SIGNPOST LITE

One minute to midnight

OCTOBER 2008

BARCLAYS WEALTH

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The articles in this edition of *Signpost Lite* are abridged from the full version of *Signpost – One minute to midnight*. We would recommend that readers also look at this full version, which is available on request. The full edition of *Signpost* now includes a new 'Investment strategies' section, which may be of particular interest. This discusses how our Investment Philosophy can be used to put our macroeconomic and asset allocation views into practice.

In addition to extended coverage of the topics in *Signpost Lite*, the full version of *Signpost* also includes pieces on the current financial market changes seen in an historical context, the Troubled Asset Relief Program, an introduction to our Investment Philosophy, the fundamental analysis of long-run returns, why cash should not be seen as a simple uniform asset class, our market and absolute return portfolios, hedge funds, private equity investment, the impact of the credit crunch on the US economy, the non-financial corporate sector, Canada, China, India, Russia and Brazil economic prospects, asset allocation going forward, the fixed income 'duration scorecard', and the UK and Europe ex-UK analyst portfolios.

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One minute to midnight

September was a terrible month for the financial markets and October has so far proved equally unsettled. Despite recent government initiatives on both sides of the Atlantic, there will undoubtedly be more bad news ahead, as the credit crunch claims more victims – and pushes global demand down at least another notch. With events moving so fast, there is a growing temptation to shy away from analysis, and fall back instead on opinion and instinct. But that would be a mistake. Indeed, the complexity of the current situation makes analysis ever more important, if we are to understand both what is driving markets and if we are to make reasonable gauges of likely future economic developments and the investment opportunities that they present.

A radical transformation…

It is important to start by acknowledging that the financial landscape has undergone the sort of radical transformation which comes about only once in a generation. So, it is important to recognise that we are not going back to the world of pre-credit crunch in any way or form. Accordingly, we need to think outside the box, and not be beholden to 'old' rules or ways of thinking which may no longer be relevant or useful. Most important in that respect, we need to rethink the way the world might look in a decade's time – both in terms of who will be relatively better off following the recent dramatic events and who stands to suffer, but also in terms of how policymakers might set very different ground rules for agents to operate in, and perhaps too use different rules of engagement (such as targeting asset price volatility). Some of these issues are (very briefly) touched on in the commentary below, but we would urge readers to look to the unabridged full edition of *Signpost*, available on request, for a full explanation of these issues. Of particular interest may be a focus article in the full edition of *Signpost* on strategic asset allocation – a piece which comes to rather different investment conclusions than a traditional data-crunching approach does.

…demands new ways of thinking

We also feel that now is an important time to look beyond the immediate crisis and its aftermath and think hard about the right way to run money. Again, we would refer readers to the full edition of *Signpost*, where you can find an explanation of how the behavioural profiling in our Investment Philosophy can guide and improve individuals' investment strategies, leading to an explicit three-way portfolio segmentation, which should suit people's 'financial personalities'. To illustrate what this means in practice, we also provide some thoughts in the full edition of *Signpost* about how people need to think regarding each of their cash, optimised and guided portfolios. And, within the optimised component, we explain the difference between the traditional (market-return) and modern (absolute-return) approaches – highlighting the benefit of having used the latter over the past year.

The environment will remain tough

When it comes to the conjunctural issues, we believe that the current US TARP legislation and more recent interventions in the UK and elsewhere will assist matters – helping to rebuild the markets' faith in policymakers (which has been severely dented by recent events). But it is no 'magic bullet'. And the process will take time, and will coincide with an already difficult macroeconomic environment. Indeed, the recent turmoil will almost certainly make that environment still tougher: we now expect recessions in all the major developed economies. So market conditions are likely to remain extremely tough for some time yet. Accordingly, we doubt that equity prices can recover much of the lost ground anytime soon. Only in 2009 are riskier asset classes likely to start to perform again.

To help clients manage their investments more effectively, we have made a number of changes to our approach. First, we have decided to distinguish between 'short-' and 'medium-' term tactical asset allocation calls – with the former looking out three months and the latter 12. Second, we have added much more detail on our year-out recommendations, including equity sector calls, bond duration weightings, credit sector calls, currency over- and under-weights etc…These can be found on the two following pages.

The main conclusions we draw are as follows:

Short-term recommendations

In the short (i.e. three-month) term, we think it unlikely that equities will manage anything more than a half-hearted bounce at best. So, we would look towards range-trade types of strategies here. As regards fixed income markets, we feel that central banks have no choice but to loosen the policy stance, and the only question is whether to do so at a fairly pedestrian pace or, instead, to slash rates. Markets are predicting the former. We think it is worth having the aggressive cut story – say because of another big shock like the Lehman bankruptcy or TARP rejection vote. After all, there is little money to be lost by rates not getting cut. But potentially lots to make if they do get slashed.

Equities and the medium term

Over the medium (i.e. one-year) term, we still expect the US to make some sort of a recovery, although a formal recession during the last quarter of this year and the first quarter of next looks a real possibility. Downwards revisions to our growth forecasts warrant taking down our medium term equity market forecasts, and we have therefore reduced our equity overweight on this medium-term view from 4% to 3%. In Europe we go from overweight to neutral, but continue to recommend an emerging markets equities overweight. For this first time, we are recommending an overweight on investment grade credit. We expect the dollar to find a floor and then to turn higher; sterling to keep falling over this medium term horizon and the euro to top out.

Long-term insights

Our new long-term analysis provides some interesting insights. Based on long-term equilibrium rates of return calculations, we judge that rates of returns on developed economy equities over the next market cycle will be somewhat lower than in the past – and that the return on their bond markets may be slightly higher. So we do not recommend as large an equity overweight as a 'raw' Black-Litterman optimisation would suggest. However, we remain keen on emerging markets equities, as their higher potential growth rates should lead them to outperform their developed brethren.

Again, we would refer readers to the full edition of *Signpost* for an extended analysis of these issues. We are sure that you will find it interesting reading.

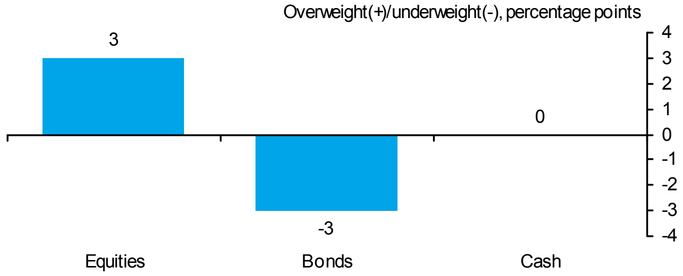
Michael Dicks, Head of Research, 6 October 2008

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

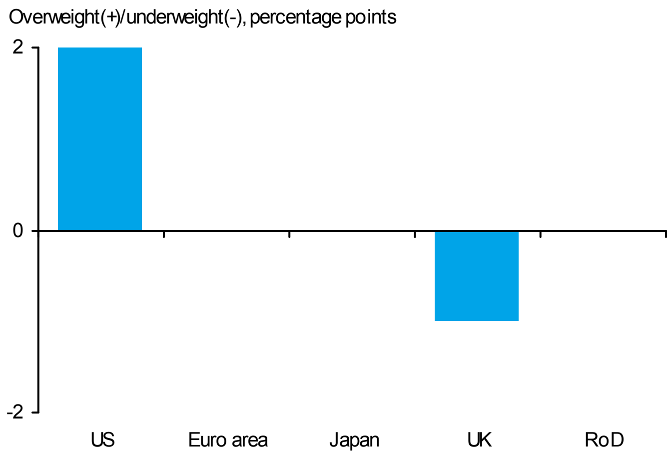
	USD ($)	JPY (¥)	EUR (€)	GBP (£)	CAD	CHF	SEK	AUD	NZD
Trade-weighted	+	+	-	--	--	+	+	--	--

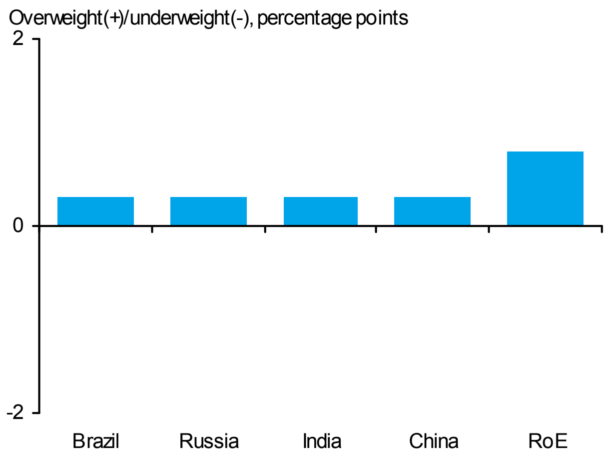
A plus (+) sign shows an expected currency appreciation and a minus sign (-) an expected currency depreciation.
Double pluses and double minuses indicate strong conviction calls

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



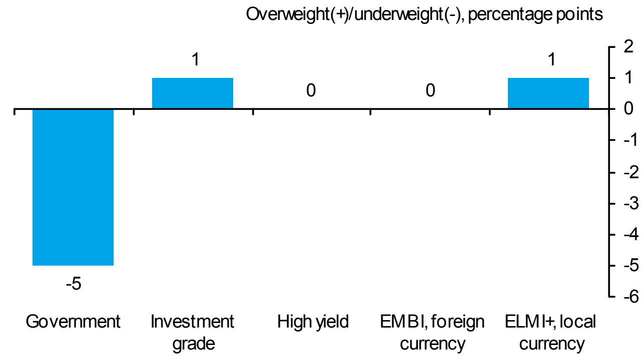


SECTORS	Energy	Materials	Industrials	Consumer discret	Consumer staples	Health care	Financials	IT	Telecoms	Utilities
Global	0	+	+	0	--	0	+	0	0	--
US	0	+	+	0	--	0	+	0	0	--
Euro area	0	0	+	0	-	0	+	0	0	-
UK	0	+	+	0	--	0	+	0	0	--

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

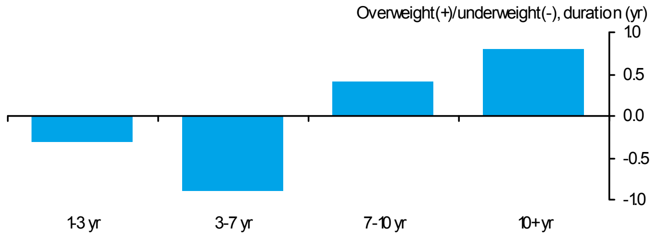
	Benchmark	Recommended portfolio	Tilt
TOTAL:	35.3	32.3	-3
Government	17.1	12.1	-5
Investment grade	13.1	14.1	1
High yield	3.0	3.0	0
EM: foreign currency	1.0	1.0	0
EM: local currency.	1.0	2.0	1



Government bonds

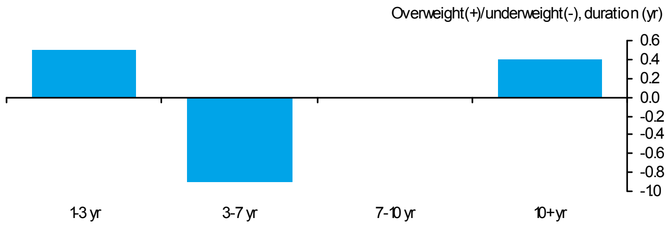
US

	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



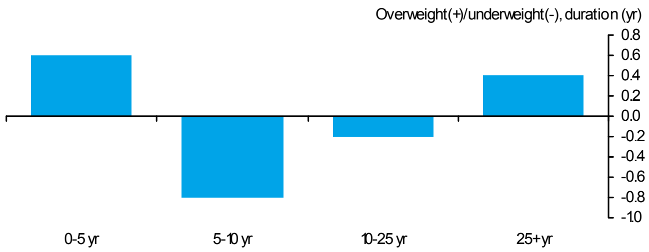
EURO AREA

	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-financial 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 look more likely to range-trade than surge.	Market risk remains high, but looks to be decreasing. Macro risk, on the other hand, has increased – and may rise further as the US economy enters a mild recession. Usually, as things improve in terms of market functioning equities pick up. However, a weaker macro picture will be a challenging backdrop this time round. Besides, we need to see the inter-bank markets start functioning again, before equities can rise meaningfully. Confirmation that inflation has peaked and that the BoE and ECB are ready to cut rates would be positive for equities and a reason for considering building longer term overweights. So would improvements in macro fundamentals.	Trade the US market in ranges. For the S&P 500, levels around 1050-1100 look like an attractive valuation entry point. At 1350, however, we would need to see improvements in macro fundamentals to be buying, rather than taking profits and selling any long positions that we might have. Absent any such improvement in fundamentals, it might make sense to go short at such a level. We expect high correlations with the FTSE. So, the range-trading strategy should work for the UK as well. However, with local fundamentals that much worse, add on a declining bias.
Stay defensive on equity sectors.	Our new equity sector score cards find different factors drive 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.	We continue to see value in financials and materials on a medium-term (one-year-out) basis. But, through the remainder of this year, we expect these sectors to continue to underperform. As for health care, it looks set to perform well in the short term, but not sustain any pick-up through 2009.
Central banks may need to cut rates aggressively and are unlikely to hike.	Markets are pricing that the major central banks may trim rates soon. That is certainly the single most likely (modal) scenario. But, there is also a significant risk that the crisis deepens still further, requiring coordinated, and perhaps deep, interest-rate cuts. Being long the futures strips seems a good insurance trade.	UK: Buy 90-day sterling futures with Dec-09 expiry to benefit from more MPC cutting than expected. (This trade gives exposure to both changes in the UK base rate and the spread between the base rate and Libor. We would expect both to move together; if the MPC cuts by more than expected, this will stabilise the banking sector and help the Libor spread to tighten.) Buy similar products for the Fed, ECB, Riksbank etc as all are likely to join the fray.
Investment-grade credit is starting to look attractive, although it may take time for the tide to turn.	Corporate defaults will undoubtedly increase as economies deteriorate going forward. Currently markets are spooked by recent events, and the Lehman default in particular. This, however, does not mean that one should expect a lot of investment-grade defaults. We would start with a small exposure. Improvements in the terms at which banks are saved (with bondholders not taking big hits), falling oil and commodity prices and better macro data would all be positive for IG spreads.	Buy investment-grade spread exposure in the US. Short-term we are happy to also be long the implied duration (but we would advise hedging out this part for a longer trade). Europe offers less opportunity as spreads are lower, but the European model of handling banks in problems also gives better protection for investors. So, we recommend taking Europe exposure too.
Sterling set to struggle.	Many of our longer-term FX calls should also deliver returns during the fourth quarter. In particular, with the BoE set to start cutting rates again, and the macro data taking a turn for the worse, we expect the pound to get pummelled.	We put on the trade versus the dollar at $1.85. Long term we would not be surprised to see it go below $1.60. The target for the current tactical position, however, is a little less aggressive, at $1.65. Our current stop loss level would be $1.885.
Go long duration, especially in European fixed income markets.	Our new duration scorecards are pointing to significant gains from getting long duration – with low to medium strength signals on a short-term basis.	Europe looks a better place to play this trade currently, although the same signed signals are coming out of the US too.

Key medium-term Tactical Asset Allocation (TAA) themes

Theme	Thesis	Investment strategies
After contracting in Q4 and Q1, the US economy should start to recover next spring and summer.	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 TARP should help policy get more traction.	The US equity market ought to register some healthy gains next year. Other markets should underperform – pointing to relative value opportunities, such as long US versus the UK or long US versus the euro area.
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 pricing in cuts, we still judge that the risks to expectations are skewed to the downside. Further surprises in financial markets like the ones we've seen in September, and coordinated rate cuts will be the order of the day.
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. And public programmes to support markets, in China and Russia, should help eventually.	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.
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. If considered in isolation, however, we would sell the GSCMI.
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.
Non-dollar dollar weakness.	The 'commodity' currencies – the Aussie, Canadian and New Zealand dollars – all look overvalued still, both because of commodity price weakness, but also reflecting their domestic macroeconomic weakness.	Put on a basket of non-dollar dollar trade, rather than take too narrow a view on what are small, volatile economies.
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.

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 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 out of other developed markets. 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.

US prospects

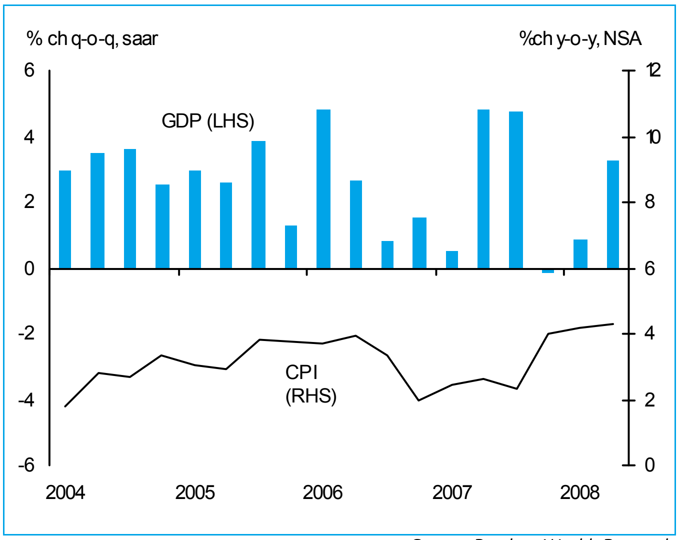
Economic outlook

- The US economy will likely contract in the fourth quarter, as fiscal-stimulus withdrawal, slower global growth and financial stress hammer confidence. The consensus continued to lift estimates of GDP growth in 2008, now looking for a 1.8% expansion instead of the 1.6% estimated in the previous month, and 1.4% growth in 2009. We judge these estimates to be overly optimistic: we expect the economy to enter a mild recession, and grow by only 1% or so next year. Likewise, cuts to consensus inflation forecasts could ensue, as weaker demand and lower oil prices are accounted for.
- Policymakers have tried to react forcefully to avert outright systemic failure in financial markets. Congressional support has been slow to build. The Federal Reserve will remain in fire-fighting mode, and keep emergency rate cuts as an option to counter extreme market developments. 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 is likely to steepen next year as growth and inflationary threats recede.
- The near-term outlook for housing remains bleak. Mortgage financing strains, elevated inventories and rising joblessness will weigh on dwellings prices over the coming months, but a sizeable housing adjustment has already taken place. We estimate that real house prices currently stand at less than 4% above ‘fair value’. We then expect them to stop dropping by next summer.

Market outlook

- Equity markets have been engulfed by the ongoing turmoil. But the fundamentals of non-financial corporates point to a price recovery next year, providing the TARP succeeds in assuaging fears.
- 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. 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

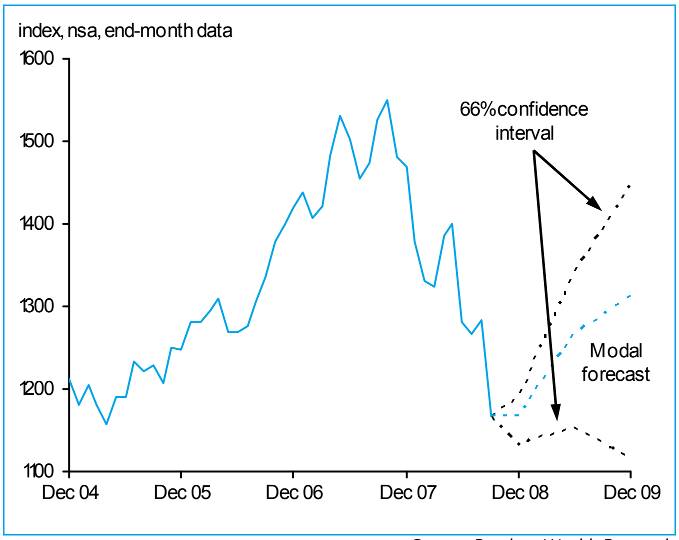
Figure 2 – The US forecast in a nutshell*

% y-o-y except where stated	2006	2007	2008	2009
GDP	2.9	2.2	1.6	1.1
CPI	3.2	2.9	4.3	2.3
Fed funds (%)	5.25	4.25	2.00	2.50
10-year yields (%)	4.7	4.1	3.5	3.75
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, the euro area looks to have stalled or even contracted slightly in Q3. This leaves the economy on the verge of a technical recession. We have cut our growth forecasts by 0.2 percentage points for both this year and next.

- The drag from surging energy costs on real household consumption could soon diminish, provided that the oil price does not rebound strongly. But firms signal increased caution on hiring, which ought to translate itself into rising unemployment before long, capping real income and thereby consumption gains. Moreover, financial contagion has necessitated the first bank rescues in the euro area and raised inter-bank lending rates, while potential regulatory changes will force a re-think on euro-area banking models as well.

- Policymakers' reaction to events has been constrained. Fiscal policy is governed by borrowing limits, and so the hurdle for a euro-area equivalent of the US TARP is relatively high. As regards monetary policy, the ECB's concern has so far been focused on high inflation. But weaker growth and the lower oil price should soon dispel inflationary fears: we have trimmed our inflation forecasts again, to show headline inflation dropping back to close to target early next year. Therefore, we now expect the ECB to begin trimming rates sooner, with a first 25 basis point cut before Christmas.

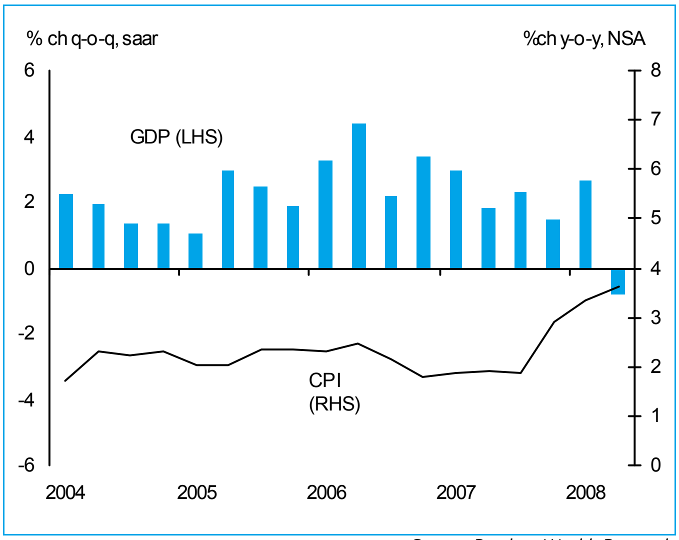
Market outlook

- European equity markets have suffered considerably this year. As elsewhere, this month, volatility has been exceptionally high.

- Valuations, based on earnings expectations versus real corporate bond yields, continue to suggest that equities are cheap. But fundamentals are not driving prices at present.

- We have scaled back expectations for the scale and timing of an equity rally and dropped our equity overweight recommendation. The turmoil in financial markets will necessitate changes to business models and depress growth, which may well delay any rebound.

Figure 1 – Euro area GDP and inflation



Source: Barclays Wealth Research

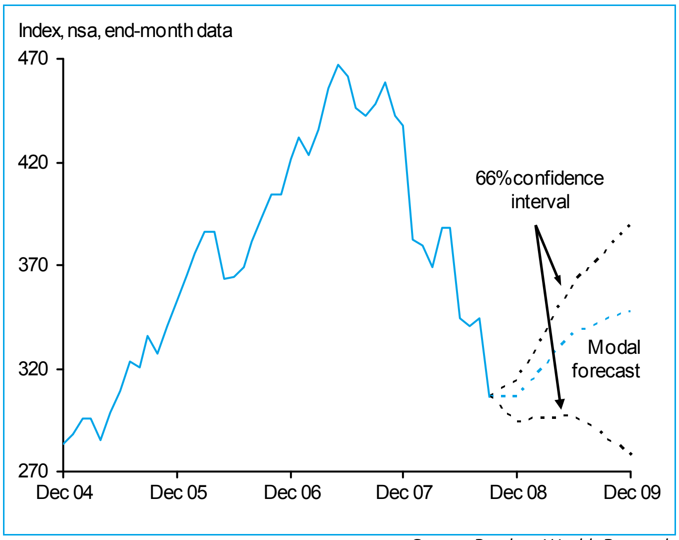
Figure 2 – The euro-area forecast in a nutshell*

% y-o-y except where stated	2006	2007	2008	2009
GDP	3.0	2.6	1.2	0.7
HICP	2.2	2.1	3.5	2.3
Refi rate (%)	3.50	4.00	4.00	3.50
10-year yields (%)	4.0	4.4	4.3	4.2
FTSE ex-UK index	20.0	3.8	-30.1	13.5
€ index	3.3	3.3	-2.9	-3.2

** 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 remains extremely grim. The economy may well be contracting, while inflationary pressures remain elevated. Lead indicators suggest that the third and fourth quarters are likely to register outright declines in GDP. As a result, we have further trimmed our GDP growth forecasts for 2008 and 2009. Inflation has continued to move higher at both the headline and underlying (excluding food and energy) level.

- House prices are falling fast and the economic slowdown is now clearly being felt in the labour market. 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 rate of job losses higher than in the US, once population differences are accounted for.

- At 4.8%, 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 fall back in oil prices.

- The dramatic 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. The further bout of financial market turmoil feels to us like the icing on the cake for the doves on the MPC: we expect a cut at this week's meeting – and seven more rate cuts by the end of 2009.

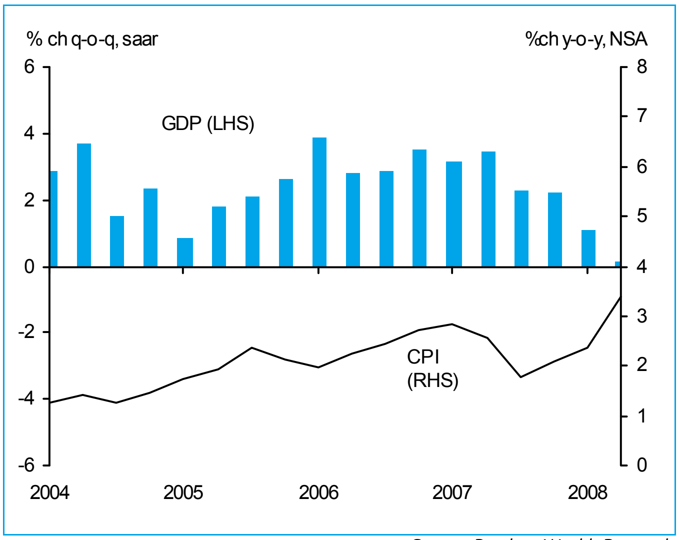
Market outlook

- 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

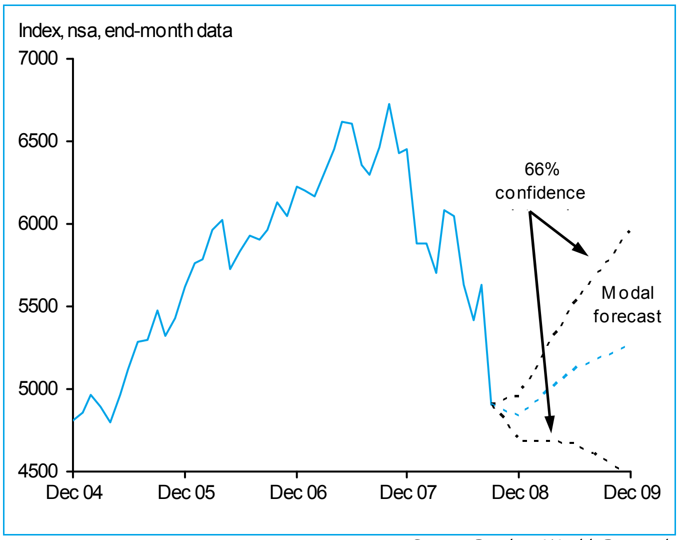
Figure 2 – The UK forecast in a nutshell*

% y-o-y except where stated	2006	2007	2008	2009
GDP	2.9	3.1	1.1	0.4
CPI	2.3	2.3	3.7	3.0
Bank rate (%)	5.00	5.50	4.5	3.5
10-year yields (%)	4.7	4.6	4.3	4.2
FTSE 100 index	11.0	3.8	-25.2	9.1
£ (index)	4.8	-6.3	-11.1	-9.0

** 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: September

Equities – financial turmoil takes markets for a bumpy ride

Equity markets fell sharply across the board, with considerable volatility in share prices throughout September. The UK and Japan indices suffered the most, falling 12.9% and 13.1% respectively. The MSCI World Index dropped 10.7% and the emerging markets continued to underperform, falling 12.4%. Markets have been nervous in the wake of the deteriorating situation in the financials, and policymakers' efforts to stem the problem have seen markets fluctuate wildly.

Bonds – a return to losses

The bond markets were all down this month. US returns were the weakest, posting declines of 2.5%. In the US, yields have been shaken by uncertainty and the curve has steepened, pulled down from the short end. Spreads continued to rise as credit markets suffered and counterparty risk has become the new focus since the implosion of Lehman and the rescue of AIG.

Commodities – further declines

The GCSI Commodity index fell for the third month in a row, although there was a turnaround halfway through the month. Overall, the GSCI Index was down 12.4%. Agriculture and industrial metals performed the worst, declining by 15.6% and 13.5% respectively; precious metals fared the best, rising 3.9%. Energy continued down for the first half of the month before a reversal came on 16 September. At its peak, crude oil was trading above $120 per barrel, but then moderated and ended the month below the $100 mark.

2008 performance*

Fixed interest: local currency returns, %										
	6m	3m	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
US	-3.1	-1.7	1.9	0.6	-0.0	-0.7	-1.0	0.2	-0.1	0.9	-2.5
UK	-1.1	1.4	-0.2	-0.7	0.0	-0.5	-1.2	-0.7	2.1	1.7	-2.4
Euro area	-0.3	2.4	2.1	0.5	-0.8	-0.4	-1.1	-1.1	1.8	1.1	-0.5
Japan	-0.4	0.9	0.5	0.5	0.4	-1.6	-0.8	1.1	0.3	0.9	-0.3
World	-0.8	0.8	1.5	0.3	-0.0	-0.6	-0.9	-0.2	0.7	1.0	-0.9
Equities: MSCI local currency returns, %											
US	-10.9	-9.0	-6.1	-3.1	-0.4	4.9	1.6	-8.2	-1.1	1.4	-9.2
UK	-12.6	-11.8	-8.8	0.4	-2.1	6.8	-0.4	-6.9	-3.7	5.1	-12.9
Europe ex-UK	-14.7	-11.1	-12.6	-0.6	-2.7	6.2	1.5	-11.1	-1.1	1.3	-11.3
Japan	-9.9	-17.5	-9.2	-1.4	-8.2	12.6	3.6	-6.4	-1.5	-3.6	-13.1
Pacific ex-Japan	-15.7	-14.2	-11.2	-1.4	-3.3	5.7	0.9	-7.8	-3.6	1.2	-12.0
Emerging	-22.0	-20.8	-12.4	6.1	-4.2	7.3	1.9	-9.9	-5.0	-4.8	-12.4
World – dev	-12.0	-11.3	-8.4	-1.7	-2.1	6.2	1.7	-8.2	-1.8	1.2	-10.7
Cash: three-month Treasury bills, end of period, %											
	2006	2007	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
US	4.8	4.5	2.0	1.8	1.3	1.3	1.9	1.7	1.7	1.7	0.8
UK	4.7	5.6	5.2	5.2	5.0	5.0	5.1	5.2	5.2	5.2	4.8
Euro area	2.9	3.9	3.9	3.9	3.9	3.9	4.0	4.3	4.3	4.3	3.8
Japan	0.2	0.6	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6

* Returns are all total returns, with September data measured to 5 October

Source: Barclays Wealth Research

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Fixed income: summary

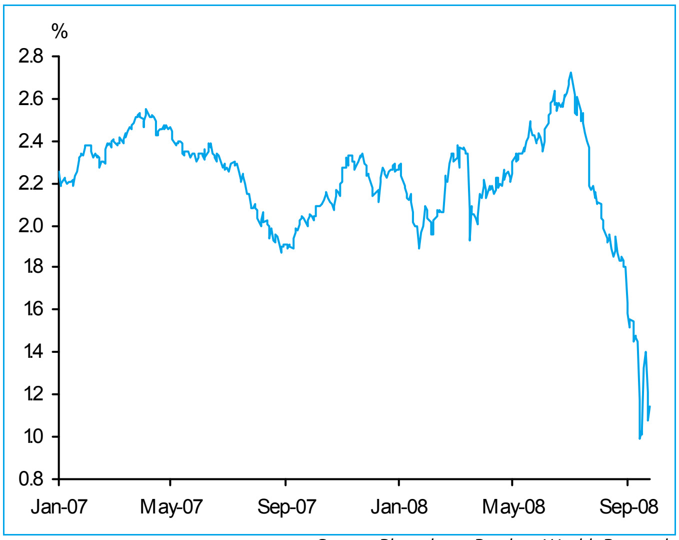
Government

- Signs of stress in the money markets have worsened in recent weeks.
- Market turmoil has supported being long government bonds; in spite of being more demandingly valued, we expect bonds to continue to perform well and recommend being long duration.
- We think TIPS are an outstanding buy relative to nominal Treasuries right now, as they are pricing in an implausibly low level of inflation in the future.

Corporates

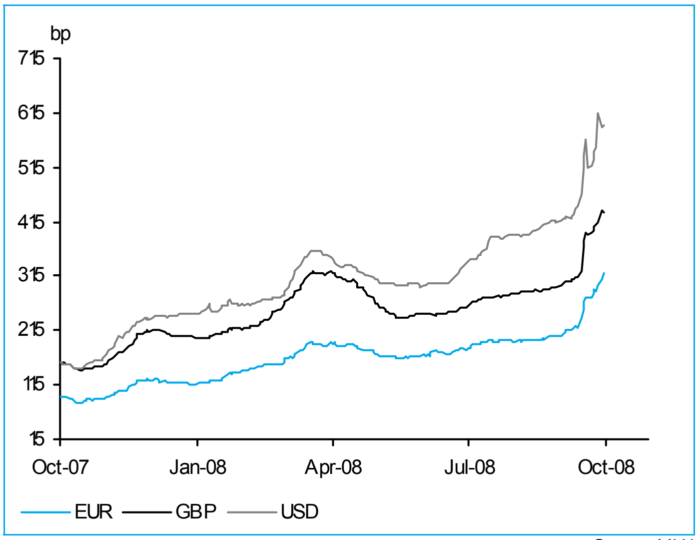
- The corporate bond market has experienced significant re-pricing following a cascade of major events in September. Recent developments have raised fears that bondholders cannot automatically expect to be favoured over equity holders in taking a share of losses.
- The current market dislocation offers opportunities for our least risk-averse investors. We also believe that some well-diversified exposure is likely to pay off longer term. While the road to recovery is likely to be protracted and more chaotic than initially anticipated, we see attractive medium-term opportunities, especially (paradoxically) in the financial sector. As we move further through the banking crisis, it is clear that stronger players with well-capitalised balance sheets are likely to increase their respective market shares, while weaker rivals are forced to merge or disappear.
- We continue to expect the credit crisis to move outwards from banks to non-banks. However, there is no doubt that the default rate will rise and we expect it to move sharply higher in 2009. S&P, the rating agency, released an article recently which predicted that the cumulative default rate could soar to 23.2% by 2010, which is comparable with a speculative default rate of about 7% per annum.
- Risks remain high in the subordinated debt market, as evidenced by current spread levels. Recent events have shown that subordinated bondholders can be hurt significantly by a default or selective default.

Figure 1 – 5-year US TIPS breakeven implies very low inflation



Source: Bloomberg, Barclays Wealth Research

Figure 2 – Banking spreads



Source: MLX

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Sector strategy

Clearly, equity markets have lots of negative news to digest over the coming months, and thus we feel that this is not the time to take brave decisions. Volatility has spiked, and is going to stay with us for some time. Furthermore, there have been dramatic moves in sector leadership over the past couple of months, as the commodity sectors have sold off in favour of defensives, and financials have shown remarkable volatility.

The impact of the credit crunch will linger for some time, as there is no 'silver bullet' to solve the problem. The impact on the financial services industry's profitability has the potential to be a long-term negative, as balance sheets are de-leveraged and business models become more tightly regulated. The problems in financials will feed through to the rest of the economy via lower lending activity. Again, this will put future earnings streams under pressure as businesses adjust to the new world order.

Avoid earnings risk

This backdrop suggests to us that earnings forecasts for next year will see large downward revisions from their currently optimistic levels. In this environment, we recommend focusing on sectors that do not have high earnings risk (cyclicals) or high leverage. This leads us to favour the healthcare and telecoms sectors, which both have defensive (non-cyclical) earnings streams, are not excessively geared and are enjoying support from price momentum. The sectors we least favour are financials and materials.

The return of fundamentals

In the medium term, we believe that fundamentals will again come to the fore as money and credit markets return to normality. Furthermore, earnings expectations should regain credibility. On a one-year view, our models see the most value in financials, as well as the industrials and materials sectors. It is easy to be too gloomy on the financials in the short term, as we still do not know which institutions will emerge from the current crisis. In fact, the only certainty is that significant parts of the sector will survive the current turmoil, and in due course return to profitability. A strong financial sector is a precursor for a strong economy, so the sector should lead a general market recovery.

We 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	3 – Neutral
Materials	4 – Moderate Underperform
Industrials	3 – Neutral
Consumer discretionary	3 – Neutral
Consumer staples	3 – Neutral
Health care	1 – Strong Outperform
Financials	4 – Moderate Underperform
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
Health care	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: Movements and opportunities

The FX market has moved substantially not just over the over past quarter, but also over the last few weeks. The recent market concerns and movements in commodity prices have caused FX movements which, we think, present good opportunities for establishing medium-term trade positions.

The **US dollar**, in trade-weighted terms, has weakened substantially over the past few weeks. Last month we reiterated our concern that US growth would slow towards the end of the year, which we thought was likely to lead to a bout of dollar weakness – before a sustained rally could build in 2009. The 3% fall in the dollar since mid-September, has not however been directly due to deteriorating growth, as we had been expecting. Rather, the disturbances in the financial market over the past few weeks have sparked renewed concern over not just the banking sector but also the sustainability of the US's public and external accounts.

The pound will stay weak in 2009 and 2010

Looking ahead to 2009, we had previously been expecting that **sterling** would weaken substantially in the first half of the year, falling below our long-run fair value of 1.75 against the US dollar, but recover towards the end of 2009. In line with our gloomy outlook for the UK economy, we have revised this outlook and expect that sterling will remain weak throughout 2009 and into 2010. We predict that there could be as much as a further 10% weakness in sterling in trade-weighted terms. Combined with our outlook of a recovering US economy during 2009 and into 2010, we expect there to be large moves in the US dollar per sterling cross rate – with 'cable' falling towards $1.60 in the second half of 2009.

In the **euro** area, the European Central Bank (ECB) continues its anti-inflationary stance, despite a further deterioration of euro-area growth prospects. The euro has depreciated as inflation expectations have declined following the fall in the price of oil and the euro area's growth outlook has deteriorated (sharply). More recently, the euro has weakened as concerns over the euro area's financial system have increased. We expect the ECB to cut interest rates late in 2008, putting further downward pressure on the currency.

Japanese yen benefits from rising risk aversion

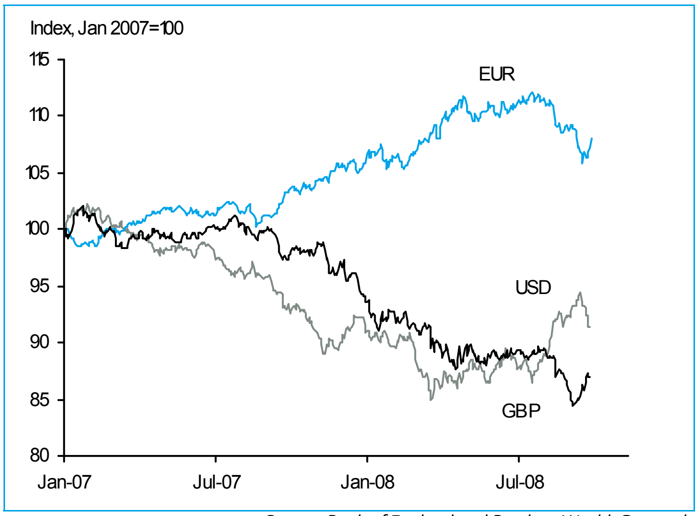
The **Japanese yen** has strengthened over the third quarter, supported by both the fall in commodity prices and, in recent weeks, an increase in risk aversion which has led to an unwinding of carry trades. In our estimation of Behavioural Equilibrium Exchange Rates (BEERs, to be discussed in the next issue of *Signpost*), we find that the yen effective exchange rate has a strong relationship with Japan's terms of trade.

Figure 1 – Exchange rate forecasts

	Spot	3-month	End-2009	End-2009
US$ per £	1.78	1.88	1.63	1.58
US$ per €	1.38	1.50	1.32	1.26
¥ per US	105	105	94	92
CA$ per US$	1.08	1.06	1.23	1.35
US$ per A$	0.77	0.83	0.72	0.68
US$ per NZ$	0.66	0.68	0.59	0.54
£ per €	0.78	0.80	0.81	0.80
SFr per €	1.57	1.60	1.44	1.42
SKr per €	9.71	9.40	9.10	8.74

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: forecasts lowered

Commodity markets have generally been highly volatile and on a downward trend over the last few months owing to the credit/financial market turmoil, expectations of slower global economic activity and dollar strength. Investors have been looking to unwind risk and de-leverage, and commodities as an asset class have been affected. With growth set to slow further, we are cutting most of our commodity price forecasts.

Oil price forecasts are lowered

The move down in crude oil prices is primarily on the back of expectations of softening global demand, but volatile crude and product inventory levels and some unwinding of speculative positions have also had a negative impact, offsetting a general increase in global geopolitical tension. We are lowering our oil price 2009 and 2010 forecasts, as given in the table below.

For metals, 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 have declined around 15% over the last month and around 30% since 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 onstream. In the case of nickel, leading producer Xstrata has shut down one of its high-cost mines because of unfavourable market conditions. This should further support prices in the medium term. This move indicates that the industry as a whole will take out supply if economic conditions remain unfavourable. 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. We are, however, still positive on the outlook for gold prices over the next 12 months.

In agricultural commodities, prices for most products have fallen sharply, in some cases as much as 30%, but much of this has been due to seasonal factors. We expect a rebound, as we continue to believe 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 wheat prices looks 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 $/bbl)	Barclays Wealth	73	102	100	110	90
	Consensus	73	97	n/a	n/a	70-80
Wheat ($c/bushel)	Barclays Wealth	822	936	940	n/a	n/a
	Consensus	822	880	840	860	n/a
Corn ($c/bushel)	Barclays Wealth	355	485	500	n/a	n/a
	Consensus	355	546	628	n/a	n/a
Copper ($/MT)	Barclays Wealth	7,129	7,500	6,500	6,700	4,500
	Consensus	7,129	7,400	6,500	n/a	n/a
Aluminium ($/MT)	Barclays Wealth	2,640	2,900	2,900	2,900	2,500
	Consensus	2,640	2,750	3,050	3,100	n/a
Gold ($/oz)	Barclays Wealth	697	910	910	n/a	n/a
	Consensus	697	910	950	925	n/a
Platinum ($/oz)	Barclays Wealth	1,304	1,800	1,850	2,000	n/a
	Consensus	1,304	2,050	1,900	1,900	n/a

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

Forecast summary

GDP (real change, %)	2006	2007	2008	2009
US	2.9	2.2	1.6	1.1
Japan	2.4	2.0	0.7	1.2
Euro area	3.0	2.6	1.2	0.7
UK	2.9	3.1	1.1	0.4
Canada	2.8	2.6	0.8	1.7
China	11.1	11.4	9.5	8.5
India	9.7	9.0	8.0	7.5
Russia	6.7	8.1	6.9	6.2
Brazil	3.7	5.4	5.2	3.5

Inflation (%)	2006	2007	2008	2009
US	3.2	2.9	4.3	2.3
Japan	0.2	0.0	1.6	0.7
Euro area	2.2	2.1	3.5	2.3
UK	2.3	2.3	3.7	3.0
Canada	2.0	2.2	2.7	2.2
China	1.5	4.8	5.9	3.0
India	5.3	4.8	9.8	6.0
Russia	9.7	10.7	12.0	9.4
Brazil	4.2	3.6	5.7	5.3

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	4.00	3.50
UK (Bank rate)	5.0	5.5	4.75	3.75
Canada (Call rate)	4.25	4.25	3.0	3.5
China (Lending rate)	5.9	6.73	7.74	7.74
India (Repo rate)	7.25	7.75	9.5	8.5
Russia (Repo rate)	6.75	7.0	7.25	7.25
Brazil (SELIC rate)	13.25	11.25	14.5	13.75

Source: Barclays Wealth Research

10-year bond yields (%)	2006	2007	2008	2009
US	4.7	4.1	3.5	3.75
Japan	1.7	1.4	1.2	1.5
Euro area	4.0	4.4	4.3	4.2
UK	4.7	4.6	4.3	4.2
Canada	4.1	4.0	3.8	4.0

Equity returns (%)	2006	2007	2008	2009
US (S&P 500)	13.6	3.5	-20.6	12.6
Japan (Topix)	32.7	6.5	-28.6	20.8
Euro area (FTSE Europe ex-UK)	20.0	3.8	-30.1	13.5
UK (FTSE)	11.0	3.8	-25.3	9.1
Canada (S & P/TSX)	14.5	7.2	-15.0	12.0

Currencies	2006	2007	2008	2009
Indices				
US dollar index (% change)	-3.9	-5.8	-1.4	8.2
Yen index (% change)	-6.5	-4.0	9.0	3.9
Euro index (% change)	3.3	3.5	-2.9	-3.2
Sterling index (% change)	4.8	-6.3	-11.1	-9.0
Canadian dollar index (% change)	-1.6	11.7	-8.3	-10.5
Cross rates				
$ per €	1.26	1.37	1.50	1.32
¥ per $	116	118	102	105
$ per £	1.84	2.00	1.88	1.63
£ per €	0.68	0.68	0.80	0.81

All market variables are end of period rates

Source: Barclays Wealth Research

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