

For professional investors only

# Schroders Global Market Perspective

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Multi-Asset Group: Asset Allocation Views Q4 2010



**Schroders**



## Introduction

The quarter has been dominated by talk of a double dip and fears that the world economy is about to stall. Forecasts for growth have been downgraded and surveys confirm that global activity has cooled. In turn, expectations for higher interest rates have been pushed out further into next year as central banks have signalled increasing concern about the strength of the recovery. The US Federal Reserve and Bank of England are actively considering a further round of asset purchases or quantitative easing (QE).

The problems in European government bond markets, which dominated sentiment in the second quarter, have moved from the centre of attention. Greece has kept its finances on track and received funding from the IMF as part of the three-year package agreed in May. However, spreads remain wide and credit default swap (CDS) prices have risen for the peripheral Eurozone economies – a clear indication that investors do not believe the crisis is over. Despite this, the euro has not repeated the weakness seen earlier in the year, an indication perhaps of the poor outlook for other currencies at the current time.

Whilst we continue to believe that our baseline forecast of a slow but positive recovery is the most likely path for the world economy, we attach a significant risk to a double dip. Against this backdrop, we adopted a more defensive strategy at the beginning of the quarter by adding government bond duration and introducing some counter cyclical trades. More recently, we have reversed these moves and taken a more positive tack as bad news became priced in through lower equity markets and bond yields. In addition, we sensed that negative sentiment was becoming overdone.

The combination of low interest rate expectations and strong balance sheets in the corporate sector means that we continue to favour credit. We are neutral on equities, but within the asset class prefer the emerging markets given their ability to deliver growth. On the currency front, we favour those countries which are ahead in the economic cycle and we have a number of relative value trades to take advantage of any divergence in monetary policy.

**Keith Wade**, Chief Economist and Strategist, Schroders

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# Global Asset Allocation Committee

## Members



**Alan Brown**  
Chief Investment Officer



**Johanna Kyrklund**  
Head of Multi-Asset Investments



**Keith Wade**  
Chief Economist and Strategist



**Mike Spinks**  
Fund Manager, Multi-Asset



**Richard Coghlan**  
Head of Multi-Asset,  
Hong Kong



**Gregor Hirt**  
Head of Multi-Asset,  
Continental Europe

# Asset Allocation Views

## Global Overview

### Economic View

Over the next six months, our central forecast for the global economy can be best described as a 'two speed world' with steady growth and low inflation. An important feature of the recovery is that the emerging markets are leading the way, with these economies now playing a significant part in global growth. Unlike their developed peers, this region has been less affected by the financial crisis, as their banking sectors were not as heavily leveraged or dependent on wholesale markets as those in the US or Europe.

In terms of our macro forecasts, we have downgraded global growth this year to 3.5%, a tick down of 0.1% on our previous forecast. Our growth forecasts for 2011 are also marginally lower at 3% with a moderation in activity expected as fiscal stimulus fades and the de-leveraging process continues to hold back consumer spending.

Meanwhile, we have revised down our growth forecasts in the US, China and emerging markets to reflect the mid-year slowdown and a more difficult outlook, whilst the UK and Eurozone have been upgraded to reflect a better than expected recent performance. The improved numbers in Europe are just a lagged effect, as we expect activity in the Eurozone to slow again later this year. We do not believe the euro crisis is over and expect concerns about solvency to return as weak growth undermines internal support. However, we believe contagion to be limited by EU (European Union) and IMF (International Monetary Fund) support.

On the inflation front, we have edged our global CPI forecast down slightly to 2.6% for 2010. Generally, inflation is coming in as expected with a moderation in US core inflation. The exception continues to be the UK where we have increased our forecast for inflation. We continue to forecast a further rise in inflation in China, before a slowdown in growth helps moderate price pressures later in the forecast.

### Interest Rate View

Although our forecasts for global growth and inflation are little different from last quarter, monetary tightening is delayed due to concerns about the fragility of the recovery. We now expect the Federal Reserve (Fed) and European Central Bank (ECB) to raise rates in September 2011. Rate increases are also delayed in the UK, but the need to contain inflation expectations results in the Bank of England (BoE) raising rates in August next year.

### Implications for Markets

In view of our expected steady growth, low inflation outcome and the level of valuations, we continue to have a tilt towards risk assets. This is primarily through our exposure to corporate bonds, emerging market equities and currencies. We have closed some of our more defensive positions such as long US Treasury bonds. Overall, we are neutral equities and commodities, with a moderate overweight in credit and underweight cash. While growth is slowing and there are uncertainties ahead given the potential impact of a slowdown in China and event risk in Europe, equity market valuations are attractive and corporate profitability is expected to rise further.

# Multi-Asset Group: Asset Allocation Views

## Global Overview (continued)

### Implications for Markets (continued)

Within equities, we have downgraded US equities to moderately underweight given our lower growth forecasts. By contrast, we have upgraded emerging markets from neutral to moderately overweight, as this region is best positioned to sustain growth in the current environment.

Meanwhile, we are also moderately overweight UK equities given that valuations are attractive and a large part of the market is geared to benefit from overseas growth. However, we remain underweight Europe ex UK and Japan, but neutral on Pacific ex Japan. Within the equity sectors, we prefer technology stocks in the US, which are expected to benefit from the rise in corporate capital expenditure.

For the bond sector, we continue to prefer investment grade and high yield bonds. This is underscored by the view that credit is less vulnerable to the slowing top-line growth forecast than equities. We also believe that in an extended period of low cash rates, investors will continue to seek higher yields by moving into credit. In comparison, we are neutral on government and inflation-linked bonds, which results in a moderate overweight in the bond asset class overall. At the same time, we are light on cash.

### Currencies

We prefer Asian currencies where growth is relatively robust and economies are based on much sounder structural fundamentals including surplus external positions. For the developed economies, the preferred currencies are those supported by macro fundamentals, such as the Swedish Kroner.

### Asset Allocation

Cash – negative
Government bonds – neutral
Credit bonds – positive
Equities – neutral
Commodities – neutral
Property – neutral
Currencies – positive on emerging markets

The above ranking represents a general guide and the actual weight in our Multi asset portfolios will depend on portfolio objectives and restrictions, the conviction of the fund manager and the contribution to risk within the overall portfolio allowing for volatility and correlation with other assets.

# Economics

## Executive Summary

### Introduction

Each quarter we present three sets of economic scenarios. These are debated and a central scenario is adopted. Our current base case is where the global economy experiences steady growth and low inflation ('two speed' world). In terms of the risks around this view, the main alternative is a double dip recession where there is lower growth and inflation worldwide. The other scenario is that the global economy experiences a strong recovery where the growth path is 'V' shaped.

### Central View

#### Two speed world

Global growth is expected to be relatively subdued, particularly in 2011, as fiscal stimulus fades and the de-leveraging process holds back consumer spending. Meanwhile, monetary tightening is delayed due to low inflation and concerns over the fragility of the recovery. The relative strength of the emerging markets helps the world economy avoid another recession.

### Alternative 1

#### 'V' shaped recovery

Confidence and spending rises, as households ease back on the pace of de-leveraging. This leads to a strong rebound in global growth, but it comes at the expense of an unwanted rise in inflation. Against this backdrop, central banks worldwide are compelled to raise rates to lean against the pick up in inflation.

### Alternative 2

#### Double dip recession

The US goes back into recession as the recovery in consumer spending falters and firms retrench ahead of the fiscal tightening in 2011. There is a knock on effect to the rest of the world as demand for exports weakens. The combination of weaker growth and lower inflation forces central banks to maintain ultra-loose monetary policy for longer.

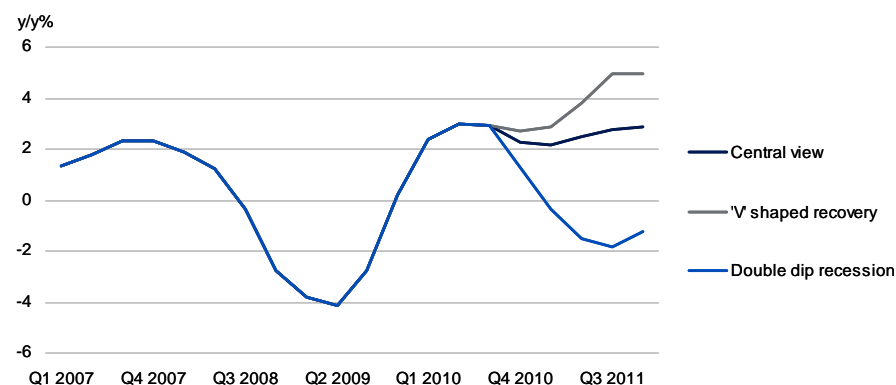
### Economic central and alternative views – global summary

	Central View			V-Recovery		Double Dip	
	2009	2010	2011	2010	2011	2010	2011
Growth	-2.1	3.5	3.0	4.1	5.2	2.7	-0.1
Inflation	1.4	2.6	2.3	3.0	3.7	2.3	1.5
Interest Rates*	0.5	0.5	1.1	0.8	3.1	0.5	0.5

Key: Growth – GDP y/y%, Inflation – CPI y/y%, interest rates – 3 month, %.

\*Q4 interest rate, OECD average.

Chart 1: US GDP Profile: Central view and scenarios



Source: Schroders, September 2010.

## Economics

### Central View: Two Speed World

GDP y/y%	2010	2011
US	2.5	2.5
UK	1.6	2.1
Eurozone	1.7	1.4
Japan	2.7	1.2
Australia	3.0	3.2
OECD	2.2	1.9
EM	6.5	5.5
World	3.5	3.0
CPI y/y%	2010	2011
US	1.5	1.0
UK	3.1	2.9
Eurozone	1.8	1.3
Japan	-1.0	-0.3
Australia	2.6	3.0
OECD	1.4	1.1
EM	5.2	5.0
World	2.6	2.3
In. rates %	2010	2011
US	0.25	1.00
UK	0.50	1.25
Eurozone	1.00	1.50
Japan	0.10	0.10
OECD	0.53	1.09

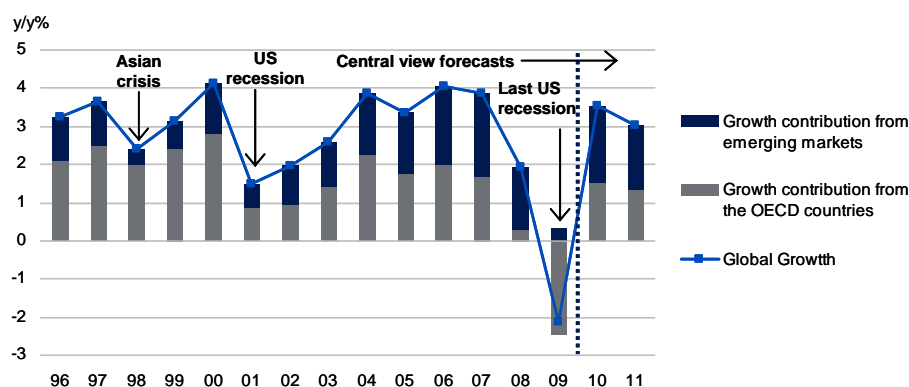
All figures are calendar year average, except interest rates which are end of year

#### Steady growth, low inflation

We expect world growth to be relatively subdued at 3.5% this year. In particular, global activity is expected to moderate in 2011 as the impact of government stimulus fades. At the same time, final sales are constrained by ongoing de-leveraging in the household sector. However, we assume that the corporate sector continues to spend and increase employment, providing support for the recovery.

Amongst the developed economies, the UK and Eurozone have the weakest growth outlook this year. Fiscal consolidation and the weakness of household spending account for most of this, offset to some degree by currency weakness. Meanwhile, the strongest growth prospects remain in the emerging markets. This divergence in growth rates leads to a 'two speed world' where the emerging countries account for more than half of global growth (chart 2).

Chart 2: Subdued recovery in global growth



Source: International Monetary Fund (IMF), Consensus Economics, Schroders, September 2010.

On the price front, we have edged our global inflation forecast down to 2.6% for 2010. For 2011, we expect world CPI to decline primarily led by the US and Europe as commodity price gains moderate and core prices recede further. In contrast, we have increased our forecast for UK inflation for this year and next. This follows a run of higher than expected CPI outcomes, which indicate there is less slack in the economy than widely believed, and the increase in value added tax (VAT) in 2011.

In the meantime, major central banks are expected to leave interest rates unchanged until next year when the Fed and the ECB are forecast to raise rates by 25 basis points (bps) in September. Despite the need to contain inflation expectations, the BoE also delay rate rises until August next year. Such a prolonged period of very low interest rates is consistent with concerns about the strength of the recovery, the need to offset tighter fiscal policy and low inflation at the core level. The forecast assumes another spell of quantitative easing (QE) by the Fed in the coming months.

## Economics

### Alternative 1: 'V' Shaped Recovery

GDP y/y%	2010	2011
US	2.7	4.2
UK	1.9	4.0
Eurozone	2.0	3.7
Japan	3.7	3.7
Australia	4.0	4.2
OECD	2.6	3.9
EM	7.5	8.0
World	4.1	5.2
CPI y/y%	2010	2011
US	1.7	2.8
UK	3.3	3.6
Eurozone	2.0	2.2
Japan	-0.7	0.2
Australia	3.1	3.5
OECD	1.7	2.3
EM	6.2	6.8
World	3.0	3.7
In. rates %	2010	2011
US	0.50	3.50
UK	1.00	3.50
Eurozone	1.25	3.25
Japan	0.50	1.00
OECD	0.82	3.06

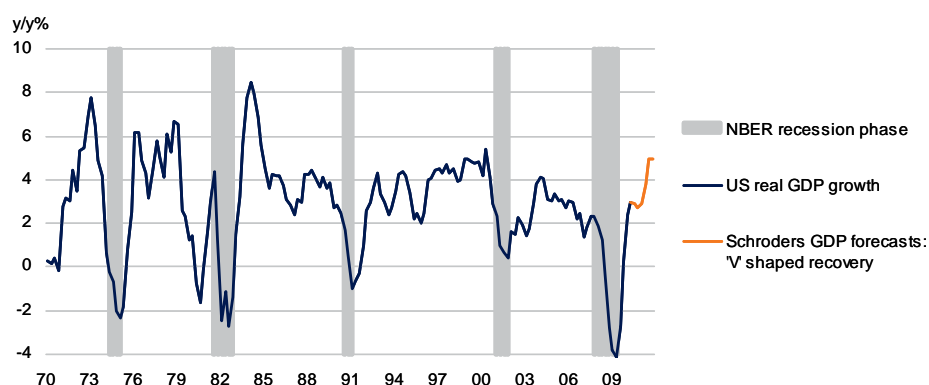
All figures are calendar year average, except interest rates which are end of year

#### Strong rebound in growth

The world economy experiences a strong recovery where the growth path is 'V' shaped. In many ways, this outcome is more in line with previous economic cycles where a sharp fall in output is matched by a greater bounce in activity (chart 3). Global growth accelerates, rising above 4% in 2010 and above 5% in 2011 respectively. Meanwhile, emerging markets are expanding by nearly 8% by the end of the forecast period.

In this scenario, we would see the catalyst for the recovery as being a decline in the savings ratio as households ease back on the pace of de-leveraging. Confidence rises and the global economy moves into a virtuous circle as stronger trade growth boosts household incomes and expenditures.

Chart 3: US GDP growth rebounds sharply after major recessions



Source: Thomson Datastream, National Bureau of Economic Research (NBER), Schroders, September 2010.

The downside is that inflation picks up as stronger growth drives commodity prices higher with oil going back above \$100 per barrel. After falling sharply in 2009, global inflation rises to 3% in 2010 and 3.7% in 2011. This rise in inflation is greatest in the emerging economies, which have less spare capacity and are more sensitive to commodity prices.

On the policy front, central banks have to reverse the monetary stimulus put in place during the financial crisis. As a result, the Fed, BoE and ECB begin to tighten again and raise interest rates throughout 2011. By the end of 2011, policy rates have risen significantly as central banks lean against the pick up in inflation.

Meanwhile, the return of global growth is likely to support the EUR and GBP, as this facilitates fiscal consolidation in these economies without the risk of a double dip. Both currencies are also expected to appreciate against the USD in this scenario. Moreover, increased confidence in the global economy results in the return of the carry trade and a spell of JPY weakness.

#### Implications for markets

The return of growth is likely to stimulate an increase in the performance of cyclical assets. Commodities and emerging market equities are likely to rally strongly whilst government bonds sell off.

## Economics

### Alternative 2: Double Dip Recession

GDP y/y%	2010	2011
US	2.4	-1.2
UK	1.5	0.0
Eurozone	1.7	-0.8
Japan	1.7	-1.8
Australia	2.5	2.2
OECD	2.0	-1.0
EM	4.5	2.0
World	2.7	-0.1
CPI y/y%	2010	2011
US	1.2	0.0
UK	2.8	2.0
Eurozone	1.6	0.7
Japan	-1.5	-0.8
Australia	2.1	2.5
OECD	1.2	0.4
EM	5.0	4.0
World	2.3	1.5
In. rates %	2010	2011
US	0.25	0.25
UK	0.50	0.50
Eurozone	1.00	1.00
Japan	0.10	0.10
OECD	0.53	0.53

All figures are calendar year average, except interest rates which are end of year

#### Recession returns

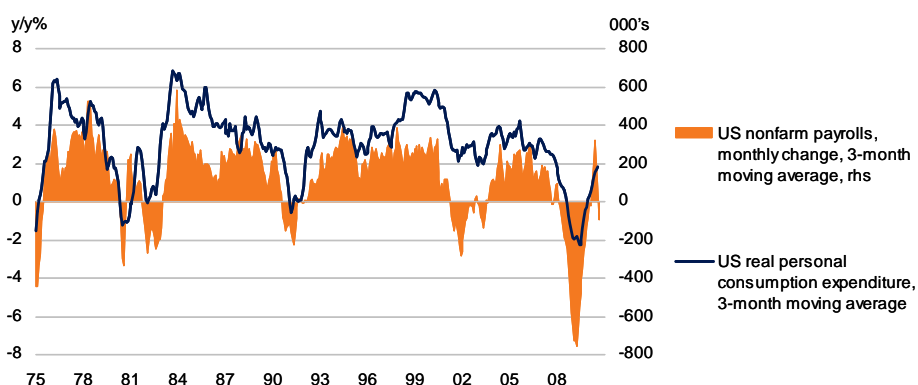
In this scenario, the US goes back into recession as the recovery in corporate spending stumbles and firms retrench ahead of the tightening of fiscal policy in 2011. Unemployment begins to rise again and consumer spending falters in the US. This risk is underscored by the strong relationship between consumer spending and the state of the labour market, measured by nonfarm payroll employment (chart 4).

With recession returning to the US, there is a knock on effect to the rest of the world as demand for exports weakens hitting the emerging markets, Japan and Germany, in particular. Faced with a weaker world economy, banks and investors worldwide become more risk averse thus compounding the impact on activity. The Euro crisis is also expected to flare up again as weak growth prevents countries from achieving their targets on fiscal deficit reduction.

The net impact on the world economy is deflationary with both growth and inflation substantially lower in 2010 and 2011 than in the central scenario. Commodity prices are significantly weaker with oil falling below \$50 per barrel in 2011.

The combination of weaker growth and lower inflation forces central banks to maintain ultra-loose monetary policy for longer. Consequently, all the major central banks keep rates on hold through the forecast period. We would expect the Fed and BoE to return to quantitative easing measures.

#### Chart 4: Consumer spending and the state of the labour market



Source: Thomson Datastream, Schroders, September 2010 .

On the currency front, the USD initially weakens as the US leads the fall into recession. However, as other countries subsequently slow, we would expect the EUR and GBP to weaken in 2011. Safe haven flows are also likely to favour the USD in 2011.

#### Implications for markets

Cyclical assets, equities and some commodities are expected to perform poorly. Instead, against a backdrop of increased risk aversion, investors are likely to turn to gold and high quality government bonds.

# Regional Equity Views

## Key Points

-	US	<ul style="list-style-type: none"> <li>- We have downgraded our growth forecast for the US to reflect the weaker performance of the economy around mid-year. While there are signs of improvement in consumer spending, housing activity is still in the doldrums and households continue to de-lever their balance sheets.</li> <li>- However, the bright spot is the corporate sector where firms continue to maintain strong cash balances. Eventually, this could be a positive catalyst for the market, particularly if this leads to greater share buybacks and M&amp;A (mergers and acquisitions) activity.</li> <li>- Judging from recent institutional surveys, US equities are no longer favoured by international investors. Moreover, compared to elsewhere, more US companies are receiving downward revisions to earnings than upgrades.</li> </ul>
+	UK	<ul style="list-style-type: none"> <li>- The UK still faces significant fiscal challenges, but the budgetary measures to cut the deficit have reassured the market to some extent. Meanwhile, UK companies are benefitting from the competitiveness of sterling. Moreover, the FTSE 100 companies are less geared towards the domestic economy, instead they should benefit from overseas growth.</li> <li>- From a valuation perspective, UK equities continue to appear cheap relative to history and other markets. In addition, institutional investors have become more positive on the market's performance prospects.</li> </ul>
-	Europe ex UK	<ul style="list-style-type: none"> <li>- Compared to the rest of the developed world, the weakest growth prospects are to be found in the Eurozone given the region's structural debt issues and the impact of fiscal consolidation. We also expect that concerns over the solvency of the peripheral economies to increase later in the year.</li> </ul>
-	Japan	<ul style="list-style-type: none"> <li>- Recent macro news on Japan has disappointed and consensus has been revising down the market's growth outlook. However, further intervention by the central bank to weaken the yen could spur equity gains.</li> <li>- This market tends to benefit from the pick up in US monetary tightening expectations. With US interest rates likely to stay low for an extended period, Japanese stocks may fail to find the impetus to outperform.</li> <li>- Japan has received the lowest score from our quant models. Not only is this region the least preferred region to overweight by global investors, even momentum behind their stock index is one of the weakest.</li> </ul>
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	<ul style="list-style-type: none"> <li>- Pacific ex Japan should continue to respond well to a loose US monetary policy, fostering benign liquidity conditions in the region. At the same time, countries such as Hong Kong should benefit from China stepping back from further monetary tightening. Although in terms of equity valuations and forward-looking metrics on earnings, the region is looking unattractive relative to elsewhere.</li> </ul>
+	Emerging markets	<ul style="list-style-type: none"> <li>- The best sustainable growth prospects remain in the emerging world due to their stronger structural fundamentals including trade surplus positions. Meanwhile, increased signs that inflation pressures in China are starting to wane should provide the authorities with a chance of a benign soft landing scenario.</li> <li>- Based on our quant models, the emerging world is one of our favourite markets to overweight. Both momentum and investors' sentiment towards the market has turned more positive compared to three months ago.</li> </ul>

Key: +/- market expected to outperform/ underperform (maximum +++ minimum ---) 0 indicates a neutral position

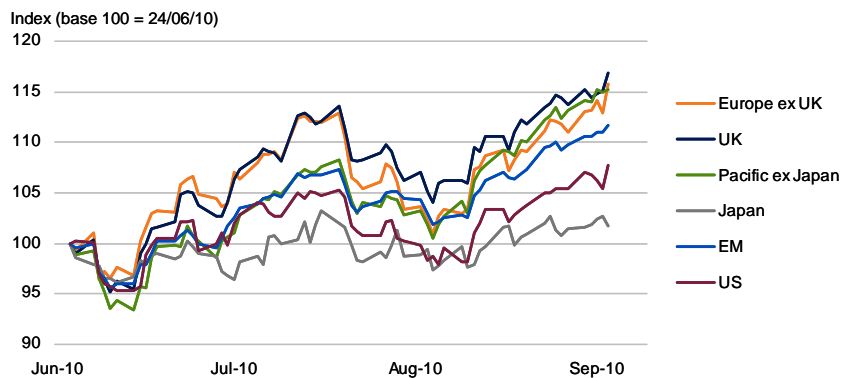
# Equity Markets

## Market Review

Equities bounce back from summer losses...

It has been a choppy three months for equities around the world where summer losses were recovered by September's gains. While global markets made positive headway, the US and Japan failed to match the UK and Europe ex UK in the performance stakes (chart 5). In the US, investors struggled to balance the strong Q2 earnings season with the loss of momentum behind the recovery story. In particular, disappointing retail sales and home sales painted a weaker picture on the US economy.

**Chart 5: Performance of equities over the last three months**

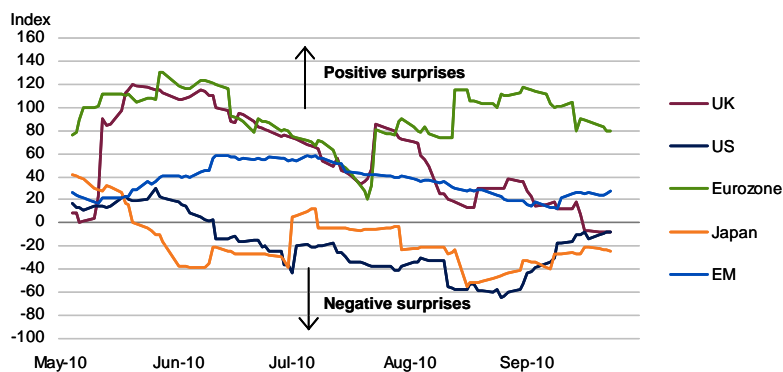


Source: MSCI total return indices (USD), Thomson Datastream, 27 September 2010

...although Japan is the weakest performer

Across the Atlantic, Europe ex UK has made a strong comeback after suffering heavy losses three months ago due to sovereign debt concerns in the peripheral Eurozone economies. This has been aided by signs of improvement in these countries' fiscal positions, as well as better economic news relative to consensus (chart 6). Meanwhile, Japanese equities have suffered from international investors trimming their exposure in the region and this has been reflected in fund outflows.

**Chart 6: Economic surprise indices**



Source: Citigroup, Bloomberg, 27 September 2010. Economic surprise indices are weighted historical standard deviations of data surprises (actual releases versus Bloomberg survey media). The indices are calculated daily in a rolling three-month window.

Against a backdrop where US equities delivered positive returns over the last three months, defensives managed to outperform the more cyclical sectors. In particular, defensive stocks in the telecoms and utilities sectors stormed ahead of their cyclical peers such as tech and consumer discretionary. Meanwhile, the style winners were large cap and growth stocks. Notably, value stocks were dragged down by the poor returns of financials with the majority of banks falling short of consensus revenue expectations.

# Equity Markets (continued)

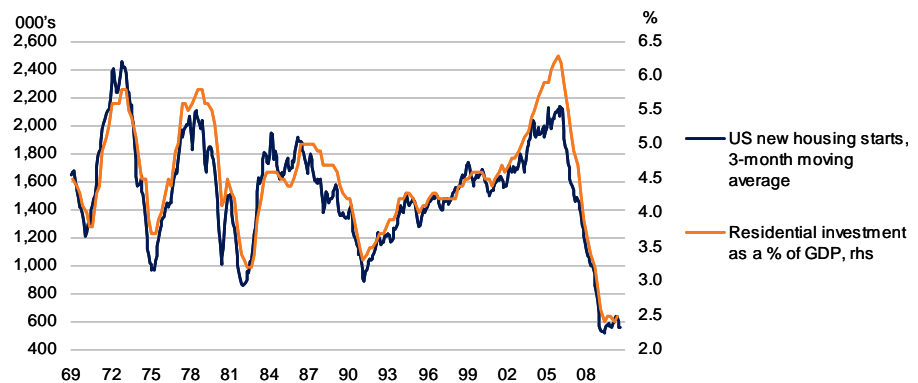
## Market Outlook

Downgrade on US equities...

Within equities, we have downgraded our view on US equities to moderately underweight to reflect our lower growth forecast with the economy expected to be weaker around mid-year. While there are signs of improvement in consumer spending, housing activity is still in the doldrums (chart 7). Households also continue to de-lever their balance sheets, with the savings rate in the US rising to the highest level for more than a decade (chart 8). Although in terms of the impact to consumption, the worst seems to be behind us.

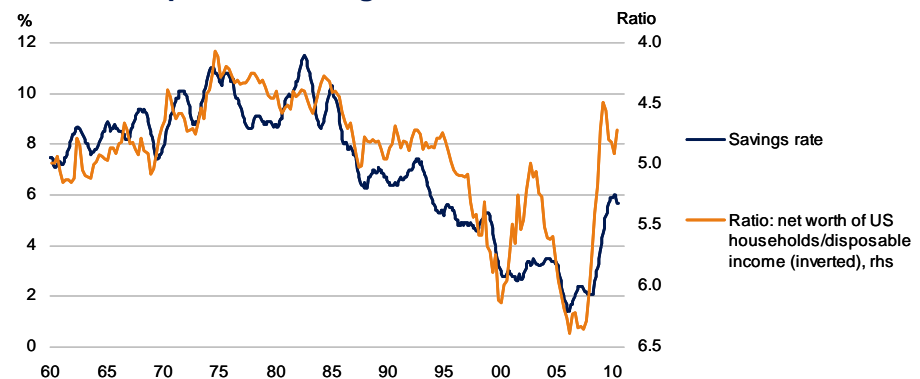
...is a reflection of weaker growth

**Chart 7: US residential investment and housing starts**



Source: Thomson Datastream, Schroders, 27 September 2010.

**Chart 8: US personal savings rate and net worth**



Source: Thomson Datastream, Schroders, 27 September 2010.

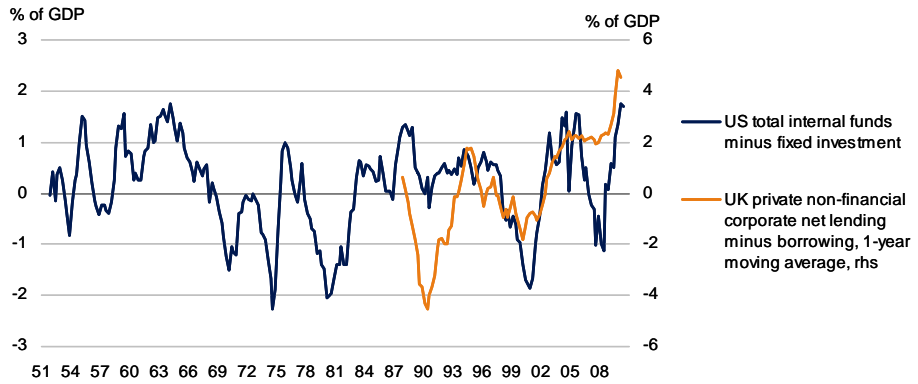
Corporate cash balances remain healthy...

Despite the gloomier outlook on the domestic side, the bright spot is the US corporate sector where firms continue to maintain strong cash balances. UK companies have also seen a surge in cash flow (chart 9 on next page). Arguably, these ample cash balances could eventually feed into greater share buybacks, M&A activity, and capex spending, which ultimately is a positive for US and UK stocks.

# Equity Markets (continued)

## Market Outlook

**Chart 9: US and UK corporate cash balances**

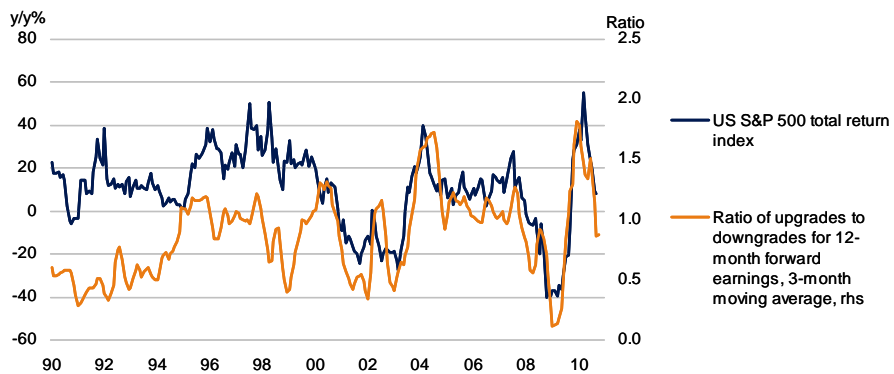


Source: Thomson Datastream, Schroders, 27 September 2010.

...but downward revisions to US earnings

However, analysts have continued to revise down their earning expectations on the US. As a result, stocks are receiving more downward revisions to future earnings than upgrades (chart 10). Of the S&P 500 companies, more than a half experienced a reduction in their earnings estimate for the next 12 months. Moreover, consensus has also been cutting sharply their earning forecasts on Pacific ex Japan equities (chart 11).

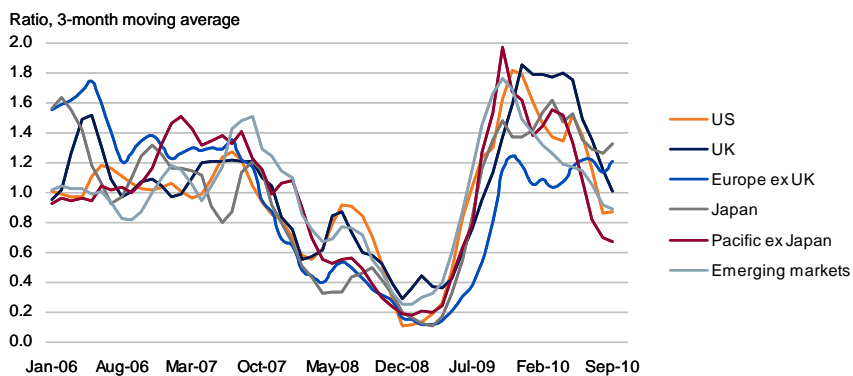
**Chart 10: S&P 500 earning revisions and performance**



Source: Thomson Datastream, Schroders, 27 September 2010.

Earning forecasts on Pacific ex Japan equities have deteriorated rapidly

**Chart 11: Earnings revision ratio across markets**



Earnings revision ratio based on upgrades versus downgrades for 12-month forward earnings. Source: IBES, Thomson Datastream, Schroders, 27 September 2010.

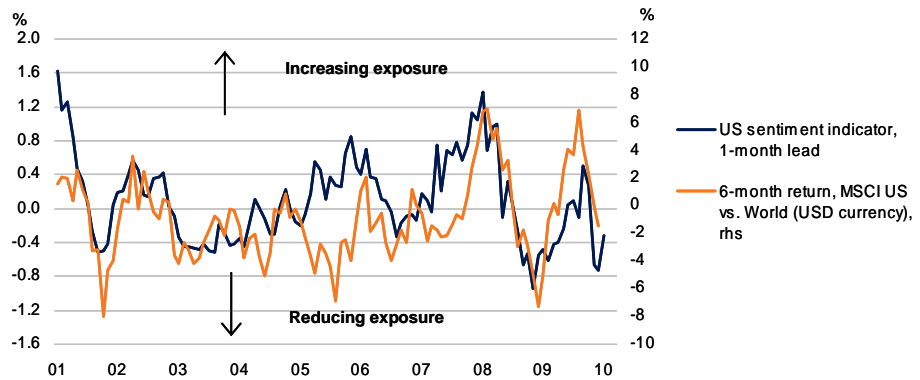
# Equity Markets (continued)

## Market Outlook

Investors no longer favour US and Japanese equities...

Meanwhile, according to our regional equity sentiment model which gauges investors' sentiment towards a market, international investors have cooled towards US and Japanese equities (chart 12). On a forward-looking basis, this appears to be a negative for both markets given that there tends to be a good relationship between our sentiment indicator, and relative equity performance versus the world.

**Chart 12: Investors' sentiment towards the US**

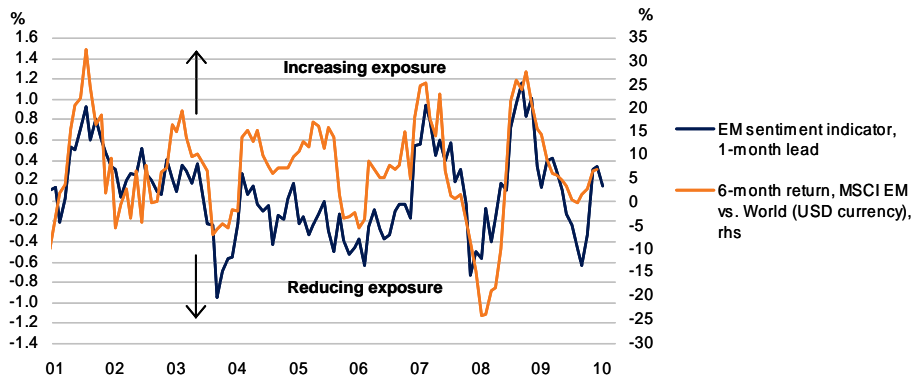


Source: Thomson Datastream, Schroders, 27 September 2010.

Instead, institutional investors have turned more positive towards UK and emerging equities (chart 13), which suggests these markets could benefit from additional fund flows over the coming months.

..but have warmed to the emerging markets

**Chart 13: Investors' exposure towards the emerging markets**



Source: Thomson Datastream, Schroders, 27 September 2010.

Growth prospects look the best in the emerging world...

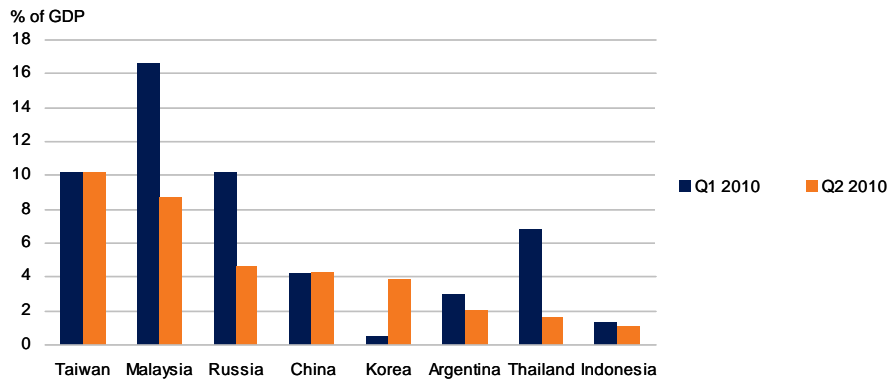
Arguably, the best sustainable growth prospects remain in the emerging world due to their stronger structural fundamentals including current account surplus positions (chart 14 on next page). We expect the emerging countries to account for more than half of global growth this year and next (chart 2 on page 6).

# Equity Markets (continued)

## Market Outlook

...given their stronger structural fundamentals

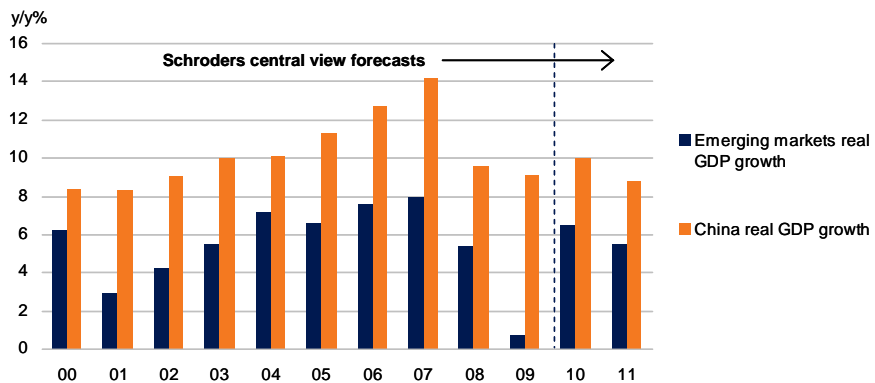
**Chart 14: Current account surpluses in the emerging world**



Source: Thomson Datastream, September 2010.

Unsurprisingly, one of the key contributors to emerging growth is China, which is forecast to expand by 10% and 8.8% respectively in 2010 and 2011 (chart 15). Meanwhile, inflation indicators in China have started to turn down, which suggests that prices have peaked in the region. For instance, the rise in the headline CPI rate has followed money growth in China (chart 16 on next page). The latter has started to decline rapidly over recent months.

**Chart 15: Growth prospects of emerging markets and China**



Source: IMF (International Monetary Fund), Thomson Datastream, Schroders, September 2010.

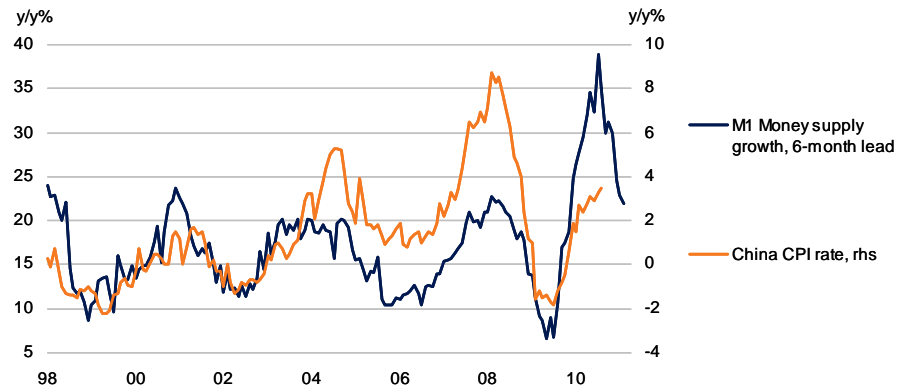
Inflationary pressures have started to wane in China

Increased signs that inflation pressures in China are starting to wane should provide the authorities with a chance of a benign soft landing scenario. This in turn should be a positive macro backdrop for emerging equities. At the same, countries in the Pacific ex Japan, such as Hong Kong, should benefit from China stepping back from further monetary tightening. This is underscored by the importance of China to sentiment and liquidity in the region (chart 17 on next page).

# Equity Markets (continued)

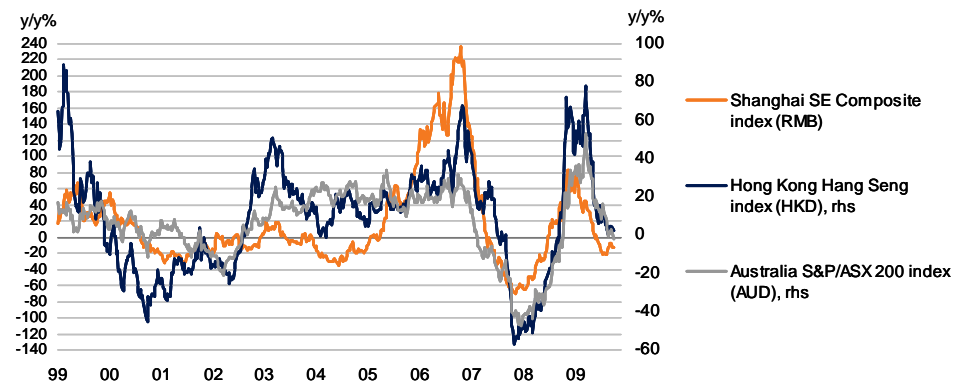
## Market Outlook

Chart 16: M1 money supply indicates lower inflation in China



Source: Thomson Datastream, 27 September 2010.

Chart 17: Performance in Hong Kong, Australia and China



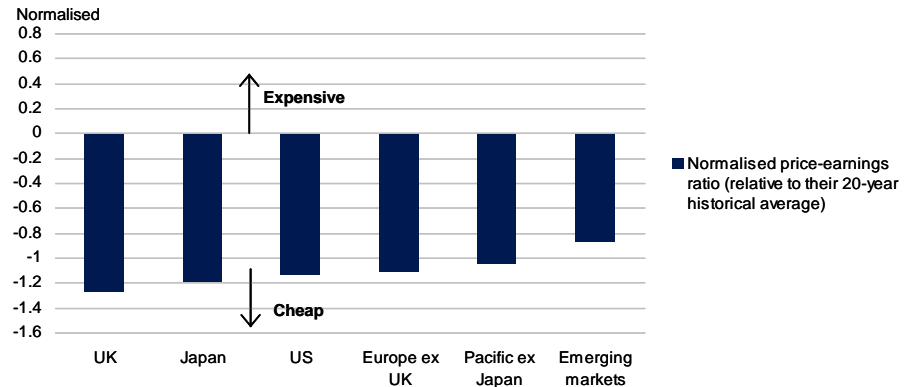
Source: Thomson Datastream, 27 September 2010.

Performance of Pacific ex Japan tied to China...

..but valuations appear unappealing

Although in terms of equity valuations and forward-looking metrics on earnings, the region is looking unattractive relative to elsewhere. Based on the latest 12-month forward price-earnings ratio compared to their 20-year history, Pacific ex Japan equities appear expensive relative to their peers (chart 18). Instead, UK and Japanese equities look the most attractive from a valuation perspective.

Chart 18: 12-month forward price-earnings ratios compared to history



Price-earnings ratio based on MSCI benchmarks. Source: Thomson Datastream, RIMES, Schroders, 27 September 2010.

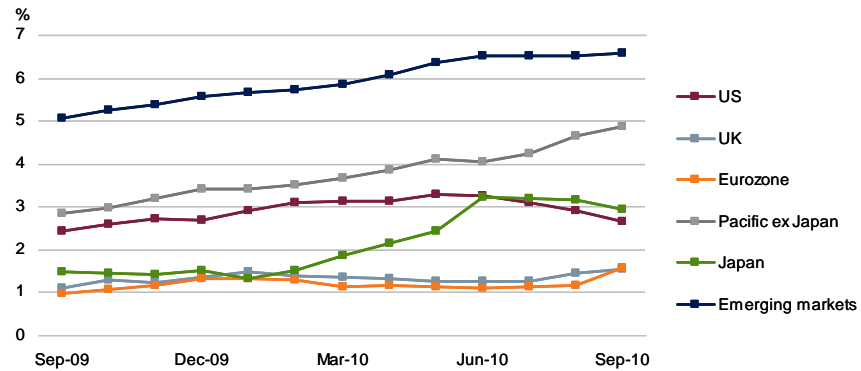
# Equity Markets (continued)

## Market Outlook

Consensus expects growth to be the weakest in the UK and Eurozone

Despite attractive valuations in the UK, forecasters are expecting growth in the UK along with the Eurozone to be weakest relative to the rest of the world (chart 19). Although both economies are likely to benefit from a weaker currency, fiscal consolidation over the coming year could constrain their growth prospects.

**Chart 19: Consensus growth forecasts for 2010**

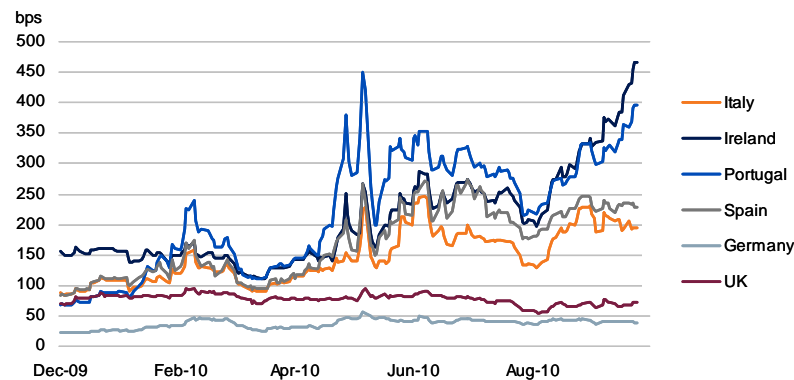


Source: Consensus Economics, Schroders, September 2010.

Eurozone particularly hampered by the return of solvency concerns

However, UK's budgetary measures to cut the deficit have reassured the market to some extent when compared to their European neighbours. Lately, there has been a sharp rise in the cost of buying protection against a sovereign default measured by the credit default swap (CDS) spread (chart 20). In particular, the CDS spread for Ireland has rocketed to 465 basis points (bps) since the beginning of August. Looking ahead, we expect that concerns over the sovereign solvency of the peripheral European economies to increase later in the year, and be a drag on performance.

**Chart 20: European CDS spreads**



Source: Bloomberg, 27 September 2010.

The FTSE 100 companies are also less geared towards the domestic picture, and instead they should benefit from overseas growth and earnings (foreign income represents 59.2% of total income versus 35.1% in the Euro Stoxx 50 companies).<sup>1</sup> Overall, we are positive on the UK, but have underweight positions in Europe ex UK and Japan.

<sup>1</sup> Figures sourced from PRISM (Portfolio Risk Investment Strategy Manager), Schroders, 28 September 2010

# Equity Markets (continued)

## Market Outlook

Weaker yen offers respite to exporters and equities...

The recent macro news on Japan has disappointed and consensus has been revising down the market's growth outlook (chart 19 on page 16). However, further intervention by the central bank to weaken the yen could spur equity gains (chart 21). In particular, a weaker currency should be a welcome respite for Japanese exporters given the importance they play in the performance of the market.

**Chart 21: Japanese equities and the yen**

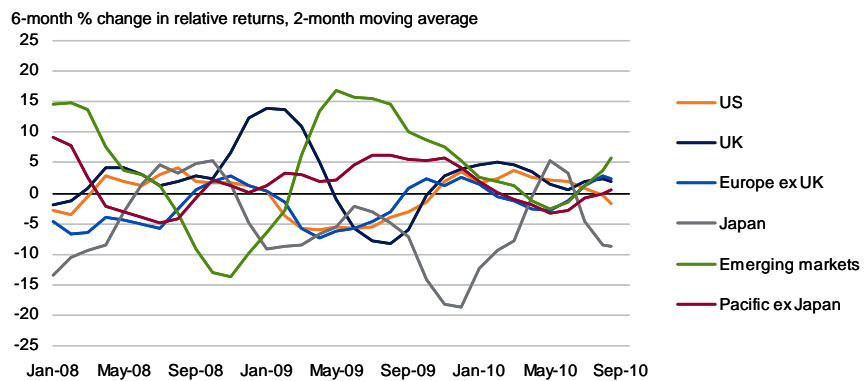


Source: Thomson Datastream, 27 September 2010.

...but negative momentum behind the market

Nevertheless, Japan has received the lowest score from our quant models. Not only is this region the least preferred to overweight by global investors, even momentum behind their stock index is one of the weakest (chart 22).

**Chart 22: Price momentum behind markets**



Price momentum calculated using the MSCI total return indices in local currency with each region's returns compared to an equal weighted benchmark over the last 6 months. Source: Thomson Datastream, Schroders, September 2010.

# Equity Markets (continued)

## Market Outlook

This market also tends to benefit from the pick up in US monetary tightening expectations, which is indicative of the strength in global economy and demand for exports. With US interest rates likely to stay low for an extended period, Japanese stocks may fail to find the impetus to outperform (chart 23).

**Chart 23: US government bond yields and the performance of the TOPIX**



Source: Thomson Datastream, 27 September 2010.

# Fixed Income

## Key Points

### Fixed Income

0	Government	<ul style="list-style-type: none"> <li>- Policy rates in the developed world should remain low for an extended period. Underlying this view is the balancing act faced by central banks when governments are tightening their fiscal balance sheets and inflation is low.</li> <li>- In the near-term, yield curves are likely to remain steep as short rates are anchored by major central banks leaving interest rates at current levels until next year.</li> <li>- However, we believe that the world economy is on a sustainable growth path, which suggests that the recovery could put government bond yields under increasing pressure.</li> <li>- On valuation grounds, government bonds are looking expensive given that yields have declined to historical lows.</li> <li>- Based on our quant models, the Swiss and European government bond markets are the least favoured.</li> </ul>
+	Investment Grade (IG) Corporate	<ul style="list-style-type: none"> <li>- Interest rates are expected to stay low for some time. This suggests that IG should remain attractive relative to cash given the strong search for yield amongst investors.</li> <li>- Recent spread narrowing has added to the case that IG bonds are no longer compelling from a valuation perspective. However, credit is less vulnerable to the slowing top-line growth forecast than equities.</li> </ul>
++	High yield (HY)	<ul style="list-style-type: none"> <li>- While HY spreads have narrowed, spreads remain reasonable on valuation grounds given that they are still elevated relative to pre-crisis levels.</li> <li>- With record cash cover, US corporates have a greater incentive to pay back their debt. At the same time, the recovery in corporate profits, which is likely to continue over the coming months, should also be a positive for corporate credit.</li> </ul>
0	Emerging market debt (EMD)	<ul style="list-style-type: none"> <li>- Many emerging sovereign issuers have a domestic economy in better fiscal shape than their developed peers.</li> <li>- However, the contraction in emerging sovereign spreads suggests that valuations for some countries are trading towards the more expensive end.</li> </ul>
0	Index-Linked	<ul style="list-style-type: none"> <li>- We expect global inflation to ease as commodity gains moderate and core prices recede further. The latter is expected to remain subdued given the presence of a significant output gap.</li> <li>- The exception continues to be the UK where we have increased our forecast for inflation. Besides the rise in VAT next year, the continued elevated outturn of the headline and core CPI rate suggests that there is less slack in the economy.</li> </ul>

Key: +/- market expected to outperform/ underperform (maximum +++ minimum ---) 0 indicates a neutral position

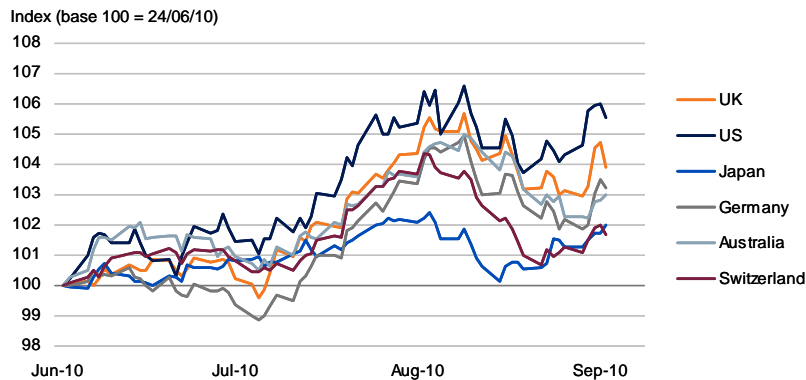
# Fixed Income Market Review

Government bonds have continued to rally...

In keeping with the performance during the start of the year, government bonds have continued to rally over the last three months. Instead, the focal point has switched from the sovereign problems in the Eurozone periphery to fears about US growth. Weaker US data has led markets to worry that the world's largest economy could slide into a double dip recession. This prompted speculation that the Fed was likely to engage in a further round of quantitative easing to ensure the US recovery remained on track.

Unsurprisingly, amongst the developed debt markets, US Treasuries were the clear outperformers (chart 24). In contrast, Japanese and Swiss government bonds were the laggards of the pack. In particular, the Swiss economy surprised consensus by growing 0.9% q/q in Q2 this year.

**Chart 24: Performance of government bonds over the last three months**

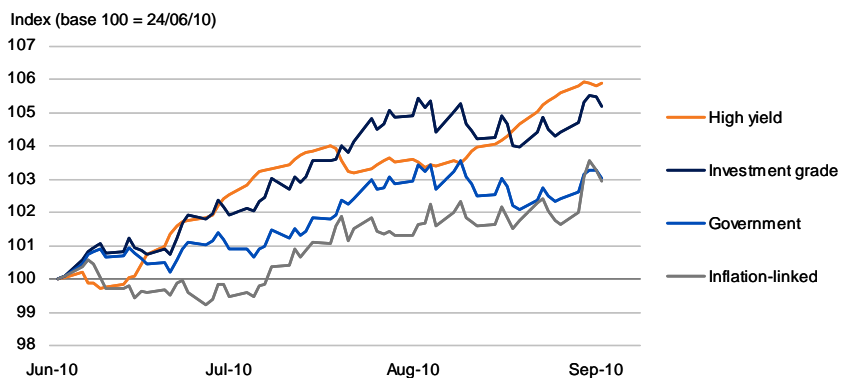


Source: Thomson Datastream, 27 September 2010. Performance based on 10-year government bond total return indices, local currency.

...but high yield has outperformed the rest

Within the bond spectrum, despite underperforming for most of the last three months, US inflation-linked bonds have delivered similar gains to nominal equivalents. However, US Treasuries have significantly underperformed their credit peers with high yield leading the way followed closely by investment grade bonds (chart 25). While credit spreads for investment grade bonds have only been marginally tighter than they were three months ago, returns have been stronger than government bonds due to their higher yield.

**Chart 25: Performance of US bond sectors over the last three months**



Source: Thomson Datastream, 27 September 2010. Performance based on Bank of America/ Merrill Lynch bond total return indices for all maturities, USD currency.

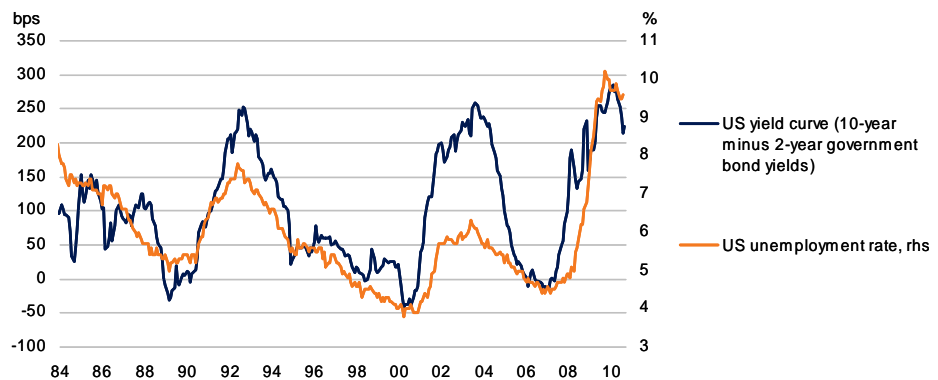
# Fixed Income Market Outlook

Low interest rates for longer...

We expect policy rates in the developed world to remain on hold for an extended period. Underlying this view is the balancing act faced by central banks to keep monetary policy loose due to concerns over the strength of the recovery. Consequently, we have delayed our first rate rise in the US and Eurozone to September next year. Eventually, when the key central banks start to raise rates, the pace of policy tightening is likely to be slow. This is to accommodate fears of a relapse into recession, particularly in those economies facing fiscal consolidation.

With rates lower for longer, government bond yields are likely to be well anchored. Although there is the risk that yields could be dragged down further by additional quantitative easing by the central banks. However, we believe this outlook has largely been priced in by the market. Moreover, we assume that the world economy is on a sustainable growth path, the US is unlikely to drop back into recession. This suggests that at some point the recovery could put yields under increasing pressure.

**Chart 26: US unemployment rate and jobless claims**

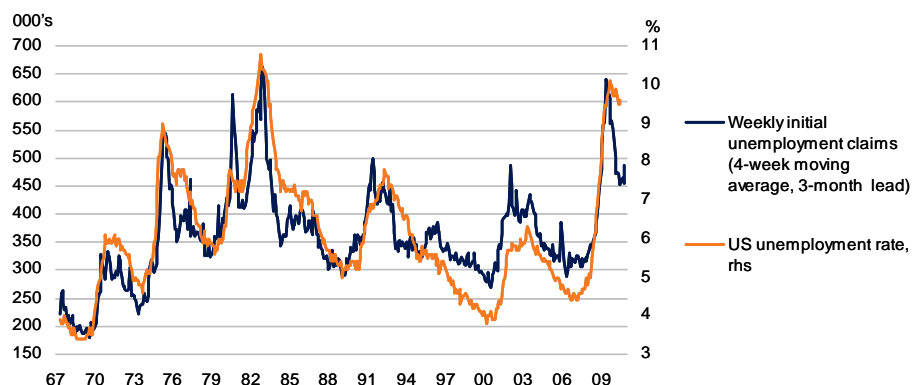


Source: Thomson Datastream, 27 September 2010.

...which suggests US yield curve is likely to remain steep

Against this backdrop, government yield curves for most of the major developed economies are likely to remain steep in the near-term. In the US, the improvement in the labour market is taking more time, but the fall in jobless claims signals that unemployment could trend lower over the coming months (chart 26). Historically, the yield curve has flattened following a fall in the unemployment rate (chart 27).

**Chart 27: US unemployment rate and the yield curve**



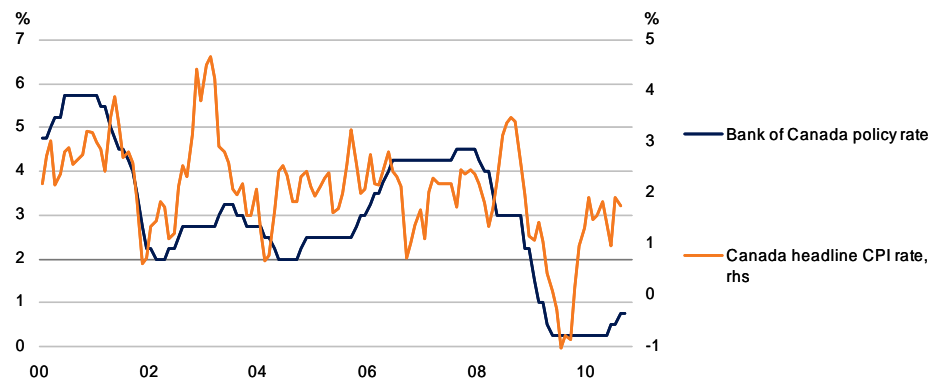
Source: Thomson Datastream, 27 September 2010.

# Fixed Income Market Outlook

Other central banks have started to tighten

By contrast, the central banks of some developed economies have started to tighten interest rates, such as the Bank of Canada (BOC). Canada is expected to continue with its rate normalisation policy given the macro improvements and pick up in inflationary pressures in the domestic economy (chart 28). Looking ahead, higher rates could depress bond returns in this market.

**Chart 28: Inflation and interest rates in Canada**

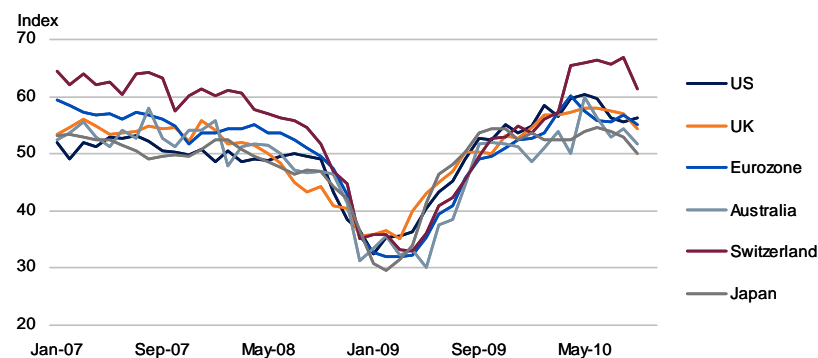


Source: Thomson Datastream, 27 September 2010.

Swiss bonds expected to underperform...

Similarly, according to our quant models, the Swiss and Eurozone government bond markets are the least favoured. Currently, Switzerland has one of the strongest purchasing managers' indices (PMIs), which is a leading indicator of economic activity (chart 29). This in turn suggests that Swiss sovereign debt could underperform over the coming months.

**Chart 29: Purchasing managers' indices**



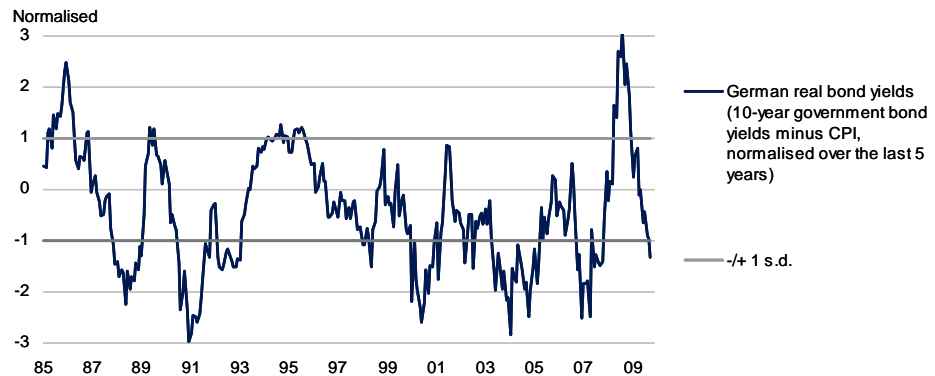
Source: Markit PMI, 27 Septmeber 2010.

In terms of bond valuations, German government bonds are looking unattractive when compared to their own history and other markets (chart 30 on next page). The Eurozone has the added difficulty where sovereign default risk still persists. While the peripheral countries have attempted to reduce their budget deficits, their debt levels remain unfavourable and more debt issuance is expected to follow (charts 31 and 32 on next page).

# Fixed Income Market Outlook

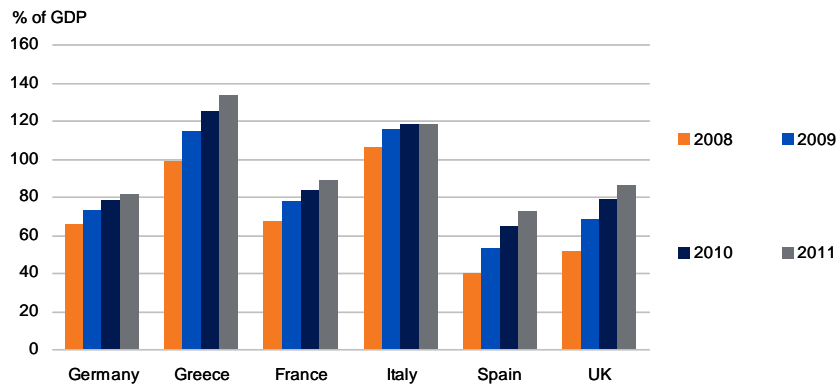
...along with  
Eurozone  
sovereign debt...

Chart 30: German real government bond yields



Source: Thomson Datastream, 27 September 2010.

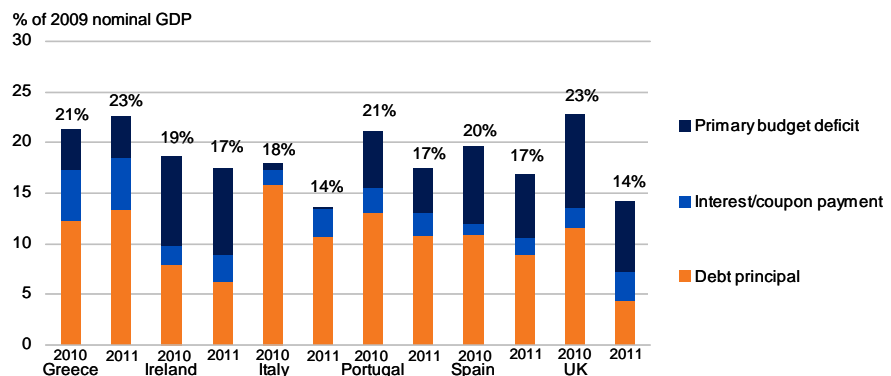
Chart 31: General government debt levels in Europe



Source: European Commission, Spring 2010.

...which faces  
further issuance

Chart 32: Debt finance in Europe



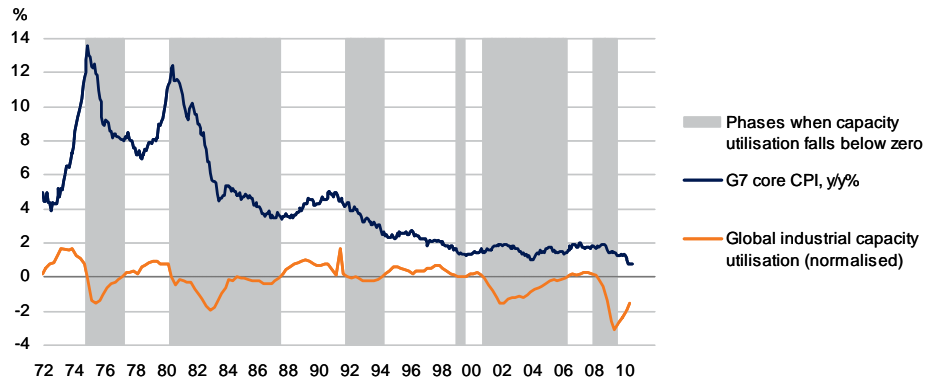
Source: European Commission, Bloomberg, 10 September 2010

US core CPI  
expected to  
remain subdued

Meanwhile, we expect global inflation to ease as commodity gains moderate and core prices recede further. The latter is expected to remain subdued given the presence of a significant output gap measured by the capacity utilisation rate (chart 33 on next page). Overall, we are neutral on the inflation-linked bond market.

# Fixed Income Market Outlook

**Chart 33: G7 core CPI and global capacity utilisation rate**



Global capacity utilisation rate is a GDP-weighted average of US, Japan and Germany's capacity utilisation rates. Source: Thomson Datastream, Schroders, 27 September 2010.

Credit offers  
value...

On credit, we remain positive on investment grade and high yield. Recent spread narrowing has added to case that these credit bonds are no longer compelling from a valuation perspective. However, spreads continue to appear reasonable as they are still some way from pre-crisis levels (chart 34). Importantly, credit is less vulnerable to the slowing of top-line growth forecasts than equities.

**Chart 34: Credit spreads still above pre-crisis levels**



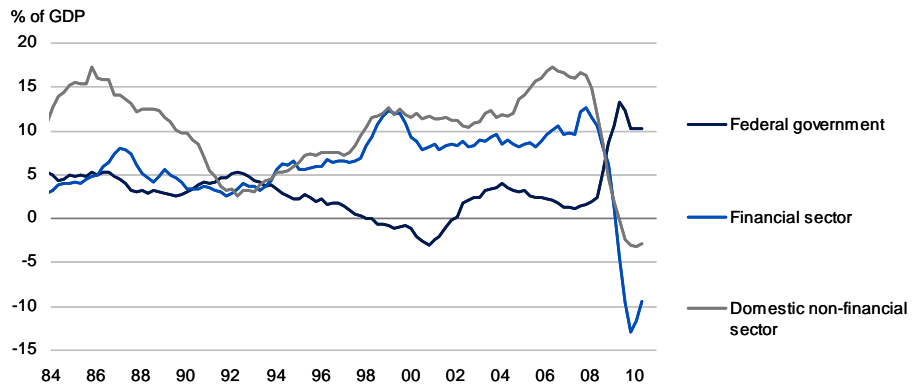
Source: Bloomberg, 27 September 2010.

...benefitting  
from corporates  
borrowing less

Meanwhile, there is clear evidence that US corporates are de-leveraging their balance sheets and paying back their debt, which should be a positive for the credit sector (chart 35 on next page). This is underscored by the record cash cover on their books (chart 9 on page 12).

# Fixed Income Market Outlook

**Chart 35: Borrowing by sector**

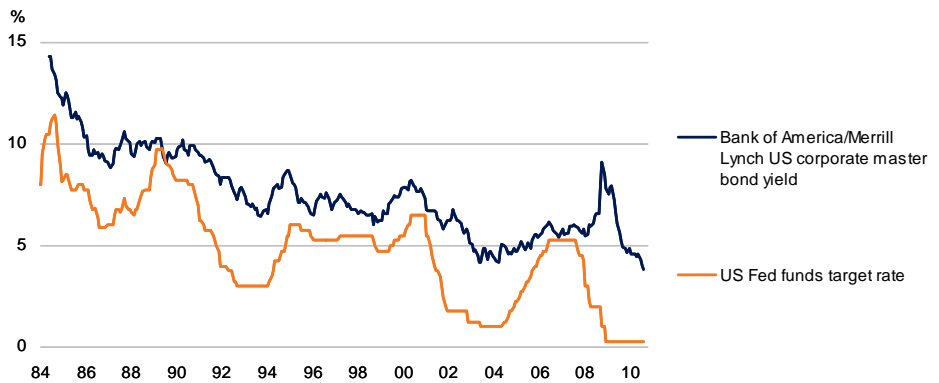


Source: Thomson Datastream, Schroders, 27 September 2010.

Carry from credit is attractive relative to cash

With interest rates also expected to remain low for an extended period, the yield from credit remains attractive (chart 36). Looking ahead, this is a plus for the sector, as investors continue to move funds away from money markets to credit bonds.

**Chart 36: Carry between US corporate bonds and cash**



Source: Thomson Datastream, Schroders, 27 September 2010.

# Alternatives

## Key Points

### Alternatives

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0	Commodities	<ul style="list-style-type: none"><li>- With global activity expected to moderate as we head into the New Year, particularly in the OECD economies, the performance of this asset class faces a bumpy road ahead. Nonetheless, demand for commodities from the emerging world should remain resilient due to their stronger growth prospects.</li><li>- Meanwhile, with the exception of copper, most of the forward curves for the major commodities are in contango, which is a negative for this sector.</li><li>- Within the commodity space, our quant models prefer industrial and precious metals, but are cautious on the agriculture and energy sectors.</li><li>- Nonetheless, the long-term structural themes behind the case for investing in agricultural commodities remains compelling, such as a growing world population, climate change, emerging market diet development and planting competition with biofuels.</li><li>- For precious metals, gold looks attractive given that real interest rates are expected to remain low. The performance of gold benefits from investors looking to hedge against a rise in risk aversion. However, the price of gold has reached an all-time high.</li></ul>
0	Property	<ul style="list-style-type: none"><li>- Growth in the UK and Eurozone is likely to moderate as we move into 2011 as governments tighten their fiscal belts. Hence, there is the risk that property yields could start rising again if the recovery falters.</li><li>- However, Schroders commercial property yield models for the UK and Europe, both suggests further compression in yields over the coming months.</li><li>- From a valuation perspective, the direct and listed property sectors in the UK and Europe broadly appear fair value relative to history and other assets.</li></ul>

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Key: +/- market expected to outperform/ underperform (maximum +++ minimum ---) 0 indicates a neutral position

# Commodities

## Market Review

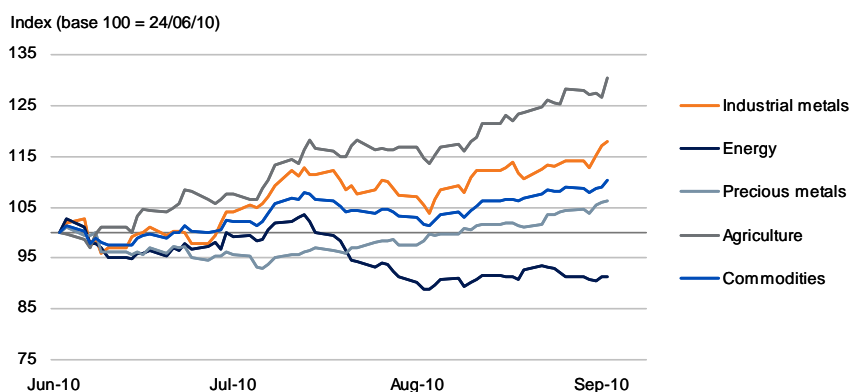
Agriculture sector has been the star performer...

Over the last three months, the strongest commodity performer by far was the agricultural complex, where prices have been predominately driven by fundamentals and sentiment. Wheat and grain prices have rocketed given the reduced crop forecasts on adverse weather conditions and resultant export restrictions. By contrast, the energy sector has been lacklustre despite the cyclical sector of industrial metals making strong gains (chart 37).

Meanwhile, AUM (assets under management) in commodity investments reached an all time high over recent months and surpassed \$300 billion for the first time as commodity inflows continued and prices strengthened. Growth in index swaps was the main driver, more than offsetting a large outflow of funds from exchange-traded products, especially from physically backed gold products.<sup>2</sup>

..while their energy peers have failed to shine

**Chart 37: Performance of commodities over the last three months**



Performance based on the DJ UBS commodity total return indices (USD currency). Source: Thomson Datastream, 27 September 2010.

## Market Outlook

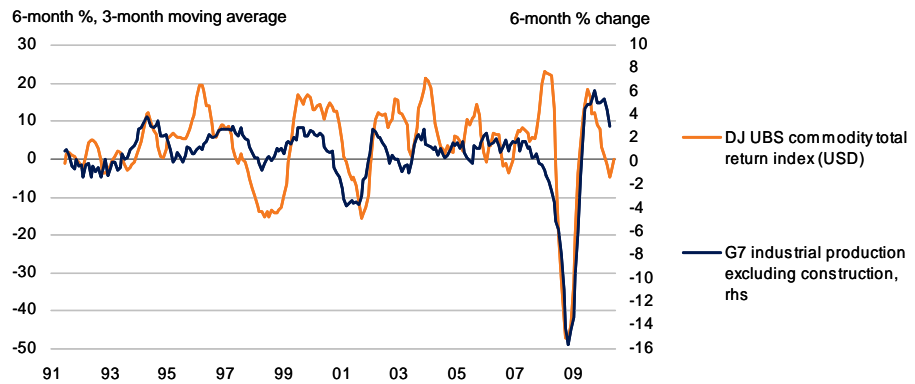
Commodities face a bumpy road ahead...

With global activity expected to moderate as we head into 2011, the performance of commodities face a bumpy road ahead. Amongst the OECD economies, demand for commodities face the hurdle of governments and households retrenching their balance sheets. Activity in the world economy has already started to ease, which does not bode well for this asset class (chart 38 on next page).

<sup>2</sup> Source: Barclays Capital, September 2010

# Commodities Market Outlook

**Chart 38: Performance of commodities and G7 industrial production**

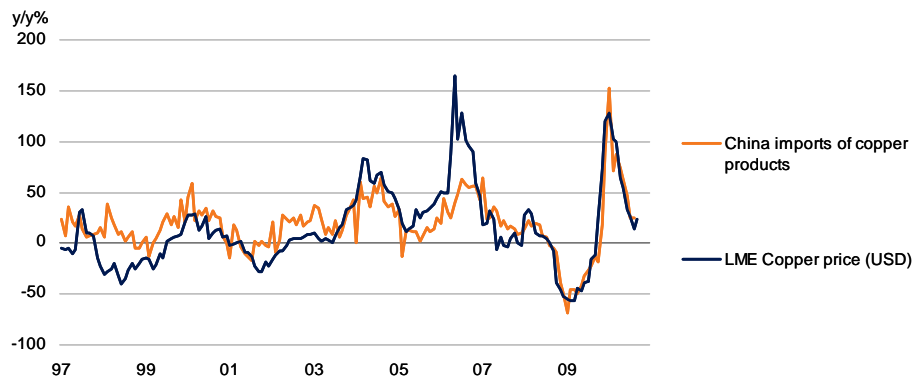


Source: Thomson Datastream, Schroders, 27 September 2010.

...but should continue to receive a helping hand from the emerging world

Nonetheless, demand for commodities from the emerging world should remain resilient due to their stronger growth prospects (chart 15 on page 14). Moreover, inflationary pressures in China have started to show signs of easing, which should provide the authorities with greater leeway to create a benign soft landing scenario for China. This in turn is a positive for commodities especially given the importance of this market (chart 39).

**Chart 39: Copper prices and China's import demands**



Source: Thomson Datastream, 27 September 2010.

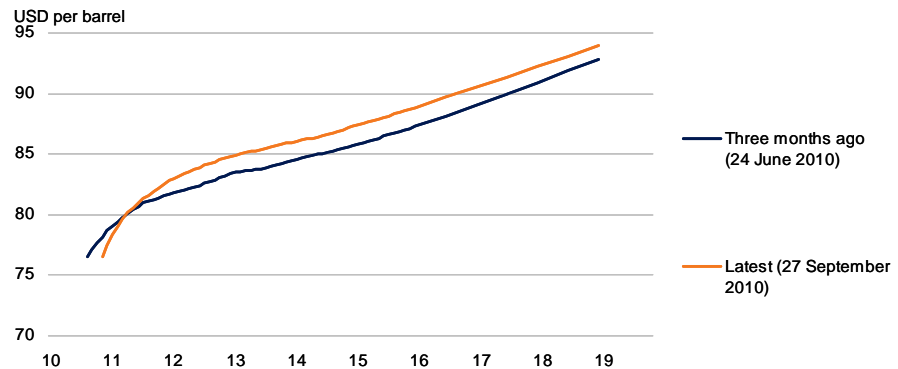
Commodity curves in contango, particularly in the gold market...

Meanwhile, with the exception of copper, most of the forward curves for the major commodities are in contango (where future delivery prices exceed spot prices). This makes investing in commodities expensive in terms of roll yield.<sup>3</sup> In particular, the forward curve for crude oil has steepened over the last three months (chart 40 on next page).

<sup>3</sup> Roll yield is the return received when the future delivery price converges to the spot price. For commodity curves in contango, there is a negative roll yield as the future delivery price is greater than the spot price, and rolls down the curve to converge towards the spot price.

# Commodities Market Outlook

**Chart 40: Crude oil forward curves**

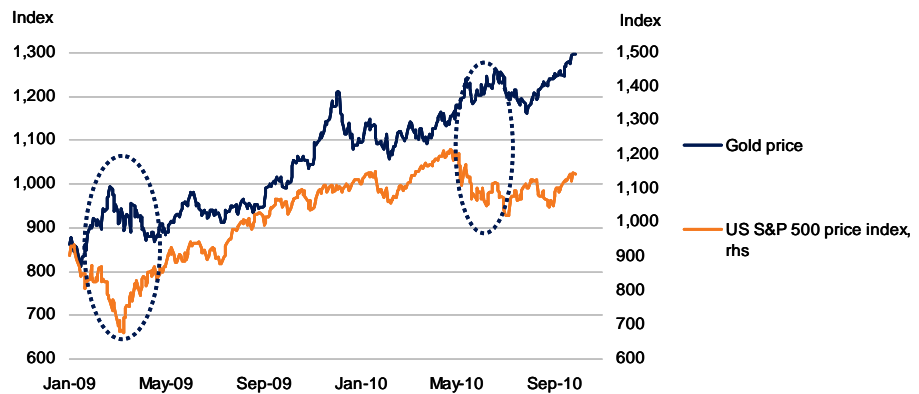


Source: Bloomberg, 28 September 2010

...but risk aversion could drive gold prices higher

However, the price momentum behind precious metals, particularly gold has surged over recent months taking prices to an all-time high. Gold is looking attractive given that real interest rates are expected to remain low for an extended period. Meanwhile, in some instances, the gold price has benefitted from investors looking to hedge against a rise in risk aversion (chart 41). The latter illustrated by episodes where a sell-off in the US S&P 500, a proxy for risk aversion in the market, sees a bounce in the gold price.

**Chart 41: Performance of gold and risk aversion**



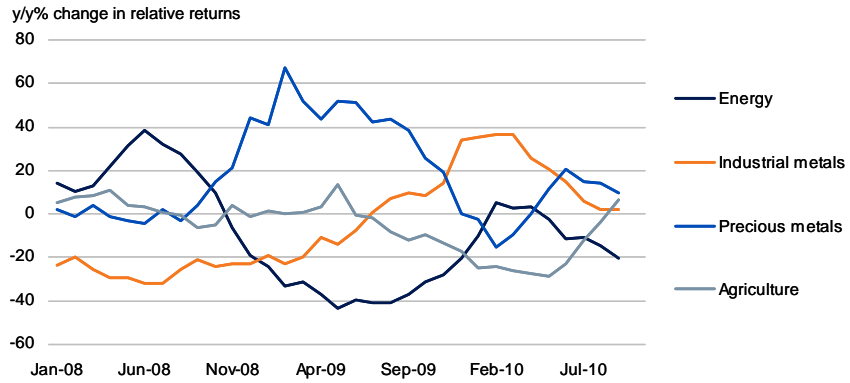
Source: Thomson Datastream, 28 September 2010.

Quant models favours precious and industrial metals

By contrast, our quant models are negative on the agriculture and energy sectors, but favour precious and industrial metals. In particular, the price momentum behind the energy sector, a technical indicator based on the relative returns over the last 12 months, is the weakest compared to other commodities (chart 42 on next page).

# Commodities Market Outlook

**Chart 42: Price momentum behind the performance of commodities**



Source: Thomson Datastream, Schroders, 27 September 2010. Returns based on the S&P Goldman Sachs commodity indices in USD.

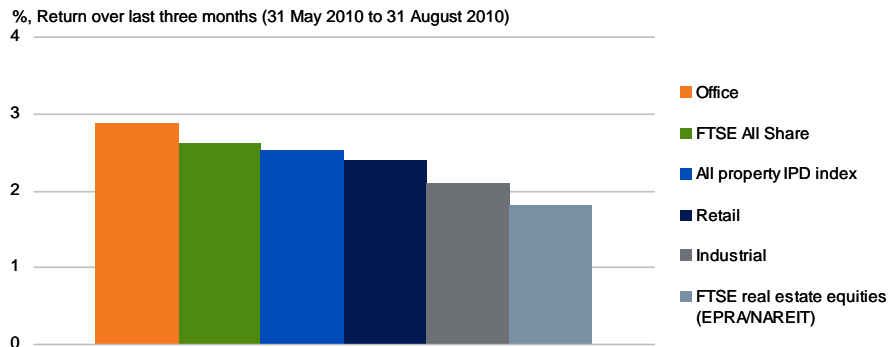
Nevertheless, amongst the commodity sectors, agriculture is one the least cyclically connected. Instead, the long-term structural themes for investing in agriculture commodities remain compelling, such as a growing world population, climate change, emerging market diet development and planting competition with biofuels.

# Property Market Review

UK direct property market has underperformed equities

Over in UK commercial property, the favourable yield compression, which lifted capital values and total returns through the first half of 2010, has moderated. Instead, investors have paused for breath and are waiting for clarity on the sustainability of the economic recovery. Against this backdrop, the UK direct property sector has managed to outperform the listed sector, but has failed to keep up with the broad equity market (chart 43). Within the direct commercial real estate space, the greatest gains were seen in the office end while the industrial sector lagged behind.

**Chart 43: Performance of UK property and the equity market**



Source: IPD (Investment Property Databank), Thomson Datastream, September 2010.

## Market Outlook

Commercial property yields expected to fall a bit further

We continue to expect yields to fall further in the UK and Europe. Although we cannot rule out an unfavourable upward shift in property yields over the next 6 to 12 months, this seems unlikely given that we are not expecting a double dip recession, which would trigger a further fall in rental values. While institutional appetite for property has ebbed since the start of 2010, as yields have fallen, it remains solid.

Schroders commercial property yield model for the UK is currently suggesting a further decline in yields over the next six months (chart 44 on next page), as momentum in the investment market carries on. However, compared to the start of the year, the contraction in property yields has slowed somewhat. Similarly, further property yield compression is expected across the channel in Continental Europe (chart 45 on next page).

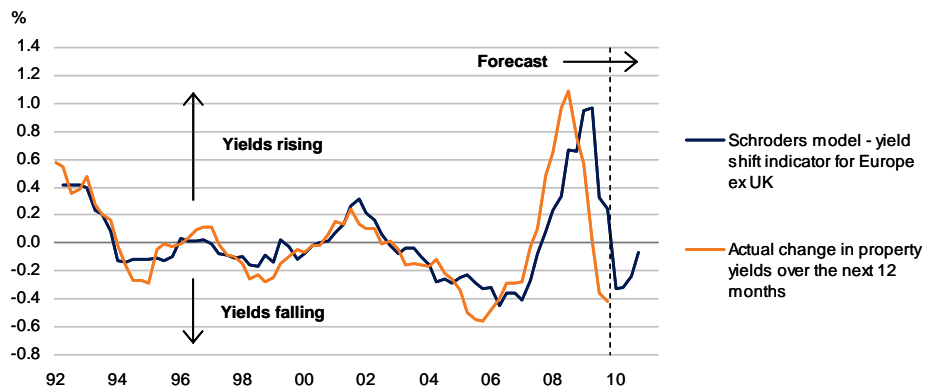
# Property Market Outlook

**Chart 44: Schroders commercial property yield model for the UK**



Source: Thomson Datastream, IPD (Investment Property Databank), Schroders, September 2010.

**Chart 45: Schroders commercial property yield model for Europe ex UK**



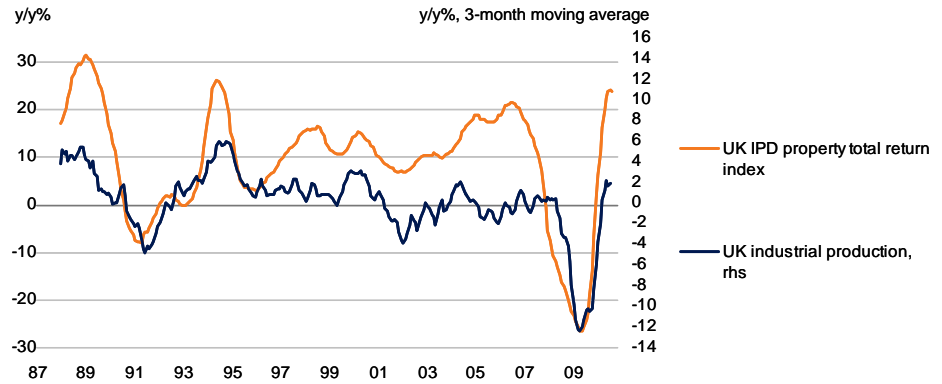
Source: Thomson Datastream, IPD (Investment Property Databank), Schroders, September 2010.

UK property vulnerable to tax rises and cuts in government spending

Meanwhile, UK commercial real estate, measured by the IPD all property total return index, has continued to make moderate gains over recent months as activity in the UK picks up (chart 46 on next page). However, fiscal consolidation next year, such as the VAT hike from 17.5% to 20%, could constrain UK's growth prospects and activity in the property market.

# Property Market Outlook

**Chart 46: UK commercial property prices and industrial production**

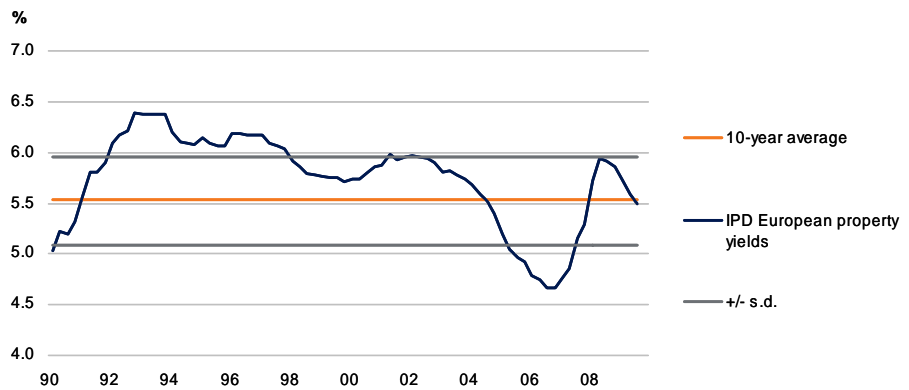


Source: Thomson Datastream, IPD (Investment Property Databank), 28 September 2010.

Property  
valuations  
appear  
reasonable

Although from a valuation perspective, the direct and listed property sectors in the UK and Europe ex UK appear fair value relative to history and other assets (chart 47). Overall, we are neutral on commercial property.

**Chart 47: Europe ex UK property yields over history**

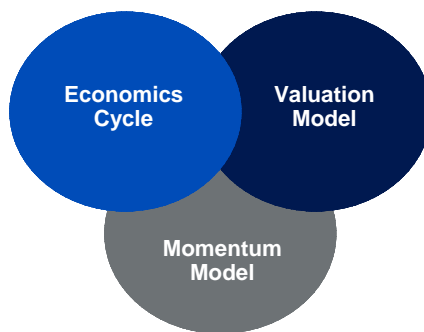


Source: IPD (Investment Property Databank), Schroders, September 2010.

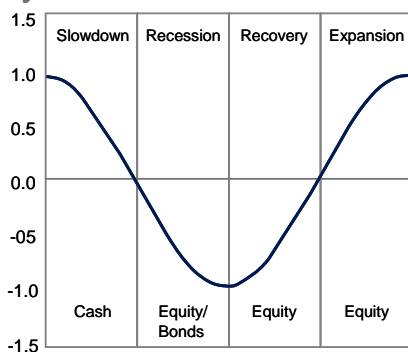
# Appendix

## Quantitative Framework

Our quantitative model is designed to assist in top-down asset allocation between equities, bonds and cash. Analysis of past cycles shows that market performance varies with the state of the economic and interest rate cycles and the valuation of markets. This information can be used to derive a model, which picks the optimal mix of equities, bonds and cash on a monthly basis and can be varied according to the degree of risk an investor wishes to take. In addition to macro and fundamental factors, we incorporate a momentum factor to form an overall view to assist in our asset allocation process.

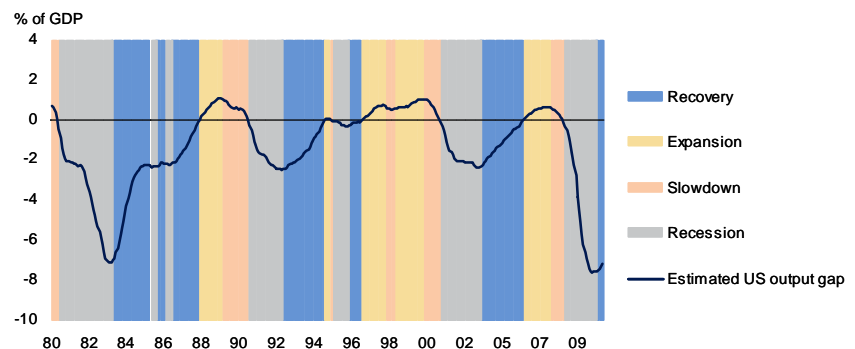


### Market performance varies through the cycle



### Economic cycle in the US

We break the economic cycle down into four phases based on the level and strength of activity relative to trend. Statistical tests show that market return and volatility varies in each stage and that there are differences across asset classes in each phase. Adjusting returns for volatility then helps determine the best risk adjusted asset allocation mix. The table overleaf summarises the main results using US data for the period from 1950 to today. The diagram below is a stylised representation of the cycle and the preferred asset in each phase.



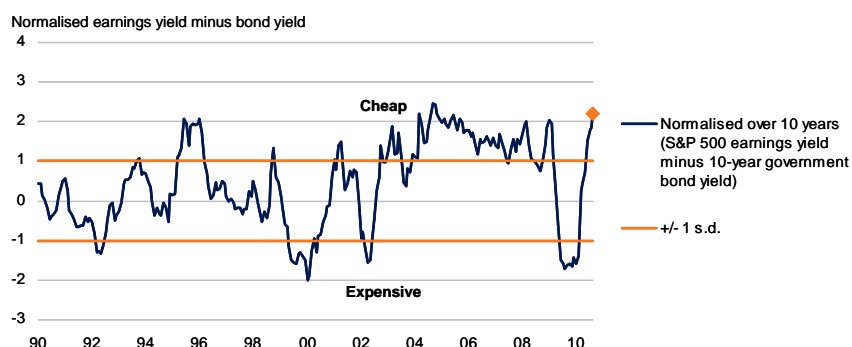
Source: Schroders, September 2010.

In conjunction with the economic cycle model, we have added information on the valuation of equities relative to bonds. This model helps to capture periods when equities appears extremely cheap or expensive relative to bonds. The metric used is the gap between earnings yield and bond yield (chart overleaf).

# Appendix

## Quantitative Framework (continued)

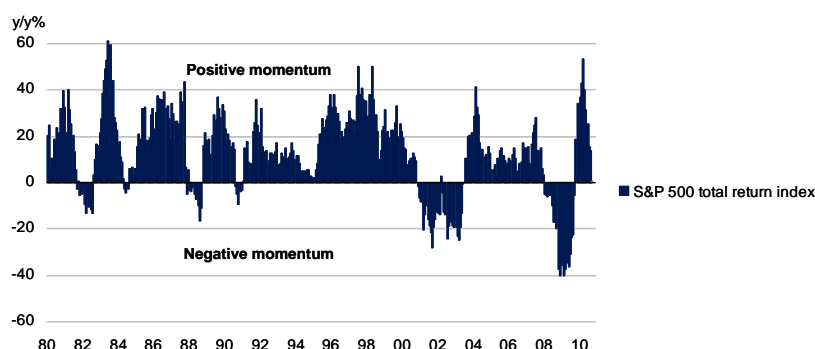
### Valuation of equities relative to bonds



Source: Thomson Datastream, Schroders, September 2010.

### Momentum model

The momentum model is a technical indicator based on the total returns of the US S&P 500 Composite. The indicator is constructed by taking the year-on-year change of the index. The model overweights equities relative to bonds when returns are positive and vice versa. For negative returns, we also examine the gradient of these returns to determine important turning points in the model. Currently, the momentum model is in positive territory, which produces an overweight signal for equities (chart).



Source: Thomson Datastream, September 2010.

### Integrating macro, valuation and momentum factors

The first step is to determine an optimal mix of asset allocation from the macro and fundamental factors. Information from the economic model determines the prevailing phase of the cycle. In the case where the model signals a critical stage for the equity markets, this information is overlaid with interest rates to determine the overall asset allocation decision. The interest rate cycle is primarily used in timing the switches into bonds, which delivers the best performance during periods of monetary easing.

Meanwhile, information on the valuation model becomes important when the economic model signals a favourable environment for the equity markets. The valuation model is used to compare equities relative to bonds. Information from the valuation model is overlaid with interest rates to determine the optimal mix of asset allocation.

In the second step, we combine the above model signal and the momentum signal giving equal weight to both models based on their information ratio.

Overall, the current model stance is marginally overweight equities, market neutral on government bonds and underweight cash. The overweight equities signal from the macro and valuation factors more than offset the neutral signal from the momentum factor.

#### Asset performance in different stages of the economic cycle

Phase/Asset	Statistics	Recovery (17) <sup>3</sup>	Expansion (15)	Slow (Stagflation) (9)	Recession (Disinflation) (16)
<b>Equity</b>	Excess Return <sup>1</sup>	<b>8.6 (100%)<sup>4</sup></b>	<b>8.4 (83%)</b>	-8.4 (22%)	<b>7.5 (88%)</b>
	Volatility	<b>13.7</b>	<b>12.4</b>	17.4	<b>16.2</b>
<b>Bond</b>	Excess Return <sup>1</sup>	1.0	-0.9	0.0	2.1
	Volatility	6.9	4.7	8.8	9.3
<b>Cash</b>	Absolute Return	4.6	4.8	<b>6.1</b>	5.0
	Absolute	0.7	0.6	<b>0.8</b>	1.2
	Volatility				

1. All risk/return figures are in % and annualised from monthly data. Equity and bond risk return figures are relative to cash.
2. Figures in bold refer to the best performing risk adjusted asset relative to the stage of the cycle.
3. These numbers refer to the average consecutive length of each phase (in months). Average length of one complete cycle defined recovery – slowdown is about 5 to 6 years.
4. The figures in brackets refer to the number of times the equity markets outperformed cash on average during each phase of the cycle since 1950.

#### Definition of Asset Class

Equities	- S&P 500 Composite
Bonds	- US 10 year treasury bonds
Cash	- US 3 month treasury bills
Total return indices (nominal), starting in 1950 -2010, monthly data	



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