



SIGNPOST

Glimmers of hope

MONTHLY UPDATE - MARCH 2009

Monthly update

Two months into 2009, we remain generally confident with the analysis we propounded in our Annual Outlook of December of last year. The downturn has been sharp, yet is probably still best seen as a 'brutal' recession rather than a slump. Against this testing backdrop, it is pleasing to report that our recommended TAA has outperformed its benchmark by around 175 basis points so far in 2009.

The sky is dark, but there are glimmers of hope. Recent macroeconomic data has not been wholly disastrous, the adjustment of inventories appears to be well underway and policymakers appear increasingly willing to explore new approaches. In addition, it is clear that investors are considering how to move money into asset classes with more upside potential, with both 'high' and 'low' risk credit already benefiting from this.

Michael Dicks, Head of Research, 27 February 2009

Contents

Essay: Glimmers of hope –	page 2
A primer on Quantitative Easing –	page 7
Model portfolio update –	page 8
TAA recommendations –	page 9
Global overview –	page 10
Key Tactical Asset Allocation (TAA) themes –	page 12
Global economic overview: GDP –	page 13
Global economic overview: Inflation and interest rates –	page 14
Macro update: US –	page 15
Macro update: Euro area –	page 16
Macro update: UK –	page 17
Macro update: Emerging markets –	page 18
Global markets overview –	page 19
Asset allocation: Not yet worth taking the risk –	page 20
Equities update: Back through the November lows –	page 21
Fixed income: One port in the storm –	page 22
FX: The sands have yet to shift –	page 23
Commercial real estate: Really in a state –	page 24
Commodities: In gold we trust –	page 25

This month's *Signpost* will only be available in this slimmed-down version of 25 pages. There will therefore be no *Signpost Lite* or *Signpost Essentials*. Over the next few months, we will publish a range of supplementary material in electronic-only form.

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Our predictions for 2009...

...highlighted the need for different short- and long-term investment time horizons...

...and while we still think that the economic contraction will find a floor...

Glimmers of hope

- After a sheer drop in economic activity, there are tentative signs that policymakers' efforts to stem the tide are gaining some traction.
- The financial system remains extremely vulnerable. Policy shifts have failed to be fully convincing thus far. More needs to be done.
- Our asset allocation calls for 2009 remain on track, with our recommended TAA outperforming by around 175bp so far this year.

Last month, we highlighted that the majority of macro-economic news had been bad of late, but only about as bad as expected. Consequently, we felt it necessary to 'tidy up our numbers', as it were – i.e. revise our growth, inflation and asset price forecasts here and there – but not 'change our story'. In other words, we were very content with our Annual Outlook *leitmotif*, of 2009 being a year in which most economies would enter a deep, and possibly protracted, recession; policymakers would have to work exceptionally hard to turn things around, using all the weapons at their disposal; and that, eventually, they would succeed in getting recoveries going again – and that riskier asset classes would respond to this improved outlook. Or, to put it more succinctly, we reckoned 2009 was going to be 'a long, hard slog'.

From an investor's point of view, our analysis suggested that, for those with a short-term investment horizon (of three months), they should have started this year underweight equities, high-yield credit, real estate and commodities; be neutral investment grade credit; and overweight cash, government bonds, emerging market bonds and hedge funds. However, given our projections for a turnaround in the course of 2009, for those investors with a slightly longer investment horizon (of 12 months), we recommended a more aggressive stance towards riskier asset classes – with an overweight in investment-grade credit and US equities, and an underweight in government bonds. For those who prefer to think of the long-run as merely the envelope of a number of short-runs, we also showed how we expected our short-term tactical asset allocation (TAA) to evolve through the course of the year, with for example the cash and bond overweights set to fall markedly by the spring, and the investment-grade credit neutral allocation to move to an overweight during the first quarter. Full details appear in the following 'Model portfolio update' section.

Salvation or nationalisation?

Two months on, and we feel that the messages we signalled a month ago – or, for that matter, in our Annual Outlook in December – are still apt. The macro-economic outturn has been even worse than we feared, but is probably still best described as being a 'brutal' recession (as opposed to a full-blown depression, or 'slump'). The efforts of policymakers to turn things around are turning out to be both conventional and unconventional, much as we had expected they would be – and again are, if anything, turning out to be a little more aggressive in their implementation than we had thought likely.

Overall, we remain comfortable with our assessment that the moves should eventually set a floor to the contraction and, in time, help turn things around, providing a better climate for investors. But, we do remain cognizant of the fact that the risks around this modal forecast are skewed heavily to the downside. Indeed, they are probably a bit more heavily skewed now than they looked to be a month or two back. That reflects two things:

...macro news suggests things may be different from usual...

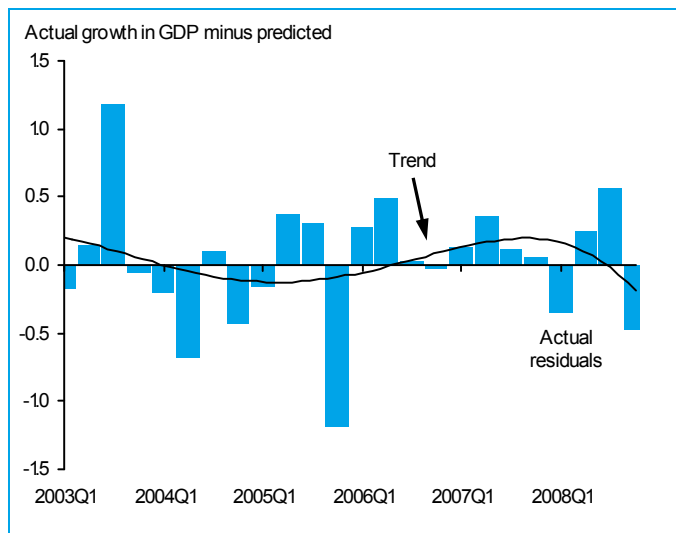
- Macro news hints at things being somewhat different than usual this time around.** This recession is clearly rather different from its predecessors. Unlike most of the post-World War II slowdowns, in which some sub-trend growth was generally required in order to eradicate imbalances that had developed (say between aggregate demand and supply), this slowdown has ‘come out of nowhere’, driven as it is largely by the crisis in financial markets, as opposed to in the real economy. In a sense it is now much more like the sorts of slowdowns prevalent during the 19th century, in which ‘confidence’ or, as Keynes put it, ‘animal spirits’ suddenly evaporated.¹ One advantage of using formal frameworks to try to model economies is that they provide explicit gauges of how well we understand recent developments. Consequently, the gaps between what the models suggest ought to have happened and what really did transpire – the so-called ‘residuals’ on the equations – provide one way of measuring if something unusual is going on. Towards the end of last year, actual GDP in both the US and Europe fell away much more dramatically than typical macro-economic models suggested it would – hinting that animal spirits evaporated (Figures 1 and 2). If that situation persists, then it may well be that the usual policy mechanisms at work – such as lower interest rates and tax cuts acting to boost economic activity – might not work this time around. In other words, there is a clear risk that confidence stays so low that a slump develops.

...and the financial system may still implode

- The financial system may still implode.** Just like a ship in a storm, the financial system is creaking – under vast pressures as it is buffeted by wave upon wave of bad news, both micro and macro. Although policymakers have made clear that they do not want to let another major bankruptcy occur, and are so doing their utmost to support the main players, their handling of the crisis has been found to be wanting somewhat, in terms of the reception that markets have given to recent policy pronouncements. In particular, the new Treasury secretary, Timothy Geithner, sketched out a new Financial Stability Plan (to take over from the TARP) last week, but without providing sufficient details for market participants to judge its likelihood of success. The resultant uncertainty led to equity markets nose-diving, and fears were raised that several financial institutions (such as Bank of America and Citigroup) might end up being nationalised, as time was running out for policymakers to find, and implement,

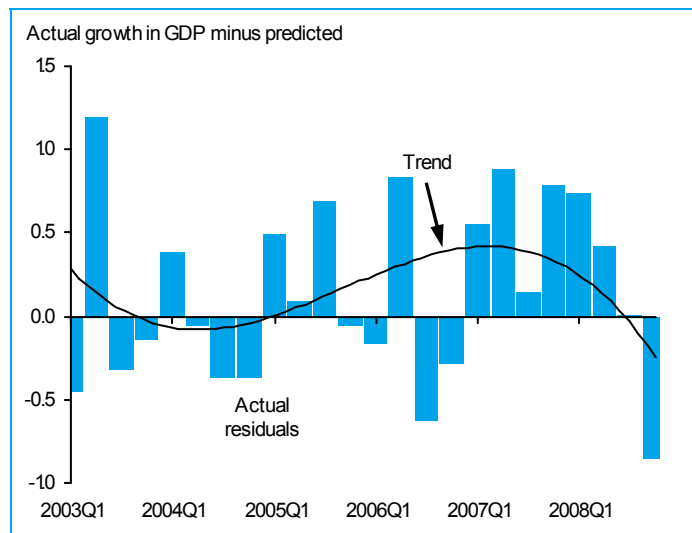
¹ Of course, other factors may have helped cause these fluctuations in confidence. One possibility, for example, is weather, and the resultant shifts in harvests, as advocated by Davis, Hanes and Rhode, “Harvest and Business Cycles in 19th-century America”, NBER working paper no. 14686, January 2009.

Figure 1 – Residuals on our US GDP model



Source: Barclays Wealth Research

Figure 2 – Residuals on our European GDP models



Source: Barclays Wealth Research

But there are some glimmers of hope...

...with macro news now not all bad...

a workable solution to their problems. These fears were assuaged somewhat earlier this week, when policymakers both reiterated their intentions to use nationalisation only as a last resort and to provide further support to both BoA and Citigroup in such a form that the US government remains only a minority shareholder. Nevertheless, in such stormy seas, it is apparent that the risk of the ship 'losing its mast' is a significant one.

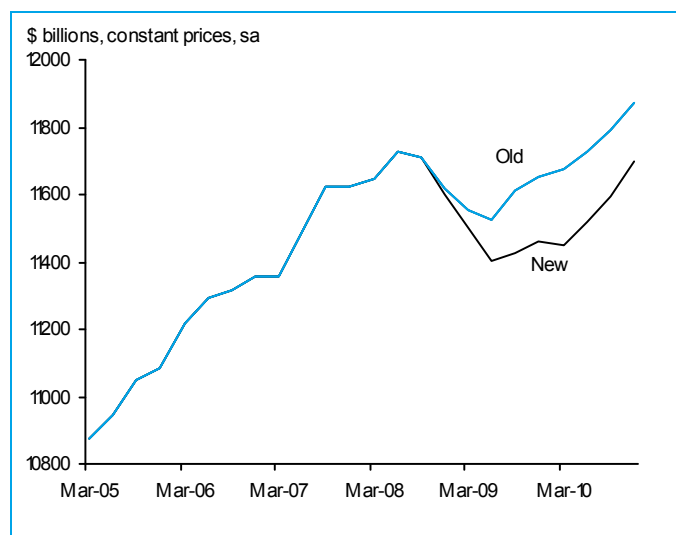
These risks have naturally led us to be a little more hesitant to call the bottom, as it were, and push on with the strategy that we had proposed at the start of the year – especially when the latest macro-economic data require us to take down our 2009 growth forecasts for most of the major economies. However, there are a number of glimmers of hope that lead us to retain our overall stance, and story of a US recovery in 2009, even if it is more of a second-half-year story than a second quarter one (Figure 3). There are two separate strands to this more positive narrative: macro and markets.

Macro adjustment beginning to shape up

When it comes to the macro-economic story, there are three important reasons to think that, even if we not yet at the end of the slowdown, we may at least be at the beginning of the end:

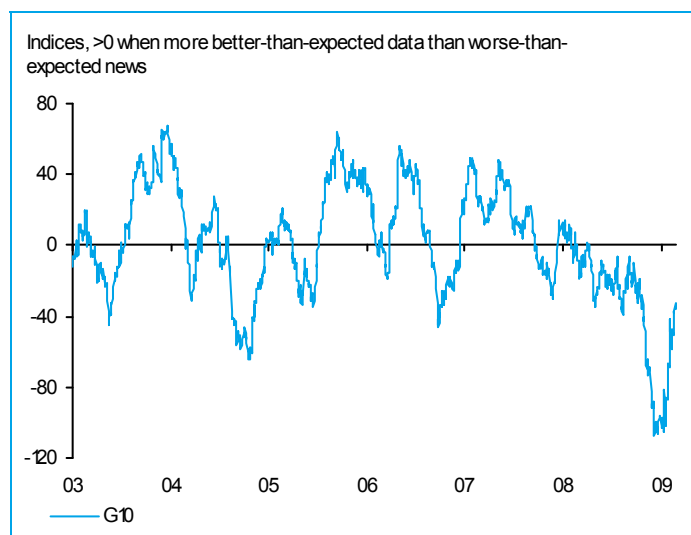
- **The macro 'traffic' is no longer all one way.** Economic 'surprises' are defined as outturns different from consensus expectations. Each month, professional economists are asked to provide their best guesses for the latest set of macro data – whether that be elements of economic activity, such as retail sales or industrial production, or inflation, such as producer and consumer prices. The average predictions can then be compared with the new data, once they are released, and indices constructed of aggregate surprises. When these are negative, economists – and markets – are nearly always taking down not just their short-term (current-quarter) GDP and CPI estimates but also their longer-term projections. That has been the story for much of last year and early this. At last, however, some semblance of balance has started to return to the macro news – taking a bit of the pressure off people to revise down their numbers yet again (Figure 4). In the United States, the United Kingdom and in France, for example, retail spending clipped northwards for a change in January, and by more than generally expected. Likewise, in China growth in money and lending – thanks to the authorities directing banks to make more loans to firms and households – is showing up in higher business confidence

Figure 3 – Revisions to our US real GDP forecast



Source: Barclays Wealth Research

Figure 4 – Economic surprises across the G10



Source: Barclays Wealth Research

...production cuts countering inventory build-up...

...and even conservative policymakers thinking radical

readings. Some of the purchasing managers' indices have even broken through the 50 mark, hinting that output is rising again.

- Inventory adjustment appears to be well underway.** Firms faced with an unexpected slowdown in demand usually find that their production plans have proved to be excess to requirements. Consequently, unsold goods pile up on the shelves and, with a short lag, in factories and warehouses. This unintended stockpiling, or inventory accumulation, provides firms with a strong signal that they need to curb production plans, unless they have good reason to believe that the demand drop is only temporary. The sharper the drop in demand, the quicker, and steeper, the resultant inventory build-up. Right around the world, firms discovered that a huge inventory build took place towards the end of last year. That, however, has now led to the 'correct' (or 'normal') reaction: firms are slashing production (or 'supply') to bring it back in line with the now lower level of demand. Best news of all is the fact that the surprising resilience of retail sales, and an apparent bottoming out in new car registrations – which suggests that demand is no longer falling. So, it should not take too long for demand and supply to roughly realign again, and for firms to start working off their excess of unwanted inventories. Figure 5 illustrates in the case of the United States, euro area and Japan (combined).
- Policymakers are acting in a more heterodox manner.** In conventional policy-making, central banks cut official rates and finance ministers cut taxes and/or boost spending. That clearly helps, provided that the policy transmission mechanism isn't completely jammed up. (And that, despite the clear evidence of some grit being in the wheels, is still a good description of the mechanism currently.) But, once orthodoxy is jettisoned – or its limits reached, as happens when, for example, official rates hit zero – it is evident that policymakers can, in theory, do a lot more to help bolster activity. In recent weeks, it has become clear not just that the US authorities are pressing on with its policy of delivering stimuli via forms not normally used to promote demand (such as the programme to limit foreclosures, even if that requires legal contracts to be rewritten and state subsidies to incentivise change) but that others have got the message too. Here in the UK, for example, the state is now directing/targeting credit expansion in the case of Northern Rock and moving towards doing so for other lenders, even if the mechanisms for doing so have yet to be fully designed and articulated. Even in the much more conservative institutions of the ECB and BoJ, discussions are taking place, and decisions being taken, on how to engineer forms of quantitative easing (QE), or credit

Figure 5 – Supply and demand in the US, euro area and Japan

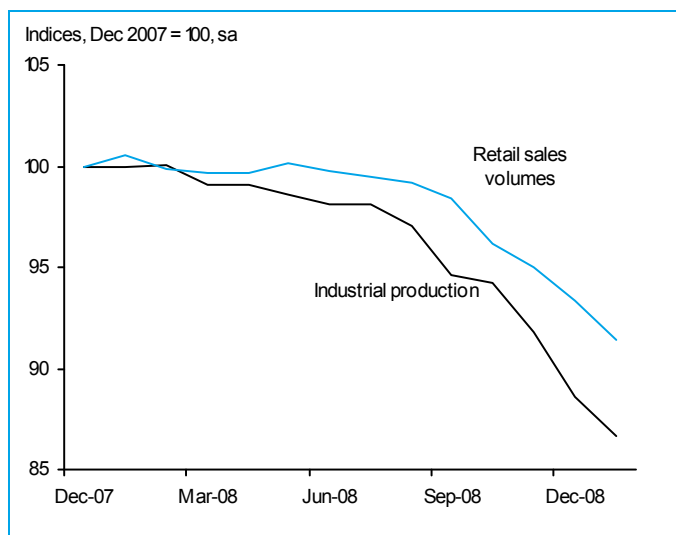
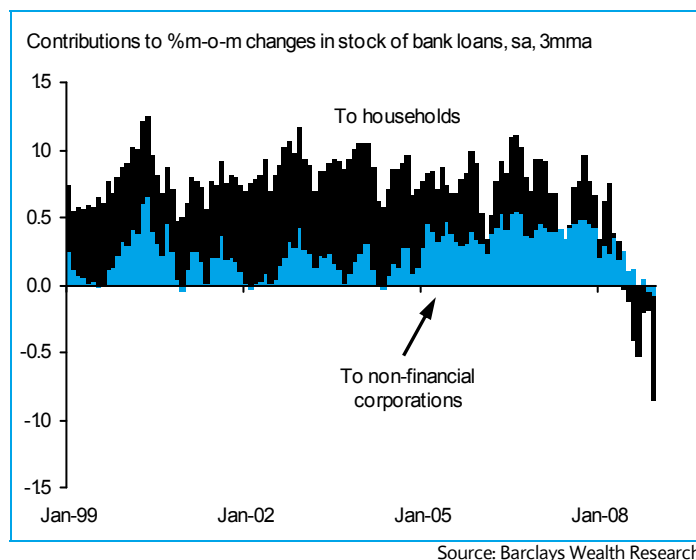


Figure 6 – Bank lending in the UK



easing in Ben Bernanke's parlance. (The box overleaf, written by Jonathan Ashworth, explains QE in more detail for those interested in knowing how such unconventional measures might work when others fare less well or reach their limit.) Such developments reinforce our confidence that the authorities will, in time, engineer the policy shifts required to generate a recovery, albeit one from a lower base than had seemed likely a month or two ago, and one with perhaps less of a pace of pick-up than seemed plausible back then. From a practical perspective, that means we will be watching the credit data closely in the future (Figure 6).

Market participants not so panicky

Some investors are also starting to take on more risk

Before considering bottom lines for investors, it is also worth noting that, despite equity markets having had another torrid month – with most of the major indices registering mid-single-digit percentage declines – some investors are nevertheless beginning to exhibit the stretch for yield that we anticipated would be a major theme for this year. In other words, watching short-term interest rates declining to zero fast, and almost everywhere in the developed world, investors are looking to shift money into asset classes with more upside potential, even though that naturally requires them to take on more risk.

Our presumption was always that this would be a 'dipping one's toes in the water' story, and that lower-risk asset classes would see the first of the action. Thus, for example, we expected investment-grade credit spreads to come in before high-yield ones; and credit to perform before equities. In fact, both 'low' and 'high' risk credit have performed well so far this year. So, as happened in January, although our overall Tactical Asset Allocation has performed well – outperforming the benchmark by about 100 basis points in February – one of the few asset classes where we got it wrong was remaining underweight high-yield credit: we should have been a little more optimistic about markets getting ahead of the economic cycle, and recognising that 'going with policymakers' (in the sense that QE means that central banks are increasingly buying corporate bonds these days) makes sense when it is a policy that is likely to succeed.

Conclusions

...even though an equities turnaround will take time

All in all, we feel a little more comfortable today being overweight credit than we did a month ago (although we still prefer the slightly less adventurous forms of investment in this asset class than the riskier ones). We also feel a little more conviction in adopting the equities underweight that has served us well so far in 2009. Looking ahead, the slightly more negative story on the GDP recovery – coming later than formerly, from a lower base, and with less vigour – hints that it might be necessary to wait a little longer to push the boat out with a return to neutral/overweight position on equities. But we still feel that will be the story for later in the year, although perhaps not one for as early as the spring. Key to this will be the details – and hence the credibility – of the new Financial Stability Plan, along with households' reaction to tax cuts. All in all, while the world might be a more gloomy place than one month ago, there are glimmers of hope that the global economy, and with it market sentiment, may be shaping up to 'find a bottom'.

We may be nearly at the bottom

A primer on Quantitative Easing

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As interest rates headed towards zero after the collapse of investment bank Lehman Brothers in September 2008, the US Federal Reserve (Fed) began to engage aggressively in what is commonly referred to as 'quantitative easing' (QE). Moreover, as the global slowdown and 'credit crunch' have intensified, the Bank of Japan (BoJ) has resumed QE after a break of almost three years while the Bank of England has indicated its willingness to embark on a similar path in coming weeks. Below, briefly, we address some of the key questions around QE.

Q: Where did the term QE originate and what does it actually mean?

Until recently the term QE was synonymous with the monetary policy programme adopted by the BoJ from March 2001 to early 2006. After years of extremely low interest rates failed to restore lending by Japanese banks, the BoJ reduced its main interest rate to zero and changed the operational target of monetary policy from the uncollateralised overnight call rate to the absolute level of 'current account balances' (bank reserves plus deposits of non-bank financial institutions) held at the central bank. In addition, the BoJ committed to maintain the new procedures until inflation became positive on a consistent basis.

Strictly speaking, QE is where the central bank switches from targeting the price of money to the amount of money in the banking system. QE can in theory be implemented at virtually any level of interest rates, although it is significantly easier to manage when rates are at zero. This is because regardless of how much liquidity is pumped into the banking system the benchmark nominal interest rate cannot turn negative. By contrast, if a central bank attempts to enact QE at an interest rate of say, 7%, the extra liquidity it injects into the system will push the rate of interest below this level. One option is for the central bank is to pay interest of say 6.5% on the reserves banks hold overnight with it, which would in theory put a floor on the cost of borrowing irrespective of how much liquidity flows into the system. This is because, if banks could earn an interest rate of 6.5% by keeping money at the central bank, then they are unlikely to want to lend this money to other commercial banks at lower rates. In practice this is often not the case. In the US recently, the Fed Funds rate actually went below the level the Fed would pay banks on its reserves, as a number of key institutions are not eligible to receive interest on their reserves.

Q: How does the QE implemented by the Fed differ from the Japanese version and are the US authorities likely to have more success in restoring lending flows and staving off deflation?

The QE regimes adopted by the Fed and the BoJ differ in many ways. In simple terms, the balance sheet of a central bank is just like a company's with assets and liabilities which offset each other. Operationally, the Fed has been targeting the asset side of its balance sheet by making different types of loans and purchasing various assets from financial institutions. A by-product of this is a huge increase in bank reserves on the liability side of the Fed's balance sheet as financial institutions park much of the cash that they have received back at the Fed. In contrast, the BoJ actually targeted the liability side of its balance sheet by setting targets for current account balances held at the central bank by financial institutions – the rationale being that, if banks held large stocks of reserves (thus facing little prospect of a liquidity shortage), then they would feel more confident about beginning to start lending again.

Crucially, the QE being adopted by the Fed could prove more successful than Japan's was for a number of reasons:

- **Better timing.** The US authorities adopted full-scale QE within weeks of the collapse of Lehman Brothers, whilst Japan waited almost ten years after the bursting of its real estate bubble.
- **Larger scale.** The magnitude of QE has been much greater than anything ever witnessed in Japan. Less than two months after the collapse of Lehman, the Fed's balance sheet had doubled in size – this took years in Japan.
- **Different characteristics.** The form of QE in the US suggests that it is likely to achieve a greater 'bang for its buck' than was the case in Japan, with the Fed, unlike the BoJ, increasingly exposing itself to significant credit risk. A key focus of the Fed has been to increase liquidity and reduce the level of interest rates in a number of key asset markets from which private investors have almost completely withdrawn. As a result, the Fed has been, or is due soon to start purchasing, huge amounts of asset-backed securities and commercial paper (CP) from financial institutions and is actually bypassing the financial system to buy CP from non-financial corporates. In contrast, the BoJ primarily restricted its asset purchases to government securities. (The Fed has clearly indicated its willingness if necessary to begin buying longer-dated government securities also, although this may only happen if the upcoming surge in issuance pushes bond yields up materially).
- **Greater co-ordination.** Despite some clear mistakes, there has generally been a greater level of policy co-ordination between different levels of government in the US than was the case in Japan. Crucially, the US banks were re-capitalised (and more capital is likely to follow) just as QE began to take hold and the major fiscal stimulus from the Obama administration will coincide with this. In contrast, much of the fiscal boost in Japan came well before the onset of QE and the receipt of public capital injections by banks.

All in all, QE in the US look like 'the real thing'. So, we have confidence that it will work.

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We combine momentum and value based investment strategies...

...with both helping us to stay short equities in January and February

Government bond markets have weakened but we retain a small overweight

Model portfolio update

- As in January, our model portfolio outperformed its benchmark – by 100 basis points (bp) – taking the year-to-date outperformance to 175bp.
- Most beneficial to its performance have been the TAA underweights in equities (in all parts of the globe) and in real estate.
- The continued sell-off in government bonds has been the main detrimental factor in performance terms, albeit only by a small amount.

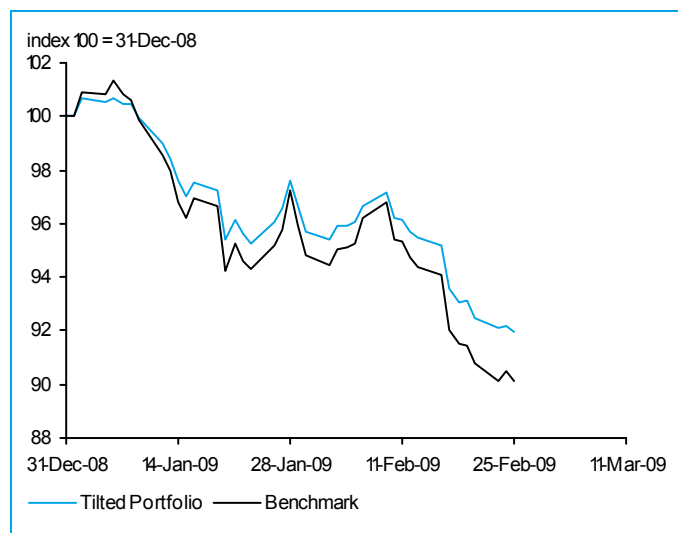
In order to construct our model portfolio, we combine asset class return forecasts based on our fundamental (or ‘value’) analysis of the global economic outlook with momentum-based return forecasts – using a Black-Litterman analysis to calculate ‘tilts’ (i.e. recommended Tactical Asset Allocation overweights and underweights for each asset class).

Our defensive strategy suggested adopting underweights in equities (both in developed and emerging markets), real estate, high-yield credit and commodities at the start of 2009. It suggested being overweight cash, government bonds, hedge funds and emerging market bonds (both sovereigns and local markets). On investment-grade credit, it suggested being neutral.

So far, the recommendations have worked out quite well, with the model portfolio outperforming its benchmark by nearly 175bp in January and February combined – with a slightly better performance this month than last (Figure 1). By far the biggest contributions to the portfolio’s performance have come from the equity and NAREIT underweights (Figure 2).

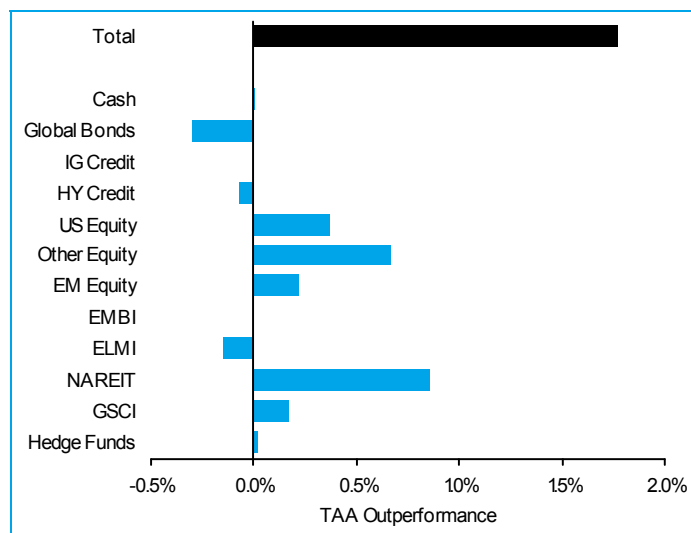
The main (slight) harm to the portfolio has been a consequence of being overweight government bonds, which have sold off despite weak economic data and lower-than-expected inflation readings. The sell-off may be due to worries that rising budget deficits will ultimately lead to inflation. Also relevant, perhaps, are fears of foreign demand for US Treasuries waning, especially from Asian central banks and sovereign wealth funds. We suspect that neither of these concerns are justified. So, although bond yields are certainly inconsistent with long-run growth and inflation prospects, we suspect that the short-term story will be one of continued contractions in GDP and outright deflation exerting downward pressure on yields. Accordingly, we retain a small bond overweight.

Figure 1 – Performance of our model portfolio



Source: Barclays Wealth Research

Figure 2 – Performance attribution



Source: Barclays Wealth Research

Automatic Momentum-Based Asset Allocation

	Benchmark weights (%)	2009				Forecast Return		TAA	
		Q1	Q2	Q3	Q4	(3-mths)	(12-mths)	(3 mths)	(12 mths)
Cash	8.3	16.7	16.7	8.3	0.0	1.4	0.9	8	2
Global bonds	8.3	16.7	16.7	8.3	0.0	2.3	2.5	8	2
IG credit	8.3	8.3	8.3	16.7	8.3	19.0	9.4	0	2
HY credit	8.3	0	0.0	8.3	8.3	5.7	18.1	-8	-4
US equities	8.3	0	0.0	8.3	16.7	-22.2	22.1	-8	-2
Other dev. equities	8.3	0	0.0	8.3	16.7	-17.8	21.7	-8	-2
EM equities	8.3	0	0.0	8.3	16.7	-20.7	26.1	-8	-2
EMBI	8.3	16.7	16.7	8.3	8.3	-9.7	0.9	8	4
ELMI	8.3	16.7	16.7	16.7	16.7	-18.1	4.7	8	8
NAREIT	8.3	8.3	8.3	0.0	0.0	-40.8	-12.2	0	-4
GSCI	8.3	0.0	0.0	0.0	8.3	-38.3	21.4	-8	-6
Hedge funds	8.3	16.7	16.7	8.3	0.0	-15.0	15.0	8	2
	100	100	100	100	100	-12.8	10.9	0	0

Value-Based Asset Allocation

	Benchmark weights (%)	2009				Forecast return		TAA	
		Q1	Q2	Q3	Q4	(3-mths)	(12-mths)	(3-mths)	(12-mths)
Cash	5	9	6	4	0	1.0	0.9	4	0
Global bonds	20	25	21	15	10	2.5	2.5	5	-2
IG credit	10	11	12	13	14	4.4	11.7	1	3
HY credit	5	4	4	5	6	5.7	20.6	-1	0
US equities	15	15	17	19	19	0.3	22.1	0	3
Other dev. equities	15	14	16	17	18	0.3	21.7	-1	1
EM equities	5	4	4	6	8	0.2	26.1	-1	1
EMBI	5	3	3	3	4	-5.6	0.9	-2	-2
ELMI	5	5	5	3	4	-2.7	4.7	0	-1
NAREIT	5	0	0	0	0	-7.5	-12.2	-5	-5
GSCI	5	5	6	7	9	-0.5	21.4	0	2
Hedge funds	5	5	6	8	8	3.0	15.0	0	2
	100	100	100	100	100	0.7	12.1	0	0

Overall Tactical Asset Allocation

	Benchmark weights (%)	2009				Forecast return		TAA	
		Q1	Q2	Q3	Q4	(3-mths)	(12-mths)	(3-mths)	12-mths)
Cash	5	10	8	4	0	1.08	0.92	5	1
Global bonds	20	23	20	14	10	2.44	2.50	3	-3
IG credit	10	10	11	13	14	7.23	11.39	0	2
HY credit	5	3	3	5	6	5.72	20.28	-2	0
US equities	15	12	15	18	19	-4.03	22.08	-3	1
Other dev. equities	15	11	14	16	18	-3.18	21.74	-4	0
EM equities	5	3	3	6	8	-3.82	26.09	-2	0
EMBI	5	6	5	4	4	-6.40	0.94	1	0
ELMI	5	7	7	4	5	-5.68	4.71	2	1
NAREIT	5	2	1	0	0	-13.89	-12.18	-3	-4
GSCI	5	4	5	6	9	-7.76	21.40	-1	1
Hedge funds	5	7	8	8	8	-0.46	15.00	2	3
	100	100	100	100	100	-1.4	12.1	0	0

Global overview

Cash*	Weights (%)	2008				2009				Forecast return (2009 vs 2008)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	26	2.69	2.78	4.05	1.43	1.00	0.75	0.50	0.50	0.9
UK	5	6.01	5.95	6.30	2.77	1.80	1.40	1.10	0.90	1.8
Euro area	22	4.73	4.95	5.27	2.89	2.00	1.60	1.50	1.40	2.0
Japan	8	0.91	0.93	1.02	0.83	0.70	0.65	0.60	0.55	0.7
Emerging	39	5.70	6.99	8.64	10.29	8.50	8.00	8.00	7.50	8.7
Global	100	4.34	4.92	5.98	5.24	4.17	3.80	3.69	3.46	4.2

* 3-month interbank rates, % end-of-period except for emerging, which is the ELMI yield.

Bonds*	Weights (%)	2008				2009				Forecast return (2009 vs 2008)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	28	3.41	3.97	3.83	2.35	2.65	2.60	2.90	3.00	-3.0
UK	6	4.35	5.13	4.46	3.02	3.40	3.40	3.50	3.50	-0.8
Euro area	39	3.90	4.61	4.00	2.95	2.90	2.90	3.00	3.00	2.5
Japan	26	1.28	1.61	1.47	1.18	1.25	1.30	1.40	1.50	-1.8
Emerging	1	3.16	2.98	4.29	7.05	6.80	6.80	6.30	5.70	2.0
Global	100	3.10	3.68	3.32	2.32	2.43	2.43	2.58	2.64	-0.3

* 10-year bond yields, %, end-of-period, except for emerging markets, which is the EMBIG spread, in % points.

Investment-grade credit*	Weights (%)	2008				2009				Forecast return (2009 vs 2008)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	50	2.89	2.65	4.41	5.55	4.90	4.50	4.20	4.00	10.0
UK	11	2.81	2.29	3.81	5.65	5.40	5.10	4.80	4.50	9.3
Euro area	32	1.88	1.70	3.11	4.61	4.35	4.05	3.80	3.70	9.8
Japan	7	0.55	0.46	0.68	0.94	0.90	0.70	0.60	0.50	1.8
Rest-of-world	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Global	100	2.39	2.15	3.66	4.93	4.49	4.15	3.88	3.70	9.3

* Option-Adjusted Spreads (OAS) on the Barclays Capital indices (%), end-of-period.

High-yield credit*	Weights (%)	2008				2009				Forecast return (2009 vs 2008)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	88	7.81	7.08	10.20	16.6	16.5	15.4	15.4	14.5	20.8
UK	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Euro area	12	7.06	6.84	10.76	19.5	17.0	16.5	15.5	15.0	38.3
Japan	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Emerging	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Global	100	7.7	7.1	10.3	17.0	16.6	15.5	15.4	14.6	22.9

* Option-Adjusted Spreads (OAS) on the Barclays Capital indices (%), end-of-period.

Equities*	Weights (%)	2008				2009				Forecast return (2009 vs 2008)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	42	-9.3	-2.1	-9.0	-22.2	-8.0	4.0	6.0	8.0	9.5
UK	10	-10.4	-0.9	-11.8	-8.7	-6.0	4.0	6.0	8.0	11.9
Euro area	16	-15.5	-4.1	-11.1	-20.8	-8.0	3.0	5.0	7.0	6.5
Japan	9	-17.8	9.1	-17.5	-22.3	-7.0	1.0	4.0	6.0	3.5
Rest of world	25	-12.4	-1.1	-11.6	-20.7	-8.0	4.0	8.0	10.0	13.7
Global	100	-11.7	-0.9	-12.4	-20.7	-7.7	3.6	6.2	8.2	9.8

* MSCI total return indices in local currency, % changes during period.

Currencies*	Weights (%)	2008				2009				Forecast return (2009 vs 2008)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Dollar	26	-5.3	1.9	6.6	1.5	6.2	1.8	2.6	-1.5	9.3
Sterling	5	-5.3	0.6	-3.1	-18.4	1.4	6.4	7.7	4.6	21.5
Euro	22	3.7	0.8	-4.7	4.4	-5.4	-4.6	-4.8	-4.0	-17.5
Yen	8	9.1	-6.0	5.2	20.4	8.9	3.6	-4.6	-2.2	5.3
Swiss franc	1	7.0	-2.1	0.1	7.5	-3.3	-1.8	-1.6	2.1	-4.6
Rest of world	38	7.0	-1.6	2.5	13.1	-0.3	-1.7	-2.6	-1.0	-4.7

* Bank of England effective exchange rate indices, % changes during period. Rest-of-world is calculated by residual.

Commodities*	Weights (%)	2008				2009				Forecast return (2009 vs 2008)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Energy	70	10.0	38.0	-30.0	-45.0	-15.0	0.0	5.0	10.0	-1.8
Agriculture	12	6.0	9.0	-28.0	-20.0	-5.0	0.0	2.0	5.0	1.7
Livestock	5	-14.6	7.0	-7.0	-11.0	-5.0	0.0	2.0	5.0	1.7
Industrials metals	11	20.7	-4.0	-23.0	-34.0	-8.0	0.0	3.0	6.0	0.4
Precious metals	2	9.9	1.0	-9.0	-11.0	18.0	3.0	0.0	5.0	27.6
Global	100	9.5	27.5	-27.4	-38.3	-15.2	-3.4	3.9	7.8	-0.3

* GSCI indices in dollars, % changes during period.

Real estate/ commercial property*	Weights (%)	2008				2009				Forecast return (2009 vs 2008)
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
USA	30	1.4	-5.5	4.5	-40.8	-35.0	-10.0	0.0	0.0	-41.5
UK	10	1.3	-22.6	4.7	-33.6	-30.0	0.0	5.0	10.0	-19.2
Euro area	25	1.7	-13.0	-10.4	-28.8	-10.0	0.0	0.0	5.0	-5.5
Japan	20	-19.9	5.1	-15.0	-37.6	-25.0	-5.0	0.0	0.0	-28.8
Rest of world	15	-14.0	-5.5	-2.6	-22.5	-35.0	-5.0	0.0	5.0	-35.2
Global	100	-5.1	-7.0	-4.2	-33.7	-26.3	-4.8	0.5	3.0	-26.8

* EPRA/NAREIT indices in local currency, % changes during period.

Key Tactical Asset Allocation (TAA) themes

Theme	Thesis	Investment strategies
1. Don't get too depressed about depression.	Markets appear to be putting a significant probability on the next few years playing out just like the Great Depression. We suspect, however, that policymakers' efforts, will be successful – in which case we will have a recession, but not a complete meltdown.	The equity market has performed much as it did during the run in to the Great Depression. And credit spreads are priced much like they were 80 years ago. Accordingly, if we avoid a depression, these asset classes should outperform over the next year, as investors grow more positive about prospects. Credit should lead equities in this process.
2. The stretch for yield is just beginning.	As rates fall – with the Fed already at zero and European central banks moving in the same direction, if not quite as far – and as central banks start purchasing bonds, so the yield on fixed income instruments will drop. Adding to the pressure, economic slowdown will lead to higher savings rates and reduced investment demand. So, long-term interest rates will also decline.	Conservative investors will struggle to find alternative assets that offer risk-free returns anything close to those that they enjoyed last year. But in time they will likely take on private-sector risk. As the recovery bottoms and turns, expect to see a more forthright rotation into riskier asset classes, such as equities.
3. Deflation fears will be fanned by falling prices.	Consumer prices are set to drop later in 2009 – i.e. inflation will soon turn negative. But, unlike many, we doubt very much that sustained deflation will occur. So, fears of it happening should provide investors with clear opportunities.	Inflation-linked bonds look attractive relative to conventional bonds: there remains a good opportunity for investors who get long on them. However, it may well be that they get cheaper before they perform, thanks to inflation surprising on the downside for a while longer yet.
4. The emerging world is not resilient. But it will re-emerge.	Although catch-up means that policymakers in countries like China and India have more ability to promote domestic demand to help offset the hit to export prospects, there are limits to what can be achieved through this route. However, once global demand begins to pick up again, emerging economies – and their markets – will turn out to be leverage plays on the recovery.	Emerging equities is the easiest way to play the 'leverage' theme – especially the 'BICs' (as opposed to the 'BRICs'). But investors may prefer to start by differentiating between 'good' and 'bad' emerging markets. Creditor countries stand to do better, and sooner, than debtor ones. That goes for their currencies as well as their debt.
5. Volatility will drop back – thanks in part to asset price targeting.	In the 'new world' that policymakers are designing, asset price fluctuations will be accorded a more prominent role: policymakers will react to them, rather than dismiss them as something that is not of their concern or making. Regulatory reform is likely to help limit the cyclical nature of liquidity provision and leverage.	It may well take time. But equity volatility should trend lower during 2009 this year and into 2010. Lowered volatility in housing and commercial property markets should help these asset classes recover some sort of reputation. But it looks increasingly likely to be more a 2010 story than a 2009 one.
6. Real estate is really in a state.	Both house prices and commercial property values soared above their 'fair values' during the 'noughties'. But they are now nose-diving. Some are already back to fair value.	Undershooting is the norm in these markets. So, 'momentum' may well drive prices lower in the short run. Nevertheless, long-horizon, risk tolerant investors are beginning to sniff opportunities in these markets – rightly in our opinion.

Global economic overview: GDP

	Nominal GDP (\$bn, 2007)	Global share (%)	Population (m, 2007)	GDP/capita (\$000, 2007)	2007	Real GDP (% y-o-y) ¹		
						2008F	2009F	2010F
North America	15244	27.9	335	45.5	2.2	1.1	-1.9	1.5
United States	13808	25.3	302	45.7	2.2	1.2	-2.0	1.5
Canada	1436	2.6	33	43.7	2.7	0.6	-1.0	1.5
Latin & Central America	3609	6.6	552	6.5	5.5	4.3	1.1	3.7
Brazil	1314	2.4	189	6.9	5.4	5.4	2.0	4.1
Mexico	1023	1.9	105	9.7	3.2	1.5	-2.3	2.7
Argentina	260	0.5	39	6.6	8.7	6.6	0.6	2.3
Euro area	12231	22.4	318	38.4	2.6	0.7	-2.5	1.0
Germany	3321	6.1	82	40.4	2.5	1.0	-3.2	1.3
France	2594	4.7	62	42.0	2.2	0.7	-2.1	1.2
Italy	2105	3.8	59	35.7	1.5	-0.9	-3.4	0.5
Spain	1440	2.6	45	32.1	3.7	1.2	-2.7	0.7
Netherlands	777	1.4	17	46.8	3.5	2.0	-1.5	1.2
Belgium	454	0.8	11	42.6	2.8	1.2	-1.6	1.2
Austria	371	0.7	8	44.8	3.1	1.5	-1.4	1.0
Greece	314	0.6	11	28.2	4.0	2.7	-0.1	1.9
Ireland	261	0.5	4	60.2	6.0	-1.8	-4.2	0.3
Finland	246	0.5	5	46.9	4.5	1.5	-1.6	1.7
Portugal	223	0.4	11	21.1	1.9	0.0	-2.8	0.4
Other developed Europe	4388	8.0	87	50.2	3.0	0.8	-2.0	0.7
UK	2804	5.1	61	46.1	3.0	0.7	-2.5	0.5
Switzerland	427	0.8	7	58.5	3.3	1.8	-1.1	0.9
Sweden	455	0.8	9	49.6	2.7	0.7	-1.2	1.1
Norway	389	0.7	5	83.5	3.7	2.1	-0.6	1.3
Denmark	312	0.6	5	57.1	1.7	-0.6	-1.5	0.9
Central and Eastern Europe	3583	6.6	470	7.6	7.0	4.7	1.1	4.0
Russia	1290	2.4	142	9.1	8.1	6.0	-1.0	4.1
Turkey	659	1.2	69	9.6	4.6	0.6	-1.3	2.5
Poland	422	0.8	38	11.1	6.6	4.4	1.5	3.4
Asia	12924	23.6	3698	3.5	6.1	3.6	1.3	4.1
Japan	4382	8.0	128	34.3	2.1	-0.7	-3.6	1.2
China	3280	6.0	1321	2.5	11.4	8.5	7.5	7.6
Korea	970	1.8	48	20.0	5.0	2.5	-2.0	4.0
India	1101	2.0	1169	0.9	9.0	7.5	5.0	6.0
Australia	909	1.7	21	43.2	4.2	2.3	0.5	1.6
Taiwan	383	0.7	23	16.7	5.7	0.1	-4.0	4.0
Indonesia	433	0.8	225	1.9	6.3	6.0	4.5	5.5
Hong Kong	207	0.4	7	29.8	6.4	2.9	-2.0	2.5
Singapore	161	0.3	5	35.2	7.7	1.2	-3.0	4.0
Middle East	1400	2.6	239	5.9	6.0	6.5	5.5	6.1
Saudi Arabia	382	0.7	24	15.7	3.5	5.3	1.7	4.2
Iran	285	0.5	72	4.0	6.4	5.5	5.0	4.9
UAE	191	0.3	4	42.5	7.4	7.0	6.0	5.6
Africa	1107	2.0	845	1.3	6.3	5.6	5.2	5.9
South Africa	283	0.5	48	5.9	5.1	3.1	0.7	3.3
Global	54673	100	6552	8.3	4.0	2.3	-0.6	2.5

¹ GDP growth forecasts for USA, euro-area countries, UK, Japan and BRIC countries are Barclays Wealth forecasts. All other GDP growth forecasts are based on Barclays Capital Research, Consensus Forecasts, and the IMF's *World Economic Outlook*.

Global economic overview: Inflation and interest rates

	Inflation (average consumer prices, % y-o-y)				Official interest rate (end of period, %) ¹			
	2007	2008F	2009F	2010F	2007	2008	2009F	2010F
North America	2.8	3.8	-0.9	0.6	4.25	0.25	0.14	0.25
United States	2.9	3.9	-1.1	-0.9	4.25	0-0.25	0-0.25	0-0.25
Canada	2.1	2.4	0.6	1.9	4.25	1.50	0.25	1.50
Latin & Central America	5.4	7.8	7.0	6.0	10.01	12.18	9.13	10.73
Brazil	3.6	5.7	4.5	4.0	11.25	13.75	10.00	11.00
Mexico	4.0	5.1	4.6	3.3	7.50	8.25	5.25	6.75
Argentina	8.8	8.7	7.1	7.4	13.65	19.75	20.00	25.00
Euro area	2.1	3.3	0.5	1.0	4.00	2.50	1.00	2.00
Germany	2.3	2.6	0.3	0.8	4.00	2.50	1.00	2.00
France	1.6	2.8	0.3	0.9	4.00	2.50	1.00	2.00
Italy	2.0	3.3	0.7	1.1	4.00	2.50	1.00	2.00
Spain	2.8	4.1	0.3	1.4	4.00	2.50	1.00	2.00
Netherlands	1.6	2.5	0.8	0.7	4.00	2.50	1.00	2.00
Belgium	1.8	4.5	1.8	1.3	4.00	2.50	1.00	2.00
Austria	2.2	3.2	0.9	1.2	4.00	2.50	1.00	2.00
Greece	3.0	4.2	2.2	2.1	4.00	2.50	1.00	2.00
Ireland	2.9	4.1	1.5	1.4	4.00	2.50	1.00	2.00
Finland	1.6	4.0	1.3	1.2	4.00	2.50	1.00	2.00
Portugal	2.4	2.8	0.8	1.1	4.00	2.50	1.00	2.00
Other developed Europe	1.9	3.5	0.7	1.3	4.97	2.07	0.70	1.16
UK	2.3	3.6	0.6	1.3	5.50	2.00	0.50	1.00
Switzerland	0.7	2.4	0.2	1.0	2.75	0.50	0-0.25	0-0.25
Sweden	1.7	3.5	0.1	1.0	4.00	2.00	0.50	1.50
Norway	0.8	3.8	1.7	2.0	5.25	3.00	2.00	2.00
Denmark	1.7	3.4	1.5	1.7	4.25	3.75	2.00	2.50
Central and Eastern Europe	8.1	11.0	7.8	6.4	10.71	12.13	9.58	9.49
Russia	10.7	13.0	9.0	7.7	10.00	13.00	11.00	10.00
Turkey	8.8	10.2	8.0	7.3	15.75	15.00	11.00	12.00
Poland	2.5	4.4	2.7	2.0	5.00	5.00	3.00	4.00
Asia	2.7	4.8	1.5	1.5	4.4	3.1	2.1	2.7
Japan	0.0	1.4	-1.2	-0.5	0.50	0.10	0.10	0.50
China	4.8	5.9	1.5	2.0	7.47	5.31	3.69	4.60
Korea	2.5	4.7	2.2	1.1	5.00	3.00	1.50	1.50
India	4.8	9.1	2.5	3.0	7.75	6.50	4.00	4.00
Australia	2.3	4.4	2.4	1.7	6.75	4.25	3.00	5.00
Taiwan	1.8	3.5	-0.4	0.1	3.38	2.00	1.00	2.00
Indonesia	6.2	8.8	5.0	3.6	8.00	9.25	6.50	6.50
Hong Kong	2.0	4.3	1.3	2.0	5.75	0.50	0.50	0.50
Singapore	2.1	6.5	0.7	0.5	2.38	0.85	0.70	1.00
Middle East	9.5	14.1	11.9	9.4	5.1	2.2	1.7	2.4
Saudi Arabia	4.1	9.5	6.4	5.4	5.50	2.50	2.00	2.75
Iran	18.4	26.0	22.0	18.0	NA	NA	NA	NA
UAE	11.1	12.9	10.8	8.1	4.25	1.50	1.00	1.75
Africa	6.2	10.0	7.5	5.8	11.0	11.5	8.0	8.0
South Africa	7.1	11.6	5.8	5.4	11.00	11.50	8.00	8.00
Global	4.2	5.0	1.7	1.7	5.2	3.4	2.2	2.8

¹Inflation and interest rates forecasts for USA, euro-area countries, UK, Japan and BRIC countries are Barclays Wealth forecasts. All other forecasts are based on Barclays Capital Research, Consensus Forecasts, and the IMF's *World Economic Outlook*.

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Despite significant policy initiatives, markets have remained anxious

The Federal Reserve has deepened its commitment to expansionary policies

Reacting to substantial drops in activity and confidence, GDP growth forecasts have been cut

Macro update: US

- Policymakers in Washington have stepped up efforts to stabilise the financial system and moderate the recession, but downside risks still predominate.
- Concerned about falling inflation expectations, the FOMC has announced that it will act to bring inflation back to the 1.7-2.0% range over the long run.
- US GDP growth expectations for both this year and next have continued to deteriorate. Our forecasts are a little more gloomy than consensus ones.

Policymakers' efforts to stabilise financial markets and stave off worst-case deflationary scenarios have taken centre stage over the past month, as weakening activity data continued to feed market participants' anxiety. The \$787 billion fiscal stimulus package was finally signed into law, and the Treasury outlined the Financial Stability Plan (FSP) with which it hopes to stop the haemorrhage of capital from the banking sector. In the event, although the fiscal boost is largely expected to support the economic recovery later in the year, the FSP was found wanting in details and the letdown weighed on asset prices.

The Obama administration has also charged ahead with the Homeowner Affordability and Stability Plan, a targeted initiative that should facilitate refinancing of agency mortgages and promises to prevent foreclosures via interest rate reductions. On the monetary policy front, the Federal Reserve reaffirmed its commitment to supporting dysfunctional credit markets and wielded a key weapon in the fight against falling inflation expectations: the FOMC communicated that it sees personal consumption expenditures (PCE) inflation of between 1.7 and 2.0% in the long run, thereby outlining its definition of price stability. As core inflation appears to have embarked on a softening trend, this statement underlines the need to carry out expansionary policies for the foreseeable future.

Despite the flurry of activity in Washington the ongoing sequence of downbeat economic data releases has weighed further on the consensus, which now sees US GDP shrinking by 2.1% this year (-1.8% in the previous month) and a milder recovery in 2010 (2%, down from 2.3% in the previous month). Our model-based forecasts point to even weaker growth figure in 2010, 1.5%, but we are close to the consensus in expecting a significant drop in GDP this year (Figure 1).

Figure 1 – US GDP growth forecast

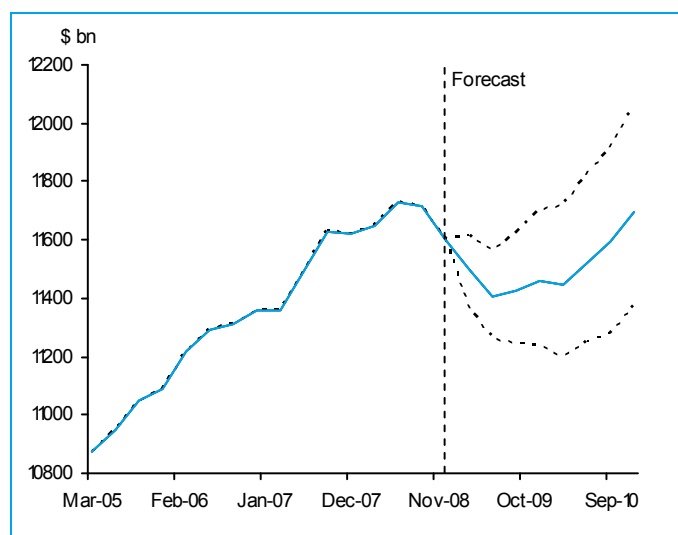


Figure 2 – The US forecast in a nutshell*

% y-o-y except where stated				
	2007	2008	2009	2010
GDP	2.2	1.2	-2.0	1.5
CPI	2.9	3.9	-1.1	-0.9
Fed funds (%)	4.25	0-0.25	0-0.25	0-0.25
10-year yields (%)	4.1	2.2	3.0	3.5
S&P 500 index	3.5	-37.0	6.2	13.4
\$ index	-9.3	4.4	9.2	1.5

* Note that all market variables are end-of-period rates.

Source: Barclays Wealth Research

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Macro update: Euro area

- The unexpectedly large drop in GDP in Q4 and worries about excess inventories have led us to lower our GDP growth forecasts further.
- Inflation rates, which have already plunged, stand to fall further. But we still believe that it is unlikely that a deflationary spiral will develop.
- The poor macro backdrop suggests equity markets will take longer to recover. We continue to expect investment-grade credit to perform before stocks do.

The euro area has suffered a sharp contraction and output is set to slide further from here

The stability of core inflation could be challenged, but a downward price spiral is unlikely

The ECB is likely to provide further monetary stimulus

Credit markets expected to outperform

Euro-area GDP contracted even more steeply in Q4 than expected, falling at its fastest rate in 34 years. Full details are not yet available, but partial country data suggest that investment and exports reeled the most, as a dearth of financing hit domestic and foreign consumers. There is also evidence that plunging demand left firms with excess unwanted inventories, which will take time to work through, even once funding access improves. Achieving the latter, meanwhile, is likely to be an uphill struggle, as data show bank loans to firms and to households to have dried up since the autumn (Figure 1). All in all, the likelihood is therefore that Q1 GDP growth, while less negative than in Q4, will be weaker than we previously expected. We have cut our 2009 GDP growth forecast from -1.7% y-o-y to -2.5%.

As regards inflation, energy and food prices should continue to exert downward price pressure in the spring, pulling inflation temporarily into negative territory. We expect the relative stability of 'core' inflation until now to be challenged as firms attempt to clear inventories and gain market share through discounting, but that a deflationary spiral fed by falling inflation expectations is unlikely to develop.

Turning to policy, on the fiscal side and for certain industries deemed systemically important, stimulus has been provided, albeit on a relatively modest scale. The ECB is likely to add more monetary stimulus too. In part, this should come via rate cuts, but we think rates will trough clearly above zero. In addition, unconventional policy measures may be stepped up, although the institutional framework makes it hard to replicate the Fed's or the Bank of England's quantitative easing policies.

Altogether, the poorer macro backdrop has led us to lower our forecasts for interest rates and equity prices, while the relative ranking of asset returns remains as before, leaving our asset allocation recommendations intact. Specifically, we continue to expect investment-grade credit to start performing well before stocks.

Figure 1 – Euro-area loans to the private sector

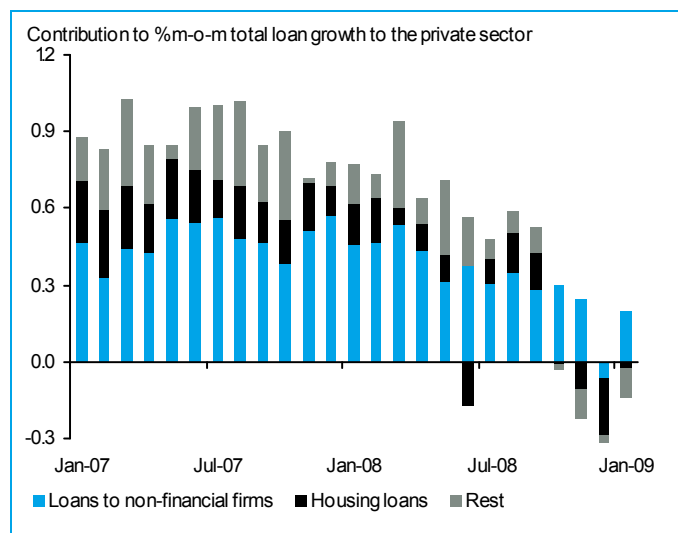


Figure 2 – The euro-area forecast in a nutshell*

% y-o-y except where stated				
	2007	2008	2009	2010
GDP	2.6	0.7	-2.5	1.0
CPI	2.1	3.3	0.5	1.0
Refi rate (%)	4.00	2.50	1.00	2.00
10-year yields (%)	4.4	3.0	3.0	3.5
Euro STOXX 50 index	6.8	-44.4	2.1	7.0
€ index	6.6	4.1	-17.5	3.7

* Note that all market variables are end-of-period rates.

Source: Barclays Wealth Research

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We continue to expect a sharp contraction in GDP this year

Inflation looks set to remain muted for some time

The BoE will soon embark on quantitative easing...

...in an attempt to boost activity via the supply of money

Investment-grade credit spreads should narrow further

Macro update: UK

- We continue to expect a 2.5% drop in GDP in 2009 and only a very modest recovery in 2010.
- CPI inflation is likely to undershoot the Bank of England’s target for some time, but we do not think that a full-blown deflationary spiral will develop.
- The policy response has shifted up a gear with the Bank of England (BoE) set to embark on ‘quantitative easing’. Further fiscal support is also likely.

The UK economy remains in the grips of a downward spiral, caught between a contraction in lending activity and declining economic demand. We have not revised our GDP forecast since February and continue to expect a drop of 2.5% this year, with only an anaemic recovery thereafter.

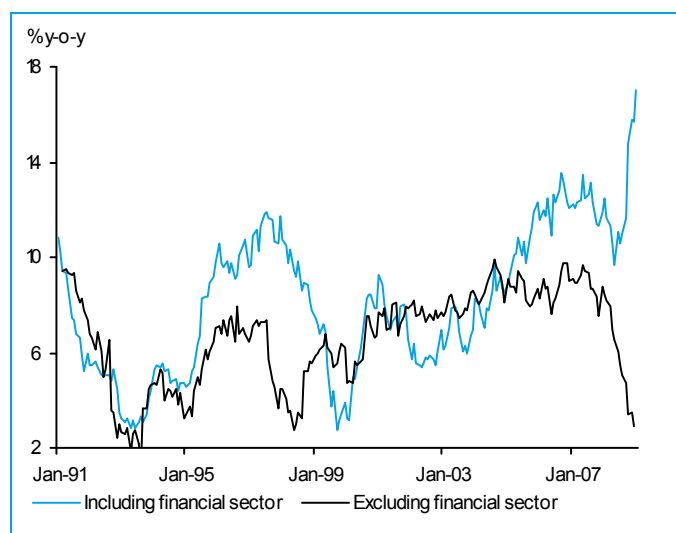
Meanwhile, we have revised our forecast for CPI inflation slightly higher for 2008 but lower for 2009, reflecting the assumed timing of cuts in domestic energy prices. The broad story remains the same: downward pressure from falling activity, energy prices and the cut in VAT will push CPI inflation close, if not into, negative territory during 2009. We expect a return to positive territory by early 2010 but the BoE’s 2% target is likely to be undershot this year and next.

Policymakers have ramped up their efforts to support the economy. The BoE is likely to cut rates for the last time in this cycle in March, to 0.5%. Thereafter ‘quantitative easing’ will be the primary tool of monetary policy. In essence, instead of setting the rate at which central bank reserves are remunerated – Bank Rate – the BoE will directly set the quantity of those reserves and use the proceeds of newly-created central bank money to purchase government and high-grade private assets.

The hope is that this direct boost to the monetary base will feed through to greater credit extension to firms and households. Developments in the growth of the broad money supply outside of the financial sector, which has fallen very sharply in recent months (Figure 1), will provide a measure of success.

In terms of markets, we expect equity prices to recover in the second half of the year, but with the UK underperforming its peers. Investment-grade credit spreads should continue to narrow. Indeed, the authorities’ proposed purchase of highly-rated corporate paper could provide a key support to this market.

Figure 1 – Broad (M4) money supply



Source: Barclays Wealth Research

Figure 2 – The UK forecast in a nutshell*

% y-o-y except where stated				
	2007	2008	2009	2010
GDP	3.0	0.7	-2.5	0.5
CPI	2.3	3.6	0.6	1.3
Bank rate (%)	5.50	2.00	0.50	1.00
10-year yields (%)	4.6	3.1	3.5	4.0
FTSE 100	3.8	-31.3	6.5	7.4
£ index	-6.0	-24.7	21.5	-0.2

* Note that all market variables are end-of-period rates.

Source: Barclays Wealth Research

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Macro update: Emerging Markets

- Growth in emerging economies has slowed dramatically in recent months, with many countries now expected to contract in 2009.
- The larger countries should show more resilience, especially China and India. Smaller, open economies in Eastern Europe and Asia will be hit hard.
- Policymakers have responded to the downturn quite aggressively over recent months. But additional policy easing is needed, and expected.

Slow overall growth in 2009 will still compare favourably to the rest of the world

Huge variation in GDP rates will be evident, China to be the best performer

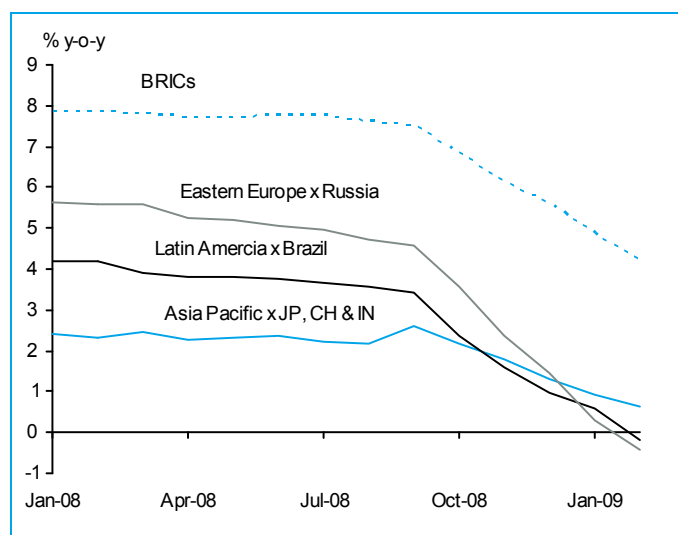
Additional policy stimulus likely

Economic newsflow emanating from emerging markets has deteriorated dramatically over recent months, with growth forecasts for 2009 being cut aggressively across all regions. The consensus now expects emerging economies to expand by just 2.1% in 2009, compared with 5.4% and 7.5% in 2008 and 2007 respectively. Moreover, these numbers are likely to be pared back further over coming months. Indeed, most countries will record their worst annual outturn in over a decade, although this compares favourably to developed economies – many of which will experience their worst downturn since at least the 1970s.

There will however be huge divergence in economic performance over the next 12 months, however. The larger, less trade-dependent economies – China, India, Indonesia, Brazil, Poland and South Africa – will generally show a greater amount of resilience (the latter three to a lesser extent than the former). China, with its huge fiscal stimulus package, will once again be the best performing economy, closely followed by India. Worst hit will be the smaller, more open economies of Asia and Eastern Europe (Figure 1). Many of the latter (suffering from bursting asset price and credit bubbles) will experience large contractions in 2009, with the Baltic States and Ukraine particularly severely hit.

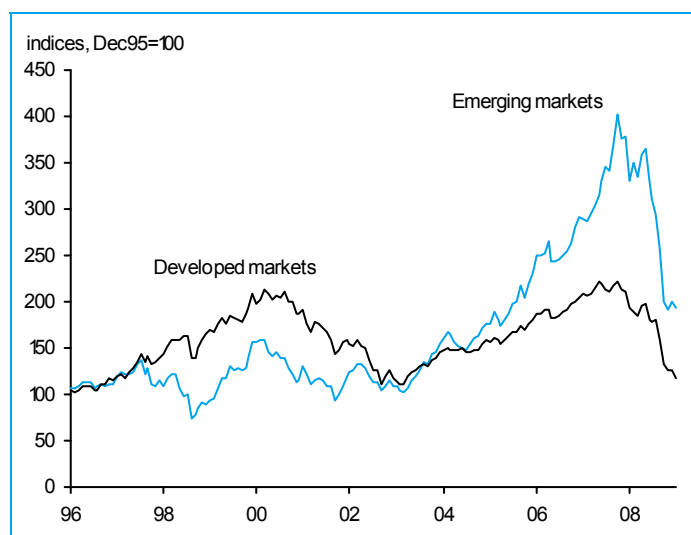
Amid the dramatic slowdown in global trade and falling commodity prices, policymakers have generally responded quite aggressively over recent months. Central banks have cut interest rates across all regions and, with inflation likely to fall back significantly further, additional monetary easing is likely over coming months. Moreover, a number of governments have introduced large fiscal stimulus programs, with China's package (officially gauged at over 20% of GDP) standing out. We suspect that China and Brazil (the former with sound government finances and the latter with very high real interest rates) remain best placed to provide further policy stimulus if underlying conditions so dictate.

Figure 1 – 2009 Consensus GDP growth estimates



Source: Barclays Wealth Research

Figure 2 – Relative equity market performance



Source: Barclays Wealth Research

Global markets overview table

	Equity free market cap ¹ (\$ billion, 2008)	Share (%)	Equity free market cap/GDP	Bond market cap ² (\$ billion, 2007)	Share (%)	Bond market cap/GDP
North America	8,970	48.3	56.4	7,774	33.8	50.9
US	8,322	44.8	58.1	7,294	31.8	52.7
Canada	647	3.5	41.4	479.6	2.1	33.5
Latin & Central America	367	2.0	10.6	303	1.3	8.8
Brazil	226	1.2	13.6	119	0.5	9.0
Mexico	91	0.5	8.0	119	0.5	13.3
Argentina	2	0.0	0.7	8	0.0	3.2
Euro area	2,629	14.2	18.7	7,371	32.1	61.1
Germany	679	3.7	17.8	1,779	7.7	53.5
France	846	4.6	28.4	1,504	6.5	58.7
Italy	285	1.5	11.9	1,687	7.3	80.2
Spain	352	1.9	20.9	548	2.4	38.1
Netherlands	189	1.0	20.8	403	1.8	52.4
Belgium	58	0.3	11.0	431	1.9	94.9
Austria	25	0.1	5.7	300	1.3	80.1
Greece	37	0.2	10.0	383	1.7	121.6
Ireland	24	0.1	8.3	73	0.3	28.1
Finland	108	0.6	37.5	93	0.4	38.0
Portugal	26	0.1	10.1	170	0.7	76.2
Other developed Europe	2,464	13.3	53.1	1,648	7.2	37.8
UK	1,543	8.3	55.4	1,357	5.9	48.9
Switzerland	652	3.5	132.3	83	0.4	19.5
Sweden	156	0.8	30.4	108	0.5	23.7
Norway	48	0.3	9.9	34	0.1	8.6
Denmark	65	0.4	17.7	68	0.3	21.7
Central and Eastern Europe	180	1.0	3.9	357	1.6	10.0
Russia	99	0.5	5.6	64	0.3	4.9
Turkey	26	0.1	3.3	93	0.4	14.0
Poland	28	0.2	5.0	100	0.4	23.9
Asia	3,642	19.6	28.3	5,421	23.6	42.1
Japan	1,960	10.6	40.5	4,152	18.1	94.7
China	318	1.7	7.5	358	1.6	11.0
Korea	238	1.3	24.9	208	0.9	21.7
India	114	0.6	9.2	258	1.1	23.5
Australia	462	2.5	43.3	109	0.5	12.0
Taiwan	190	1.0	49.6	99	0.4	25.7
Indonesia	26	0.1	5.2	25	0.1	5.8
Hong Kong	156	0.8	69.6	6	0.0	3.1
Singapore	84	0.5	43.4	39	0.2	24.4
Middle East	150	0.8	7.8	35	0.2	2.5
Saudi Arabia	65	0.3	12.3	-	-	-
Iran	-	-	-	-	-	-
UAE	10	0.1	3.8	-	-	-
Africa	156	0.8	11.5	62	0.3	5.6
South Africa	147	0.8	48.9	56	0.2	19.7
Global	18,557	100.0	29.9	22,971	100	42.2

Source: Barclays Wealth Research, FactSet, Citigroup

¹ The market cap weightings are based on the MSCI AC World index for equities and Merrill Lynch indices for fixed income. ² Fixed income consists of both conventional and inflation-linked bonds, emerging market bonds and corporate bonds.

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Not yet worth taking the risk

- Recent policy packages may not have wowed the markets, but the core measures are actually well directed.
- The problem however will be the time-lag; in the short term the situation may well continue to deteriorate, absent new measures.
- We stick to our recommendation of an overall defensive allocation in portfolios. One recent bright spot has been investment-grade credit.

Policies may not have wowed the markets...

...but core measures are actually well directed

Any short-term bounce may not be long-lasting

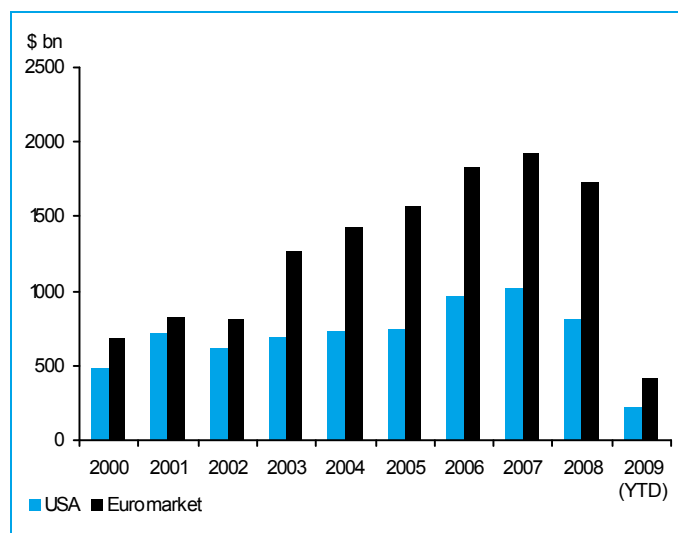
Investment-grade credit remains a bright spot

Adding to some troublesome recent newsflow, the US fiscal stimulus package came out on the small side of expectations and was perceived by some as party-biased and poorly communicated. Adding pain to the policy process, the US Treasury's plan for the financial sector and the communication of the policy initiative was less than perfect, and therefore also didn't deliver a boost to confidence: equity markets failed to rally. This is the reason why we currently focus more on the response to a policy communication than the policy itself.

But, looking beyond the headlines, the core policy measures are actually well directed. Supporting the housing market and banks at the same time (by tying financial assistance to the financial sector to loan modification) is probably a positive for both the US economy and for equities. The problem for equity markets, however – as with most of the fiscal stimulus plans around the world – is the likely time lag. In the short term, the situation will carry on deteriorating, with corporate data worsening and both earnings expectations and actual earnings (losses) continuing to both disappoint and point to further problems. So, while one cannot rule out a short-term bounce in risk assets (e.g. equities) after the recent sell-off, we would not expect it to be lasting.

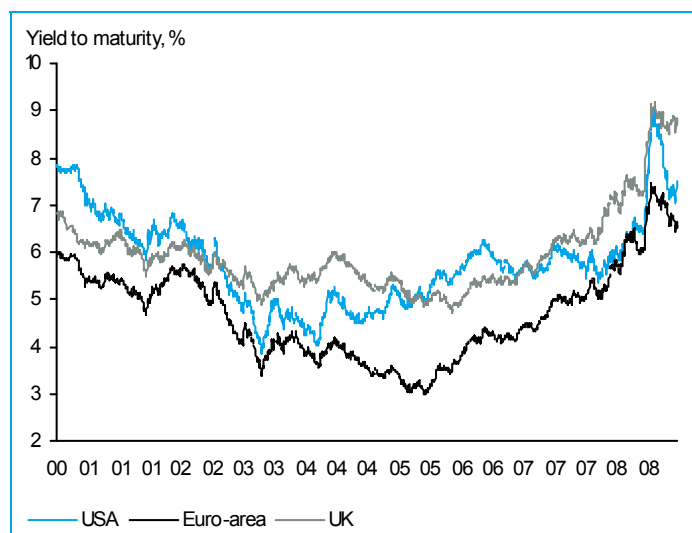
We still see equities performing later this year, but we don't see the risk of a tactical overweight as being worth taking yet – and thus stick to our recommendation of an overall defensive allocation in portfolios. The bright spot in financial markets remains investment-grade corporate bonds. Here issuance remains a lot stronger, and has been better received, than was expected only a few months back (Figure 1). While investment-grade bonds gave up some performance during February, their performance relative to equities and the rest of the market still points to a more favourable risk/return trade-off. This is signalled by the unusual elevation of spreads, illustrated in Figure 2.

Figure 1 – Investment-grade bond issuance in EUR and USD



Source: Barclays Wealth Research

Figure 2 – Investment-grade bond spreads



Source: Barclays Wealth Research

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Markets have been unimpressed by the response from policymakers

The earnings outlook remains bleak

We make some minor adjustments to our sector recommendations...

...but risk-averse investors should look elsewhere

Equities update: Back through the November lows

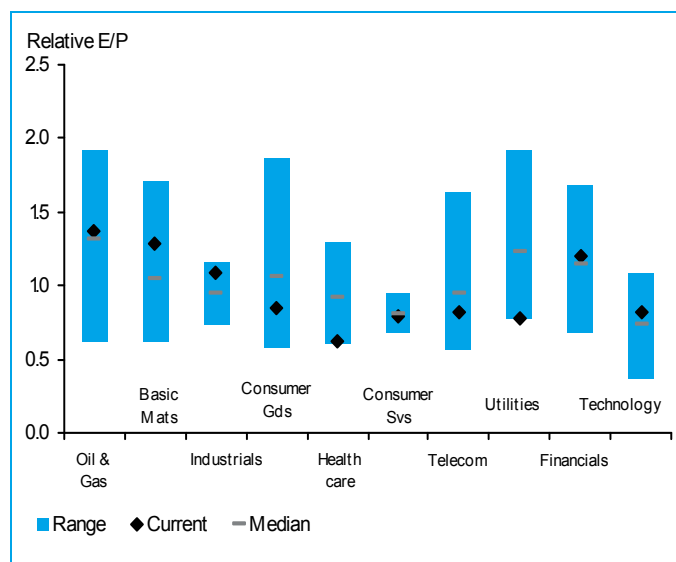
- The failure of policymakers to act as decisively as was hoped has sapped confidence from markets.
- Earnings growth expectations for 2009 took a further leg down this month. Global earnings are expected to contract by -4% this year.
- Short term, we would recommend staying defensive. But we are toning down this stance as relative valuations amongst the sectors are looking extreme.

Much was expected from policymakers this month but, as we write, not very much has been delivered. Combined with continued gloomy macro news, equity markets have given up most of their recent gains and we have seen the S&P 500 fall through November's lows; markets are now trading at levels not seen since 1997. Most of the selling has taken place in financials, as markets worry about the sector's survival in the continued absence of a clear, detailed plan of action from policymakers.

The news on earnings over the past month has not improved, with the fourth-quarter earnings season in the US disappointing. We continue to see the impact of the global recession being factored in to 2009 earnings – these are now expected to contract by -4% – with downward revisions in all major markets. Sector-wise, pessimism is spreading from financials into other sectors, with substantial downgrades seen in energy, materials and industrials.

Regular readers will be aware of our concerns about the relative valuation of the defensive sectors following their outperformance over the past year. Figure 1 shows the relative earnings yield of the major global sectors and the trading range for the sectors since 1979. One thing that stands out to us is that the relative valuation of the health care and utilities sectors is higher than at any time in the past 28 years. With this in mind, we are reducing our short-term recommendation on health care to slight overweight and upgrading the materials recommendation to slight underweight as this looks more attractively valued. These changes are not the result of us becoming more bullish on equities in the short term: it is just in recognition of how expensive defensive stocks have become. Consequently, we continue to recommend that investors remain underweight equities (and overweight cash and fixed income). Only once the US economy starts to turn is it likely that equities can recover some of the lost ground.

Figure 1 – Relative E/P ratio for global sectors, 1979 to date



Source: Datastream, Barclays Wealth Research

Figure 2 – Current sector recommendations

	Short-term call	Medium-term call
Energy	-	0
Materials	-	+
Industrials	0	+
Consumer discretionary	0	+
Consumer staples	0	--
Healthcare	+	0
Financials	0	+
IT	0	0
Telecoms	+	0
Utilities	0	--

A plus (+)/minus (-) sign shows an expected out/underperformance relative to the market. Double pluses and minuses indicate strong conviction calls.

Source: Barclays Wealth Research

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Fixed income: One port in the storm

- Government bonds remain a safe haven. We continue to recommend this asset class, as it is evident that tough times will persist a while yet.
- We see value in the EMU sovereigns – Austria, Ireland and Spain – that have cheapened due to the credit crisis.
- We continue to recommend high grade, senior credit bonds. Subordinated and preferred paper offers fundamental value but is high risk.

We maintain a long duration stance

We see value in EMU sovereigns – Austria, Ireland, Portugal and Spain – that have cheapened due to the credit crisis

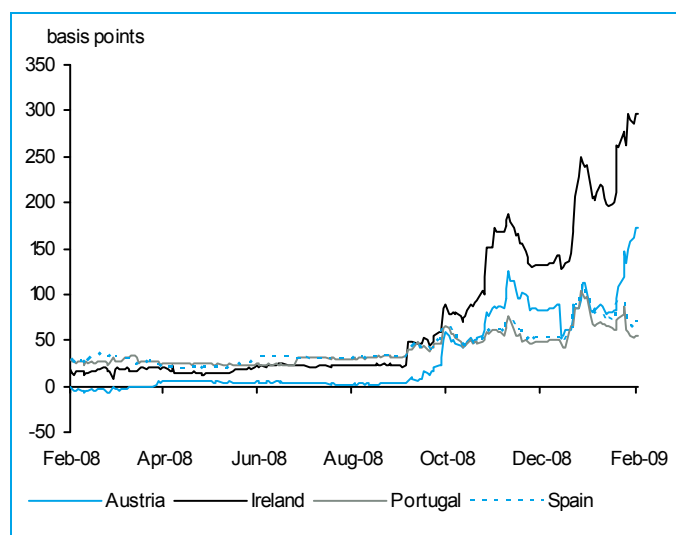
Senior high-grade paper remains our major call; junior paper offers value but is very risky

February has demonstrated that the world remains a very risky place, and that government bonds are the only true safe haven in this environment. Therefore, in spite of demanding valuations, we continue to recommend investors adopt a long duration – i.e. overweight bonds versus cash – position in their portfolios. Our quantitative model for duration positioning still suggests it is a good time to be taking such risk.

However, it is becoming increasingly important to distinguish between issuers when talking about government bonds these days. In particular, the risks associated with the European countries most exposed to the ‘credit crunch’ – Austria, Ireland, Portugal and Spain – have widened massively versus perceived low-risk issuers like Germany, as can be seen from their CDS spreads (Figure 1). Given that these issuers (with the exception of Portugal) entered the crisis with low debt to GDP ratios and small fiscal deficits, and that a co-ordinated EU bail-out is plausible in the worst-case scenario, we judge that these spreads overstate their default risk – i.e., we believe buying government (or government-guaranteed) paper from these sovereigns makes an attractive risk-reward trade.

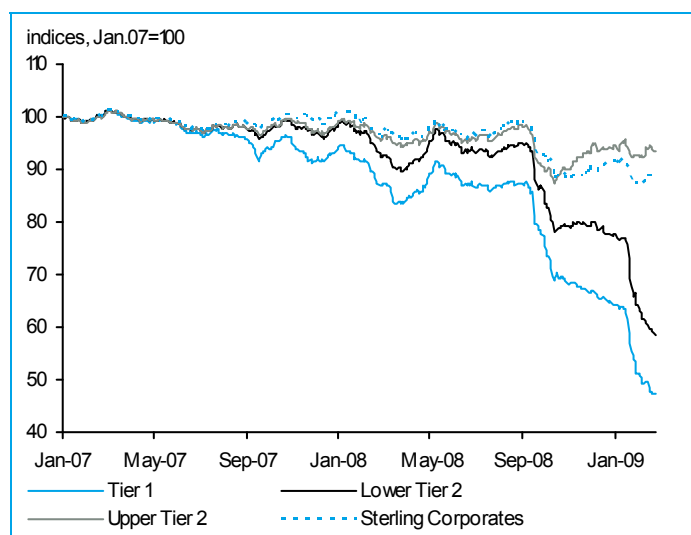
Conditions in credit became less favourable in February, with credit generally underperforming government bonds. Liquidity remains a major issue, despite large amounts of new issuance in the high-grade space (high-yield issuers have not yet returned to the market), as there has been significant retail money flowing in to the sector. This means that, in practice, the easiest way for investors to access the credit space in a prudently diversified manner is through ETFs and managed funds. We remain convinced that investment-grade credit is a key asset for investors to gain exposure to in 2009. Further down the capital structure we note that junior subordinated debt and preferred shares continue to cheapen (Figure 2); while offering fundamental value, the risk associated with lower-tier paper means that we would only recommend it to very risk tolerant investors.

Figure 1 – 5y CDS spreads versus Germany



Source: Barclays Wealth Research, Bloomberg.

Figure 2 – GBP lower tier credit versus market index



Source: MLX

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The US dollar continues to benefit from high risk aversion

Investors doubt the viability of the yen as a 'safe haven' currency

Sterling has strengthened, although this is unlikely to be a sustained rally

We expect the euro to continue to weaken

FX: The sands have yet to shift

- The US dollar has benefited from high risk aversion of late while the yen, usually a 'safe haven' currency, depreciated sharply following awful economic data.
- Sterling has recovered from its January lows, although the fundamentals do not suggest that this is the beginning of a long and sustainable recovery.
- The euro continued to weaken as the outlook for the region's economy has deteriorated sharply. We expect it to continue to depreciate this year.

Risk aversion, which has been a major driving force of FX markets in recent months, remained high in February as global equity markets tested their lows of autumn last year. The US dollar continued to be the main beneficiary, despite negative newsflow from the US being one of the drivers of investor concerns. Paradoxically, bad news for the US economy is good news for the dollar if it corresponds to a deteriorating global outlook and increases investors' appetite for 'safe haven' assets.

The yen weakened substantially at the end of February due to dreadful GDP data causing concerns over the yen's status as a 'safe haven' currency: the economy shrank 12.7% in the fourth quarter at an annualised rate. The currency is still undervalued. So, we expect the yen to recover when weak sentiment towards the currency diminishes. In the short term, it is likely to be supported by further unwinding of carry trades and yen-purchasing as Japanese exporters and importers adjust their currency hedges. In the long term, however, we have revised our forecasts slightly – to show less appreciation – in consideration of a further deterioration of the Japanese economy.

Sterling was the best performing G10 currency in February as sentiment towards the UK economy improved as policy actions from the Bank of England and government were positive for the UK's economic outlook. However, we expect the economy to remain weak and for investors to continue to avoid UK assets, limiting the potential for sterling rebounding further in the short term.

The euro has continued to weaken recently as the outlook for the euro-area economy deteriorated: we, like others have revised down our GDP forecast for 2009 from -1.7% y-o-y to -2.5%. Concerns about the stability of the euro area have also increased. The currency is overvalued, so we expect further depreciation this year.

Figure 1 – Recent FX moves, trade-weighted indices

	USD	GBP	EUR	JPY	CAD	CHF	SEK	AUD	NZD
Current	92.7	78.8	99.9	152.7	92.2	119.7	67.5	75.9	81.1
1 month ago	89.3	74.2	101.4	163.5	93.7	118.8	73.8	75.3	81.8
% change	3.9	6.1	-1.5	-6.6	-1.6	0.8	-8.6	0.7	-0.8
3 months ago	90.8	82.4	98.9	152.9	93.3	114.9	74.9	74.6	85.1
% change	2.1	-4.3	1.0	-0.1	-1.2	4.2	-9.9	1.7	-4.7
End 2007	83.7	96.5	101.5	123.8	114.1	109.8	82.4	97.3	113.5
% change	10.8	-18.4	-1.6	23.3	-19.2	9.0	-18.1	-22.1	-28.5

Source: Bank of England and Barclays Wealth Research

Figure 2 – FX forecasts

	FORECASTS					
	Spot	1mth	3mth	6mth	9mth	12mth
EUR/USD	1.27	1.28	1.25	1.23	1.19	1.16
USD/JPY	98	86	84	88	92	95
GBP/USD	1.42	1.39	1.42	1.45	1.53	1.58
USD/CHF	1.17	1.17	1.22	1.22	1.26	1.25
USD/CAD	1.26	1.30	1.23	1.33	1.40	1.35
AUD/USD	0.65	0.60	0.58	0.55	0.55	0.56
NZD/USD	0.51	0.48	0.48	0.45	0.45	0.48
EUR/JPY	125	110	105	108	109	110
EUR/GBP	0.90	0.92	0.88	0.85	0.78	0.73
EUR/CHF	1.49	1.50	1.52	1.50	1.50	1.45
EUR/SEK	11.36	10.25	9.90	9.88	9.45	9.12
EUR/NOK	8.75	8.75	8.40	8.43	8.07	7.79
GBP/JPY	139	120	119	128	140	150
GBP/AUD	2.19	2.32	2.45	2.64	2.78	2.82
GBP/NZD	2.79	2.90	2.96	3.22	3.40	3.29
GBP/CAD	1.78	1.81	1.75	1.93	2.14	2.13
GBP/CHF	1.66	1.63	1.73	1.77	1.93	1.98

We utilise our colleagues at Barclays Capital for short-term (1- and, 3- month) forecasts. Longer-term forecasts are our own projections, based on our macro-economic assessment.

Source: Barclays Wealth Research and Barclays Capital

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Property values in the UK and US have fallen towards our estimates of fair value

Extensive rights issues indicate we have yet to see the bottom...

...as do elevated initial yields over government bonds

Commercial real estate: Really in a state

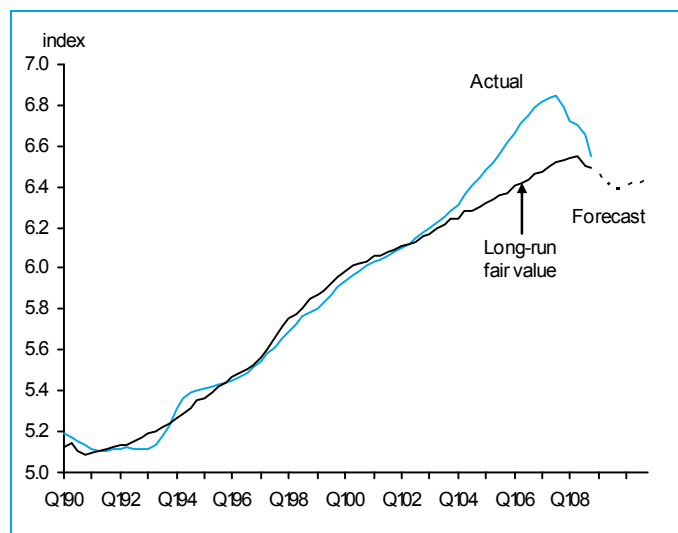
- UK and US property indices have dropped sharply, and are now in line with our fair value estimates. But downward momentum continues unabated.
- There have been extensive rights issues by Real Estate Investment Trusts, but asset disposals could still increase in future.
- Rental yield spreads over government bonds have climbed as investors demand greater compensation for perceived increased risks.

Regular readers over the past 18 months will be aware that we have been using – very successfully – a simple valuation model to gauge the long-run fair, or equilibrium, value of commercial property to guide our underweight recommendation. Following the recent falls in the commercial property market, values are now in line with our equilibrium estimate, hinting at the need to shift our assessment. However, continued downward momentum suggests a period of undershooting in the short term.

As an example of the problems faced by UK commercial property, the two Real Estate companies in the FTSE 100 have between them announced rights issues totalling 22% of their market capitalisation. As they are in danger of breaching loan-to-value covenants imposed by their banks, they have been forced to raise capital. One option is to sell assets, realising losses in the process and further driving down capital prices due to the lack of liquidity in the market. The other option is to turn to shareholders to raise (very expensive) capital. While rights issues are the preferred option at the moment, there is only a limited scope for these and disposals may well increase in the near future.

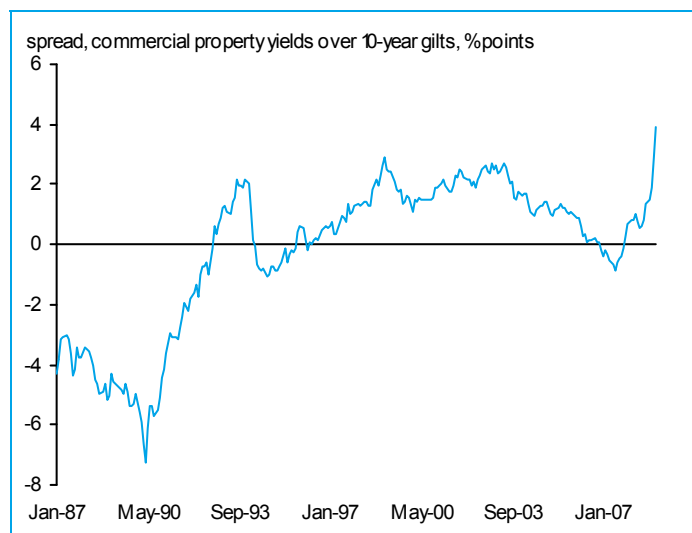
Another useful valuation measure for commercial property, especially in determining shorter-term moves in the market, is the spread of property yields over government bonds. Looking at the UK (Figure 2), we can see that yields have risen to almost 400bp over gilts. This is 25% higher than during the recession of the 1990s, although the rise in absolute yields has been accentuated by the current depressed level of gilt yields – reflecting fears of a slump and outright deflation. Such a high risk premium suggests that investors remain wary of further capital depreciation, potential voids and decreases in rental income. All in all we remain comfortable staying underweight commercial real estate for the moment, but we do recognise that the case for doing so is becoming less convincing, as the needed readjustment in valuations is occurring.

Figure 1 – An estimate of ‘fair value’ for UK property



Source: Barclays Wealth Research

Figure 2 – UK property yield spread over gilts



Source: Barclays Wealth Research

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Commodities continue to be affected by poor economic prospects and de-leveraging

Most commodities have been hit hard in the sell-off but oil seems to have stabilised

We continue to favour precious metals, most notably gold

Commodities: In gold we trust

- Prices in commodities remain weak as recession still dominates market sentiment, but divergences between markets offer opportunities.
- Our 'fair value' model for oil indicates that much of the (required) downward correction has still occurred. A recovery is still likely later.
- We remain positive on gold, which should benefit from its safe-haven status and sound fundamentals, with the US dollar posing the main risk to prices.

Commodity prices continue to be dominated by poor market sentiment and weak economic prospects. At the time of writing, the GSCI index is down 14% from last month and 21% year-to-date (in dollar terms). So, the downward trend which started in July 2008 remains in force. However, the composite index masks an increasing divergence between its components. While traditionally pro-cyclical commodities have been severely impacted by the economic slump, counter-cyclical ones have performed well and offer selected opportunities (Figure 1).

Energy, agriculture and industrial metals, which account for most of the index, have been badly hit, due to macro (world recession and Chinese slowdown) and financial (investors' flight to quality and de-leveraging) factors. However, oil prices now seem to have stabilised somewhat, hovering around the \$40/bbl mark in recent weeks. Our model of its long-run fair value, based on supply, demand, OPEC and refiners' utilisation rates and the futures market, points to a fair value of about \$60/bbl (Figure 2). This suggests that the downward correction could be close to its end and gives us confidence in our forecast of a modest recovery to \$65/bbl by the end of this year.

Given the highly uncertain environment, investors have been turning to precious metals and in particular gold as a 'safe haven'. The GSCI precious metals index is up 14% year-to-date, which makes it one of the best-performing asset classes so far this year. This positive momentum looks set to be sustained by strong fundamentals and market dynamics. Physical investment demand in gold has surged of late and, with deflation likely in many countries soon, the status of gold as a safe haven is unlikely to be dented. The main risk to this assessment is the performance of the US dollar over the coming quarters, as its negative correlation with gold has been robust historically. (For further details, please see "Gold to keep its glitter, despite deflation and dollar worries", 4 February 2009).

Figure 1 – GSCI indices and forecasts

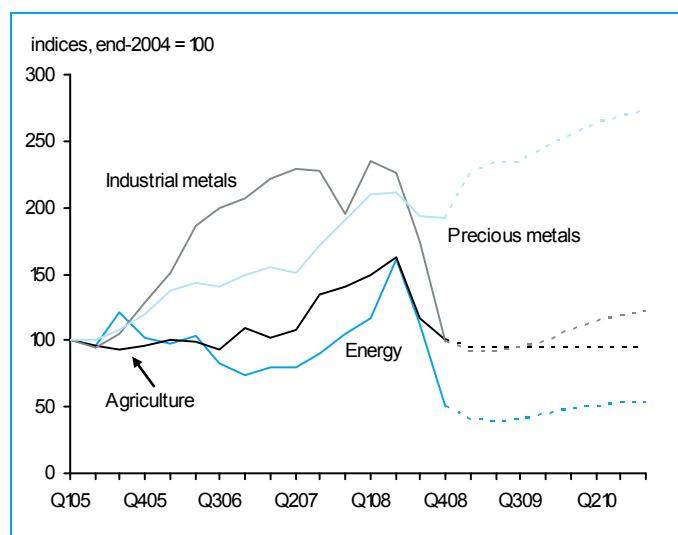
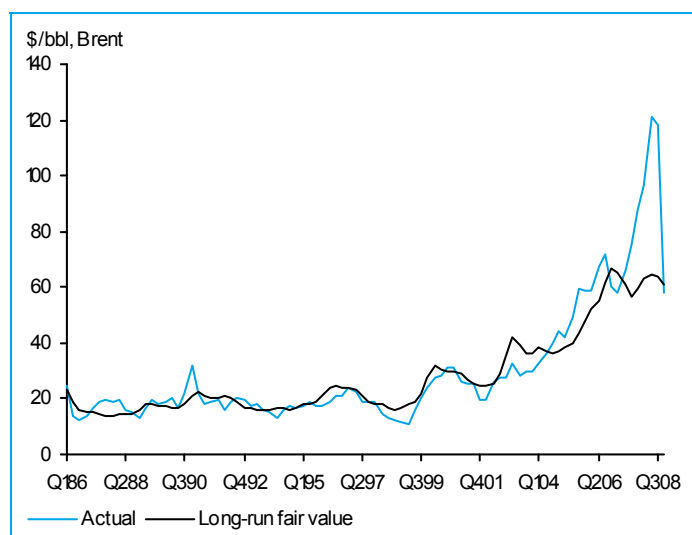


Figure 2 – Gauging a long-run 'fair value' for oil prices



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