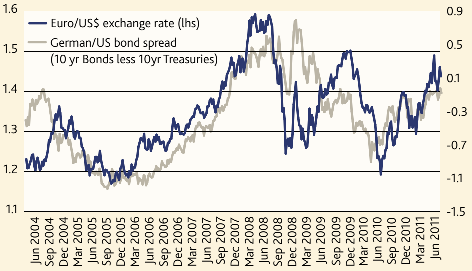
Global Investment Outlook

The monthly investment outlook from Aberdeen's multi-asset team

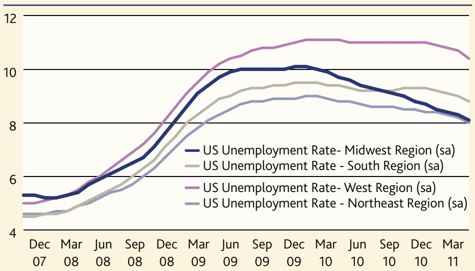
Aberdeen

Interest rate differentials have led euro vs dollar



Source: Datastream

Manufacturing and agriculture revival in the US Midwest



Source: Datastream

Key forecasts	US	Japan	Euro-zone	UK	China	Global
GDP rolling 12m forecast	2.4	0.7	1.7	1.9	9.2	2.6
Consensus	2.9	1.2	1.7	1.9	9.2	2.8
CPI rolling 12m forecast[A]	2.1	(0.2)	1.8	3.4	4.9	2.0
Consensus	2.6	0.3	2.3	3.4	4.4	2.4
Current Base Rates	0 - 0.25	0.10	1.25	0.50	6.31[B]	–
Monetary Policy (3m)	0.25	0.10	1.50	0.50	6.31[B]	–
Monetary Policy (12m)	0.25	0.10	2.00	1.00	6.56[B]	–

[A] headline rate [B] PBOC 1 year Yuan Lending Rate
Source:Aberdeen Asset Managers Ltd

Executive Summary

Sovereign indebtedness remains in the spotlight

- Global economic environment becomes unclear
- Budget consolidation now a universal aim
- Developed world monetary policy still accommodative despite a turn in Europe

May witnessed a distinct downturn in economic data from many parts of the world. We suspect that the extent of the weakness has been exacerbated by natural disasters in the first quarter rather than solely a weakness in demand. Demand itself has suffered from a combination of higher oil prices along with tighter monetary and fiscal policies. We mentioned in our last outlook that there was some evidence that growth momentum was declining, but also that an improving labour market picture provided hope that recovery may become more self sustaining. Whether the former or latter prevails is still very uncertain.

Lingering inflationary pressures induced by higher commodity prices, along with more robust growth in Asian and emerging countries as well in the core countries of Europe have prompted further policy tightening. However commodity prices have now receded somewhat and the likelihood is that headline inflation rates peak at some point in the next few months alleviating the pressure for further monetary measures. What is now key is the extent to which developed country fiscal initiatives impact the level of demand, just at the point where the private sector may be gaining slight traction in its support for growth. We would reiterate that the risk of excessive fiscal tightening remains high as investors as well as credit rating agencies are more forthright than ever in detecting weaknesses.

The bellwether S&P500 index reached a peak of 1363 at the end of April, before retracing recently to below 1300. It surpassed our initial target of 1350 but did not quite get as high as 1400 which we latterly thought possible. It now seems that risk appetite in general will recede whilst the budget situation and its impact on the macro environment becomes clearer. We therefore feel that the S&P500 will fall below its level at the start of the year even as low as 1220 in the summer months, in a repeat of events in 2010. However it is too soon to say that this bull market phase is over and we would not rule out a recovery in the final quarter.

Mike Turner
Head of Global Strategy & Asset Allocation, and manager of Aberdeen Multi-Asset Fund

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Economic and monetary policy outlook

Supply chain disruption has caused temporary soft patch

The loss of global growth momentum has been exacerbated by an unusually severe decline in manufacturing growth. For example the US ISM business survey suffered its ninth largest monthly decline in its 63 year history in June, resulting from a disruption to supply chains in auto parts and information technology industries, following the Japanese earthquake. Whilst final demand may well have been impacted by other factors, it still seems quite possible that we see some sort of rebound once supply chains are restored. Service sector indicators have been more resilient of late and as long as this continues, it may be that we are merely going through a temporary soft patch in global growth, though much depends on policy makers.

US

Upturn likely to be exaggerated once full auto production resumes

The US economic environment has undoubtedly become more uncertain, but there are reasons to believe there is scope for some respite later in the year. Demand has suffered from higher oil prices and fiscal tightening at the state level, but should oil prices retreat then consumers may benefit from the impact on real incomes. In addition the recent rally in long treasury yields could also spur some modest refinancing of mortgages. Manufacturing employment was beginning to show good momentum for the year, but more recently jobless claims have jumped because idled auto union workers are automatically fed into initial jobless claim benefits. Continued opaque data about the state of the economy, is making the Federal Reserve reluctant to countenance a third round of quantitative easing. With deflation now less evident it seems a remote prospect at this point, but at the very least the timing of any policy exit may be further delayed.

Europe

Strong growth in core Europe is a dilemma for the ECB

The possibility that headline inflation is peaking, suggests the ECB, which signalled the pace of interest rate increases this year may slow, will be extremely cautious in their move to normalise policy. But although leading indicators, such as Germany's Ifo index of business sentiment, have been rolling over, the prospect of the German recovery experiencing a lengthy expansion are rising, according to the Bundesbank, which has raised its forecast for GDP growth this year to 3.1%. This could yet put pressure on the ECB to keep raising rates – potentially causing problems for Europe's banking system, even as the sovereign debt crisis afflicting peripheral countries worsens. The ECB's dilemma could yet be resolved if expectations of growth in the euro-zone's core are affected by the slowdown in Asia, and fiscal tightening in peripherals prove a further drag on growth. But it looks likely the ECB will lift its policy rates by 0.25% to 1.5% in July.

UK

Signs that the recovery is gathering momentum

Consumption is still suffering from an anaemic housing market, but increased borrowing and recruiting are signs the recovery is gathering slight momentum, with small companies leading the way. News that Nissan and BMW are both increasing their investment in UK car manufacturing also suggests the UK economy is rebalancing toward the manufacturing sector. The export sector continues to do well – supported by sterling's weakness. Inflation looks like it's peaking though, as the VAT hike, which accounts for most of the recent increases in prices, starts to drop out of the data. It is still possible rates rise later this year - if only to give the Bank of England credibility and support the pound, but with inflation expectations levelling off and the outlook for growth remaining muted, we don't expect the Bank to act now until February 2012.

Japan

V-shaped recovery could send growth soaring

The Japanese economy looks likely to experience a V-shaped path, with the Bank of Japan expecting the recovery to accelerate over the coming months. Following the earthquake Japanese industrial output fell by 15.5% in March but is now expected to increase by 8% in both May and June, providing welcome relief to the global industrial sector. The fall in activity through the permanent destruction of industrial output capacity should be offset by construction activity, with $300 billion of government reconstruction set to propel growth over the next couple of quarters. Reinforcing this view are comments from hard-hit companies such as Toyota, which have suffered from power outage, confirming production is returning to pre-quake levels faster than anticipated. We doubt though that this will provoke any change in monetary policy.

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Asia and emerging economies

Accelerating inflation is a big risk

The tighter policy environment is beginning to slow growth in Asia, particularly in China. Slowing Chinese export growth - with exports to the US and EU at their weakest since late 2009 – combined with rapidly falling money supply and new loan growth in May, have added to concerns about the global economic "soft patch". We don't see the Chinese economy experiencing a hard landing, but emerging country economic problems and their policy responses are becoming more diverse. For example Brazil faces increasing pressure from public sector unions for real wage increases, and countries like India whose inflation rate now exceeds 9% still have much more tightening to do. In general the policy cycle has not peaked yet, as illustrated by South Korea's recent unexpected hiking of interest rates.

Equities

Risk assets under pressure

Weaker economic data has once more raised investors concerns over the sustainability of global growth, impacting risk assets. Alongside this of course has been the anxiety over the Greek debt situation and the prospect of default through a debt rescheduling. We see risk aversion continuing as the second round of US quantitative easing ends in June, and the sovereign debt woes within Europe continue to rumble under the surface. Recovery in the global economy (if the situation in Japan improves) would help global equities in the second half, but this is unlikely to occur for some time yet and indeed events with Greece provide considerable tail risk to markets in general.

Within the markets themselves, we continue to see the relative underperformance of the Asian and emerging markets, but some investors are beginning to sense it may be time to return. We would have more conviction about this view if we felt the monetary policy cycle in these areas was about to turn, and indeed if global growth data began to stabilise. We may not be far from that point.

Rally possible after summer lull

With US corporate margins at an all time high, market expectations of further improvement in 2012 look optimistic. Margins, which are mean reverting, are more likely to fall in our view, which will put pressure on valuations. However, asset prices are likely to be supported by the liquidity that remains in the system, and which is available to the banks to lend. Although the markets now look set for a period of consolidation during the traditional summer lull, we see scope for them to regain some poise and wouldn't dismiss a fourth quarter rally if this soft patch of growth ends and investors realise the global economy is not going to re-enter recession just yet.

Bonds & currencies

The debt markets have been taking unrest in the Middle East and the sovereign debt crisis in their stride, and surprisingly the ending of QE2 has not had that negative an impact. We suspect that the ten year treasury may continue to gain support whilst equity markets fall, but still believe that below 3% bond yields do not offer an attractive risk reward prospect.

Cautiously long in credit, but favour investment grade debt

Within credit markets, the German government's desire for a private sector contribution as a condition of German participation in a further bail-out of Greece, has kept the euro-zone's credit markets jittery. Sustained growth and inflation in the core countries complicates the picture, as do the rating agencies' warnings that the risk of a default have increased significantly. That said, we're still cautiously optimistic about credit, as corporate fundamentals and valuations support tighter spreads over the long term. In the near term though we tend to favour investment grade debt, while the balancing act between western government finances, economic recovery, and emerging markets inflation continues.

Euro-dollar still trading off interest rate differentials

Despite the sovereign debt crisis, rate differentials continue to support the Euro, but we expect it to trade within a relatively tight range, as sentiment oscillates between sovereign debt issues, subdued US and European inflationary pressures, and acute bouts of risk aversion. For now, another round of quantitative easing is off the table - unless there's a serious slowdown – though the Fed will push back the day when they stop reinvesting maturing treasuries and mortgage backed bonds.

Commodity currencies vulnerable

While risk aversion dominates market sentiment – and continues to boost the safe haven Swiss franc - Asian currencies could suffer marginally versus the US dollar, but we don't expect this to last long as currency appreciation is increasingly being used as a policy tool for tightening. It seems the most vulnerable currencies in the short term could be commodity currencies like the Australian, New Zealand, and Canadian dollars. However even here, their substantial interest rate advantage will make it hard for these units to suffer significantly.

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Commodities vulnerable to sell-off

Commodities

To the extent that commodity markets have been supported by ample liquidity in the last couple of years, and are presently dominated by investors rather than physical end users, we think that sharp falls are possible. Base metals have come under pressure, as fears of a hard-landing in China resurfaced in June following the release of a second consecutive weak manufacturing PMI report. News that Chinese copper imports were down 36% from the previous year in May are also sobering.

Many agricultural commodities remain supported by supply factors, though. And while we see the potential for near term weakness in commodities, we don't expect a repeat of the sell-off in 2008. Oil remains highly correlated with the strength of the dollar against the euro, as do other commodities, and should trade in a range unless the dollar strengthens dramatically. In precious metals, while investment demand has replaced jewellery demand as the key driver of the price of gold in the last few years, the fact that it's seen as a hedge against fiscal and financial crisis means that it should be well supported, and longer term we feel there is still scope for appreciation.

Real Estate

Global capital values are estimated to have risen around 1% in the first quarter, and should remain supported by strong interest for institutional grade assets. An earlier than expected upswing in tenant demand in major cities should support ongoing capital value appreciation in North America, northern euro member countries, and the Nordics in the second half of the year. Prime assets in western markets are looking expensive, though the broader institutional market is at fair value or under-priced for certain sectors and countries, such as retail in northern Europe. Southern Europe, including Spain, looks unattractive given economic conditions look set to be poor for at least the next 1-3 years.

The near-term outlook for the Japanese real estate market is weak, but may present opportunities for investment in the next 12 months. For much of the rest of Asia, robust economic expansion and strong business demand for space, should feed into sizable increases in capital values – though higher interest rates could threaten prices in late 2011 and into 2012. Corrections in places like Hong Kong, where prices have become stretched relative to fundamentals, are likely. The best value in the region is found in Australia where yields are high in a global context - though the window for investment may be closing for core assets.

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