Investment strategy

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Economic and market commentary

Little has happened in the past month to change our overall view of the world, with data continuing to suggest a three-speed global macroeconomic backdrop. We remain confident that the Chinese authorities will succeed in managing a soft landing and believe that emerging markets in general will continue to lead global growth. At the other end of the scale, we remain of the opinion that the invisible hand of deleveraging will constrain activity in Europe including the UK for a number of years. The US lies somewhere in the middle, with the housing and employment markets stabilising and austerity measures waiting till next year.

As the effects of the Long-Term Refinancing Operation have faded, we have seen risk assets enter a holding phase. We reduced our overweight in equities in February and are comfortable with a more balanced positioning. With real risks remaining, we expect to be presented with opportunities to add back to our equity overweight in the coming months.

Among equities, the US is our favourite developed market. The US banking system has repaired itself far more quickly than its European counterparts, with the recent stress tests arguably marking the end of the financial crisis in America. This provides one of the necessary conditions for economic recovery and we expect the better tone in macro data to be maintained at least up to November's presidential election. On a longer-term view, fiscal drag could reduce GDP growth by 1.5% p.a. over three years from 2013. However, this will be somewhat offset by the advantage of cheap domestic energy, which is likely to support an industrial renaissance in the US in the coming decade. Elsewhere in equities, we are maintaining our exposure to the emerging market consumer – both domestically and via companies in areas such as European luxury goods and UK industrials. However, we have started to hear more cautious noises from some of the emerging market earners that we meet, and we will remain alert to any dislocations caused by China's transition to a more balanced economy.

Thematically we continue to favour higher quality companies with good long-term growth characteristics. These are expected to lead the market in the government and consumer deleveraging phase. We particularly like companies with strong balance sheets and robust cash flows, as they are less reliant on economic conditions and will be able to return value to shareholders through buybacks and increased dividends.

In fixed income, core government bond yields finally broke higher during March in response to improving macro sentiment and the suspicion that QE in all its guises may be on hold. However, yields still look too low given the economic background and the challenges facing governments. We continue to favour higher-yielding areas in fixed income, where spreads are discounting higher default rates than we deem likely. Moreover, credit markets are also benefiting from broadly positive technicals – a trend that we expect to continue in the second quarter. Finally, we remain underweight in property, where healthy yields are outweighed by the prospect of falling rents and capital erosion as a result of the lacklustre UK economic backdrop.

Economic forecasts Q1

US

				(T)	(Cons)	(T)	(Cons)
	2009	2010	Current	End 2011	End 2011	End 2012	End 2012
GDP (year/year)	-3.5	3.0		1.5	1.8	1.5	2.2
Headline Inflation (year end)	2.7	1.2	3.4	3.3	3.5	2.0	2.0
Core Inflation (year end)	1.8	0.8	2.2	2.5		1.5	
Official Rates[1] (year end)	0.25	0.25	0-0.25	0-0.25	0.06[1]	0.25	0.06[1]
10-year bond yield	3.8	3.3	1.89	1.9	1.9/4.5[2]	2.5	2.8/4.5[2]
EUR/USD (year end)	1.43	1.34	1.29	1.3	1.30	1.25	1.30
USD/JPY (year end)	93	81	77	77	77	82	78

Updated 25 January

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

Euro Area

				(T)	(Cons)	(T)	(Cons)
	2009	2010	Current	End 2011	End 2011	End 2012	End 2012
GDP (year/year)	-4.1	1.7		1.6	1.6	-1.0	-0.3
Headline Inflation (year end)	0.9	2.2	2.7	2.7	2.7	2.0	1.5
Official Rates[1] (year end)	1.0	1.0	1.0	1.0	1.0	0.5	0.5[1]
10-year bond yield	3.4	3.0	1.8	1.8	1.8/4.0[2]	2.5	2.5/4.0[2]
EUR/USD (year end)	1.43	1.34	1.29	1.3	1.3	1.25	1.3
EUR/JPY (year end)	134	109	99	100	100	103	101

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Japan

				(T)	(Cons)	(T)	(Cons)
	2009	2010	Current	End 2011	End 2011	End 2012	End 2012
GDP (year/year)	-6.3	4.0		-0.8	-0.8	0.5-1.0	1.9
Headline Inflation (year end)	-1.7	0.0	-0.5	-0.2	-0.2	-0.2	-0.2
Official Rates[1] (year end)	0.1	0.1	0.1	0.1	0.1[1]		0.1[1]
10-year bond yield	1.3	1.1	1.0	1.0	1.0/2.0[2]		1.2/2.0[2]
USD/JPY (year end)	93	81	77	77	78	82	78
EUR/JPY (year end)	134	109	99	100	100	103	101

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Economic forecasts Q1

UK

				(T)	(Cons)	(T)	(Cons)
	2009	**2010**	**Current**	**End 2011**	**End 2011**	**End 2012**	**End 2012**
GDP (year/year)	-4.9	1.4		1.0	0.9	0.0	0.5
Headline Inflation (year end)	2.9	3.7	4.2	4.2	4.2	2.3	2.0
Official Rates[1] (year end)	2.0	0.5	0.5	0.5	0.5[1]	0.5	0.5[1]
10-year bond yield	4.0	3.4	2.0	2.0	2.0/4.5[2]	3.0	2.5/4.5[2]
USD/GBP (year end)	1.61	1.55	1.54	1.49	1.61	1.52	1.63
EUR/GBP (year end)	0.89	0.86	0.84		0.88	0.82	0.85

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Developing Markets

	2012		2013	
GDP (YoY)	**Consensus**	**Threadneedle[1]**	**Consensus**	**Threadneedle[1]**
Brazil	3.3	▼3.0-3.3	4.3	►4.0-4.5
Mexico	3.3	▼3.0-3.3	3.4	►3.5
China	8.4	►8.0-8.5	8.6	▲8.5-9.0
India	7.0	▼7.0-7.5	7.3	▲7.5-8.0
South Korea	3.4	▲4.0	4.1	►4.0-4.5
Taiwan	3.3	►3.0-3.5	4.6	►4.5-4.8
South Africa	2.8	►	n/a	3.5-4.0
Russia	3.5	►	3.9	►3.5-4.0

[1]Difference from consensus.

Investment themes

Theme	Thesis	Investment conclusions
Search for yield	■ Deflationary environment will keep yields low. ■ Above average and relatively safe yields will be increasingly in demand.	■ High quality, non-financial corporate bonds and high yield debt remain attractive. ■ Above average and/or growing yields, especially being paid by businesses with stable earnings and cash flows, will remain in demand.
Global capital expenditure growth	■ 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.	■ 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	■ 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. ■ Growth will remain focused on infrastructure spending led by the authorities but emerging consumer markets likely to be a feature.	■ 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	■ Risks as governments, consumers (and companies) seek to reduce indebtedness. ■ First order effects in expenditure cuts, second order effects in weak demand outlook.	■ 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	- Growth constrained 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.	- 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 round 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	