

INVESTMENT OUTLOOK | Q3 2011



A summary of F&C's views on the prospects for global investment markets

Current Strategy

F&C's balanced funds are managed by the Global Asset Allocation team, which is based in London. Asset class strategy is determined through the application of both qualitative and quantitative research processes.

Equities

Overweight

Emerging Markets
UK

Underweight

North America,
Europe ex-UK

Bonds

Overweight

Convertibles
Investment Grade
Corporate Bonds
High Yield Corporate
Bonds

Underweight

Sovereign Bonds

Strategic View: Equities overweight maintained

Equities versus Bonds

Global equity markets were buffeted in the second quarter as confidence was hit by disappointing economic data in the US and a worsening of the sovereign debt crisis in Europe. However, given the negative newsflow, it is surprising how resilient share prices have been. If the economic data begins to recover later in the summer, as we expect, then equity markets should start to regain positive momentum.

Although we are less bullish than we were last quarter, we continue to favour equities over bonds. Government bonds enjoyed a rally in the second quarter but the fundamental case for most sovereign stock remains unappealing, especially in developed economies. The huge size of government debt levels means that there will continue to be a steady supply of new issuance and the current yields on most AAA-rated bonds are insufficient compensation for the risks that lie ahead. The main threats include potential credit rating downgrades for countries whose rates of economic growth will not be high enough to bring down their deficits naturally. Both the US and the UK fall into this category.

Equity Market Positioning

We continue to prefer emerging markets. The weakness of the asset class so far this year reflects a combination of the continuing geo-political risk as well as less positive economic data. The markets tend to be highly sensitive to economic sentiment and have a correlation to commodity prices, which have fallen sharply in recent weeks. Nevertheless, the tightening of monetary policy is a correct and necessary response to rising inflation and the beneficial effects of this should be seen soon. We have moved the UK from underweight to overweight as sound company fundamentals and attractive valuations could well outweigh macro-economic threats.

The US remains underweight. To compound our concerns that the economic recovery is running out of steam, there are fears about the fading effects of fiscal and monetary stimulus, with the latter relying solely on low interest rates after the liquidity injection of quantitative easing expires. We also hold a negative view on Europe ex-UK. The eurozone economy remains divided into fast and slow speed nations, with the periphery countries, weighed down by sovereign debt issues, continuing to struggle. While the core countries are still growing strongly, there are signs of a slowdown as the strong euro hurts the outlook for exporters. Elsewhere we have moved Japan from overweight to neutral. We believe the lasting economic effects of the earthquake have been underestimated and that the economy will continue to be negatively impacted through the collateral damage to the financial system.

Bond Market Positioning

Within bonds, we continue to favour corporate to government stock. Yield spreads relative to sovereign bonds have tightened considerably, but we still believe the corporate market is attractively valued, even if absolute yields are no longer so compelling and issuance is high. In terms of sovereign bond markets, we are overweight the US and Japan and underweight the UK as inflation looks to be more of a threat. Elsewhere, we are neutrally positioned in emerging market debt as the asset class is vulnerable to profit taking. Convertibles remain overweight as they should profit from their sensitivity to equities, lower duration and reasonable credit spreads. Although yields are no longer attractive against dividends, they remain higher than sovereigns.

The Ted Scott Perspective



Ted Scott, F&C's Director of Global Strategy, offers an insight into themes and developments influencing the world's investment markets. His views are very much his own and may not correspond with those expressed elsewhere in this document.

Why Equities Are Cheap

The case for the UK equity market from a bottom-up perspective

The macro-economic picture may be clouded with uncertainty and fraught with risk but the case for the equity market from a bottom-up perspective is actually compelling. We have just completed the second quarter results season and in the UK, as elsewhere, company performance remained robust. Although the broader UK economy is treading water, or growing well below trend at best, the quoted sector is on course to deliver earnings growth of about 20% this year. On top of this, aggregate dividend payments are forecast to increase by about 10%.

While the macro-economic threats continue to weigh on the market, it is important not to lose sight of the fundamental attraction of the equity market in aggregate or individual companies on a valuation basis. Consensus earnings forecasts for the UK market equate to a prospective price-to-earnings ratio of just over 10 times for December 2011, comfortably below its long-term average and the best of the major global equity markets. Also, on a Shiller price-earnings ratio, a measure that looks through the economic cycle by adjusting the earnings of the market on a 10 year trailing basis, the market has also fallen to an attractive level. It shouldn't be forgotten either that the UK is one of the world's highest yielding markets.

Of course, a default by Greece can render such statistics redundant but the essential cheapness of stocks will provide some downside protection to the market. Moreover, if the event risks of Greece defaulting or a double-dip recession fail to materialise then there is scope for a strong rally.

What does the market's valuation imply?

The cheap valuation of the market and a 10-year gilt yield of around 3.1% indicate an environment of slow growth but not a recession. Within the equity market, defensive shares, such as tobacco, utilities, pharmaceuticals and telecommunications, have done well and are now trading towards the upper end of their valuation range, but not at the top. This also points to continued below-trend growth but not a recession.

In the gilt market, the yield gap between conventional and index-linked gilts of 10 year duration is currently 3.3%. This reflects the expected rate of inflation and, in a recessionary environment, it would be expected to fall below 3%. However, because index-linked gilt yields have fallen so much recently, the gap has actually widened slightly, implying that the gilt market is happy with a low growth, non-recessionary outlook. Thus, the gilt market is consistent with the equity market in that they are both signalling slow and below-trend growth but no recession.

Strong rally a possibility

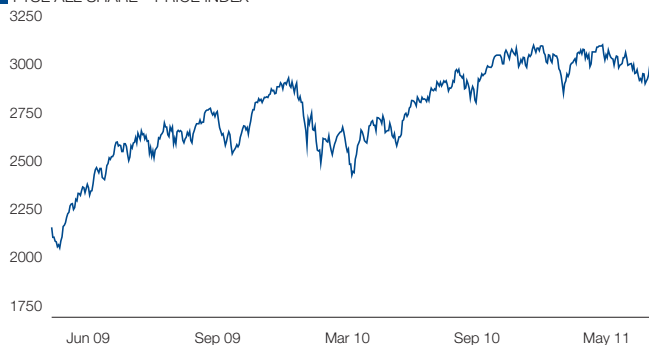
The recent pullback in the market has been caused by macro factors that have fuelled uncertainty and risk aversion. In particular, the deterioration of the eurozone sovereign debt situation is an asymmetric risk event that cannot be modelled or evaluated but could trigger another financial crisis with many of the hallmarks of 2008 when Lehman Brothers was allowed to go bust.

From a bottom up perspective, however, the equity market appears attractively priced, even allowing for a large increase in the risk premium in recent decades which has risen further following the last recession. The market is already discounting a slow growth economy with significant downgrades implied for the commodity sectors. Therefore, if a Greek default is avoided and the recent soft patch of data proves to be transient, as I expect, there should be a strong market rally.



UK Equities

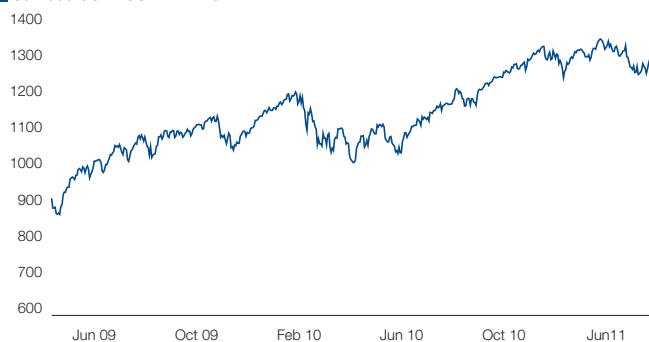
■ FTSE ALL SHARE – PRICE INDEX



The UK stock market is currently lacking momentum as investors assess an uncertain economic outlook both domestically and abroad. However, we are not expecting the UK to slip back into recession and when economic data starts to improve, shares, which still offer attractive value relative to other markets, should begin to post more sustainable gains. Monetary policy will continue to reflect the challenging economic environment and, with the recent falls in commodity prices having lessened the inflationary threat, another round of quantitative easing looks more likely than a hike in interest rates. In terms of corporate activity, mergers and acquisitions will continue to support the market. However, making profits from new issues will be difficult given the unattractive pricing of many deals.

US Equities

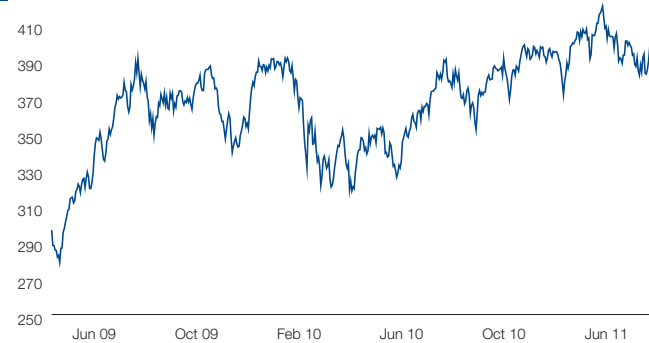
■ S&P 500 COMPOSITE – PRICE INDEX



Our quantitative investment process for US equities aims to deliver outperformance of the index irrespective of market conditions. Therefore we do not explicitly position our portfolios to reflect particular macroeconomic or thematic views.

Continental European Equities

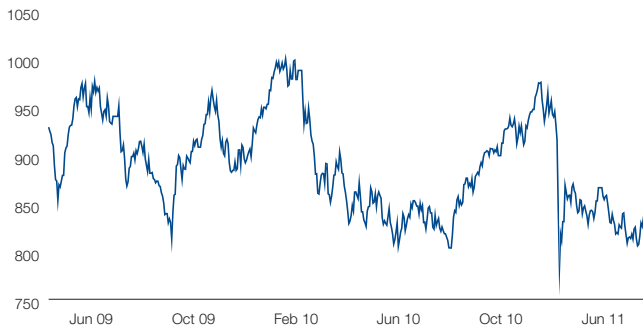
■ FTSE WORLD EUROPE EX UK £ – PRICE INDEX



The sovereign debt crisis in the eurozone is likely to remain unresolved for some time and we expect future developments to lead to bouts of share price volatility. In the developed markets, the risk of further rises in inflation is prompting us to focus on companies with strong pricing power. We also favour strongly deposit-funded and well capitalised banks as we believe that valuations fail to reflect potential returns. Non-financial companies are enjoying healthy balance sheets and we believe that, for long-term investors, valuations are attractive. With organic growth likely to remain low and with abundant cheap funding still available to quality companies, we expect mergers and acquisitions to be a driver of the market.

Japanese Equities

■ TOPIX – PRICE INDEX



Japan's equity market remains under pressure from the aftermath of the natural disaster that befell the country in March. However, we expect industrial production to rebound sharply as the supply chain normalises and the manufacturing sector gets back on its feet. Such a recovery would restore a measure of confidence to this attractively priced market and, if macro-economic factors - notably the sovereign debt crisis in Europe - take a step towards resolution, share prices could rally. In the meantime, investors will have to look beyond short-term factors that could undermine sentiment, such as the government's potentially highly costly plan to compensate those affected by the crippled Fukushima nuclear plant.

Pacific ex-Japan Equities

■ S&P/IFCI D ASIA \$ – PRICE INDEX



The backdrop for Asia Pacific equities is likely to remain challenging in the near term. While inflationary pressures are expected to moderate through the third quarter, thus allowing investors to look forward to a possible peak in policy tightening, liquidity conditions are expected to remain constrained as the region's monetary authorities continue in their attempts to keep rising prices in check. The outlook for Asian exporters is being tempered by signs that the global economic recovery is stuttering. This is leading to muted expectations for company earnings for the first half of the year and we are currently seeing little scope for meaningful positive surprises. The lacklustre performance of Asian equities so far this year has at least left valuations looking more attractive. By the end of the second quarter, the market was trading at just over 11 times forward earnings.

Emerging Market Equities

The prospects for emerging markets are being clouded by signals that growth has started to slow in the OECD countries as companies and consumers battle against rising inflation. Fears of sovereign debt default by Greece are also dampening risk appetite. Within the emerging economies, inflation is a more serious issue, particularly in India, China and Brazil.

■ S&P/IFCG D LATIN AMERICA \$ – PRICE INDEX



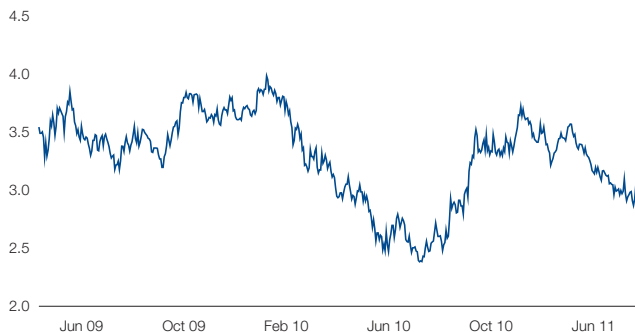
However, we expect it to peak in the next few months in most countries as food and soft commodity prices fall back from their highs. This will improve sentiment towards equity markets. In country terms, we are directing renewed focus towards those where domestic consumer confidence and demand are robust and valuations remain attractive. Our key overweights are China, Indonesia, Brazil, Poland and Turkey.

■ S&P/IFCI D EMEA \$ – PRICE INDEX



Sovereign Bonds

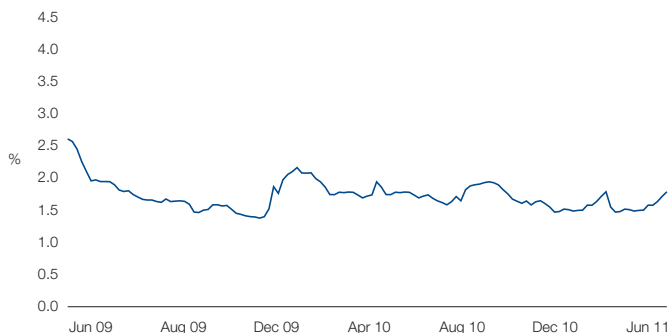
■ US BENCHMARK BOND 10 YR DS GOVT INDEX - RED. YIELD



There has been very little difference in the performance of the US, UK and German government bond markets during 2011. Over the last quarter, yields moved lower as economic data has disappointed despite accommodative monetary policy. Furthermore, austerity measures lie ahead to rein in unsustainable fiscal deficits. The ECB has increased interest rates by 0.25% and hinted that there will be additional increases on the way. However higher German bond yields have not materialised due to the flight to quality created by the heightened default probability of eurozone members, particularly Greece, Ireland and Portugal. The yield on short-dated Greek bonds has moved to a high of almost 30%. With the economic cycles of developed markets moving in tandem for now, shorter-term tactical trades will be the focus in the near term.

Investment Grade Bonds

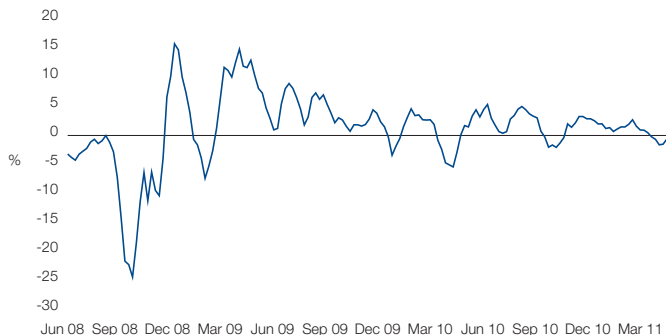
■ EURO-AGGREGATE CREDIT



We remain cautiously positive on the credit market in the medium to longer term, based on slowly improving credit fundamentals. In the short term, however, we favour a more neutral stance, in view of the numerous negative themes dominating global headlines. Credit markets are likely to remain unsettled as long as the Greek debt problem is unresolved. We anticipate economic growth in the US and eurozone economies to be moderate in 2011, hampered by high unemployment rates, weak real estate markets, sovereign fiscal deficit issues and ongoing deleveraging by banks and consumers. Nevertheless, we expect global growth as a whole to be supported by strong performance from the emerging market economies. In the meantime, capital buffers and the profitability of banks continue to improve as loan-losses generally trend lower. Within this environment, global credit fundamentals remain solid.

High Yield Bonds

■ GLOBAL HIGH YIELD TOTAL RETURN

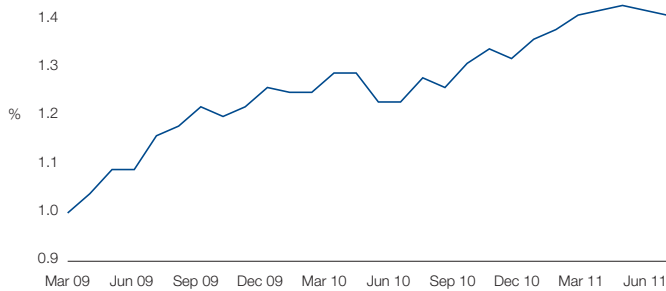


We believe that global high yield bond spreads have the potential to tighten further in the medium term as a result of low default levels and improving corporate earnings. The Moody's global high yield default rate stood at 2.4% at the end of May and is expected to decline to a range of 1.5-1.7% in a year's time. Moreover the asset class remains attractive on a relative basis, especially within fixed income, on account of its low interest rate sensitivity and the high coupons of the bonds. However, while the debt crisis in Greece continues to dominate market news and as economic newsflow remains mixed, investors are likely to continue to seek comfort in safe haven assets. However, this could provide a good entry point for buying longer-term positions at attractive prices.

Convertibles

■ CONVERTIBLES COMPOSITE INDEX*

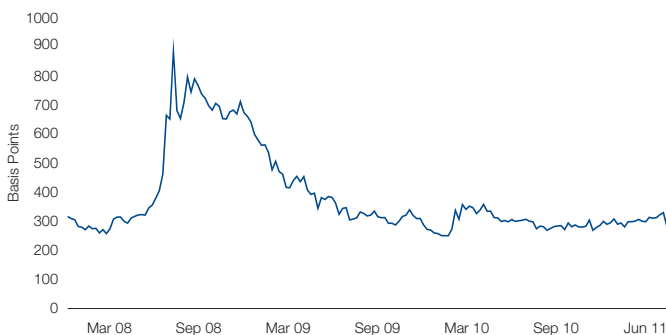
*Composite of the UBS Europe Focus Convertibles Index, UBS Asia Focus Convertibles Index, UBS US Focus Convertibles Index



Growth in the developed economies is slowing but we expect it to pick up again towards the end of the year. In the US, improvements in the housing sector and pent-up demand for cars could be the drivers. In Europe, if the Greek sovereign debt issue can be convincingly addressed, markets could recover from recent set backs. In any case, equities remain attractively valued, supported by profits growth, compelling dividend yields (compared to bonds) and a low risk of recession. Balance sheets and cash flows are generally strong and this is favourable for bond floors. Our base case therefore remains for a gradual recovery but with markets and consensus estimates for growth to be impacted by short-term negative themes, such as the euro sovereign debt crisis, fiscal austerity measures and on-going unrest in the Middle East. A cautiously optimistic strategy will thus continue to be pursued.

Emerging Market Bonds

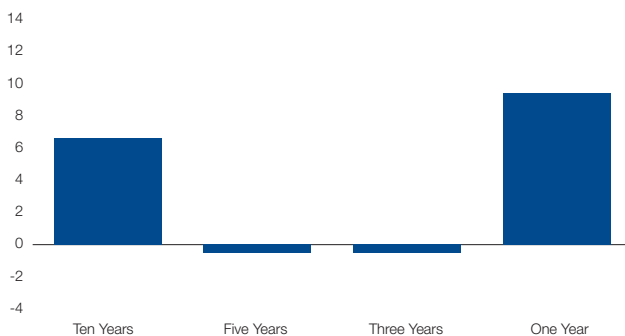
■ EMBI GLOBAL SPREAD



While the fundamentals of emerging market countries are generally strong (high quality balance sheets, resilient economic growth, healthy external accounts and generally low financing requirements compared to developed market) we are mindful of global risks. These include a lack of agreement to increase the US Treasury's debt limit, which could potentially lead to a sovereign default and problems with the implementation of a highly unpopular austerity plan in Greece. Technical considerations include market liquidity, which tends to thin out in the summer months, balanced against expected low net new issuance. Taking all of this into account we favour liquid, benchmark bonds. We are cautious about corporates because the technical factors here are less favourable. Likewise, extreme positioning against the US dollar prevents us from being overly positive on emerging market currencies.

UK Property

■ Source: IPD Monthly Index May 2011



The UK property market has continued to deliver positive total returns, driven by income but also registering modest capital growth. However, the disparity in performance between central London, where rents and capital values are rising, and the weaker markets in the regions, has persisted. Investors remain risk averse and there is little interest in secondary property. While banks are starting to release more stock, the unwinding of property loans still has some way to go, and there is little new lending. The market is expected to be challenging, reflecting the effects of slow economic growth and higher inflation. Nevertheless, it will continue to be supported by its attractive income return of more than 6% per annum.

Investment outlook

Winning gold with F&C

Delivering highly effective investment strategies is just one part of the service we provide. As principled asset managers, we are determined to lead our industry in all aspects of our business.

In 2010 F&C were voted winners of the 'Gold Standard' in the Fund Management category for the fifth year in succession. Only a few companies have been privileged enough to win a Gold Standard award, and as such, this is an exceptional achievement. The Gold Standard Awards aim to identify financial services companies that excel not just in service but in five key areas important to consumers of financial products and services:

Financial strength

Ability to meet and exceed customer expectations

Capability

Outstanding expertise and aptitude as a fund manager

Service

Ability to maintain and grow an effective post-sales relationship

Fair value

Assessing whether customers receive great value for money

Trust

Ability to instil confidence in consumers

As a result, the Gold Standards are one of the hardest, most sought after awards in the financial market place.



WINNER



Products

F&C offers a wide range of investment opportunities for pension funds, charities, financial institutions, corporations and other organisations. We offer segregated and pooled portfolio management through a range of onshore and offshore vehicles. These cover developed and emerging markets in equity, bond, cash, property and alternative investment funds.

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Important information

All data is as at 30 June 2011 unless otherwise stated.

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