A weak start to the year, but we remain positive on the outlook for 2008

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Summary

- Although data is pointing to a slowdown in economic growth, we do not expect the US to slip into a deep and sustained recession.
- We remain overweight equities in our multi-asset class portfolios, with a preference for emerging markets.
- With government bonds, we feel prices are at unsustainable levels and expect yields to rise.
- In commodities, although some prices are being affected by poor economic data in the short term, longer term drivers for positive performance remain in place.
- We are reducing our US dollar underweight versus European currencies into strength but continue to short sterling.

"Despite a slowdown in economic and corporate profits growth, equity market valuations are reasonably positive. We have maintained a moderate overweight in equities relative to bonds in our multi-asset class portfolios. For long-term investors, the current period of volatility could provide opportunities to add to their equity market exposure in the months ahead."

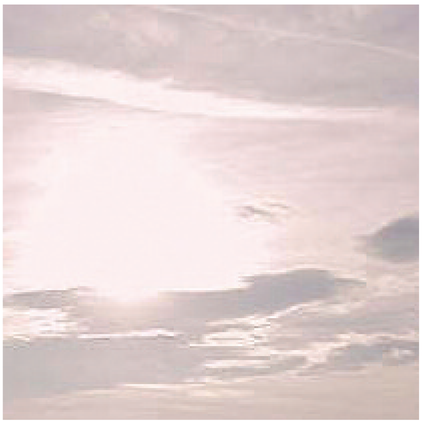
Financial markets continue to be volatile – has the economic situation worsened?
Over the last few weeks, the economic picture has certainly changed – and not for the better. Investors continue to fear the worst: a deep and sustained US recession and the subsequent negative impact on rest of the world. With the US, two key sets of data have been under the spotlight – employment numbers and the Institute for Supply Management's (ISM) non-manufacturing index.

Employment numbers have turned weak, driving consumer confidence lower and increasing recessionary fears. In fact, the key non-farm payrolls number would need several months of 200,000-plus growth to get back on track to an economic growth scenario – something which is very unlikely to happen.

On the production side, the ISM non-manufacturing index contracted in January, falling to 44.6%. Surprisingly, it is the more defensive sectors of agriculture and healthcare that have seen particular weakness. In addition, the ISM's business activity index fell to 41.9% – its first contraction for almost six years.

Has this changed your expectations about a US recession?
We have been saying for sometime now that our expectations were for weak US growth in the first half of 2008, followed by a pick-up in the third and fourth quarters. We remain of the same opinion. In our view, thanks to the aggressive actions of the Federal Reserve (interest rates cut by 125bps within a nine day period and further cuts likely) and the Bush administration's $150bn fiscal stimulus package, the US economy is unlikely to experience a deep and sustained US recession.

What about economic growth outside the US, are things looking better?
Unfortunately, economic growth appears to be slowing globally. European indicators are on a downward trend. Although sentiment indicators in the key Eurozone economies remain above average, they are clearly headed in the wrong direction, as shown in chart 1.



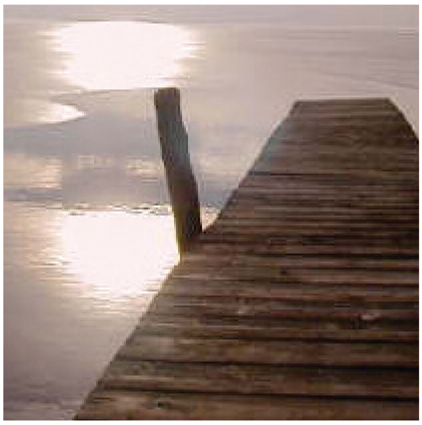
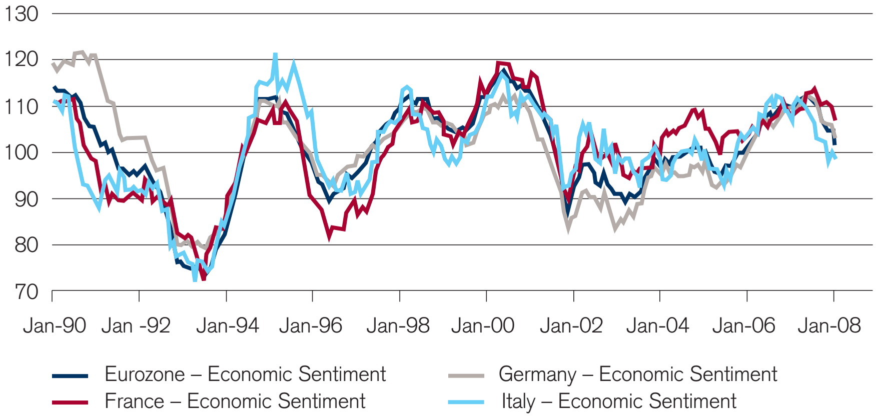


Chart 1: Macro Data EMU – Economic Sentiment



Source: BNB, Bloomberg, EC, IFO, INSEE, Credit Suisse/IDC

Last Data Point: 31.01.2008

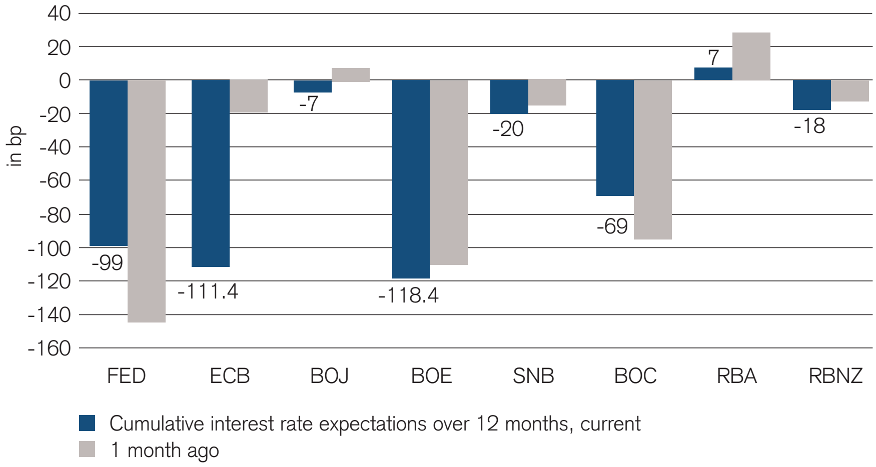
For several months, there has been a lot of talk about the de-coupling scenario – the idea that non US economies would not struggle in the face of a US economic slowdown. We are now seeing this talk move back towards a re-coupling scenario. Market movements over the last few weeks would certainly indicate that investors are not convinced that the economies of Europe and Asia will be able to insulate themselves from a slowdown in the US.

Are you worried about inflation?

The inflation threat is a very real one and not something that should be ignored. Although the Fed, through their focus on stimulating economic growth, is indicating their willingness to ignore inflation, we believe the European Central Bank (ECB) will continue to be much more disciplined. They have not cut interest rates yet, based on concerns about inflation, and we believe they will continue to monitor the situation closely and not act hastily.

That said, expectations of what the ECB will do have changed considerably over the last month. At the start of the year, there were expectations of less than 20bps of cuts this year – but this has now changed and market participants are predicting more than 110bps of cuts.

Chart 2: Central Bank Rates: Interest Rate Expectations



Source: Bloomberg, Credit Suisse/IDC

Last Data Point: 08.02.2008

How do these views then translate in terms of asset allocation?
As our expectations surrounding the possibility of a US recession have not really changed, nor have our asset allocation views. Within our multi-asset class portfolios we continue to have a preference for assets that are seen as relatively less defensive. In particular, we are focusing on equities and alternative investments over bonds.

Although the macroeconomic situation is turning less positive, with growth expectations being revised lower and inflation rates rising, in our opinion, there is still lots of value to be found in equity markets. We would view the current volatile environment more as a correction rather than a real reversal in market participants' risk appetite.

In an environment of slowing economic growth there are, not surprisingly, concerns about what will happen to corporate profits. While we agree with the consensus that the pace of profits growth will slow, the truth is that even if profits stay stable or slightly negative, at current valuation levels equities are still very attractive. Therefore, despite the weak start that we have had, returns from equity markets should be positive for the year as a whole.

Which equity markets offer the best value?
We are especially positive about emerging markets. Despite the fact that emerging markets generated very strong returns last year, we believe they remain the place to be. However, this year we expect growth to be less export orientated and skewed more towards domestic demand. During the market sell-off in January these markets were amongst the worst affected, indicating the level of risk they carry. This means that volatility could continue to be a feature.

We remain wary of Japan where a collapse in consumer confidence is screaming "Danger Ahead!". In addition, there are concerns about sub-prime induced losses and write-offs as the fiscal year end is getting closer and the quite strict regulations will force Japanese companies to be more transparent about their balance sheets over the coming weeks.

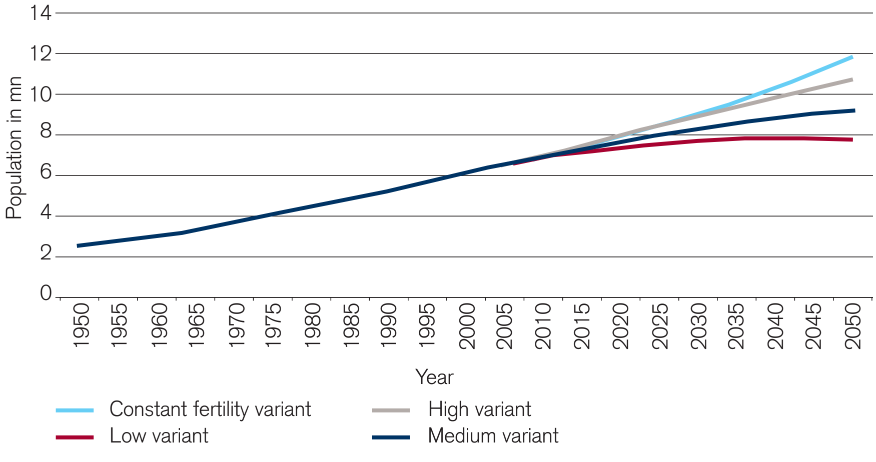
You said you were underweight bond markets – can you expand on this?
Government bonds have been a beneficiary of the "flight to quality" that we have been seeing for several months now and not just the last few weeks. In our opinion, yields are now at unsustainably low levels and in some instances are yielding less than the rate of inflation. Although they could remain supported by further short-term volatility in equity markets, we expect prices to correct over the coming months.

On the contrary, we see some good opportunities in top rated corporate bonds, which have been equally priced down in the overall risk aversion.

Is slowing economic growth not bad news for commodities?
Expectations of a slowdown in economic growth have had some negative impact on commodities with investors pricing in a drop in demand. However, if the global economy picks up as expected in the second half of 2008, there will be renewed demand and we could see prices move higher.

While we may see some short-term volatility, it´s important to remember that long term drivers of commodities remain in place. A key driver is population growth – regardless of economic ups and downs, the world's population is only going in one direction. The long-term supply/demand equation therefore remains firmly biased in favour of higher commodity prices.

Chart 3: Population Growth until 2050



Source: UN

At the moment our favoured areas are precious metals and agriculture, while we are avoiding the more cyclical industrial metals.

Can you comment briefly on currencies?

With respect to our currency exposure, we are reducing our US dollar underweight versus European currencies into strength but continue to short sterling. We believe that the UK economy is likely to be one of the worst impacted by a slowdown. UK consumers are heavily leveraged to house prices and, with all expectations pointing to a severe slowdown in the property market, we could see consumers tighten their belts significantly.

Although we could see dollar weakness reverse against European currencies, we expect it to remain weak against emerging market currencies.

Finally, what would you say to investors who are worried about the increasing levels of volatility in financial markets?

With uncertainty high in many areas, volatility is likely to continue to be a feature. In fact, it could be argued that rather than the exception, 2007 and the start of 2008 are a return to more normal conditions and it was in fact the low volatility years of 2003 to 2006 that were abnormal.

However, with volatility comes opportunity, and for investors looking to make longer term allocations to the equity markets the weeks and months ahead could provide some good opportunities.

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