

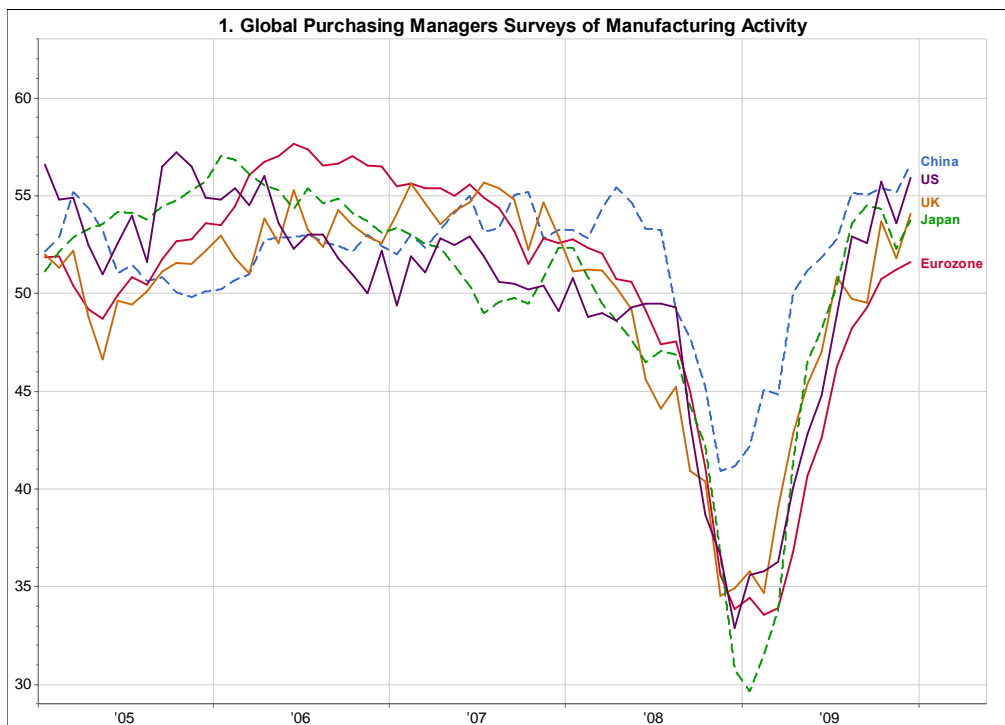
Global Economic Outlook and Portfolio Strategy

Fulcrum Asset Management LLP

Global Economic Outlook

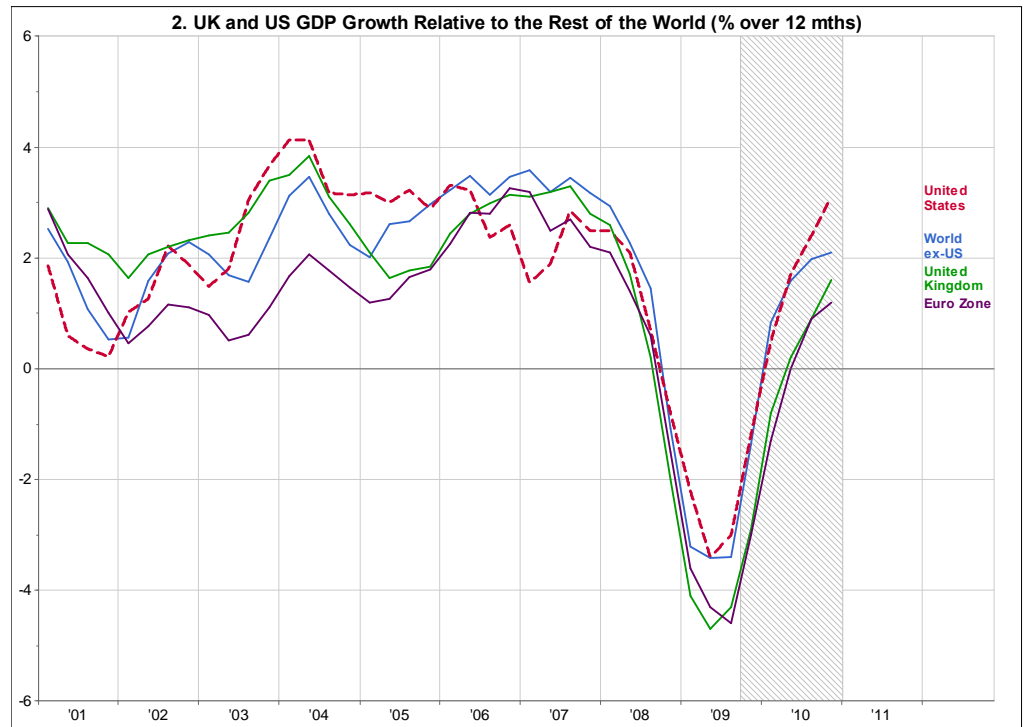
The fourth quarter of 2009 saw continued improvements in the global economy, with synchronised growth apparent in all major regions of the world. Thus far, the economic recovery has been heavily dependent on government stimulus, without which a much more severe and prolonged recession would have undoubtedly materialised. However, business surveys of the global manufacturing sector continue to signal a sharp acceleration in economic activity. This bodes well for GDP growth and corporate earnings over coming quarters.

Global economic growth will remain strong for the first half of 2010, as low interest rates and government stimulus prompt a recovery in business investment.



Longer-term growth prospects are more uncertain, as government support for the economy wanes and the painful process of debt deleveraging continues.

Graph 2 outlines a possible short term path for GDP growth in the world, the US, Europe and the UK. Beyond 2010, we expect the recovery to be below average as the inevitable withdrawal of fiscal stimulus and normalisation of interest rates weighs on the global economy. In the UK, which has been particularly exposed to the housing and financial market recessions, the recovery may lag that seen in the US and some other economies.



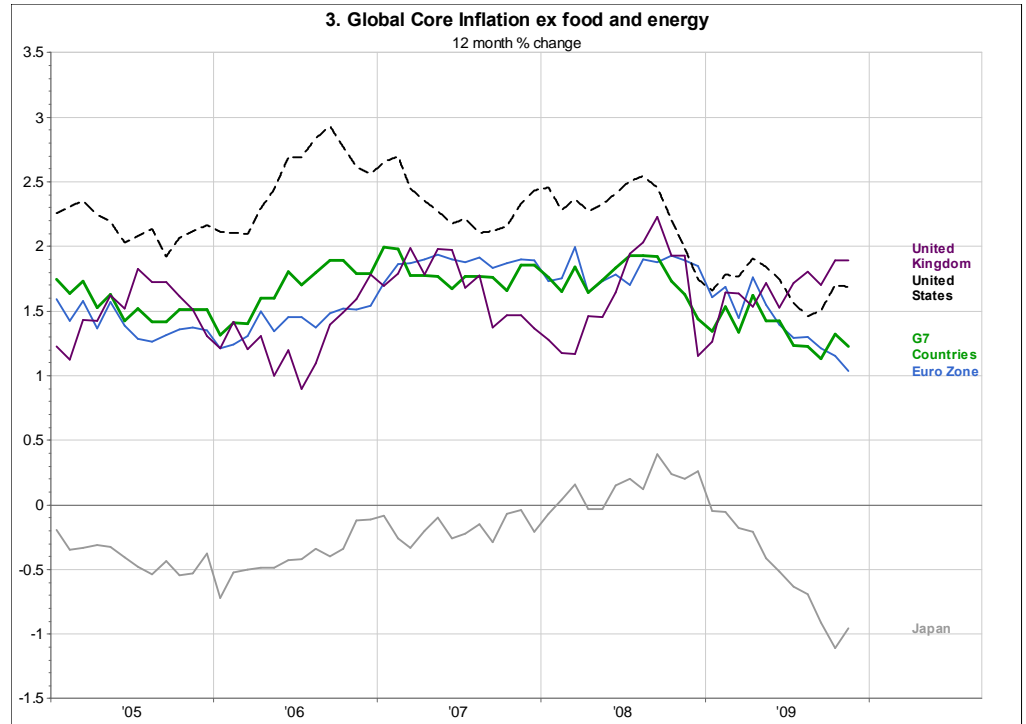
The near-term inflation outlook remains benign, driven by stressed credit markets and substantial excess capacity in the manufacturing sector.

In our opinion, it will be very difficult to generate inflation in Western economies over the next two years. Although uncertainties abound beyond that horizon, asset prices will first react to benign near-term inflation expectations and only subsequently reflect the longer-term outlook. As we attempt to identify potential sources of near-term inflation, the current evidence suggests that upside risks to inflation are in fact quite small, for two primary reasons:

1. Despite the deluge of new corporate bond issues, bank lending remains abnormally low. Going forward, we expect lending standards to remain tighter than usual, thereby keeping credit channels clogged.
2. The severe extent of the 2008/9 recession has resulted in substantial excess manufacturing capacity (high unemployment and low utilisation of plant and equipment) within the developed world. While business surveys have indeed improved, the level of GDP remains substantially below levels reached prior to the most recent recession.

Taken together, these two factors are intensely deflationary and should more than counter the inflation uncertainty brought about by rising government debt levels and a prolonged period of low interest rates. Core inflation levels are already falling in most parts of the developed world, with Japan experiencing the most severe deflation it has faced in the post-war period.

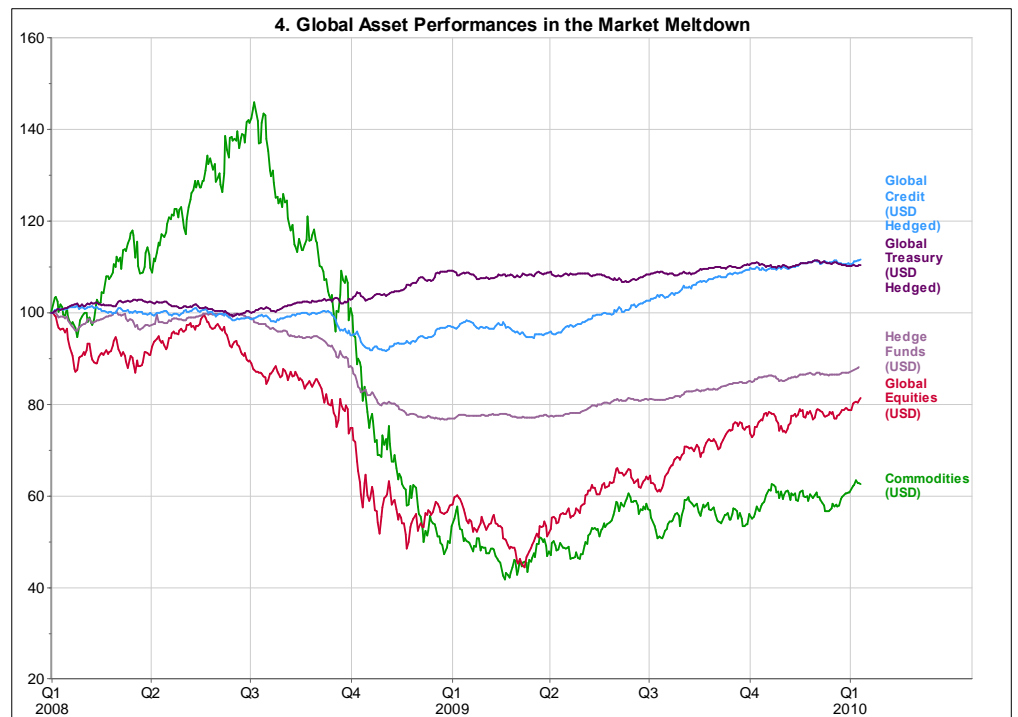
With the exception of the UK, where currency weakness has increased inflationary pressures, core inflation is trending lower in most major economies.



Portfolio Positioning

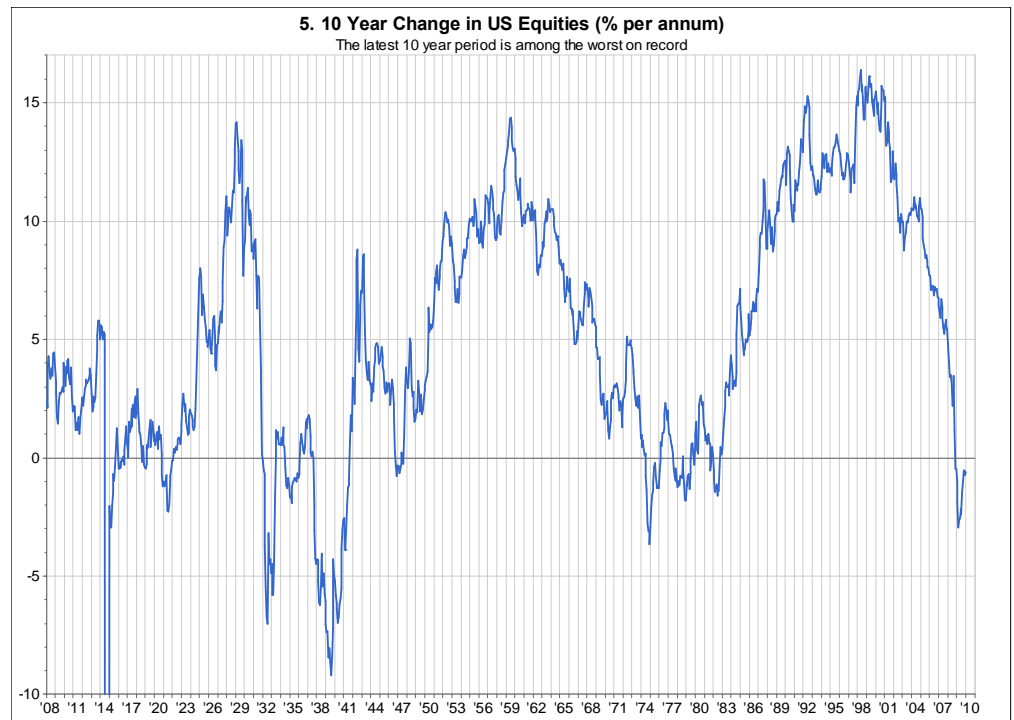
The overall environment of strong short term growth and well behaved inflation continues to be favourable for equities, commodities and hedge funds.

The improvement in economic indicators during the second half of 2009 helped sustain strong returns from equities, credit, commodities and hedge funds, while posing substantial headwinds for government bonds.



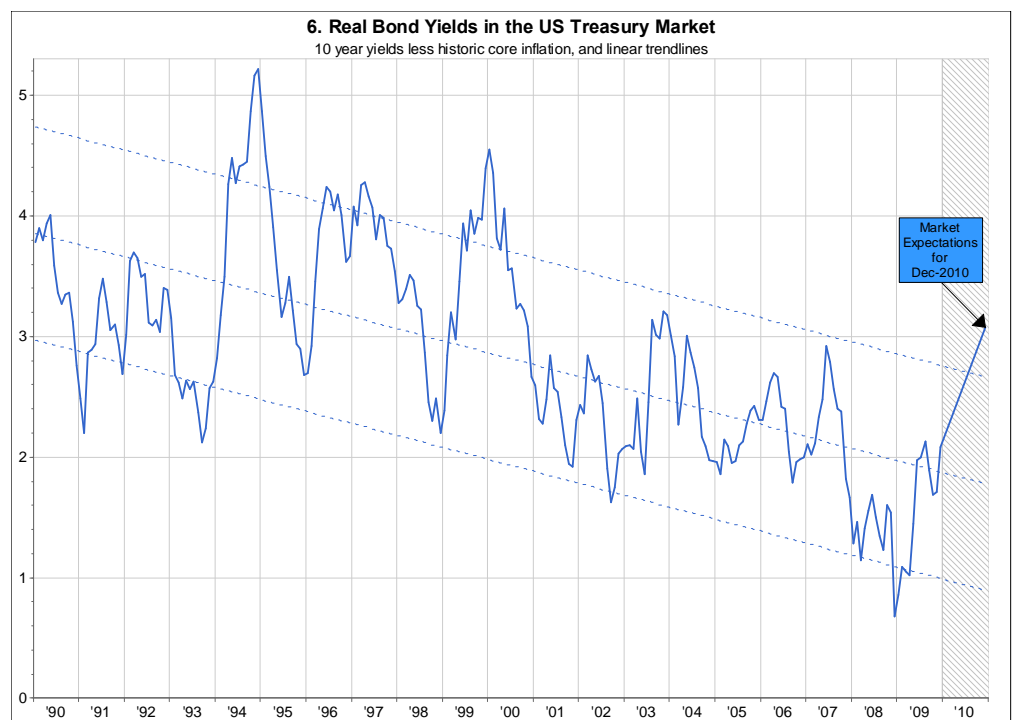
We believe that the combination of economic recovery . albeit at a slow pace . and low inflation is likely to provide further support for risky assets, such as equities, credit and commodities. While valuations for cyclical assets are no longer as cheap as they were in the spring of 2009, neither are they overly expensive. Even after the recent rally, it remains true that the last decade has been one of the worst on record for equity prices; global equities

remain substantially below levels reached ten years ago and are at the low end of their 25 year range versus government fixed income securities.



The market expects 10 year real bond yields in the US to head higher than 3% over the next twelve months. We believe this is highly unlikely in the context of sub-par economic growth.

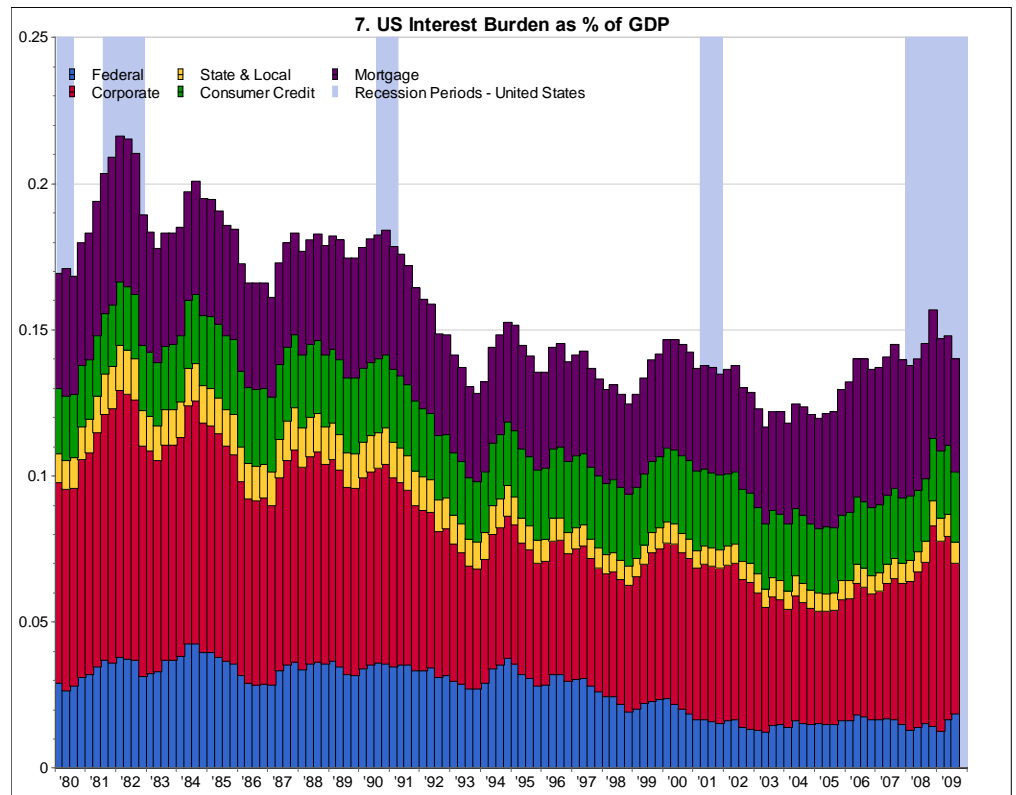
Graph 6 shows that the real yield on US Treasuries has been dropping for about twenty years and is expected to break significantly higher over the next twelve months.



While a 2.5% to 3% real yield is in line with trend GDP growth and appropriate for the long term, we believe that the US economy is likely to grow below trend for the next several years and be unable to withstand a sharp increase in the cost of borrowing without heading back into recession. Graph 7 shows that the interest burden faced by the broad economy

With debt to GDP levels approaching 250% in the US, the ability of the economy to withstand a normalisation in interest rates is questionable.

(including households, corporations and government) is currently close to average levels in spite of the low level of interest rates . a reflection of excessive debt levels. Even a one percent increase in the cost of borrowing could prove highly dangerous for economic prospects.

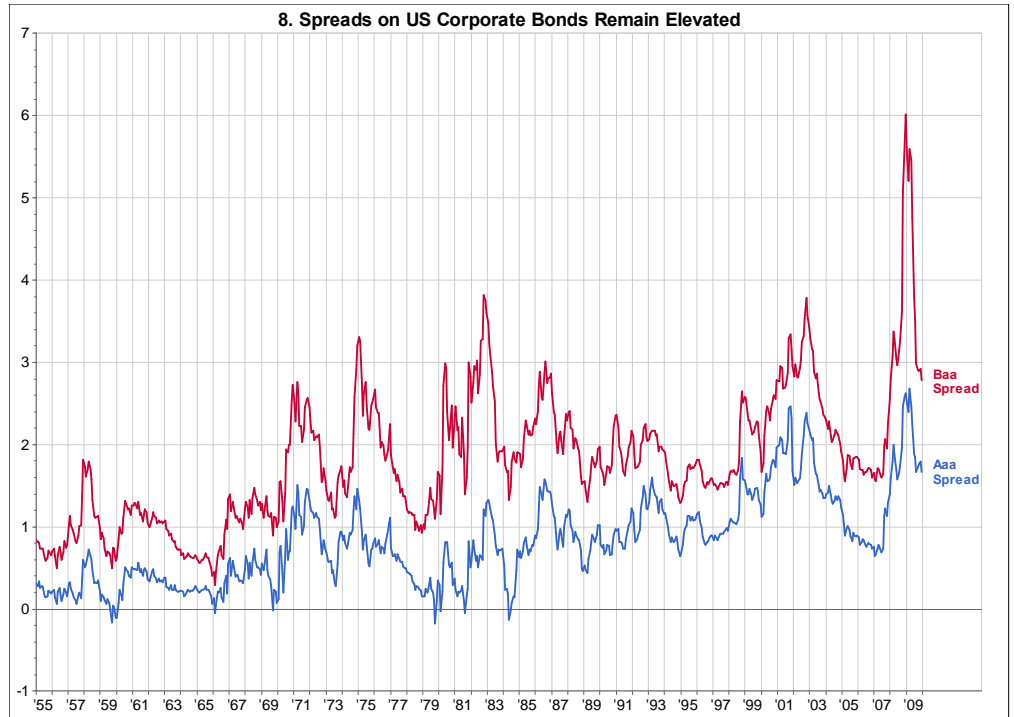


Benign inflation and low short term interest rates should prevent longer dated bond yields from rising significantly. At the same time, the steepness of yield curves should allow bonds to outperform cash, which will continue to yield close to zero.

Given this backdrop, it is likely that bond investments will outperform cash in 2010. In our opinion, major central banks will maintain interest rates at extremely low levels throughout the year in fear of a growth relapse and comforted by the absence of inflationary pressures. In such an environment, steep yield curves afford bond investors substantial protection against capital losses. Importantly, the vast majority of investors already expect 10 year government bond yields to rise substantially over the course of the year and have been selling bonds aggressively over recent weeks; as a result, December was the second worst month for US 10 year Treasuries in over twenty five years! From a contrarian perspective, we believe that short term prospects for government bonds are quite attractive. Over a longer horizon, however, bond returns may be rather lower than they have been in the past couple of decades as increasing government debt puts upward pressure on yields.

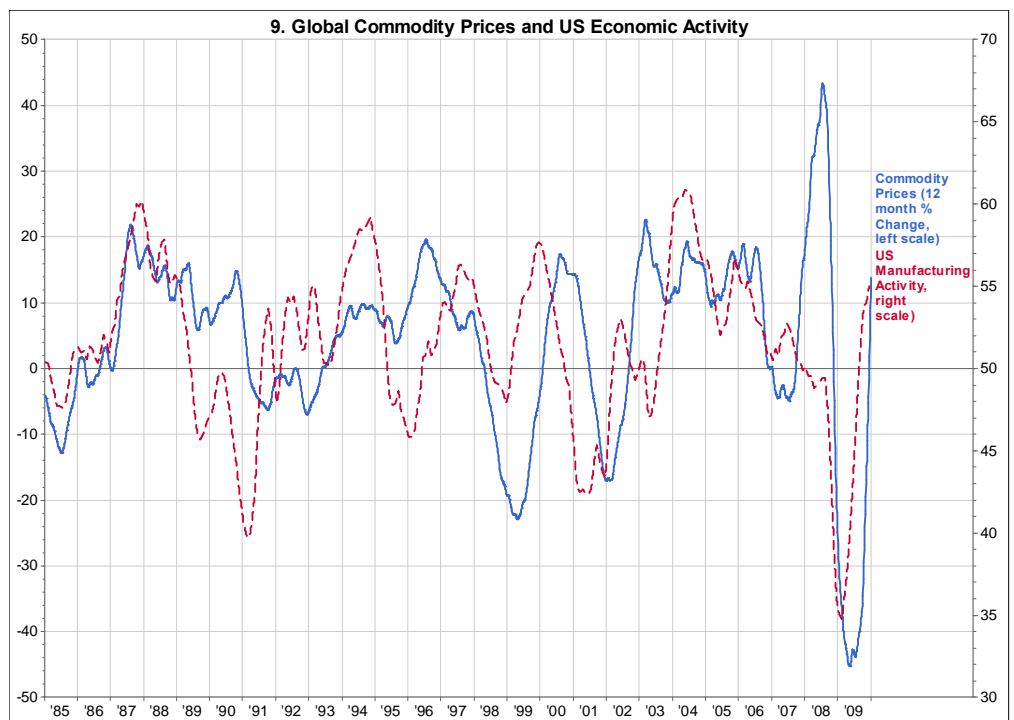
Elsewhere within bond markets, the outlook for investment grade corporate and asset backed bonds remains favourable, with spreads still well above long-term averages and offering attractive protection against defaults. High yield corporates, on the other hand, face the daunting prospect of significant refinancing and a deterioration of credit quality . a reflection of issuance during the boom years. As a result, we maintain all of our credit exposure within investment grade markets.

Corporate bonds continue to offer attractive returns and should outperform government securities.



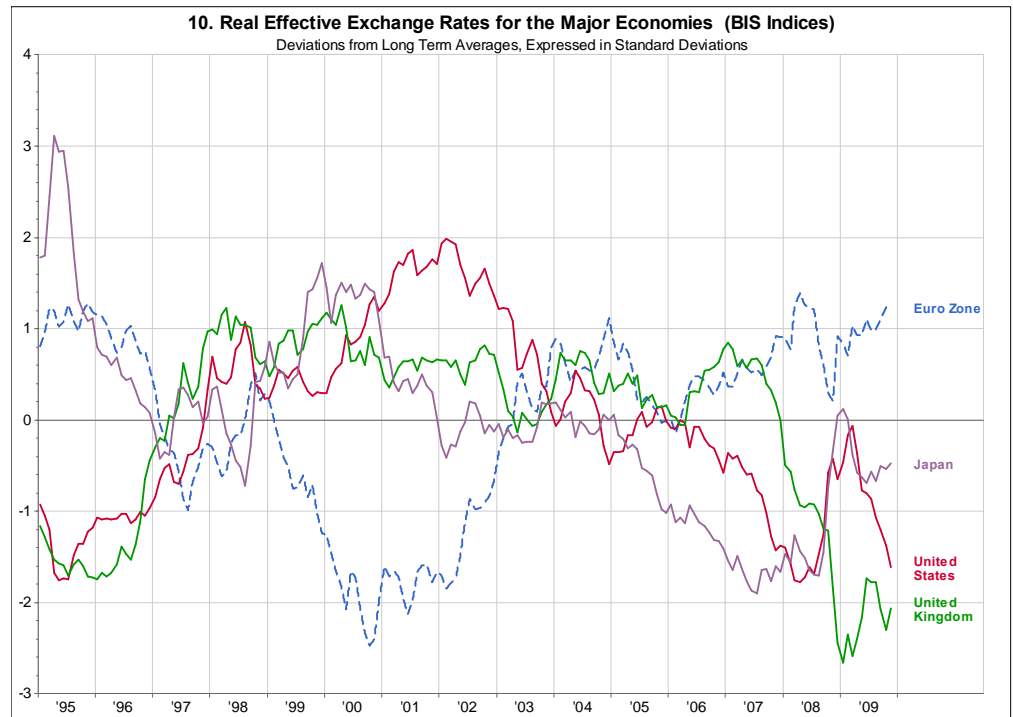
We maintain exposure to commodities, including gold and oil, in anticipation of strong returns and as a portfolio hedge, in case we underestimate inflationary pressures.

Turning to commodities, we maintain a positive stance towards the asset class for three primary reasons. First, the violent correction in commodity prices during 2008 has removed most of the speculative froth from this market and brought it more in line with long-term trends and fundamentals. Secondly, commodities should provide diversification and act as a hedge against unanticipated inflation shocks. Finally, commodity prices are likely to be supported by improving domestic demand in both developed and emerging market countries, such as China, where the fiscal stimulus has boosted economic activity and re-ignited demand for resources. As the global economy normalises, we will carefully assess actions of the Chinese authorities, who are likely to introduce further tightening measures in order to prevent their economy from overheating.



The British pound is extremely cheap against the euro; this misalignment will likely correct in 2010.

Within currencies, the only major standout is the overvaluation of the euro versus the British pound. Having been very pessimistic on the British pound throughout 2008 and comfortably on the sidelines throughout 2009, we believe that 2010 will see this valuation misalignment significantly corrected. Elsewhere within currencies, we anticipate continued strength in emerging markets on the back of robust domestic demand and sound government finances. On the other hand, we expect weakness in the Japanese yen as investors return to higher yielding currencies and sell the low yielding yen to fund these positions. Furthermore, embracing currency weakness remains one of the few policy options left for Japanese authorities if they are to successfully fight against worsening deflation.



Conclusion

In conclusion, we believe that the global economy will continue to strengthen over coming quarters but lose some of its current steam towards the end of 2010. Meanwhile, inflation will remain subdued which in turn should enable central banks to maintain unusually low interest rates for an extended period of time. The combination of positive economic growth, generally attractive valuations and low interest rates will help provide a supportive backdrop for risky assets, such as equities, credit and commodities, all of which are likely to outperform government bonds.

Despite this positive backdrop, it is important to maintain diversification and remember the importance of active risk management. The global economic recovery will remain vulnerable until domestic demand picks up sufficiently to help the broader economy withstand a gradual normalisation in interest rates and withdrawal of government stimulus. Currently, the recovery is strong but not yet robust.

Graphics Source: Factset

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