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Economic and market commentary

After cutting exposure to European and Asian equities during the strength of the first quarter, equity markets softened in April, with continental European bourses experiencing sharp declines.

Risk premia are extremely high across most markets. High yield bonds discount a lot of bad news, while low forward and historic P/E ratios, and dividend yields that in many markets exceed government bond yields, make equities look attractively valued versus their recent history. But government bond yields look to be at rock-bottom levels, with inflation-linked bond yields offering investors the 'opportunity' to lock in negative real rates of return for the next 15 years. And cash offers next to nothing. For the first time in a generation, the prospective risk-free return looks more like a return-free risk, and investors wishing simply to maintain the real value of their assets are forced to buy assets that are traditionally extremely volatile, such as equities. In this context, we have been comfortable to take a modest amount of these high risk premia in exchange for the meaningful risks on the horizon, and maintain the overweight in non-eurozone equity markets, concentrating what eurozone equities we have in Germany.

The market has increasingly moved its economic forecasts towards our more conservative views, although we did take the opportunity to increase our forecast for US economic growth in 2012 from 1.5% to 2% after some strong first quarter data. Despite this upgrade, we remain of the view that the US economy will slow in the second half of the year. Our view is driven by an expectation that capital expenditure and a ramp-up in employment will be impeded by uncertainties over the fiscal environment at the end of the year. As things stand, there is a 'fiscal cliff' which will see an extremely sharp contraction in government spending and a rise in personal taxes, taking around 3.5% out of the economy. Our economic forecasting group expects that there will be some agreement between Democrats and Republicans to smooth the fiscal austerity programmed into the government's plans, but not until after the November elections. Conversations that we have had with management at large US companies so far confirm our worry that investment decisions are all being postponed until after fiscal clarity is delivered. Furthermore, it will become incrementally harder (absent a major market dislocation caused perhaps by an event in Europe) for the Federal Reserve to apply new unconventional monetary stimulus as the election approaches in November, and this poses a potential threat to the stability of the bond market.

Coming back to Europe, the new Greek government is going to have to implement further austerity measures which will reduce GDP by another 5%. This is being done at a time of rising unemployment, with youth unemployment reaching 50%. The social consequences of Greece entering its sixth year of recession are clear, and maintaining social cohesion during periods of massive austerity is going to be profoundly difficult. This is true to a lesser extent of Spain, Italy and even France, and is perhaps one of the reasons that talk of a 'growth pact' has started to be mentioned by European politicians and authorities. This leaves Germany looking increasingly isolated, a situation likely to be exacerbated with the election of Francois Hollande. Heightened tensions look likely to cause financial

markets some difficulty. Within our European fixed income exposure we continue to be positioned extremely defensively where we need to take exposure to the market.

Economically, we find it hard to get excited about the prospects for the UK. With its main trading partners across the Channel stuck in an economic-financial-monetary-political quagmire, the coalition government's austerity only just beginning to bite, and the (at least) temporary cessation of quantitative easing, we maintain our forecast for zero growth in 2012, and have initiated a forecast for an extremely anaemic pick-up to 1% GDP growth in 2013. We remain underweight UK property due to our expectation that the prospect of falling rents and capital erosion as a result of this poor economic backdrop will outweigh the attractions of the sizeable yields on offer. But we find plenty of high quality companies, and remain overweight UK equities due to the attractive valuation of their international earnings. Gilts, on the other hand, offer little value and we have been looking for opportunities to reduce exposure in our fixed income allocations to UK interest rate risk.

Despite our gloomy economic views with regard to the developed world, we find plenty of things to be excited by in the other 50% of global GDP represented by emerging markets. Real consumption growth is healthy, and – in contrast to the developed world – policy tools to support growth abound. The political challenges associated with both the Chinese political transition and the economic rebalancing away from fixed asset investment are not to be overlooked, but we believe that the earning potential of emerging market growth in selected developed and emerging companies remains undervalued.

Economic forecasts

Summary

In early 2012, we have seen a continuation of the divergence that characterised growth momentum towards the end of last year. The US and Japanese economies have started the new year on a strong footing, shrugging off worries that emanated from Europe. Accordingly, we have revised up our estimates for growth in 2012 in these countries. In the euro area and the UK, economic activity has continued to stutter, the former being dragged down by the austerity-hit periphery. Emerging markets appear to have weathered the weakness in global demand that hit around the turn of the year, and the continued outperformance of these countries is expected.

Looking forward, we find that any euphoria surrounding the US recovery should be tempered, partly because early 2012 economic data was flattered by kind weather conditions, and partly because the imminent presidential election will lead to a rise in uncertainty in the second half of the year. In Europe, peripheral weakness continues to represent a downside risk to the region, and in the worst case scenario, to the rest of the world as well.

In aggregate, we continue to expect that developed economies will tend to underperform consensus expectations, with very lacklustre growth. By contrast, we are happy to be broadly in line with more upbeat expectations for emerging economies.

An interesting dynamic against this backdrop will be the reaction of various central banks. The major central banks appear reluctant to add stimulus in the short term, but previous episodes of letting markets and economies fend for themselves have been short-lived. Well-behaved inflation in emerging economies allows room to ease policy, further supporting the view that these economies are set to outperform.

Economic forecasts

US

				(T)	(Cons)	(T)	(Cons)
	2010	2011	Current	End 2012	End 2012	End 2013	End 2013
GDP (year/year)	3.0	1.7		2.0	2.3	1.5	2.5
Headline Inflation (year end)	1.6	3.1	2.7	2.0	2.1		2.1
Core Inflation (year end)	0.8	2.2	2.3	1.5			
Official Rates¹ (year end)	0.25	0.25	0-0.25	0-0.25	0.15 ¹		0.24 ¹
10-year bond yield	3.3	1.9	2.0	2.5	2.6/4.5 ²		2.8/4.5 ²
EUR/USD (year end)	1.34	1.30	1.32	1.25	1.29		1.28
USD/JPY (year end)	91	82	82	82	82		85

Updated 25 April

Notes: (T) = Threadneedle forecast, (cons) = consensus forecast, ¹consensus = derived from market expectations, ²first bond yield consensus number represents economists' views, second represents TAM's measure of 'Fair Value'.

Changes to Threadneedle forecasts: 2012 GDP changed to 2.0% from 1.5%, 2013 GDP set at 1.5%.

Good start, likely to fade into elections

A strong end to 2011, with decent momentum into Q1, leads us to surmise that growth for the year is likely to come in around 2% – above our previous call of 1.5%. The unemployment rate continues to fall, which improves sentiment and aids consumption. Even the moribund housing market is seeing rising sales and better builder optimism. Some of the strength in Q1 may be partly attributed to the historically warm winter, which has played havoc with seasonal adjustments to data. Certainly, it seems logical to assume that sectors of the job market that are not inside during the winter months would not have seen the usual slowing of activity.

We continue to pay attention to the hiring intentions of the small business community. Having peaked at 7 in November, the monthly report has slipped back to zero, implying that the recent expansion of the workforce is due to slow. This sector of the economy is key to the prospects for growth going forward, as it employs half the workforce, and historically adds two-thirds of new jobs during expansions.

We believe that there may be two factors at work in the cooling of optimism. The first is already upon us. Gasoline prices have climbed to just below \$4, in a similar but steeper move to last year. Domestic-facing businesses are at the mercy of consumer cash flows, as more spent at the pumps is potentially less spent with them. Going forward, volatility at the pumps will have less of an effect on sentiment as efficiency strides in new cars will outweigh the extra cost of a gallon. The second dampening factor will come increasingly into focus from now on. Much has been written in recent weeks about the 'Fiscal Cliff' at the year end. Following the election of early November, the country faces automatic spending cuts and expiring tax breaks, amounting to approximately 3.5% of GDP. Put into context, Italy and Spain are currently overlaying similar levels of austerity to their economies. Given that the Democrats and Republicans have shown on many occasions recently their inability to compromise, there is a strong chance that all programmes will expire at the year end. We believe that the shock to the economy will last no more than

one quarter, since the likelihood of many of the programmes being re-implemented is high. However, uncertainties around the tax regime will likely lead companies and individuals to shelve investment plans before the election. For this reason, we may have seen the best of growth for this year.

Economic forecasts

Euro Area

				(T)	(Cons)	(T)	(Cons)
	2010	2011	Current	End 2012	End 2012	End 2013	End 2013
GDP (year/year)	1.9	1.5		-1.0	-0.4	0.5	0.9
Headline Inflation (year end)	1.6	2.7	2.7	2.0	1.9		1.6
Official Rates¹ (year end)	1.0	1.0	1.0	0.5	1.0		1.0 ¹
10-year bond yield	3.0	1.8	1.8	2.5	2.3/4.0 ²		2.5/4.0 ²
EUR/USD (year end)	1.34	1.30	1.29	1.25	1.29		1.28
EUR/JPY (year end)	109	100	108	103	106		109

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Notes: (T) = Threadneedle forecast, (cons) = consensus forecast, ¹consensus = derived from market expectations, ²first bond yield consensus number represents economists' views, second represents TAM's measure of 'Fair Value'.

Changes to Threadneedle forecasts: 2013 GDP set at 0.5%.

Austerity fatigue or austerity collapse

Spain has become the epicentre of euro area worries in recent weeks, due to the severe budget cuts announced by the government. The fiscal correction of 5.5% pencilled in over the next two years is as ambitious as any over the past three years, and the experience of Greece and Portugal suggests that once growth is contracting, there is a risk that the recession will intensify. Export growth represents a positive risk, but downward momentum for domestic demand is likely to increase through the middle of the year as budget cuts take effect. Stresses in the banking system will put downward pressure on private sector lending, so any monetary policy loosening will have limited effect.

Many of the issues faced by Spain are also seen in Italy, with negative growth a theme throughout, and the austerity hit will continue to hamper growth into 2013. Germany's domestic economy will be subject to very little fiscal correction this year. Falling unemployment and a thriving construction sector represent an upside risk to our forecast, although export demand will be threatened by the contracting economies around Germany.

Political risks are seemingly on the rise, with austerity being increasingly rejected, most notably now in France and the Netherlands. Whether this represents a positive development as governments realise previous tactics have failed, or a negative factor as Germany comes to blows with others, remains to be seen.

Risks to the forecast

- Bond market tension has feedback effect – negative.
- Social upheaval in periphery – negative.
- Austerity fatigue leads to political friction – negative.
- Greek exit – negative.
- Stronger global growth – positive.
- ECB easing/intervention – positive.
- Politicians show more harmony, boost growth – positive.
- Spanish bank recapitalisation done effectively – positive.

Economic forecasts

Japan

				(T)	(Cons)	(T)	(Cons)
	2010	2011	Current	End 2012	End 2012	End 2013	End 2013
GDP (year/year)	4.5	-0.7		1.8	2.0	1.0	1.5
Headline Inflation (year end)	-0.7	-0.3	0.3	-0.2	-0.1		0.1
Official Rates ¹ (year end)	0.1	0.1	0.1	0.1	0.1 ¹		0.1 ¹
10-year bond yield	1.1	1.0	0.9	1.0	1.1/2.0 ²		1.2/2.0 ²
USD/JPY (year end)	91	82	82	82	82		85
EUR/JPY (year end)	109	100	108	103	106		109

Updated 25 April

Notes: (T) = Threadneedle forecast, (cons) = consensus forecast, ¹consensus = derived from market expectations, ²first bond yield consensus number represents economists' views, second represents TAM's measure of 'Fair Value'.

Changes to Threadneedle forecasts: 2012 GDP changed to 1.8% from 1.0%, 2013 GDP set at 1.0%.

2012 looking solid but much uncertainty into 2013

Growth momentum in early 2012 has beaten our expectations, as strong global auto sales have aided exports alongside solid consumer demand. Accordingly, we have increased our forecast for 2012 to 1.8%. Although Q1 may be the peak in sequential growth, reconstruction demand will underpin domestic activity.

Going forward, a number of potential events could have repercussions for economic growth. With PM Noda's approval rating below the level deemed to be irretrievable, it is not clear who will be in power by the end of 2012. The emergence of a new political force, Your Party, threatens to create more uncertainty in political circles. In particular, Your Party opposes the advent of a consumption tax, pencilled in for late 2013, which had gained political support from the main parties. The outcome of this debate will be key for the economic outlook for 2013, as consumption patterns will be significantly affected.

There is also uncertainty surrounding who will become the governor of the Bank of Japan following current governor Shirakawa's departure. Extra easing measures announced in February 2012 had raised hopes that the Bank of Japan was beginning to follow the lead of other central banks by resorting to aggressive measures to facilitate currency devaluation. However, with Japan it is unlikely to be that simple. Given that the Bank of Japan governorship is a political appointment, negotiations are likely to drag on for some time before we get a clearer picture.

Risks to the forecast

- Stronger global growth – positive.
- Reconstruction demand – positive.
- Bank of Japan personnel changes – potentially positive.
- Political upheaval – negative.
- Consumption tax in 2013 – timing dependent.

Economic forecasts

UK

				(T)	(Cons)	(T)	(Cons)
	2010	2011	Current	End 2012	End 2012	End 2013	End 2013
GDP (year/year)	2.1	0.7		0.0	0.7	1.0	1.8
Headline Inflation (year end)	3.3	4.5	3.5	2.3	2.2		2.3
Official Rates¹ (year end)	0.5	0.5	0.5	0.5	0.5 ¹		0.5 ¹
10-year bond yield	3.4	2.0	2.17	3.0	2.5/4.5 ²		2.6/4.5 ²
USD/GBP (year end)	1.56	1.55	1.61	1.52	1.56		1.58
EUR/GBP (year end)	0.86	0.84	0.82	0.82	0.83		0.81

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Changes to Threadneedle forecasts: 2013 GDP set at 1.0%.

Stagnation

The structural headwinds of private sector deleveraging and public sector austerity dominate the economic landscape and will continue to do so in the coming years. A complete lack of private sector credit and employment growth is resulting in zero or negative GDP growth in the short term. The Bank of England, however, is disregarding the official GDP data and instead seems to be basing policy on the PMIs. This seems a risk given the current significant divergence between the business surveys and the data from its own agents. Our downbeat 0% GDP forecast for this year remains on track at this early stage. This is a far more pessimistic assessment than the Bank of England, which foresees a healthy acceleration in the second half based on stronger real income growth.

Looking ahead to 2013, we continue to see a weaker than consensus outcome for GDP. There is scope for small upside surprises from business investment but the chance of a sharp acceleration in consumer spending seems low. Whilst exports to non EU countries are clearly on an improving trend, the weakness in the eurozone economy suggests little chance of a boost from net trade. A GDP outturn of 1% relative to official forecasts for 2013 seems appropriate at this stage.

Risks to the forecast

- Higher than forecast inflation will prohibit improvement in real incomes: this is most likely to result from higher commodity/import prices.
- Rising unemployment: to date, the increase in unemployment has been low given the decline in GDP. This may be due to banks not calling in loans from SMEs, which consequently remain in business.
- Eurozone: further weakness will hit exports.
- Fiscal outlook: at some stage growth disappointments and revenue shortfalls could destabilise UK financial markets.

Economic forecasts

Emerging Markets

GDP (year/year)	2012		2013	
	Threadneedle	Consensus	Threadneedle	Consensus
Brazil	3.0-3.5	3.3	4.0-4.5	4.3
Mexico	3.0-3.5	3.5	3.0-3.5	3.4
China	8.0-8.5	8.4	8.5-9.0	8.5
India	6.5-7.0	7.2	6.5-7.5	7.7
South Korea	3.0-3.5	3.3	4.0-4.5	3.9
Taiwan	3.0-3.5	3.1	4.5-5.0	4.5
Russia	3.0-3.5	3.5	3.5-4.0	3.9

Updated 25 April

Changes to Threadneedle forecasts: South Korea – 2012 GDP changed to 3.0-3.5% from 4.0%; India – 2012 GDP changed to 6.5-7.0% from 7.0-7.5% and 2013 GDP changed to 6.5-7.5% from 7.5-8.0%.

Recent data out of China has been soft, but we believe the outlook is better over the second half of the year. Following a marked slowing in investment spending, the Chinese authorities are slowly shifting to a more accommodative policy stance, as evidenced by a pick-up in loan growth in March. Strong consumer demand will continue to underpin the evolution to a domestic demand driven economy.

Elsewhere in emerging markets, inflation has been well-behaved in early 2012, affording central banks room to ease policy where appropriate to support growth. This is most notable in Brazil, where rates have been cut by 3.5% since August 2011. Strong fundamental backdrops continue to support an outperformance of emerging economies versus developed economies.

Investment themes

Theme	Thesis	Investment conclusions
Search for yield	<ul style="list-style-type: none"> ■ Deflationary environment will keep yields low. ■ Above average and relatively safe yields will be increasingly in demand. 	<ul style="list-style-type: none"> ■ Growing yields being paid by businesses with stable earnings and cash flows will remain in demand. ■ High yield alone may be a value trap.
Global capital expenditure growth	<ul style="list-style-type: none"> ■ Investment in infrastructure and fixed assets in the developing economies will provide a strong backdrop for global industrial demand. ■ In addition, investment in improving productivity will continue as the competitive environment gets tougher. ■ Cyclical forces will weaken this long-term trend in some areas from time to time. 	<ul style="list-style-type: none"> ■ Theme 1 - Automation. Investment in improving production efficiency is occurring, particularly in the developing economies. ■ Theme 2 - Companies that are exposed to growing expenditure on infrastructure projects. ■ Theme 3 – Specialist companies with leading technologies or products will continue to see demand growth as investment to improve competitiveness continues in a slowing world.
China/Asian growth	<ul style="list-style-type: none"> ■ Economic expansion/industrialisation of China is a long-term story driving growth for many developed world companies. ■ Policy initiatives will cause periodic concerns about growth but will not derail the overall story. ■ Over-investment and property market speculation with the attendant financial risks are a significant issue. 	<ul style="list-style-type: none"> ■ Exposure to infrastructure spending. ■ Industrials (see above). ■ Emerging consumer markets and growth in demand for luxury goods. ■ Commodity and resource sectors. ■ Demand for soft commodities and impact on pricing/input costs.
Over-indebtedness	<ul style="list-style-type: none"> ■ Risks as governments, consumers (and companies) seek to reduce indebtedness. ■ First order effects in expenditure cuts, second order effects in weak demand outlook. 	<ul style="list-style-type: none"> ■ Dangers of taxation of immovable assets (e.g. utilities). ■ Low end consumers under pressure as unemployment stays high and incomes remain under pressure. ■ Potential revaluation of companies exposed to non-discretionary spending.
Opportunities in a low growth developed world	<ul style="list-style-type: none"> ■ Growth constrained in some markets by headwinds of deleveraging and ageing populations. ■ Poor asset quality, the size of bank balance sheets and new capital requirements will limit the supply of credit to fund growth. ■ Areas of stronger growth (see above) will revalue. 	<ul style="list-style-type: none"> ■ Theme 1 - Secular/strong growth will command a premium valuation. ■ Theme 2 - Strong franchises and high returning businesses will revalue as investors pay a premium for quality and reliability. ■ Theme 3 - Turn around and recovery situations where returns are improving are attractive. ■ Theme 4 - M&A should increase – look for undervalued franchises, market consolidation opportunities and undervalued cash flow. ■ Strong corporate cash flow will support dividend growth (reductions in cover), and M&A and share buybacks.

Asset allocation

	Equities Overweight	Bonds Underweight	Property Underweight	Cash Overweight
Overweight	US Asia (ex Japan) Latin America UK Japan	Emerging Market Investment Grade and High Yield Corporate		Cash
Neutral				
Underweight	Europe	Government	UK Property	

Important information

Past performance is not a guide to the future. The value of investments and any income from them can fall as well as rise. Exchange rates may cause the value of underlying investments to fall as well as rise. The naming of any specific shares/securities should not be taken as a recommendation to deal. Any opinions expressed are as the date of issue, but may be subject to change. The research and analysis contained in this document has been prepared by Threadneedle Asset Management Limited (an associated company) primarily for its own investment management activities and may have been acted upon prior to publication. Issued by Threadneedle Asset Management Limited. Authorised and regulated by the Financial Services Authority. Registered in England and Wales. 60 St Mary Axe, London, EC3A 8JQ. Registered No. 573204. Threadneedle is a brand name, and both the Threadneedle name and logo are trademarks or registered trademarks of the Threadneedle group of companies. threadneedle.com