

The Fed's adoption of additional quantitative easing (QE2) provides insurance against a US recession but raises additional stresses. This is especially the case in the currency arena where the threat of competitive devaluation raises political pressures with uncertain consequences. Renewed sovereign debt concerns in the European periphery complicate matters further but the recovery remains on track for now.

## Economic outlook

The global recovery remains fragile, as demonstrated by the need for additional policy stimulus in the US, renewed financing strains in the European periphery, and fears that policy tightening in China could stall Asia's growth engine.

Against this backdrop, it is fortunate that the deceleration in activity over the second quarter now looks to have been a pause in growth within a continued recovery phase.

We still expect the pace of growth in the G4 countries to moderate from here, but a relapse into outright recession is unlikely, barring new shocks, as robust growth in the developing world continues to be a source of support.

In the US, the motivation behind QE2 is two-fold: policy makers want to avoid a 'Japanisation' of the economy and are concerned about deflation and the lack of employment growth. Policy-makers' second concern is over the poor ability of the financial system to cope with further stresses or shocks, which also argues in favour of proactive action.

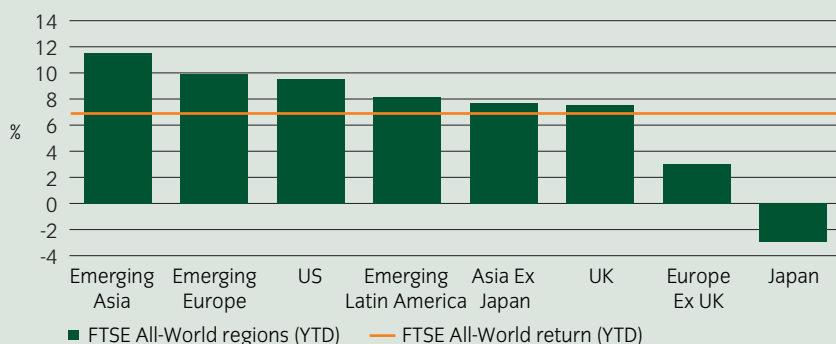
After a period of relative calm, Europe is again experiencing a crisis of confidence in the sovereign debt position of its peripheral economies. Overall, however, the recovery continues and is being driven by Germany. There are signs that it is broadening but the spectre of a rolling sovereign debt crisis and the prospect of acute structural adjustment in the periphery cast a shadow over the

regions prospects. That said, additional monetary stimulus, in the form of QE, is not on the ECB's agenda

The UK's gradual recovery continues. Easy monetary policy remains a natural counter-weight to fiscal tightening but with inflation persistently over-shooting expectations it is now unclear whether the Bank of England will follow the Fed's lead on QE.

Emerging market growth is moderating from exceptional levels. Food price rises are causing inflation problems but policy makers are generally reluctant to raise rates aggressively, fearing this will attract yet more 'hot money' and result in unwanted currency appreciation.

Chart 1: YTD regional equity market performance



Source: Insight Investment.

## Absolute valuations

No asset class appears particularly compelling from a valuation standpoint but the global cost of capital is being held down by monetary authorities and is likely to remain low for some time yet.

In a highly uncertain environment we would prefer a larger valuation cushion to compensate for risk and in many cases this buffer is uncomfortably thin. However, short rates are anchored at historically low levels which has spurred

a search for yield and higher-returning assets, to the benefit of both equities and corporate bonds.

We draw comfort from the fact that corporate balance sheets are generally in good shape and remain a support for corporate debt and the ability of large parts of the equity market to pay dividends. At this stage of the cycle, however, investors should be more selective in their investments and not rely heavily on market beta.

Yields on government bonds are low by historical standards, but with large amounts of spare capacity still available in the economy, core inflation looks set to remain low in the G4 arena. We therefore expect sovereign debt (outside of the periphery of Europe) to retain some attraction, not least since it has proven to be one of the few diversifiers in times of stress.

## Risk appetite

Risk appetite is skittish, but risk-seeking behaviour was in the ascendency in anticipation of the US Fed's QE announcement. Their actions may provide insurance against a down-turn in US growth but raises additional stresses, most obviously in the currency arena where the prospect of competitive devaluations raises political pressures with uncertain consequences.

This realisation has now been intensified by sovereign risk, centred on Ireland and other peripheral European countries, and policy tightening in China, which has combined to temper risk-seeking behaviour. Unsurprisingly, 'real money' investors are running less extreme positions than their speculative counterparts but common features

## Peripheral pressures

After Greek concerns peaked back in May, it is Ireland that currently sits as the focal point of the sovereign debt crisis surrounding the eurozone. It is dangerous to underestimate strategic and political commitment behind the eurozone project but from an economic perspective, monetary union without fiscal policy compatibility was always a theoretical cause for concern. That is the reality that now challenges not only the European periphery but also those who offer financial assistance to aid in the adjustment process. For deficit countries to adjust requires them to deliver nominal growth in excess of the growth in their debt burden. Making this adjustment without currency flexibility requires a degree of economic pain that will test the resolve of the most ardent of fiscal reformers and the patience of a fickle market.

include a strong bias for emerging markets, commodities and a mild preference for equity over debt.

## Sentiment & positioning

In the absence of compelling valuation signals, we are adopting a tactical approach to asset allocation. In fixed income we have had a bias to be either long or neutral duration depending on market positioning. We also have a slight bias for higher beta credits.

Our foreign exchange positions are set up to benefit from a pick-up in a global activity following the recent pause but we are flexible as to the appropriate funding vehicle (US dollars or euros) given the fluid macro environment.

After a period in which equity market correlations have been abnormally high, we are seeing increasing opportunities to add value both through stock selection and relative trades.

Our multi-asset portfolios are well balanced. Our equity exposure is biased towards areas where growth drivers are more evident (e.g. Asia) and those best placed to deal with the European sovereign debt crisis. Our bond exposure is slightly tilted to short-dated credit relative to government bonds. Our opportunistic exposure tends to be focused on investments that offer a high certainty of return and income generation.

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Chart 2: YTD peripheral bond spread moves



Source: Insight Investment.

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