Global Investment Outlook

The monthly investment outlook from Aberdeen's multi-asset team

The US yield curve should remain steep as supply supports long yields and policy is eased

Source: Factset

S&P 500 low in 2002 was 776 which may represent a buying opportunity

Source: Factset

Key forecasts	US	Japan	Euro zone	UK	China	Global
GDP rolling 12m forecast	0.9	0.4	0.6	-0.4	9.2	1.3
Consensus	1.4	0.9	1.1	0.1	9.2	1.8
CPI rolling 12m forecast[1]	3.1	1.3	2.5	3.0	5.0	2.8
Consensus	3.1	1.3	2.5	3.0	5.0	2.8
Current Base Rates	1.00	0.30	3.25	3.00	6.93*	–
Monetary Policy (3m)	0.75	0.30	2.75	2.50	6.39*	–
Monetary Policy (12m)	1.00	0.30	2.25	2.00	6.39*	–
10 Yr bond Yields (12m)	4.00	1.50	4.40	4.50	n/a	–

[1]core rate *PBOC 1 year Yuan Lending Rate
Source: Aberdeen Asset Managers Ltd

Asset allocation	Deviation (%)
Equities	5.0
- UK	-(1.0)
- US	0.0
- Japan	1.0
- Europe ex UK	1.0
- Asia	2.0
- Emerging Markets	2.0
Fixed Income	-(5.0)
- Conventional	-(3.0)
- Index Linked	-(2.0)
Property	0.0
Cash	0.0

Source: Aberdeen Asset Managers Ltd

Summary of Aberdeen's multi-asset views

- Mounting evidence of global recession
- Fed could cut rates to 0.75% before 2009
- Keynesian policies on the rise

As evidence of recession accumulates, central banks have continued to ease monetary policy, with the US Federal Reserve likely to cut rates further to 0.75% before 2009. Meanwhile, fiscal stimulus packages are forming worldwide, as almost the entire globe embarks upon an introduction of "Keynesian" policies.

Given tumbling commodity prices and shrinking economic activity, deflation is now the dominant risk. Fortunately, political authorities remain alert for the most part, strenuously avoiding the policy mistakes of the 1930s and those of Japan in the 1990s.

Market volatility remains high. Within equities, the capitulation trade could be starting to end, as the intense forced selling associated with the hedge fund industry abates, but investors will want to see valuations hit lows before they begin to commit money. A further fall to the October 2002 low of 776 on the S&P 500 is conceivable, and may represent a buying opportunity.

However, we believe a recovery in equity risk appetite requires the following in order of preference: a reduction in Libor rates to within 50 basis points of premium to policy rates, the stabilisation of corporate bond markets and a modest return of liquidity, and the stabilisation of the banking sector itself.

Encouragingly, in the US, the program to buy commercial paper direct from corporations has slowly begun to defrost the money markets and lower dollar Libor rates. However, the outlook for corporate bond markets remains very difficult, with prospects for the financial sector looking particularly cloudy.

As far as asset allocation is concerned, it still seems reasonable to incrementally add risk in most markets. We remain marginally overweight equities within our multi-asset portfolios, favouring Asia, whose companies have strong foundations from which to prosper.

Mike Turner
Head of Global Strategy & Asset Allocation, and manager of Aberdeen Multi-Asset Fund

Global Investment Outlook

Global leading indicators continue their decline, suggesting recession.

US unemployment has risen beyond the levels of 2002/3, and housing activity is still lacklustre.

Euro-zone entering downturn with a low government deficit to GDP ratio, implying ample scope to expand fiscal policy.

Global interdependence taking its toll on Japanese, Asian and Emerging economies.

Deflation now the dominant risk as commodity prices fall and activity shrinks, but thankfully political bodies remain alert.

Economic and Market Outlook

Global leading indicators continue their decline and suggest we are in recession. This contraction in activity will be most acute in the developed world as opposed to the developing nations. The latter may not experience outright decline, but it may seem like it.

The emphasis of policy amongst the authorities will now shift towards fiscal expansion. Deficit and debt to GDP ratios will rise substantially in G7 countries, as social welfare payments take an increasing share of domestic budgets following climbs in unemployment rates. However this phase of demand management will not just be confined to normal cyclical deterioration in government accounts, but is likely to be accompanied by outright increases in expenditure or indeed some tax cuts.

US

Lack of credit availability has brought US activity to near stand-still in sectors reliant upon finance for sales. This has further undermined confidence and unnerved policy makers. Democrat President elect Obama has indicated his desire for a second stimulus package but this will likely be expenditure rather than tax focussed, and it will take some time to enact.

In the short term there may be some impetus from lower energy prices and an Obama 'feel good' factor, but it is uncertain how much demand has dropped following the disruption to the supply of credit. Unemployment has risen beyond the levels of 2002/3, and housing activity is still lacklustre.

Euro-zone

Euro-zone growth is set to stall in 2009. Disparities between countries still exist, with Germany the most robust, but slowing exports will undermine growth. At least the region is entering this downturn with a low government deficit to GDP ratio (0.9%), implying there is ample scope to expand fiscal policy. Some countries may break the 3.0% limit enshrined in the Maastricht Treaty but breaches are allowed under exceptional economic circumstances.

UK

The UK has not suffered a recession for 16 years, and one could argue it is overdue. The housing bubble is following the US, but given the greater excesses we agree with the IMF prognosis that the fall will be sharper. The UK financial sector is also more important, and this too is contracting swiftly with concurrent job losses.

Asia and emerging markets

Japanese, Asian and Emerging economies' growth has been propelled by global trade in recent years, but these are also now retrenching, as global interdependence takes its toll. No region is immune, and fiscal stimuli packages are forming (the most prominent in China) as almost the entire globe embarks upon an abrupt introduction of "Keynesian" policies.

Deflation

Deflation is now the dominant risk as commodity prices fall precipitously and activity shrinks. We don't believe that a Japanese style problem will persist, although some countries may see prices decline for a period. Political bodies are alert, and have been swift in endorsing substantive action. Most importantly the authorities are strenuously avoiding the policy mistakes of the 1930s and those of Japan in the 1990s.

Global Investment Outlook

Bond Yields, Currencies and Monetary Policy

Monetary Policy

The Federal Reserve will probably cut rates further to 0.75% before 2009, as it characterises the balance of risks as heavily tilted towards weaker growth. The program to buy commercial paper direct from corporations has begun to defrost the money markets, and lower dollar Libor rates. The TARP program has now been shelved in favour of more direct equity capital injection into the banking system, and fund provision for consumer loans. The IMF estimate of a further requirement of US$675bn to fully recapitalise the global banking system (made in mid October) appears quite accurate.

The Bank of England has at last employed risk management tactics by lowering base rates by 1.5%. The consideration here is that the risks of doing too little far outweigh the risks of doing too much to maintain inflation in a 1% to 3.0% band around the central target. Some analysts are projecting base rates at 1.0% in the first quarter of 2009, something we do not consider impossible. It has been suggested that Sterling's recent fall will be an impediment to lowering rates. This would be the case in more normal cyclical times, but this cycle is anything but normal.

The European Central Bank has also lowered rates and we believe will continue to do so, with policy rates reaching 2.75% early in the New Year. The risk once again is that rates go even lower than this.

Japan surprised everyone by lowering their policy rates by 0.2%. Given the extremely accommodative state of monetary policy that already existed, we think this only serves to express the gravity of the global situation.

Monetary policy in Asian and emerging economies should loosen in due course and indeed has already started to do so dramatically in countries such as South Korea where rates have fallen by 1.25% recently.

Government bonds

Government bond yields are likely to trade in a range in the near term as the beneficial impacts of looser monetary policy and weaker equity markets are offset by increased supply from fiscal expansion.

Index-linked markets continue to build in lower break-even inflation rates. We believe that this will continue for the moment as commodity prices weaken and economic data remains weak.

Credit

October was the weakest and most volatile month on record for credit market performance. Spreads were wider in every sector of the market, with high yield naturally suffering the most.

Liquidity in all areas of secondary bond markets remains extremely poor as the amount of risk capital devoted to market making has been severely curtailed by the problems suffered in the banking system. The result is that any new issuance is sold at cheaper levels than existing bonds, which then pushes spreads wider in those existing issues.

Spreads may temporarily narrow into the year end, but we doubt this will be significant as the expectation of rising default rates, continued de-leveraging by financial institutions, and poor liquidity, impede the market.

Corporate credit markets have suffered a tumultuous time in the last month. The financial sector is likely to be more regulated and less profitable post the crisis, and non-financial issues will suffer increased default rates in coming months. The bigger question remains as to whether the current level of spreads for the market on aggregate is fully pricing risk.

Emerging market debt

Emerging market bond spreads appear attractive on aggregate, despite high profile support from the IMF for some smaller countries such as Hungary and Ukraine. However like corporate issues, the realisation of value is dependent upon a normalisation of market operation.

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Some analysts project UK base rates at 1.0% in first-quarter 2009.

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Currency

Within the currency arena, the US dollar has continued to benefit from market turmoil, and the yen has prospered from unwinding of leverage and the so-called 'carry trade'. We feel we may be approaching the end of this as we near our target on the euro of US$1.17. Our projection for sterling at US$1.60 has been surpassed, and whilst the Bank of England is depicting the possibility of deflation, then it seems reasonable to assume that sterling may revisit the old lows of 2001 at US$1.40.

Equities

Volatility remains high and sentiment poor within stock markets. Risk appetite has remained well inside the panic zone for over four weeks now, which is unprecedented. Usually risk appetite recovers some months before the trough in global industrial production, and some analysts think that an extreme loss of momentum in industrial production could occur by the first quarter of next year. This is not to be confused with a sustained recovery in production; it simply means that the greatest point of deceleration may be approaching.

As an example of this point, the focus of the US government on restoring an efficiently functioning loan securitisation market (through the switch of emphasis of TARP to consumer loan help rather than just the purchase of assets that may still default) could be a significant move in slowing the decline of activity.

Concurrent with this we feel that the capitulation trade could be starting to end. Markets are trying to establish a bottom and the intense forced selling associated with the hedge fund industry has abated.

However investors may want to see extremes of valuation before committing money, prompting market stabilisation. Thus we would not rule out a further fall to the lows of October 2002 (776 on the S&P 500), giving it a significant probability of 40%.

From a longer term perspective, equities probably present reasonable value, but the risks are high given the deflationary threat that is now presenting itself. As we have indicated though, the authorities have made momentous efforts to avoid such a scenario, and they will continue to do so.

A recovery in risk appetite requires in order of preference: a reduction in Libor rates to within 50 basis points of premium to policy rates, the stabilisation of corporate bond markets and a modest return of liquidity, and the stabilisation of banking stocks as a sector within markets themselves. These are pre-requisites for general equity market stability. With regard to this last element, we are focussing on the Goldman Sachs share price as the embodiment of fortune on Wall Street.

In sum we may see a broad range develop for the S&P 500 over the following months of 776 to 1100.

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