↔	Liquidation sales	No longer expensive
9	Alternative Trading Strategies	Neutral	↔	Relatively inert	Portfolio diversification

Economic outlook					
	Growth	Recovery continuing but patchy	↓	Fiscal retrenchment; higher inflation	Private sector cash flow; accommodative monetary policy; EM structural growth
	Inflation	Inflation firming up in both developed and emerging economies	↑	High unemployment and large output gaps in developed economies	Indirect taxes; food and energy costs; EM inflation
	Exchange Rates	The US dollar to remain weak	n/a	Risk aversion (MENA tensions; concerns about European peripherals and global growth outlook)	Sterling and Swedish krona to appreciate; the Swiss franc to weaken

¹ Overweight or underweight relative to our Strategic Asset Allocation.

² The change in our Q3 2011 asset allocation, as published below, relative to our Q2 2011 asset allocation



Economics update: a soft patch, not a downturn

Japan's earthquake, higher oil prices, and fiscal worries in both the US and euro area have had an impact on many economic indicators (some of which were at unsustainably-high levels to begin with). We think that the resultant "soft patch" will be temporary, and would focus instead on ongoing growth.

Weak economic data is being extrapolated into another "double dip" scenario. However, our colleagues at Barclays Capital estimate that the global economy continues to grow solidly, and expect it to accelerate into the second half. We do expect the gap between the growth of developed and emerging worlds to narrow for a while.

US: a soft patch

In the US, the soft pace of growth witnessed in the first quarter of the year has extended into the second quarter, rekindling fears of a sharp slowdown and raising renewed doubts about the ability of the US economy to grow without some sort of policy support. Most notably, employment data show a slowdown in job creation, and manufacturers' order books have fallen sharply (albeit from historically-high levels). Our colleagues at Barclays Capital have revised their second quarter real GDP forecast to 2.0% from 3.5%.

In our view, talk of a "double dip" is again premature; we expect growth to accelerate in the second half of the year to a healthy 3.0-3.5%. We attribute much of the weaker-than-expected growth in the first half of the year to temporary factors and the usual ebb-and-flow of the inventory cycle. Higher energy prices, abnormally bad weather, and the Japanese earthquake have all affected US production, and we expect the impact of these factors to ease in the third quarter. The main risk to our positive view is that US consumers fail to spend, either because they become more cautious in light of discouraging economic and financial news, or because they are unable (or unwilling) to dip further into their savings as a result of a new shock in commodity prices. At present, however, there is little sign that this has been happening. Consumer spending is increasing and the labour market recovery continues – albeit frustratingly slowly.

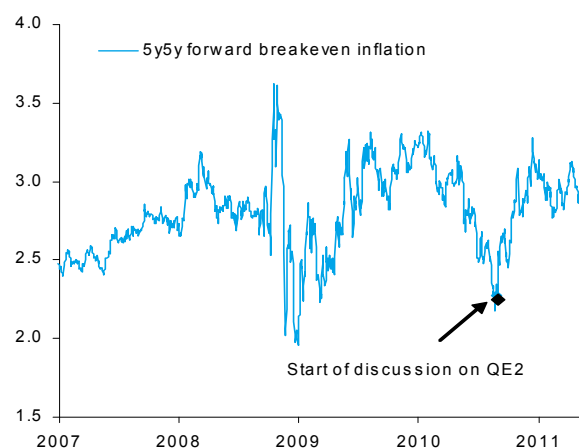
"QE3" looks unlikely – as does a US default

We expect the Federal Reserve to complete its second round of quantitative easing (QE2) in June, as originally planned, and to refrain from initiating a third round of it. The risk of outright deflation has diminished since

last autumn, and longer-term measures of inflation expectations are well-anchored (Figure 1). Of course, if growth remains below trend, the unemployment rate does not fall as we and the Fed expect it to, and core inflation and inflation expectations remain contained, then the Federal Open Markets Committee may eventually decide to initiate a third round of quantitative easing. But on balance, we think the Fed will likely remain patient, and will wait for growth to pick up as we expect it to. We are not expecting the end of quantitative easing to have any impact on yields, as it is largely priced into current levels.

Meanwhile, the debate over the debt ceiling continues. US Treasury Secretary Geithner has warned Congress that failure to raise the ceiling by 2 August could precipitate a technical default. However, there will still be a few postponement options available, including the sale of about \$90 billion in agency MBS, about \$400 billion in student loans, and \$140 billion in TARP equity investments. The sale of any of these assets, especially the TARP equity investments, could spark a sell-off in risk assets – we have already seen a dry run with some auction sales by the NY Fed in the second quarter – but the impact would likely be less devastating than a technical default.

Figure 1 – US inflation expectations have risen since the launch of QE2



Source: Barclays Wealth, Bloomberg

The Treasury department also has the option to prioritise payments to bond holders, although it would be politically difficult to do so, and a dramatic cut in other spending would hit third quarter GDP hard.

We think Congress will most likely raise the debt ceiling, but the spending cuts needed to resolve the immediate impasse will likely restrain growth in the medium term. We do not expect any longer-term entitlement or tax reform to be agreed in July, and this may also dampen risk appetite until a durable agreement is reached.

Europe: core growth continues

Economic growth in Europe has unsurprisingly slowed in the second quarter: growth in the first quarter was erratically high. Although sovereign debt issues are again dominating headlines, Germany and France, which together account for nearly 50% of total European output, continue to grow solidly. The German economy grew at its fastest pace since reunification in the first quarter, and our colleagues at Barclays Capital expect the economy to grow an impressive 3.4% this year. Portugal and Greece will likely contract this year, but together account for only 4% of European activity.

The European Central Bank (ECB) has signalled its intent to raise its main refinancing rate by 25 bps in July, and we expect a further rate hike in December. Inflation has routinely exceeded the central bank's target, and the ECB appears intent on keeping monetary policy separate from the debate around sovereign debt.

Greece still poses a risk

Greece's second bailout hangs in the balance. In a face-off with the ECB, Germany has indicated a willingness to soften its demands for private sector burden-sharing, but the ball is now firmly in the Greek politicians' court: at the time of going to press, they are still discussing the new austerity package required by the EU before the latter advances funds. We expect that Greece will receive its short-term funding. The jury is still out on a longer-term solution – keeping markets nervous – but we think that the ECB and EU politicians will do all that they can (which should be plenty) to contain systemic risk.

UK: growth, not inflation, is driving policy

Our colleagues at Barclays Capital estimate that fiscal retrenchment will subtract around 2pp from UK growth both this year and next: growth will be modest at best. Inflation shows no signs of easing, but we expect the majority of the Monetary Policy Committee (MPC) to focus on the tepid growth outlook, and do not now expect a first rate hike until the end of the year.

Japan: V-shaped recovery

We expect the Japanese economy to rebound strongly from the current disaster-driven downturn, with quarterly growth reaching 5% in the fourth quarter of this year. We expect post-earthquake reconstruction to take priority over fiscal worries. The disaster in Japan has

undoubtedly had a significant impact on the global economy in the second quarter, and more so than we expected, but we believe this impact will be temporary as reconstruction gains momentum.

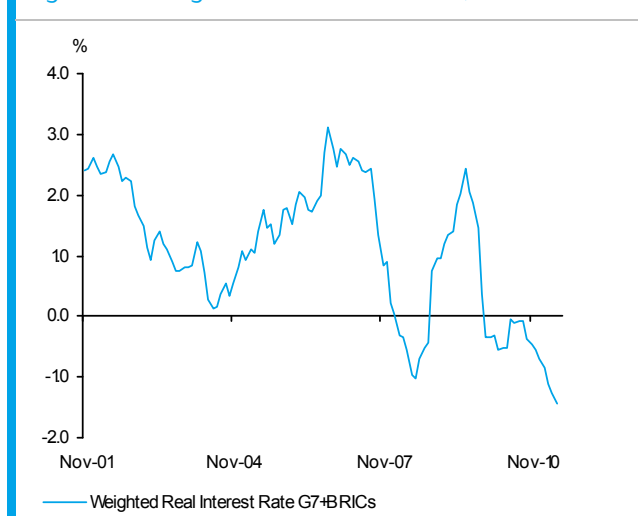
China: policy is working

In our view, the Chinese economy is slowing down, but only moderately, and a “hard landing” appears unlikely. The aggressive monetary tightening pursued by Chinese policymakers since the end of last year has clearly had an effect on economic activity, with business surveys showing a deceleration in manufacturing growth, and money growth slowing to a 30-month low in May. However, resilient readings in both industrial production and retail sales for May suggest that the slowdown has been modest so far. Even though inflation remains high (5.5% in May), and the Chinese government's stated top priority is to tackle it, political pressures against further policy tightening may increase, if it begins to look as if growth is being hit harder. Overall, we expect growth to continue to abate only gradually: our colleagues at Barclays Capital have recently revised down their 2012 real GDP forecast from 9.0% to 8.7% – slightly down on the likely 9.3% outturn for 2011.

Policy underpins recovery

Globally, one of the biggest frustrations faced by income-seeking investors is actually one of the factors underpinning economic recovery – namely, the historically-low level of real interest rates (Figure 2). Despite the ECB's visible hawkishness, it is the emerging world where inflationary pressures and the need for tighter policy will remain most visible. This is one of the reasons for thinking that the developed world may see its growth deficit narrow a little – albeit temporarily.

Figure 2 – Weighted real interest rates, G7 + BRICs



Source: Barclays Wealth, Datastream

Economic forecasts

Growth and inflation

	Real GDP % y/y				CPI % y/y			
	2009	2010	2011F	2012F	2009	2010	2011F	2012F
Global	-0.8	4.9	4.0	4.3	1.1	2.6	3.8	3.0
Developed	-3.6	2.5	1.9	2.8	0.0	1.4	2.7	1.9
US	-2.6	2.9	2.5	3.4	-0.4	1.6	3.2	2.5
Euro area	-4.1	1.7	2.1	1.8	0.3	1.6	2.7	1.8
UK	-4.9	1.3	1.6	2.2	2.2	3.3	4.6	2.8
Japan	-6.3	4.0	-0.5	3.2	-1.3	-1.0	0.3	0.1
Emerging	2.5	7.9	6.6	6.2	3.6	5.3	6.2	5.4
Brazil	-0.6	7.5	3.8	4.2	4.9	5.0	6.6	5.7
Russia	-7.8	4.0	4.3	4.6	11.6	6.9	9.1	7.1
India ¹	7.2	9.0	7.7	7.9	2.3	9.6	9.1	6.7
China	9.0	10.4	9.3	8.7	-0.7	3.3	4.8	4.0

Fiscal and external balances; unemployment

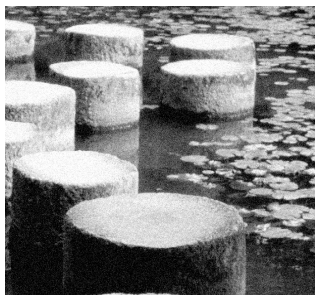
	Budget deficit % GDP			Current account % GDP			Unemployment rate		
	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Developed	-8.1	-7.2	-5.8	-1.4	-1.8	-1.7	-	-	-
US	-10.2	-9.9	-8.0	-3.2	-3.5	-4.0	9.6	8.8	7.7
Euro area	-6.0	-4.4	-3.4	-0.6	-1.3	-1.0	10.1	9.8	9.2
UK	-9.5	-7.7	-6.1	-2.5	-0.7	0.1	7.9	7.9	7.9
Japan	-9.5	-9.2	-7.8	3.6	1.8	2.5	5.1	4.7	4.2
Emerging	-2.9	-2.5	-2.4	2.2	1.5	0.8	-	-	-
Brazil	-2.6	-3.0	-3.0	-2.3	-2.3	-3.0	6.7	6.2	6.6
Russia	-4.0	-0.6	-1.2	4.8	5.4	2.7	-	-	-
India ¹	-8.2	-8.3	-7.3	-2.5	-2.9	-2.7	-	-	-
China	-1.6	-1.9	-2.0	5.2	4.3	3.6	4.2	4.0	4.0

Interest rates

	Current	Last move	Next expected move	Mid-11	End-11	Mid-12	End-12
Fed funds rate	0-0.25	Dec 08 (-75-100)	Jul 12 (+25)	0-0.25	0-0.25	0-0.25	1.25
ECB refinancing rate	1.25	Apr 11 (+25)	Jul 11 (+25)	1.25	1.75	2.25	2.25
BOJ overnight rate	0.10	Oct 10 (0-10)	Q1 13 (+20)	0-0.10	0-0.10	0-0.10	0-0.10
BOE bank rate	0.50	Mar 09 (-50)	Nov 11 (+25)	0.50	0.75	1.50	2.50
Brazil: SELIC rate	12.25	Jun 11 (+25)	Jul 11 (+25)	12.25	13.50	13.50	13.50
Russia: Refi rate	8.25	Apr 11 (+25)	Jun 11 (+25)	8.50	8.50	8.50	8.50
India: Repo rate	7.50	Jun 11 (+25)	Jul 11 (+25)	7.50	7.75	n/a	n/a
China: Working capital rate	6.31	Apr 11 (+25)	Q2 11 (+25)	6.56	6.56	6.56	7.06

¹ Fiscal years.

Source: Barclays Capital



TAA: holiday insurance

We remain overweight developed stock markets, but are trimming risk ahead of a very uncertain summer. We are cutting high yield and emerging market bonds to underweight, and moving the funds into cash, where we are now tactically overweight for the first time.

As outlined above, we still believe that recent weakness in economic data reflect a temporary “soft patch” and not the start of a slide back into recession. The earthquake in Japan is having a more noticeable impact on manufacturers’ order books in the rest of the world than we’d expected, and the surge in oil prices in the first quarter had a sharp effect on real disposable incomes that seems to have carried over into the second quarter. Both factors have amplified the natural ebb and flow of inventories that is a component of every business cycle, but both factors are also likely to prove transient.

In the wake of the last few traumatic years, it is easy to forget that the default setting for the global economy is growth. Companies and workers steadily benefit from experience and new technology – productivity and living standards tend to increase as a result. For advanced economies in particular, this is the source of most economic expansion.

Indeed, the corporate sector, in particular, has again shown itself capable in the current cycle of delivering levels of profitability that compare favourably with historical norms. Non-financial business seemingly continues to raise the bar, and, as in the last business cycle, is doing so without resorting to leverage. Operating margins seem poised to hit new highs. The very discipline that has made this recovery such a

frustrating event for US consumers – the slow pace of hiring – has helped deliver the fastest rebound in profitability on record for US Inc., and probably its most liquid balance sheet.

However, we doubt that investors generally will come to share our views in this respect – at least during the early summer. For one thing, if we are right, it will still take several months for the data to bottom-out. For another, global capital markets face some very visible short-term risks in addition to the patchiness of the economic data – and one of those risks is a test that we have not experienced in our working lifetimes, namely, the serious possibility of a significant downgrading of the creditworthiness of the US government.

To be clear, we still doubt that this will happen. But with nerves already frayed by the revived “double dip” debate – even if mistakenly so – we think that client portfolios need to have fewer risky assets in them as US political brinkmanship intensifies. This could go to the wire – and indeed, beyond; the “deadline” of 2 August is not a rigid one.

Figure 1: Q3 Strategic (SAA) and Tactical (TAA) asset allocation - moderate risk portfolio.

Asset Class	Indices	SAA	SAA +TAA Asset allocation %	TAA	+/- Q2 TAA
Cash & Short Maturity Bonds	Barcap Global Treasury 1-3y	10.0%	13.0%	3.0%	+4.0%
Developed Government Bonds	Barcap Global Treasury 7-10y	11.0%	11.0%	0.0%	-
Investment Grade Bonds	Barcap Global Corporate	6.0%	1.0%	-5.0%	-
High Yield & Emerging Markets Bonds	Barcap Global High Yield and EM	6.0%	2.0%	-4.0%	-4.0%
Developed Markets Equities	MSCI World Index	36.0%	43.0%	7.0%	-
Emerging Markets Equities	MSCI EM	8.0%	8.0%	0.0%	-
Commodities	DJ UBS Future Commodity Index	6.0%	6.0%	0.0%	-
Real Estate	MIT/CRE IBI US Index & IPD UK	4.0%	3.0%	-1.0%	-
Alternative Trading Strategies	Barclays Wealth ATS Weighted Index	13.0%	13.0%	0.0%	-
TOTAL	N/A	100.0%	100.0%	0.0%	-

Source: Barclays Wealth Strategy

A further reason to be trimming risk is the ongoing uncertainty in peripheral Europe. As we go to press, the Greek government is struggling to enact the latest round of austerity measures to unlock the next phase of EU (and IMF) funding. Investor nerves will likely be rattled further by the evolution of this ongoing crisis during the summer months. There is no painless way out of its predicament for Greece itself, but we continue to believe that in the last resort, the “troika” of EU politicians, the ECB, and the IMF will make sufficient funds available to prevent the crisis becoming a systemic one. And the scale of that systemic risk may have fallen, not risen, in the last year; the time bought by “kicking the can down the road” has allowed European bank capital to be augmented, and exposures to be partially-hedged and provided for. The foreign exchange markets at least seem to agree with us – the euro is stronger now than it was a year back. But again, we doubt that the wider capital markets will relax on this front for a while, adding to potential summertime volatility.

Given the markets’ concerns over economic uncertainty and sovereign creditworthiness, we want to trim risk, and to add some portfolio insurance to our Tactical Asset Allocation. However, we continue to recommend a level of risk that is modestly above the “neutral” level embedded in our long-term Strategic Asset Allocation, and are reluctant to reduce our positioning in developed market equities. The positive corporate story outlined above is not close to being priced-into current valuations, and when the economic mist clears, the big markets are quite capable of rebounding quickly. This could leave investors stranded out of the market – as many found to their cost last summer. Instead, we are cutting high yield and emerging market bonds to an underweight position, and placing the notional funds into cash and short-dated bonds. This reduction in risk is much smaller, but the underlying investment case for high yield credit is weaker.

As we see it, a reduction in equity weightings now would be likely short-lived. The combination (eventually) of ongoing recovery with very favourable valuations suggests that the best for the cycle still lies ahead (in terms of levels – we know that the market is unlikely to double again from here). By contrast, the best of the current cycle is likely behind us for high yield bonds: spreads and prospective defaults have only been lower in the credit bubble period (Figure 2); the absolute level of yields is a standard deviation below its trend; and corporate balance sheets are unlikely to deleverage further. Moreover, the gathering momentum behind M&A promises to replace equity with debt – or at least, less cash – although this particular effect may be greatest for

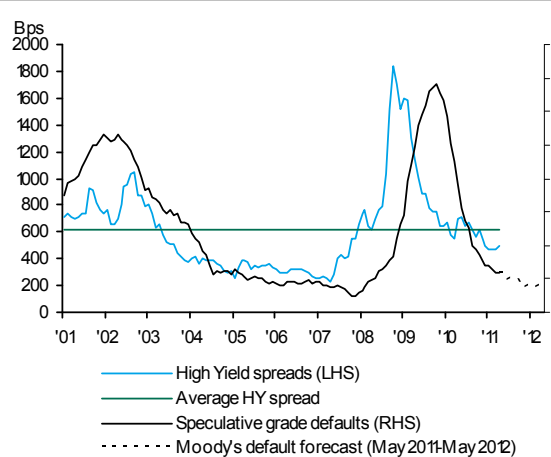
investment grade credit, where we are already underweight. The high yield asset class has outperformed equities materially since 2008, and relative valuations of the two assets are back at levels last seen in the credit bubble (Figure 3).

This is not to say that high yield and emerging market spreads will widen from here in a straight line. Indeed, when interest rates and core government bond yields normalise, many credit spreads may narrow further for a while at least. But this is an expensive asset class, while equities are cheap; and we think the attractions of being an owner will increasingly outweigh those of being a creditor through the rest of 2011, and into 2012 at least. Stocks have no par value, and while this means that they can fall a long way when the cycle tilts against them, it also means that their upside is not capped when the economy is growing.

We are aware that both equities and high yield bonds have already weakened modestly in Q2. Our overweight position in developed equities means that this has cost our tactical portfolio some underperformance, though not – yet – sufficient to reverse the gains made in Q1. We estimate that for the year-to-date, both our tactical and strategic asset allocations are showing small gains.

The parallels with last summer’s sell-off and rebound in risk assets are striking. Many analysts assert that the autumn rally was driven primarily by the Fed’s second wave of quantitative easing – the idea being that with no “QE3” now waiting in the wings, the chances of history repeating itself with another rally are slim.

Figure 2 – High yield spreads and default rates, 2001-2011



Source: Barclays Wealth, Barclays Capital, Moody's

We are sceptical: it always looked to us as if it was the reacceleration in economic growth (the fading of “double dip” worries, rather than QE2) that did the job. We do not believe that QE2 had much impact as there was neither the time nor the transmission mechanism for it to do so. On this view, markets can indeed rally again – provided, of course, the economy does stabilise as we expect it to.

Selected asset classes: implementation

Cash and short-term bonds: Switching from high yield bonds to cash gives us an overweight position in the latter for the first time since *Compass* has been published (a little over two years). But we view this as likely transient: the low level of interest rates makes this an expensive asset, and we do not expect to want to shelter here for long. Within the asset class, in US holdings we would focus more on cash per se and less on yield enhancement than before: we still think that interest rates will rise only slowly, but the creditworthiness of some short-term bonds may be questioned as the federal debt ceiling approaches. In Europe, we have favoured liquidity already in euro holdings, and with the ECB poised to hike further in Q3, we would stay put for now. In the UK we might, if anything, move the other way, towards some yield enhancement, as we now see the Bank of England as unlikely to hike rates until November.

We stay neutral on **developed government bonds**. They have rallied in Q2, and look more expensive even than they did, but they continue to offer some insurance against geopolitical risk. Within the asset class, we would favour slightly shorter duration than the benchmark. For US taxpayers, municipals remain the most appropriate implementation. In the case of the UK, we continue to favour index-linked over conventional gilts, particularly out to about ten years.

Investment grade credit is the asset class where we remain most underweight. It is expensive, inert, and most vulnerable to the resurgence of M&A activity (inasmuch as credit quality here can only deteriorate). We would favour taking positions here that enhance yield – perhaps by moving down the capital structure for financial issuers, where we continue to believe that the additional risk involved is more than priced-in.

High yield and emerging market bonds are discussed above. We are broadly indifferent between the two main components, but for the emerging market segment, we continue to favour local currency bonds structurally.

In implementing our ongoing overweight in **developed equities**, we continue to believe that regional and sectoral views are of secondary importance currently. Bottom-up themes such as the revival in M&A; the hunt for yield; and the search for inflation hedges, are some important cross-sectoral drivers.

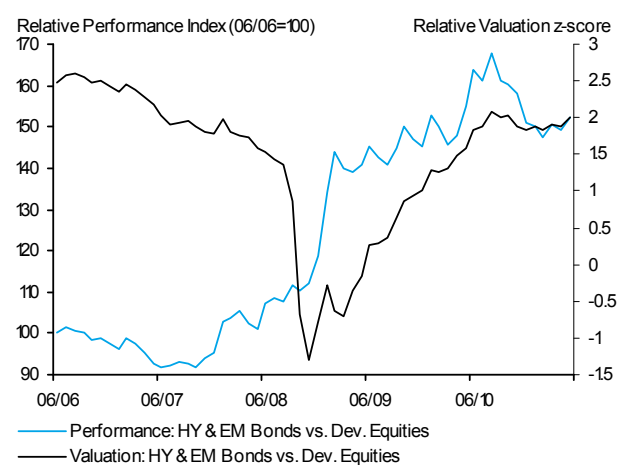
That said, we continue to favour the US market ahead of Continental Europe; we are neutral on Japan; and underweight the UK, where domestic growth is most fragile (though admittedly also of less relevance, given the large international content of the UK market). We also continue to recommend a broadly cyclical sectoral disposition, favouring energy, consumer discretionary and technology sectors ahead of more defensive sectors.

Other favoured ways of gaining exposure to the asset class include long-short equity funds and private equity. For the latter, especially in Europe, there has been some rationalisation of the sector. Mega buy-outs still face some funding constraints, so the practical impact of private equity activity for now is most likely to be felt at the mid-cap level. But a more widespread revival eventually would sit naturally with the M&A theme, inasmuch as they are both driven by the same underlying valuation metric – cheap equity and expensive credit.

We stay neutral on **emerging equities**, but having lagged developed markets for much of the last six months, their relative valuation may start to look more attractive. Interest rate and inflation risk argues still for near-term caution, but eventual signs of “soft landings” during H2 could prove to be positive catalysts. Our preferred emerging markets bloc remains North Asia.

We stay neutral on **commodity futures and ATS**. Commodity futures look expensive, even after their “flash crash” in early May, but they offer some protection against geopolitical risk. Extreme weather conditions (such as droughts) favour the agricultural group currently, but not on a longer-term view. ATS is not an asset class that we expect often to take a “tactical” view on, but within it, we favour relative value and event-driven strategies; we would be neutral on macro; and we would underweight managed futures.

Figure 3 – High yield and emerging market bonds compared to developed market equities



Source: Barclays Wealth, Factset

Focus: equity valuations

Developed equity markets look to us to be the cheapest of the nine asset classes in our Strategic Asset Allocation. However, not everyone agrees, and with the MSCI World Index up by 98% from its March 2009 low point, many investors are understandably unconvinced. Here we take a look at the most visible area of disagreement.

In comparing valuations, we focus on the divergence of a key measure for each asset from its 10-year moving average, and express the result in terms of standard deviations. In the case of equities, we use the forward PE ratio – that is, the level of the market relative to the expected level of earnings in the coming twelve months. On this basis, developed equities are currently about one standard deviation cheap – essentially due to the fact that, while markets have rallied strongly, so too have expected earnings.

However, some commentators argue that this is too short-term a perspective, and that when we allow for the last fifty or one hundred years, and for the volatility in annual earnings, the picture is very different (based on data for the US equity market, which is all that is available – long-term valuation data for other stock markets, and for other asset classes, are frustratingly patchy). It is true that longer-term comparisons do look different, but it may not be important.

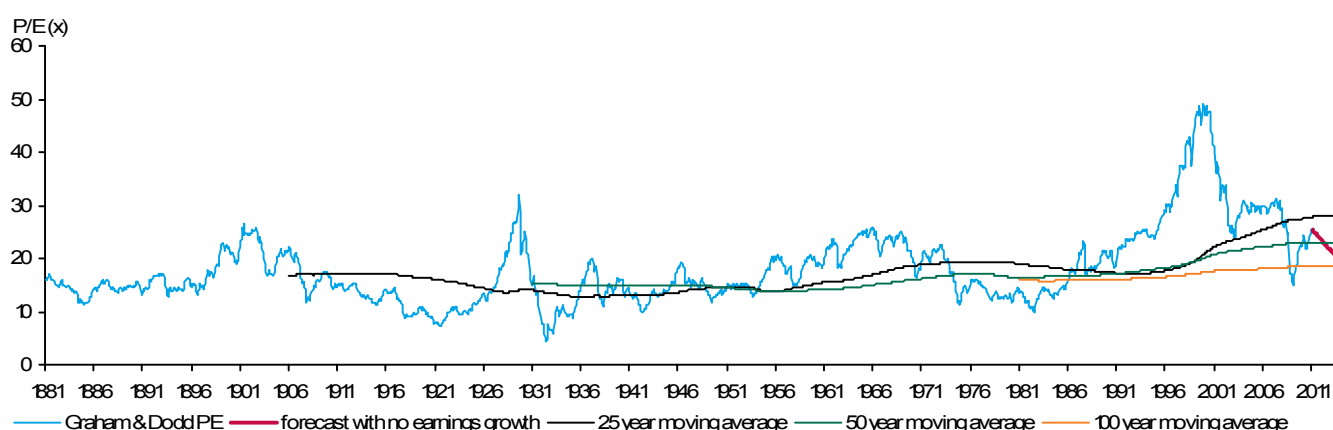
The chart below shows one of the measures commonly used to show that stocks are expensive. The “Graham & Dodd” PE ratio, named for two pioneering value investors, takes a 10-year moving average of trailing earnings, thereby smoothing out annual fluctuations. As such, it can be seen as a “cyclically adjusted” PE (a closely-related variant is the “Shiller” PE). Currently, this measure stands some 9% and 34% above its fifty- and one hundred year-moving averages respectively.

However, accounting standards are a relatively modern invention. Before the Great Depression, there was no agreed accounting code: by way of example, the treatment of depreciation in particular could vary tremendously. Moreover, the number and industrial diversification of stocks has changed dramatically over time – as has the general mobility of capital, the liquidity of markets, and the cost of information. It is not clear how relevant the valuation of a small basket of mostly railroad stocks in the late Nineteenth century is to the valuation of today’s S&P500 index.

Finally, the proponents of the cyclically-adjusted approach may also have forgotten that 2002 and 2003 were very weak years for earnings – and in the next two years, those years’ earnings will drop out of the 10-year calculation, thereby pulling the smoothed PE down sharply even if earnings now stand still.

None of the above takes into account recent trends in non-financial operating margins, return on capital, and balance sheet management. Nor does it allow for changes in the general level of real interest rates. In a more comprehensive, net present value analysis, stocks arguably look more inexpensive again.

Figure 4 – A cyclically-adjusted PE for the US stock market, 1881-2013(e)



Source: Barclays Wealth; Datastream; Robert Shiller



Currencies and strategic asset allocation: a clarification

Because Barclays Wealth advises clients with a broad range of base currencies, we evaluate asset classes for purposes of determining strategic or tactical asset allocation under the assumption that all currency risk will be hedged. When our clients come to implement our recommendations, however, many of the investment vehicles they use to do so – individual securities, index funds, actively managed funds, separate account portfolios, etc. – are not currency-hedged. So the question naturally arises as to whether the performance of currency-hedged and -unhedged portfolios is very different (a topic that we discussed in the context of a weaker dollar in June's *Compass*). Our answer is that whether or not one hedges currency exposure makes a big difference in the performance of fixed-income portfolios, and much less difference in the case of equity portfolios. Our broad strategic recommendation, therefore, is that for most investors most of the time, fixed-income investments should be denominated in or hedged into one's base currency. Investors should, however, feel comfortable if all (or most) of their non-base equity investments are unhedged. This is our strategic recommendation. There may be times when it makes tactical sense for investors to alter the currency composition of their portfolios, either by changing the assets they hold or through the use of one or more currency hedging techniques.

To understand this recommendation, consider the relative riskiness of bond and stock portfolios.

Figure 1 shows the volatilities (standard deviation of monthly returns) of hedged and unhedged stocks and bonds over the past decade (the text box on the following page illustrates the concept of currency hedging). As the table indicates, currency hedging has a modest to minimal impact on individual equity portfolios' volatility, while the effect on bond portfolios is much larger.

How exchange rate changes affect asset class returns and risk

There are several reasons why this is so. First, and most importantly, since hedged or base-currency bond portfolios' volatility is relatively low, adding exposure to much more volatile exchange rate fluctuations has a dramatic impact. Equities are already risky assets, so adding the currency factor has no more than a modest proportional impact.

Second, to some extent, equity portfolios hedge themselves automatically against currency risk. Consider an investment by a euro-based investor in US stocks: if the dollar depreciates against the euro, US exporters become more competitive globally and US companies selling in their domestic market can gain share from foreign competitors. Rising profitability of US companies boosts US share prices and offsets some of the effect of dollar depreciation on the total return European investors realise on unhedged US equity investments.

Figure 1 - annualised Standard Deviation of Monthly Returns - June 2002 - May 2011

	Hedged	Unhedged	Unhedged Excess Over Hedged, Pct.
EQUITIES			
FTSE All World USD	15.2%	17.2%	13.4%
FTSE All World GBP	15.2%	15.8%	4.1%
FTSE All World EUR	15.2%	14.7%	-2.9%
BONDS			
BarCap Global Treasuries 7-10 year USD	3.8%	8.4%	119.1%
BarCap Global Treasuries 7-10 year GBP	3.9%	10.3%	163.5%
BarCap Global Treasuries 7-10 year EUR	3.9%	7.1%	83.9%

Note: For all base currencies the hedged equity return is the local currency FTSE All World Index. For bonds the hedge return is as calculated and reported by Barclays Capital.

Source: Barclays Wealth

This hedging effect tends to work in the opposite direction for bond portfolios. When a country's currency depreciates, local interest rates tend to rise and bond prices decline. For unhedged foreign investors in the market, therefore, the currency losses can be compounded by poor performance in local currency terms.

Conclusions and caveats

The impact of currency fluctuations on portfolio performance varies by country and over time. In most cases, over most time periods, an unhedged portfolio will be more volatile than a hedged portfolio, although there are exceptions, as illustrated in the table. Over the period we looked at from the point of view of euro-based investors, unhedged equity portfolios were a bit less volatile than hedged ones. Furthermore, whether a particular asset class is hedged or unhedged can affect the *correlation* of its returns with those of other investments in the portfolio. So it may very well be that at any point in time the precisely optimal asset allocation will vary depending on the investor's base currency and on whether and how non-base currency investments are hedged.

This said, however, the practice of asset allocation is not a precise science. That is why we generally round our recommended allocations to individual asset classes to the nearest percentage point. Under most circumstances for investors in most base currencies, most of the time, the difference between the precisely optimal allocation for, say, a sterling-based investor holding an unhedged equity portfolio and our recommended strategic asset allocation will be very small and irrelevant in the real world. Our recommendation would be very different, however, for investors holding unhedged investments in foreign-currency bonds from what we would suggest to an investor with a hedged or local currency bond portfolio. This is the basis for our recommendation that investors following our asset allocation advice should feel comfortable holding either hedged or unhedged equity portfolios, but most investors at most times should hold fixed income portfolios that are limited to base-currency bonds or fully hedged-into the base currency.

This general advice holds for most investors at most times. But in individual cases, such as advice for a client whose private business is subject to particular currency risks, and at some points in time, such as when we expect a substantial decline or appreciation of a specific major currency, we

may make customised (bespoke) or tactical recommendations that differ from the general approach.

Currency hedging: an example

Suppose someone invested US \$1 million in the S&P 500 at the market close on December 31, 2009, reinvested all dividend payments in the same index as they were received, and sold the entire position at the close on December 31, 2010. The proceeds of the sale, gross of any fees, would have been US \$1,150,642, for a return of 15.06%. Now suppose the investor had been a UK resident, whose base currency is sterling. On December 31, 2009, with the USD/GBP exchange rate at 1.6148, the UK resident would have put up £619,271.70. On December 31, 2010, by which time the dollar had appreciated to 1.5591 per pound, he or she would have realised £738,016.80, for a return of 19.17%.

The UK investor's returns were affected by both the performance of the US stock market and the dollar-sterling exchange rate. In this instance, the effect was positive, but it could have gone the other way. Investments in non-base currency assets can but do not necessarily involve exposure to exchange-rate risk. The currency component of investments can be hedged and often is.

In our example, suppose the UK investor believed that the US stock market would perform well, but also expected that the dollar would depreciate against the pound. To express this view, the investor might buy \$1 million with £619,271.70 to fund the purchase of the S&P 500 and *simultaneously* enter into an agreement to exchange \$1,150,642 for GBP on December 31, 2010. At that time, the quoted exchange rate for 12-month forward settlement was 1.610872. The sterling proceeds of the combined transactions would have been 15.34%, much closer to the total return in US dollar terms.

Of course the example is not very realistic. The investor would not have known, when the trade was initiated, what the US dollar value of the portfolio would have been one year later, and the example ignores transaction costs and any management fee on the instrument used to gain S&P exposure.

But the example does illustrate two key points. First, investments in non-base currency assets can involve currency risk. Second, currency risk can be effectively hedged, but not necessarily perfectly.

Risks worth taking: stand-alone opportunities

Specific Investment Ideas at the sub-asset class level

Live calls from previous months	Inception date	Exit plan/reason for exiting	
Selectively buy European Investment Grade Financial bonds ^a	20-May-2011	Exit if the weighted benchmark spread of the Barclays Capital Euro-aggregate consisting of 35% A-rated financials and 65% Baa-rated financials increases by 70bps over a 30 day period, and re-assess in a gain scenario if the yield drops to 5%.	Loss
Buy a refocused Asian Fusion Portfolio ^a	09-May-2011	Exit if (i) we were to reconsider our views on Asia-ex Japan growth prospects or (ii) we felt that playing Asia growth directly would be more compelling	Loss
SEK vs. CHF ^a	15-April-2011	As both currencies are very sensitive to a fall in risk appetite, investors should be aware that the cross may fluctuate considerably. We are looking to close the position at CHF/SEK 6.30.	Loss
Buy Convertibles ^a	02-Mar-2011	Exit if the Barclays Capital US Convertible Composite Index return falls below 5% or exceeds 10% per year and/or the sensitivity of the index to the stock market falls below 60%.	Loss
Buy Euro Stoxx 50 index dividends ^a	17-Feb-2011	We recommend a stop-loss at -20% for this strategy. Meanwhile, any deterioration in the European economy that threatens the ability of the corporate sector to pay dividends would warrant a review.	Loss
Buy Korea, China, Taiwan equities ^b	5-Nov-2010	Consider an exit from this idea if the valuation, macroeconomic or policy environment were to deteriorate	Gain
Buy backstopped Greek debt ^c	3-Sep-2010	Expect to hold to maturity	Loss
US 30- to 10-year Treasury spread ^d	11-Aug-2010	Exit when spread is within a standard deviation of historic norm	Loss
GBP vs. JPY ^f	09-Apr-2010	Exit if target forecast is reached before YE 2011 or in the event of a sharp and sustained increase in risk aversion globally	Loss
Anticipate a gradual renminbi appreciation ⁱ	04-Jan-2010	Exit if the majority of the currencies in the basket reach or exceed our estimate of fair value or if Asian economies slow significantly	Gain
Position to benefit from increased M&A activity ^{h,i}	04-Jan-2010	Exit if funding costs increase significantly, equity valuations move to previous highs, or if an unexpected downturn in economic activity occurs	Gain
Buy direct exposure to UK commercial real estate ^{h,j}	06-Nov-2009	Exit only when the likely long-term returns on other assets begin to look compelling. We expect this investment idea to be a multi-year call	Gain
Recently exited calls			
Short gold, but in a way that limits possible losses ^j	25-Nov-2009	Replaced with Short silver investment idea; Idea exited on 03-Mar-2011	Loss
Short silver, but in a way that limits possible losses ^a	03-Mar-2011	Exited due to bullish investment demand following building inflationary pressures. Idea exited 15-Apr-2011	Loss
SEK vs. EUR ^f	28-May-2010	We retain our bullish view on SEK, but we judge that the currency has more scope to appreciate against CHF rather than EUR. Idea exited 15-Apr-2011	Gain
Buy an Asian Fusion Portfolio ^k	07-Aug-2009	We widened the basket of stocks due to concentration in the US semiconductor sector. Idea exited 09-May-11	Gain

^a Explanatory note available on request. ^b Discussed in the November/December 2010 issue of *Compass*. ^c See the October 2010 issue of *Compass*.

^d See the September 2010 issue of *Compass*. ^e See the June 2010 issue of *Compass*. ^f See the May 2010 issue of *Compass*. ^g See the March 2010 issue of *Compass*. ^h See the February 2010 issue of *Compass*. ⁱ See the January 2010 issue of *Compass*. ^j See the November/December 2009 issue of *Compass*. ^k See the October 2009 edition of *Compass*.

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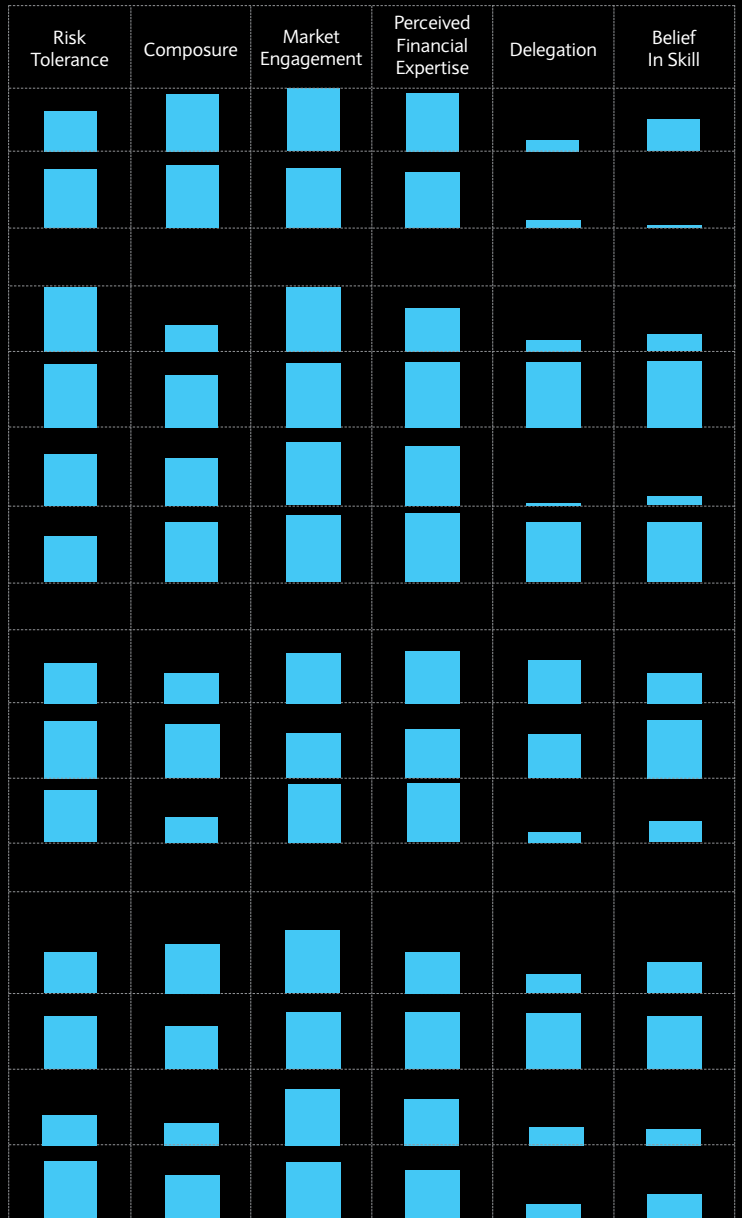
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Risk tolerance

Our psychological risk tolerance measure is an expression of the long-term trade-off between risk and return in your portfolio. Higher risk tolerance indicates a higher risk, higher return portfolio, while low risk tolerance leads to a lower risk, lower return solution.

Composure

The composure scale measures how emotionally engaged you tend to be with the investment journey – how much you feel and respond to short-term month-by-month gains and losses.

Market engagement

Market engagement measures the degree to which you are inclined to avoid or engage in financial markets. This scale acts as an indicator of whether you have a mental hurdle to investing in markets, usually due to a fear of the unknown or wrong timing.

Perceived financial expertise

The perceived financial expertise dimension assesses how familiar and informed you feel you are with current financial circumstances, and how confident you feel in your own financial knowledge and decision making.

Delegation

The delegation scale assesses how much you believe you can benefit from delegating day-to-day portfolio management decisions to someone. The higher your delegation, the greater will be your desire for advice and for someone to assume the effort of portfolio management.

Belief in skill

The belief in skill scale assesses how much you believe it is worth paying for an investment professional's potential to achieve above-market returns.

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