



Mark Burgess
Chief Investment
Officer

Economic and market commentary

Recent economic data points to diverging circumstances in different geographical regions. On the one hand, the eurozone remains in crisis with austerity and bank deleveraging eroding growth potential. Consequently, we have cut our forecast for GDP for the current year to show a fall of 1.0%. On the other hand, in Asia and emerging economies we see growth maintained at high levels with consumption remaining buoyant and scope for monetary loosening as inflationary fears subside. Between these two extremes lies the US where recent figures have surprised on the upside, benefiting from a stronger banking sector than the eurozone, fewer austerity measures and a significant boost from the collapse seen in natural gas prices. In aggregate we continue to expect developed economies to underperform consensus expectations with very lacklustre growth. We have done considerable work on the way that the money supply is behaving. We feel that the outlook for inflation is fairly benign as the extraordinary levels of liquidity provided by policymakers continue to have little impact on growth. In addition we do not expect commodity prices to rise materially or act as a significant source of inflation. We anticipate falling global inflation over the course of the year.

The improved tone of recent economic data, especially in the US and emerging economies, and the boost to liquidity from the Long-Term Refinancing Operation (LTRO) in Europe have significantly increased risk appetite in equity markets. This has led to increased demand for the more cyclical, higher risk sectors and assets that performed badly last year. We made some moves in this direction towards the end of last year. For example, we added to banks following a dreadful year for performance and seeing the sector as a major beneficiary of the LTRO. We added to auto stocks, which had fallen due to concerns over the sustainability of Asian demand, and we added to companies exposed to US housing, where eventually some stability appears to be returning. In light of the depressed levels of valuations in these sectors and the ongoing liquidity injection we expect them to have further to run in the short term. However, further out we see divergent sector performance in different parts of the globe driven by a different economic outlook. In particular in the US, where we have seen some improvement in the economic picture and in Asia and emerging economies, where we see healthy medium-term growth potential, we expect some cyclical sectors and banks to show more sustained performance. However, in Europe we believe the economic outlook for the next few years remains bleak and therefore continue to have a cautious approach to these areas of the markets on anything other than a tactical view.

We have recently had a close look at the energy sector where we expect the oil price to remain high, averaging \$115-\$120 for 2012 as supply remains tight, inventories low and geopolitical risks are numerous. In addition Saudi Arabia, the swing producer, has a stated aim of a \$100 floor. In light of this we like the exploration and production stocks and oil services companies. However, the lion's share of the sector is made up of the large integrated companies where we generally see a poor outlook for production growth and therefore retain an underweight position in the sector. We also looked at basic materials where we have moved to a tactical overweight based on an improved outlook for mining

companies. This results from an expectation of resumed growth in demand from China, continued supply difficulties, high margins in the sector, low valuations and many investors having very limited exposure.

Equity markets have enjoyed a strong rally over the last part of 2011 and early part of 2012. We believe equities offer good value and retain an above benchmark position. The LTRO programme, undertaken by the ECB, offers considerable support to the European banking sector and in turn other assets. This boost to liquidity is quite likely to be augmented by further quantitative easing, of one form or another, by a number of central banks. This is also likely to help the performance of risk assets. However, our primary reason for optimism on the outlook for equities is the attractive valuation levels. These more than discount the difficult economic environment. Having said this, in the short term, markets may see a setback after recent strength and we have top-sliced some holdings into strength.

In contrast to the valuation support for equities, we see little value in government bonds. However, we recognise that yields may remain at around current low levels in the months ahead due to continued measures from central banks to try to boost economic activity. We do see value in corporate and emerging market bonds, where fundamentals are generally healthy and spreads offer decent value.

Our stance on property is neutral. The running yield is reasonably generous but the outlook for tenant demand and rental levels for commercial property in the UK over the course of 2012 appears difficult.

Economic forecasts

Summary

Many of the trends that we identified when we last put pen to paper in November 2011 are still very much in place. On the positive side US economic data has, for the most part, continued to beat expectations, with a solid end to the year for retail sales and clear signs of a pick-up in the crushed housing market. Bond yields have stayed low, and gasoline and natural gas prices have fallen, helping this process. Also on the positive side China seems to be managing its way to a soft landing, sustaining growth at around 8% per annum. This is a real relief for investors fearing that the process of Western bank deleveraging and bloated levels of public debt were just about to be compounded by significantly slower growth in developing markets.

On the negative side the eurozone continues to be in crisis and austerity is biting away at the growth potential of the periphery. We are especially concerned about how the interaction of deleveraging and fiscal consolidation feeds through to the broader economy. In many respects the UK stands closer to these concerns than the US, but global inter-linkages still suggest that an abrupt negative credit event would be very unsettling at this stage.

In aggregate we continue to expect that developed economies will tend to underperform consensus expectations with very lacklustre growth. By contrast we are happy to be broadly in line with more upbeat expectations for emerging economies.

We have done considerable work on the deleveraging process and how money supply is behaving and, on what we currently know, we feel that the outlook for inflation is fairly benign as the extraordinary level of liquidity provided by policy-makers continues to fail to boost growth (although it may have acted to prevent a far more brutal contraction following the credit crunch).

Economic forecasts

US

				(T)	(Cons)	(T)	(Cons)
	2009	2010	Current	End 2011	End 2011	End 2012	End 2012
GDP (year/year)	-3.5	3.0		1.5	1.8	1.5	2.2
Headline Inflation (year end)	2.7	1.2	3.4	3.3	3.5	2.0	2.0
Core Inflation (year end)	1.8	0.8	2.2	2.5		1.5	
Official Rates ¹ (year end)	0.25	0.25	0-0.25	0-0.25	0.06 ¹	0.25	0.06 ¹
10-year bond yield	3.8	3.3	1.89	1.9	1.9/4.5 ²	2.5	2.8 / 4.5 ²
EUR/USD (year end)	1.43	1.34	1.29	1.3	1.30	1.25	1.30
USD/JPY (year end)	93	81	77	77	77	82	78

Updated 25 January

Notes: (T) = Threadneedle forecast, (cons) = consensus forecast, ¹consensus = derived from market expectations, ²first bond yield consensus number represents economists' views, second represents TAM's measure of 'Fair Value'.

Changes to Threadneedle forecasts: 2012 US 10-year bond yield placed at 2.5%.

A bit better

Although we have not changed our 2012 growth forecast – we'd like to assess the Q4 2011 GDP number and wait to see a few more of the data points for Q1 2012 – it is clear that the US economy is starting to make a bit of positive progress. The unemployment rate continues to fall, consumption is being helped by lower energy prices and even the moribund housing market is seeing rising sales and better builder optimism.

In the background, US energy independence is undergoing a renaissance as the technology to exploit natural gas is allowing the country to exploit reserves that can last over 100 years – we think the US is now at less risk of an energy shock (barring major conflict in the Middle East).

We are now looking for further good news in housing and the labour market to encourage us to raise our growth forecast.

Risks to the forecast

- Lower commodity prices – positive and now more in evidence
- Eurozone dislocation – could be sharply negative
- Global trade outlook – a moderate negative but a seemingly smaller problem now
- Presidential election year and impasse over debt – the situation remains uncertain but may become less unsettling as the market sees how the race will open up
- Lack of confidence in small and medium-sized businesses – a moderate negative after lost tax advantages

Economic forecasts

Euro Area

				(T)	(Cons)	(T)	(Cons)
	2009	2010	Current	End 2011	End 2011	End 2012	End 2012
GDP (year/year)	-4.1	1.7		1.6	1.6	-1.0	-0.3
Headline Inflation (year end)	0.9	2.2	2.7	2.7	2.7	2.0	1.5
Official Rates¹ (year end)	1.0	1.0	1.0	1.0	1.0	0.5	0.5 ¹
10-year bond yield	3.4	3.0	1.8	1.8	1.8 /4.0 ²	2.5	2.5 /4.0 ²
EUR/USD (year end)	1.43	1.34	1.29	1.3	1.3	1.25	1.3
EUR/JPY (year end)	134	109	99	100	100	103	101

Updated 25 January

Notes: (T) = Threadneedle forecast, (cons) = consensus forecast, ¹consensus = derived from market expectations, ²first bond yield consensus number represents economists' views, second represents TAM's measure of 'Fair Value'.

Changes to Threadneedle forecasts: 2012 GDP changed to -1.0% from 0.0%.

Long-Term Refinancing Operation

Our work on deleveraging pointed to the potential for an enormous financial accident in the first half of 2012 if Greece defaulted and the banking system went into complete shock. Fortunately the ECB not only came to the same conclusion but acted by opening another chapter in the central bank book for dealing with this ongoing financial crisis – the 3-year LTRO. However, we remain concerned that more liquidity for a very weak banking system is not the same thing as getting growth back on the right road. Without better growth, economies will struggle to work off their debt burdens and the region will probably veer from one crisis to another. At the time of writing Greece continues to stand on the brink of bankruptcy and Portugal seems to be following the same path.

Meanwhile, the EU (led by Germany), the ECB and the IMF continue to pressure governments into fiscal consolidation and a further round of bitterly slow growth seems assured for the biggest deficit countries. Paradoxically this can start to look like running hard just to stand still, and the social and political stability of countries like Greece is constantly under scrutiny.

We have decided to lower our 2012 growth forecast further to show outright contraction in the eurozone led by very weak out-turns for Italy, Spain and the periphery. Germany continues to hold up but, as a surplus country, weakness in its neighbours is likely to be felt through lower export potential. This also makes it critical that the global economy can hold up – otherwise things could become a whole lot worse for the eurozone.

Risks to the forecast

- QE/unsterilised bond purchases – very positive (and LTRO nods in this direction)
- Tangible political agreement on a common fiscal approach – very positive but still lacking
- Global trade outlook – moderately negative but less apparent now
- Disorderly default or exit by one or more members of the eurozone – very negative
- Evidence that newly formed governments cannot deliver objectives – Italy has done rather better than feared on this front, helping to stabilise the bond market
- Delaying Basel III – softening tighter bank regulation would be a positive
- A softer euro – a useful by-product of eurozone angst for exporters; could offset the downside

Economic forecasts

Japan

				(T)	(Cons)	(T)	(Cons)
	2009	2010	Current	End 2011	End 2011	End 2012	End 2012
GDP (year/year)	-6.3	4.0		-0.8	-0.8	0.5-1.0	1.9
Headline Inflation (year end)	-1.7	0.0	-0.5	-0.2	-0.2	-0.2	-0.2
Official Rates¹ (year end)	0.1	0.1	0.1	0.1	0.1 ¹		0.1 ¹
10-year bond yield	1.3	1.1	1.0	1.0	1.0/2.0 ²		1.2/2.0 ²
USD/JPY (year end)	93	81	77	77	78	82	78
EUR/JPY (year end)	134	109	99	100	100	103	101

Updated 25 January

Notes: (T) = Threadneedle forecast, (cons) = consensus forecast, ¹consensus = derived from market expectations, ²first bond yield consensus number represents economists' views, second represents TAM's measure of 'Fair Value'.

Changes to Threadneedle forecasts: None.

Japan – a warrant on global growth

Japan continues to face challenging supply problems – earlier in 2011 it was the horrific earthquake and then the floods in Thailand. However, catch-up from this and the post-earthquake rebuild encourage us to believe that GDP growth will be positive in 2012 despite ongoing deflation. In addition, a soft landing in China and a gentle pick-up in the US are exactly the dynamics that allow Japan to do better given the importance of trade and foreign earnings to this economy.

Risks to the forecast

- China and US growth outlooks – now balanced to slightly positive: an improvement
- Eurozone dislocation – negative
- Yen strength – negative (we actually expect a modest weakening)
- Politics – looking more positive

Economic forecasts

UK

				(T)	(Cons)	(T)	(Cons)
	2009	2010	Current	End 2011	End 2011	End 2012	End 2012
GDP (year/year)	-4.9	1.4		1.0	0.9	0.0	0.5
Headline Inflation (year end)	2.9	3.7	4.2	4.2	4.2	2.3	2.0
Official Rates¹ (year end)	2.0	0.5	0.5	0.5	0.5 ¹	0.5	0.5 ¹
10-year bond yield	4.0	3.4	2.0	2.0	2.0/4.5 ²	3.0	2.5/4.5 ²
USD/GBP (year end)	1.61	1.55	1.54	1.49	1.61	1.52	1.63
EUR/GBP (year end)	0.89	0.86	0.84		0.88	0.82	0.85

Updated 25 January

Notes: (T) = Threadneedle forecast, (cons) = consensus forecast, ¹consensus = derived from market expectations, ²first bond yield consensus number represents economists' views, second represents TAM's measure of 'Fair Value'.

Changes to Threadneedle forecasts: None.

Flirting with recession

At the time of writing Q4 GDP data has just been published showing the economy contracting once more and flirting with recession. Austerity measures are biting into public sector employment and whilst private sector jobs growth has offset some of this, the rise in self-employment casts doubt on just how successful this really is. Real wages have been falling and, although some help may come from a more benign outlook for energy prices, there seems little prospect of wages moving higher to support consumption.

A zero per cent growth estimate for next year keeps us firmly in the sceptical camp. Fiscal consolidation is slowing economic growth and driving unemployment higher. High street retail is under considerable pressure from the combination of a change in spending habits and refinancing problems, as the banks delever and have little appetite to entertain new projects. At least Mr King's forecasts for lower inflation may start to bear some fruit given this backdrop.

Risks to the forecast

- Lower energy prices – positive and partly coming through as some utility bills fall
- Eurozone dislocation – could be sharply negative – still a very major focus
- Further QE – should be supportive but its ability to provide a positive shock seems to be wearing a bit thin

Economic forecasts

Developing Markets

GDP (YoY)	2012		2013	
	Consensus	Threadneedle ¹	Consensus	Threadneedle ¹
Brazil	3.3	▼3.0-3.3	4.3	►4.0-4.5
Mexico	3.3	▼3.0-3.3	3.4	►3.5
China	8.4	►8.0-8.5	8.6	▲8.5-9.0
India	7.0	▼7.0-7.5	7.3	▲7.5-8.0
South Korea	3.4	▲4.0	4.1	►4.0-4.5
Taiwan	3.3	►3.0-3.5	4.6	►4.5-4.8
South Africa	2.8	►	n/a	3.5-4.0
Russia	3.5	►	3.9	►3.5-4.0

¹Difference from consensus.

Investment themes

Theme	Thesis	Investment conclusions
Search for yield	<ul style="list-style-type: none"> ■ Deflationary environment will keep yields low. ■ Above average and relatively safe yields will be increasingly in demand. 	<ul style="list-style-type: none"> ■ High quality, non-financial corporate bonds and high yield debt remain attractive. ■ Above average and/or growing yields, especially being paid by businesses with stable earnings and cash flows, will remain in demand.
Global capital expenditure growth	<ul style="list-style-type: none"> ■ Investment in infrastructure and fixed assets in the 'developing' economies will provide a strong backdrop for global industrial demand. ■ In addition, investment in improving productivity will continue as the competitive environment gets tougher. 	<ul style="list-style-type: none"> ■ Theme 1 - Automation. Investment in improving production efficiency is occurring, particularly in the developing economies. ■ Theme 2 - Companies that are exposed to growing expenditure on infrastructure projects. ■ Theme 3 – Specialist companies with leading technologies or products will continue to see demand growth as investment to improve competitiveness continues in a slowing world.
China/Asian growth	<ul style="list-style-type: none"> ■ Economic expansion/industrialisation of China is a long-term story driving growth for many developed world companies. ■ Policy initiatives will cause periodic concerns about growth but will not derail the overall story. ■ Growth will remain focused on infrastructure spending led by the authorities but emerging consumer markets likely to be a feature. 	<ul style="list-style-type: none"> ■ Exposure to infrastructure spending. ■ Industrials (see above). ■ Emerging consumer markets and growth in demand for luxury goods. ■ Commodity and resource sectors. ■ Demand for soft commodities and impact on pricing/input costs.
Over-indebtedness	<ul style="list-style-type: none"> ■ Risks as governments, consumers (and companies) seek to reduce indebtedness. ■ First order effects in expenditure cuts, second order effects in weak demand outlook. 	<ul style="list-style-type: none"> ■ Dangers of taxation of immovable assets (e.g. utilities). ■ Low end consumers under pressure as unemployment stays high and incomes remain under pressure. ■ Potential revaluation of companies exposed to non-discretionary spending.

Opportunities in a low growth developed world	<ul style="list-style-type: none"> ■ Growth constrained by headwinds of deleveraging and ageing populations. ■ Poor asset quality, the size of bank balance sheets and new capital requirements will limit the supply of credit to fund growth. ■ Areas of stronger growth (see above) will revalue. 	<ul style="list-style-type: none"> ■ Theme 1 - Secular/strong growth will command a premium valuation. ■ Theme 2 - Strong franchises and high returning businesses will revalue as investors pay a premium for quality and reliability. ■ Theme 3 - Turn round and recovery situations where returns are improving are attractive. ■ Theme 4 - M&A should increase – look for undervalued franchises, market consolidation opportunities and undervalued cash flow. ■ Strong corporate cash flow will support dividend growth (reductions in cover), and M&A and share buybacks.
Defensive growth	<ul style="list-style-type: none"> ■ With economic growth set to remain low, cash flows high and pay-out ratios rising, dividends are likely to be an increasingly important component of total returns. ■ Companies in defensive sectors that boast strong balance sheets are likely to be best placed to weather the lacklustre growth conditions we foresee. These companies will also tend to offer higher yields. ■ Low interest rates and core government bond yields mean that investors will continue to search for alternative sources of income. 	<ul style="list-style-type: none"> ■ Income is likely to outperform growth in equities. ■ Demand for high yielding areas of fixed income will continue.

Asset allocation

	Equities Overweight	Bonds Underweight	Property Neutral	Cash Underweight
Overweight	US Asia (ex Japan) Latin America UK Japan	Emerging Market Investment Grade and High Yield Corporate		
Neutral	Europe		UK Property	
Underweight		Government		Cash

Important information

Past performance is not a guide to the future. The value of investments and any income from them can fall as well as rise. Exchange rates may cause the value of underlying investments to fall as well as rise. The naming of any specific shares/securities should not be taken as a recommendation to deal. Any opinions expressed are as the date of issue, but may be subject to change. The research and analysis contained in this document has been prepared by Threadneedle Asset Management Limited (an associated company) primarily for its own investment management activities and may have been acted upon prior to publication. Issued by Threadneedle Asset Management Limited. Authorised and regulated by the Financial Services Authority. Registered in England and Wales. 60 St Mary Axe, London, EC3A 8JQ. Registered No. 573204. Threadneedle is a brand name, and both the Threadneedle name and logo are trademarks or registered trademarks of the Threadneedle group of companies. threadneedle.com