

December 2009

Investment decisions for 2010

- Excess capacity will moderate inflation pressures in 2010, and therefore keep interest rates lower for longer
- The strength of corporate earnings growth will be the key driver for stock markets in 2010
- Valuations have become attractive for commercial property in some countries, although levels of bank exposure still require monitoring

Global Perspective

2010: risks and opportunities as economies rebalance

As economies rebalance from the excesses of the bubble years, and policymakers begin to withdraw their unprecedented policy response, investors face substantial opportunities as well as risks within a volatile market environment.

Andrew Milligan
Head of Global Strategy

The outlook for 2010

During 2009 it became clear that the exceptional policy stimulus introduced in many countries would be sufficient to halt the global recession and dampen the worst effects of the financial crisis. While equity, bond, credit and property markets have responded, it is no surprise that investors have become more circumspect into year end.

We emphasise that successful investment calls in 2010 will depend not only on the normal detailed analysis of the business cycle but also understanding a wide range of political issues. As well as obvious examples such as tax changes or spending cuts, policymakers face difficult decisions about the withdrawal of quantitative easing, while major changes in the regulatory structure could have a material impact on future profitability for many companies. When interest rates are increased, history suggests that this can be a difficult period for financial markets. Investors are anxious about the end of the liquidity driven phase of a bull market until they become confident that policy changes will elongate the business cycle.

The business cycle

The good news for policymakers is that the global recession is ending, albeit earlier in some countries such as Australia, China and Korea than in others such as the UK, Spain and Ireland. As economies have stabilised, the next consideration for policymakers will be to nurture a sustainable recovery. Investors will begin to notice more country divergence, especially volatile currency movements. At the start of 2009 we argued that the economic recovery would fall into three phases. The first two of these have begun to be seen, namely the turn in the inventory cycle and then a pickup in industrial production, as companies began to synchronise output and order books. However, for the recovery to become entrenched, the third important step will require a sustained expansion in consumer demand and then capital spending. Here the picture is mixed; undoubtedly households are spending in many emerging economies, a prime example being Chinese retail sales growing 15% p.a. The picture is more mixed across the industrialised economies. On the negative side households face higher unemployment and weak wages growth, on the positive side they benefit from sharp cuts in debt servicing costs and various tax incentives. On balance, there are positive signs in the US, UK and France, less so in Japan and Germany. Looking ahead, a key trigger will be what happens to employment and therefore consumer confidence. With so many

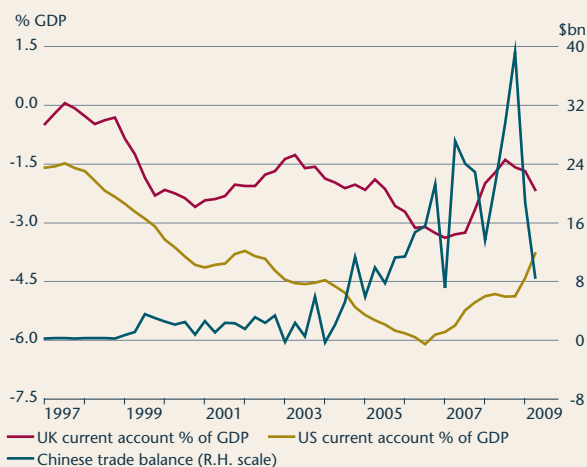
employees working on a part time basis, the first moves could see firms ask part time workers to become full time, then full time workers to get more overtime, before finally the hiring cycle turns higher.

2010 is not expected to be a year of above trend global growth. After most OECD recessions, the first year or two of recovery normally see a sharp snap back, say 4-5% a year. On this occasion, US GDP growth should only be say 3% a year. The recovery will be constrained by several factors such as the lack of credit from a weak financial sector as well as tighter fiscal policy. Many governments realise that they need to begin restraining public sector deficits approaching 10% of GDP; some such as Greece and Ireland are already paying higher debt servicing costs as bond investors become concerned. In contrast, economic growth can return above trend across many global emerging markets (GEMs). Most notably the Chinese economy should grow 9-10% p.a. as the authorities press ahead with the second year of the major infrastructure packages.

Profits will grow in 2010; the key question is whether they can beat already optimistic market expectations. Analysts are forecasting earnings growth up some 20- 25% over the coming 12 months. The positive drivers are the extent of cost cutting already put into place by companies, albeit more in the US than the UK or Europe, and how much more companies can do in an environment where pricing power is limited and nominal GDP growth muted. US business productivity has jumped in the past year, helped by a decline in employment double that seen in the early 1980s recession. Currency factors are positive for the UK and US, negative for Europe and Japan although more firms are responding by shifting production between centres. The key issue for companies and stock markets is their exposure to the faster overseas parts of the global economy rather than slower growing domestic earnings. For example, about 65% of FTSE350 profits come from overseas. Some brokers estimate that emerging markets could account for more than 50% of global consumer demand growth between 2010 and 2015.

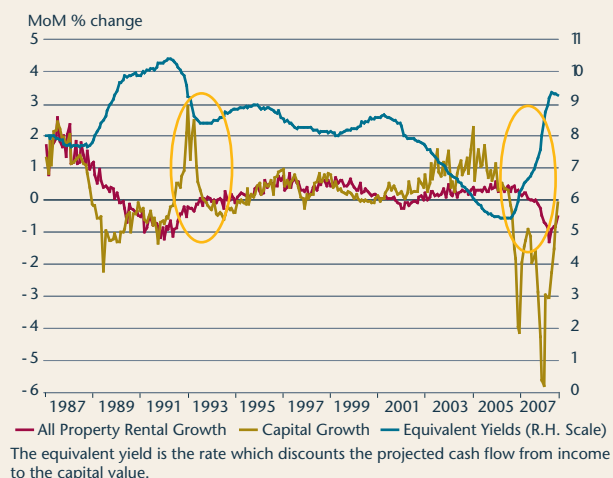
Inflation will remain a problem for many central banks in 2010. More emerging economies are worrying about inflation as a consequence of past stimulus. Notably China, the world's second largest economy, has boosted money supply by over 30%. Investors need to monitor GEM central bank decisions about whether and when to allow their exchange rates to appreciate to

Chart 1
Rebuilding economies



Source: Bloomberg

Chart 2
Value in property



Source: IPD Monthly Digest

offset such inflation pressures. Headline inflation in the OECD economies will move higher in the first half of 2010, before easing, boosted by the impact of recent increases in energy prices as well as consumer tax changes. The major concern for many central banks though will be the downward pressures on core inflation into 2010, towards 1% a year. This reflects the sizeable amount of excess capacity, such as around 10% unemployment rates. 2010 looks set to be a year of 'jobless recovery', similar to the early 1990s, good for corporate profitability but a noticeable headwind for consumer demand. Further ahead, inflation remains a risk if central banks do not successfully manage the withdrawal of excess liquidity from the financial system.

Rebalancing the global economy

As the authorities move away from fire fighting the recent crisis, there is a growing realisation that economies need to re-balance. While much of the discussion has been in terms of deleveraging the debts incurred by households and banks, new challenges are looming, notably the sizeable build up of public sector debts. Some is cyclical, and will improve as economies grow out of the recession, but the majority is structural, reflecting for example a permanent collapse in the tax base. Hence, the IMF has concluded that many OECD economies will need to tighten fiscal policy by about 1% of GDP a year for several years. Rebalancing can be seen in other ways, for example the US and UK shifting resources into high value manufacturing and service sectors in order to improve their current account positions, while conversely China moves away from exports and public sector investment and develops a sound domestic consumer base (see chart 1). In this regard, sizeable currency depreciation by the US dollar and sterling is very helpful. Looking into 2010, G20 decisions on currency movements and IMF oversight of economic policymaking could be a significant trigger, whether more sustained efforts will be made towards global economic co-operation.

The risks of policy errors

Investors must pay close attention to political decisions next year. Election results in the US and UK could determine the speed with which fiscal policy is tightened. 2010 may see a conclusion to the Copenhagen discussions on climate change and therefore movement on, say, carbon trading schemes. The outcome of the wide ranging political debate about revamping the regulatory regime for the financial sector could have significant implications for future profits. Markets are pricing in a halt to quantitative easing (QE) in the first half of 2010 and tighter interest rates during the second half.

Although we expect central banks to be wary of imitating Japan's mistakes in the 1990s, in view of the low inflation and high unemployment backdrop, there is a risk that policy is tightened too rapidly. Not all of the major policy decisions lie with OECD economies: for example, Chinese policymakers must decide how and when to tighten monetary policy, allow the currency to appreciate, take further steps to make the currency convertible, and curtail excess capacity, while ensuring high levels of rural unemployment do not become problematical.

The House View

During 2009, the House View has balanced its risk holdings in selected equity markets with a preference for income. In stock picking terms, quality companies with good management and sustainable earnings are favoured. The business environment is one of limited pricing power and continuing restrictions on the availability and cost of credit. Sustainable yield remains a profitable investment style in an environment of very low official interest rates. Hence, portfolios have been tilted towards the benefits of income from corporate bonds, dividend paying equities, the steep yield curves in government bonds, and commercial property. Although valuations of corporate bonds are not as attractive as they were in the spring, the House View still sees opportunities for further improvement into 2010 as default rates peak and roll over. Government bonds remain attractive while inflation is low, although the implications of the QE and rate decisions will eventually prove a major headwind. During the course of the past year, the weighting for UK property was raised from Light to Neutral, and recently it was increased to Heavy. This reflects the favourable valuation backdrop (see chart 2) plus the improvement in the supply/demand balance. The decline in sterling has boosted overseas investor interest in UK prime property. There are risks, notably from banks crystallising their losses on property debt by a forced sale of the underlying assets, although these look to be manageable. Lastly, the GIG expects that capital flows could drive significant currency movements in 2010, as investors look for the small number of growth opportunities.

House View

Standard Life Investments recommended asset allocation for Canadian balanced mandates.

	Positive	Negative	Our View
Canadian Equities	<ul style="list-style-type: none"> Earnings will respond to lower loan losses and higher commodity prices as the economy expands. Canada remains a geared play on global growth. 	<ul style="list-style-type: none"> The market is ahead of likely earnings in 2009 but higher commodity prices and stable to lower provisions in financials offer better support on 2010 earnings. 	<p>The portfolio continues to feature high-quality companies. We are selectively adding to our exposure.</p> <p>OVERWEIGHT</p>
US Equities	<ul style="list-style-type: none"> We expect the US market to be more stable through the current bottoming in the long-term cycle. Operating leverage is beginning to turn positive and margins are holding up better than expected. 	<ul style="list-style-type: none"> The market is ahead of 2009 earnings but lower financial provisions and positive operating leverage offers the prospect of better earnings in 2010. 	<p>We have further added to positions in US equities within balanced funds, reflecting the valuation, the appeal of the dollar vs. the loonie and the relatively defensive nature of the market. We are selectively adding to the cyclical of the portfolio, especially in industrial, financial and consumer related stocks.</p> <p>OVERWEIGHT</p>
EAFE Equities	<ul style="list-style-type: none"> We have benefited from strong stock picking in early cycle parts of the market and sectors we believed to be excellent value. 	<ul style="list-style-type: none"> International stocks have suffered severe P/E compression, but EAFE typically carries more cyclical risk than the US and Europe will likely lag the US in any recovery. 	<p>With a still strong rebound in global activity, we have lifted our position to OVERWEIGHT in recent weeks.</p>
Real Estate	<ul style="list-style-type: none"> Capitalization rates are now attractive for long-term investors. Real estate typically produces positive returns even in a difficult period. Vacancy rates are low in Canada. 	<ul style="list-style-type: none"> Capitalization rates have risen sharply at year end. We expect a challenging environment near term, but excellent long-term prospects. 	<p>This asset class benefits from cash flow and stability over the cycle.</p> <p>NEUTRAL</p>
Canadian Bonds	<ul style="list-style-type: none"> Inflation is low in Canada and the economy is slowing under US weakness and soaring loonie. Credit spreads in Canada began to narrow and corporate and provincial bonds remain attractive. 	<ul style="list-style-type: none"> Long-term yields at 3.5% are not attractive on a multi-year view, especially compared to equities. 	<p>Within the portfolio, we hold longer-dated corporate and provincial bonds, and benefit from still very wide spreads.</p> <p>We are UNDERWEIGHT current benchmarks, while holding a higher bond exposure than most of our peers.</p>
Cash	<ul style="list-style-type: none"> We maintain flexibility to raise cash if conditions warrant. 	<ul style="list-style-type: none"> Not attractive as a long-term asset given the low yields. 	<p>We are holding minimal cash levels, having redeployed into equities.</p> <p>UNDERWEIGHT</p>

The terms Overweight, Neutral and Underweight express Standard Life Investments' view of a Canadian Balanced Portfolio against a given benchmark.

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