

Economic & Market Developments

As of 9 March 2009

Overview

Bonds and equities moved lower for a second consecutive month. Bonds were hit by debt issuance worries and equities by the continued bank crisis, grim corporate profits and lower dividends.

Economic Developments

The US Q4 2008 GDP drop was revised far lower to 6.2% pa and February data points to little improvement in the economy in Q1 2009. Consumer and business confidence have remained depressed and households and businesses have continued to slash spending. The unemployment rate has climbed to 8.1%, the highest level since the end of 1983 and looks set to rise even further.

The Obama Administration's fiscal stimulus has been approved and should provide some economic lift from mid-year. A new round of supports for the banks and the credit markets have also been announced, but the markets reacted negatively to the lack of detail on how the new supports would be implemented.

In Europe, the economic data have continued to worsen, with business sentiment even lower in February than was the case in January. But inflation stayed on a downward trend. The ECB cut rates to 1.5% and put the markets on notice to expect more rate cuts soon. The UK recession also remained severe. The BoE reduced rates close to zero (0.5%) and will now buy government bonds and private sector assets to try to revive the UK credit markets.

The data also stayed grim in Japan and political uncertainties increased. The BoJ kept interest rates at 0.1% and also stepped up its quantitative easing.

In the Emerging Markets, exports remained under pressure, but China's fiscal stimulus measures are now lifting business sentiment and bank loan growth. Governments elsewhere continued to cut interest rates but the crisis in Emerging Europe intensified.

Market Trends

Pressures in the credit markets worsened. Risk aversion kept the USD strong against Europe but the JPY fell back sharply as Japan's recession was confirmed as being more severe than the recessions in the US and in Europe.

Equities were pulled lower on the disappointment that the latest bank rescue packages in the US and Europe lacked sufficient detail to reasonably judge the chances of them being successful. Terrible 2008 corporate profit results, dividend cuts and more rights issues also pulled equities lower. Emerging equities held up best in relative terms but were also down.

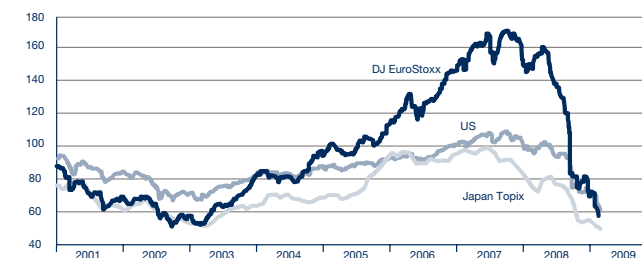
Government bonds fell again on worries over the imminent massive rise in debt issuance and on the improved corporate bond market. The sharply weaker JPY hit USD-returns from Japan.

Stock and Bond Returns*

Annual % Returns, end year to end year, y-t-d*** 2009 USD Basis	07	08	09	Feb 09
Fixed Income				
Cash/Near Cash	7.2	6.6	-0.5	-0.3
US\$ Bonds	9.0	13.9	-3.6	-1.2
European Bonds	12.1	0.6	-8.6	-0.1
Japanese Bonds	9.5	27.8	-7.7	-8.0
Emerging Bonds	6.5	-9.7	-1.0	-1.0
Equities				
US Large Cap	5.5	-37.0	-18.2	-10.6
US Small Cap	-1.6	-33.8	-21.9	-13.3
Europe	14.4	-46.1	-20.0	-7.7
Japan	-4.1	-29.1	-18.3	-10.4
Emerging (Total)	40.3	-53.7	-11.7	-3.2
Emerging Asia	44.5	-52.2	-11.6	-4.3
Emerging LA	52.8	-51.6	-5.1	-3.3
Emerging Europe/ME	28.6	-56.9	-15.4	-0.2

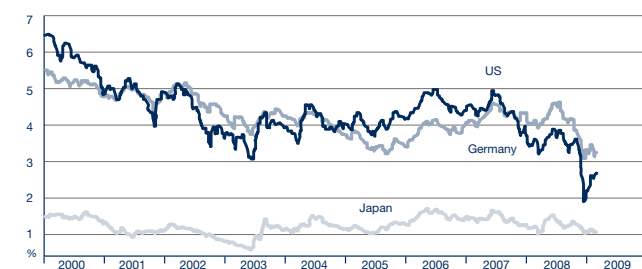
* Past performance is no guarantee of future results.

Global Stock Markets*



Index (01/2001=100)
Source Thompson Datastream
* 10-yr government bond yields

Global Bond Markets*



Source Thompson Datastream
* Indices used: For Europe; Dow Jones EuroStoxx. Japan; Japan Topix (Tokyo). US; S&P 500.

* The indexes are presented to provide you with an understanding of their historical long term performance and are not presented to illustrate the performance of any security. Investors cannot directly purchase any index. *** Year-to-date. The S&P500 (a registered trademark of McGraw Hill companies) is an unmanaged index of common stock. Sources: Citigroup Bond Indices, JP Morgan EMBI+, S&P return index, Russell 2000, S&P for Emerging, except Asia.

Overview

The equities bear market is well advanced, but the recessions currently being worked through will be far worse than average and the near-term stocks outlook remains challenging. The good news is that the financial panic phase of the crisis is probably over, whilst the aggressive worldwide monetary and fiscal policy response means that the risk of a 1930s-type economic slump is diminishing fast. On a 12-month view, we are more positive on equities, especially Asia ex Japan and Emerging Markets. However, adding some risk back into investment portfolios should be done very cautiously.

Economic Outlook

US

The recession deepened and broadened in Q4 2008 as the labour market deteriorated, house prices continued to fall, consumers stopped spending and companies slashed orders and inventories. Q4 real GDP likely dropped 7% pa.

The financial sector and households will suffer a prolonged deleveraging. House prices also still have to bottom and the unemployment rate is likely to move up further – we forecast to around 9% by end 2009 from 7.2% now. Real GDP growth is expected to be negative through to mid-2009, but recovery should start, albeit a sluggish recovery, in the second half.

The good news is that gasoline prices should stay lower. The Fed will also keep rates close to zero for as long as it takes to revive the economy and will continue with its non-conventional easing to lower credit spreads. The Obama Administration will also quickly implement another big fiscal stimulus programme.

Europe

Eurozone activity has deteriorated sharply on the financial crisis, housing slumps in a number of countries and weaker exports to the US and emerging markets. Spain, Ireland, Portugal and Greece have been under stress for some time, but recent data has brought sharp deterioration in Germany as well.

The recession will last most of 2009, but Eurozone companies and households do not need to suffer the prolonged deleveraging probable in the US and UK. Inflation should also continue to fall back. We expect the ECB to cut rates soon (from 2.5%) and see rates bottoming at 1.0% in mid-2009.

The UK recession will stay severe into 2010, given its housing slump, high consumer debt levels and banking sector downsizing. UK rates should fall to 0.5% soon (now at 1.5%).

Japan

The impact of the banking crisis has been relatively mild, but exports, industrial output and investment have been hit hard by the global slowdown. The domestic economy also has little forward momentum. Nevertheless, balance sheet rebuilding is largely complete and rates should stay ultra-low. Japan should emerge from recession ahead of the US and Europe.

Emerging Markets

The counterpart of the pull back in orders and inventories in the US, Europe and Japan, has been a Q4 collapse in exports and industrial output in Asia and the Emerging Markets.

We expect more bad news over the next few months, but the economic slowdowns should bottom out ahead of the US and Europe and a gradual recovery in the big emerging markets is expected from the second half of 2009. The combination of fiscal stimulus, sharply lower interest rates and generally sound banking systems, should lift domestic demand.

Investment Strategy

Bonds

US bond prices have soared. Concern over increased debt issuance has been outweighed by the prospect of continued disinflation and possible sustained deflation, as recessions and debt deleveraging are worked through.

We are neutral on US and European bonds near term, but expect yields to move higher (sending prices lower) over the next 12 months, even though inflation is likely to remain low far into 2010. Central bank rate cuts are likely to bottom out soon, debt issuance is set to soar during the rest of 2009 and economic activity will eventually revive. In addition, safe-haven buying should diminish as risk appetite, we forecast, gradually improves this year.

Bank of Japan rates are already very low and Japanese bond prices remain too high. Therefore, we are underweight for the short term and the long term.

Equities

Global equities bounced in December on the concerted policy response to the banking crisis/recessions and the rally may continue for a while. However, we expect the markets to move lower again over the next few months, possibly through the lows of October/November 2008, before a sustained new bull market can eventually start again.

The equities bear market is well advanced, but the recessions have a long way to go in the US and UK, and could potentially be very severe in the Eurozone and in other countries as well. Financial sector profits are only likely to recover slowly and current 2009 non-financial sector profit expectations, particularly in the US, remain too high. US corporate profits are likely to fall this year, after also falling in 2008. Therefore, we remain underweight US equities both for the near term (next three months) and for the long term - the next 12 months.

We are more positive on Europe for the long term. Valuations are more attractive, the dividend yield is higher and profit expectations look more realistic. Japan is still underweight - given soured foreign investor sentiment, the weak economy and little domestic interest.

Emerging Markets

Emerging equities should outperform over the long run, but US stocks have to bottom first. Valuations now look cheap and profit growth expectations have also moved down to achievable levels. Stimulus measures should also avert the risk of prolonged economic slumps.

Emerging debt spreads have blown out on the financial crisis, but key countries have strong balance sheets which should be resilient to slower economic growth. Liquidity or solvency crises are unlikely. Performance will improve once equities and risk appetite pick up.

Committee Actions

One-year view

Changes are now made to the one-year view every three months. The allocations for Q1 2009 are unchanged compared to Q4 2008. Equities are at neutral weight. The US and Japan remain underweight, but Europe is neutral and Emerging markets, both Asia and elsewhere, are overweight. Bonds are neutral as well, with a US, Europe and Japan debt underweight offset by an Asia/Emerging debt overweight - in line with our more positive long-run view on Asia/Emerging equities. Alternative investments and cash are also neutral.