Henderson Global Investors

Economics & Strategy
March 2010

Global Snapshot

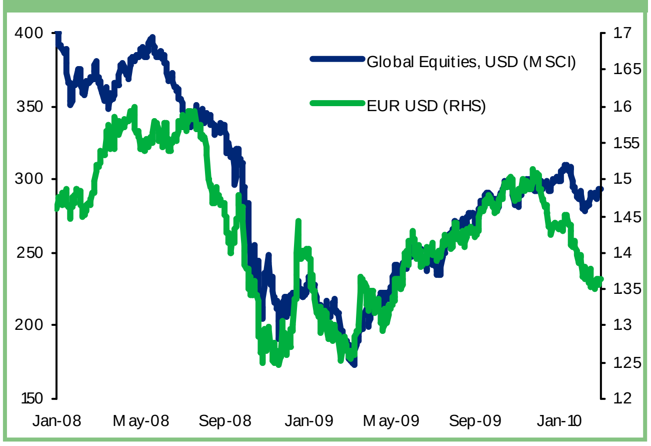
Contents

- Global risk assets staged a spirited recovery in the second half of February following a slide that began in mid-January. Better-than-expected earnings releases and signs that European and Greek officials were nearing some sort of resolution to the latter's fiscal crisis were the main catalysts for the rebound.

- German government bonds performed strongly, driven by a 'flight to quality' out of debt issued in euro peripheral countries, including Greece. On a similar theme, G7-focussed investors moved out of the euro as a result of the single currency zone's ongoing fiscal challenges, with the US dollar and Japanese yen benefitting, whilst ongoing political uncertainty sent sterling sharply lower on the month. Commodity-producing and emerging market currencies benefited from better risk sentiment.

- Policymakers continue to face a tremendous challenge in trying to foster sustainable growth against the need for more fiscal austerity. Monetary policy will likely do the 'heavy lifting' in the short run, but financial markets will force politicians' hands on fiscal consolidation. The prevailing environment presents a high level of uncertainty for risk assets in the months ahead, especially as fiscal stimulus programmes begin to 'roll off' in the second half of the year.

Markets begin to differentiate

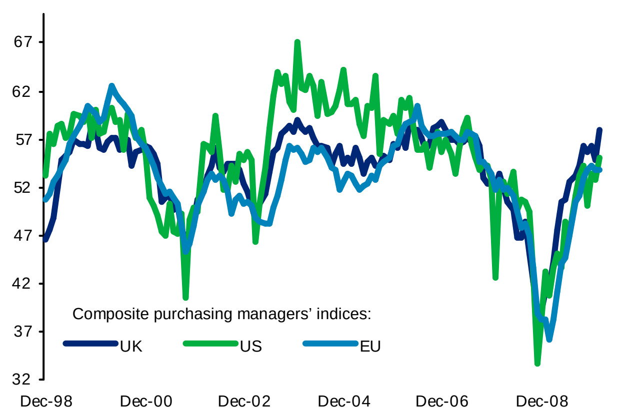


Source: Datastream, Henderson Global Investors, as at 28 February 2010

Adrian Pankiw
Strategist

Economic outlook

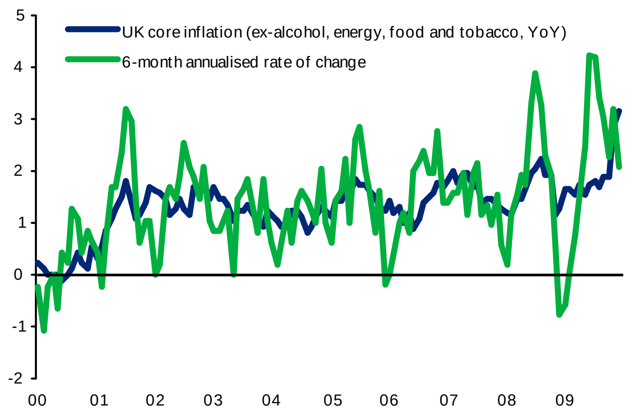
Eurozone economy beginning to lag?



Source: Bloomberg, Henderson Global Investors, as at 28 February 2010

- After moving sideways over the last few months US and UK purchasing managers' indices (PMI) – broad leading indicators of economic activity – have risen to new cyclical highs. At the same time, the eurozone's PMI has begun to falter.
- The eurozone PMI's relative weakness is unlikely to be a harbinger for a double-dip recession in the region, but rather a divergence in relative growth rates.
- The pattern resembles previous recoveries, whereby UK and US growth recovered more sharply on the back of the proportionally larger household sector, whilst the eurozone recovery, led by the smaller export sector, was somewhat more tepid.

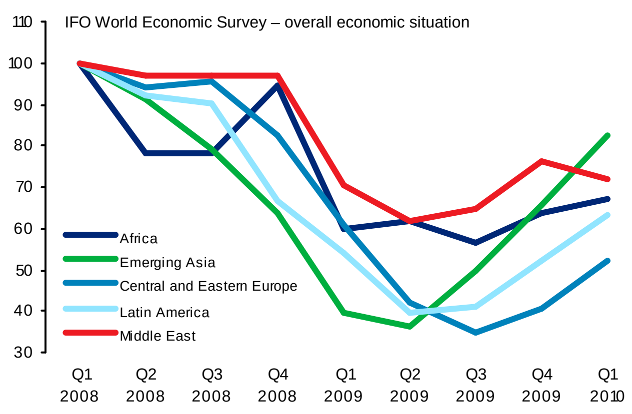
UK inflation is peaking



Source: Bloomberg, Henderson Global Investors, as at 28 February 2010

- UK inflation picked up sharply in January as the Bank of England (BoE) and most investors had been predicting. However, the high frequency rates of change show that consumer price inflation has peaked and will begin to fall sharply in the next two to three months.
- This is consistent with underlying fundamentals: a large amount of slack persists within the UK economy, average earnings growth remains subdued, and leading indices (VocaLink) point to a further decline, consumption is weak and trade-weighted sterling has been at or above year-ago levels for more than three months.

Emerging markets – Asia continues to power ahead



Source: Datastream, Henderson Global Investors, as at 28 February 2010
Rebased to 100 at Q1 2008

- Despite some signs of moderating growth, the broadbased IFO World Economic Survey indicator shows that emerging market corporate and household confidence continued to increase mid-way through the first quarter of the year.
- Emerging Asian confidence increased more than in any other region on the back of strong survey results in China, Indonesia, and Korea, whilst emerging Europe continued to lag. The Middle East was the only region to see a decline in confidence in the first quarter. The IFO/WES correlates well with actual output growth and thus points to continued strong growth in the emerging markets.

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Economic outlook

Consensus GDP growth estimates (%)	2009	2010	2011
US	-2.4	3.1	3.0
Japan	-5.3	1.5	1.5
Eurozone	-3.9	1.3	1.5
UK	-4.8	1.4	2.2
G7	-3.5	2.1	2.2
Asia ex Japan	5.4	7.9	7.4
World	-2.2	3.1	3.3

Source: Consensus Economics, as at 8 February 2010

- Low interest rates, government spending, falling inflation and a stabilising labour market should allow growth to continue to improve until mid-2010.
- Economic growth looks likely to ease in the second half of 2010 as the spending from government fiscal measures is set to wane.
- A continued labour market improvement should subsequently become the primary driver for growth.

Consensus inflation (CPI %)	2009	2010	2011
US	-0.3	2.3	2.0
Japan	-1.4	-1.0	-0.3
Eurozone	0.3	1.2	1.5
UK	2.2	2.6	1.7
G7	0.0	1.5	1.5
Asia ex Japan	1.8	3.8	3.8
World	1.4	2.7	2.7

Source: Consensus Economics, as at 8 February 2010

- Headline inflation appears to have found a nadir on stronger energy and food prices.
- Persistent excess slack is likely to restrain global core inflation.
- Taken together, headline inflation will rise, but remain below target for most of 2010.

Interest rates (%)	28 Feb 2010	Jun 2010*
US	0–0.25	0–0.25
Japan	0.1	0.1
Euro-area	1.0	1.0
UK	0.5	0.5

Source: Datastream, Henderson Global Investors, as at 28 February 2010
* Henderson Interest Rate Team forecast

- It appears as if developed market target interest rates will remain on hold until at least the middle of 2010, but probably longer.
- The Bank of England, Bank of Japan and Federal Reserve (Fed) will have paused quantitative easing by the end of this month.
- Emerging and commodity producing countries' central banks will lead the interest rate normalisation process.

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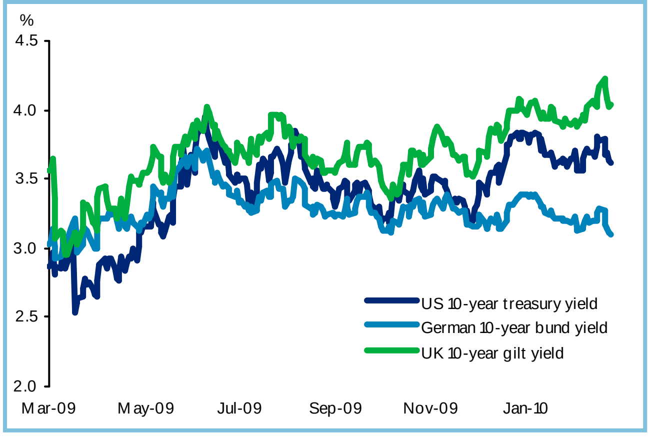
Bond and currency outlook

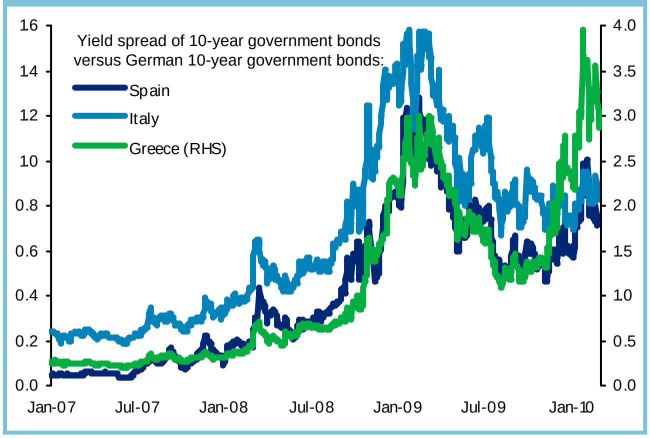
Eurozone weakness sees flight to bunds



Source: Bloomberg, Henderson Global Investors, as at 28 February 2010

- Government bond markets were mixed over February; gilts showed some volatility, selling off on some poor government tax receipts numbers, then rallying into a remarkably dovish Bank of England inflation report and subsequent rhetoric. Sterling came under sustained pressure, principally against the US dollar, on concerns about government spending and the prospect of a hung parliament in the upcoming election.
- German government bonds were the best performers (-10bp), in contrast to weakness in the UK (+12bp). The bund's strong performance has been driven by a 'flight to quality' out of debt issued in euro peripheral countries, such as Greece, into this perceived 'safe-haven'. Elsewhere, US yields finished nearly flat with the Fed's decision to raise the discount rate having little effect.

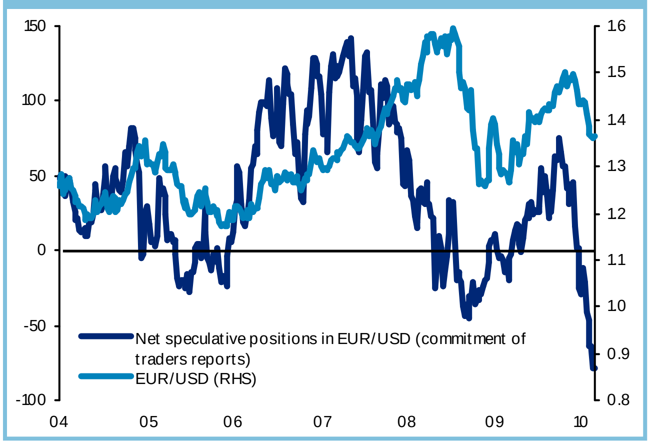
Will eurozone peripheral outperformance be sustained?



Source: Bloomberg, Henderson Global Investors, as at 28 February 2010

- In recent months, eurozone government bond performance has mostly been driven by news flow on Greece's fiscal crisis.
- Thus, the most recent deficit reduction measures taken by Greece and indications that 'some sort' of EU-backed support was forthcoming drove eurozone peripheral government bonds* to outperform toward the end of February.
  *each of Greece, Italy, Portugal, and Spain either have a large government debt burden and/or unsustainable deficit
- Though the eurozone will continue to face fiscal challenges, eurozone officials are unlikely to allow a default scenario to play out given the damage this would cause to eurozone credibility. As a result, peripheral yield spreads (chart) should tighten further.

Short positioning in euro is extreme



Source: Bloomberg, Henderson Global Investors, as at 28 February 2010

- Investors are short the euro in record amounts, according to the CFTC's commitment of traders reports.
- The market has only been net short the euro three other times in history, but nowhere near the current magnitude.
- Extreme positioning of this sort often leads to a sharp move in the opposite direction as fresh news contradicting the prevailing view emerges.
- With a resolution to Greece's fiscal travails likely to emerge before April and eurozone economic data holding in, a snap-back in the euro may be imminent.

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Bond and currency outlook

10-year bond yields (%)	28 Feb 2010	2010*	2011*
US	3.61	↑↑	↑
Japan	1.31	↑	↑
Eurozone	3.10	↑	↑
UK	4.03	↑↑	↑

Source: Datastream, Henderson Global Investors, as at 28 February 2010
* Henderson Interest Rate Team view

- Government bonds are likely to weaken in the near term as quantitative easing comes to an end.
- Improving economic growth, rising inflation, normalising interest rates, and heavy issuance will send government bond yields higher in 2010.

Currencies	28 Feb 2010	2010*	2011*
Yen/$	89	↑	→
$/Euro	1.36	↓	→
Euro/£	1.12	↑	↑
$/£	1.52	→	↑

Source: Datastream, Henderson Global Investors, as at 28 February 2010
* Henderson Interest Rate Team view

- The dollar could continue to appreciate on the back of solid US data during the first half of 2010, but the path of least resistance for the dollar remains down in the longer term.
- Despite an attractive valuation, sterling will struggle against most G10 and emerging market currencies until there is more clarity on the UK government's fiscal position.

Emerging markets and commodities	2010*	2011*
G4/EMFX	↑	↑↑
Emerging market interest rates	↑	↑↑
Oil	↑	↑↑
Base metals	↑	↑↑
Precious metals	↑	↓↓
Agriculture	→	↑↑

Source: Datastream, Henderson Global Investors, as at 28 February 2010
* Henderson Interest Rate Team view

- Strong productivity growth, higher relative interest rates, positive demographics and in, some cases, an abundance of natural resources should ensure emerging market currency appreciation against the major, non-commodity producing developed markets.
- Gold has benefited from abundant liquidity conditions, which should persist at least until mid-2010. Beyond then, the outlook is less certain.
- Oil and base metals should continue to benefit from an improving economy and tight supply conditions.

↑↑	Strong upward trend
↑	Upward trend
→	Little change
↓	Downward trend
↓↓	Strong downward trend

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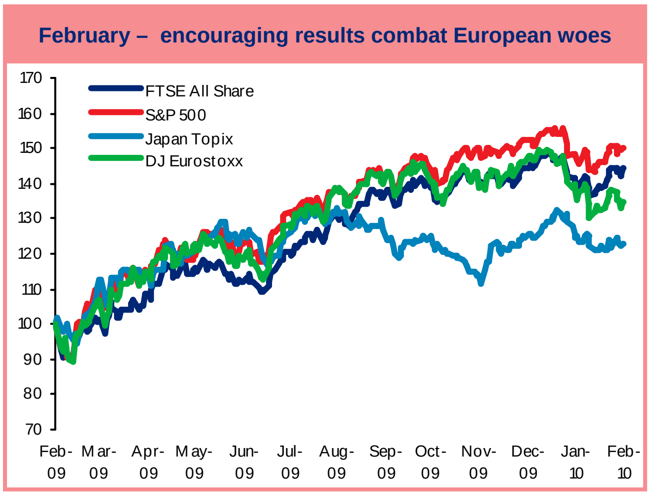
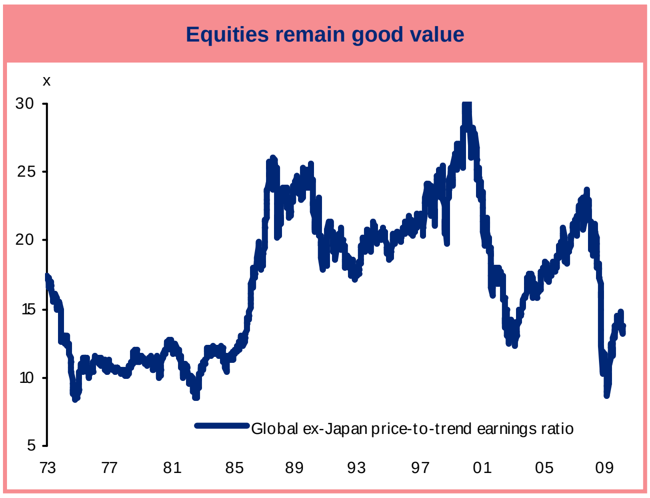
Equity outlook



Source: Datastream, Henderson Global Investors, as at 28 February 2010
Rebased to 100 at 28 February 2009

- During February better-than-expected Q4 results, driven notably by both bottom and top-line growth, played off against a more mixed macroeconomic backdrop. Greece's fiscal crisis continued to weigh on sentiment, with questions also being asked about the size of the UK's deficit. Tightening measures in China ahead of the lunar new year and the US Fed's earlier-than-expected move to raise its discount rate contributed to the volatility.

- Global equities (MSCI World) finished the month 2.0% higher, although this masked regional variations. The US market finished 3.1% higher, fuelled by a good earnings season, but Europe posted a 1.7% decline on Greek fears. Japan was also marginally weaker (-0.7%), hit by yen strength.

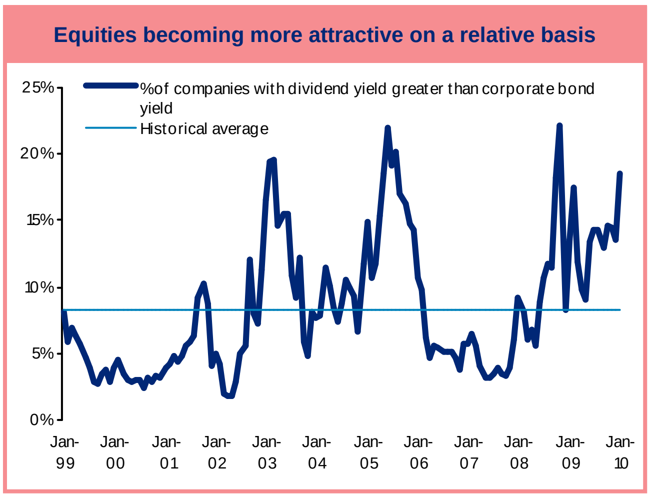


Source: Datastream, Henderson Global Investors, as at 28 February 2010

- As mentioned in the previous month's edition of *Global Snapshot*, earnings and revenues have both beaten analyst estimates in the fourth quarter in the US.

- The positive surprises have led to a further ratcheting up of analyst estimates to 25% earnings growth from current levels, which some see as unrealistic.

- However, even a 25% increase in earnings from current levels would still leave them 11% below their trend level and the market trading on a 15x price-earnings ratio, which is below its historical average of 17x.



Source: Goldman Sachs as at 31 January 2010

- Equity investors have often used a positive spread between equity dividend yields and benchmark government bond yields as one of a number of reasons to be bullish on equities, although this simple assessment has not always worked.

- One reason for this is that government bonds are a nominal asset whilst equities are a real asset, which makes their direct comparison somewhat flawed.

- A better comparison is between the yields on individual companies' bonds and their equity dividend yields as both have embedded elements of credit risk. Currently, there is a relatively high percentage of companies whose dividend yields are higher than their corporate bond yields, making equities look relatively attractive from an asset allocation perspective.

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Equity outlook

Equity market levels	2010*	2011*	2012*
US	→	↑	↑↑
Japan	↑	↑	↑
Euro-area	→	↑	↑↑
UK	↑	↑	↑↑
Asia ex Japan	↑↑	↑	↑
MSCI Emerging Markets US$	↑↑	↑	↑

Source: Henderson Global Investors, as at 28 February 2010
* Henderson Interest Rate Team view

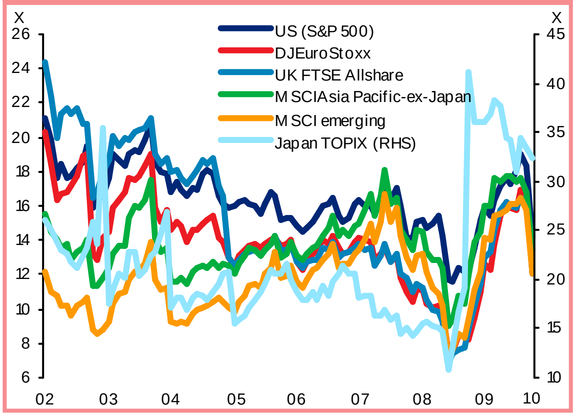
Consensus EPS growth forecast	2010	2011	2012
US	29.9	20.1	13.3
Japan	N/A	88.6	23.9
Euro-area	29.0	23.4	13.7
UK	30.9	24.0	13.2
Asia ex Japan	27.3	16.0	9.1
MSCI Emerging Markets US$	31.3	19.1	13.1

Source: Datastream, Henderson Global Investors, as at 28 February 2010

Equity market returns for February 2010 (%)	Local	Sterling	Dollar
US	2.9	7.9	2.9
Japan	-0.8	5.6	0.7
Euro-12	-1.9	1.2	-3.6
UK	2.9	2.9	-1.9
MSCI Far East ex Jap (US$)		5.2	0.3
MSCI Emerging Markets US$		5.2	0.3

Source: Bloomberg, Henderson Global Investors, as at 28 February 2010

Price-to-forward earnings ratio



Source: Datastream, Henderson Global Investors, as at 28 February 2010

- With over a third of S&P 500 companies having reported at time of writing, 75% of companies have beaten their earnings and revenue estimates.
- Due to Japanese earnings estimate volatility, a valid growth rate for 2010 cannot be calculated.
- Multiple expansion has stalled and equities appear fair value on most measures. Equities appear cheap on a cyclically-adjusted (Graham-Dodd) price-earnings basis.
- If signs emerge that forward earnings estimates may not be achieved, then multiples may once again compress. To that end, the bottoming in resource utilisation rates is encouraging.
- We believe the equity market rally will continue during the first half of 2010 on the back of positive earnings growth and continued positive surprises in both industrial production and household consumption data.
- The outlook beyond the second quarter remains highly uncertain and is reliant on continued positive data surprises and resultant positive earnings revisions.

↑↑	Strong upward trend
↑	Upward trend
→	Little change
↓	Downward trend
↓↓	Strong downward trend

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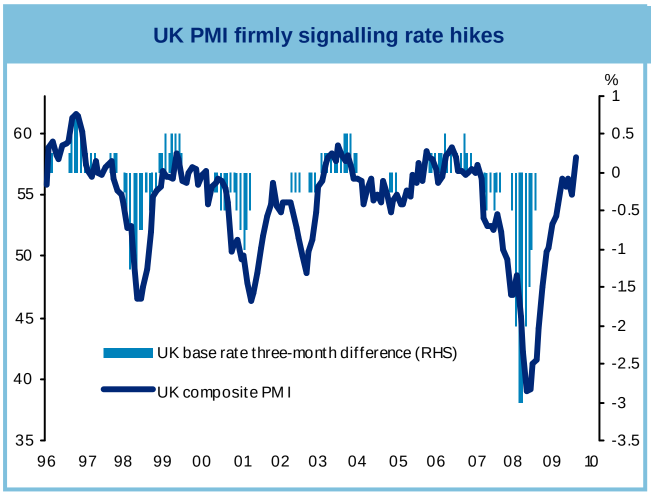
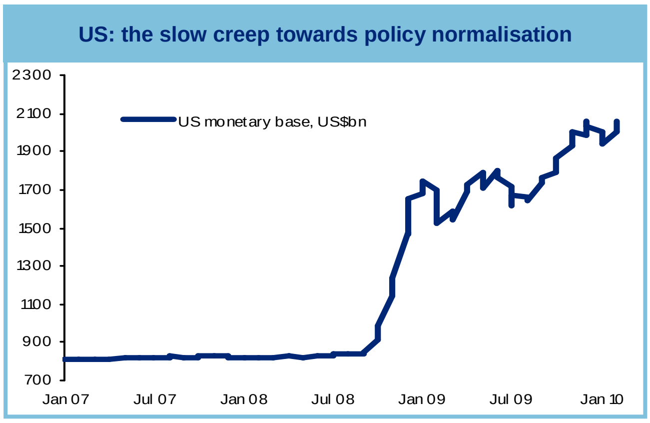
Key issues



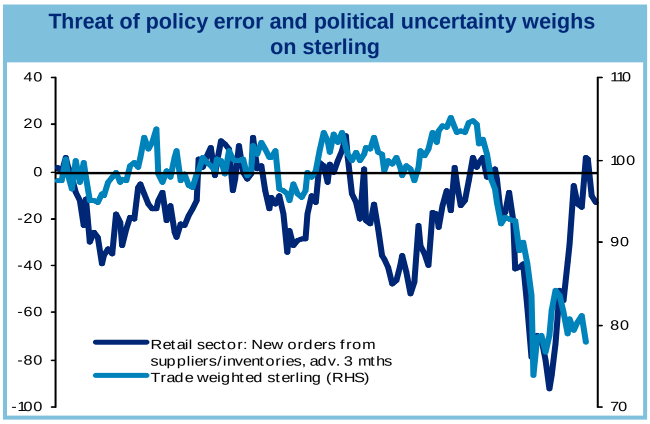
Source: Bloomberg, Datastream, as at 28 February 2010

- As mentioned in the economic outlook section, the UK's composite PMI picked up sharply in February to a level that has historically been consistent with rate hikes by the BoE.
- The rebound in the PMI and other leading indicators – notably in the labour market – at a time when the BoE's monetary policy remains ultra-accommodative and the UK's inflation rate is more than 1% above its target, has begun to unnerve some investors.
- The expected decline in inflation in the months ahead should give the BoE some respite, but as growth picks up it will be forced to either prepare markets for policy normalisation or face the prospect of a sterling crisis.



Source: Datastream, as at 28 February 2010

- The Fed continued to unwind some of its emergency policy measures in February – most notably through the expansion of its special funding program (SFP) and a hike in its discount rate.
- The increase in the SFP amounts to $200bn more discount bill issuance, which is meant to absorb most of the liquidity created from the remaining mortgage-backed securities purchases the Fed has committed to. The discount rate increase is meant to bring its spread to the Federal funds rate closer to historical levels – around 100bp.
- These measures amount to small liquidity operations when compared to the total size of the balance sheet, but do signal the Fed's intent to slowly normalise monetary policy.



Source: Datastream, Henderson Global investors, as at 28 February 2010

- Sterling came under renewed pressure towards the end of February, having dropped over 4% – its largest monthly decline since November 2008.
- A confluence of factors were to blame for the fall, including heightened political uncertainty (and hence uncertainty regarding the prospect for fiscal consolidation), expectations of a large M&A-related outflow out of sterling and rising unease about the possibility of a monetary policy error resulting in an inflation overshoot.
- As all three factors are expected to persist, the potential for a sterling rally remains rather low over the next two to three months.