



SIGNPOST LITE

How far down?

NOVEMBER 2008

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The articles in this edition of Signpost Lite are abridged from the full version of Signpost – How far down? We would recommend that readers also look at this full version which is available on request. The full edition of Signpost includes a guest essay by Barclays Capital's Tim Bond on equity buying opportunities.

In addition to extended coverage of the topics in Signpost Lite, the full version of signpost also includes pieces on AMBECA, a momentum-based approach to national equity markets, European banks after the bail-outs, the threat of financial leverage in emerging market currencies, developing an FX portfolio, UK real estate, Canada, China, India, Russia and Brazil economic prospects, asset allocation, the fixed income duration scorecard, and the UK and Europe ex-UK analyst portfolios.

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How far down?

The impact of the credit crisis on the real economy is becoming all too readily apparent. The obvious question now is ‘How far down?’ – are we talking a standard recession, a full-scale depression, or somewhere in between? We start this edition of *Signpost Lite* by looking at recent developments, three possible future scenarios, and the investment implications. We leave it to the reader whether they choose to enter the water gently, or dive deep straight into the detailed analysis of our tactical asset allocation (TAA).

Policymakers adopted a coordinated approach...

Figure 1 presents major economic and policy developments over the past month or so (more than enough, in this strangely compressed world, to comfortably fill a decade or two in more normal times). Amidst the storm, one can identify some general trends: the slow shift to a more coordinated approach by policymakers, and then their belated recognition that the financial turmoil would hit the real economy, and hard. But the overall picture remains one of policymakers trying desperately to catch up, and not altogether succeeding. Adding to the gloom, emerging markets have also fallen back badly. And hedge funds have struggled.

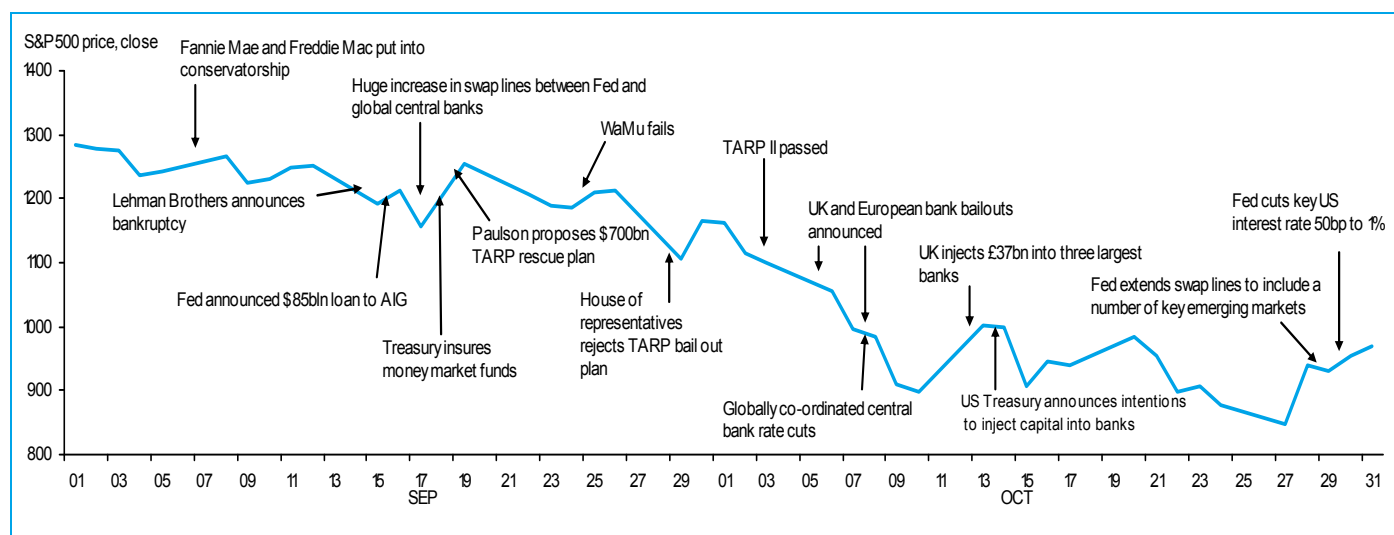
...but too late to avoid recession

It is certain that the authorities’ failure to act in accordance with the scale of the problems facing them has jeopardised chances of the global economy avoiding recession. Indeed, it now looks just about inevitable that *all* of the major economies will witness at least two consecutive quarters of declining output. So, the real question that has to be answered now is more about the scale of the slowdown, not whether or not there will be one.

An ABC of possible future scenarios

Possible future scenarios can, for ease of reference, be reduced to a simple A, B, C mnemonic: ‘awful’ (a typical post-war recession comprising a fairly brief, and shallow, slowdown from which the economy emerges largely intact); ‘brutal’ (a deeper, and longer-lasting, slowdown); and ‘catastrophic’ (not so much a recession as a depression – in which GDP collapses). At some stages, markets have seemingly been pricing in the ‘C’ scenario (a depression) but we think that this is too pessimistic. Instead, we expect something between an ‘A’ and a ‘B’. In other words, the recession will be longer and deeper than those experienced in recent decades. It is usually the case that recoveries start four or five quarters into the slowdown – but this time around we suspect that it will be nearer six or seven. So in our view recovery will not happen until at least the second half of next year, if we are lucky.

Figure 1 – S&P timeline during September and October



Source: Barclays Wealth Research

Financial markets will take time to mend

We remain neutral on equities but look to get long

Long-duration government bonds are still attractive

The reason that we think that this recession will be a long, drawn-out affair is that the financial markets are going to take quite some time to mend, and hence for trust to return. And the credit crunch will hurt households and non-financial corporations, leading to a sharp decline in ‘animal spirits’ (or confidence). But this need not necessarily act as a big drag on the economy, provided that the fundamental factors dragging down the household sector – which we take to be a collapsing housing market and real wage declines – both turn around.

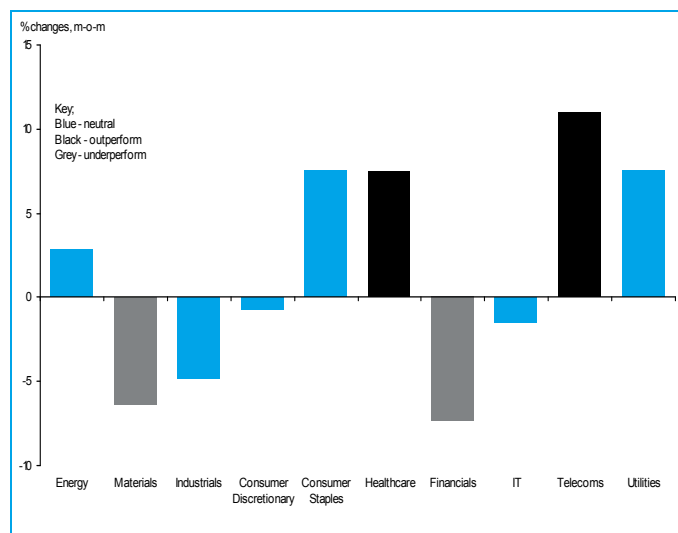
How could an investor play this? Equities have certainly fared worse than we expected in October, due largely – we suspect – to the inadequate policy response. Looking ahead, however, the response is enough, we judge, to avoid a depression. (So ‘tail risk’ should fall away.) On the other hand, the macro environment will be tough, as economies contract. All in all, we have decided to remain neutral for now on equities; but we are looking for opportunities to get long, as we believe equities will outperform on a 12-month basis. If, for example, the US were to announce a substantive further fiscal effort, we might well go long. On sectors, we stick with our recommendation to focus on ‘dull’ defensive stocks, rather than fall for the apparent price attractions of financials and industrials. (Figure 2 illustrates how our sector recommendations performed last month.)

On fixed income, our previous small overweight on investment-grade credit turned out to be premature. Hence, we now go neutral credit in our short-term TAA. Our suggestion to go long duration on government bonds, on the other hand, has done well, and our analysis suggests that the case for this is getting even stronger. Meanwhile, our recent FX recommendations have turned up trumps, and yielded some impressive returns. But we are reluctant to get carried away, and suggest smaller positions. We also suggest taking off the yen as a short-term bet, and are now more willing to accept the gloomy market consensus on emerging market currencies (and, for that matter, emerging market equities). Figure 3 summarises our current FX recommendations.

We find it unnecessary at present to make major significant changes to our medium-term TAA and long-term strategic asset allocation recommendations, although we have lowered our modal forecasts for GDP and equity returns. Markets will eventually recover some lost ground and equities do look remarkably cheap. But this does not sound like a story for the short term.

Michael Dicks, Head of Research, 3 November 2008

Figure 2 – Equity sector performance chart



Source: Barclays Wealth Research

Figure 3 – FX recommendations

Trade-weighted x-rate	Three-month	End-2009	End-2010
US dollar	+	+	+
Sterling	-	-	-
Euro	-	-	neutral
Japanese yen	+	+	+
Swiss franc	++	++	+
Swedish krona	+	+	+
Canadian dollar	-	-	-
Australia dollar	-	-	-
New Zealand dollar	-	-	-

+ represents an appreciation with ++ indicating a strong conviction

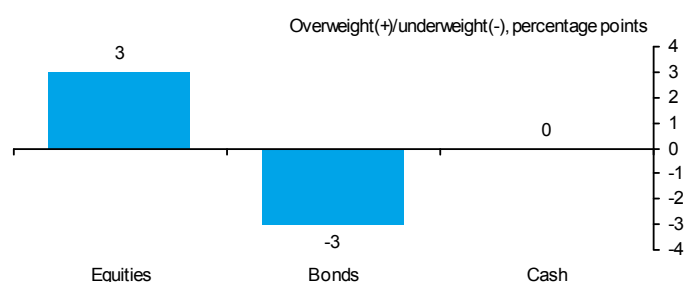
Source: Barclays Wealth Research

Medium-term (one-year) tactical asset allocation recommendations

ASSET ALLOCATION	Benchmark	Recommended portfolio		Tilt
EQUITIES	59.7	62.7	3	
BONDS	35.3	32.3	-3	
Government	17.1	12.1	-5	
Investment-grade	13.1	14.1	1	
High-yield	3.0	3.0	0	
Emerging	2.0	3.0	1	
CASH	5.0	5.0	0	

All figures are in percentage points

Recommended tilts on the main asset classes



Currencies

	USD (\$)	JPY (¥)	EUR (€)	GBP (£)	CAD	CHF	SEK	AUD	NZD
Trade-weighted	+	+	-	--	--	+	+	--	--

A plus (+) sign shows an expected currency appreciation and a minus sign (-) an expected currency depreciation.

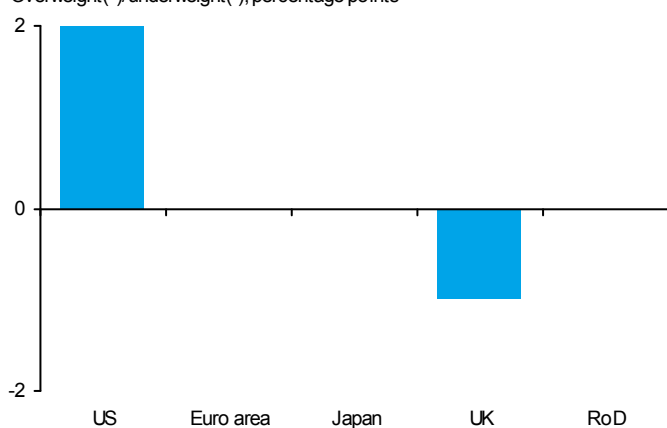
Double pluses and double minuses indicate strong conviction calls.

Equities

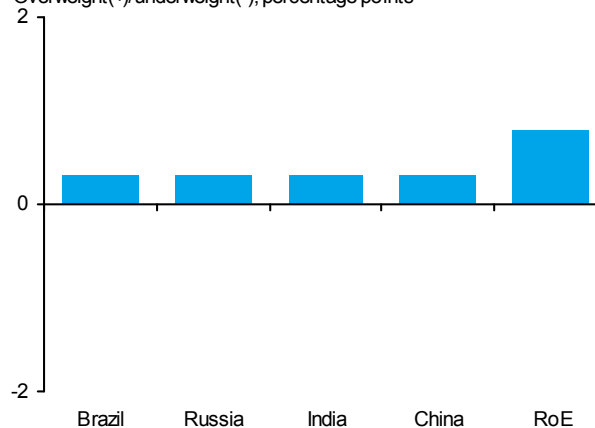
COUNTRIES	US	Euro area	Japan	UK	Rest of developed	Brazil	Russia	India	China	Rest of emerging markets
Benchmark	25.3	9.3	6.1	8.1	5.8	0.6	0.5	0.4	0.8	2.8
Recommended	27.3	9.3	6.1	7.1	5.8	0.9	0.8	0.7	1.1	3.6
Tilts	2.0	0.0	0.0	-1.0	0.0	0.3	0.3	0.3	0.3	0.8

Recommended tilts on equities by regions and country

Overweight(+)/underweight(-), percentage points



Overweight(+)/underweight(-), percentage points

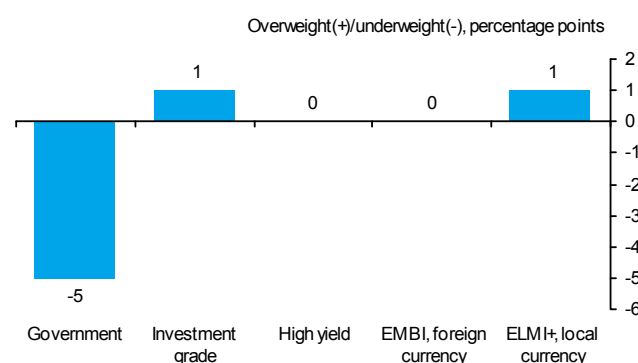


SECTORS	Energy	Materials	Industrials	Consumer discret	Consumer staples	Health care	Financials	IT	Telecoms	Utilities
Global	0	+	+	0	--	0	+	0	0	--
US	0	+	+	0	--	0	+	0	0	--
Euro area	0	0	+	0	-	0	+	0	0	-
UK	0	+	+	0	--	0	+	0	0	--

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

Bonds

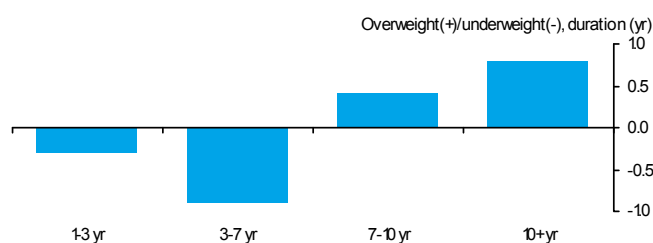
	Benchmark	Recommended portfolio	Tilt
TOTAL:	35.3	32.3	-3
Government	17.1	12.1	-5
Investment-grade	13.1	14.1	1
High-yield	3.0	3.0	0
EM: foreign currency	1.0	1.0	0
EM: local currency	1.0	2.0	1



Government bonds

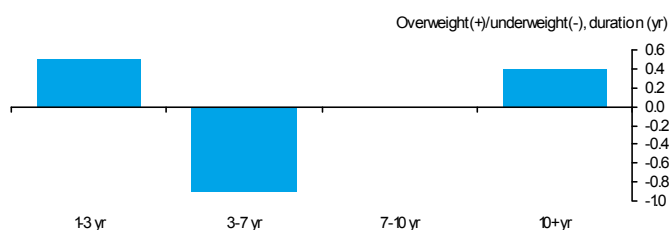
US

	1-3 YR	3-7 YR	7-10 YR	10+ YR
Benchmark	0.3	1.4	1.6	1.2
Recommended	0.0	0.5	2.0	2.0
Tilt	-0.3	-0.9	0.4	0.8



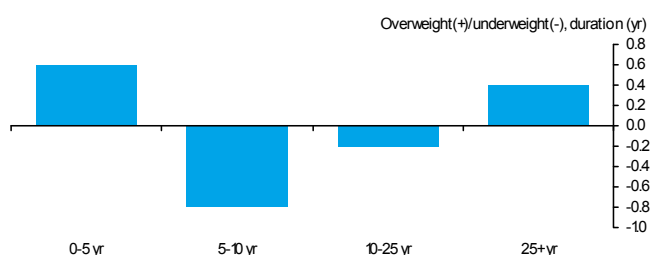
EURO AREA

	1-3 YR	3-7 YR	7-10 YR	10+ YR
Benchmark	0.5	1.4	1.1	2.4
Recommended	1.0	0.5	1.1	2.8
Tilt	0.5	-0.9	0.0	0.4



UK

	0-5 YR	5-10 YR	10-25 YR	25+ YR
Benchmark	0.6	1.4	3.2	3.4
Recommended	1.2	0.6	3.0	3.8
Tilt	0.6	-0.8	-0.2	0.4



Credit

SECTORS	Financials total	Banking	Non-financials total	Consumer cyclicals	Consumer non-cyclicals	Telecoms	Utilities
EUR	+	++	-	-	--	-	0
GBP	+	++	-	-	--	-	0
USD	+	++	-	-	--	-	0

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

Key short-term Tactical Asset Allocation (TAA) themes

Theme	Thesis	Investment strategies
Equities likely to struggle to make much of a recovery short term.	<p>Market risk remains very high, but looks to be abating somewhat – thanks to policymakers’ efforts to unfreeze markets gradually gaining traction.</p> <p>Risk aversion has been near an all-time low, and may well improve a little, given that bank bail-outs have lessened perceived bankruptcy risk within the financial sector.</p> <p>Macro risk, on the other hand, has increased – and may rise further, as hard data confirm that the advanced economies are all contracting, while emerging markets slow sharply.</p>	<p>We expect volatility to remain high, and market participants nervous. But, gradually things should improve.</p> <p>We prefer to remain defensive – not taking much risk currently. But, we would look to get long if policymakers deliver positive surprises on fiscal and monetary policy, and if markets unfreeze.</p> <p>We suspect that credit will begin to heal before equities do.</p>
Stay defensive on equity countries and sectors.	Our new equity country and sector score cards find different factors drive country/sector performance at different horizons – in much the same way that momentum sometimes works out well as a short-term driver of markets, but value kicks in longer term.	On countries, our AMBECA tool suggests being long defensive countries, such as the US, Germany and Switzerland and short the BRICs and Spain. On sectors, we’re overweight health care and telecoms and underweight energy and materials.
Central banks still have work to do in order to bolster activity.	Some central banks are running out of room to cut, including the Federal Reserve. But some have plenty of room for aggressive easing, including the European Central Bank and Bank of England. Much of that is priced in, but not all that we expect to see delivered.	With recessions likely to be worse than generally expected, central banks are unlikely to stop easing as quickly as markets are pricing in. The main risk to this trade in the UK case is that sterling takes another big leg down, importing some inflation. We recommend having some sterling weakness kept as insurance for those playing the BoE rate cuts trade.
Investment grade credit not quite ready to turn yet.	Bank bail-outs have reduced default risk in the financial sector considerably. But non-financials have to cope with a contracting economy, as well as the credit crunch. Although a depression-type scenario is priced in – suggesting investment grade spreads are currently far too wide – it may take a little while for investors to reduce the tail-risk significantly in the face of weakening demand.	<p>We have gone back to neutral on the investment-grade spread trade we recommended a month ago, although we retain it as a medium-term TAA tilt.</p> <p>Europe offers less opportunity than the US, in part because the cycle is likely to be more drawn out on the Continent.</p>
Sterling to stop sliding – but not for long.	Most of our FX medium-term calls came through in spades last month. Hence, we took profits when cable reached \$1.60. Now, there is a good chance that risk appetite recovers a little, and the pound finds its feet for a while. But that is unlikely to last for long.	If sterling goes back to \$1.70-1.75, we would look to put on another leg of sterling weakness. Likewise, with most of our FX trades: they may reverse direction for a while. But the former trends will resume again soon.
Go long duration, especially in European fixed income markets.	Our fixed income duration scorecard did a good job last month in the govies space. It now recommends even bigger positions, right across the developed world.	Keep the trade on and raise the stakes.
Emerging markets to continue to suffer.	Most emerging markets are getting tarred with the same brush, leading to poor performance in equities, bonds and FX. It will take time to turn around. Look out for market participants beginning to differentiate between the good, the bad, and the outright ugly.	For the moment, the trend is your friend: sell-offs will probably continue, especially where adjustment programmes entail fiscal and monetary tightening. In time, some countries – with better fundamentals – should do better.

Key medium-term Tactical Asset Allocation (TAA) themes

Theme	Thesis	Investment strategies
After contracting during the second half of this year and the first half of next, the US economy should start to recover next summer or autumn.	Fiscal easing works in most instances, but tends to get overlooked, and underestimated, by most economists. Cutting rates works too – although this time round not well. But, government buying of MBS and the TARP should eventually help policy get more traction.	The US equity market ought to register some healthy gains next year, as it is priced for depression rather than recession. Other markets may well follow, but underperform – pointing to relative value opportunities, such as long US versus the UK or versus the euro area.
Many central banks will turn out to be more dovish than they sound.	Polymakers have been slow to realise the seriousness of the credit crunch, and many were fixated by inflation being above target. Now that the lower oil price is feeding into inflation, however, they are switching mode – and will likely continue cutting rates even when markets judge that they are done, as risks to the consensus growth and inflation forecasts are skewed to the downside.	Although the futures strips are now pricing in lots of rate cuts by most central banks, we still judge that the risks are skewed a little to the downside. After all, although we saw the coordinated rate cuts that we predicted last month, they were pretty feeble – i.e. only 50 basis points. Rates are still high in Europe.
The UK slowdown will be vicious.	Housing is in free fall, and with a long way to go before it reaches a floor. Moreover, the Bank of England's governor has now admitted that the economy is in recession – i.e. a deep slowdown relative to the oft-used two-quarter-decline definition. The pain level is likely to increase significantly through the remainder of this year and early next.	Our UK underweight has performed well hitherto. But it may well have further to go next year. Likewise with sterling. We have taken profits on its recent collapse. But, if it continues to find its feet, as in recent weeks, we may well look for an opportunity to position for it to take a second leg down. Risks to the short strip still on the downside – i.e. more rate cuts than are currently priced in.
Emerging market equities very cheap, but will be worth looking at once investors start distinguishing between 'good' and 'bad'.	Economists have (rightly) given up on EM 'resilience', and markets too – with EM equities down more than a half so far this year. Many now have currency crises, and fears are rising of bond defaults. It may well take quite some time for emerging market equities to recover, as some look destined to default, or are beginning severe IMF adjustment programmes. But some countries are in quite good shape.	Currently, most EM countries are being tarred with the same brush. But, those without external imbalances or inflation or public finance problems should eventually start to outperform. Going long Brazil, Poland, Czech Republic versus the likes of Argentina, Hungary and Turkey, for example, is the sort of trade that might be worth beginning to think about.
Go long duration government bonds.	Our fixed income scorecard recommends being long duration government bonds, and with greater conviction than a month ago.	The recommended overweights are slightly greater in Europe than in the US or Japan.
Credit spreads for investment grade to start coming in.	Economic slowdowns will raise default rates. But this is already priced in – with some spreads higher than during the Great Depression. So, once investors grow more comfortable with the idea that next year will entail a recession, not a depression, spreads should start to narrow.	Financials will benefit from the bail-out schemes, and so should narrow versus non-financials. Investment-grade spreads should come in next year too.
Dollar recovery to lose momentum for a while, but continue next year.	The dollar is no longer cheap, thanks to its recent, sharp appreciation. Some of that reflects risk aversion, and may fade as volatility fades. But dollar strength should resume as a theme once people realise the US will recover faster than the other major economies.	Take profits on the dollar overweight position, but look to reposition for another bout of strength if it sheds more than 3-4% in trade-weighted terms.
'Non-dollar dollar' weakness a similar story.	The 'commodity' currencies – the Aussie, Canadian and New Zealand dollars – all looked very overvalued, but have plummeted of late (by close to 20% in the past month alone). Again, they may find their feet soon, or even 'bounce back' a bit. But they should resume falling again next year.	Take profits on the 'non-dollar dollar' basket trade, but look to re-enter if it rises more than 10% from its recent low.
Swiss franc to rise, again after shedding some of its recent strength.	Still cheap according to our kernel estimates. But a mini dollar story too: and may lose ground before resuming its appreciation.	Also helps diversify some of TAA calls, although less compelling on an FX basis than some other calls.

Key Strategic Asset Allocation (SAA) and long-term fundamental 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 in 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 out of other developed markets. Increase exposure to developing countries, where potential growth rates are higher.
The recovery following the credit crunch 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, although they do need to re-price the tail-risk of a depression, and so should recover from recent steep declines. Thereafter, look for more pedestrian performance – and strategies which perform in range-trading environments.
High oil prices are here to stay.	The spring surge in prices may have pushed oil prices way above their equilibrium. But, 'high' prices (i.e. above \$60/bbl) are here to stay. The corresponding wealth transfer, from oil-consuming to oil-producing nations, is of the order of 3% 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.
Asia's growing influence in the world.	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, especially India and China. 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 during the next economic cycle.
Income/wealth distributions.	We judge that much of the recent shift 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, even if there is something of a backlash in the financial sector.	Countries that invest in education stand to benefit, although it will be 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.

US prospects

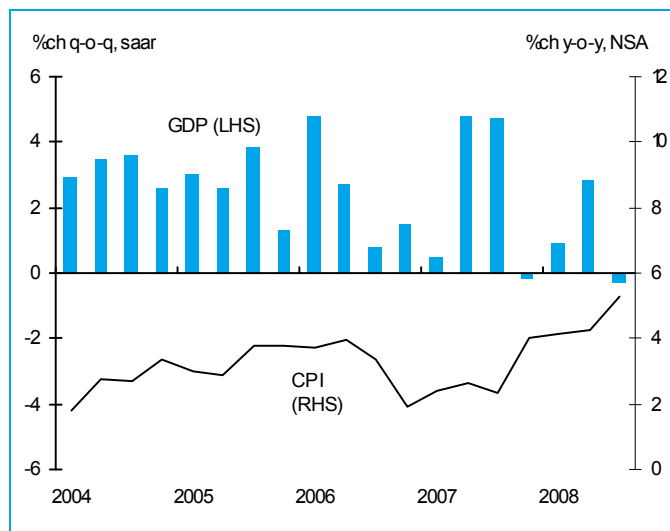
Economic outlook

- The US economy is facing a painful recession: the credit mechanism remains broken, external demand is ebbing and the housing market is still falling. The consensus has slashed its forecasts for GDP, now looking for no expansion at all next year instead of the 1.4% growth estimated a month ago. Our forecast is for a contraction by 1%. However, lower inflation should boost households' purchasing power, and that, along with additional fiscal support from the government, should help steer the economy through the recession in 2009.
- Policymakers continue to react forcefully to avert outright systemic failure in financial markets, with another round of fiscal stimulus looking likely. We expect the Federal Reserve to cut rates to 50bp next month, in an attempt to restore confidence and kick-start credit flows, and then to halt the easing process. Market pricing has shifted to take this into account. We expect money markets to gradually return to normal and interbank rates to deflate. The yield curve should normalise once safe haven flows reverse, but weak growth and falling inflation should push down fair value for yields.
- The near-term outlook for housing remains bleak. Mortgage financing strains, elevated inventories and rising joblessness will weigh on house prices over the coming months, but a sizeable housing adjustment has already taken place. We estimate that real house prices are currently less than 4% above 'fair value' but there could be some 'undershooting' ahead. We expect prices to reach a trough next summer.

Market outlook

- Equity markets have been engulfed by the ongoing turmoil. We continue to look for downward earnings revisions in the short term.
- Over the medium term, earnings expectations should realign with reality. Some sectors – such as materials and industrials – look attractive. Financials also offer some value.
- The valuation gap for equities, based on these expectations versus real corporate bond yields, suggests plenty of upside for the S&P 500. We have nevertheless lowered our forecasts for next year – reckoning it will take longer for fundamentals to drive prices.

Figure 1 – US GDP and inflation



Source: Barclays Wealth Research

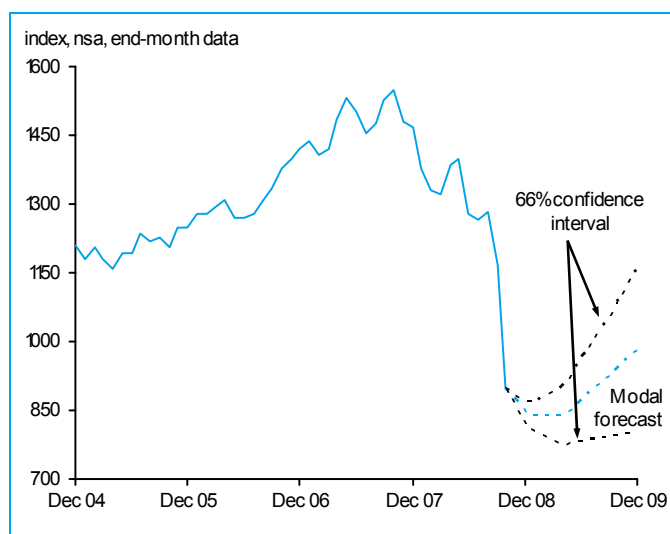
Figure 2 – The US forecast in a nutshell*

% y-o-y except where stated				
	2006	2007	2008	2009
GDP	2.9	2.2	1.3	-1.0
CPI	3.2	2.9	4.2	1.2
Fed funds (%)	5.25	4.25	0.50	0.50
10-year yields (%)	4.7	4.1	3.6	3.5
S&P 500 index	13.6	3.5	-20.6	12.6
\$ index	-3.9	-5.8	-1.4	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

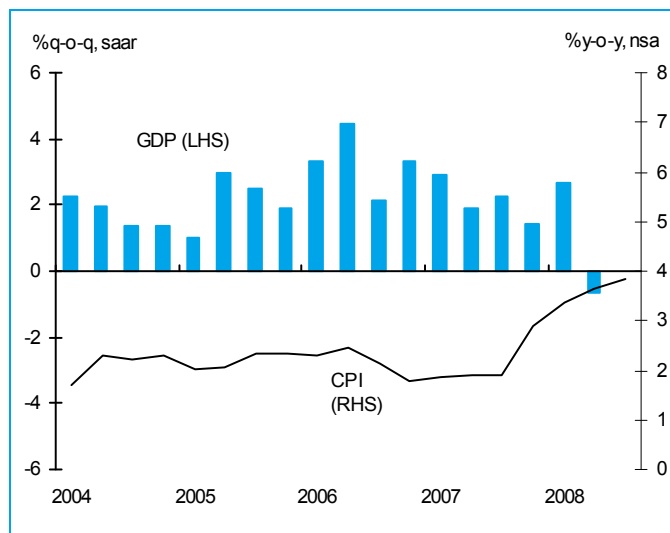
Economic outlook

- Having fallen by 0.8% quarter-on-quarter (at a seasonally adjusted annual rate) in Q2, and with output probably dropping further in Q3, the euro area looks to have entered a technical recession. We have cut our 2009 GDP growth forecast by 1.5 percentage points to -0.8%.
- The drag from energy costs on real household consumption could soon diminish, thanks to the falling oil price. However, gloomy headlines and reduced access to financing mean prospects for investment now look bleak. Firms' appetite for hiring should also diminish, pushing up unemployment and thereby capping real income and consumption gains. In addition, the prospect of a global recession will hit exports. A wildcard is the political response: the almost inevitable changes to banking regulation are likely to reduce credit provision by banks. But political goals may stipulate some minimum lending or direct it to certain borrowers, which could limit the shrinkage in balance sheets.
- Policymakers have responded to the financial crisis, but have more to do. European governments have implemented bank bail-out packages loosely modelled on the UK's and, in coordination with other central banks, the European Central Bank (ECB) has cut interest rates by 50bp to 3.75% – and will likely do more in response to the deteriorating environment. We now expect rates to trough at 2% next year, although much depends on how the financial crisis evolves. However, the ECB will probably want to raise rates again once the outlook improves.

Market outlook

- European equity markets have performed worse than most this year, but, during last month's sharp plunge, equity prices changes were not extreme relative to others.
- The market has tended to disregard valuations in favour of momentum, pricing in precipitous declines in future earnings, consistent with a deep, protracted recession.
- Policymakers' actions should prevent a much deeper slide in equity valuations from here, but with economic news poor, it will probably take time for confidence to return to markets and lift prices.

Figure 1 – Euro area GDP and inflation



Source: Barclays Wealth Research

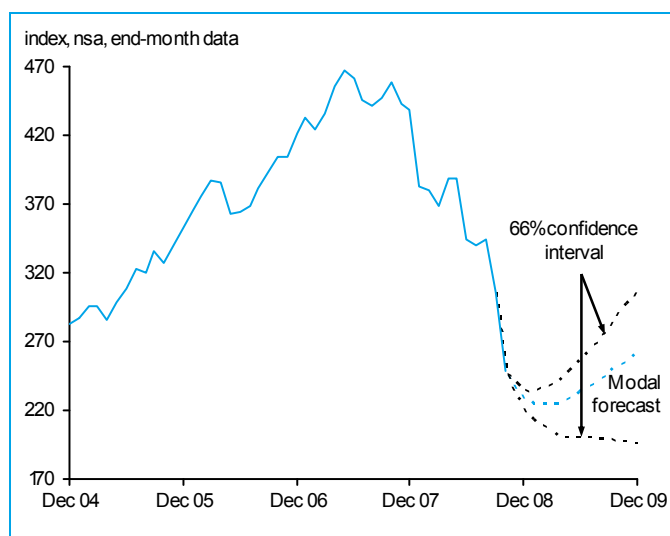
Figure 2 – The euro-area forecast in a nutshell*

% y-o-y except where stated				
	2006	2007	2008	2009
GDP	3.0	2.6	1.1	-0.8
HICP	2.2	2.1	3.6	2.4
Refi rate (%)	3.50	4.00	3.00	2.00
10-year yields (%)	4.0	4.4	3.8	4.0
FTSE ex-UK index	20.0	3.8	-47.7	14.0
€ index	3.3	3.3	-7.1	-2.7

* 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

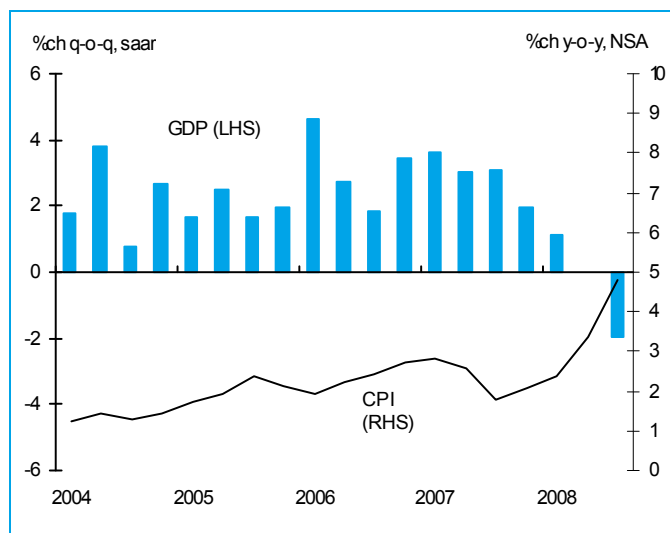
Economic outlook

- The economic news flow in the UK continues to deteriorate. UK GDP fell by 0.5% in the third quarter, the weakest result since Q4 1990. We had been forecasting that the economy would decline in the second half of this year for some time now. Given recent events in financial markets, however, we have increased our expectations for both the size and longevity of the contraction. As a result, we have reduced our estimate for 2009 GDP growth from 0.5% to -1.1%. This would be the weakest result since 1991.
- House prices have fallen 15% since their peak and the labour market is now deteriorating fast. Leading indicators point to significant further weakness ahead. We suspect that only half of the housing price adjustment has occurred so far. The labour market has deteriorated sharply in recent months, with the ILO unemployment rate increasing from 5.2% in April to 5.7% in July.
- Although consumer price inflation is well above target at 5.2%, it is likely to fall sharply through 2009, dipping below its 2% target in the second half of the year thanks to declining energy and food prices.
- The Bank of England cut interest rates by 50 basis points, to 4.5%, as part of the globally co-ordinated monetary easing on 8 October. Mervyn King's recent speech made clear that further monetary easing lies ahead. Rates are likely to fall to a record low in the current cycle – under 2.5% – although policymakers may not want to leave them there for too long once signs of a recovery finally begin to emerge.

Market outlook

- In August we 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 that view is the marked deterioration in economic prospects. Sterling weakness does not augur well either.
- In the short term, recession confirmation is likely to hurt the equity market. We have pared back both our year-end forecast for the FTSE 100 and our projection for year-end 2009.

Figure 1 – UK GDP and inflation



Source: Barclays Wealth Research

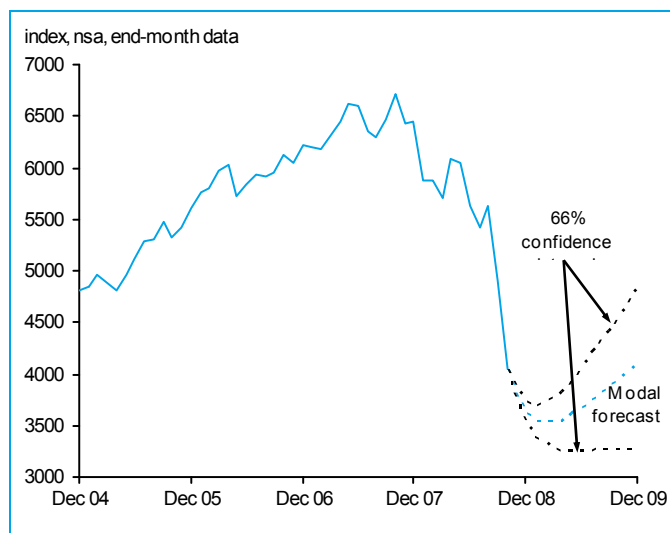
Figure 2 – The UK forecast in a nutshell*

% y-o-y except where stated				
	2006	2007	2008	2009
GDP	2.9	3.1	0.8	-1.1
CPI	2.3	2.3	3.7	2.8
Bank rate (%)	5.00	5.50	3.5	2.25
10-year yields (%)	4.7	4.6	4.3	4.1
FTSE 100 index	11.0	3.8	-43.5	12.0
£ (index)	4.8	-6.4	-10.7	-10.6

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

Source: Barclays Wealth Research

Figure 3 – The outlook for the FTSE 100



Source: Barclays Wealth Research

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Market review: October

Equities – further turmoil

Equity markets suffered their worst month since 1987 in October and year-to-date have seen the worst falls since the 1930s. Japan and emerging markets suffered the most, falling 21.1% and 22.3% respectively. The MSCI World index dropped 16.3%, a monthly fall not seen since October 1987. Year-to-date losses on markets are now -35.1% for the MSCI World, and a staggering -46% for the emerging markets index. Falls of this magnitude have never been seen in the indices' history. Sector-wise, nothing is in positive territory. However, the best relative performances were seen in telecoms, consumer staples, and healthcare.

Bonds – back to losses

Bond market performance was mixed over the month. US returns were the weakest, with declines of 3%. Japan was the best performer, gaining 0.5%. Yield curves continued to steepen as anticipation of further interest-rate cuts spread across the market. Inflation fears have abated, but the outlook for growth took a further (big) leg down this month, pushing yields down as the 'flight to safety' continued. Credit markets have firmly shifted their attention to the deteriorating growth outlook, pricing in a substantial rise in defaults from current levels.

Commodities – further declines

The GCSI Commodity index fell for the fourth month in a row, by 28.2%, led by the energy sector – reflecting the big drops expected in future demand. Energy and industrial metals performed the worst, declining by 31.2% and 26.7% respectively; agriculture fared the best, falling 17.3%. The energy sector weakness has been driven by the fall in crude oil, which was down by approximately 35% at one point, before staging a brief end-of-month rally after the US cut interest rates.

2008 performance*												
Fixed income: local currency returns, %												
	6m	3m	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct
US	-5.2	-4.3	1.9	0.6	-0.0	-0.7	-1.0	0.2	-0.1	0.9	-2.5	-3.0
UK	-1.5	-1.6	-0.2	-0.7	0.0	-0.5	-1.2	-0.7	2.1	1.7	-2.4	-1.5
Euro area	1.2	1.7	2.1	0.5	-0.8	-0.4	-1.1	-1.1	1.8	1.1	-0.5	0.3
Japan	1.5	0.9	0.5	0.5	0.4	-1.6	-0.8	1.1	0.3	0.9	-0.3	0.5
World	-1.0	-0.7	1.5	0.3	-0.0	-0.6	-0.9	-0.2	0.7	1.0	-0.9	-1.0
Equities: MSCI local currency returns, %												
US	-32.5	-26.8	-6.1	-3.1	-0.4	4.9	1.6	-8.2	-1.1	1.4	-9.2	-17.1
UK	-29.1	-20.7	-8.8	0.4	-2.1	6.8	-0.4	-6.9	-3.7	5.1	-12.9	-10.6
Europe ex-UK	-34.3	-26.5	-12.6	-0.6	-2.7	6.2	1.5	-11.1	-1.1	1.3	-11.3	-14.8
Japan	-39.4	-36.5	-9.2	-1.4	-8.2	12.6	3.6	-6.4	-1.5	-3.6	-13.1	-21.1
Pacific ex-Japan	-35.3	-27.8	-11.2	-1.4	-3.3	5.7	0.9	-7.8	-3.6	1.2	-12.0	-15.1
Emerging	-48.9	-41.4	-12.4	6.1	-4.2	7.3	1.9	-9.9	-5.0	-4.8	-12.4	-22.3
World – dev	-33.4	-27.4	-8.4	-1.7	-2.1	6.2	1.7	-8.2	-1.8	1.2	-10.7	-16.3
Cash: three-month Treasury bills, end of period, %												
	2006	2007	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct
US	4.8	4.5	1.9	1.8	1.3	1.4	1.9	1.7	1.7	1.7	0.9	0.4
UK	4.7	5.6	5.2	5.2	5.0	5.0	5.1	5.2	5.2	5.2	4.8	3.7
Euro area	2.9	3.9	3.9	3.9	3.9	3.9	4.0	4.3	4.3	4.3	3.1	2.8
Japan	0.2	0.6	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.3

* Returns are all total returns

Source: Barclays Wealth Research

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Fixed income: summary

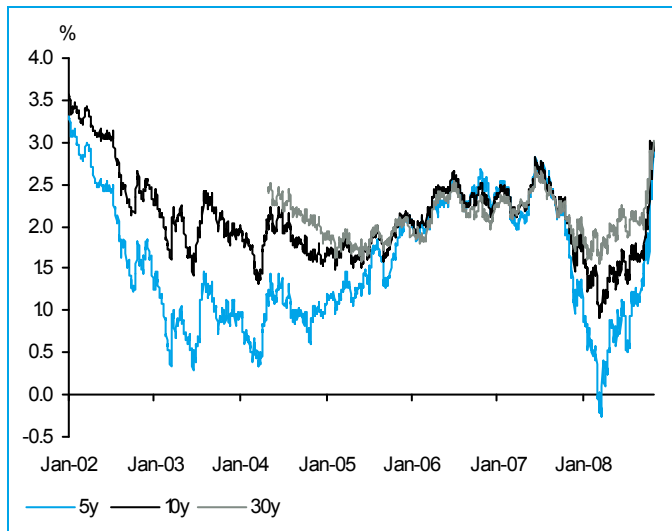
Government

- Some signs of normalisation have emerged, but overall fixed income markets remain extremely stressed.
- Extreme levels of risk aversion, along with slowing growth and declining inflation, mean we continue to recommend a long duration position.
- We believe inflation bonds, especially TIPS, offer extraordinary value at present, and forced selling is creating buying opportunities.

Corporates

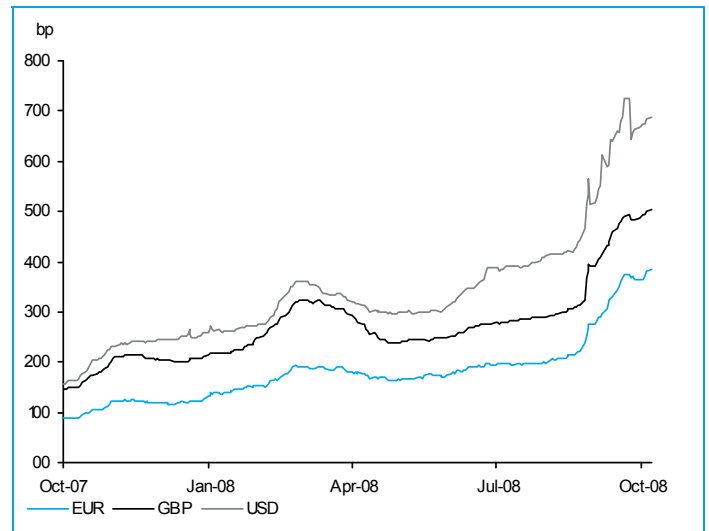
- In October many governments decided to bail out their banking systems, aiming to restore confidence. However, it will likely be some time before the corporate bond market returns to normality. Although not obvious yet in the debt markets, the situation is improving on the banking front with the virtual disappearance of the risk of default of senior debt of large financial institutions.
- A consumer-led recession could have a significant impact on pure corporates. Companies are coming under rising pressure as access to the credit market remains expensive and banks charge more and/or lend less. Most companies still have solid, although deteriorating, cash positions. However, if results are worse than expected, room for manoeuvre could become much more limited.
- Liquidity concerns in the high-yield sector could escalate in 2009. Several non-investment-grade companies had negotiated so-called 'covenant lite' financing facilities prior to the beginning of the credit crisis in June 2007. However, some of these covenants look likely to be either violated or expire in 2009 and 2010. Re-negotiation of these clauses could increase the pressure on these companies and lead to bankruptcy, increasing the level of possible defaults.
- Despite corporate bonds' attractive yields, investors have focused on the safest investments such as government bonds, gold and of course cash. Future demand for corporate bonds could remain extremely limited due to the withdrawal of previously heavy buyers of corporate bonds prior to the crunch.
- We continue to recommend the highest-rated credits, particularly banks' senior debt, which looks safe from default since the government intervention.

Figure 1 –TIPS real yields



Source: Bloomberg, Barclays Wealth Research

Figure 2 – Banking debt spreads



Source: MLX

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Earnings downgrades have spread beyond financials

Our recommendation – to stay defensive – paid off in October

Medium-term forecasts remain unchanged

Sector strategy

October was the most volatile month for equities that we have seen decades. High volatility usually means high risk aversion, and this was visible in sector performance over the month, with the defensive sectors – telecoms and healthcare – leading the market. Financials continued to underperform the market, although the sector's relative performance has improved in recent months, as investors have begun to factor in the impact of a recession on the rest of the market.

The October release of the IBES earnings estimates suggested that analysts are beginning to assess the risks to earnings beyond the financials sector. The energy, consumer discretionary and industrials sectors all saw their growth forecasts cut back. At the headline level, 2009 earnings growth forecasts were slashed by 14% month-on-month. We believe that, as the economic slowdown intensifies, earnings growth forecasts could fall further, especially for materials, energy and industrials which have enjoyed record levels of profitability on the back of high commodity prices.

Last month we took a defensive tone in our short-term recommendations, which proved to be the correct decision. We keep this defensive tone in the short term but, given their improvement relative to the rest of the market, we are upgrading our short-term call on financials back to Neutral. To balance this, we are downgrading the energy sector to Moderate Underperform in the short term, given poor momentum indicators, high earnings risk and valuation concerns.

In the medium term, we still believe that fundamentals will return to the fore as money and credit markets return to normality. Furthermore, earnings expectations should regain credibility. Our models see the most value in the industrials and materials sectors – and to a lesser extent the financials. The suspension of dividends and substantial government support will enable the banking sector to rebuild and recover at a faster pace than would otherwise be the case. As we said last month, a strong financial sector is a precursor for a strong economy, and thus the sector should lead a general market recovery.

We still see least value in the medium term in the consumer staples and utilities sectors, which currently enjoy a defensive premium. As the economy and markets recover from the current turmoil, these sectors are the obvious candidates to underperform a rising equity market.

We refer readers to the full edition of *Signpost* for a much more extensive discussion of the reasons behind these recommendations.

Figure 1 – Global short-term recommendations

Energy	4 – Moderate Underperform
Materials	4 – Moderate Underperform
Industrials	3 – Neutral
Consumer discretionary	3 – Neutral
Consumer staples	3 – Neutral
Healthcare	1 – Strong Outperform
Financials	3 – Neutral
IT	3 – Neutral
Telecoms	2 – Moderate Outperform
Utilities	3 – Neutral

Source: Barclays Wealth Research

Figure 2 – Global medium-term recommendations

Energy	3 – Neutral
Materials	2 – Moderate Outperform
Industrials	2 – Moderate Outperform
Consumer discretionary	3 – Neutral
Consumer staples	5 – Strong Underperform
Healthcare	3 – Neutral
Financials	2 – Moderate Outperform
IT	3 – Neutral
Telecoms	3 – Neutral
Utilities	5 – Strong Underperform

Source: Barclays Wealth Research

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FX: In the light of a global slowdown

Intensive intervention from authorities around the world has failed to alter the expectation that global economic growth is set to slow substantially. As a result, over the past month the FX market has been largely influenced by investors adjusting their portfolios. Perceived ‘safe haven’ currencies, such as the US dollar, yen and Swiss franc, have benefited, while the commodity currencies – the Canadian, Aussie and Kiwi dollars – and emerging market currencies have depreciated sharply (Figures 1 and 2). Further policy intervention is likely, both in the general economy and directly into FX markets. However, we think that this will only slow the FX moves, not reverse them.

The **US dollar**, in trade-weighted terms, has appreciated strongly over the past month driven by two main factors: investors’ ‘flight to quality’ and the drop in oil prices. Although we still expect the US economy to slow substantially in the fourth quarter of 2008, the dollar should remain supported as risk aversion stays high and commodity prices remain under pressure. In the long term, we continue to expect the dollar to rise, and our Fundamental Equilibrium Exchange Rate (FEER) framework suggests that there is plenty of scope for it to do so.

Sharp weakening in sterling

Having depreciated only slightly in trade-weighted terms over the past few months, **sterling** weakened sharply at the end of October following Bank of England governor Mervyn King’s acknowledgement that the economy is entering a recession. The cross-rate against the US dollar fell markedly to a low of \$1.53, but has since rebounded slightly. The cross-rate could rebound further if risk appetite returns, causing the US dollar to falter. In the short term, we doubt that sterling can fall much more, but we do expect a further drop of 10% in trade-weighted terms over the next year.

Japanese yen benefits from rising risk aversion

The **euro** continued to weaken in October. The European Central Bank’s surprise 50bp intermeeting rate cut suggests that policymakers feel they have less of an anti-inflationary battle to fight. We expect another cut in November, putting further downward pressure on the currency.

The **Japanese yen** has risen 13% since the beginning of October. We think that the yen is likely to remain supported over the coming months, as it continues to benefit from an increase in risk aversion and an unwinding of carry trades.

The **Swiss franc** has continued to benefit from its ‘safe haven’ status, although it has not risen as much as we would have expected given the current level of risk aversion and global economic uncertainty.

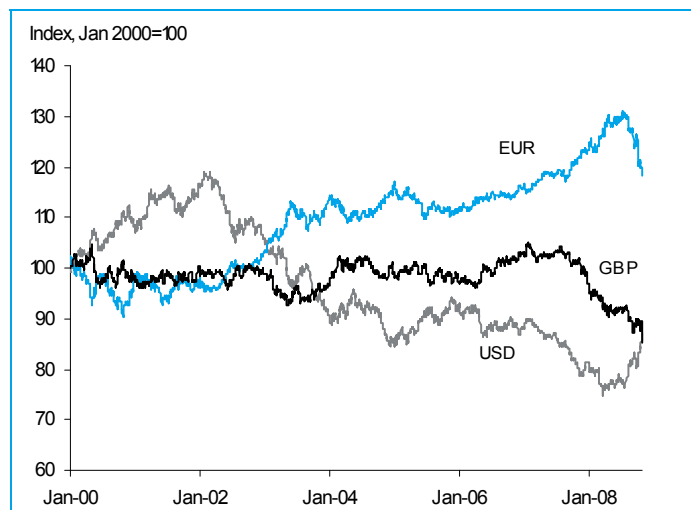
See page 18 for exchange rate forecasts.

Figure 1 – Nominal effective exchange rates

	USD	EURO	JPY	GBP	CAD	CHF	NZD	AUD	SEK
Current	91.0	95.5	149.3	87.7	93.5	120.0	91.6	76.9	76.6
1 month ago	86.6	100.6	132.2	90.0	107.2	114.3	101.6	89.4	79.3
% change	5.1	-5.0	13.0	-2.5	-12.7	5.0	-9.9	-13.9	-3.3
3 months ago	82.3	105.7	123.0	93.4	109.7	111.7	1-4.3	102.5	83.3
% change	10.5	-9.6	21.4	-6.1	-14.8	7.4	-12.2	-25.0	-8.0
End 2007	84.2	101.2	121.7	97.9	114.9	108.7	113.4	97.6	81.7
% change	8.0	-5.5	22.7	-10.5	-18.6	10.4	-19.3	-21.3	-6.2

Source: Bank of England and Barclays Wealth Research

Figure 2 – USD, GBP and EUR effective exchange rate



Source: Bank of England and Barclays Wealth Research

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Commodities: Recessionary environment dominates price developments

Commodity markets have remained highly volatile and on a downward trend over the past few weeks, owing to heightened expectations of slower global economic activity and the continued turmoil in credit and financial markets. Investors have continued to unwind risk and de-leverage, and commodities as an asset class have been affected. We have recently reduced most of our commodity price forecasts.

Oil prices continue to fall

Crude oil prices have continued to decline and, amid volatility, are now around \$65/bbl. The move down is primarily on the back of expectations of softening global demand (with recession now likely in most OECD countries), as well as adverse crude and product inventory levels. It comes despite OPEC's decision to cut production by about two million barrels per day from 1 November.

Metal prices continue to be volatile with price direction and sentiment driven by broader macroeconomic and financial factors rather than metal-specific fundamental news. **Copper** and **aluminium** prices are now down around 50% and 40% respectively from their peak in June 2008. Metal supply in general will remain constrained owing to production declines from existing mature mines, miners' strikes in major mining countries, other ongoing production problems (labour, equipment, energy and consumables shortages) and the limited number of new large-scale projects coming on-stream. If market conditions remain unfavourable, the industry will likely shut down – probably permanently – its high-cost mines and take out supply. This should support prices in the medium term. Furthermore, the current credit crisis is limiting capital to many junior mining companies for new supply projects.

Still positive on gold

In **precious metals**, **gold** prices have been extremely volatile, benefiting at times from the metal's status as a safe-haven investment and at other times suffering from expectations of dollar strength. However, we are still positive on the outlook for gold prices over the next 12 months.

In **agricultural** commodities, prices for most products remain very weak, but much of this has been due to seasonal factors. We continue to expect a rebound, believing that tight supply and demand balances, favourable market dynamics and low customer inventories will support prices. For **wheat**, while a good global harvest is likely to cap upside momentum, the medium-term outlook for prices is favourable, thanks to continued strong demand and low global inventories.

Figure 1 – Barclays Wealth Research and consensus forecasts

		2007	2008E	2009E	2010E	Longer term
Crude oil (Brent \$/bbl)	Barclays Wealth	73	102	70	80	90
	Consensus	73	97	n/a	n/a	70-80
Wheat (\$/bushel)	Barclays Wealth	822	790	800	n/a	n/a
	Consensus	822	750	770	800	n/a
Corn (\$/bushel)	Barclays Wealth	355	504	510	n/a	n/a
	Consensus	355	500	550	n/a	n/a
Copper (\$/MT)	Barclays Wealth	7,129	7,100	6,500	6,700	4,500
	Consensus	7,129	7,000	6,500	n/a	n/a
Aluminium (\$/MT)	Barclays Wealth	2,640	2,700	2,600	2,900	2,500
	Consensus	2,640	2,650	2,550	3,100	n/a
Gold (\$/oz)	Barclays Wealth	697	875	910	n/a	n/a
	Consensus	697	870	950	925	n/a
Platinum (\$/oz)	Barclays Wealth	1,304	1,700	1,475	1,750	n/a
	Consensus	1,304	1,600	1,300	1,400	n/a

Source: Barclays Wealth Research, Reuters, Bloomberg, Industry data

Forecast summary

GDP (real change, %)	2006	2007	2008	2009
US	2.9	2.2	1.3	-1.0
Japan	2.4	2.0	0.5	-0.2
Euro area	3.0	2.6	1.1	-0.8
UK	2.9	3.1	0.8	-1.1
Canada	2.8	2.6	0.4	0.0
China	11.1	11.4	8.5	8.0
India	9.7	9.0	8.0	7.0
Russia	6.7	8.1	6.0	4.0
Brazil	3.7	5.4	5.2	3.5

Inflation (%)	2006	2007	2008	2009
US	3.2	2.9	4.2	2.1
Japan	0.2	0.0	1.6	0.4
Euro area	2.2	2.1	3.6	2.4
UK	2.3	2.3	3.7	2.8
Canada	2.0	2.2	2.5	1.8
China	1.5	4.8	6.4	3.5
India	5.3	4.8	9.5	6.2
Russia	9.7	10.7	12.0	10.0
Brazil	4.2	3.6	5.7	5.3

Interest rates (%)	2006	2007	2008	2009
US (Fed funds)	5.25	4.25	0.50	0.50
Japan (Call rate)	0.25	0.5	0.3	0.3
Euro area (Refi rate)	3.5	4.0	3.00	2.00
UK (Bank rate)	5.0	5.5	3.5	2.25
Canada (Call rate)	4.25	4.25	2.0	1.5
China (Lending rate)	5.9	6.73	6.39	6.12
India (Repo rate)	7.25	7.75	8.0	7.0
Russia (Repo rate)	6.75	7.0	7.25	7.25
Brazil (SELIC rate)	13.25	11.25	13.75	13.0

Source: Barclays Wealth Research

10-year bond yields (%)	2006	2007	2008	2009
US	4.7	4.1	3.6	3.5
Japan	1.7	1.4	1.5	1.7
Euro area	4.0	4.4	3.8	4.0
UK	4.7	4.6	4.3	4.1
Canada	4.1	4.0	3.5	3.8

Equity returns (%)	2006	2007	2008	2009
US (S&P 500)	13.6	3.5	-20.6	12.6
Japan (Topix)	32.7	6.5	-45.6	14.9
Euro area (FTSE Europe ex-UK)	20.0	3.8	-47.7	14.0
UK (FTSE)	11.0	3.8	-43.5	12.0
Canada (S & P/TSX)	14.5	7.2	-37.8	13.0

Currencies	2006	2007	2008	2009
Indices				
US dollar index (% change)	-3.9	-5.8	-1.4	8.2
Yen index (% change)	-6.5	-4.3	18.4	9.1
Euro index (% change)	3.3	3.3	-7.1	-2.7
Sterling index (% change)	4.8	-6.3	-10.7	-10.6
Canadian dollar index (% change)	-1.6	11.7	-19.2	-10.6
Cross rates				
\$ per €	1.26	1.37	1.24	1.32
¥ per \$	116	118	97	94
\$ per £	1.84	2.00	1.57	1.63
£ per €	0.68	0.68	0.79	0.81

All market variables are end of period rates

Source: Barclays Wealth Research

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