

Michael Dicks  
 Head of Research  
 +44 20 7751 6641  
 michael.dicks@barclayswealth.com

## Update: Macro misery and morose markets...

- Broad macroeconomic developments over the past month or so (since we published our 'Annual Outlook 2009' version of *Signpost*) have been very much along the lines we expected. However, activity data were generally slightly worse than expected, rather than better. Consequently, we have needed to cut most of our fourth-quarter GDP forecasts a little. And this has had an impact (via what is called a 'base effect') on our 2009 GDP growth predictions. Consistent with this, most inflation data have suggested even more downward pressure on prices than we had factored into our projections.
- None of the changes require us to alter the story that we told for 2009 – of a deep recession, from which the US begins to emerge during the second half of the year, with Europe and Japan perhaps a quarter or two later. We also foresee emerging markets not remaining immune from the slowdown, but able in many cases to maintain reasonable growth rates this year – especially China, Brazil and India. Japan is perhaps the one example where the forecast revisions engender a much rougher and more painful outcome than looked likely six weeks ago.
- Likewise, we are very comfortable with the tale we have been telling of inflation switching sign – and consumer prices falling for a period during 2009 – in a number of developed economies. Although this may fan deflation fears, we very much believe that the price falls will be for an only limited time, with 2010 inflation rates back in positive territory almost everywhere.
- We are also very comfortable with the narrative we weaved of policymakers having to work exceptionally hard, in terms of policy easing, to generate a recovery. The Federal Reserve has already pushed official rates down to zero. We expect other central banks to cut rates very aggressively too, with the odd extra cut thrown into our modal forecasts compared with those we published in December. Likewise, fiscal injections look likely to take place on an even greater scale than seemed likely six weeks ago. Germany, for example, has now joined the crowd in pushing for a big relaxation of fiscal policy. Clearly, more support for financial systems is also necessary, as we assumed would be the case when we went to press in December.
- The changes to the growth forecasts are detailed in the attached table, with the 'old' forecasts taken from the 4 December edition of *Signpost* also included for comparison purposes. Our best guess currently is that the US will contract by 1.4% this year and the euro area by 1.3%. We foresee Japan and the UK hit hardest, contracting by 2.3% and 1.7% respectively. We still expect the BRIC countries to hold up relatively better, with the exception of Russia.
- This more pessimistic assessment is also reflected in our projections for inflation: we have trimmed the numbers across the board, as a result of more muted domestic price pressures. (Oil prices, by contrast, are roughly what we had pencilled in.) Most notably, we now see the US and Japan experiencing deflation in 2009, not just for the odd month but for the annual average too.
- Policymakers are likely to factor in the additional weakness. We expect additional fiscal help from governments almost everywhere and, when it comes to central banks, have lowered the trough of the official interest rate paths in our projections for the euro area to 1.25%, and for the UK to 0.5%. And we would not be surprised if they went lower still. We expect more rate cuts in the BRICs this year too, than we did six weeks ago, particularly in India and Russia. Interest rates are also likely to remain at low levels longer into 2010 than we previously forecast.

## Asset allocation

- Coming into 2009, we suggested holding a very defensive portfolio. For the first quarter, we recommended small underweights in equities – whether developed or emerging markets – in real estate and in commodities. These permitted us to overweight cash and government bonds. On credit, we were still a little underweight high-yield, but had shifted to neutral on investment-grade – with the intention of trying to find ways of getting into the asset class during the first quarter. We also had small overweights in emerging market bonds, whether sovereigns or local currency, and hedge funds.
- All of these recommendations still stand. Although market sentiment improved somewhat during December and early January, we suspected that getting through the combination of dreadful macroeconomic data and worse-than-expected fourth-quarter company results would be tough – with the latter likely to turn out to be a stronger negative for equities than the positive of slightly higher risk appetite. In recent weeks that seems to have been the right conclusion to have drawn.

## Fixed income

- On bonds, we recommended staying long duration this quarter. Our scorecards suggest continuing to do so, albeit without quite as strong a signal as they did towards the end of last year. Within fixed income, the faster-than-expected rate-cutting process is fuelling the ‘stretch for yield’ process that was one of our main themes for 2009. Accordingly, we are very comfortable with the story that the demand for higher-yielding bonds is surging, favouring the shift from government paper into high-quality (investment-grade) corporate bonds. So, for example, we are already overweight investment-grade bonds in our US portfolio. We will look to extend that position into the global portfolio pretty soon too, especially for those with investment horizons measured in quarters or years rather than weeks or months.

## Foreign exchange

- Our long-term FX outlook has remained unchanged. We judge that the (fairly large) moves in exchange rates at the end of 2008 were caused by what will turn out to be temporary drivers, and that the moves were exacerbated by illiquid markets. Accordingly, current exchange rates present several opportunities for investors, such as taking advantage of euro strength. We have updated our FX portfolio and AMBERA, which returned 0.9% and 0.6% respectively in December.

## Equities

- Our top-down outlook for equities remains unchanged too, even though the odd year-end number has changed by a few percent or so, reflecting the fact that Q4 ended up a little out from the precise end-2008 forecast we had pencilled in. We not only recommend being underweight the asset class at the moment, but suggest remaining defensive in the first half of the year in terms of sector overweights too – staying long the healthcare and telecoms sectors, for example.
- In the second half of the year, we expect to switch to overweighting equities with a bias towards the US and emerging markets. Cheap cyclical sectors and high-beta stocks should lead the recovery.
- When it comes to our bottom-up analysis, and recommended portfolios, the latest edition of *Equities Signpost*, to be published shortly, provides all the details.

	2008			2009			2010		
	Old	New	Difference	Old	New	Difference	Old	New	Difference
<b>GDP (% y-o-y)</b>									
US	1.3	1.0	-0.3	-1.0	-1.4	-0.4	1.5	1.5	0.0
Japan	0.4	-0.1	-0.5	-1.0	-2.3	-1.3	1.0	1.3	0.3
Euro area	1.0	0.9	-0.1	-1.0	-1.3	-0.3	1.3	1.4	0.1
UK	0.8	0.7	-0.1	-1.2	-1.7	-0.5	0.5	0.5	0.0
Canada	0.7	0.6	-0.1	-0.3	-0.5	-0.2	1.9	1.9	0.0
China	8.5	8.5	0.0	7.5	7.5	0.0	7.6	7.6	0.0
India	7.8	7.5	-0.3	6.0	6.0	0.0	7.0	6.0	-1.0
Russia	6.0	6.0	0.0	3.0	2.5	-0.5	4.1	4.1	0.0
Brazil	5.2	5.4	0.2	3.0	3.0	0.0	4.1	4.1	0.0
<b>Inflation (% y-o-y)</b>									
US	3.9	3.9	0.0	0.3	-0.1	-0.4	0.5	0.5	0.0
Japan	1.5	1.5	0.0	0.2	-0.8	-1.0	0.1	-0.2	-0.3
Euro area	3.3	3.3	0.0	1.3	0.6	-0.7	1.4	1.3	-0.1
UK	3.5	3.5	0.0	0.5	0.4	-0.1	1.9	1.9	0.0
Canada	2.5	2.4	-0.1	1.4	0.9	-0.5	1.7	1.7	0.0
China	3.2	5.9	2.7	2.0	1.5	-0.5	2.3	2.0	-0.3
India	9.5	9.1	-0.4	6.0	5.0	-1.0	3.0	3.0	0.0
Russia	13.0	13.0	0.0	9.0	9.0	0.0	7.7	7.7	0.0
Brazil	5.7	5.7	0.0	5.0	5.0	0.0	4.3	4.3	0.0
<b>Official rate (% , year-end)</b>									
US	0.50	0.25	-0.25	0.00	0.00	0.00	0.00	0.75	0.75
Japan	0.50	0.10	-0.40	0.30	0.10	-0.20	0.75	0.75	0.00
Euro area	2.50	2.50	0.00	1.50	1.25	-0.25	3.00	3.00	0.00
UK	2.00	2.00	0.00	1.00	0.50	-0.50	2.50	2.50	0.00
Canada	2.00	1.50	-0.50	1.25	0.75	-0.50	3.00	2.25	-0.75
China	6.39	5.31	-1.08	4.50	4.23	-0.27	5.00	4.60	-0.40
India	7.00	6.50	-0.50	5.50	4.00	-1.50	5.50	4.00	-1.50
Russia	13.00	13.00	0.00	14.50	11.00	-3.50	13.00	10.00	-3.00
Brazil	13.75	13.75	0.00	13.00	12.00	-1.00	11.00	11.00	0.00
<b>10yr yields (% , year-end)</b>									
US	3.0	2.6	-0.4	2.7	3.0	0.4	3.5	3.9	0.4
Japan	1.4	1.2	-0.2	1.5	1.5	0.1	1.8	1.8	0.0
Euro area	3.3	3.0	-0.4	2.9	3.3	0.4	3.3	3.7	0.4
UK	3.8	3.1	-0.7	3.3	3.5	0.2	3.8	4.1	0.3
Canada	3.2	2.7	-0.5	3.1	3.0	-0.1	4.0	3.9	-0.1
<b>Equity index (% y-o-y, year-end)</b>									
US	-40.6	-40.2	0.4	15.1	15.1	0.0	9.3	9.3	0.0
Japan	-44.6	-41.8	2.8	19.6	19.6	0.0	8.8	8.8	0.0
Euro area	-37.3	-41.9	-4.6	19.4	19.4	0.0	8.7	8.7	0.0
UK	-37.0	-31.3	5.7	14.6	14.6	0.0	7.4	7.4	0.0
Canada	-34.3	-35.2	-0.9	15.5	15.5	0.0	7.0	7.0	0.0
<b>Currency index (% y-o-y, year-end)</b>									
US	13.8	8.9	-4.9	4.0	6.7	2.7	0.7	0.7	0.0
Japan	19.5	26.8	7.3	6.1	3.2	-2.9	-1.9	-1.9	0.0
Euro area	-4.5	5.4	9.9	-8.7	-19.0	-10.3	4.1	4.1	0.0
UK	-10.6	-23.1	-12.5	3.4	26.5	23.1	4.0	4.0	0.0
Canada	-16.0	-17.6	-1.6	-8.2	-8.2	0.0	1.2	1.2	0.0
<b>Current account (% of GDP)</b>									
China	7.5	7.5	0.0	5.8	5.8	0.0	5.0	5.0	0.0
India	-2.5	-2.5	0.0	-2.8	-2.8	0.0	-2.6	-2.6	0.0
Russia	5.1	5.1	0.0	0.8	0.8	0.0	0.5	0.5	0.0
Brazil	-1.9	-1.9	0.0	-2.3	-2.3	0.0	-3.0	-3.0	0.0
<b>Budget balance (% of GDP)</b>									
China	1.0	1.0	0.0	-1.0	-1.0	0.0	-1.5	-1.5	0.0
India	-7.0	-7.0	0.0	-7.5	-7.5	0.0	-8.0	-8.0	0.0
Russia	3.0	3.0	0.0	1.0	1.0	0.0	0.0	0.0	0.0
Brazil	-1.4	-1.4	0.0	-1.5	-1.5	0.0	-1.7	-1.7	0.0
<b>Earnings growth (% y-o-y)</b>									
China	5.6	2.7	-2.9	10.0	7.8	-2.2	13.0	13.2	0.2
India	2.2	0.0	-2.2	17.3	12.0	-5.3	10.7	10.4	-0.3
Russia	19.8	16.4	-3.4	-5.5	-15.7	-10.2	0.8	3.5	2.7
Brazil	12.8	21.8	9.0	10.9	3.0	-7.9	17.1	20.2	3.1