



SIGNPOST LITE

Dented, but not destroyed

SEPTEMBER 2008

For financial markets, this August has been rather better than last year's. The credit crunch is by no means over, but time is a natural healer. At this point in time, we judge the outlook to be pretty closely balanced. Provided that oil prices do not soar again, headline inflation will soon start heading south. In the case of the US, we expect growth to slow towards year-end, but pick up again gradually through 2009. But in the UK, a gloomier outcome is likely: a recession next year now looks more likely than not. Markets look to us to be overly pessimistic about global macroeconomic prospects. So, we maintain a small overall equities overweight versus bonds. In the UK, however, we are adopting a small underweight.

Michael Dicks, Head of Research
4 September 2008

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For expanded versions of these articles, plus further coverage of topics including: prospects for Canada, China, India, Brazil and Russia; emerging markets asset allocation strategy; our UK and European analyst portfolios; commodities and UK and European real estate, please see the full version of *Signpost*, available on request.

Executive summary

Equities

We have extended our Automatic Momentum-Based Equity Sector Allocation (AMBESA) model to cover all general regions. Taking together both AMBESA and our value-based screens has led us to moderate our overweight financials position, and our underweights in the defensive sectors. Materials in the UK remains a strong outperform.

Equity markets are being largely driven by fear rather than fundamentals – the reason why return momentum strategies have performed so well. We believe that this will remain the status quo for a few months yet.

Thus for the near term, we would recommend that portfolios follow AMBESA's current recommendations, and focus on commodities and defensives

Asset allocation

Markets appear to be too pessimistic about global macroeconomic prospects, and we maintain a cautious 4% overall equities overweight versus bonds. In the UK, however, a recession next year now looks more likely than not, so we have shifted to adopting a small underweight. We have also boosted our tactical 'emerging markets' overweight, by going back to neutral on China and India, given that equity markets have fallen so far from their peaks.

Our view is that the balance of risk and return expectations has not changed much for markets over the last month.

We still see substantial upside for risky assets on a 12-month horizon, but we also see substantial short-term risk.

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At this point in time, we judge the outlook to be pretty closely balanced. Provided that oil prices do not soar again, headline inflation will soon start heading south. In the case of the US, we expect growth to slow towards year-end, but pick up again gradually through 2009. But in the UK, a gloomier outcome is likely: a recession next year now looks more likely than not.



Markets look to us to be overly pessimistic about global macroeconomic prospects. So, we maintain a small overall equities overweight versus tactical bonds. In the UK, however, we are adopting a small underweight.

Fixed income

The bond market rally that started in the second half of July continued in August, as falling commodity prices led to a decline in inflation expectations. Relative to cash, we see far less value than we did two months ago, although bonds could still outperform if commodity prices continue to fall. Our preferred exposure in the fixed income space, for investors looking for a 'safe haven' opportunity, remains government inflation-linked bonds.

Corporate bond markets remained depressed in August. Valuations continue to be attractive for the highest part of the investment grade universe, particularly if inflationary pressures were to recede. We remain wary of investing in the BBB bracket and the high yield sector as defaults are mounting.

Commodities & FX

The oil price has dropped further, but medium term supply and demand should be supportive and our forecasts remain above consensus. Metals prices have generally fallen, although some of this may be due to one-off effects. In

precious metals, we are still positive on the outlook for gold prices over the next 12 months, less so on silver, and have cut our platinum forecasts.

FX trends tend to continue for some time, so that 'fair value' equilibrium is overshot. In the case of the dollar's relative strength in August, it is clear that part of the story has been the fall in the price of oil. In the case of sterling, the Bank of England's perceived attitude towards inflation is key.

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Dented, but not destroyed

A month ago, we reckoned that the mood of the markets had turned slightly more positive. Our prognostications have turned out to be broadly on track thus far. Whilst our Risk Appetite Index (RAI) did drop back a little, following the re-emergence of concerns over Fannie Mae and Freddie Mac, investor confidence appears to have found its feet again pretty quickly (Figure 1).

A broader RAI...

One worry was that the narrowness of the RAI could make it misrepresentative of market opinion. So this month, we have broadened it out to use the same broad set of assets that we used when looking at automatic momentum-based asset allocation (AMBAA). The new, broad, RAI exhibits much the same general profile as its narrower sibling (Figure 2). But two differences stand out. First, the short-term moves are more worrying. While recent troughs in the narrow RAI have been higher than previous ones, the reverse is true for the broad index. This throws some cold water on the notion that confidence will build from here. But, secondly, the long-term moves in the broad RAI are less worrying. This supports our conjecture that the hit to the global macro-economy has, at least so far, been of fairly limited magnitude. In other words, the credit crisis has dented growth but not destroyed it.

...provides mixed messages...

...but the US look firmer...

Central bankers and investors seem to be split between gloom, and a belief that policymakers' interventions can deliver the sort of results that they normally do. Gloom is understandable, with many financial markets still not functioning normally, and many financial institutions still apparently facing further losses. The US economy also appears to be entering a vulnerable stage in its 'recovery'. But, on the positive side, provided that oil prices do not soar again, headline inflation will soon start falling, and this is usually correlated with growth of both nominal and real consumer spending. Time is also a natural healer.

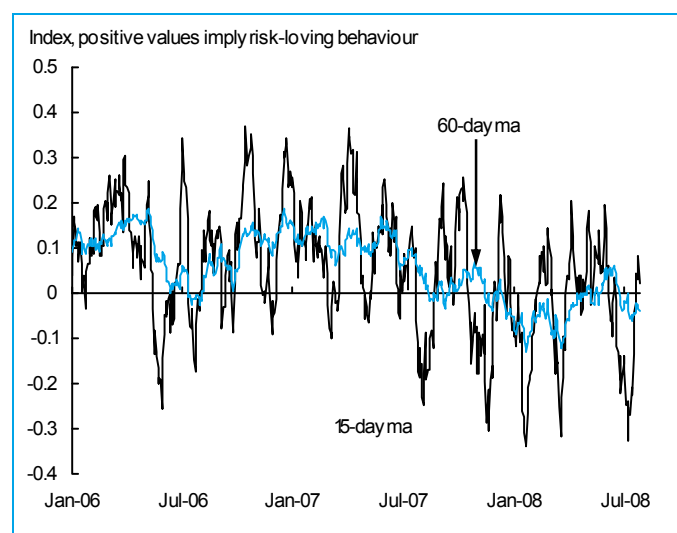
...even if elsewhere does not

But whilst the US economy looks at least to be stabilising, the rest of the world looks to be in a more sorry state, with second quarter data for Japan and Europe particularly alarming. In much of the developing world, there has also been more bad news than good. But, again, the developing world's remarkable growth engine appears to have been dented, not stopped. Accordingly, we have made a number of changes to our assessment of next year's prospects. We have trimmed non-US growth forecasts, assume a little more policy effort from central banks and have upped our dollar projections. But these do not change the big picture, and we remain just mildly overweight US equities for now, with the only significant recommended change in the TAA being to shift the UK from neutral to underweight, while going back to neutral on China and India.

Minor forecast changes...

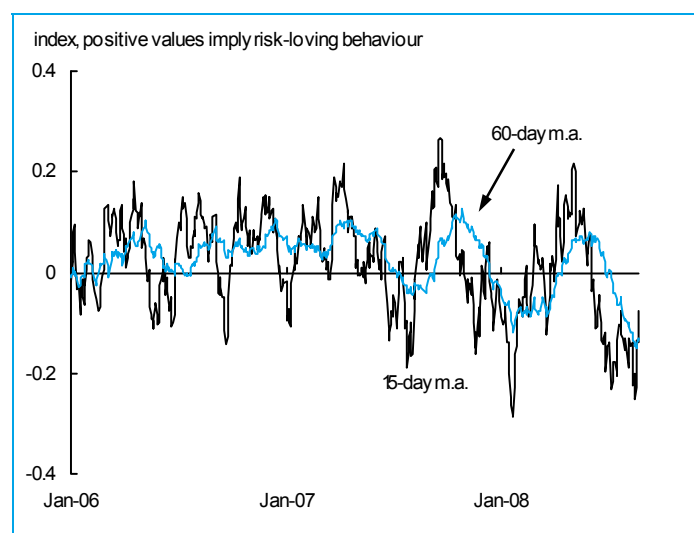
...have limited TAA implications

Figure 1 – The Risk Appetite Index (15/60-day m.a.)



Source: Barclays Wealth Research

Figure 2 – A new, broader, RAI (15/60-day m.a.)



Source: Barclays Wealth Research

Recommended strategic and tactical asset allocation

	Market cap (%)	SAA rec portfolio	SAA tilts	TAA rec portfolio	TAA tilts
Equity	55.6	59.6	4.0	63.6	4.0
Bond	39.4	35.4	-4.0	31.4	-4.0
Cash	5.0	5.0	0.0	5.0	0.0
Equities	55.6	59.6	4.0	63.6	4.0
USA	23.1	25.3	2.2	27.3	2.0
Canada	2.0	0.0	-2.0	0.0	0.0
Brazil	0.8	0.6	-0.2	1.6	1.0
Euro area	8.8	9.3	0.6	10.3	1.0
UK	5.3	8.1	2.8	7.1	-1.0
Russia	0.6	0.5	-0.2	1.5	1.0
Japan	4.8	6.1	1.3	6.1	0.0
China	1.0	0.8	-0.2	0.8	0.0
India	0.5	0.4	-0.1	0.4	0.0
Rest of the Developed World	5.1	5.8	0.8	5.8	0.0
Rest of Emerging	3.6	2.8	-0.9	2.8	0.0
Government Bonds	28.9	17.1	-11.7	13.1	-4.0
USA	7.2	4.3	-2.9	2.3	-2.0
Canada	0.4	0.3	-0.2	0.3	0.0
Brazil	0.1	0.1	-0.1	0.1	0.0
Eurozone	9.9	5.9	-4.0	3.9	-2.0
UK	1.4	0.8	-0.6	0.8	0.0
Russia	0.1	0.0	0.0	0.0	0.0
Japan	6.5	3.9	-2.6	3.9	0.0
China	0.6	0.4	-0.2	0.4	0.0
India	0.4	0.3	-0.2	0.3	0.0
Rest of the Developed World	0.7	0.4	-0.3	0.4	0.0
Rest of Emerging	1.5	0.9	-0.6	0.9	0.0
Investment Grade Corporate Bonds	8.6	13.1	4.5	13.1	0.0
USA	4.1	6.2	2.1	6.2	0.0
Euro area	2.6	3.9	1.3	3.9	0.0
Japan	0.6	1.0	0.3	1.0	0.0
UK	0.9	1.3	0.5	1.3	0.0
Canada	0.4	0.6	0.2	0.6	0.0
Rest of the developed world	0.1	0.2	0.1	0.2	0.0
High Yield Corporate Bonds	1.4	3.0	1.6	3.0	0.0
USA	1.2	2.5	1.3	2.5	0.0
Euro area	0.2	0.4	0.2	0.4	0.0
UK	0.0	0.1	0.1	0.1	0.0
Emerging Market Bonds	0.5	2.0	1.3	2.0	0.0
Total	100.0	100.0	0.0	100.0	0.0

*All figures are percentages
Source: Barclays Wealth Research

Notes:

The Market Cap weightings are based on the MSCI AC World Index for equities and Merrill Lynch indices for fixed income.

Fixed income consists of both conventional and inflation-linked bonds, emerging market bonds and corporate bonds.

The SAA recommended portfolio is based on the Black-Litterman optimisation process giving the optimal allocation for the target level of volatility.

The fixed income market split for developed markets government bonds in the SAA portfolio column is based on Black-Litterman optimisation.

The emerging market equity split is calculated as the total allocation to emerging markets, based on the Black-Litterman optimisation, but then divided by the individual country's relative weight in MSCI AC World index.

Key Strategic Asset Allocation (SAA) themes

Theme	Thesis	Investment strategies
This cycle the US's potential GDP growth rate will be weaker than it was during the previous cycle.	The overhang of the credit cycle will be a protracted period during which house prices first drop and then plateau. Policymakers will be loath to let another credit/housing boom develop. New regulatory regimes likely to crimp expansion opportunities.	Look to diversify out of real estate. Also, expect long-run returns on financials to be lower than during the past cycle, as many seek a new (less leveraged) business model.
The secular decline in GDP and CPI volatility is coming to an end. However, any pickup will be muted versus what was experienced in the 1970s.	Equity markets will perform less well through this cycle than the last, as GDP and inflation volatility both cause uncertainty – which hurts equity markets.	Diversify out of the US, and probably too other developed markets – which have ridden on the US's coat-tails. Increase exposure to developing countries, where potential growth rates are higher.
This slowdown, and recovery, will be more drawn-out than usual – more 'rice bowl' than 'V' shaped.	The hangovers from past excesses will mean the usual mechanisms during recoveries – such as cuts in official rates leading to lower borrowing costs – will not work as effectively this time round. So, there may be more 'false dawns' and bouts of 'aborted recoveries' than usual.	Equities, and other 'risky' asset classes, may not soar in the usual fashion during the recovery. So, look for more pedestrian performance – and look for strategies which perform in range-trading environments.
High oil prices are here to stay.	The recent surge in prices may have pushed oil prices above their equilibrium. But, 'high' (i.e. above \$80/bbl) prices are here to stay. The corresponding wealth transfer, from oil-consuming to oil-producing nations, is of the order of 4% of global GDP.	Getting long oil-producers' equity markets is sometimes tough. A good substitute is to get long a commodities index, such as the GSCI (which is energy heavy), especially for investors with more traditional cash/bond/equity benchmarks.
A single currency in Asia.	Although introduction of an Asian currency unit is decades away, even the idea may be enough to lead to better policymaking – such as less emphasis on mercantilism, and more power for independent central banks. In time, that should improve growth prospects and lead to convergence.	Overweight the region. Look for currencies, as a bloc, to outperform – as the authorities move away from keeping them artificially cheap. Expect more domestic demand-oriented growth too.
Income/wealth distributions.	We judge that much of the recent shifts in income distribution (towards the higher paid) will stick. Partly that seems to be due to globalisation. But skill-based technology change also seems to have been a factor. We expect returns to the highly skilled to continue to rise.	Countries that invest in education stand to benefit, although it is a long haul. China and India ought to benefit most, along with countries that reduce trade barriers – and thus encourage the forces or increased competition that globalisation entails. Latin America is one such example. Best to play these trends via equity overweights.

Key Tactical Asset Allocation (TAA) themes

Theme	Thesis	Investment strategies
Growth to rebound in the US over the summer, but slip back again in Q4.	Fiscal easing works in most instances, but tends to get overlooked, and underestimated, by most economists. Time too is a natural healer, with the corporate sector especially now gaining from the cheap dollar. But the clock is ticking; soon, fiscal support will abate. And the dollar is turning.	The US equity market ought to register some healthy gains. Other, unaffected, markets should underperform – pointing to relative value opportunities, such as long US versus the UK.
Central banks more dovish than they sound.	Markets often overreact when policymakers switch from demand support roles to focussing on inflation reduction instead. Futures strips often assume lots of hikes to come – and straightaway. Equities assume that the economy is too weak to absorb the cost of higher interest rates, and decline.	Although the futures strips are now looking less hawkish, as we suspected would happen, we still judge that the risks to expectations are skewed to the downside. The main risk is inflation keeps climbing, suggesting buying some protection – say via commodities.
UK slowdown will be vicious.	Housing is in free fall. And the BoE has now admitted that a recession is more or less baked in. But reality is still likely to prove to be more painful than a projection.	Consider an outright equity underweight. Perhaps also worth playing in a long big-cap versus short mid-/small-cap form. Sterling likely to continue to shed value in the medium term. Risks to the short strip still on the downside – i.e. more rate cuts than are currently priced in.
Emerging market equities looking cheap.	Economists have given up on 'resilience', and rightly so. But markets have probably overshot.	It may well take time for emerging market equities to recover. But they do look very cheap now. Only for the brave, or long-term focussed, investor.
Emerging market central banks have been slow to act.	Some central banks have been slow to react to higher food and oil price pressures – often more painful in the case of the former, as food has a big weight in the CPI. Now they will need to catch up.	Higher official rates and stronger currencies in Latin America and Asia look likely. Buy exposure via the likes of ELMI indices – i.e. front-end and FX exposure in basket form.
Housing slowdowns in Europe really starting to bite.	Spain, UK and Ireland are really suffering – lagging the US adjustment.	Underweight UK equities. Go short four of the 'big five' IBEX stocks. Commercial property not yet at a bottom either.
Commodities and inflation.	Although our latest analysis suggests that oil prices are still above their fundamental fair value, another surge in the oil price is certainly a possibility – worth hedging against, in a portfolio like ours: higher oil prices would hurt many of our preferred TAA plays.	Buy GSCMI is the simplest way of protecting a portfolio like ours.
Dollar turnaround.	The dollar is cheap, and US macro prospects should help support its appreciation. The main concern we have is a likely Q4 US slowdown. That could prove to be a 'speed-bump'. But it could derail the whole process.	Hold a small dollar overweight; but don't be too surprised if it doesn't perform short-term.
Swiss franc to rise.	Cheap according to our kernel estimates. And the Swiss National Bank is raising rates. Good value as a safe haven too.	Helps diversify TAA calls, although less compelling on an FX basis than some other calls.

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Some investors believe emerging markets have 'decoupled'...

...but we disagree

Our indicator expects emerging markets to outperform

Focus: emerging markets allocation strategy

We have found a strong correlation between a global liquidity indicator and the excess return from emerging markets over developed market equities.

The indicator works for both long-only strategies shifting between overweight and underweight relative to a benchmark, and long-short allocation as known from absolute return and hedge fund strategies.

For the long-short strategies tested, we achieve compound annual growth rates (CAGRs) of 15.9-19.4%, with Sharpe ratios of 0.94-1.24. Long-only strategies with a maximum allocation of +/-10% relative to a benchmark result in a CAGR difference of 1.6-1.94%.

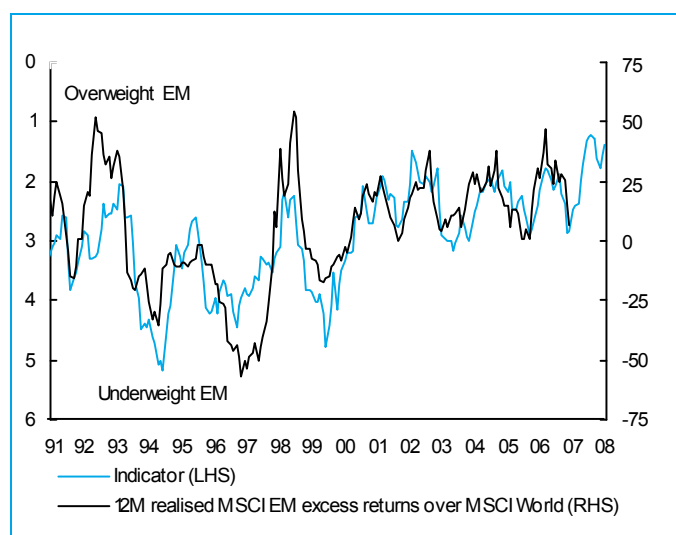
The idea behind our indicator

Over recent years, the idea that emerging markets have 'decoupled' from the rest of the global financial markets has increased in popularity. While this has some merits for economics we do not think that decoupling is a likely prospect over shorter – tactical – investment horizons.

Instead, we think emerging markets' tactical performance relative to developed markets is driven by the same factors as it has been since the break-up of the Soviet Union and the reunification of Germany. In our view, the main factors are real interest rates, global liquidity, risk, greed and fear. These are combined in our indicator, shown in Figure 1. The blue line is the indicator showing the likely direction of the relative performance for the next 12 months. The black line shows actual realised relative performance over the rolling 12 months.

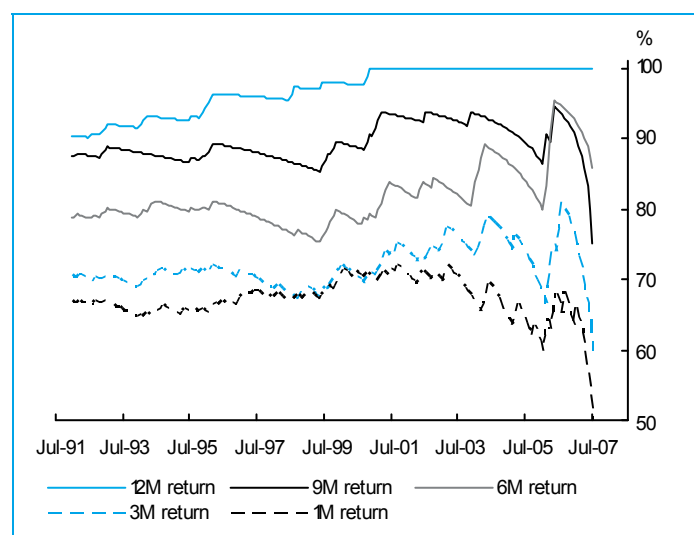
Figure 2 shows that hit ratios are much higher for positions held for longer periods than for shorter ones. The cumulative hit ratio in Figure 2 is measured from 2007 positions backwards, as a percentage of hits relative to total observations. For the long-short strategies tested, we achieve CAGRs of 15.9-19.4%, with Sharpe ratios of 0.94-1.24. Long-only strategies with a maximum allocation of +/-10% relative to a benchmark result in a CAGR difference of 1.6-1.94%. Currently we interpret the signal as indicating that one should expect strong outperformance of emerging market equities as high global risk aversion has led to a sell off in risky assets; financial conditions are also right in the sense that US government bond yield in real terms are extremely low. Accordingly we have increased our allocation to emerging market equities. This article is available in its full version in the September 2008 edition of *Signpost*.

Figure 1 – Indicator and excess total return of MSCI EM



Source: Barclays Wealth Research

Figure 2 – The indicator's hit ratio (MSCI EM / World)



Note: timescale indicates the time when the position was taken, not realised
Source: Barclays Wealth Research

US prospects

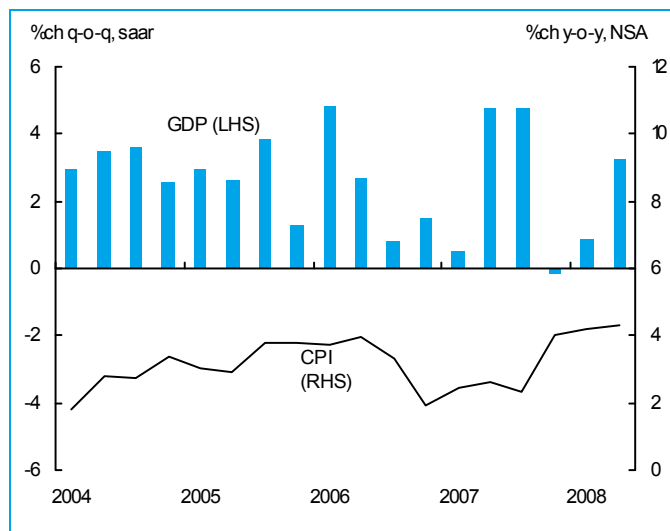
Economic outlook

- The consensus has continued to lower its GDP growth expectations for 2009 (to 1.4%), but revise up its forecasts for 2008 (from 1.5% to 1.6%). CPI inflation is expected by consensus to follow suit and drop from an estimated 4.5% this year to a close-to-historical-average 2.9% in 2009.
- Some housing market indicators show tentative signs of stabilisation. Simple extrapolation thus calls for housing market stabilisation in the months ahead, but this looks unlikely: with higher interest rates fuelled by mortgage financing strains, elevated inventories and a struggling US consumer, the near-term outlook for housing remains bleak.
- The labour market continues to deteriorate moderately, but steadily. With non-financial corporates hit by input price pressures, tighter lending standards and slowing global demand, the turning point for the labour market does not seem to be around the corner.
- The Federal Reserve has assured the public that it is worried about inflation. Downside risks to growth and the threat of a systemic financial crisis have nevertheless kept the Fed on its toes. Although willing to shift to inflation-fighting mode, we reckon that the Fed will spend the next few months overseeing the unravelling of the credit crunch, with rate hikes unlikely before Q2 2009.

Market outlook

- Corporate sector performance is split between the still generally healthy non-financial sector and a financial sector that has been hurt badly by the sub-prime crisis and resultant turmoil in markets.
- Analysts have slashed their forecasts of future earnings for the financial sector, to what are now likely to be realistic expectations.
- The valuation gap for equities, based on these expectations versus real corporate bond yields, suggests plenty of upside for the S&P 500.

Figure 1 – US GDP growth and inflation



Source: Barclays Wealth Research

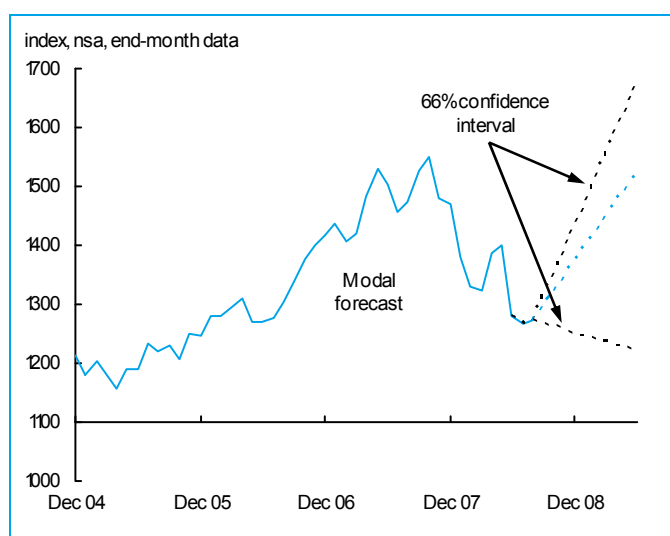
Figure 2 – The US forecasts in a nutshell*

% y-o-y except where stated				
	2006	2007	2008	2009
GDP	2.9	2.2	1.5	1.4
CPI	3.2	2.9	4.3	2.7
Fed funds (%)	5.25	4.25	2.00	2.50
10-year yields (%)	4.7	4.1	4.2	4.4
S&P 500 index	13.6	3.5	-6.3	10.6
\$ index	-3.9	-5.8	-1.40	8.2

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

Source: Barclays Wealth Research

Figure 3 – The outlook for the S&P 500 index



Source: Barclays Wealth Research

Euro area prospects

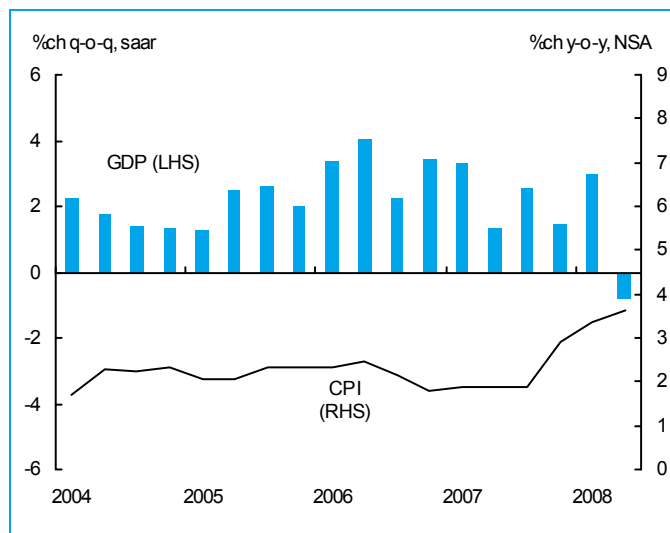
Economic outlook

- Euro-area GDP fell by 0.8% quarter on quarter (at the seasonally adjusted annual rate) in Q2, representing unexpectedly large payback for its strong growth (of 2.9%) in Q1. Worryingly, survey indicators point to barely positive growth in Q3, leaving the economy on the verge of a shallow technical recession.
- We expect growth to resume, but at a clearly sub-potential rate, leaving 2008 and 2009 growth the lowest since 2003. The main obstacles to a pick-up are weak external demand, which is curbing euro-area exports, and higher energy costs, which are denting real consumption and investment. But the euro area's lack of significant external imbalances, its (on aggregate) more limited exposure to housing, and its still relatively robust bank lending, should all cushion the slowdown.
- The European Central Bank's main concern has been inflation. Largely due to surging oil and food prices, consumer price inflation now stands at over 4%, more than double the ECB's target of below (but close to) 2%. Policymakers are worried about incipient signs that, in response, wage growth is strengthening, with unemployment near a 25-year low. So we expect the ECB to keep sounding hawkish.
- However, we expect that, unless a rising oil price throws a spanner in the works, weaker growth will damp inflationary pressure, albeit very slowly. It could take until 2009, but eventually we predict the ECB will lower rates a little in response.

Market outlook

- Spooked by rising oil prices and fearing central banks' hawkish reaction, the main stock markets have fallen through their March trough. But the pace of decline has slowed in the last two months.
- Valuations, based on earnings expectations versus real corporate bond yields, continue to suggest that equities should rally from current levels.
- But gathering clouds on the economic horizon, both within the euro area and beyond, mean equity markets are unlikely to break above their 2007 peaks before this time next year.

Figure 1 – Euro area GDP and inflation



Source: Barclays Wealth Research

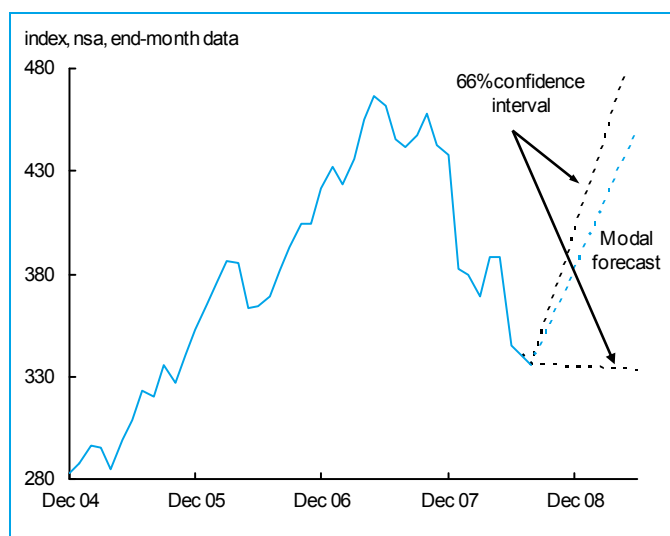
Figure 2 – The euro area forecast in a nutshell*

% y-o-y except where stated				
	2006	2007	2008	2009
GDP	2.9	2.7	1.4	0.9
HICP	2.2	2.1	3.6	2.4
Refi rate (%)	3.50	4.00	4.25	3.75
10-year yields (%)	4.0	4.4	4.4	4.3
FTSE ex-UK index	20.0	3.8	-11.1	14.2
€ index	3.3	3.5	2.2	-4.8

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

Source: Barclays Wealth Research

Figure 3 – The outlook for the FTSE Europe ex-UK index



Source: Barclays Wealth Research

UK prospects

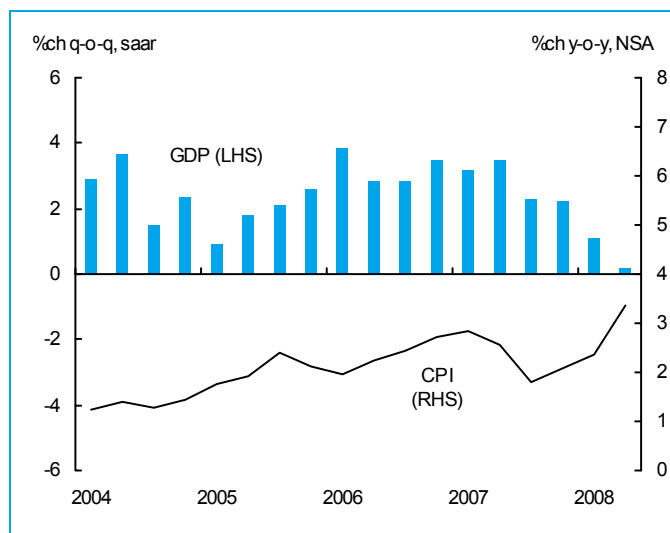
Economic outlook

- The economic news flow has gone from bad to worse in recent months. The economy may well be contracting, while inflationary pressures remain elevated. UK GDP growth was flat in the second quarter (Figure 1), the weakest period since Q2 1992. Lead indicators suggest that the third and fourth quarters are likely to register outright declines. As a result, we have cut our GDP growth forecasts for 2008 and 2009. Meanwhile, inflation has continued to move higher at both the headline and underlying (excluding food and energy) level.
- The housing market has decelerated quite sharply, with the year-on-year rate of price declines for existing homes now exceeding 12%, according to the Halifax. Leading indicators point to significant further weakness ahead. The labour market has softened significantly over recent months, with the rate of job losses higher than in the US, once differences in population size are accounted for.
- At 4.4%, consumer price inflation is more than twice its 2% target and underlying price pressures have continued to build. Moreover, households' inflation expectations and corporate pricing intentions remain extremely elevated despite the recent easing back in oil prices.
- The BoE's August Inflation Report was more dovish in tone than generally expected. The marked slowdown in activity, ongoing fragility in financial markets and easing commodity prices seem to have alleviated concerns about the risk of a wage-price spiral taking hold. We suspect that interest rates will

Market outlook

- We have reduced our recommendation on UK equities from neutral to 1% underweight. The UK is now our least-preferred major global equity market.
- The key driver behind our gloominess on the UK market is the significant and continued deterioration in the economic backdrop.
- In the short term, outright falls in GDP are likely to hurt the equity market. We have pared back our year-end forecast for the FTSE 100, reflecting the downward revisions we have made to our GDP forecasts.

Figure 1 – UK GDP and inflation



Source: Barclays Wealth Research

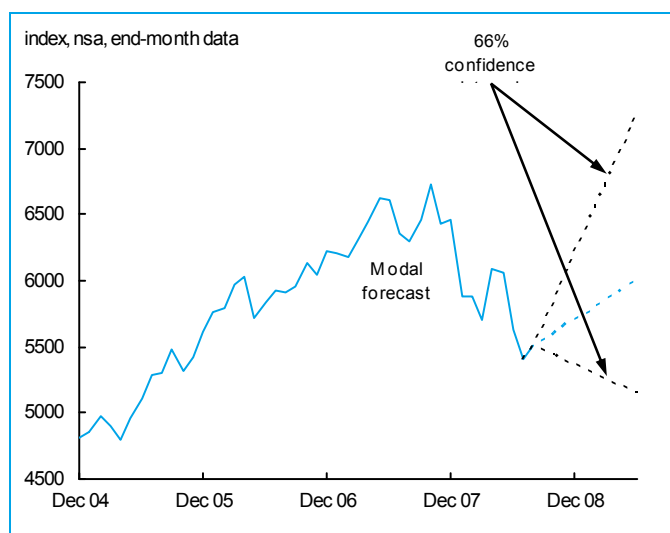
Figure 2 – The UK forecasts in a nutshell*

% y-o-y except where stated				
	2006	2007	2008	2009
GDP	2.9	3.1	1.2	0.7
CPI	2.3	2.3	3.7	3.0
Bank rate (%)	5.00	5.50	4.75	3.75
10-year yields (%)	4.7	4.6	4.7	4.5
FTSE 100 (index)	11.0	3.8	-8.2	9.0
£ (index)	4.8	-6.3	-8.2	3.3

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

Source: Barclays Wealth Research

Figure 3 – The outlook for the FTSE 100 index



Source: Barclays Wealth Research

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Market review: August

Equities – commodities-led downturn slowly continues

The decline in the oil price slowed in August. Equities followed suit, with the MSCI World losing just 0.5% over the month. The influence of commodity prices was also reflected in the difference between emerging and developed market returns: emerging markets lost another 6.5%, led by Russia, and are now firmly underperforming the MSCI World year to date. The UK and US indices actually gained a little, rising 2% and 0.4% respectively. The materials sector took a hit, alongside the financials, this month. Precious metals were the commodity underperformer of the month.

Bonds – strong returns from all major markets

The US bond market – the only major market to underperform in July – posted strong gains in August, as falling commodity prices eased inflation fears. Yields in the euro area also fell faster than in July as growth prospects dimmed. UK and Japanese yields also continued to fall, but at a slower pace.

Commodities – the downward trend continues

The GCSI Commodity index continued the downward trend seen last month, dropping -5.8%. The fall was led by precious metals, which declined -11.8%, compared with a -6.8% drop in energy. The volatile agricultural commodities sector, which rose sharply in June but fell smartly in July, was tamer this month. It posted the only gain in the commodities index, with a 0.4% increase.

2008 performance*										
Fixed interest: local currency returns, %										
	6m	3m	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
US	-0.6	1.2	1.9	0.6	0.0	-0.7	-1.0	0.2	-0.1	1.0
UK	1.3	3.1	-0.2	-0.7	0.0	-0.5	-1.2	-0.7	2.1	1.7
Euro area	-0.3	2.0	2.1	0.5	-0.8	-0.4	-1.1	-1.1	1.8	1.3
Japan	0.2	2.2	0.5	0.5	0.4	-1.6	-0.8	1.1	0.3	0.8
World	0.1	1.6	1.5	0.3	0.0	-0.6	-0.9	-0.2	0.7	1.0
Equities: MSCI local currency returns, %										
US	-3.1	-8.8	-6.1	-3.1	-0.4	4.9	1.6	-8.2	-1.1	0.4
UK	-4.6	-8.5	-8.8	0.4	-2.1	6.8	-0.4	-6.9	-3.7	2.0
Europe ex-K	-8.4	-12.7	-12.6	-0.6	-2.7	6.2	1.5	-11.1	-1.1	-0.8
Japan	-6.8	-13.0	-9.2	-1.4	-8.2	12.6	3.6	-6.4	-1.5	-5.6
Pacific ex-Japan	-9.4	-12.1	-11.2	-1.4	-3.3	5.7	0.9	-7.8	-3.6	-1.0
Emerging	-16.2	-19.9	-12.4	6.1	-4.2	7.3	1.9	-9.9	-5.0	-6.5
World – dev	-5.1	-10.3	-8.4	-1.7	-2.1	6.2	1.7	-8.2	-1.8	-0.5
Cash: three-month Treasury bills, end of period, %										
	2006	2007	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
US	4.8	4.5	2.0	1.8	1.3	1.3	1.9	1.7	1.7	1.7
UK	4.7	5.6	5.2	5.2	5.0	5.0	5.1	5.2	5.2	5.2
Euro area	2.9	3.9	3.9	3.9	3.9	3.9	4.0	4.3	4.3	4.3
Japan	0.2	0.6	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6

* Returns are all total returns, with August data measured to 26 August.

Source: Barclays Wealth Research

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Fixed income: summary

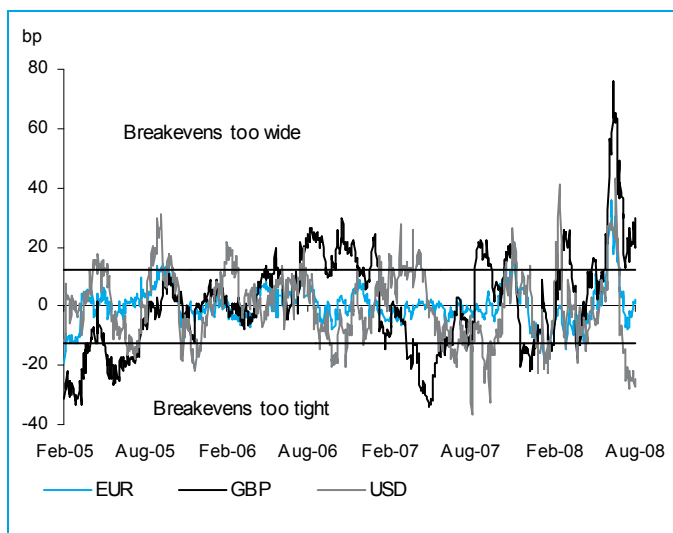
Government

- The bond market rally that started in the second half of July continued in August, as falling commodity prices led to a decline in inflation expectations.
- Relative to cash, we see far less value than we did two months ago, although bonds could still outperform if commodity prices continue to fall.
- In the UK, we judge that there is an argument to be long bonds versus cash, given the worse economic outlook. Also, at least relative to their recent history, bonds do not represent bad value relative to cash.
- Our preferred exposure in the fixed income space, for investors looking for a 'safe haven' opportunity, remains government inflation-linked bonds, especially given that breakeven spreads have now tightened significantly in shorter maturities (Figure 1 gives five year breakevens).

Corporates

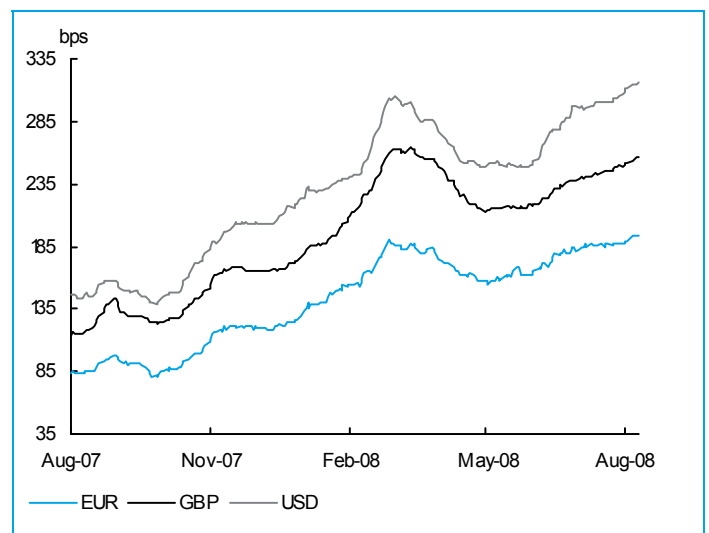
- Corporate bond markets remained depressed in August. Spreads were driven wider by fears of a major financial institution defaulting (Figure 2).
- Yet banks are clearing more hurdles in the form of the resolutions in the auction rate securities market and the sale of non core assets.
- The pain in the banking and brokerage sectors is slowly but surely moving onto other non-banking corporates. Corporate defaults are rising, which in turn, will put additional upward pressure on credit spreads.
- Supply of corporate debt to the market is likely to rise due to rising re-financing needs. Nevertheless, demand remains low as investors anticipate more widening during the rest of the year.
- Valuations continue to be attractive for the highest part of the investment grade universe, particularly if inflationary pressures were to recede. We remain wary of investing in the BBB bracket and the high yield sector as defaults are mounting.
- We continue to prefer the bank sector.

Figure 1 – US, UK & euro area 5-yr breakeven valuation



Source: Barclays Wealth Research

Figure 2 – Investment-grade spreads (\$, €, £)



Source: Barclays Wealth Research

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Changed recommendations...

...reflect continued problems

Portfolios' performance

Sector strategy: Current recommendations

We have extended our Automatic Momentum-Based Equity Sector Allocation (AMBESA) model to cover all general regions. AMBESA's current recommendations favour running with the commodity sectors, and the defensive sectors of utilities and healthcare.

The AMBESA recommendations are at odds with our current recommendations, which also incorporate a fundamental valuation-based approach. Valuation-based analysis suggests an underweight of the defensive sectors, and an overweight of the financials. Taking together both AMBESA and our value-based screens has led us to moderate our overweight financials position, and our underweights in the defensive sectors. (See the sector recommendations below, in Figures 1 and 2.) Materials in the UK remains a strong outperform, as the value and growth characteristics of the sector are supported by the AMBESA model.

Over the near term, we expect market volatility to remain high, and therefore risk appetite to stay low. Equity markets have a lot of hurdles to overcome in the next few months with the problems in the US economy still threatening the financial sector, and the global growth slowdown affecting other industries. Thus earnings forecasts are likely to be cut further in coming months, making the case for fundamental valuation harder than usual. As the results above show, equity markets are being largely driven by fear rather than fundamentals – the reason why return momentum strategies have performed so well. We believe that this will remain the status quo for a few months yet. Thus for the near term, we would recommend that portfolios follow AMBESA's current recommendations, and focus on commodities and defensives

UK

The UK portfolio rose by 3.8% over the month, while the FTSE 350 increased by 4.4%. So, the portfolio underperformed the index by 52 basis points. Utilities outperformed, but this was offset by a fall in general finance. We now have a year's worth of performance for the UK portfolio and, since its launch in August 2007, the portfolio has outperformed the index significantly, by 321 basis points.

Europe

In Europe, the portfolio rose by 0.9% during August – slightly less than the MSCI Europe ex-UK index rise of 1.1%. The financial sector saw a big improvement, but this was balanced by underperformance in healthcare and industrials. Since inception at the end of last year, the European portfolio has outperformed the index by 33 basis points.

Figure 1 – UK sector recommendations

Energy	3 - Neutral
Materials	1 - Strong Outperform
Industrials	3 - Neutral
Consumer discretionary	3 - Neutral
Consumer staples	4 - Moderate Underperform
Health care	3 - Neutral
Financials	2 - Moderate Outperform
IT	3 - Neutral
Telecoms	1 - Strong Outperform
Utilities	4 - Moderate Underperform

Source: Barclays Wealth Research

Figure 2 – Europe ex-UK sector recommendations

Energy	3 - Neutral
Materials	3 - Neutral
Industrials	3 - Neutral
Consumer discretionary	3 - Neutral
Consumer staples	4 - Moderate Underperform
Health care	3 - Neutral
Financials	2 - Moderate Outperform
IT	3 - Neutral
Telecoms	2 - Moderate Outperform
Utilities	3 - Neutral

Source: Barclays Wealth Research

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FX: Is this the start of a big dollar rally?

The US dollar has strengthened sharply over the past month against all major currencies – with the trade-weighted basket up 4% (Figure 1), and by about 8% from its end-March trough. Most other currencies fell in its wake, with sterling and the Aussie dollar taking exceptionally big hits. Naturally enough, given the speed and size of these moves, investors are asking if the dollar’s rise is the beginning of the ‘big recovery’ that many – including ourselves – have been thinking would come once the economy had bottomed and turned around. Our own estimates of fair value, whether based on our Fundamental Equilibrium Exchange Rate (FEER) or ‘kernel’ trend estimation approaches, had suggested plenty of upside potential for the dollar.

Equilibrium dynamics...

However, the rather strange concept of equilibrium which seems appropriate to FX implies that a currency’s reaching of ‘fair value’ rarely means that the recent trend will come to an end. Indeed, quite the opposite: usually the trend persists for some time, and the currency shifts from ‘cheap’ to ‘dear’ or *vice versa*. In that sense, equilibrium is perhaps a not very accurate description of our trend or FEER estimates. A better analogy is one of the kernel estimates being the point at which a piece of elastic is pinned, while the other end is attached to an (actual) currency. Thus, the further an actual currency moves away from the fair value, the more the elastic is stretched. Once it ‘pings’ back, the further the currency will depart from the pin in the other direction.

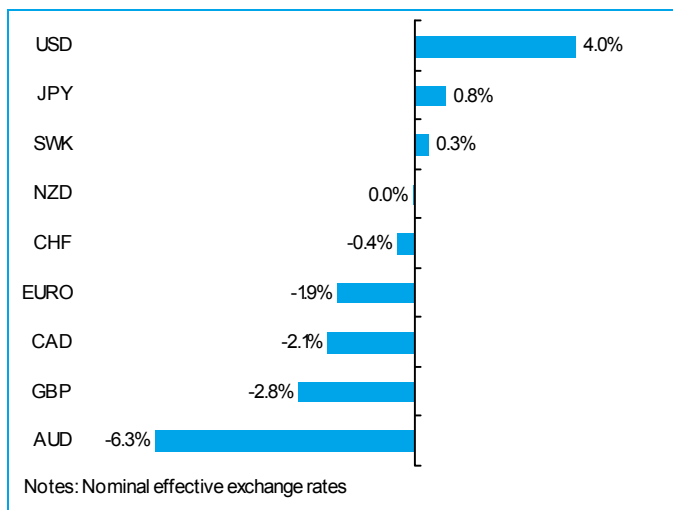
...suggest plenty of upside...

In the case of the dollar, this analogy rather suggests that the currency still has plenty of upside. Likewise, even though the sterling fall leaves it close to equilibrium, as shown in Figure 4, we doubt very much that its decline is going to come to an end anytime soon. Thus we remain comfortable looking to short sterling, as we have had in our list of preferred TAA recommendations for some time. More difficult for us, in the short run, is whether we slot in a long-US dollar TAA call too. We have decided to do this, but this is not a strong conviction call. Hence we feel the need to keep the position small, and to watch it closely.

...but our long call is only small

Two other factors are worth watching closely in the months ahead to help fathom the pressures driving the dollar and sterling. In the case of the dollar’s relative strength in August, it is clear that part of the story has been the fall in the price of oil. In the case of sterling, the Bank of England’s perceived attitude towards inflation is key. At present this appears dovish – but if oil prices surge, that might well bring inflation containment back on to the BoE’s agenda again. Our forecasts for these and other currencies are given in Figure 2.

Figure 1 – Monthly performance of currencies



Source: Bank of England and Barclays Wealth Research

Figure 2 – Exchange rate forecasts

	Spot	1-month	3-month	End-2008	End-2009
US\$ per £	1.83	1.84	1.84	1.85	1.87
US\$ per €	1.47	1.45	1.50	1.50	1.44
¥ per US	109.6	108	105	106	105
CA\$ per US\$	1.05	1.05	1.06	1.06	1.10
US\$ per A\$	0.86	0.86	0.85	0.84	0.83
US\$ per NZ\$	0.70	0.69	0.68	0.68	0.67
£ per €	0.80	0.79	0.82	0.81	0.77
SFr per €	1.61	1.63	1.62	1.61	1.53
SKr per €	9.42	9.40	9.30	9.23	9.20

Notes: Data as of 28 August. Data are end-of-period

Source: Bank of England and Barclays Wealth Research

Forecast summary

GDP (real change, %)	2006	2007	2008	2009
US	2.9	2.2	1.5	1.4
Japan	2.4	2.0	0.9	1.2
Euro area	2.9	2.7	1.4	0.9
UK	2.9	3.1	1.2	0.7
Canada	2.8	2.6	0.9	1.9
India	9.7	9.0	8.0	7.5
China	11.1	11.4	9.8	9.5
Brazil	3.7	5.4	4.8	3.5
Russia	6.7	8.1	7.0	6.5

Inflation (%)	2006	2007	2008	2009
US	3.2	2.9	4.3	2.7
Japan	0.2	0.0	1.4	1.0
Euro area	2.2	2.1	3.6	2.4
UK	2.3	2.3	3.7	3.0
Canada	2.0	2.2	2.4	1.8
India	5.3	4.8	9.0	6.2
China	1.5	4.8	5.9	3.0
Brazil	4.2	3.6	5.7	5.5
Russia	9.7	10.7	12.0	9.4

Interest rates (%)	2006	2007	2008	2009
US (Fed funds)	5.25	4.25	2.00	2.50
Japan (Call rate)	0.25	0.5	0.5	0.75
Euro area (Refi rate)	3.5	4.0	4.25	3.75
UK (Bank rate)	5.0	5.5	4.75	3.75
Canada (Call rate)	4.25	4.25	3.0	3.5
India (Repo rate)	7.25	7.75	9.75	10.5
China (Lending rate)	5.9	6.73	7.74	7.74
Brazil (SELIC rate)	13.25	11.25	14.5	13.75
Russia (Repo rate)	6.75	7.0	7.25	7.25

Source: Barclays Wealth Research

10-year bond yields (%)	2006	2007	2008	2009
US	4.7	4.1	4.2	4.4
Japan	1.7	1.4	1.8	2.2
Euro area	4.0	4.4	4.4	4.3
UK	4.7	4.6	4.7	4.5
Canada	4.1	4.0	3.8	4.1

Equity returns (%)	2006	2007	2008	2009
US (S&P 500)	13.6	3.5	-6.3	10.6
Japan (Topix)	32.7	6.5	-5.0	4.6
Euro area (FTSE Europe ex-UK)	20.0	3.8	-11.1	14.2
UK (FTSE)	11.0	3.8	-8.2	9.0
Canada (S & P/TSX)	14.5	7.2	3.1	4.5

Currencies	2006	2007	2008	2009
Indices				
US dollar index (% change)	-3.9	-5.8	-1.4	8.2
Yen index (% change)	-6.5	-4.0	10.5	8.7
Euro index (% change)	3.3	3.5	2.2	-4.8
Sterling index (% change)	4.8	-6.3	-8.2	3.3
Canadian dollar index (% change)	-1.6	11.7	-4.8	-10.0
Cross rates				
\$ per €	1.26	1.37	1.50	1.44
¥ per \$	116	118	106	105
\$ per £	1.84	2.00	1.85	1.87
£ per €	0.68	0.68	0.81	0.77

All market variables are end of period rates

Source: Barclays Wealth Research

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