Quarterly Asset Allocation No. 13, 1st April 2013
(i.e. 6 months – 2 years global asset allocation views)

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The Real Great Rotation: East back to West

Summary & Conclusion

"…As such, and having been cautious in December (ahead of the 'US fiscal cliff' risk), we favour increasing (i.e. rebuilding) our exposure to equities. Within that, though, we recommend starting to shift allocations towards developed, and in particular Western, markets and away from emerging markets..."

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Important disclosures are included at the end of this report

The Real Great Rotation: East back to West

(6 month – 2 year investment view on all major asset classes)

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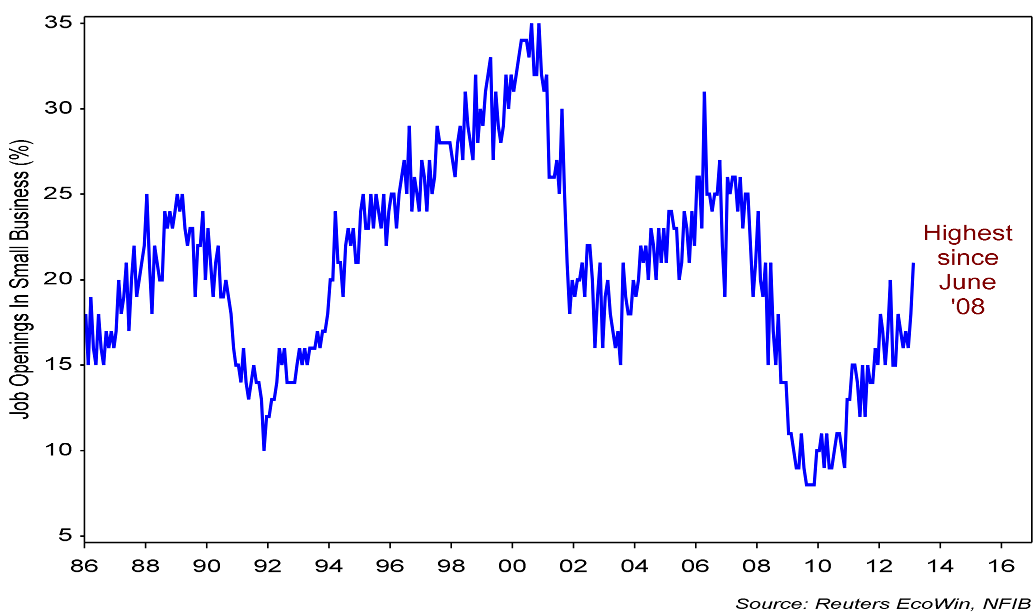
Summary & overview

The stage is set for a good year for equities in 2013 (and probably beyond), particularly in the West. Underpinning that, US economic growth has become increasingly self-sustaining, monetary policy remains loose, the 'fiscal cliff' outcome was benign and valuations, while not cheap, are undemanding. Furthermore, the European macro outlook is improving at the margin (given multiple signs of stability and/or recovery) – with the Euro zone likely to emerge from recession in 2H 2013* (see Section 2 for detail on the global macro outlook).

As such, and having been cautious in December (ahead of the 'US fiscal cliff' risk), we favour increasing (i.e. rebuilding) our exposure to equities. Within that, though, we recommend starting to shift allocations towards developed, and in particular Western, markets and away from emerging markets. That reflects, most notably, rising structural risks in China** (given its rapid buildup of indebtedness) and, by association, rising risk in other Asian & emerging markets. On top of that, and more generally, the risk of owning EM assets, perhaps somewhat counter intuitively, should rise as US growth gains traction over coming quarters (and as monetary policy eventually starts to normalize) – *for detail see Longview Letter No 70, Jan '13 "Dollarisation & EM Fault Lines a.k.a. When might the EM secular Equity Bull Cycle End"*. In that respect the balance of global risk is *starting* to shift from the West to the East (and, to reflect that, we lay out top level portfolio recommendations in Section 1).

Fig 1: US NFIB small business survey: Job Openings



Small business job openings, despite recent US fiscal tightening, have risen sharply – and are at their highest level in 5 years…

**Assuming no recurrence of significant financial stress in the Euro area*
***see Longview Letter No 71 "Is Chinese Growth a Ponzi Scheme? a.k.a. China's credit bubble"*

Section 1: Top Level Portfolio Recommendations

The key changes to 'top level' asset allocation recommendations*** are laid out below (table 1):

- **Increase Developed Market Equity weightings** (from 15pp to 35pp) – given the favorable outlook for US growth and improving outlook for Euro zone growth. In particular, the US economy appears increasingly self-sustaining while the outlook for Europe suggests a return to growth later in 2013, Section 2 (albeit some social & political risks remain and, given the nature of the Cypriot deal, the risk of capital flight has increased).

- **Reduce Emerging Market Equity weightings** (from 25pp to 20pp) with further reductions likely in coming quarters. Of note, structural risks in China are rising (driven by evidence of an inflating credit bubble). Furthermore, general EM risk should continue to rise (particularly as US growth gains traction in coming quarters and monetary policy eventually starts to normalize). For that reason we have also begun to reduce EM sovereign debt weightings (down from 10pp to 5pp), see table 1.

- **Reduce US & Euro Zone high grade corporate debt weightings to ZERO** (due to their rich valuations). Of note both categories offer a negative risk premium relative to sovereign counterparts (i.e. sovereign spreads are negative).

- **Maintain precious metals weightings** as a hedge against central bank money creation *(see Jan 2013 Commodity Monthly: "Has Gold Lost its Shine?" for detail)* as well as protection against risk events and potential safe haven buying (note, for example, the inherent confiscatory nature of governments under pressure – i.e. as in Cyprus). In that respect building risks in Slovenia also add to the case for owning precious metals.

Table 1: Top level 'Long Term'*** Recommended Asset Allocation (% weightings)

Asset Class	NEW % of total (Updated – Mar '13)	% Breakdown	Change from last quarter	OLD % of total Dec 2012)	Rationale
Equity:	**55**		**+15**	**40**	See tables 8a & 8b
- Developed		35	**+20**	15	
- Developing		20	**-5**	25	
Corporate Debt:	**5**			**5**	
- US High grade corporate		-	-	2	-
- EZ High grade corporate		-	-	na	
- US High yield corporate		3		3	
- EZ High yield corporate		2		na	
Commodities:	**10**			**10**	See table 8
- Gold		4	-	4	
- Silver		2	-	2	
- Agricultural		2	-	2	
- Base metals		0	-	0	
- Energy		2	-	2	
Sovereign debt	**25**		-5	**30**	Tables 8d & 8e
- Developed		20	-	20	
- Developing		5	-5	10	
Cash	**5**		-10	**15**	Poor real return

Source: *Longview Economics*

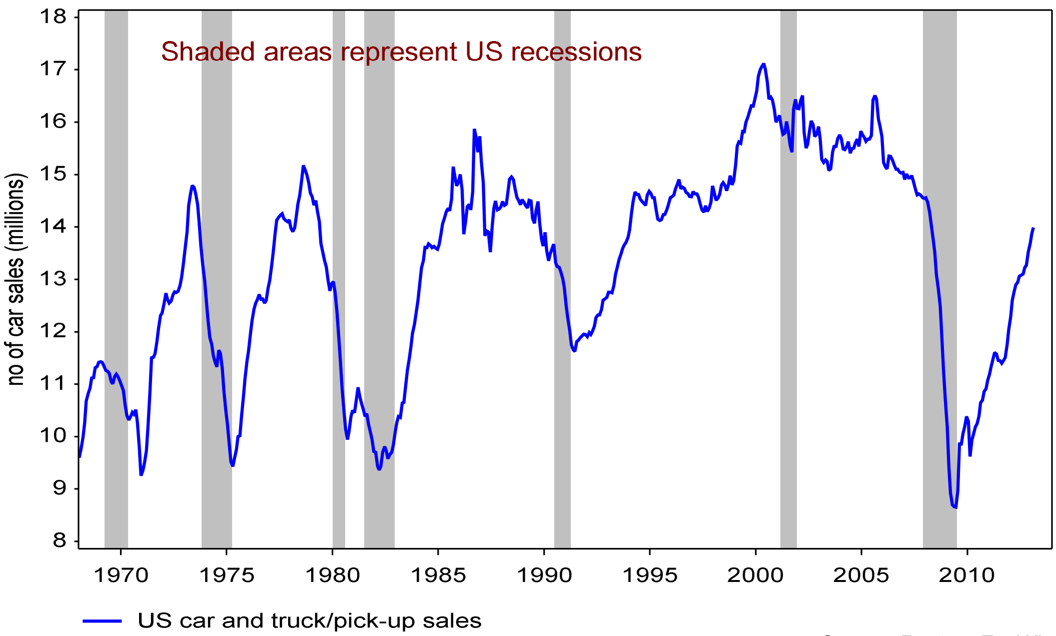
***For 'Long term' investors (i.e. 6 month to 2 years); for shorter term 1 – 2 month tactical views see Longview Economics' Monthly market timing updates & Longview Alerts.

Section 2: Global Macro Outlook

The outlook for US and Euro zone growth continues to improve. In China, growth is (cyclically) reaccelerating and therefore also adds to the case for owning equities in coming months (see below). Structurally, though, China's outlook is deteriorating (with the risks of a bursting credit bubble clearly building – i.e. a risk that could materialize within the next 12 – 24 months).

The US outlook has continued to improve markedly in recent months. Of note, several key headwinds have either dissipated – or become tailwinds and, with that, US growth is becoming increasingly self-sustaining. The shale oil and gas revolution, for example, is now adding significantly to job and wealth creation at the margin (as well as putting downward pressure on oil prices). State and local government budgets, having been cut notably in recent years, are now mostly back in balance while the US house price bubble has deflated with housing having now become a tailwind for the economy (i.e. broadly since late 2011) instead of a headwind. Housing starts and permits, which are in a strong uptrend (fig 3c), the NAHB index (which points to increased activity, fig 3b) and inventories of unsold homes (which have fallen back to arguably 'normal' levels, fig 3d) are all signs of that new uptrend in housing.

Fig 2: US car and truck/pick-up sales (6 month smoothed & shown with US recession bands)



US vehicle sales have risen sharply in recent months…

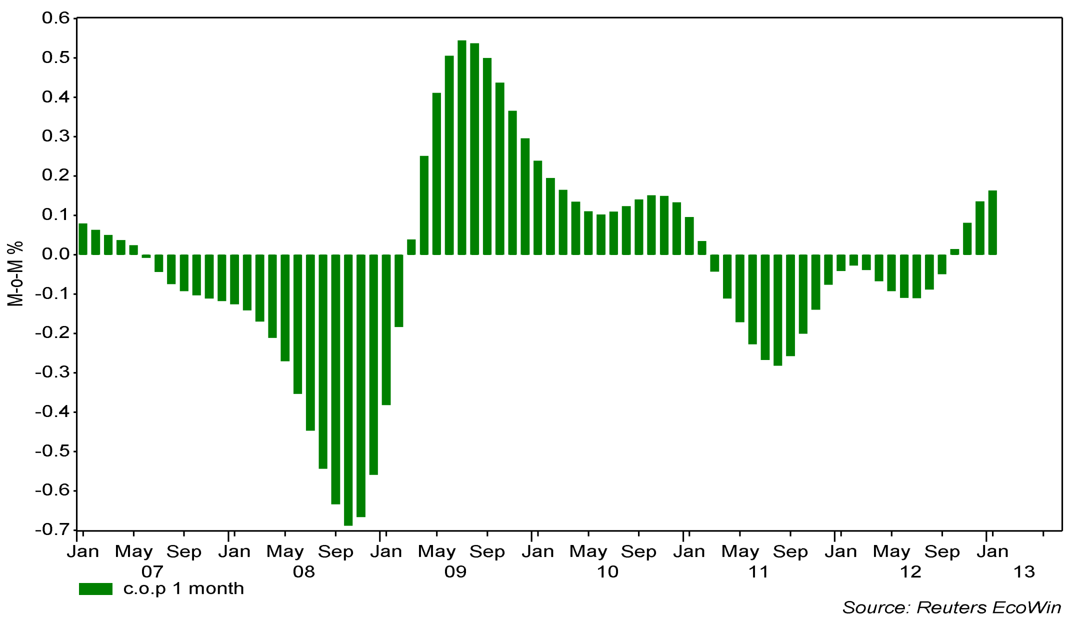
Source: Reuters EcoWin

With that, other cyclical parts of the economy are accelerating. Car sales, for example, have continued to trend sharply higher (in a manner consistent with recoveries from prior recessions – see fig 2). Indicators which lead the economic cycle suggest that the cyclical upswing should continue to gain traction. Credit growth, for example, (both at the consumer & corporate level) is expanding (supported by loose credit conditions); Leading Economic Indicators are trending higher (both OECD & Conference Board indices, fig 3a) and small business job openings have risen sharply in recent months (currently at a 5 year high, fig 1) – i.e. as animal spirits are returning to the corporate sector (another key factor which points to an emerging 'self-sustaining' recovery). Other leading indicators, such as the ISM new orders index also have a positive message *(for detail of key US macro indicators, see our 'traffic light' analysis, Section 3).*

Europe is also improving at the margin and, in our view, should emerge from recession in 2H of this year. In particular, and despite the poor message of coincident (i.e. backward looking) indicators, *leading indicators* are turning higher. The OCED LEI, for example, has expanded (M-o-M) in each of the last 4 months (fig 3). German IFO expectations (relative to current conditions) have risen sharply (a key leading indicator of German industrial production – fig 4c) while Euro zone money supply growth (both M1 & M3) is trending higher (see figs 4a & 4b). *See Section 4 for our 'traffic light' analysis of Euro zone macro indicators*.

Furthermore, the degree of structural healing in the peripheral Euro zone economies is advanced. Of note, current account deficits in Italy, Spain & Portugal (amongst others) have reversed (and have moved back into surplus territory). Those economies are therefore now self -funding (and 'living within their means') which has historically preceded a return to growth *(see March 2013 Mid-Month Global Macro "Is there any hope for growth in Europe?" plus Sept 2012 "Ireland: Poster Child for the Periphery?" for detail)*.

Fig 3: Euro zone (OECD) Leading Economic Indicator (M-o-M, %)



Euro zone Leading Economic Indicators are turning higher (for the first time since 2010)…

China is undergoing a cyclical recovery. That is evidenced by rapid credit growth (fig 5c), a pick-up in car sales as well as resurgent house prices (which have broken out to new highs in major cities, albeit only just, fig 5a) – *see Section 5 for our 'traffic light' analysis of Chinese macro indicators*. While that cyclical upswing is neither high quality nor broad based it should continue for the next 6 – 12 months *(see March '13 "China's Cyclical Recovery: Not Firing on all Cylinders")*.

Beyond that time frame, though, China's credit bubble (which has been building & inflating rapidly since 2009) poses a key risk to the outlook for Asia and Australasia (as well as emerging markets which depend on China for their economic growth). While it's challenging to identify the potential triggers for (and the timing of) China's bursting credit bubble, we favour starting to shift portfolio weightings away from markets which are sensitive to China – with the expectation that China-related fears start to emerge over the next 12 – 24 months *(for detail on this theme see Longview Letter No 71 "Is Chinese Growth a Ponzi Scheme? a.k.a. China's credit bubble")*.

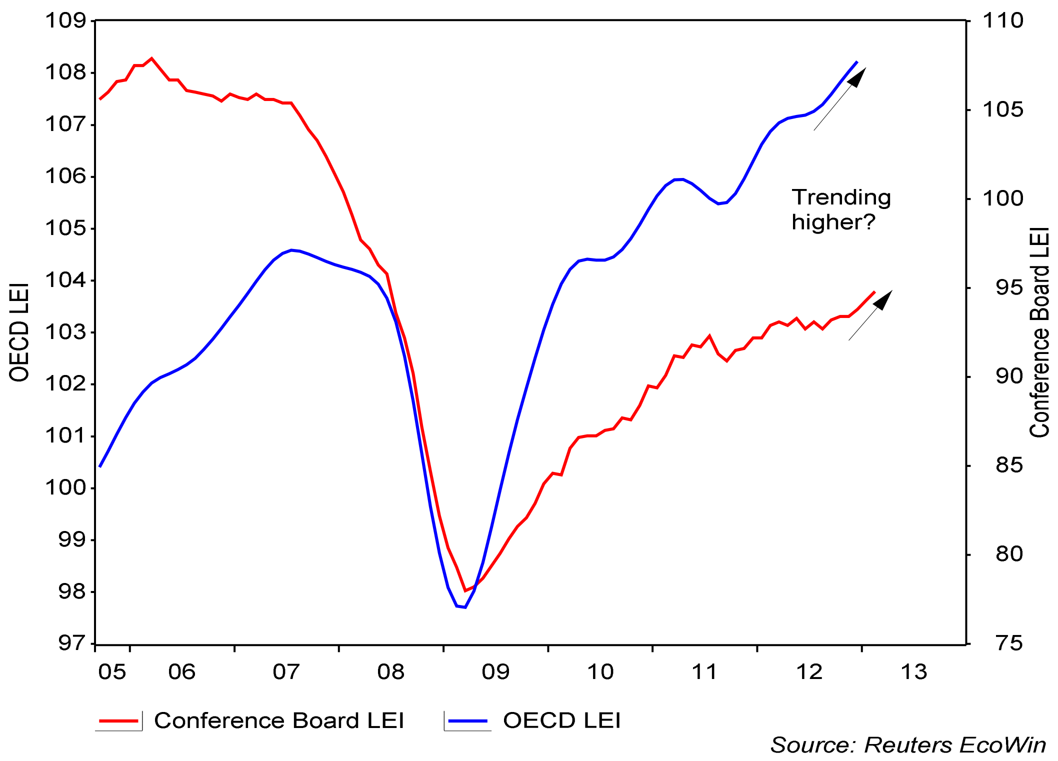
Section 3: Key US Macro Traffic Lights & indicators

Table 3: Key 'big picture' US macro indicators

Indicator	Status	Comment
Corporate financing gap	GREEN	Spare cash flow still being generated
Credit conditions	GREEN	Still loose
Yield curve	GREEN	Still Steep => signalling ongoing recovery (although distorted by Op twist/QE)
Real short rates	GREEN	Lowest since '80
Car sales	GREEN	Trending up (now @ 14mn+ run rate) – strong in Dec
Housing	GREEN	Most indicators now in clear uptrend
Leading Economic Indicators (conf board)	GREEN/AMBER	Edging higher
Leading Economic Indicators (OECD for US)	GREEN	Back in uptrend
Corporate credit	GREEN	Expanding
Consumer credit	GREEN	Good growth
ISM New orders less Inventories	AMBER/GREEN	Bounced off low levels
Philly Fed Capex plans	AMBER/GREEN	Turning higher from low levels
Chicago PMI (& new orders sub index)	AMBER	Higher in recent months
NFIB Small Business optimism	AMBER/RED	Higher in Jan & Feb (but from low levels)

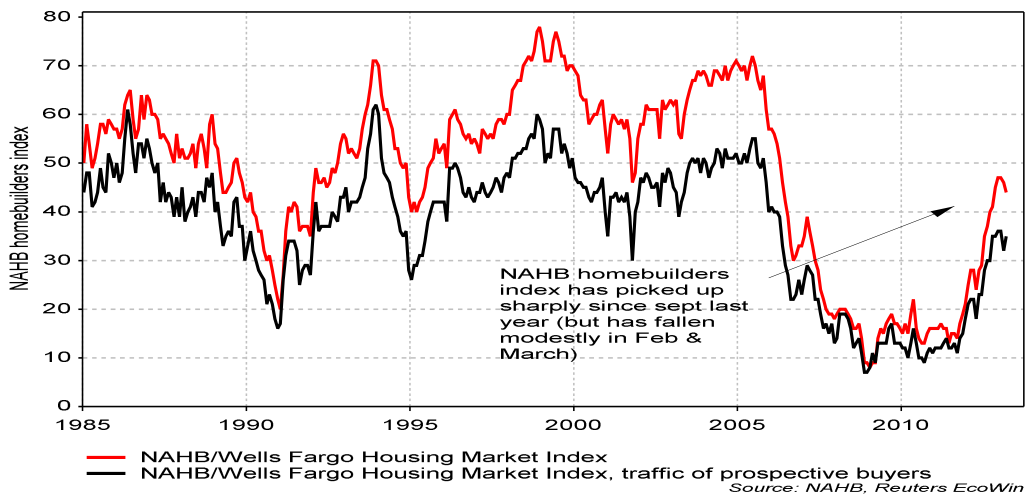
Source: Longview economics, Federal Reserve, Reuters Ecowin

Fig 3a: US Leading Economic Indicators (OECD & Conference Board indices)



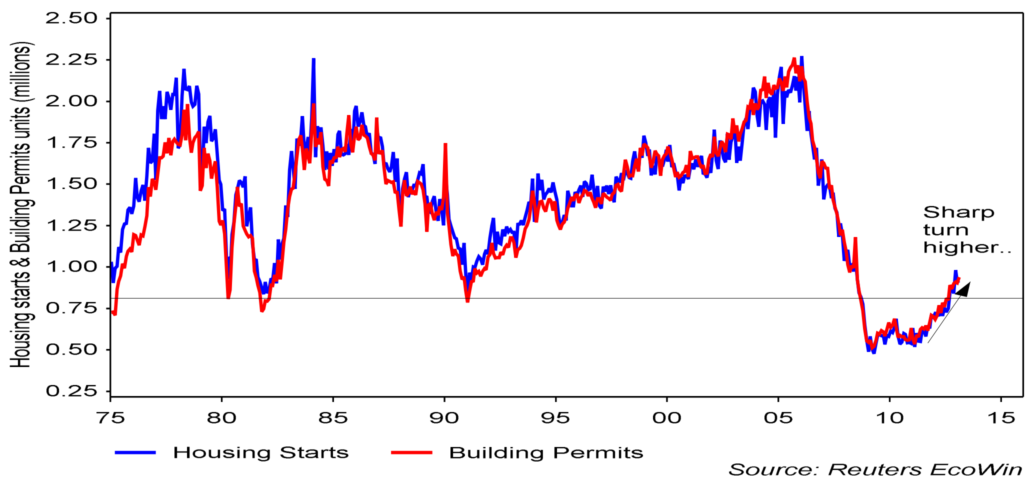
Leading indicators – trending higher?

Fig 3b: US housing data: NAHB homebuilders index (Overall & prospective traffic)



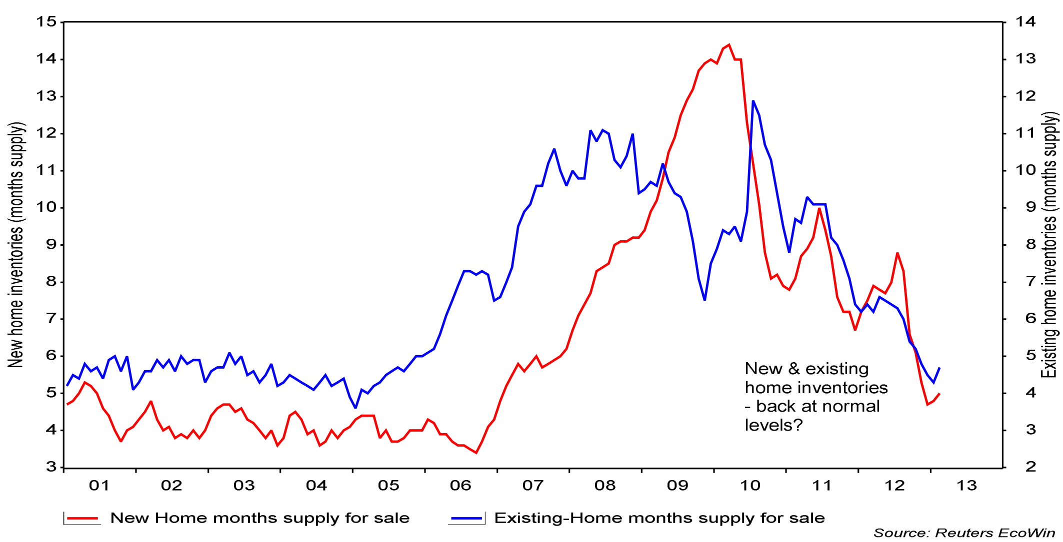
Most US housing data shows strong Y-o-Y growth/strong underlying trends – e.g. the home builders index shown here

Fig 3c: US Housing starts & permits, million (SA & annualized)



Sharp acceleration in US housing data in recent months

Fig 3d: US new & existing housing inventories (months supply)



US housing inventories – back at 'normal' levels?

Section 4: Key Euro zone Macro Traffic Lights & indicators

Table 4: Leading Indicators

Indicator	**Status**	**Comment**
Leading indicators	RED/AMBER	Low – but modestly up past 4 months
Belgian leading indicators	RED/AMBER	At low levels – but starting to stabilise
German yield curve	AMBER/GREEN	Steep – but modest flattening in recent years/months
Monetary conditions	GREEN	Very Loose
Real M1 growth	GREEN	Trending higher
M3 money supply growth	GREEN/AMBER	Positive & an improving trend
Credit conditions	GREEN/AMBER	Credit conditions – modestly tighter on the qtr
German IFO expectations less conditions	AMBER	Sharp improvement in recent months
Business confidence indices	RED/AMBER	@ low levels – but stabilising/turning higher

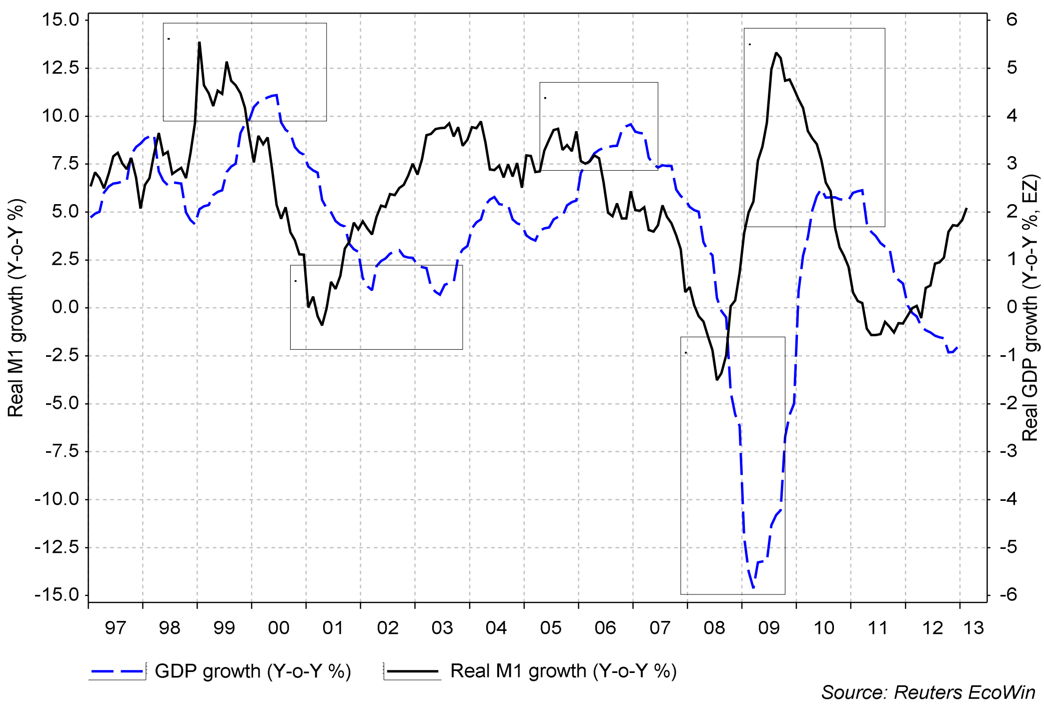
Source: *Longview Economics, Reuters EcoWin*

Table 4a: Coincident Indicators

Indicator	**Status**	**Comment**
New car sales	RED	Trending down - @ multi decade lows
Private sector credit growth	RED	Continues to contract
Consumer credit growth	RED	Contracting at 2.8% pa
German New manufacturing orders	AMBER/RED	In modest downtrend
Consumer confidence	RED	At low levels - better in 2013 though
Euro zone Manufacturing PMI	RED	Stable BUT below key 50 level
Euro zone Services PMI	RED	Stable BUT below key 50 level

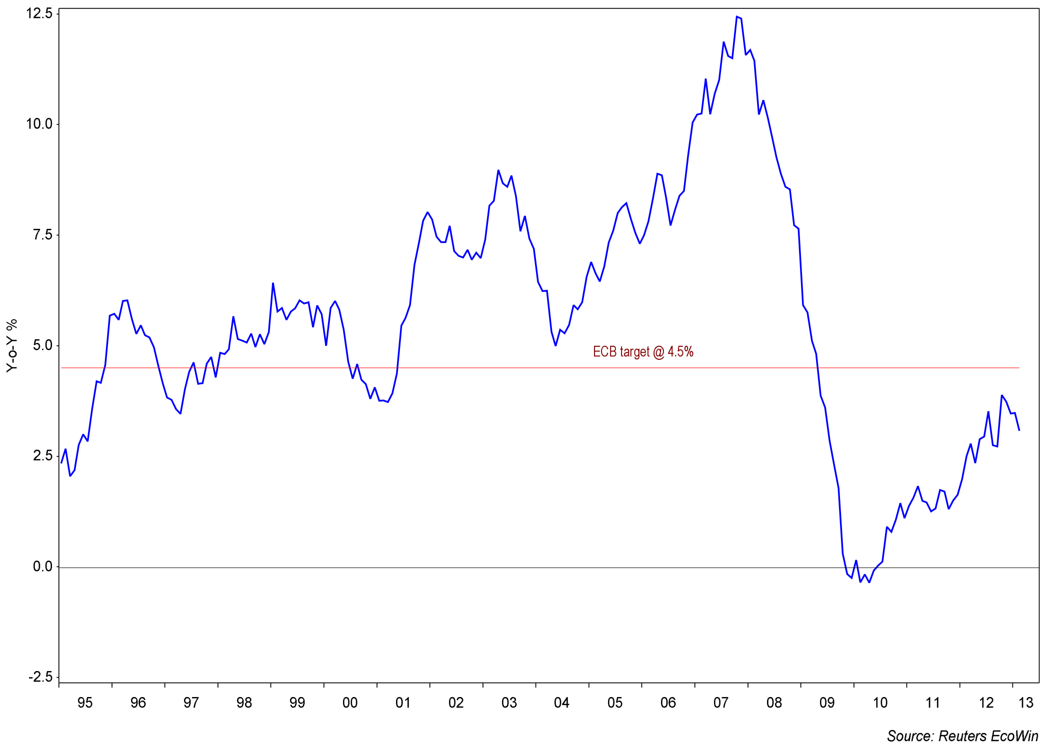
Source: *Longview Economics, Reuters EcoWin*

Fig 4a: Real M1 growth (Y-o-Y vs. Real GDP growth)



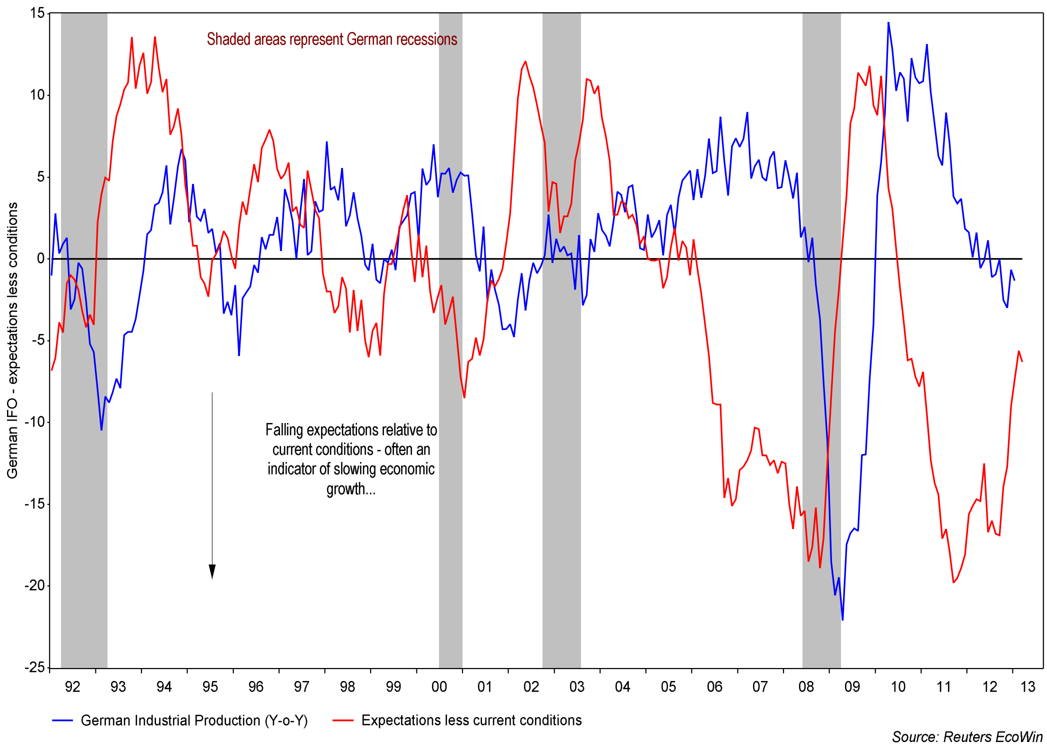
Real M1 growth is trending higher (which has historically foreshadowed a turn higher in real GDP growth)…

Fig 4b: Eurozone Money Supply (M3, Y-o-Y %)



The trend in money supply growth is improving (NB good leading indicator of economic growth)

Fig 4c: IFO expectations less current conditions vs. German industrial production (Y-o-Y %)



German IFO expectations have improved notably in recent months (relative to current conditions) – i.e. a key leading indicator of German IP

Section 5: Key Chinese Macro Traffic Lights & indicators

Table 5: Leading Indicators

Indicator	Status	Comment
LEI - NBS	AMBER/GREEN	Better last 3 months – possibly turning up
LEI - Conference Board	GREEN	Trending up
LEI - OECD	AMBER/GREEN	Possibly turning up (slowly)
Yield curve (10 yr less 2 yr)	AMBER	Flat in recent weeks/months (@ low-ish level)
New export orders index (PMI subcomponent)	AMBER	Just below key 50 level

Table 5a: Credit Indicators

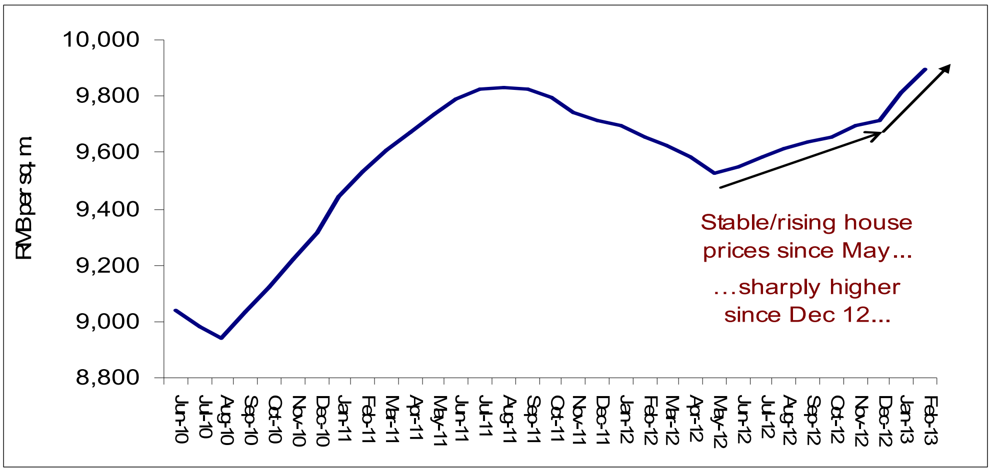
Indicator	Status	Comment
RMB lending growth	AMBER/GREEN	Growth (just) trending higher
System wide lending	GREEN	Trending up
M2 money supply	AMBER/GREEN	Trending up
Total lending by financial institutions	GREEN	Lending growth is at a high rate
Shibor (2 wk & 1 month)	GREEN/AMBER	Elevated but lower than 2011

Table 5b: Coincident indicators

Indicator	Status	Comment
Cargo handled at ports	AMBER/GREEN	Growth picking up
Imports from Asia	AMBER	Sharp pick up last month
Supplier Deliveries (a Manufacturing PMI sub-index)	AMBER	Sideways in the last year
Electricity production	AMBER	Improving since June
Vehicle sales	AMBER/GREEN	Improving trend – breaking out to new highs
Production of cement	AMBER	Flat/low growth
Steel production	AMBER	Flat/low growth
Floor space started	AMBER/RED	Rolling over?
Imports of copper and iron ore	AMBER	Copper trending down; iron ore trending up…
Imports of oil	GREEN	New highs…
House prices (in 100 cities)	GREEN	Accelerating to the upside
Manufacturing PMI (NBS data)	AMBER	Currently @50.1
Manufacturing PMI (HSBC data)	AMBER	Currently @50.4
Service PMI (NBS data)	AMBER	Trending down - but above 50
Service PMI (HSBC data)	AMBER	Trending sideways & currently just above 50
Fixed Asset Investment	AMBER/GREEN	Growing at 20% - but below higher rates of recent years

Source: *Longview Economics, Reuters EcoWin*

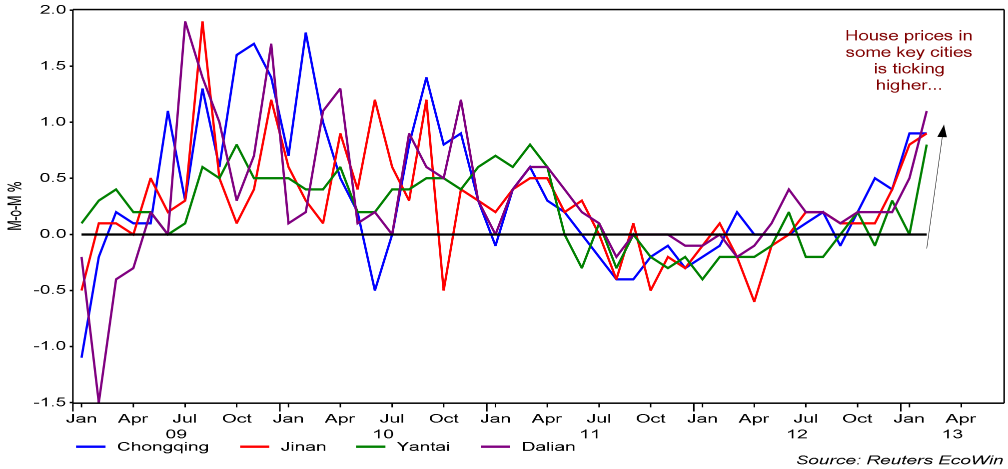
Fig 5a: Chinese house prices across 100 cities (RMB/sq. m.)



Source: *Longview Economics, Wind*

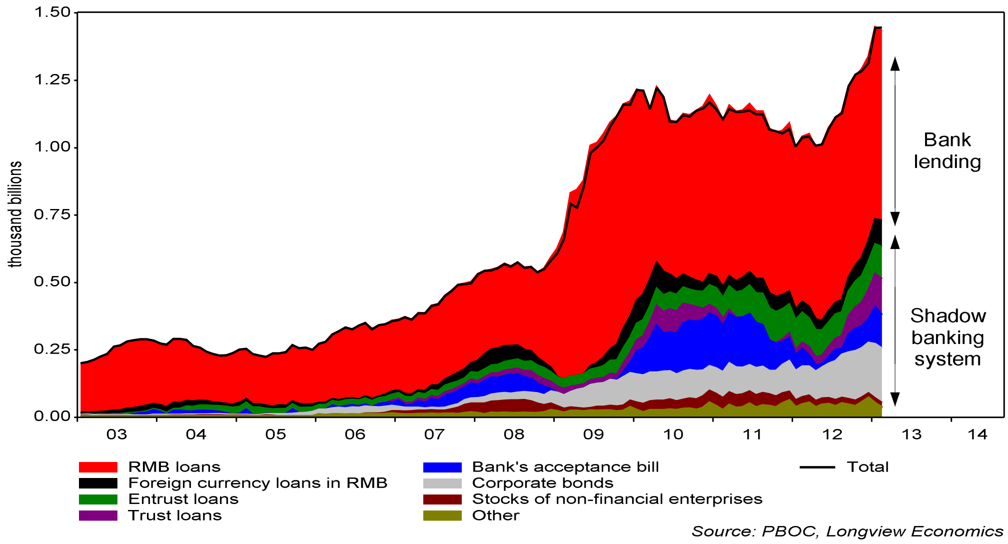
Average house prices in China – ticking higher…

Fig 5b: Chinese house prices across 100 cities (RMB/sq. m.)



House prices – sharply higher in some cities in recent months…

Fig 5c: Chinese credit growth (trillion RMB, 12 month smoothed)



Chinese credit growth has been rapid in recent months

Section 6: Global PMI trends

Table 6: Various trends in PMI indices – Western economies

Country	PMI type	Feb-13	Jan-13	Dec-12	Nov-12	Oct-12	Sep-12
USA (ISM data)	Manufacturing	54.2	53.1	50.2	49.9	51.7	51.6
	Non-Manufacturing	56.0	55.2	55.7	54.8	54.8	55.2
Eurozone	Manufacturing	47.9	47.9	46.1	46.2	45.4	46.1
	Services	47.9	48.6	47.8	46.7	46.0	46.1
Germany	Manufacturing	50.3	49.8	46.0	46.8	46.0	47.4
	Services	54.7	55.7	52.0	49.7	48.4	49.7
France	Manufacturing	43.9	42.9	44.6	44.5	43.7	42.7
	Services	43.7	43.6	45.2	45.8	44.6	45.0
UK	Manufacturing	47.9	50.5	51.2	49.2	47.3	48.1
	Services	51.8	51.5	48.9	50.2	50.6	52.2
Italy	Manufacturing	45.8	47.8	46.7	45.1	45.5	45.7
	Services	43.6	43.9	45.6	44.6	46.0	44.5
Sweden	Manufacturing	50.9	49.2	44.6	43.2	43.1	44.7
	Services	54.6	52.6	49.1	46.3	50.2	47.2

Source: *Markit, Swedbank, ISM, Longview Economics*

Fig 6: Euro zone Manufacturing & Service sector PMIs

Europe's manufacturing PMI has begun to edge higher in recent months (while the service PMI has trended sideways)…

NB both indices remain below the key +50 line

Table 6a: Various trends in PMI indices – Asian economies

Country	PMI Type	Feb-13	Jan-13	Dec-12	Nov-12	Oct-12	Sep-12
China	Manuf (NBS)	50.1	50.4	50.6	50.6	50.2	49.8
	Serv (NBS)	54.5	56.2	56.1	55.6	55.5	53.7
	Manufacturing (HSBC)	50.4	52.3	51.5	50.5	49.5	47.9
	Services (HSBC)	52.1	54.0	51.7	52.1	53.5	54.3
Japan	Composite	48.5	47.7	45.0	46.5	46.9	48.0
India	Manu PMI	55.3	51.3	54.4	53.4	53.2	53.1
	Sevices	53.7	54.7	54.3	52.0	53.6	53.6
South Korea	Manu PMI	50.9	49.9	50.0	48.2	47.4	45.7
Singapore	Manufacturing (IPAM)	49.4	50.2	48.6	48.8	48.3	48.7
Taiwan	Manu PMI	50.2	51.5	50.6	47.4	47.8	45.6
Indonesia	Manu PMI	50.8	48.5	50.3	51.5	52.3	48.0
Hong Kong	Manu PMI	45.2	51.8	52.9	52.9	51.1	49.5

Source: *Markit, NBS, HSBC, NTC, Nomura/JMA, Institute for Purch & Materials*

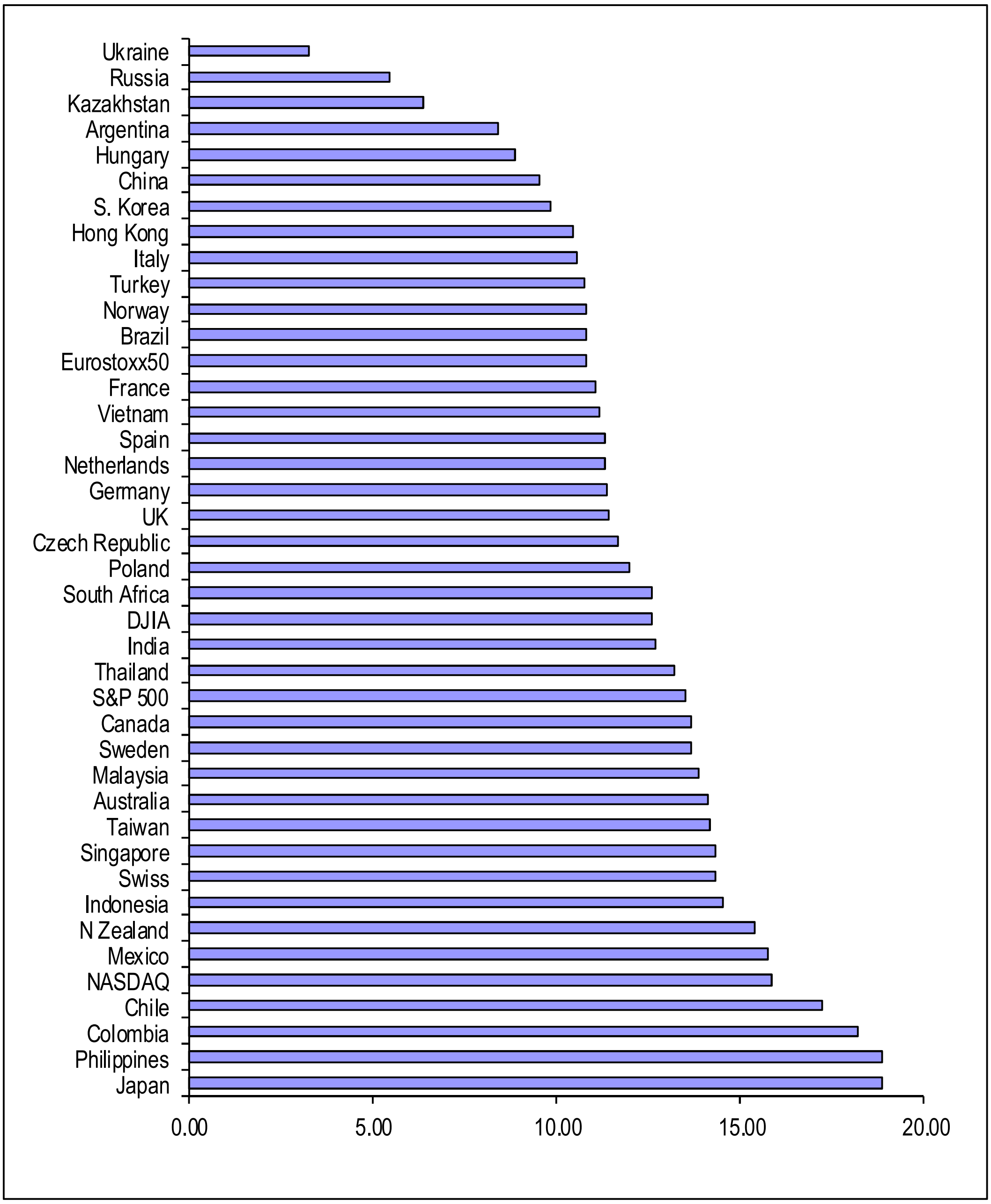
Table 6b: Various trends in PMI indices – Various other countries

Country	PMI Type	Feb-13	Jan-13	Dec-12	Nov-12	Oct-12	Sep-12
Brazil	Manu PMI	54.7	55.8	52.5	53.9	51.3	51.0
	Serv (NTC)	48.7	50.8	53.1	52.1	50.4	52.9
Russia	Manu (HSBC)	52.0	52.0	50.0	52.2	52.9	52.4
	Serv (HSBC)	56.8	42.4	57.5	55.5	58.9	58.0
Turkey	Manu (HSBC)	53.5	54.0	53.1	51.6	52.5	52.2
Poland	Manu (Markit)	48.9	48.6	48.5	48.2	47.3	47.0
Hungary	Manu (HALPIM)	57.7	60.6	47.1	53.4	52.1	52.9
Czech Republic	Manu (Markit)	49.9	48.3	46.0	48.2	47.2	48.0
Canada	Manu (PMAC)	51.7	50.5	50.4	50.4	51.4	52.4
RSA	Manu (Kagiso)	52.9	44.3	49.9	55.4	52.1	51.0
Australia	Manu(AIG)	45.6	40.2	44.3	44.3	42.8	43.0
	Services (AIG)	48.5	45.3	43.2	47.1	42.8	41.9

Source: *Markit, AIG, HSBC, NTC, PMAC, HALPIM, Kagiso*

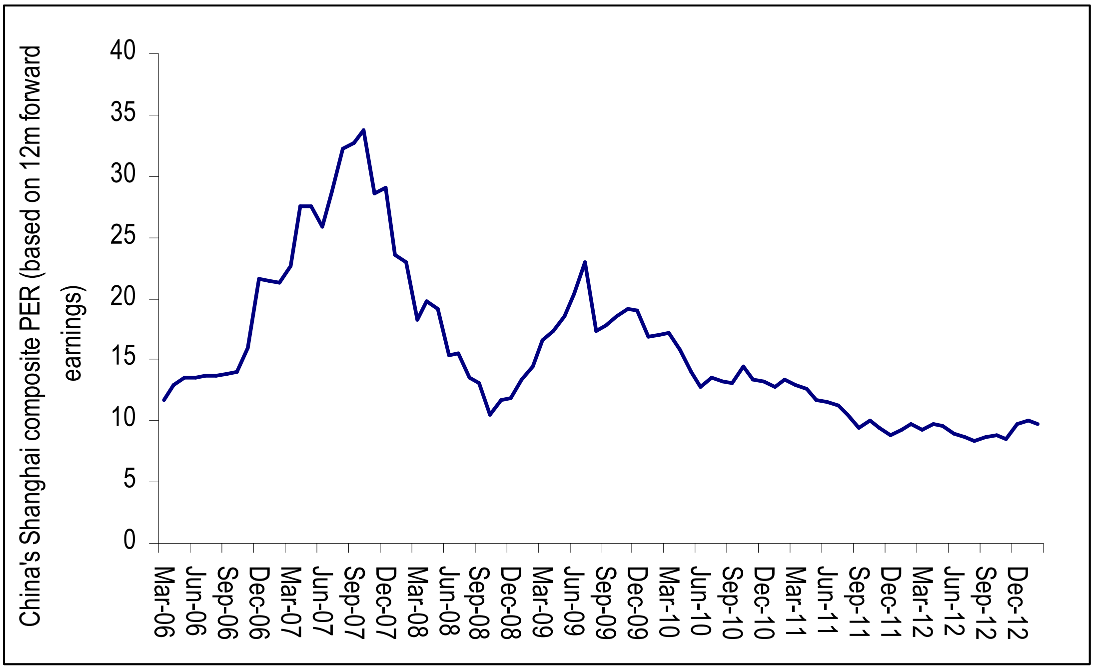
Section 7: Valuation Analysis

Fig 7a: PE ratios – various country indices (based on 12m fwd consensus EPS)



Source: *Longview Economics, Bloomberg*

Fig 7b: China's Shanghai Composite PER (based on 12m FWD EPS)



China's equity market – cheapest in recent history (on PER)

***Source:** Bloomberg*

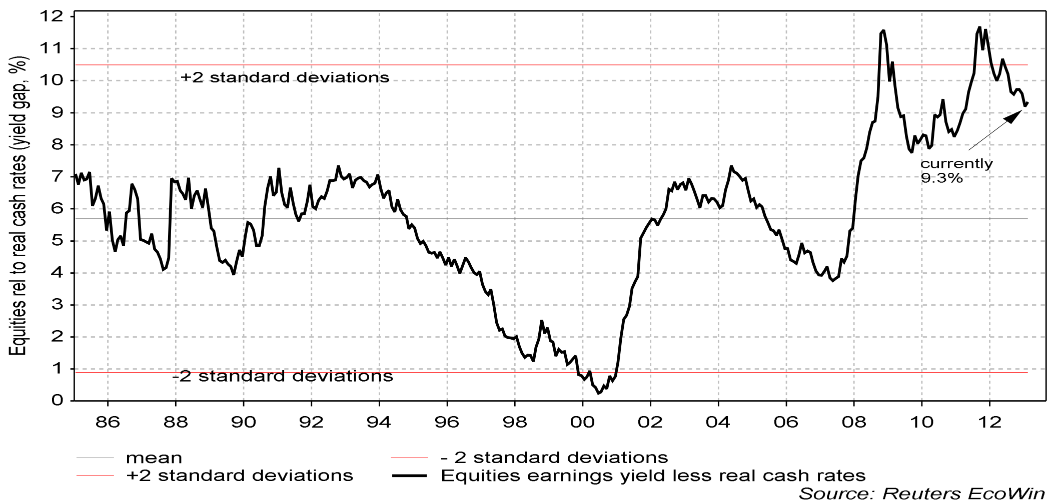
Table 7b: Various Valuation indicators/comparatives (UK, US & Euro zone)

	UK	Historical range	US	Historical range	E'zone	Historical range
PE ratio (12m fwd EPS)	11.4x	7.5 – 23.0 (1988-2013)	13.5x	6.0 – 26.5x (1979–2013)	10.8x	7.9 – 25.9x (1994–2013)
PE ratio Shiller	17.1x (in line with mean)	5.5 – 28.0x (1955 – 2013)	22.8x	5.0x to 44.2x (1881–2013)	N/A	N/A
EY	8.8%	-	7.4%	-	8.8%	-
ERP (vs RBY)	9.9%	1.8% – 12.7% (1988 – 2013)	7.9%	0.2% to 11.7% (1985–2013)	8.4%	History N/A
ERP (vs real cash rates)	9.3%	-0.15 to 16.9% (1981 – 2013)	9.3%	0.2%- 11.9% (1982–2013)	9.7%	1.9 to 13.7% (1999–2013)
ERP (corporate high grade i.e. AAA for UK & EZ)	5.4%	-2.0 to 7.3% (1997 – 2013)	5.5%	-3.6 to +7.0% (1990-2013)	6.9%	-2.4 to +9.7% (1996-2013)

Source: Longview Economics, Reuters Ecowin

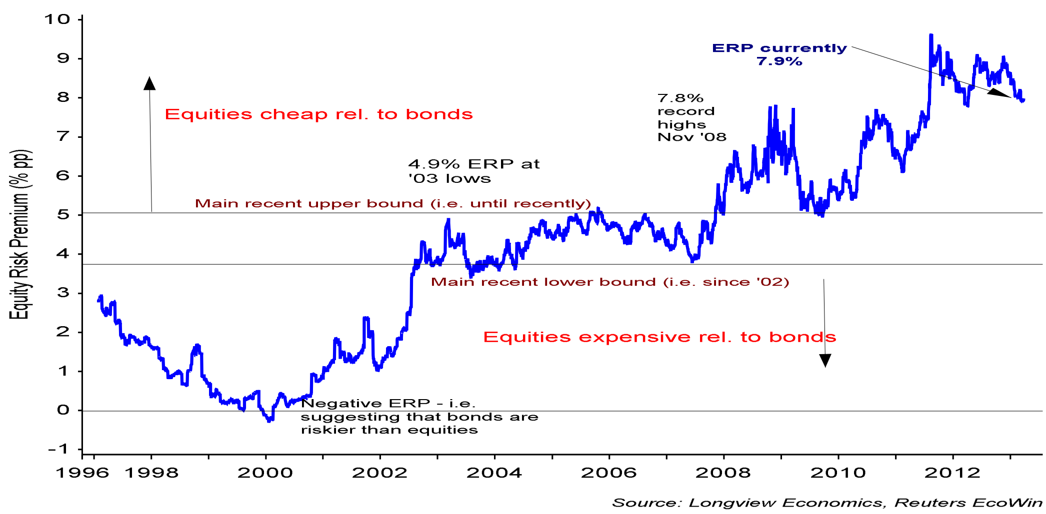
Fig 7c: Euro zone Equity risk premium (Equities EY less AAA corporate bond yield)

Fig 7d: US Equity risk premium: Equities rel to Real Cash rates (%)



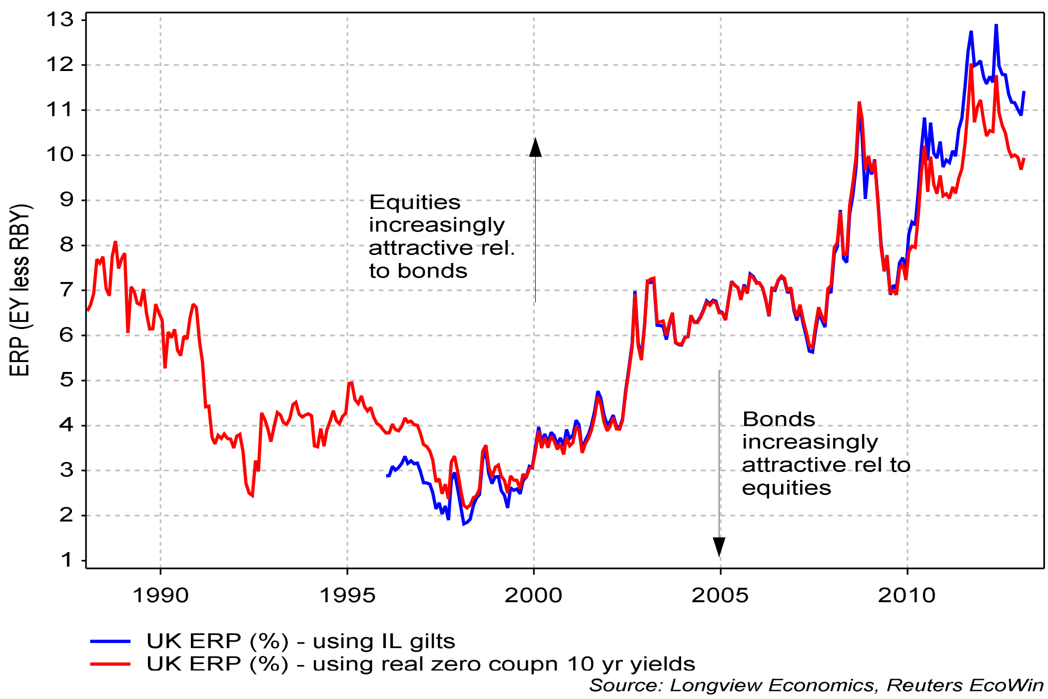
US equities continue to offer a considerable yield pick-up relative to real bond yields, real cash rates (shown here) as well as corporate bond yields

Fig 7e: US Equity Risk Premium (%, ERP = EY less real bond yield)



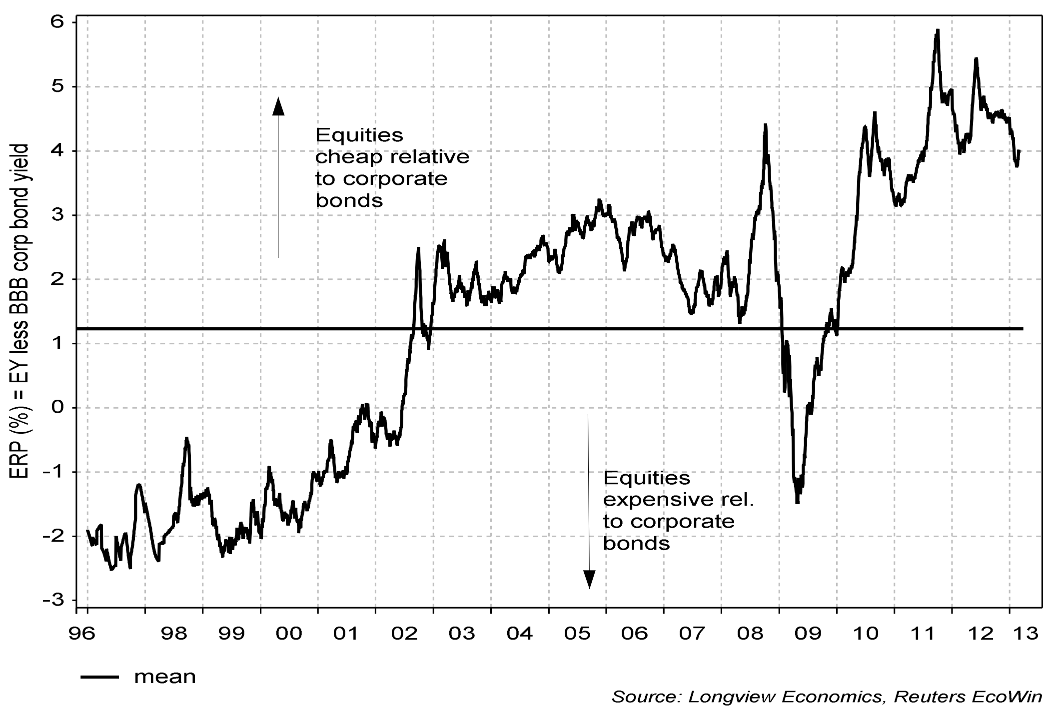
US equities are cheap relative to US bonds

Fig 7f: UK Equity Risk Premium (%, ERP = EY less real bond yield)



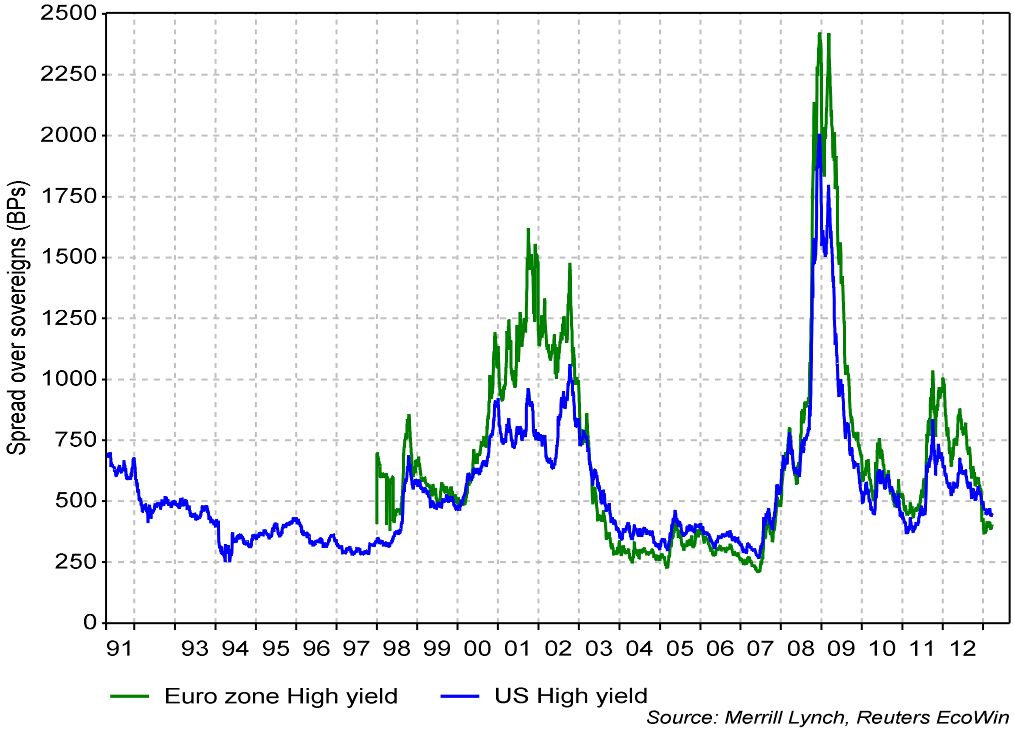
UK equity risk premium remains at high levels (despite moving lower in recent months)

Fig 7g: UK Risk Premium – Equities relative to BBB UK corporate bonds (Yield differential)



Equities also still notably cheap relative to BBB corporate debt

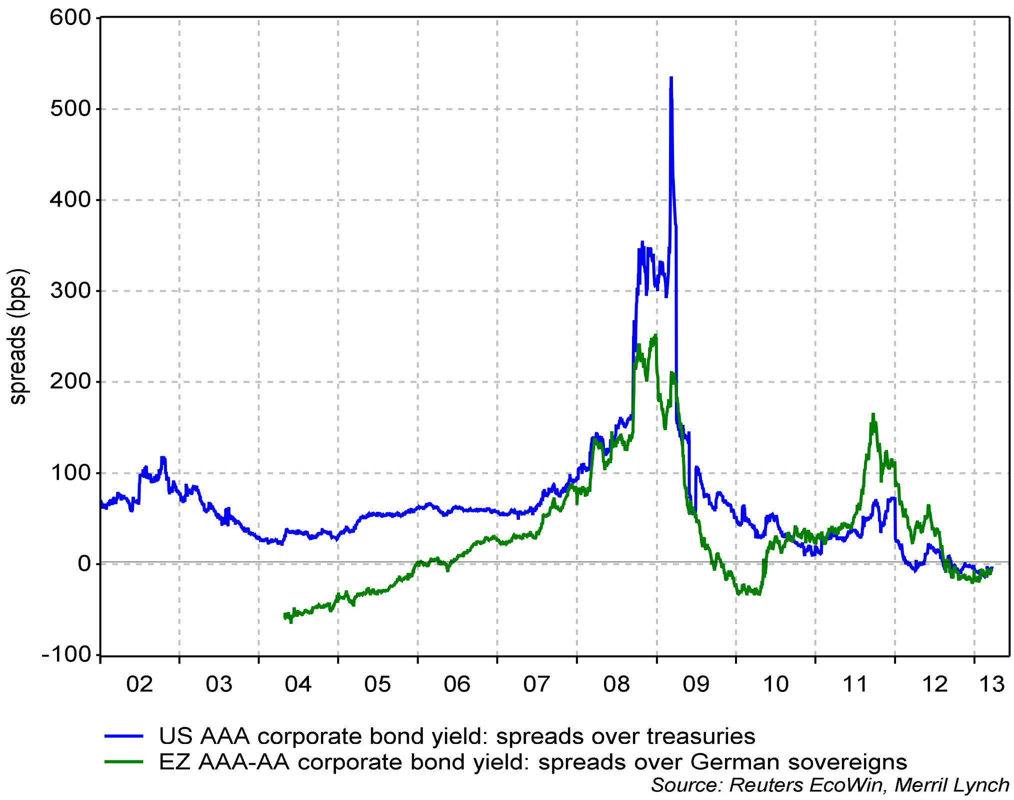
Fig 7h: US & Euro zone high yield corporate bond spreads (over governments)



Whilst nominal yields (on high yield) bonds are at record lows, relative to governments, there is still room for the risk premium to tighten

That would be consistent with structurally lower mid cycle equity volatility

Fig 7i: US & EZ high grade corporate bond spreads (relative to respective sovereign yields)



High grade (AAA-AA) corporate debt yields less than their respective sovereigns yield. That highlights the rich valuation of high grade corporate debt

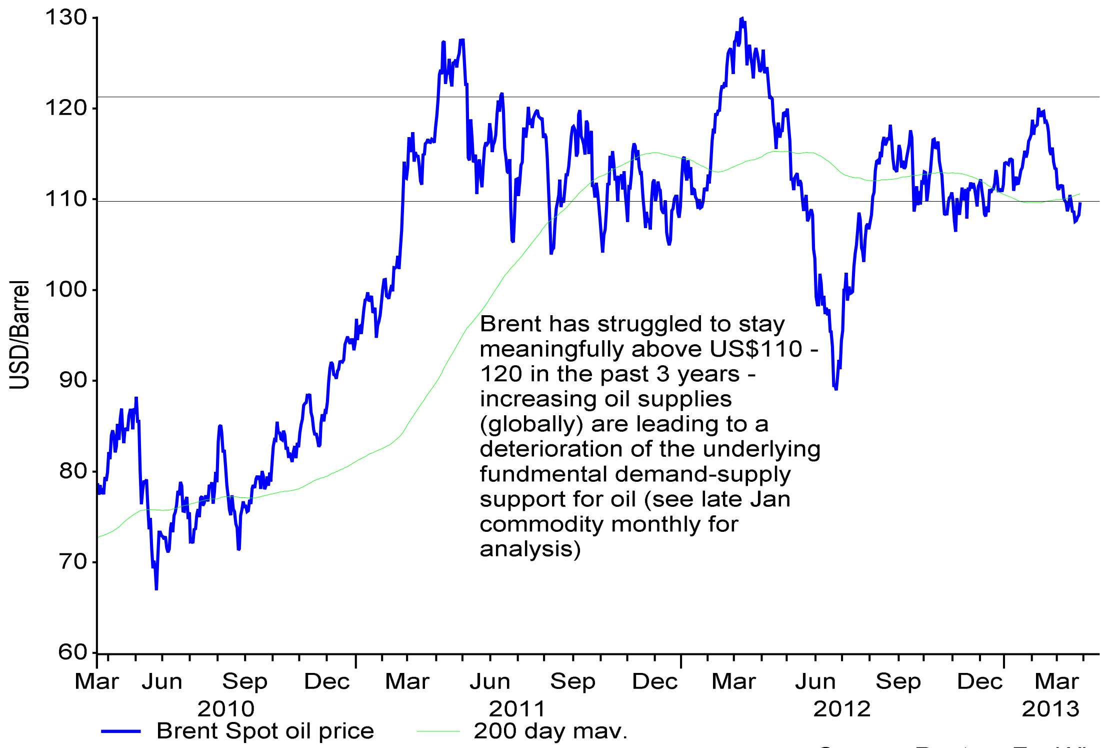
Section 8: Detailed Asset Allocation Recommendations

Table 8: Commodities weightings – **Maintain Precious Metals Weightings**

	Total (Mar '12)	**Break down** (Mar '12)	Total (Dec '12)	Break down (@ Dec '12)	**Rationale**
Total	**10%**		**10%**		
Gold		4%		4%	Keep gold position as hedge against money creation and ever changing rules of bailouts (e.g. as per Cyprus)
Silver		2%		2%	Argument as above for Gold – maintain size
Agricultural		2%		2%	We'd expect ag prices to be beneficiaries of central bank liquidity creation. As such we recommend modest weightings. Global food inventories are also low
Base metals		ZERO		0%	Zero weight in base metals given concerns regarding China's credit bubble (NB China has been a major driver of base metal demand growth)
Energy		2%		2%	Keep LONG as i) good hedge against geopolitical unrest. We have concerns though re oil fundamentals (see late Jan commodity monthly)

Source: Longview Economics

Fig 8: Brent Oil price (US$): Last 3 years



Source: Reuters EcoWin

Table 8a: Equity split – Developed market country allocation

Country	Longview weighting	Country split	Rationale
DM	**35%** (15%)		
US		18% (3%)	Given benign resolution of US fiscal cliff issues PLUS increasingly self-sustaining US economic momentum PLUS ongoing loose monetary policy, we recommend significant a weighting in US equities
Japan		3% (1%)	Japanese equities remain attractive (especially as a hedged play). New Abe policies expected to continue to weaken YEN. Modestly increase weighting – albeit exposure of Japan to China is significant
Germany		4% (1%)	Increase exposure to Germany – Euro zone recovery expected in 2H 2013 PLUS reasonably cheap equity market
UK		2%	Retain low weighting to UK. Market has high exposure to base metals and energy
France		1%	Retain low exposure to France. Considerable structural weaknesses remain in economy and banking system. If (not our central expectation) the Euro crisis re-emerges, France could be at the centre of that re-emergence
Italy		1%	Given that, in our view, Euro crisis is much closer to end than start (adequate crisis fighting tools now arguably in place – albeit some latent risks remain) => maintain some exposure to Italy
Spain		1%	As above for Italy => hold some exposure to Spain – while considerable long term economic problems remain, Spain's current account deficit now reversed
Canada		1% (2%)	Canadian dollar under increasing pressure from resurgent US economy and therefore US$ as well as poor trends in some commodity prices (including the price of Canadian crude oil)
Australia		0%	Keep Australian exposure at zero – risks associated with unwinding of Chinese infrastructure boom are ongoing – see recent commodity note for detailed analysis – recent bounce in iron ore price expected to (continue to) fade
Holland		1%	Strong fiscal position – high current account surplus; index composed of a number of plays on global growth – small commodities exposure – small equity market though – some concerns re: housing bubble and overindebtedness (in household sector).
Sweden		2% (1%)	Reasonably expensive equity market but strong banking system; good public finances; fast growing economy; low commodities & energy weightings. Equity market in an uptrend – modestly increase weighting
Switzerland		1%	Global stock index – low commodities exposure – in an uptrend
Sub total		**35%**	

Source: Longview Economics

Table 8b: Equity split – Emerging market country allocation

DEVELOPING	20% (25%)	
India	4% (5%)	Easing cycle has started once again – valuation broadly mid-range amongst EM. High growth economy (i.e. 6 – 9% real GDP); government starting to address recent political paralysis (e.g. new finance minister earlier this year) – modestly reduce weighting but maintain as favoured major EM play.
China	3% (5%)	While valuation remains attractive and a cyclical recovery remains ongoing, concerns are increasing regarding China's credit bubble.
Brazil	2% (3%)	Equity market valuation still reasonable (on 10.8xs) – NB high exposure to the Chinese growth story through commodities plus no rate cuts since October therefore modestly reduce weight
South Korea	2% (3%)	Given economy is key export play on China – reduce from 3% to 2%, maintain modest weighting given cyclical pick up in China
Taiwan	1%	One of the most expensive major EM equity markets => keep low weighting
Russia	2%	Inexpensive market (5.5xs forward earnings) – but highly geared to oil price – given cheap valuation, maintain weighting in Russia
South Africa	2%	Mid range valuation – in uptrend; Major commodity producer – equity market at/close to record highs – keep weighting unchanged
Mexico	0%	Expensive equity market (on approx 16.4x fwd EPS) – most expensive of major EM markets. Play on US economic recovery - maintain at zero, though, as expensive
Turkey	2%	Strong economic growth, reasonably inexpensive equity market, inflation seems currently contained – **concerns though re size of current a/c deficit**
Indonesia	2%	Emerging Asian economy – relatively autonomous growth profile – small weighting – market in uptrend
Other	0%	Mostly small markets – see table 8c below
Sub total (EM)	**20%**	

Source: Longview Economics

Table 8c: iShares MSCI Emerging Market country breakdown (at 20th March 2013)

Country	% Weighting	Country	% Weighting
China	18.3	**Mexico**	5.3
S Korea	14.8	**Malaysia**	3.4
Brazil	12.7	**Indonesia**	3.1
Taiwan	10.9	**Thailand**	2.7
S Africa	7.3	**Turkey**	2.0
India	6.7	**Chile**	1.8
Russia	5.9	**Others***	5.1

Source: iShares MSCI Emerging Markets

*Others include: Egypt; Peru; Hungary; Czech Republic; and Philippines; Poland; Columbia; & Morocco

Table 8d: Sovereign debt – INCLUDED – Total weighting – unchanged this qtr

Country	Weighting (%)	Yield (10 year bonds) 27 Mar 2013	Gvnmt debt* to GDP (%, 2013 est.)	Fiscal balance (as % of GDP, 2013 Est)	Reason for inclusion
UK	1	1.76	93.3	-7.3	Credible austerity plan in place – intent on dealing with deficit PLUS freely floating CCY
Germany	2	1.30	81.5	-0.4	Legislation in place to balance budget by 2016 PLUS Eurozone safe haven
Denmark	1	1.48	47.6	-2.0	Low debt; reasonably low deficit
Sweden	1	1.81	35.9	-0.2	Low debt; low fiscal deficit; strong banking system (albeit some exposure to Baltics)
New Zealand	2	3.52	38.1	-2.7	Low debt; low(ish) deficit
South Korea	2	2.77	31.6	+2.7	Low debt; fiscal surplus
Norway	2	2.19	49.6	+12.5	Large fiscal surplus; medium debt levels; significant reserves PLUS oil reserves
Australia	2	3.43	27.2	-1.0	Low debt levels; low fiscal deficit
Canada	2	1.76	87.8	-3.0	Medium debt levels; low fiscal deficit; no housing bubble in last decade; strong banking system
Finland	1	1.55	53.9	-0.9	Low debt; low fiscal deficit
Netherlands	1	1.78	70.2	-3.2	Medium debt; low(ish) fiscal deficit
Spain	1	5.05	96.9	-5.7	Current a/c deficit now closed – yields now (probably) capped at 6 to 6.5% by ECB Bond Buying plan – higher yield and likely capital appreciation warrant a small holding
Portugal	1	6.42	123.7	-4.5	Current account deficit almost closed (& fiscal deficit shrinking) – and undergoing internal devaluation
Italy	1	4.73	127.8	-1.8	Current a/c deficit now now closed – yields capped by ECB bond buying plan

Source: *IMF, Reuters Ecowin, Longview Economics*

Table 8e: Sovereign debt – EXCLUDED (ALL ZERO WEIGHTED)

Country	Yield (10 year bonds) 27 Mar 2013	Gvnmt debt* to GDP (%, '13 est)	Fiscal balance (as % of GDP '13 est.)	Reason for Exclusion
Austria	1.69	74.9	-2.1	Medium government indebtedness; modest fiscal deficit – marginal call
Belgium	2.23	99.4	-2.3	Large government indebtedness – in fixed CCY region
France	2.02	92.1	-3.5	Has lost its triple AAA rating. High banking sector exposure to wholesale funding and periphery – continue to avoid
Greece	12.70	181.8	-4.7	Ability to grow private sector economy limited without more meaningful haircut (i.e. below 120% debt to GDP target by '20).
Ireland	4.22	119.3	-7.5	Plan in place to address issues – yields have fallen significantly – economy growing again and back in current a/c surplus
Japan	0.51	245.0	-9.1	High government indebtedness PLUS large fiscal deficit PLUS ageing population and shrinking working age population (i.e. diminishing tax base) – an accident waiting to happen – albeit new government increases money creation levels
US	1.84	111.7	-7.3	Large debt levels; large fiscal deficit; currently attempting to address deficit; global lender of last resort (as a result of US$'s reserve CCY status) – overly-reliant of overseas funding of deficit – at long term risk of losing reserve CCY status – economy increasingly self-sustaining => strong argument that low in yields has past

Source: *IMF, Reuters Ecowin, Longview Economics*

*NB gross government debt