



Asset Allocation
Investing in the new reality...



CONFERENCE

Beyond Green Shoots

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25 August 2009

Disclaimer

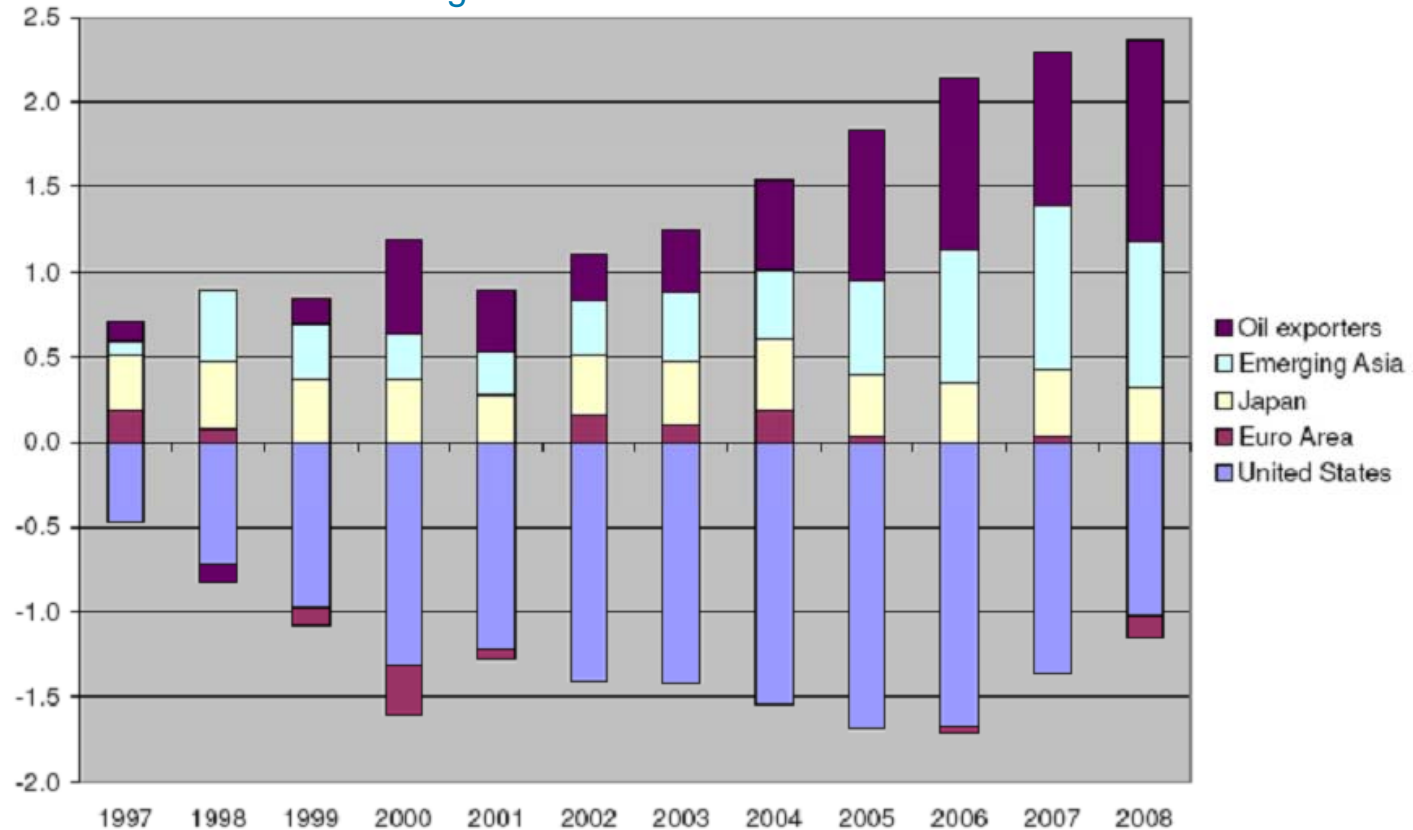


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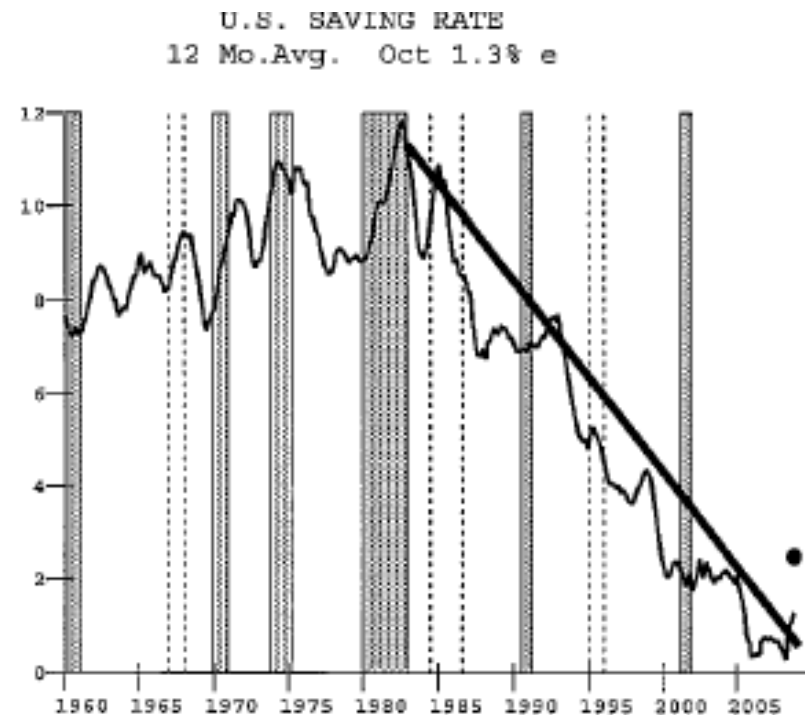
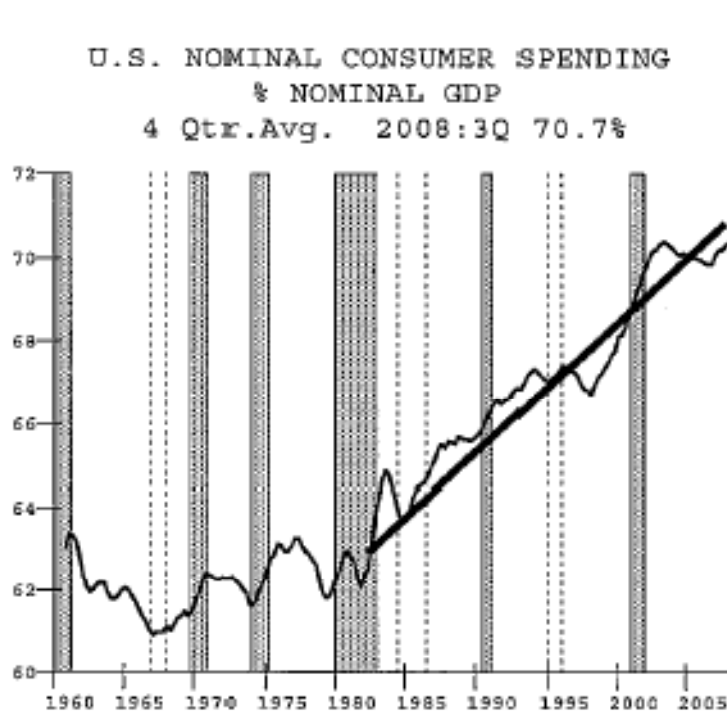
“Stable disequilibrium”

Current account balances as % of global GDP



Source: Niall Ferguson, “Geopolitical consequences of the Credit Crunch”

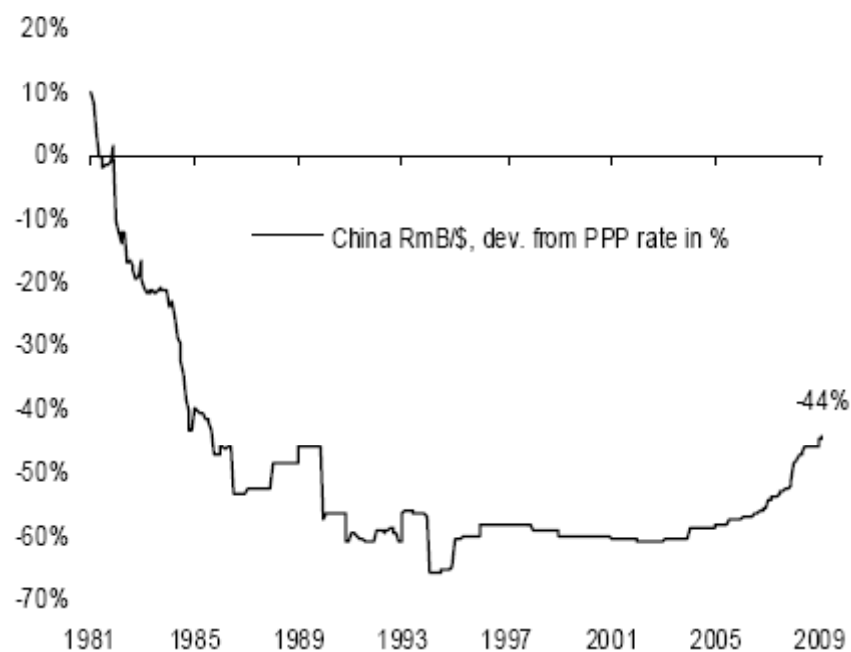
Benefits of globalisation spent on immediate consumption



Source: ISI – Weekly Economic Report 17-11-08 p19

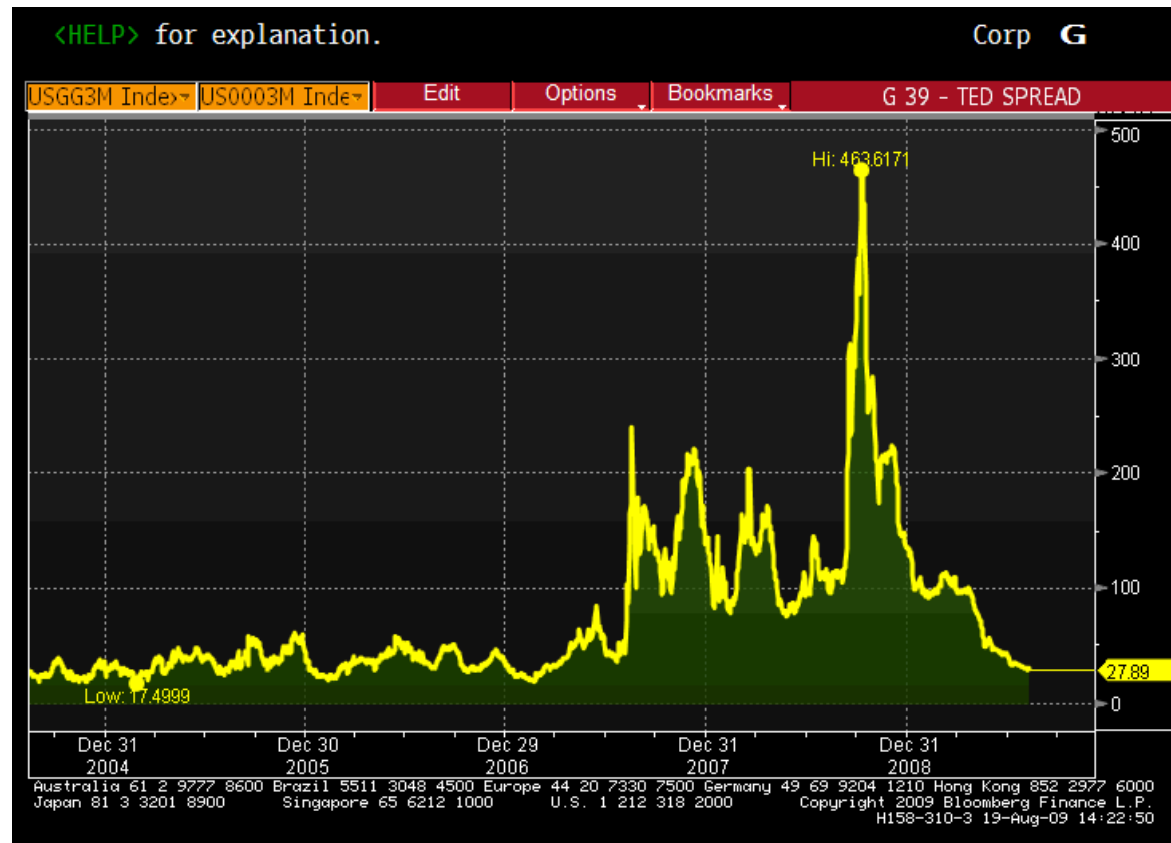
Funded in part by China

RMB deviation from PPP rate in %



Source: Datastream International Limited, Credit Suisse

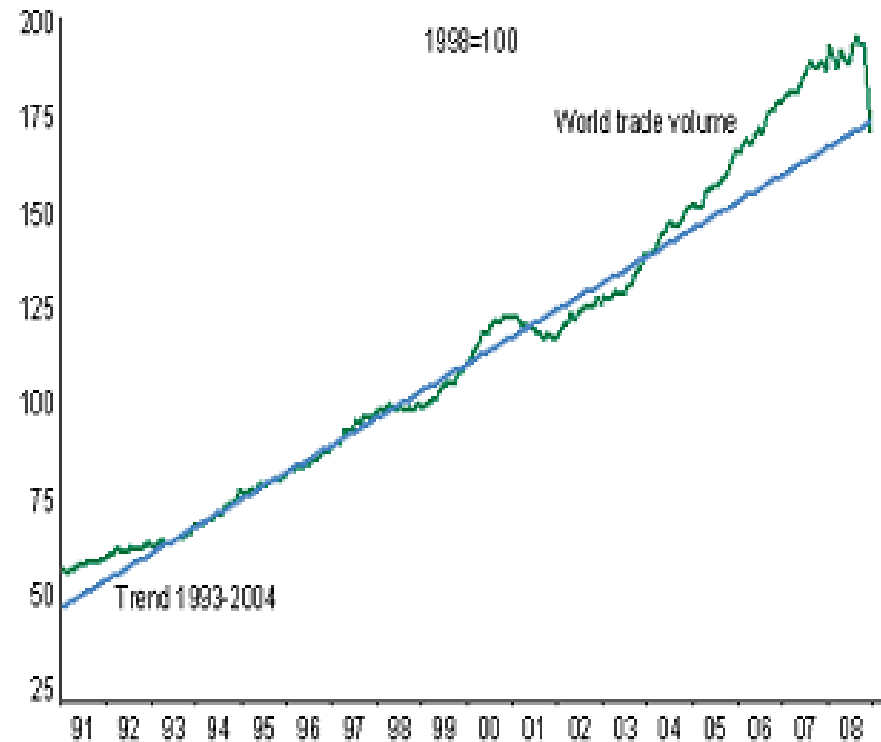
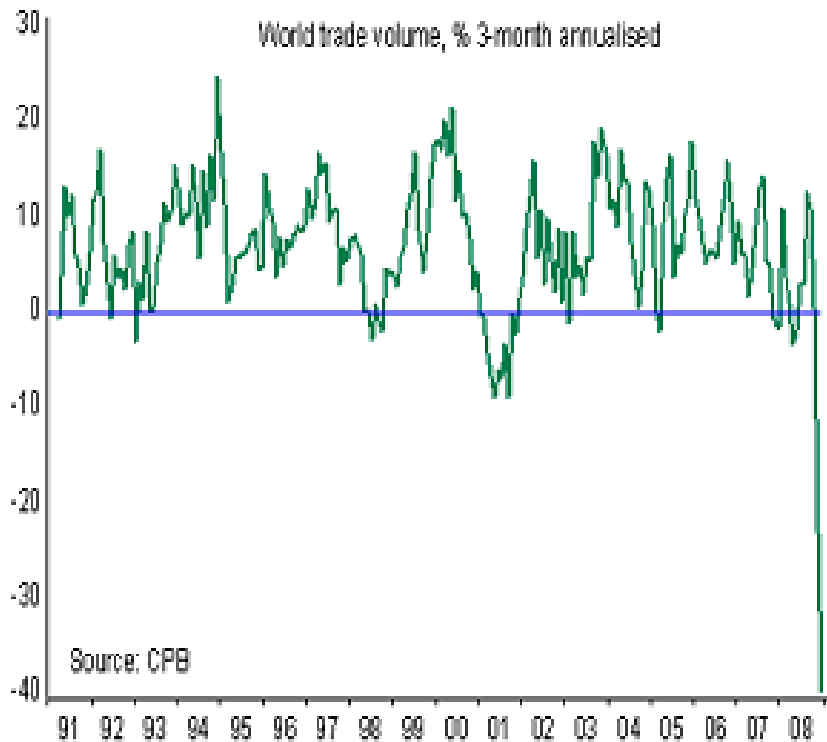
Supply of credit effectively dries up



Source: Bloomberg

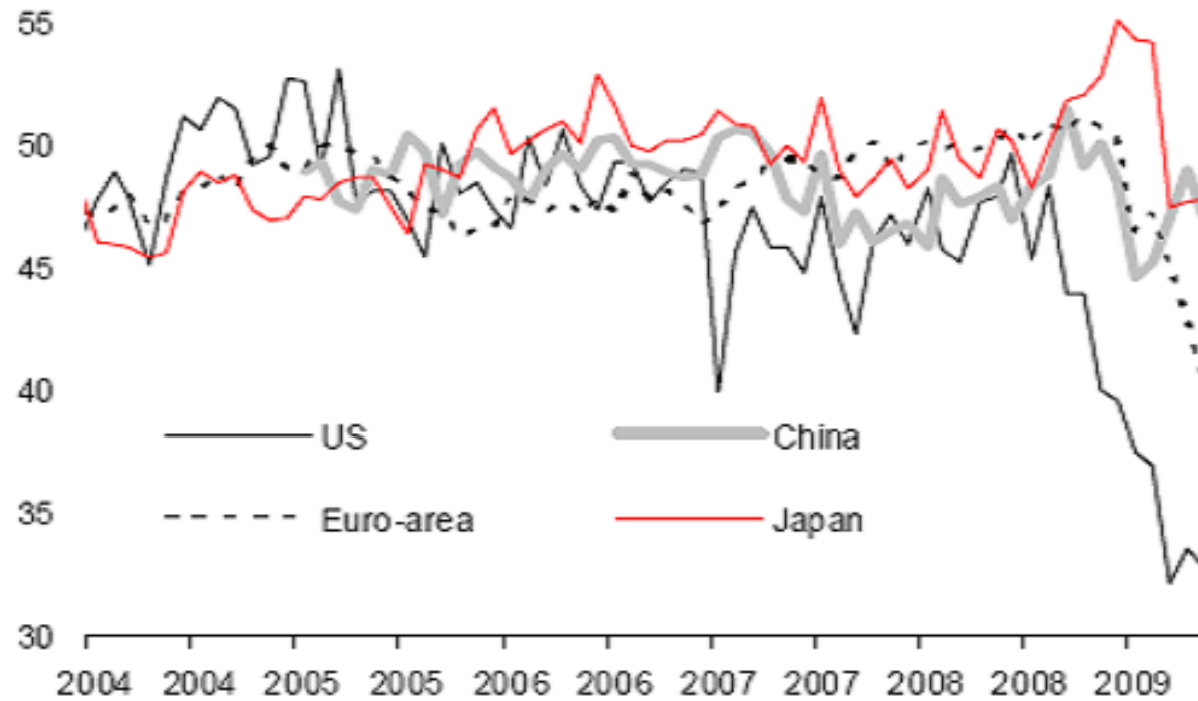
World Trade Collapse...

Down 39% annualised in 4th Qtr 2008



Inventory cycle

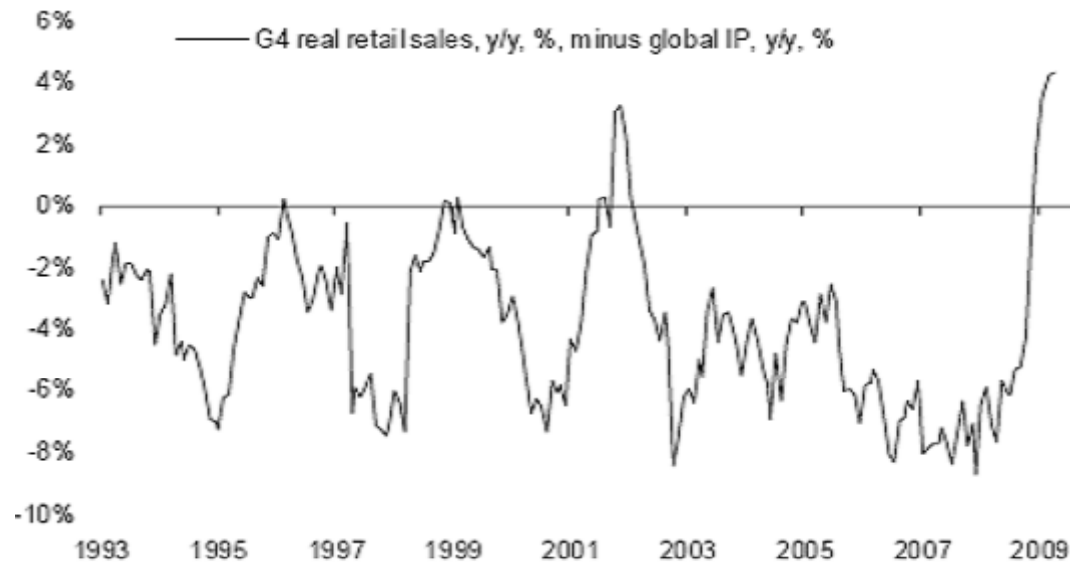
PMI inventories



Source: Datastream International

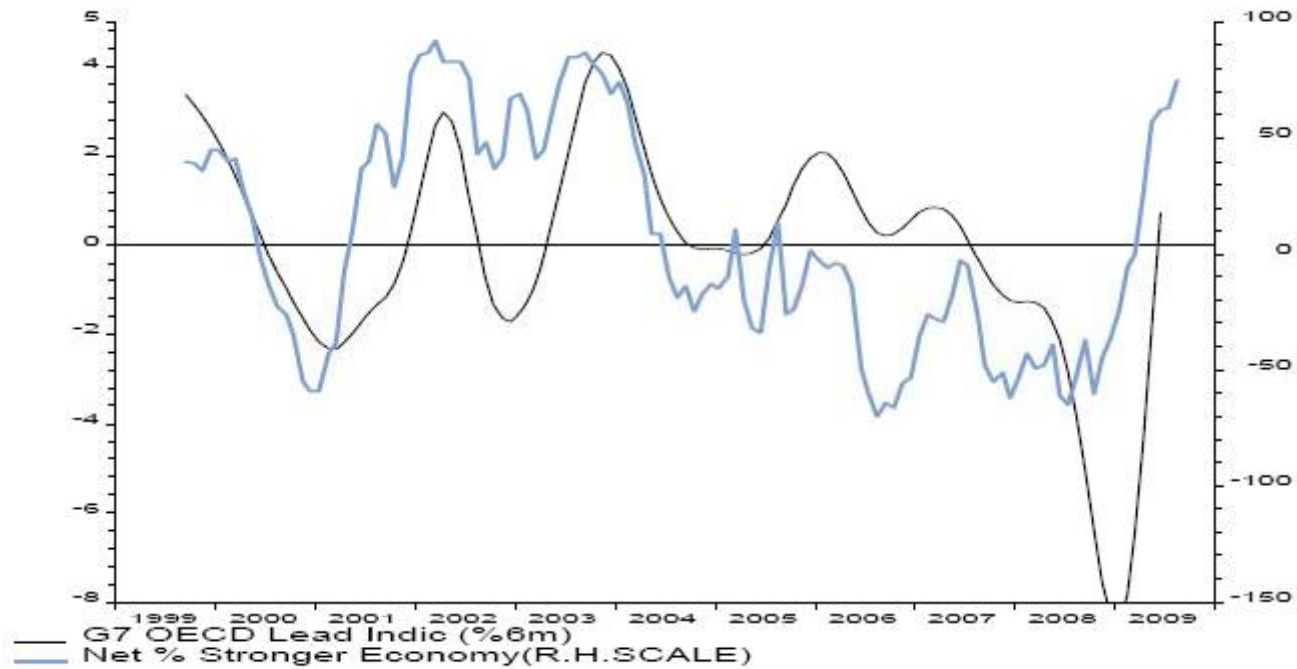
In fact inventories fell a LOT more than retail sales

The gap between the fall in global IP and retail sales is higher than at any point during the past decade



Source: Datastream International

Fund Managers' growth expectations & OECD leading indicator



Old versus new cycle

Old cycle

1. Fed cuts rates
2. Value of financial assets rises
3. US consumer and property rebound
4. US\$ strengthens
5. Exports from Europe and ASIA pickup
6. Europe and Asia come out of recession lagging the US
7. End point... Fed raises rates

This cycle

1. Fed cuts rates and prints money
2. Value of financial assets rises
3. US consumer and property stalled
4. China stimulates
5. Chinese consumption expands
6. Commodity prices rise
7. Income to commodity producers rise, funding inter-regional trade
8. US\$ weakens
9. Exports from developed world pick up
10. World comes out of recession emerging markets leading
11. What is the end point?

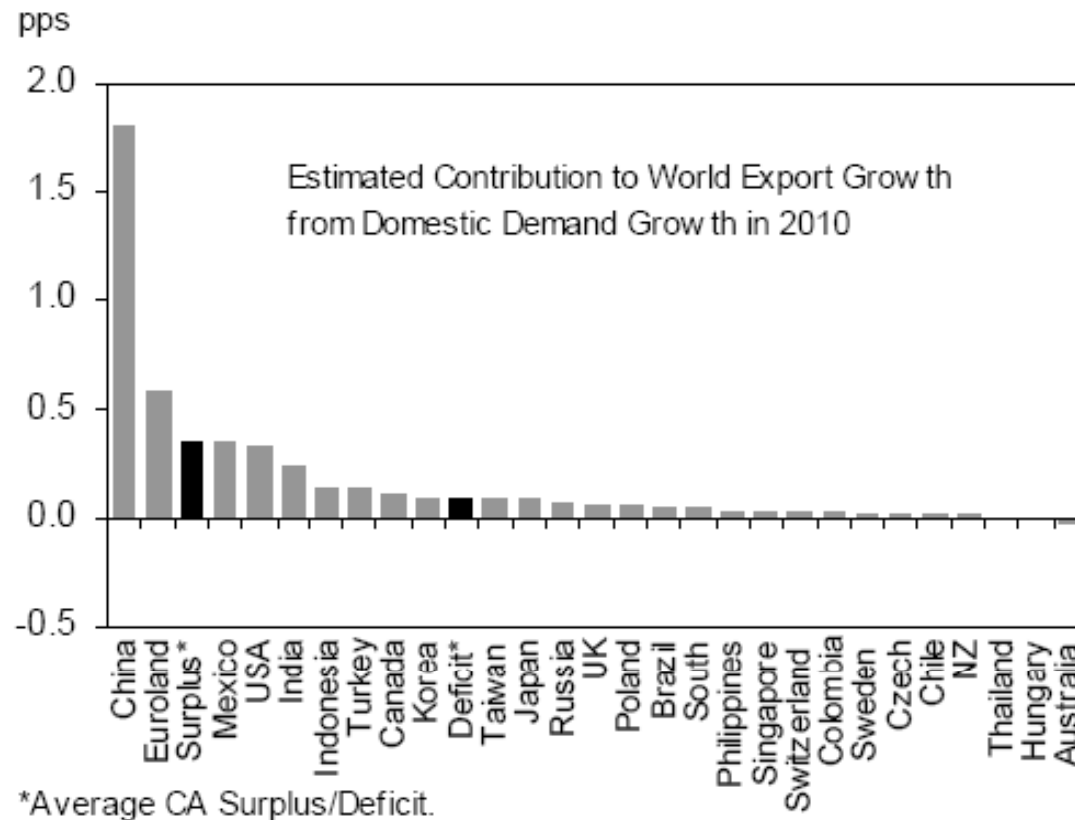
Strengths



- Emerging market growth is supported by combination of under-serviced domestic demand and cheap domestic capital reserves
- US housing and banking system stabilising with solid valuation and profitability support
- Leading indicators show exiting crisis
- Corporate balance sheets strong margins and operating margins have been resilient

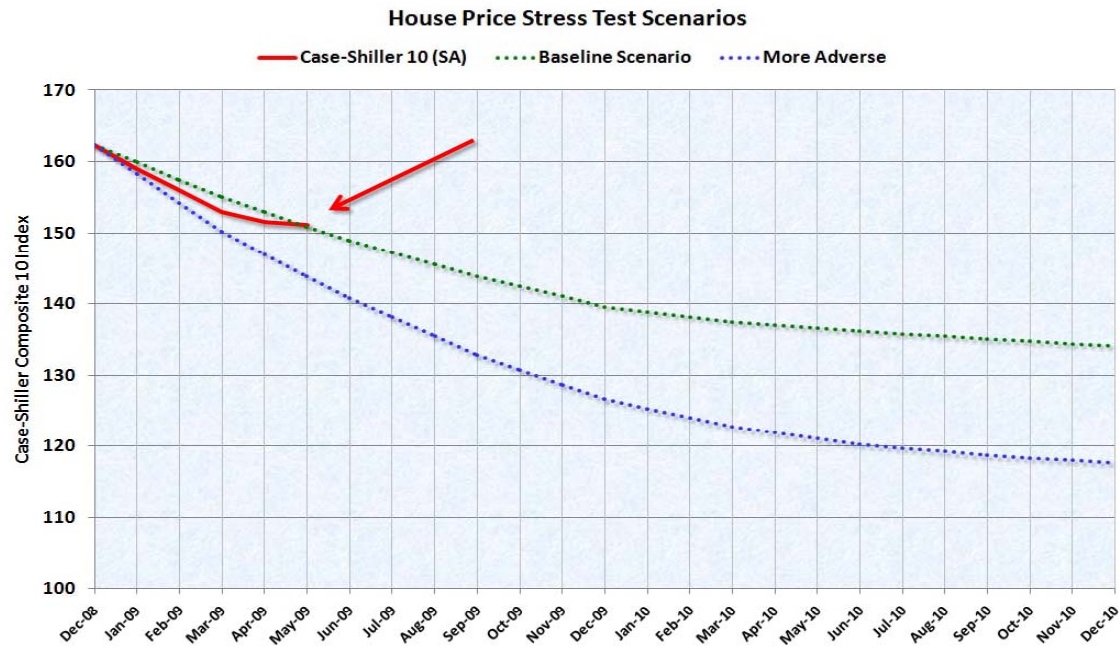
Importance of Chinese domestic demand

China's dominance likely to continue in 2010



Source: IMF, National Source, Global ECS Research Calculations

Rate of housing price decline vs what's in the stress test

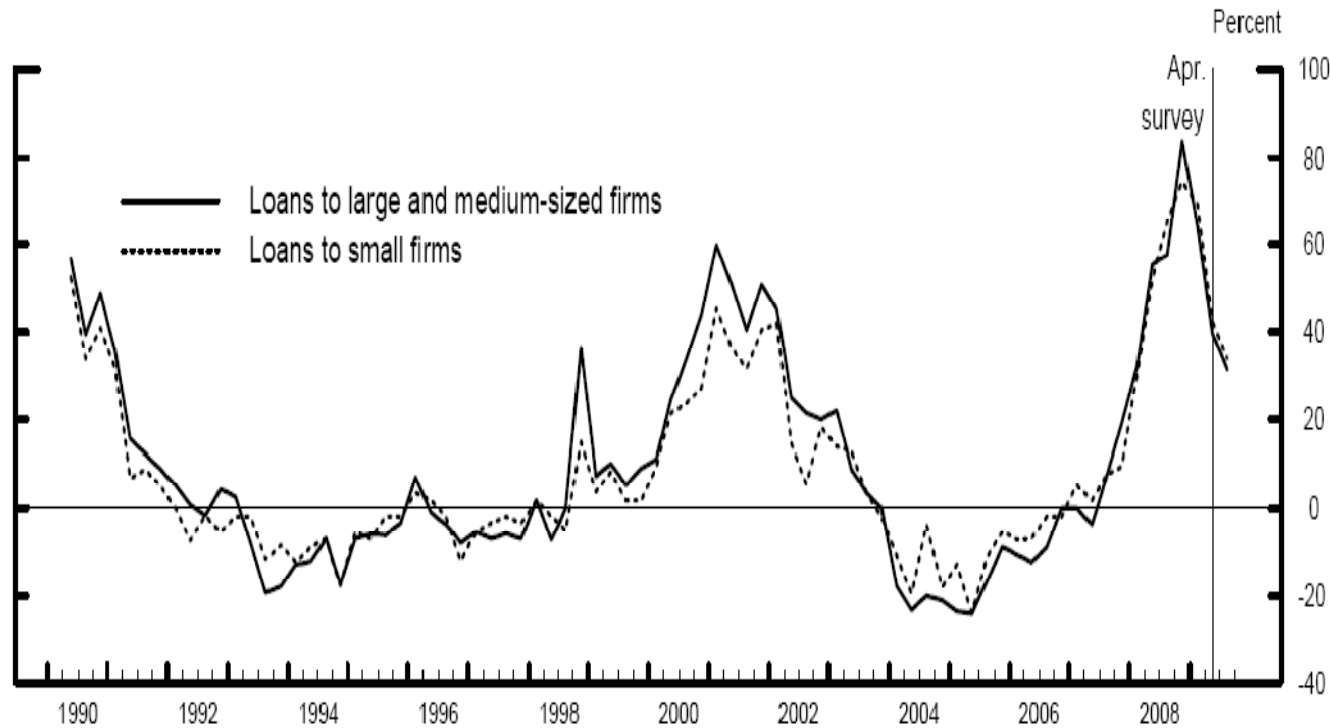


Weaknesses

- Monetary Aggregates
 - Are we seeing any loan growth?
- US consumer likely to remain weak
- Unemployment still deteriorating
- Any pick up in growth is likely to be held back by rises in input costs aka oil unproductive investment will be penalised if not by interest rates, by oil prices

Credit supply is still tightening though at a decreasing rate

Net Percentage of Domestic Respondents Tightening Standards for Commercial and Industrial Loans



Opportunities



- Tech cycle
- Infrastructure spending to substitute excess consumption
 - productive spending replaces immediate consumption
- Green Revolution offer new growth engine funded by savings on energy bills
- Commodity boom to resume?

Tech product cycle revving



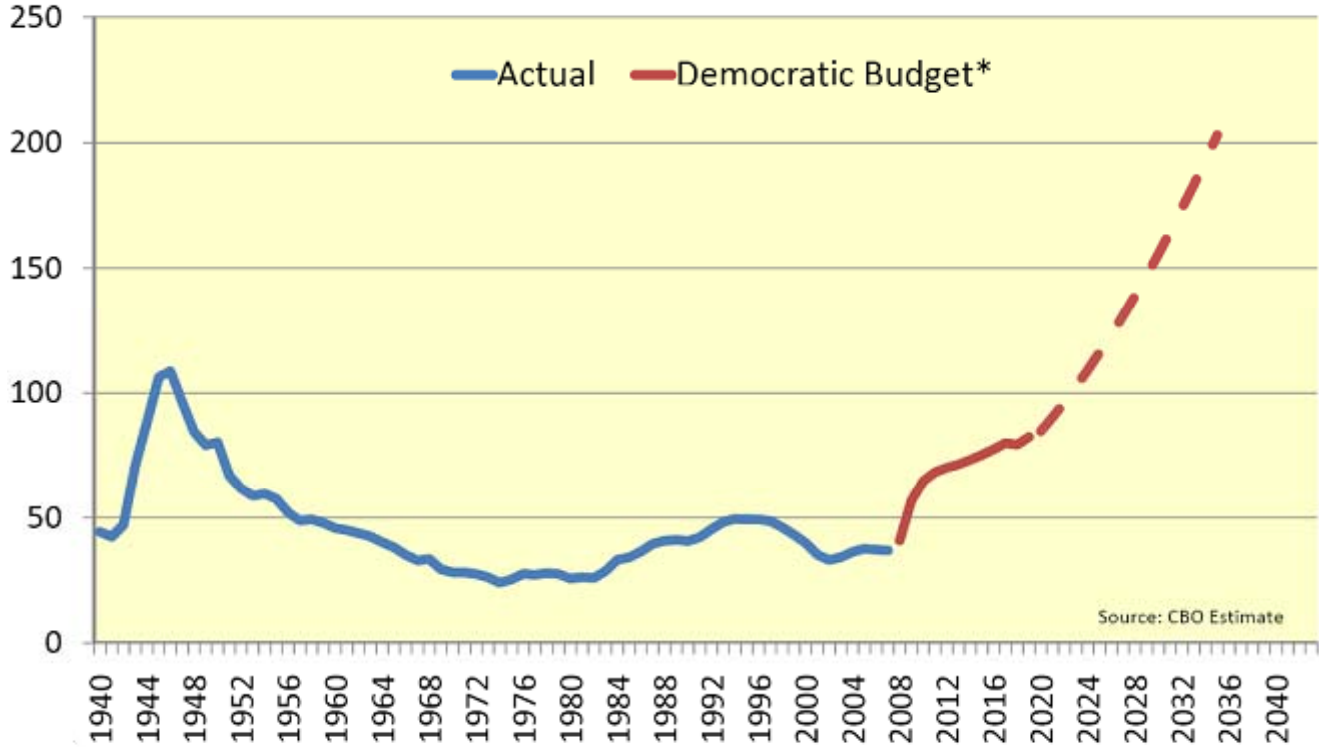
Threats

- How to shrink central bank balance sheets
- Tackling government debt
- China stimulus is transitory
- Chinese moves to bubble territory
- Inflation - commodity boom to resume
- Deflation
- Anti-business political backlash – is regulation bad?
- Government programmes undermine entrepreneurialism and sound asset allocation
- Behavioural change in West; the new frugality
- Demographic – the aging population

US debt burden CBO projections



Future debt burden – debt held by public as % of GDP

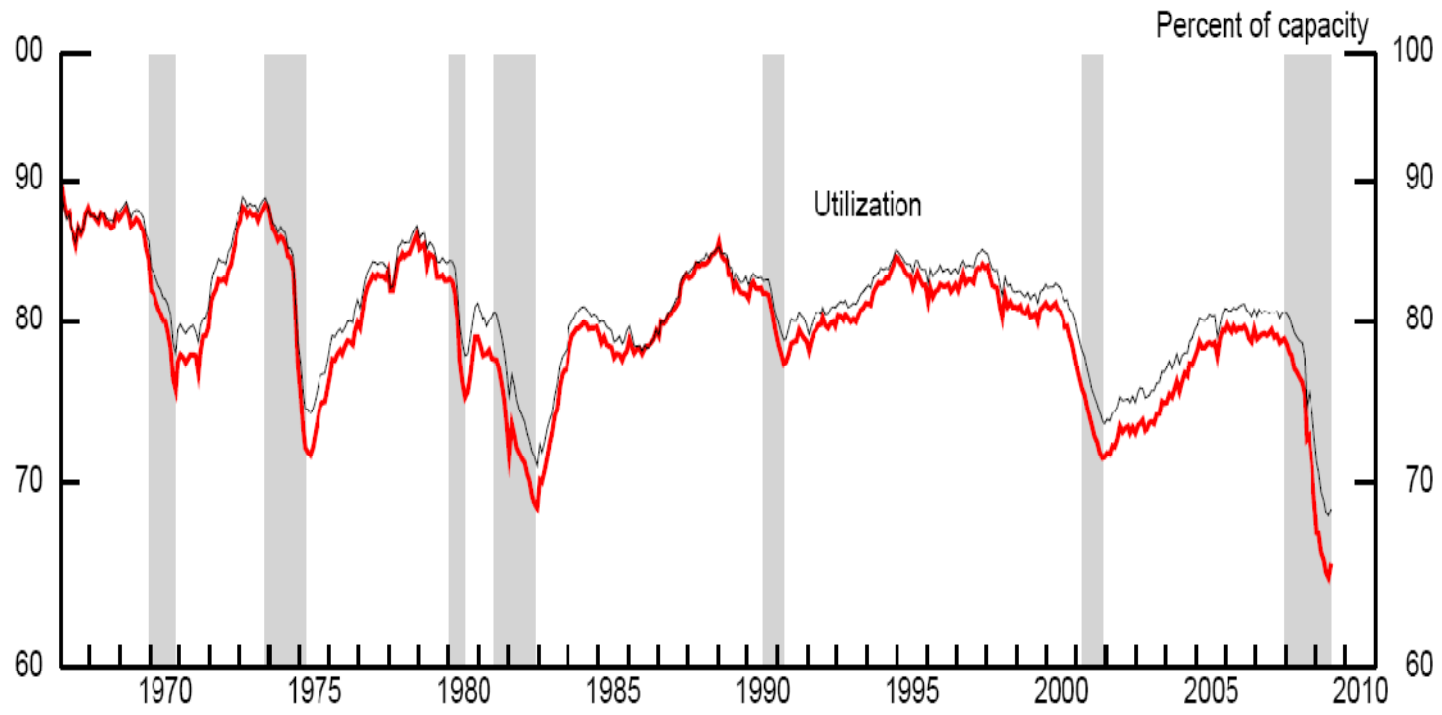


* - - - Out-years based on CBO's Long-Term Projections

Source: CBO Estimate

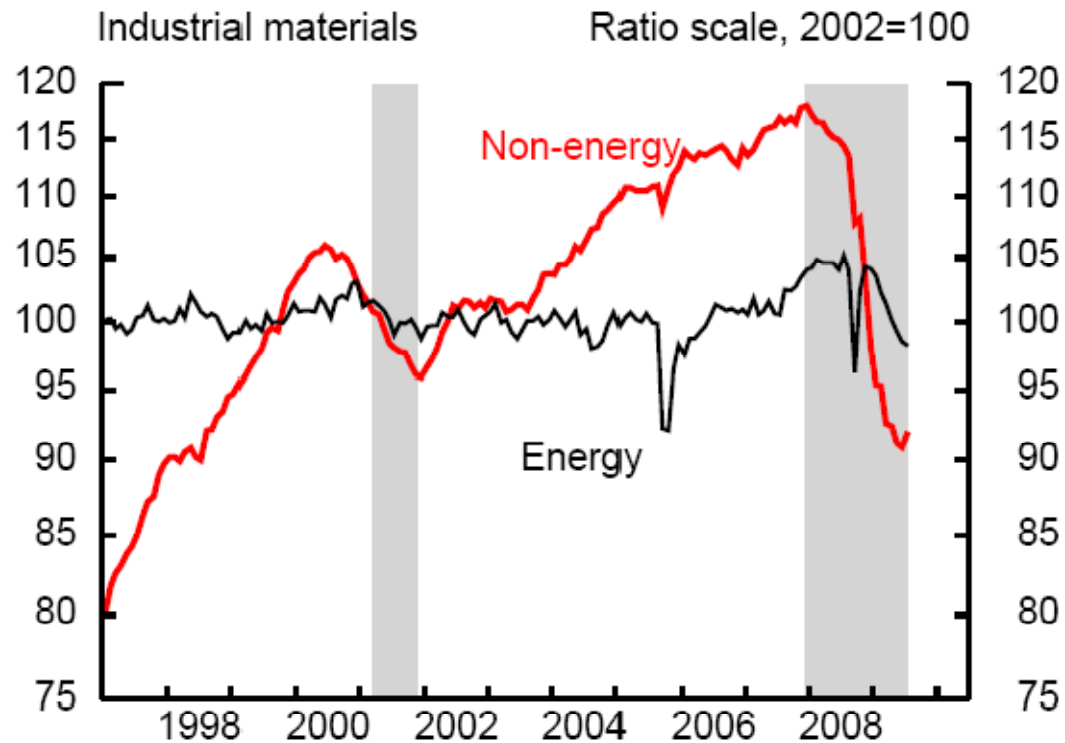
Deflation risk

Capacity utilisation in the US

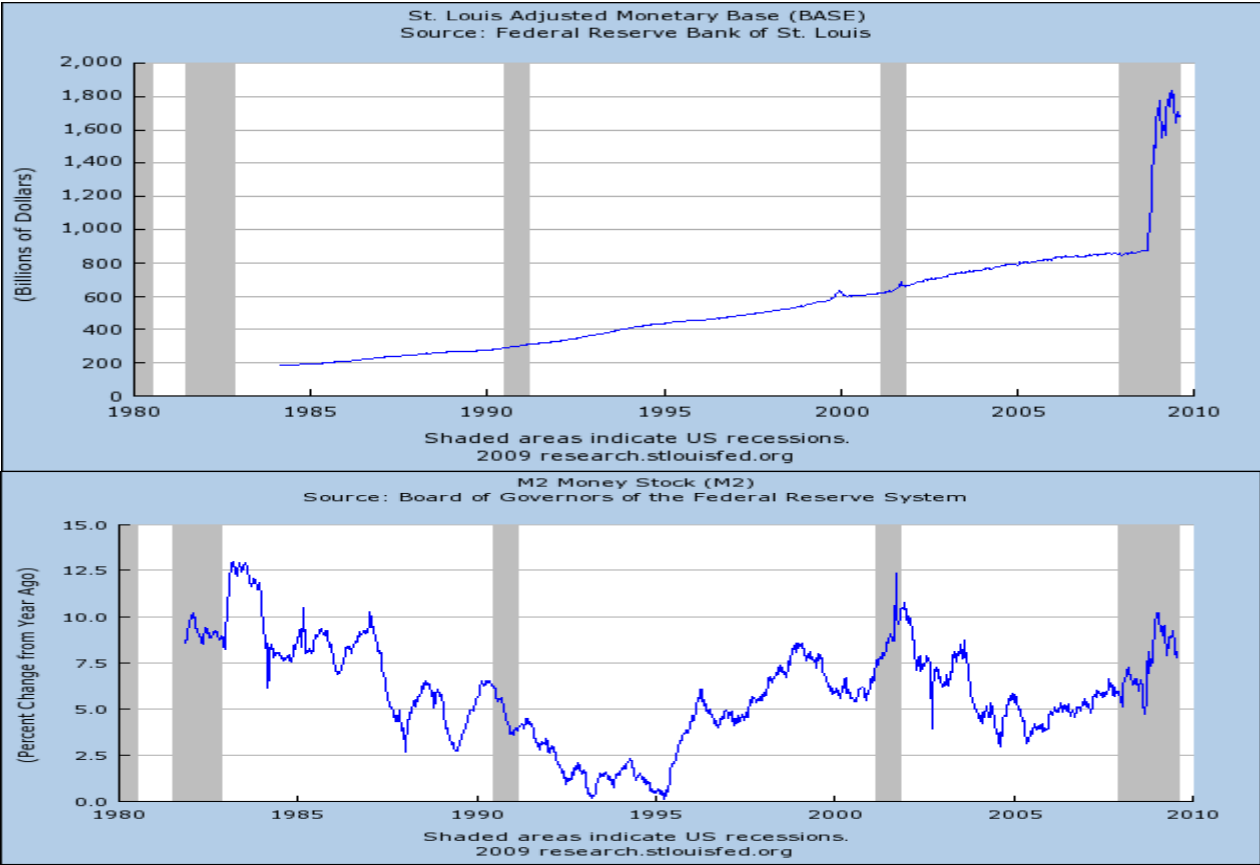


Inflation Risk

But look at capacity utilisation in energy...



US monetary supply

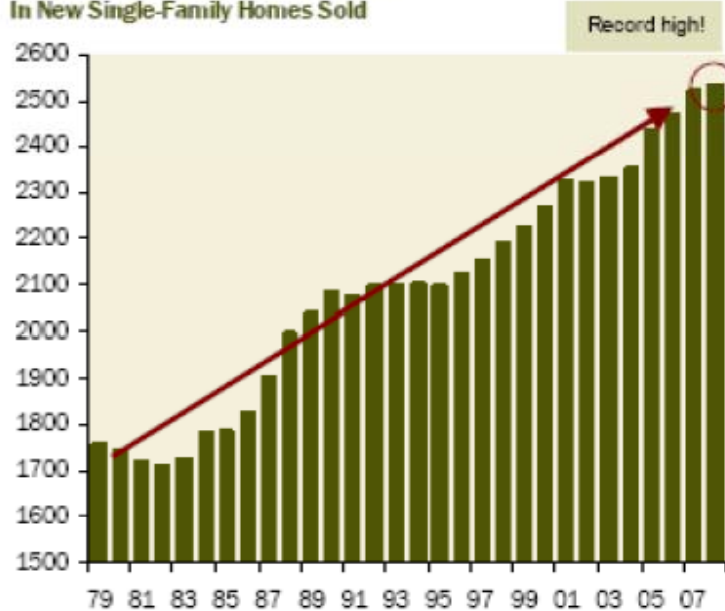


Behavioural change

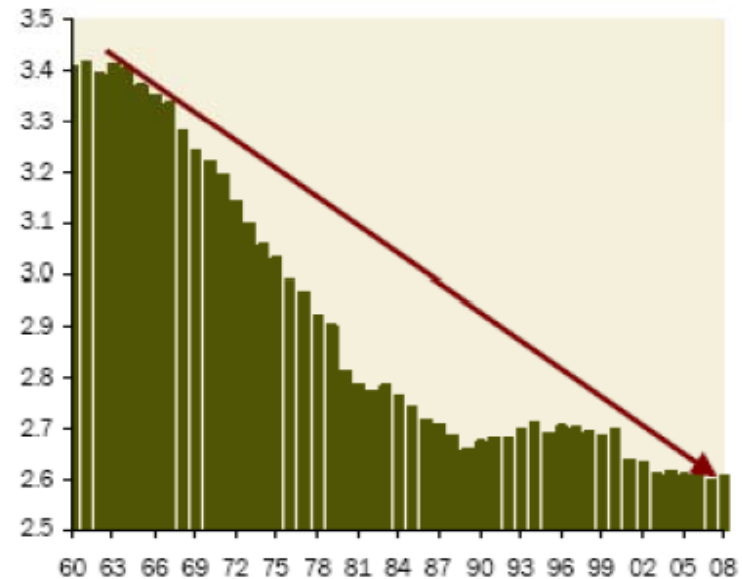
The new frugality?

United States

Average Square Feet of Floor Area
In New Single-Family Homes Sold



Persons per Household at a Record Low
(persons/household)



Source: Haver Analytics, Gluskin Sheff

Market valuation fair... But we never got to cheap

Super cycles in valuations

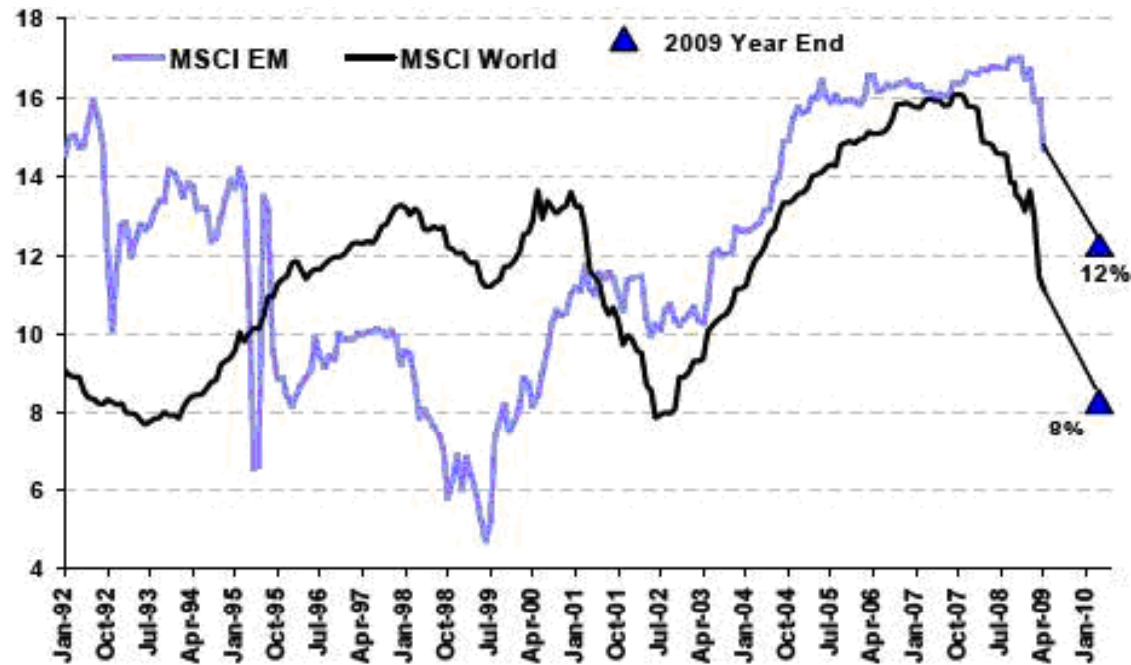


Source: BLS, Standard & Poor's, Robert Shiller; Morgan Standley Research

Corporate structural profitability remains strong



Trailing ROE: MSCI EM vs MSCI World, 1992-2008

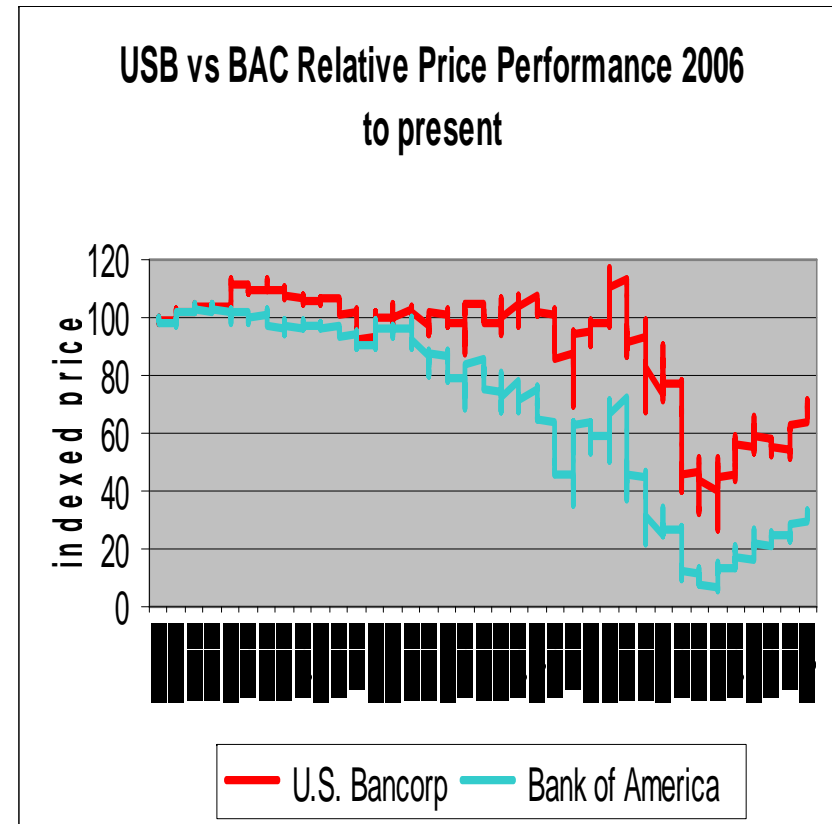
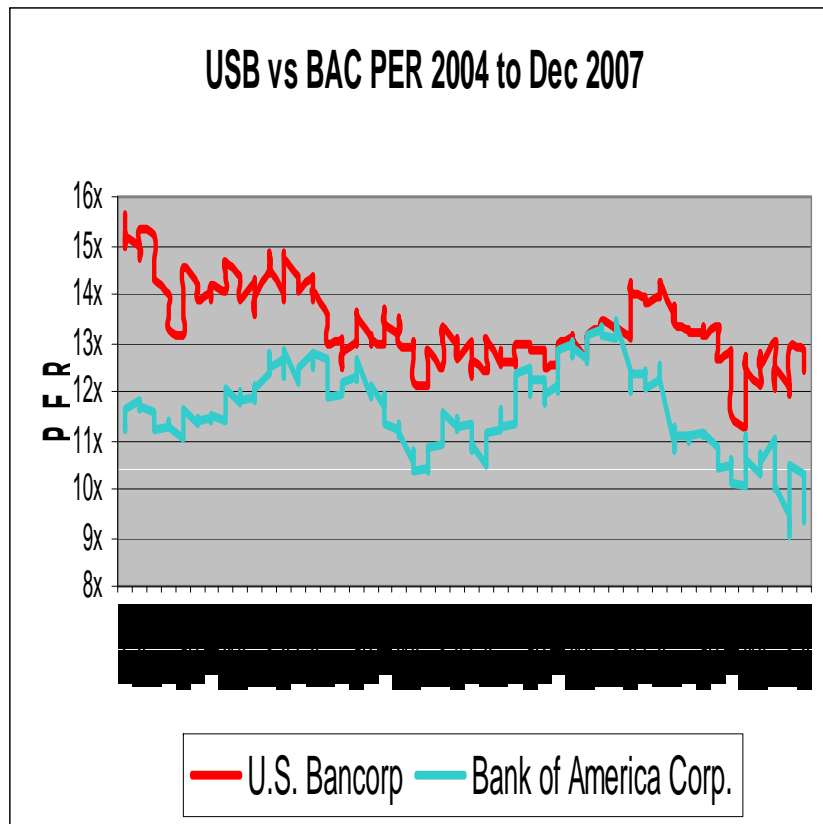


Source: MSCI, FactSet, Morgan Stanley Research

Valuation and the Banks



End of 2007 Bank of America trading at a significant discount to US Bancorp on PE



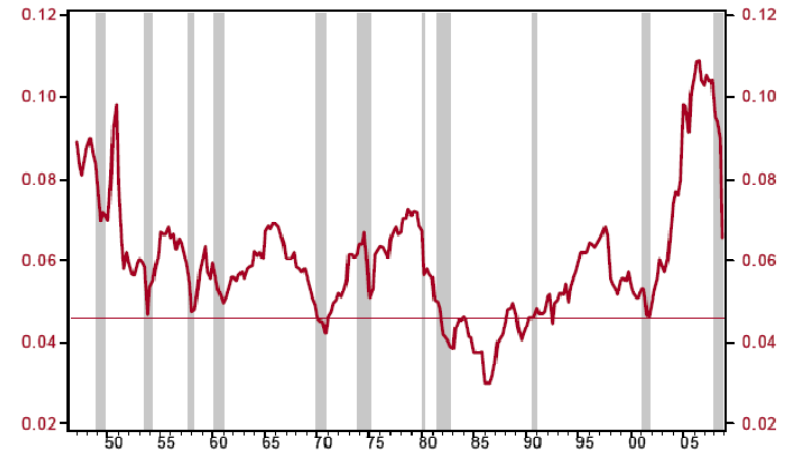
Financials' Profits at unsustainable levels

Chart 2: Financial share of domestic corporate profits



Source: Bureau of Economic Analysis, Haver Analytics

Chart 1: Corporate profits-to-GDP ratio

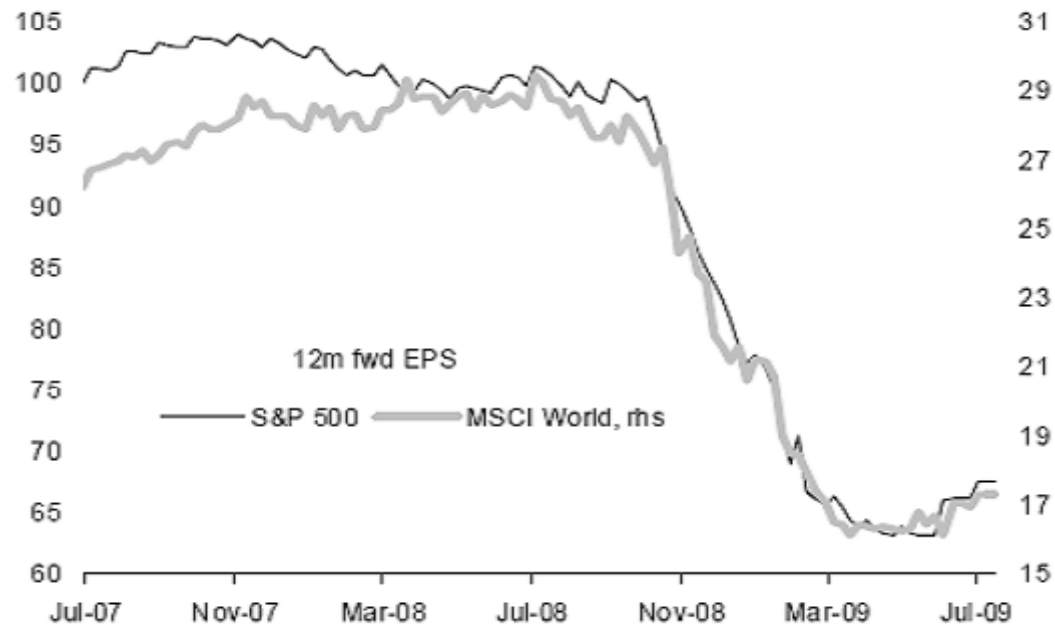


Source: Bureau of Economic Analysis, Haver Analytics

Earnings momentum turning positive



12 month forward earnings estimates are now rising



Source: Datastream International

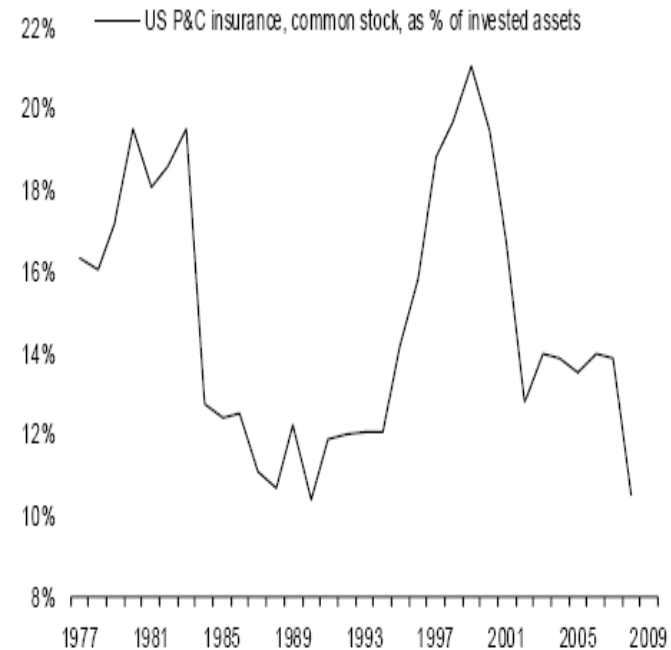
Equity weightings are relatively low

Figure 1: Equity holdings of UK insurance companies and pension funds, % total assets



Source: © Datastream International Limited ALL RIGHTS RESERVED, Credit Suisse research

Figure 2: US P&C insurance industry's common stock holding, % total invested assets



Source: US insurance team, Credit Suisse research

“Buy humiliation?”

S&P Rolling 10-yrs annualized monthly returns since 1926, %



Source: Banc of America Securities – Merrill Lynch

Cyclical vs structural change



- Was the crisis just another cyclical peak, a cyclical bubble, with mean reversion or is it a long cycle or structural change where there is no mean reversal?
- Is Asia exhibiting a cyclical pattern versus the west which is secular?
 - Consensus runs along these lines...

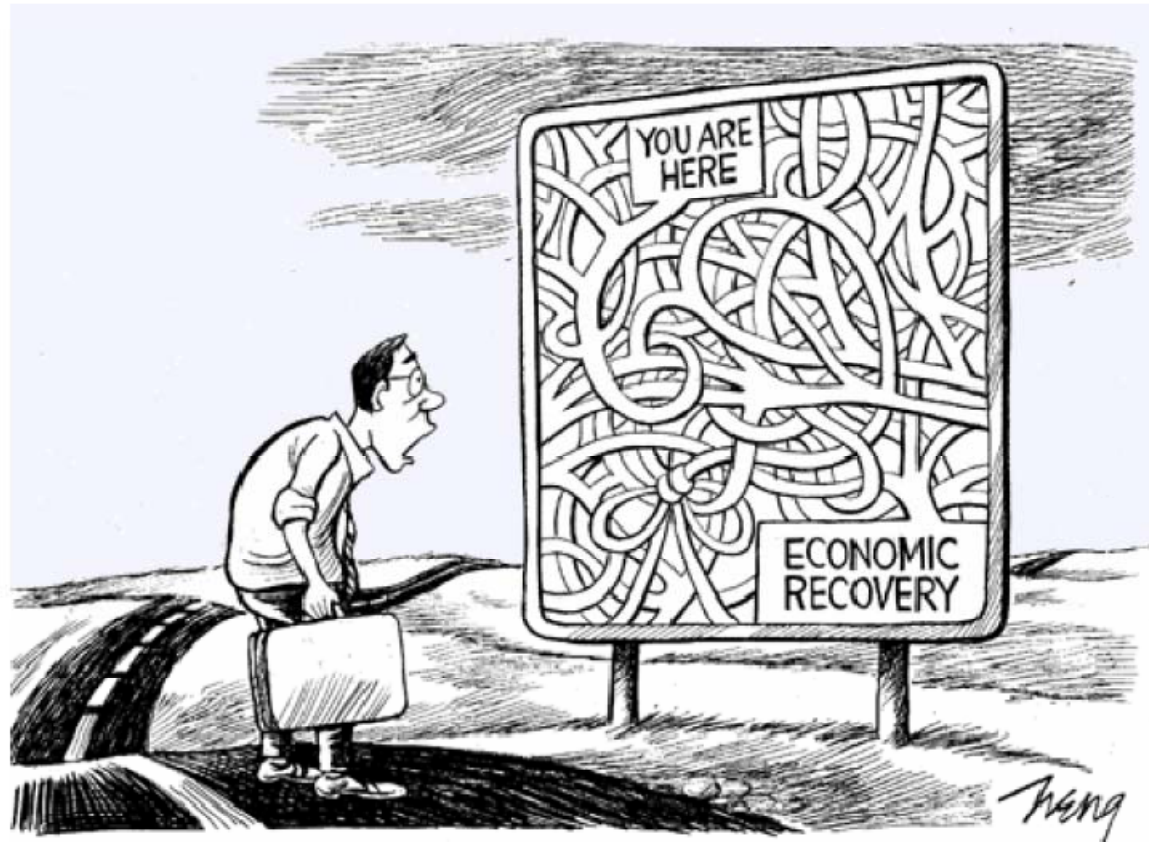


Strategies in times of massive change?



- Find the Genius who picks it or...
- Acknowledge a complex system with tipping points – adjust tactically
 - Be aware of the possibility of disequilibrium over certain time frames
 - Have capacity to adjust your positions when some of those tipping points are hit
 - Buy insurance when its cheap
 - Buy stocks when they are cheap and sell when they're expensive rather than making the big call
 - Know when to be contrarian....
- Expensive is always dangerous, cheap is not always a lead indicator

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