

A 2011 Outlook from the Multi-Asset Strategy Team

January 2011

Last year saw a continuation of the global recovery, although the economic rebound was somewhat muted, with the after-effects of the financial crisis still being felt across the globe. This was particularly the case in southern European countries, which emerged as an area which is under particular financial stress.

In a bid to encourage a self-sustaining recovery to take hold, policymakers, especially in the US, have continued to provide support with monetary stimulus. This has not only involved keeping interest rates at historically low levels, but has also been extended to the unconventional policy measures in the form of quantitative easing. US policymakers have clearly looked at their mistakes of the 1930s, (or Japan's in the 1990s) and this time are intent on avoiding deflation and have opted for a very stimulative response. The continuation of the emerging markets growth story was also a principal theme of 2010, with growth rates in less developed countries remaining considerably higher than in the West.

Signs of a broadening recovery

Looking forward to 2011, there are a number of reasons why investors could be cautiously optimistic. There are signs that the recovery is broadening out, with not only US economic data starting to improve but also an encouraging positive turn in the NFIB (National Federation of Independent Business) small business optimism index. Furthermore the US labour market is stabilising with jobless claims falling and the unemployment rate starting to decline. Notwithstanding weakness in peripheral Europe, growth in the core countries, centred around Germany, is proving to be very strong, with a weaker euro boosting demand for manufactured goods such as luxury cars, particularly in the Far East. Similarly, the UK is in recovery mode, supported by expansionary monetary policy, growth in global demand and the depreciation in sterling.

Significant risks remain

The situation in the eurozone is perhaps the main risk for investors in 2011, with sovereign debt levels unsustainably high in peripheral countries, which is causing repeated spikes in the government bond yields of those nations. Although periodic respite is possible, the problem is structural and therefore unlikely to go away in the near future. For example, the renewal of Spanish debt required later in the first quarter of this year is a potential catalyst for renewed volatility.

While growth in the developing world has been a strong support for the global recovery, rising inflation in many developing countries is now leading to policy tightening in China and elsewhere. This brings with it a delicate balancing act between maintaining growth and controlling inflation. More generally, as the global recovery matures, markets are beginning to anticipate the start of policy normalisation in the developed world. The recovery, in our opinion, remains fragile with the headwinds of deleveraging leaving governments and central banks in uncharted territory. This means a heightened risk of policy mistakes. We are starting to see a rise in bond yields in the UK and US. While this is consistent with a recovery cycle up to a point, a meaningful spike in yields could be negative for the global economy, pushing up the price of borrowing and reducing liquidity levels.

Asset class implications

If the recovery continues to unfold then policy should normalise, which would lead to a rise in interest rates probably in the second half of 2011 for mainland Europe and the UK, although we do not anticipate that the US will begin raising official interest rates any time in the next year. The short end of the bond market is most vulnerable to changes in rate expectations although the whole curve will be vulnerable should inflationary expectations rise further. Despite the recent rises, it is important to remember that bond yields remain low in a historical context, which means that further rises are possible without necessarily undermining risk assets. As long as the recovery continues, corporate bonds, particularly in the high yield space, and equities should be supported by solid underlying earnings growth. The commodity complex has been a key beneficiary of improving risk appetite and growth expectations, but tightening in China represents a serious risk to the asset class, as well as emerging market assets in general. Investor positioning in these areas already appear stretched and this heightens the risk of reversals.

Overall, when we look at this recovery cycle we feel the recovery is looking in reasonable shape, especially given the ample monetary stimulus. We wish to stress, however, that the process of deleveraging in the western world has some way to go. As such the recovery is reliant on the market continuing to be happy to fund past excesses. This combination of positive cyclical forces but weak structural backdrop leads to considerable uncertainty in the investment outlook, with material tail risks of both deflation and inflation. Inflation could be an issue if policy measures work too well but a Japanese-style deflationary outcome is possible if the US government's policy measures fail.

With this backdrop in mind and with few glaring valuation anomalies apparent, we continue to advocate a tactical approach to asset allocation, actively managing our exposure to bonds, equities, commodities, credit and currencies. We have a constructive view on stocks (although we have a bias away from peripheral Europe) and on growth currencies. Our government bond holdings are materially lower than they have been in recent years, although we still see attraction in corporate debt and have targeted exposure to commercial property. We also see opportunities within asset classes via relative value trades. We have exposure to investment strategies which have a greater certainty of return and which are not wholly reliant on simple market beta. In this context we continue to see attraction in real asset investments such as the infrastructure arena, and in range of opportunistic investments that are well placed to perform well in the year ahead.

Please note the value of investments and any income will fluctuate and is not guaranteed (this may be partly due to exchange rate fluctuations). Investors may not get back the full amount invested.

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