

4th Quarter 2010

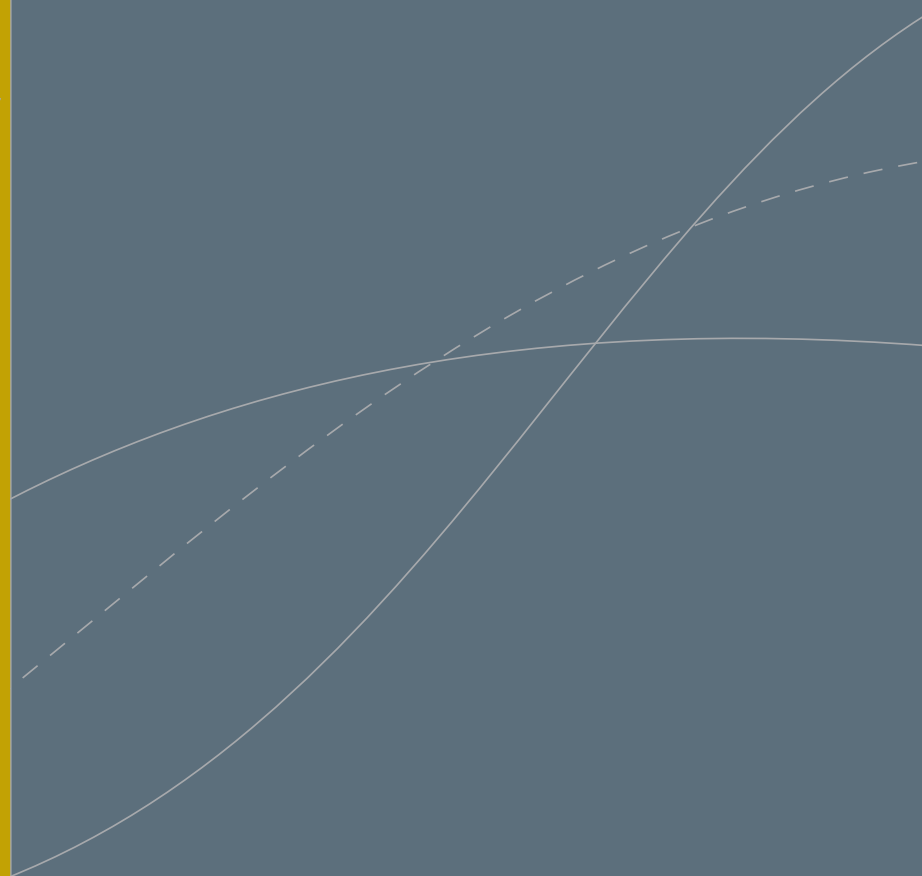
Economic views

- OECD economies face several more years of rebalancing
- Central banks set to respond with further unconventional policies

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The financial crisis has revealed many fault lines and prejudices about the way that capital markets work in a modern economy.

Standard Life Investments is one of the world's major investment companies. Responsible for investing funds on behalf of over five million retail and corporate customers including the Standard Life Group, we offer global coverage of investment instruments and markets.

We are active fund managers, who place significant emphasis on research and teamwork. After in-depth analysis, our Global Investment Group forms a view of where to allocate assets, based on the prevailing market drivers and on forecasts of future economic indicators. The Global Investment Group is made up of senior investment managers from the Strategy and Asset Class teams and is responsible for providing the overall strategic focus to the investment process.

The House View delivers a consistent macro-economic framework to our investment decisions. It generates the market and thematic opportunities for us to add value to our customers over the timescales they use to measure our success. It is formulated in such a way as to make timely investment decisions but to also allow all members of the investment teams to influence its conclusions.

Standard Life Investments is a dedicated investment company with global assets under management of approximately £143.00 billion (as at 30 June 2010) – this equates to \$213.9 billion, C\$227.3 billion, A\$253.3 billion and €174.7 billion.

In a diverse, dynamic world we use our insight and intellect to seek out investment opportunities. Our ability to predict, react and adapt rapidly helps us to maintain our position as a leading investment house.

Foreword

Keith Skeoch
Chief Executive

Markets continue to be characterised by fragile investor sentiment, uncertainty about the economic outlook and, as a result, very short investor time horizons. Correlations within and across markets remain at very elevated levels, with the result that any major economic or corporate surprise continues to generate high levels of volatility across the riskier asset classes. Equities have been both 8% above and 8% below their starting level so far this year, and continue to deliver a return behind that of government bonds.

For some, the current environment is the final nail in the coffin of the cult of the equity, signalled in particular by the fact that dividend yields are now persistently above 10-year government bond yields for the first time since the 1950s. For the past 50 years or so, equivalence between bond and dividend yields has given a strong buy signal for equities. However, this signal has not worked so far in the current environment. It raises the intriguing question about whether the old rules of thumb are suspended or, as some are arguing, we are witnessing a dramatic structural shift in the return climate and a reassessment of value within asset classes.

An important point to note in this context is that it is the level of interest rates that is outside historical norms, rather than the dividend yield. Richard Batty, in his Focus on Change article, points out that corporate behaviour appears to be changing. In the face of considerable economic uncertainty companies are acting to improve their financial strength and either protect or raise their free cash flow yield. This puts the quoted corporate sector in better shape than either the personal or government sectors, both of which are trying to de-leverage, or indeed the financial sector, the bulk of

which is still rebuilding its balance sheet. In the absence of outright deflation, the corporate part of such yields should be increasingly secure.

However, as Andrew Milligan points out in his Global Overview, policy uncertainties abound, the pace of economic recovery is slow, while debt levels are high, bolstered only by the exceptionally low level of official interest rates and bond yields. These are supported in turn by exceptional policies such as Quantitative Easing (QE). The long-term consequences of a prolonged period of QE are poorly understood, especially for inflation. Hence, it is perfectly possible that the real issue in the market's mind is the sustainability of the current interest rate structure and the extent to which it will translate into the drop in the long-term discount rate needed to drive up the value attached to corporate cash flows. If growth, even very subdued growth, is maintained for a long enough period then the current yield gap looks unsustainable. It may be closed by rising bond yields or indeed by the corporate sector using cheap debt either for M&A or by retiring expensive equity and hence pushing up earnings per share.

While it is impossible to know how the gap will close, and the point at which investors become confident about lengthening their time horizons, we suggest that focusing on sustainable yield to take advantage of the risk premia available in the market place remains a dominant investment strategy. This is an approach which has generated value from tactical asset allocation since risky assets hit bottom in early 2009, and we find little reason to change it at this point in time.



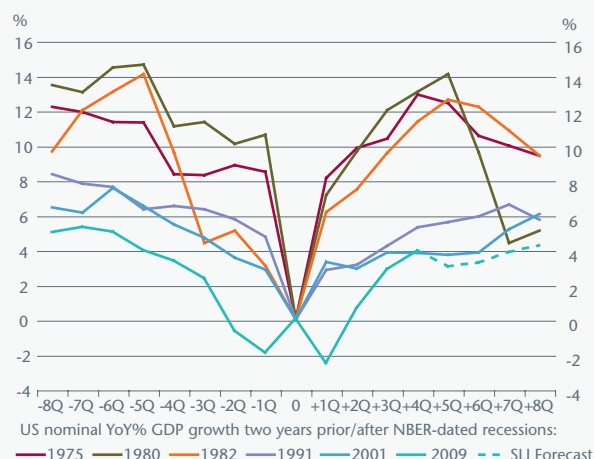
Global Overview

Lower for longer

Investors should prepare for a lengthy period of adjustment in the global economy, with sharp upswings and downswings in economic activity and investor sentiment partly driven by further QE. Assets with sustainable high yield remain the preferred investment option.

Andrew Milligan
Head of Global Strategy

Chart 1
A fragile recovery suggests a policy response



Source: Thomson Datastream, NBER, Standard Life Investments



Introduction

The central message from the Global Investment Group's analysis is that the after effects from the recent financial crisis will last several more years. Policy makers, financial and household sectors are collectively starting to face up to difficult decisions about their debt burdens. In some respects, western economies are facing their version of the after-effects of the 1997-98 Asian crisis, which required a lengthy rebalancing. Looking ahead, central banks are gearing up for further episodes of Quantitative Easing (QE), which could lead to volatility, especially in currencies. The good news remains the corporate sector is better positioned than other parts of the economy; indeed the shape of the next economic cycle will largely depend on important decisions which management take in coming months.

Chipping away at the debt mountain

This is not a normal economic recovery, as chart 1 demonstrates, nor do we expect it to become one, largely because of the debt burdens built up in the past decade. While central bank actions have succeeded in reducing debt servicing ratios for many corporates, governments and households, debt levels remain high. The extent of the debt deleveraging, whether voluntary or involuntary, through default and bankruptcy, remains very modest (see chart 2). Our analysis suggests it will be several years before this process is complete, certainly in Europe where most governments have chosen a five year long period of fiscal austerity. Related to this, sizeable bad debts mean the financial sector is still not sufficiently healthy to extend large amounts of new credit to the household and small business sectors. This will be reinforced by the lengthy timescale for implementing the Basel III decisions on capital ratios, allowing banks some years to use retained earnings to shore up capital levels rather than expand balance sheets, and the results of the European stress tests, especially for certain banks in, say, Germany and Spain.

More Quantitative Easing

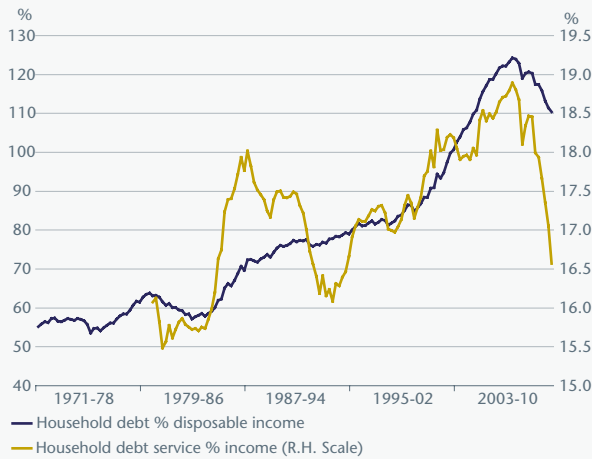
Central banks are increasingly concerned about the weak pace of nominal GDP growth, exemplified by muted employment and money supply growth, and the downside risks, signalled by weaker leading indicators. Although the US recession officially ended in June 2009, it has not finished for housing in most states or for many small businesses. Policy makers have started to respond in some countries, for example the recent unexpected currency intervention by the Bank of Japan to stem the yen's appreciation for the first time since 2004. In coming months, we expect at least the Federal Reserve and Bank of Japan to do more QE, possibly the Bank of England's MPC and the European Central Bank as well.

What triggers will determine the extent of any policy response? Some are domestic; the Fed will react more aggressively if unemployment moves up past 10%, ISM surveys fall below 50, or the loan officer surveys suggest bank lending is turning negative. Noticeable falls in house prices could seriously damage consumer sentiment. Property is expensive on historical measures in the UK and Spain, while the US housing market cannot reach a clearing level while foreclosures are creating the equivalent of two years' new housing supply. Some triggers will be external; we assume that the major emerging economies will continue to see steady growth, say 8-9% p.a. for China. Much slower export demand from such economies would be a considerable problem, perhaps reflecting a squeeze on consumer incomes from food inflation or the effects of a property crisis after recent mis-investment.

Some triggers will relate to debt funding, such as the ECB being forced to step up QE whenever investors lose confidence in fiscal austerity programmes in peripheral European countries. How fiscal and monetary policy interact will be important elsewhere. In the UK, for example, it is assumed that the MPC stands ready to offset overly damaging effects from fiscal tightening. The situation is more complicated in the US due to the forthcoming mid-term elections. The balance of power in the new Congress will determine whether or not the Bush tax cuts are allowed to expire next spring, whether they are rolled forward a few more years, or even whether there is a further stimulus, say action to support the corporate or housing sectors.

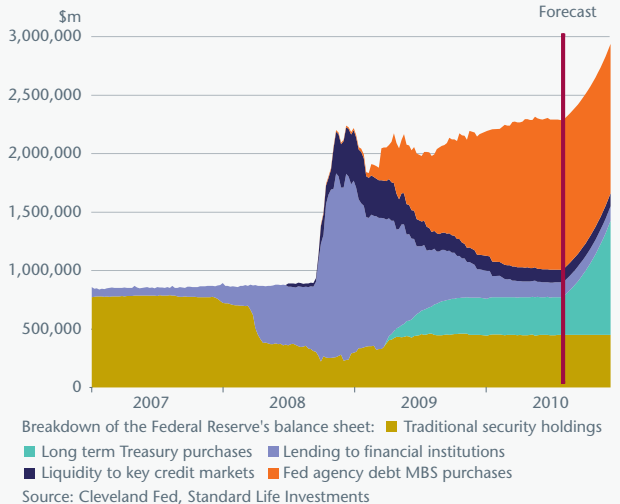
Further QE could be significant, say raising the Federal Reserves balance sheet from \$2tn towards \$3tn. The main aims of such policy will be to lower borrowing costs in the economy, noticeably mortgage rates in the US, and to boost asset values, providing a positive wealth effect. While

Chart 2
Debt levels remain high



Source: US Federal Reserve, Standard Life Investments

Chart 3
Expanding Treasury purchases ahead



transmission mechanisms are still damaged though, the effect of QE on boosting nominal GDP growth remains debatable, risking a reliance on more QE in the absence of other policy stimuluses. There could be an important side effect, however, namely more volatile currencies. There are already signs that certain governments are unhappy with the impact of recent currency changes, and may even seek currency devaluation as a way of buying future growth. As well as the recent Japanese intervention to prevent further yen appreciation, there is growing pressure from US policy makers, ahead of the mid-term elections, on the Chinese government to allow the renminbi to appreciate. The UK was criticised earlier this year for its unduly competitive exchange rate, while a helpful side effect from the European sovereign debt crisis was the impact of a much lower level of the euro on European exporters.

We conclude that the major economies will experience modest real GDP growth, say 2% p.a. into 2011, with more downside than upside risks. Excess capacity remains high, and hence core inflation will remain well under control in most countries. The risks of a marked upturn in inflation would require the central banks to alter their style of QE, adopting money supply targeting or for a big pickup in, currently subdued, wage growth. This backdrop will restrain growth in the emerging economies, but we still expect 5-6% p.a. growth for the emerging economies in 2011, lower than prior to the crisis but still a noticeable gap.

The importance of corporate profits

While equity markets are undoubtedly affected by swings in the economic cycle, their long term performance will be driven by profits growth. Earnings have been strong so far this year – US and Japanese firms commonly showed earnings up 30-40% pa in Q2 – driven by strong cost control and some top line sales growth. However, uncertainty about the sustainability of the recovery has led investors to downgrade markets, shown by lower P/E ratios. Hence, investors need to analyse how quickly or slowly profit growth decelerates from here, partly reflecting the pace of the fall in leading indicators and partly the ability of companies to benefit from emerging market demand or push through further productivity growth. Putting aside a renewed recession, our analysis suggests 5-15% p.a. earnings growth in 2011.

Management face some important decisions about how to use this cash flow: whether to hoard cash due to concerns about the economic outlook, whether to distribute it as a signal about their underlying confidence, or whether to spend it in order to grow their underlying businesses, organically through capital spending or via M&A activity. One risk they face from holding onto cash is that it may attract interest from

governments facing difficult fiscal decisions. On balance, a mixture of M&A, share buybacks, dividend distribution and investment look the most likely prospects, as companies try to win market share in a low growth environment.

Strategy

Although some commentators argue that financial markets are close to an inflection point, this is not the conclusion of our analysis. Superficially there are some arguments to suggest that equity markets could surge much higher, as certain valuations appear attractive. However, we are wary that old signals, such as the dividend yield exceeding the gilt yield, matter as much in the current environment where government decisions are influencing one, or both, markets, and where the volatility of future economic and profits growth and inflation looks to be rather higher than in the Great Moderation of the 1980s and 1990s. Our valuation analysis suggests that some government bond markets are becoming relatively expensive on a long-term basis, albeit supported in the short term by double dip fears, expectations of further QE and hence the likelihood of interest rates lower for longer. Some commercial property markets are relatively good value on a long-term basis, as the size of the yield gap over interest rates, inflation and funding costs demonstrates. Corporate bond spreads over government bonds suggest a substantial pickup in corporate defaults. The strength of corporate cash generation suggests this is too pessimistic and that corporate bonds remain attractive. There are few strong signals from other asset classes. Value certainly can be revealed in parts of the equity markets when investors begin to lift their time horizons, but this will require either a very marked change in policy making, or sustained evidence of a move back towards a rather higher growth path.

The House View has not made any major asset allocation changes in the last quarter, while its current disposition has added value in client portfolios. The preferred asset allocation choice remains assets with 'sustainable yield', equally emphasising both words. There are still a number of opportunities for investors to find yield from companies with sustainable business models, and the key issue is where best to look along the capital structure, from low to high quality debt, amongst different types of equity and across a range of property markets. In recent months the House View has found more attractive offerings in high yield corporate bonds, benefiting from the steady reduction in default rates – itself related to the sharp turnaround in corporate balance sheets. Meanwhile the positions in government bond markets have been lowered modestly, for example in US Treasuries, as short-term valuation signals have proven less positive.

Focus on Change

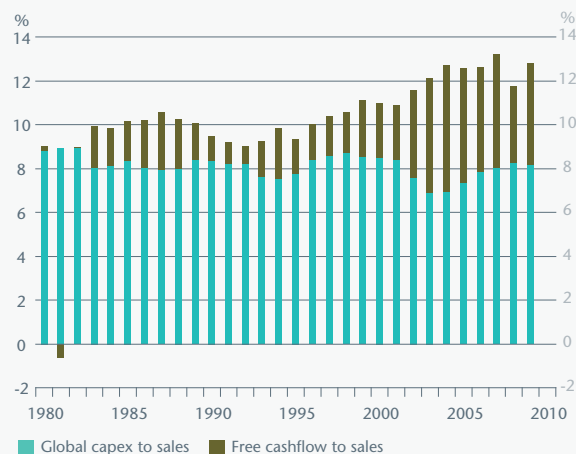
What is changing about corporate behaviour?

High dividend yields relative to those on other asset classes, and a need to engineer strong top-line sales growth, suggest companies will start deploying more of their accrued cash towards growth rather than dividend distribution policies.



Richard Batty
Global Investment Strategist

Chart 1
Companies have been hoarding cash



Source: Citi

Focusing on changing corporate behaviour

Our investment process is based on a foundation of rigorous research, guided by our Focus on Change investment philosophy. Central to this is our Common Investment Language, which we use to validate all our investment decisions. In previous editions of Global Outlook, we examined how Focus on Change drives specific asset allocation and corporate profits growth, as well as demonstrating our sector picking decisions. In this edition, we investigate what is changing about investor and corporate behaviour across the major economies given the record amounts of cash which businesses are generating. In particular, we focus on how the outlook for dividends is likely to change, as well as that for other recipients of corporate cash flow. Our analysis shows that investor behaviour is already altering, and the corporate sector may be changing the way it views dividends as a signal of management behaviour.

We examine what is changing about corporate behaviour, the outlook for dividends and other uses of companies' retained cash, using our Focus on Change philosophy:

- What are the key drivers?
- What is changing?
- What expectations are priced into the markets?
- Why will the market change its mind?
- What are the triggers?

What are the drivers of changing corporate behaviour?

These include:

- Profits growth – the sharp pick-up in profits is forcing managers of businesses to decide how to deploy the associated increase in cash flow that is being generated;
- Risk appetite – the extent of management risk appetite will determine how accrued cash flow is distributed;
- Opportunities to grow businesses – high cash balances can be put to work if management sees growth opportunities via capex or acquisitions, which can be partly or wholly funded by cheap and available debt;
- Investor signalling mechanism – with dividend yields their highest since the 1950s, not in absolute terms but relative to yields on other assets such as government bonds and cash, do managers need to increase dividends aggressively, rather than say buying back shares?

What is changing?

During the last decade corporate behaviour towards dividends changed, as dividends began to matter more to investors. This followed a long period, culminating in the tech bubble in the late 1990s, where capital growth, rather than dividends, was favoured by investors. During the recent financial crisis a number of companies, noticeably banks in the developed economies were forced to omit dividend payments as profits came under severe pressure. In many cases management were reluctant to change such corporate policy as typically this has signalled a fundamental change in the subsequent financial health of the company. However, many of these companies, even in the absence of a dividend turnaround, have recently seen their share prices rebound more strongly than the general market. This has been because investors are anticipating a return to more normal financial health going forward and a return to regular dividend payments. This is an unusually positive reaction compared to previous cycles and may be driven by a changed environment for companies for the following reasons:

First, companies are seeing a very strong pick-up in profits, albeit from a low base. This is forcing managers of businesses to decide how to deploy the associated cash flow that is being generated. Cash balances held by companies are rising – see chart 1. Globally the operating cash flows to sales ratios rose from 11.8% to 12.8% between 2008 and 2009, while free cash flow to sales has risen from 3.5% to 4.7% over the same period.

Secondly, the risk appetite of management to deploy this free cash flow is key to the both the business and investment outlook. Companies have been keener to hoard cash and call a halt to increasing capex which remained close to 8% of sales each year between 2007 and 2009. However, recently some of these high cash balances have begun to be put to work via organic growth, such as capex or via acquisitions, which can be partly or wholly funded by cheap and available debt.

Thirdly, related to this, there are important questions about whether, when and how management deploy this cash as it could be an important signalling mechanism to investors. In recent years, our in-house style analysis across the UK stock market, for example, has shown that on average investors have rewarded the share prices of companies with strong earnings momentum, rather than those with high dividend yields. Our meetings with company management also suggest many are keen to maintain current dividend growth

Chart 2
UK dividends yield more than the risk free rate

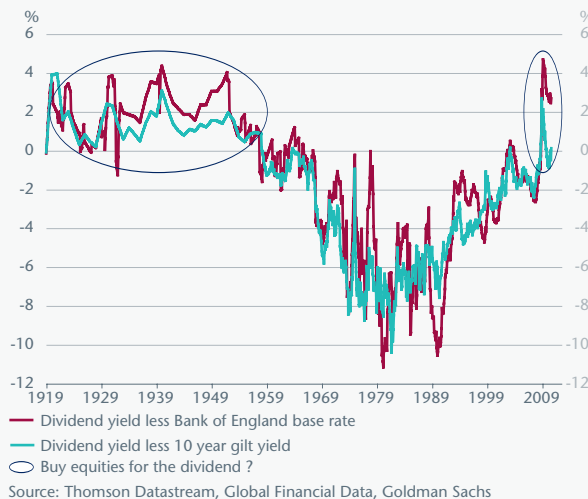
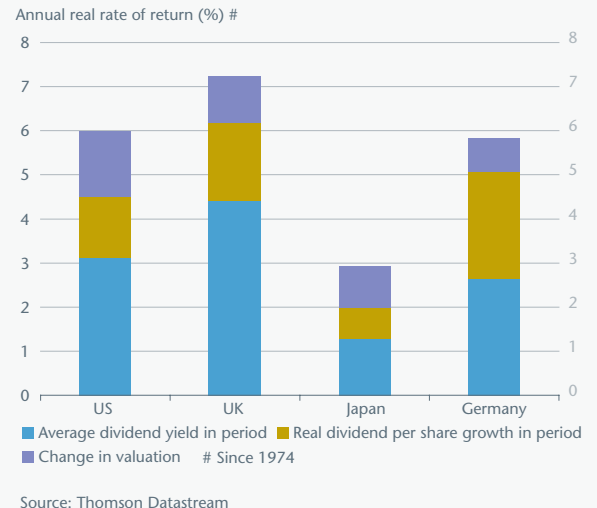


Chart 3
The importance of dividends for equity returns



policies, but also start to invest accrued cash balances in order to grow their businesses.

We believe this trend will continue and drive investor behaviour for a number of reasons. With dividend yields the highest relative to other assets such as government bonds and cash since the 1950s – albeit driven by unusually low interest rates rather than unusually high dividend yields - we ask whether company management need to increase dividends aggressively. On balance some companies that have foregone dividends in recent years may start reinstating them and many companies will choose to continue to increase dividends modestly. However, if managers worry about the choppy nature of the economic recovery ahead, a world where growth is hard to come by, they may want to spend cash balances to engineer future growth. If, at the same time, investors consider equities are cheap, companies will not necessarily need to grow dividends and distribute all of their high cash balances.

What is in the price?

One way to show how investors judge whether corporate behaviour is changing is through the valuation of equities relative to other assets. Looking at the current UK dividend yield relative to other asset classes, chart 2 shows that equities have de-rated noticeably relative to various interest rates.

While some of this valuation change has been driven by dividend cuts, which as we discussed earlier may be short lived, most of the valuation gap has been driven by the dramatic fall in both bank and market interest rates. The likely low nominal GDP environment ahead plus recent monetary policy communications, suggest that central banks in the major developed economies are unlikely to tighten policy any time soon, indicating the valuation gap will be maintained. In fact, the bias is now towards further easing of market interest rates, targeted via quantitative easing and the potential for competitive currency devaluation. Hence, the authorities are struggling to engineer nominal economic growth high enough to satisfy their mandates. This implies it may be difficult for some time for equities to re-rate.

The key question this raises for company management is whether investors increasingly view equities as a way to access income, or high yields, rather than to rely on capital growth as a chief driver of total returns. As chart 3 shows, the real return available to investors has been typically been mainly earned from the initial dividend yield, with the rest of equity return

coming from a re-rating of the asset class and the real growth in dividends.

Why will companies change their behaviour? What are the triggers?

The corporate sector is likely to change its behaviour if a number of triggers occur:

First is whether a fragile economic recovery continues, driven by continued deleveraging and excess capacity in product and labour markets in western economies. The resultant outcome, weak sales growth, will encourage companies to deploy their high cash balances either in capital spending or making acquisitions or through tapping into emerging market growth, say via advertising. This, however, is likely to be a relatively slow process and consequently corporate cash balances would remain high. Payout ratios will be a useful trigger to monitor.

Second, if interest rates and bond yields stay lower for longer, because of the anaemic developed economy recovery, dividend yields will continue to look attractive, mitigating the need of managers to grow dividends aggressively. Hence, management could engage in benign neglect when it comes to dividend growth policies, secure in the belief that investors believe dividend yields are attractive for some time relative to other asset classes. Indeed, recently, fund flow data from exchange traded funds (ETFs) indicates investors have started to move into higher-yielding equities. This suggests yield characteristics are becoming more of a focus for investors.

Conclusions

Corporate behaviour is likely to change in the years ahead. While managers were keen to show their companies had financial strength, typically shown by accruing cash and in many cases distributing this as dividends, a new environment may be starting to appear. Investors have been recently more willing to reward companies that embark on growth strategies, and management are taking note. One reason for this is that dividend yields are high relative to the risk-free rate, mitigating the need to distribute high cash balances. The corporate signalling mechanism may be changing, allowing companies to claim that they are able to sustain current dividend distribution policies and embark on a variety of growth strategies by spending their accrued cash balances.

Global Sectors

Asian trade winds boost banks

Asian banks have been benefiting from a recovery in the region's trade, while internet savvy-consumers are shaping the future of the telecoms industry.



Mikhail Zverev
Investment Director

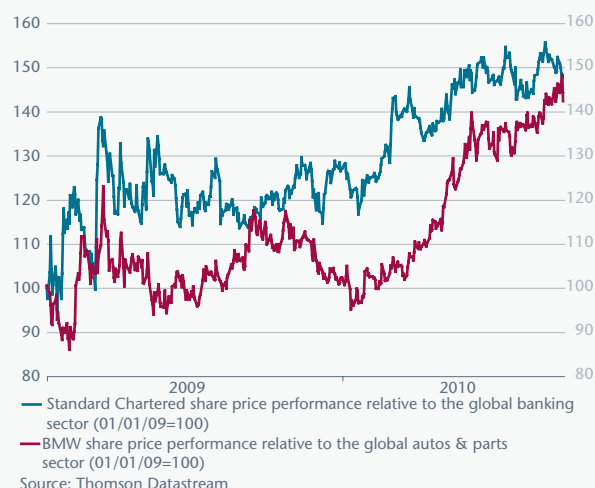
One of the success stories of 2010 has been the rebound in Asian trade volumes, both with Europe and the US, but also intra-Asia. In fact, trade volumes within Asia now surpass the region's trade with developed markets. This has presented a compelling opportunity for some of the region's most prominent trade finance banks. One company that has benefited more than most is Standard Chartered. The firm emerged from the global credit crisis with a relatively strong balance sheet and has been able to support the global expansion of its Asian clients. This not only led to market share gains, but also to deeper relationships with corporate clients, allowing the bank to cross sell other wholesale banking products alongside its trade finance offering.

The lender has also benefited from a structural improvement in the competitor landscape as a number of the world's largest trade banks, including RBS, Citi and Wachovia, have been forced to reduce their commitments to the segment. The withdrawal of some of the largest trade banks from the region has also presented opportunities for Chinese banks. These banks are following their corporate clients into global markets, which will require them to develop new skills and capabilities to serve their clients' needs. This is likely to be done via their Hong Kong subsidiaries. We own shares in one such subsidiary bank, Bank of China (Hong Kong). In the short term, we expect it to benefit from being able to sell its products and services into the corporate client base of its parent, Bank of China. In the medium term it stands to benefit from the emerging opportunity for its overseas business, as the Chinese government increasingly liberalises its currency controls and fosters the creation of an offshore renminbi capital market in the Asia region.

Cable guy to prosper

The emergence of new technology is expanding the services available to households through their telecoms networks. This has triggered a race between the traditional telecoms companies and the cable networks to provide the high-bandwidth broadband that their internet-savvy customers demand. Our analysis indicates that cable companies have secured a position of technological advantage over their rivals. Much of the capital investment by cable companies is

Chart 1
Asian strength driver



complete, while their networks also have a broad coverage. In addition, the new cable data standard, DOCSIS 3, allows them to offer compelling 'triple-play' services (phone line, broadband and pay-TV in one package) and high-speed broadband with speeds up to 100 Mbps (or even up to 200 in some cases). This compares with the current global average of 7.67Mbps. This is appreciated by customers, who increasingly consume memory-intensive online content, such as YouTube videos or music downloads. Traditional telecom companies are struggling to match the quality of services with their legacy ADSL offering. Their fibre-to-the-home product can just about match cable speeds but this will require substantial capital expenditure in the future.

At the same time, the wireless business of telecom companies may be under long-term threat from WiFi networks. Many smartphones, on which the industry relies to achieve growth, now come with WiFi connection chips as standard. A proliferation of WiFi in the home and in public spaces may make accessing the internet through mobile devices a better option. This potential threat to the wireless telecom business does not appear to be in the share price of global telecom companies. These important dynamics in the broader telecom sector have prompted us to hold shares in cable firms Virgin Media and Time Warner Cable, and to stay substantially underweight the traditional telecom sector.

Strategy

Investors will continue to pay close attention to events in Europe and the rate of slowdown in the Chinese economy, with particular regard to the demand contagion that could impact corporate balance sheets. In the meantime, corporate earnings estimates continue to be revised up, with earnings projections looking healthy thanks to the extent of cost-cutting carried out by many businesses. We continue to favour those firms that are likely to grow top line revenues such as auto company BMW, which has benefited from rising sales in Asia. We are also positive on mining firm Vedanta Resources on the back of its acquisition of Cairn India. We employ a fundamental bottom-up approach, holding our largest positions in those stocks where we feel we have strong insights that are generally unrecognised by the wider market.

US Equities

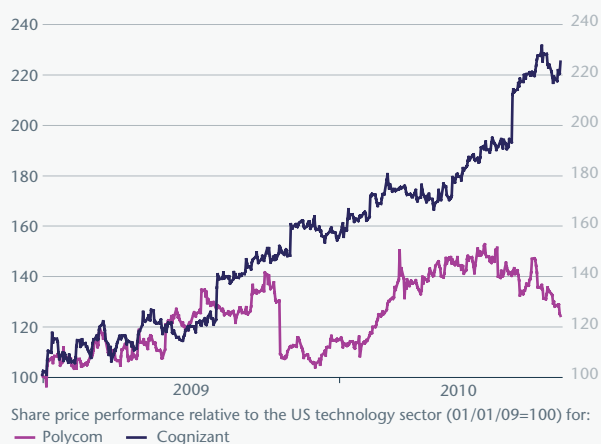
Technology enhancement

Certain companies within the materials sector are appealing. We also remain positive on prospects for corporate IT spending.



Euan Sanderson
Senior Vice President, US Equities

Chart 1
Relative outperformance



Source: Thomson Datastream

Material benefits

The market in rare earth materials (a collection of 17 chemical elements in the periodic table) is slightly unusual, in that the overwhelming majority of the world's supply comes from China. These metals are critical to a broad range of established and emerging technologies, such as hybrid and electric vehicles, fibre optics, lasers, hard disk drives, and green technologies like wind power turbines, which have attractive growth prospects. The combination of growth in demand and a restriction in Chinese export supply has driven prices substantially higher recently.

There are only two major producers outside China; one in Australia and Molycorp, which we own in our US equities funds. With its Mountain Pass mine in California, one of only two major rare earth projects outside China, Molycorp possesses a highly desirable asset. The firm will use the proceeds of its recent flotation to fund an upgrade of its mining facilities. It plans to increase production, capture more of the value add for its principal rare earth product, and sell the other rare earths produced at different stages of processing. As Molycorp's public profile grows, we think share price appreciation will follow as investors recognise the uniqueness of its assets and its favourable strategic positioning.

Elsewhere within the materials sector, we like coking coal producer Walter Energy. With both limited supply available and brisk demand from China, we believe that prices for this grade of coal have healthy long-term prospects. However, it seems the market is pricing in future metallurgical coal prices significantly below current spot prices. There have been signs of mounting corporate activity across the global metals and mining producers, and as a low-cost producer with high-quality assets, Walter ranks as an attractive potential takeover target.

Enterprising IT opportunities

There have been some cautious comments from major industry players, including Intel and Cisco, regarding a potential slowdown in corporate IT spending. However, we remain optimistic on specific growth prospects within the sector, and favour Polycom and Cognizant; two companies that exhibit structural growth characteristics.

On the back of improved technology and attractive return on investment, the video conferencing market could see

substantial growth over the medium term. Customers are increasingly attracted to the savings offered by being able to interface virtually with other global users, thereby reducing the need for international travel. The management of Polycom, which sells video, voice conferencing and communication equipment, is positioning the firm to benefit from this trend, with a marked focus on improving network architecture for its fixed networks business.

Meanwhile, interesting changes are happening within the marketplace. A rival of Polycom, Cisco has recently acquired video conferencing firm Tandberg. This opens up potentially positive avenues for Polycom, in the form of partnership and market share opportunities. Since the deal was announced, Polycom has confirmed partnerships with HP, Siemens and Juniper in addition to existing relationships with IBM and Microsoft. In effect, Polycom now stands as the 'go-to' provider for companies preferring to limit exposure to Cisco. The potential share gains following the acquisition of Tandberg and the associated operating leverage should prove beneficial for Polycom, particularly relative to what we consider are modest sales growth expectations for next year.

Similarly, we believe growth prospects at offshore outsourcing provider Cognizant are under appreciated. In an attempt to cut costs, companies began to outsource IT functions and services throughout the downturn. The new business pipeline remains strong and with an improving economy, spending on growth-related IT initiatives is beginning to recover. In addition, the company should benefit from the pick-up in M&A activity, as merging companies increase spending to integrate IT systems.

Our strategy in US equities

Given that US economic growth is likely to remain sluggish for the foreseeable future, and interest rates consequently lower for longer, investors have an increased focus on achieving a high level of income. One area to consider from an income perspective is telecoms. We are invested in local telecom provider Frontier Communications, which offers a dividend yield of 10%. The firm has recently done a deal to acquire some assets from Verizon. The integration of these assets appears to have cleared significant hurdles, which we think could lead to future cashflow growth. In contrast, we have been reducing our exposure to Verizon, on cashflow concerns given the challenges it faces in its wireline business and from wireless competition.

UK Equities

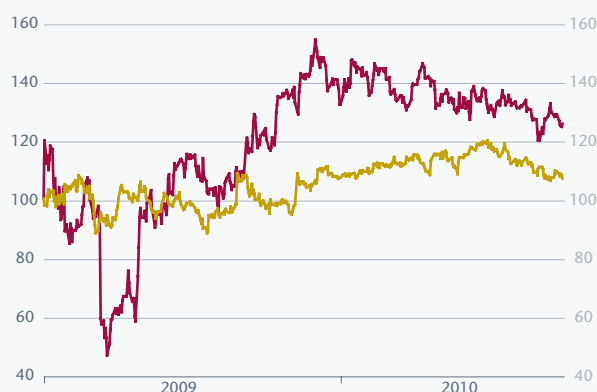
Cyclical momentum, defensive value

Positive newsflow and earnings momentum should help industrial engineers. Meanwhile, divergences in dividend and corporate bond yields highlight an opportunity among pharmaceuticals.



David Cumming
Head of UK Equities

Chart 1
Improving industrial engineering



Share price performance relative to the UK industrial engineering sector (01/01/09=100) for : Fenner IMI

Source: Thomson Datastream

Earnings revisions benefit engineers

The possibility of double-dip recession remains a key concern for investors and has resulted in flat market returns so far this year. At a corporate level, newsflow has been more upbeat, with consensus earnings revisions remaining in positive territory since August 2009. Upgrades have been particularly strong in corporate-facing sectors such as industrial engineers and our meetings with companies suggest there is more to come.

We are exposed to the engineering sector through companies such as manufacturing buyout firm Melrose which has three main businesses: precision engineer Dynacast, plastic component manufacturer McKechnie and engineering group FKI. The company recently posted its best interim profit since it went public in 2003, raised its dividend and issued positive guidance. Our analysis suggests there should be further upside from FKI, with the business having already generated around £440 million in cash. There is also potential for a further positive catalyst from the acquisition of another engineer or manufacturer.

Industrial engineer IMI also recently announced interim results ahead of expectations and increased its dividend. The company was similarly bullish about its future, expecting further margin improvement in the traditionally stronger second half of the year. In addition, it moved to allay fears over reliance on stimulus measures, stating it was not intrinsically linked to government infrastructure spend. We hold a positive view on the stock as management looks for acquisitions to develop the company, which could lead to a re-rating of its shares.

Conveyor belt manufacturer Fenner is another favoured holding. The majority of its sales are in the mining industry, particularly coal extraction, and demand in Australia is helping drive the business. Investment through the downturn has also allowed the company to emerge stronger than its peers, and increased demand for industrial belts should boost earnings and lead to further upgrades.

These are just three examples of corporate-facing companies where positive earnings momentum is yet to be fully factored in. As the recovery continues and investors again focus on stock fundamentals, we expect these companies to perform well.

Finding value in pharmaceuticals

Over recent months we have noticed increased polarisation in performance within sectors as investors chase those stocks with the strongest earnings growth and exposure to emerging markets. This has resulted in valuation disparities that provide genuine investment opportunities.

Within the pharmaceutical sector, industry giant GlaxoSmithKline, is currently undervalued on several measures. The company is also one of many stocks whose dividend yield is now higher than its corporate bond yield. Investors' unease with equities as an asset class, partly reflecting fears over the potential for dilutive share issuance, has resulted in a sharp fall in many companies' corporate bond yields, while dividend yields remain at elevated levels. However, we believe shares in GlaxoSmithKline represent good value. Cashflow is almost back at the levels it was five years ago, with free cashflow of £5 billion p.a., but this is not reflected in the share price and the company is trading on a low P/E ratio.

Meanwhile, we have benefited as other firms in the sector, such as Hikma Pharmaceuticals and animal genetics business Genus, have enjoyed strong share price gains. Both these companies are active in emerging markets, helping them trade on high P/E ratios. GlaxoSmithKline has recently provided more detail on its emerging market operations, and analysts are starting to recognise the company's long-term growth prospects. We remain a buyer of the stock as we see scope for the stock to trade on a higher rating over time.

Strategy within UK equities

While investors are gradually appreciating the earnings momentum shown by corporate-facing sectors, they remain sceptical over consumer-facing sectors despite evidence of steady improvement. We continue to favour stocks in both industrial and consumer-related sectors, where we see good investment opportunities. For example, in the travel & leisure sector, we are invested in British Airways as premium traffic improves and potential synergies from the Iberia deal emerge. Elsewhere, we hold Stagecoach, which believes it can offset government austerity measures with concessionary travel arrangements. Conversely, we remain less positive in traditionally defensive areas of the market, where we believe ratings are too high.

European ex-UK Equities

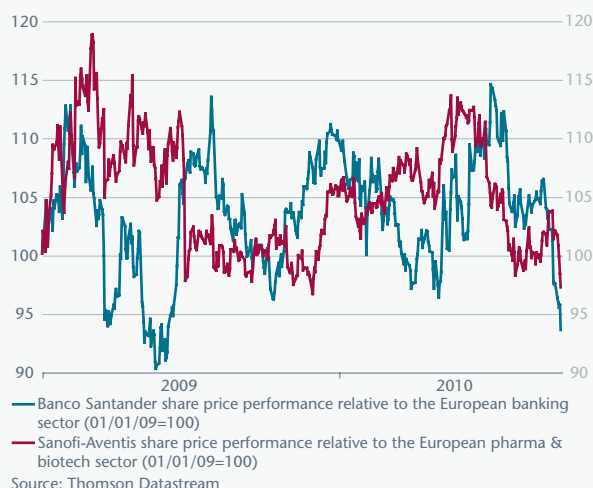
Accentuating the positive

We are finding firms able to determine their own prospects. Meanwhile, cash-rich companies have increasing opportunities to grow by acquiring attractive assets.



Chris Haimendorf
Investment Director, Europe

Chart 1
Upside opportunities



Bottom-up benefits

After months of downbeat headlines on the back of peripheral Europe's sovereign credit crisis, Europe is now displaying more encouraging signs. However, the better growth outlook is patchy; the peripheral countries are lagging considerably behind the strongest core economies, such as Germany. Nevertheless, the weaker sovereigns have not derailed the Euro-zone's overall economic health. Meanwhile, the newsflow from many European companies has also been encouraging. Many firms reported second-quarter results that exceeded expectations on both margins and revenues.

As ever, our approach remains focused on finding compelling stock-specific drivers that warrant investigation and ultimately investment. In a more stable environment, we see greater possibilities for the management of companies with solid structural growth drivers to position their companies to outperform. We have been increasing our exposure to various candidates within this category, such as Portuguese-listed food retailer Jerónimo Martins. Three quarters of its profits come from the fast-growing 'Biedronka' chain of discount outlets in Poland. Biedronka is remarkably cash-generative and can fund continued high growth rates without recourse to external financing. Meanwhile, Jerónimo's Portuguese operations remain stable, and the franchise appears well-insulated from domestic fiscal distress.

Elsewhere, we continue to favour Irish bookmaking company Paddy Power. Various drivers are contributing to its long-term structural growth story, which we believe is still undervalued by the wider market. The company's acquisition of Australian online bookmaker Sportsbet gives it access to the rapid growth occurring within the country's online betting environment, which has been opened up through deregulation. Belgium's Umicore, a precious metals recycler, is another firm whose share price fails to reflect solid medium and long-term structural growth prospects. Umicore has a leading position in rechargeable batteries and industrial recycling, yet the market does not seem to appreciate this competitive advantage.

Taking over the continent

During the downturn, European companies proved adept at cutting costs and keeping them low. Cash-rich corporations, many of which have access to finance, are now searching for new sources of revenue growth. We expect more and

more European corporates with robust balance sheets to grow by acquiring attractive assets. In fact, there have been encouraging signs of mounting M&A activity over recent weeks - including cross-border transactions - which should be good news for European stock markets.

French drug maker Sanofi-Aventis is currently negotiating to buy US biotech group Genzyme; an acquisition that should add to Sanofi's new drug pipeline. It will also provide a means of extracting more value from Genzyme's existing pharmaceutical products via Sanofi's own large sales force. We believe the market is overly concerned about the well-publicised loss of revenue over the next few years. We see upside opportunity from cost cutting, improved management and its growing emerging markets business.

Spanish bank Santander has already taken advantage of its relative capital strength within the European banking industry by buying UK names at distressed valuations during the downturn. Having integrated these businesses into its existing UK operations, Santander now has a platform from which it can cut significant costs from the 300 branches it has bought from RBS. Santander also recently acquired a controlling stake in Poland's Bank Zachodni, which it bought from the beleaguered Allied Irish Banks. The purchase gives Santander an inroad to Poland, Europe's fastest-growing banking market.

Our strategy within European equities

We believe that many European companies offer compelling investment opportunities. In addition to the themes already mentioned, many companies have maintained their expenditure on research and development (R&D) and have kept their sales forces broadly intact. This leaves them well-placed to reap the benefits of more stable macroeconomic conditions. Europe also looks attractive on a yield basis, with many European companies committing to or confirming their dividend payouts. We also continue to look for companies where management actions can improve profitability on a sustainable basis.

In the banking sector, we have been buying Société Générale. We are impressed by its plan to exit business segments where it lacks a strong market position and where it is reliant on external funding. We therefore believe Société Générale should be better-placed than the market fears under the new regulatory requirements outlined in Basel III.

Japanese Equities

Hard disk drivers

Demand for computer memory has prompted us to add to hard disk drive-related companies, while we are concerned about the threat of oversupply in the LCD TV industry.



Matt Harris
Investment Director, Asia Pacific

Good times for hard disks

With the ever-increasing choice of technology on offer to the consumer, the need for greater and denser digital storage has simultaneously grown. As a result, demand for all types of hard disk drives (HDD) has been stronger than expected, particularly with the rise of netbooks, digital video recorders and TV set-top boxes.

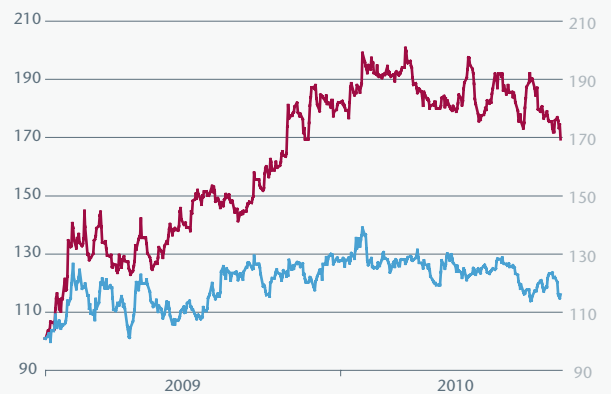
Against this backdrop, we have been adding to favoured stock Nidec, which has around a 70% share of the global market for HDD motors, and derives over 50% of its profits from this business. Over the past year, orders for all HDD products have recovered strongly, initially on the back of inventory re-stocking and then on better-than-expected PC demand. Surprisingly, this recovery in volumes has not prompted significant capacity additions by Nidec's competitors and the profitability of second-tier players such as Minebea has been limited by the lack of scale. Therefore, there is no meaningful risk to Nidec's dominant position. The emergence of flash-memory semiconductor chips as a method of storing data has been considered a threat to hard disc drives, and we do expect a degree of substitution from HDD to flash by consumers requiring greater portability. However, this is unlikely to derail Nidec dominance in HDD, particularly given the need for digital storage from high-definition television content and new non-PC applications. Consequently, we believe the two markets can grow and co-exist comfortably for a long time to come.

We have also been adding to our position in TDK, another beneficiary of the demand for digital memory. TDK makes hard disc drive heads and supplies companies such as Samsung, Toshiba, Hitachi and Fujitsu. The company continues to expand its market share and has a significant research and development advantage over its competitors. It recently added industry-giant Seagate to its list of clients, with Seagate requiring access to TDK's superior technology.

A clear view to cut glass

Following an extended period in which demand for LCD TVs consistently surprised on the upside, momentum has begun to weaken. In response, we have reduced our positions in Asahi Glass (which makes LCD glass panels), and TV-maker Sharp. Economic uncertainty in the West, as well as competition from Korea and China, have been unhelpful for Japan's TV manufacturers and related component makers.

Chart 1
Hard disk advantages



Share price performance relative to the Japanese technology hardware & equipment sector (01/01/09=100) for: — Nidec — TDK

Source: Thomson Datastream

Demand for the largest TV sizes also appears to have lessened with smaller models returning to favour with the consumer. Despite this, TV manufacturers are increasing production more than expected and we are concerned about oversupply in LCD glass panels and the TVs themselves. We are also apprehensive that the situation could be exacerbated by some of the major players in this sector aggressively increasing capex in order to take part in a land grab for the Chinese TV market.

With its significant domestic market share, Sharp had been a key beneficiary of the eco-points scheme in Japan, which encourages consumers to purchase energy-efficient appliances. However, the impetus from this scheme is beginning to wane, casting more doubts over future consumption expectations for Sharp's products. The company faces further problems over the shortage of LED components, and we also believe that Sharp is technologically weaker than some of its rivals in the LED and AMOLED fields. Asahi Glass, meanwhile, faces weaker pricing, with recent monthly data confirming the prices of glass panels falling faster than expected.

Our strategy within Japanese equities

Within the portfolios we continue to favour those companies with a dominant domestic market share and high growth prospects abroad. The technology sector falls into this category and is supported by a combination of inventory build, new product excitement and Chinese demand. We also favour telecoms where we have been adding to positions in NTT and KDDI, both of which continue to generate stable and steady cashflows from their fixed line businesses and are benefiting from new sources of revenue such as Internet TV. As ever, we continue to employ a fundamental bottom-up stock-picking approach, holding our largest positions in those companies where we have the strongest insights and which we believe are unrecognised by the wider market.

Emerging Market Equities

The rising Asian consumer tide

Opportunities continue to emerge among China's consumer-oriented companies, while some Asian firms have extended their competitive advantage through the downturn.



Ronnie Petrie
Head of Asia Pacific Equities

The emergence of the Chinese consumer is being heralded as a key impetus for the global economy and an attractive investment opportunity. This is because consumption accounts for only 35% of China's GDP, which is substantially lower than the levels seen in the developed world of 50-70%, a gap which is likely to narrow over time. We believe that this process is still at an early stage and our investment analysis has identified strong growth potential in areas of consumption where penetration remains low.

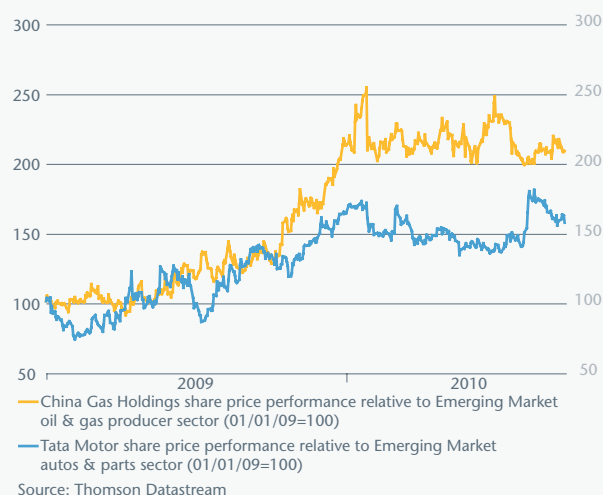
In particular, we are positive on the healthcare sector which, although rapidly developing, continues to significantly lag global standards. According to a recent industry study, the sector has a penetration rate of less than 25% of the global average. Within the healthcare industry, United Laboratories has been a strong performer for our funds, as its business benefits from its ability to develop alternatives to expensive pharmaceutical imports. The firm's new insulin drugs are also expected to be market-leading in terms of both cost and quality. Another area which is set to benefit from emerging consumer demand is the dairy industry. China Mengniu Dairy already has a strong position in the liquid milk market as the country's largest dairy processor. However, it is also set to profit from plans to diversify into premium products like yogurts and children's milk. The firm's products should be more affordable and attractive as Chinese wages continue to improve.

On the flip side of this argument, it is also important that investors avoid those areas of consumption that are already reaching saturation point. In particular, we have reduced our exposure to sportswear manufacturers such as Anta Sports, given that the industry now seems richly valued and over represented on the high street. The sportswear industry has a significantly higher penetration rate than others in the sector. As a result, we believe that there are more attractive ways to obtain exposure to the Chinese consumption story.

Pulling away from the competition

There are few companies that have emerged completely unscathed from the breadth and depth of the recent downturn. However, some Asian companies have been able to turn the extremely difficult trading conditions to their advantage. By implementing a combination of increased capital expenditure and aggressively cutting costs, these firms have extended a cost and technology advantage that already existed, even before the crisis.

Chart 1
Improving consumers



Samsung Electronics is a good example. It went into the downturn with a stronger balance sheet than its rivals and has gained market share by investing through the downturn. In the DRAM market, the firm generated an operating margin of over 40% in the second quarter in 2010, well above its rivals which have struggled to deliver returns above breakeven. Samsung clearly has a major cost advantage and is likely to continue stretching this lead, given its greater financial resources. As a result, we hold the stock in a number of our regional funds.

Our strategy within emerging markets

We favour stocks that will benefit from further structural changes in China. These include the gas distributor China Gas. China Gas should profit from improving gas supplies and the increasingly large industrial user base. We are also positive on firms that are oriented towards the services sector, such as 51jobs, a leading online recruitment agency, that is likely to continue to see improving margins. The firm has a 30% market share and is also adding HR services to its product mix.

We are optimistic about the prospects for many of our Indian holdings. Firms such as Tata Motor have proven successful in balancing the domestic and overseas aspects of their business. The turnaround of the company's UK subsidiary Jaguar Land Rover continues to be faster than consensus expectations, thanks to lower material costs and some new model launches. In addition, the company's domestic truck business is reporting robust volume growth. We also remain well positioned to benefit from improvements in the telecom sector, where the market is starting to price in the considerable growth prospects from new 3G licences.

Government Bonds

What is priced in?

The prospect of a muted global economic recovery, and concern that it might even be worse, has supported a rally in government debt markets.



Philip Laing
Investment Director, Government Bonds

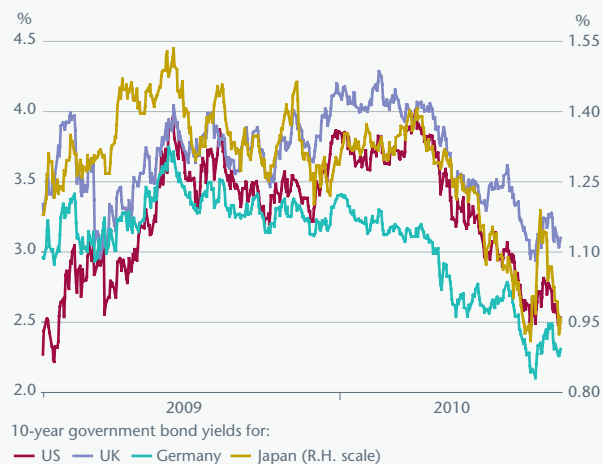
Bond markets have been subject to heightened volatility as investors alternate between 'risk-on' and risk-off'. In Europe, the fears regarding a European sovereign credit crisis have begun to subside, and investors are now focused on the challenges facing the US economy. This has led rates markets to surge to lower yield levels at an accelerating pace over the summer, whilst the transformation in US Federal Bank rhetoric from June's pointers towards 'easy-policy' withdrawal, to balance sheet equilibrium and then to the possibility of further stimulus, has added to the momentum.

Though poor US growth signals have been behind the recent bond rally, there has been relatively little variation in performance between the main developed bond markets as Quantitative Easing (QE) speculation has prompted strong bond buying across markets. Treasury bond prices and yields have flattened dramatically with the 10- and 2-year yield spread collapsing from 2.5%, in early June, to around 2%. Meanwhile, 2-year yields established a new historic low at around 40bp. The fading inventory restocking cycle appears to have awoken concerns that the recovery may not have enough escape velocity – implying that further stimulus will sooner or later be required.

Speculation on what type of action it will take has continued, with the minutes from the most recent FOMC meeting suggesting that support for a further loosening of monetary policy was far from unanimous. For some, there was concern about how the market would interpret their actions. To harbour expectations of further easing would be inappropriate before the committee had actually considered a policy change. Also, some felt that there was ample liquidity already in the system. So, for now the FOMC appears happy to maintain the status quo. Meanwhile, 10-year bond yields moved comfortably through 2.5%, encouraged by the possibility of more Fed easing. The market will be paying close attention to whether the FOMC starts to display greater unity on QE in the future.

Despite being positioned to benefit from the gloomy economic environment, we remain cautious on the outlook for the market. At this juncture, economic and financial

Chart 1
Some bonds are getting expensive



Source: Thomson Datastream

uncertainties continue to lend support. However, if the change in stance from the Fed is taken at face value, then current low yields will need to be sustained. Short-term technicals do imply current levels are overbought and require, at the minimum, a pause. Overall yields look thin and do seem to be running ahead of events, but then again we have to acknowledge the possibility of an unexpected downturn in events. Attempting to address apparently intractable core problems in the economy, having already initiated a policy of unprecedented stimulus, does warrant some pricing of a worst-case scenario (Japan/double-dip etc.). This is what bonds are starting to reflect. While we do worry that low confidence is becoming embedded, we believe that this is likely to lead to a protracted sub-trend recovery, rather than a plunge back into recession. In inflation markets TIPs breakevens have declined, but remain well above deflation crisis levels of late 2008.

Japanese lessons

Inextricably linked with the progress of Treasury bonds has been the strength of the yen, with sizeable Japanese buying ensuring comfortable absorption of supply. Indeed, the Japanese experience has been used as the roadmap for the flattening of the US yield curve. With each step change in JGB short yields (2-year to 0.5% in 1995, 0.1% in 2000), a swift compression of the curve followed. Investors have been quick to infer the possibility that trend will repeat in the US, especially with a steep yield curve to play with. We have argued in the past that although there was value in Treasury bonds on a real yield basis, an increase in supply as well as competition from 'risk-on' assets in the recovery phase could be significant drags. That has recently been the case, but it now seems to have run its course, with a subsequent flight-to-quality back into Treasuries. As such, outright strong yield declines would seem to be at an end, but the yield curve appears to offer the most sustainable opportunities going forward. Anchored short yields should lead investors to buy longer-dated bonds, or 'curve creep', especially if the Fed is acting as a backstop. If the worst-case scenario of recession is realised, then the Japanese roadmap will continue to be followed.

Corporate Bonds

Investor attitudes to lower yields

We examine the implications of depressed government bond yields for credit investors, as well as the wider opportunities presented by an environment of low interest rates.



Roger Sadewsky
Investment Director, Corporate Bonds

An all-time low

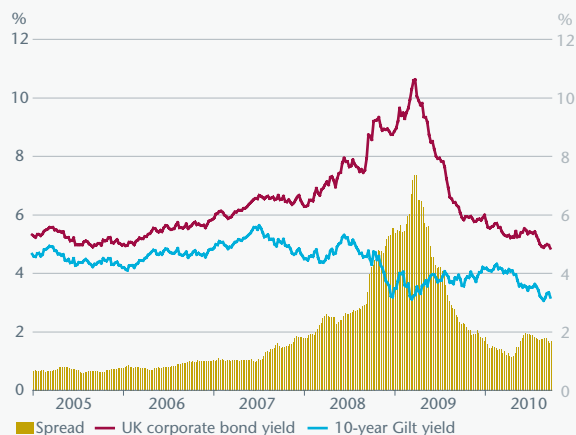
Despite short-term volatility, the over-riding trend in bond markets over the summer was towards lower and lower levels of yield. Although yields have subsequently retreated, European 10-year bond yields got to an all-time low while, in the US, 10-year bond yields dipped to levels last seen in the 1940s. These exceptionally low yields reflected a number of factors. First, there are fears of a double-dip recession, possibly accompanied by deflation, which would assure the maintenance of historically low levels of interest rates. Secondly, yields reflected both the extreme levels of liquidity in the global financial system (to prevent a collapse of the banking system) and a high level of risk aversion, given the economic outlook. Finally, investors had begun to anticipate the resumption of Quantitative Easing by the US Federal Reserve, which would likely underwrite low yield levels.

The rally in government bonds heightened the debate over the outlook for both the wider economy, and for corporate bond investors. With many government bond yields lower even than those that prevailed during the Great Depression, it seemed that bond investors were expecting a return to recessionary conditions. If that were the case then it would be reasonable to expect interest rates, and yields, to remain lower for much longer. However, it is not necessary to assume a full-blown return to recession – most economies remain sufficiently fragile to warrant an extended period of policy support.

What next for investors in corporate bonds?

Given where yields are, and against the current economic backdrop, the immediate outlook for corporate bond investors depends upon different perspectives. On the one hand, certain types of investor may find the present level of bond yields unappealing. Retail and other investor types may no longer be attracted by the yield on corporate bonds; the Merrill Lynch Non Gilt Index now yields close to 4.5% compared with around 7.5% in early 2009. Where, then, does the attraction lie in buying corporate bonds? We believe the answer lies in comparisons with competing asset types. For, although there are plenty of robust companies out there with dividend yields well north of 5%, the higher relative volatility of equities versus credit must be considered.

Chart 1
Spread attractions for corporate bonds



Source: Thomson Datastream

There is also a favourable flow of funds argument to underpin corporate bonds. Recent data supports this view: the latest ICI (US mutual fund flow) data indicates that equity funds have seen 17 consecutive weeks of outflows, of close to \$52 billion, since May, while bond inflows have continued, with \$214 billion since the beginning of the year.

However, the other key factor is just how important the credit spread is as a proportion of the overall return of a corporate bond (see chart 1). In other words, if you strip down a corporate bond, removing the non-credit component (swap risk) the excess return is now very significant. This factor helps to reaffirm attractive credit valuations.

Consequently, while economic growth is likely to be sub-trend, the differential appeal seems likely to favour credit over equities. The flows into the sector have been firm, while issuance has been light. More recently there have been some signs of a pick up in financial issuance, which in itself should help to reduce bank refinance risk. Banks including Lloyds, BBVA and Banco Popular have tapped the senior unsecured debt market, while others such as RBS, Sabadell and La Caixa have used the covered bond market. Most of these bonds were of benchmark size, indicating strong investor demand, for the moment at least. In terms of supply data, financial issuance has totalled €251 billion in the year to date across Europe, down approximately 17% from this time last year. Notwithstanding recent issuance, supply in sterling markets has been light, and with cash building up in portfolios there could well be a squeeze in cash credit.

Our position with corporate bonds

We retain a Heavy position in investment-grade credit. Although spreads could widen if recessionary fears intensify further, technical drivers such as supply, corporate balance sheets, investor cashflows and the interest rate backdrop are all supportive. Technically, the markets look well supported. With cash levels built up in August and further bond maturities due in September, the anticipated increase in new supply should not be a problem for markets.

Money Market

Turning towards the monetary pumps

The need for greater monetary accommodation has increased over the past quarter.



Gordon Lowson
Head of Money Markets

US

Fed Chairman, Ben Bernanke, has repeatedly stated that the US Federal Reserve (Fed) would be ready to act if the economic conditions warranted it. That was taken to mean a possible further injection of liquidity if the economy showed signs of slipping back into recession. Any move towards exiting Quantitative Easing (QE) was dismissed as a non-starter, with the economic recovery still not convincing and inflation very much under control.

In the event, it was concern that policy could be inadvertently tightened that provoked the Fed into making a policy change. The Bank of New York warned the Chairman that the Fed's portfolio of mortgage-backed securities was about to shrink more rapidly than anticipated. Low mortgage rates were encouraging more Americans to refinance their mortgages, which would mean that many of the mortgage securities held by the Fed would be paid off.

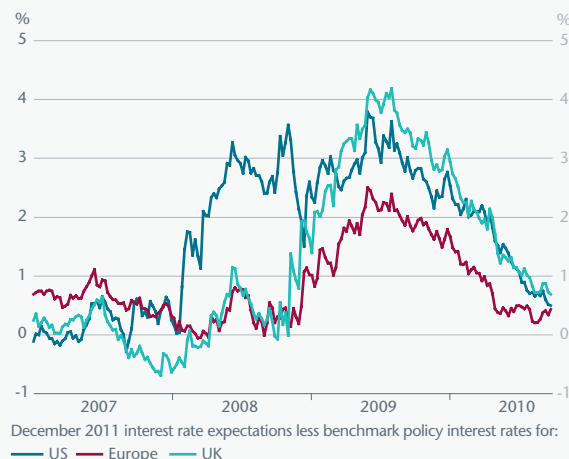
If the Fed did nothing, then the liquidity provided for the financial system by QE would shrink, and policy would thus be tightened. So the Fed decided to re-invest the proceeds of maturing or pre-paid mortgage debt into US Treasuries, which would effectively maintain the prevailing level of policy support. Increasing support beyond present levels will be dependent on a further significant deterioration in economic conditions.

UK

A change in personnel in the Monetary Policy Committee (MPC), or any other decision-making committee, can signal a change in bias within the team or a continuation of the status quo. All the signs are that the MPC's latest recruit, Martin Weale, will reinforce things as they stand now. The ex-director of the NIESR has made it clear that he considers the committee's policy stance as being appropriate for the present economic environment.

If anything, he seems likely to err on the dovish side, as he believes that Britain faces a significant risk of a renewed slide into recession. The trigger, as he sees it, could be another surge in unemployment, further declines in house prices or a new banking crisis. The claimant count for unemployment rose in August for the first time since January and house prices have been softening over the summer. That should be sufficient to ensure interest rates are not going up any time soon.

Chart 1
Interest rates close to the bottom



December 2011 interest rate expectations less benchmark policy interest rates for:

— US — Europe — UK

Source: Bloomberg, Thomson Datastream

And, despite inflation's prolonged stay above target, Weale seems decidedly unfazed. Regarding the Bank's economic forecasts, he said 'I find it easier to see why growth should come in a bit below forecast than I do to see why inflation should come in above forecast'. It's quite clear where his bias lies.

Europe

Although the European sovereign debt and banking crises largely disappeared from the headlines over the summer, neither has gone away. So, even if the ECB had concerns about the pace of growth or an incipient pick up in inflation, these more fundamental issues are more likely to dominate policy focus.

The emergence of concerns about the parlous state of public finances in Greece and some of the other periphery countries saw their yield spreads with bunds balloon out. The announcement of a 'war chest' to guarantee these sovereign debts initially succeeded in narrowing these yield spreads. However, the doubts and the problems remain and spreads have since widened out again – close to, and in some cases through, previous highs.

The bank stress test was seen as a major contribution to restoring confidence in the banking system. It was hoped that a demonstration that banks' financial stability was not in doubt would lead to consolidation and recapitalisation for the banking system. It hasn't happened, and the ECB has had to extend its policy of providing unlimited amounts of liquidity through year-end to stop-gap banks' continuing funding problems.

Japan

The noticeable weakening in the Japanese economy over the last few months has been attributable to the ever-appreciating value of the yen. The scope to galvanise the faltering economy through fiscal or interest rate policy initiatives is severely constrained by the extent of government debt and by the already low level of interest rates. Consequently, the authorities decided to tackle yen strength through direct intervention to sell the currency.

It is not a conventional policy tool in that this is the first intervention since 2004. It is, also, not guaranteed of success in that the Japanese authorities are unlikely to get support from other central banks. And, lastly, it risks retaliatory action from other countries anxious to give their economies a boost from currency manipulation. However, it's a risk the Japanese authorities have been willing to take.

Currency

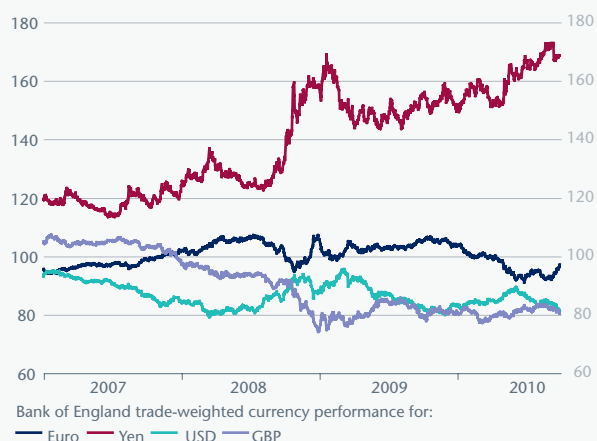
Beggar thy neighbour

Increasing competitive devaluation risks in response to concerns that monetary policy is becoming ineffectual across the major developed economies creates a greater chance of volatility in currencies going forward.



Ken Dickson
Investment Director, Currency

Chart 1
Currency volatility picking up



Source: Thomson Datastream

US dollar

Over the past quarter the stuttering US recovery, combined with the spectre of a further round of Quantitative Easing (QE), weighed heavily on the US interest rate curve, which in turn led to weakness in the US dollar (USD). The narrow trade-weighted basis has now fallen 6% over the past three months. The market had been expecting US rates to start normalising in 2011, but the recent run of poor data and dovish Fed utterances has led to a revision in those expectations to a much later date. The decision of the Fed to re-invest principal repayments from its securities holdings started the weaker dollar tone, but their most recent statement suggested that, in the light of continued low inflationary pressures, additional QE measures are likely to be announced at the November meeting. With this as the dominant driver, the current USD weakness looks set to gain momentum and continue into year end barring a major turnaround in US economic indicators, in particular in the employment data. This is despite the USD starting to look increasingly undervalued on many valuation methods although not, as yet, at anywhere near the extreme undervaluation levels reached in 2008.

Euro

The euro had a volatile last quarter. Sovereign worries in the Peripheral 5 economies in particular weighed heavily at times, as did concerns over individual banks performance in the stress tests. This was countered by a robust German economic performance, particularly in the export sector buoyed by this year's euro decline. However, sovereign concerns are still lurking as increasingly divergent productivity and inflation performance continues to create further competitiveness pressures between the core and peripheral European countries. On most valuation measures the euro is again looking expensive as it benefits from the malaise affecting the USD and a feeling that most bad news is already discounted for the currency. However, even if the currency misalignment for the euro-area as a whole is currently modest, the currency overvaluation for non-core European countries is significant at the current euro exchange rate. This, combined with new evidence of a slowdown in German economic performance and the expectation of a gradual withdrawal of ECB market aid, would lead us to anticipate the euro strength to be relatively short lived with upside momentum running out as the year comes to a close.

Sterling

Sterling (GBP) started last quarter well but has since declined. There is still a great deal of international and domestic suspicion over the durability of the coalition government, particularly over the willingness to deliver severe public spending cuts amid the ensuing union and public reaction. The economy remains generally sluggish, even extending to exports which as yet are not benefiting to any significant degree from the overall GBP depreciation seen over the past two years. A second round of QE has still not been ruled out by the MPC despite the fact that headline inflation remains stubbornly high. While there is a theoretical trade-off between the export support from, and the inflationary risks of, a weaker currency, the MPC continues to look beyond the imported cost effect given their belief that there is still a large output gap. This policy bias tends to encourage further currency weakness. However, it is our belief that once the October spending review has been completed and further economic weakness in competitor countries emerges the market will begin to lose its negative bias towards GBP which will then begin to appreciate into year end.

Yen

The rationale for buying yen has not disappeared despite the Bank of Japan's market intervention in mid-September, and a high valuation measure on most currency models. The narrowing of interest rate spreads with the rest of the world (interest free hedging for Japanese overseas investments), an attractive high domestic real yield and the very public moves by sovereign wealth funds into Japanese bonds have all contributed to considerable yen strength for most of the year. Current intervention efforts have temporarily slowed yen strength but there has been no evidence from the market that the trend is yet over. Unilateral intervention tends to be limited to a smoothing exercise. The market has good recent experience of how to trade these efforts from the work of the Swiss National Bank this year. This ended up halting intervention as it clearly became too expensive to change the trend of an in demand and strongly appreciating Swiss franc. Unless, or until, there is significant coordinated action backed up by meaningful monetary policy changes we expect the yen to remain strong into the close of the year with a good chance of the all time lows in the US dollar/yen being tested.

Property

Commodity-linked property markets

Australia and Canada were spared the worst of the economic downturn, and their resilience has played out in their real estate markets.



David Paine
Managing Director, Property Investment

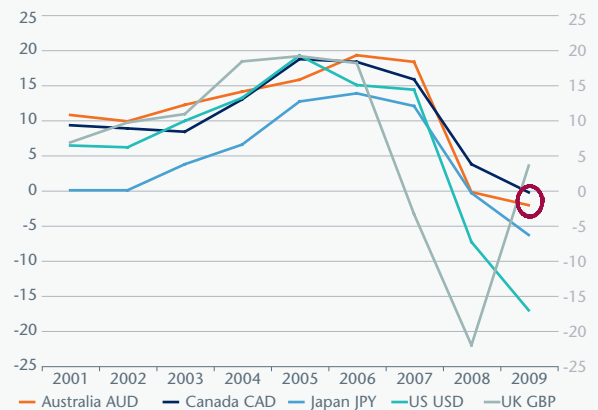
Australia has experienced uninterrupted economic growth over the past 20 years, except for one quarter of negative growth in 2008. Likewise, Canada was spared the depth of decline in most western economies, experiencing a 2.5% contraction in 2009 compared with much more severe recessions in the US, Japan and across Europe. There is a common thread that connects the relative fortunes of the two countries: stable banking systems and the commodity driven nature of their economies.

IPD returns mirror the similarities of the Australian and Canadian markets. The property performance of both these countries held up very well through the recent downturn relative to developed markets globally.

The relative strength of their real estate markets has partly been driven by their stable banking systems. While bank bail-outs were the order of the day in other developed economies, Australian and Canadian banks experienced a relatively shallow downturn in underlying profits. This resulted in less retrenchment and the office markets remained relatively intact compared with other developed markets. In Australia, rents and capital values for both office and industrial premises, while still below their mid-2008 peak, are no longer declining, reflecting a modest increase in white-collar employment and a pick up in overall business activity. In Canada, rents are broadly stable and rising in a few select markets and yields are now improving under considerable weight of money. Contrary to other developed markets, there was a reasonable increase in finance, insurance and real estate employment in 2009, driving the office market, especially in Toronto. This competitive advantage over other developed markets is expected to drive these real estate markets.

World demand for commodities is strong, driven by expanding emerging economies and the capital flows they and their trading partners, like Australia and Canada, attract. Large projects, such as the Gorgon gas project in Australia, are driving the demand for office space and total net absorption of office space in the first half of 2010 has increased to almost double the long-term average across all CBD (central business district) markets in Australia. The Calgary industrial market, on the other hand, experienced a correction due to weakened commodity prices, lack of US demand and the strong Canadian dollar which significantly impacted the manufacturing sector. However, the market is not overbuilt, excess supply is dwindling and rents are expected to remain stable.

Chart 1
Resilience in Canada and Australia



Source: IPD

The property markets in Australia and Canada have benefited from healthier public finances. In contrast to the stimulus and austerity measures in Europe, these countries have started the process of interest rate increases and have been able to reduce taxes to stimulate the economy. Consumer confidence is resilient, driven by the lower taxes, relatively lower unemployment and a healthy housing market. A significant downturn in retail sales has thus not materialised. The relative strength of the retail sector over the past couple of years has seen rents and prices in this market segment remain broadly unchanged.

Against the backdrop of improved demand, future supply is dwindling across all commercial market sectors. Development pipelines have shrunk significantly due to the lack of development finance. Vacancies have therefore remained in the single digits in most markets, compared with the double digits they reached in the early 2000s. However, recovery is still hampered by a reduced appetite for lending, although lenders and commercial property borrowers indicate that this has eased. Australian and Canadian commercial property markets are therefore set for continued improvement and positive performance in 2011.

Our strategy within property

Globally, we favour core prime locations and we see the best resilience in better quality assets. In Asian markets, we hold a preference for office markets with the tightest supply pipelines, such as Sydney, and truly emerging markets, such as Chinese logistic warehouses. Across North America we see value in underdeveloped industrial locations in Canada and we favour the cyclical office markets in the US. We believe the European commercial property markets to be further into the recovery and favour the Paris office market and high-yielding logistics markets. In the UK, the Central London markets continue to be most attractive. Our overweight recommendation, in place since Q3 2009, is based on the impending supply and demand balance which is already placing upward pressure on rents of Grade A office space.

Stewardship

An important role in creating prosperity

The financial crisis has revealed many fault lines and prejudices about the way that capital markets work in a modern economy.



Keith Skeoch
Chief Executive

Guy Jubb
Head of Corporate Governance

One issue that has gained increasing traction with politicians and regulators both at home and abroad is that one important fault line runs through the way shareholders engage with the companies they invest in. While the anger over corporate failure among financial institutions is understandable, and the aim of improving engagement laudable, it is important that any policy prescriptions are soundly based rather the product of any particular political prejudice.

The key issue in this respect is an understanding of what shareholders actually own. Shareholders do not own companies in the sense that an individual owns a car. They have no right to dispose of a company's assets, use its products or services or indeed to price a company's product in its markets. What shareholders own is the equity component of a company's capital structure. Equity is the purest form of capital, it is both loss bearing and has no maturity date. Equity holders are simply entitled to the residual assets of a company after other obligations have been met on wind up. Equity has clear attractions for issuers and regulators but as the purest form of capital is also the most risky component of the capital structure. In order to make equity more attractive, shareholders are granted certain rights that aim to protect their interests and the delivery of the implied higher return. These rights mainly relate to the ability to vote on matters that may impact on the long-term performance of the company. In the UK this includes a vote on the election and re-election of directors, any dividend payment, the accounts, the remuneration report and any special resolution on matters prescribed by company law.

Much of the debate about ownerless corporations is actually about the extent to which these rights also carry with them obligations. At the simplest level this could mean an obligation to vote; however, the implicit challenge appears to be that shareholders should have active involvement in shaping the decisions that they are likely to vote on.

At Standard Life Investments, as providers of equity capital and perpetuity owners, we take our stewardship responsibilities very seriously and believe we have an

Corporate Governance

Our Principles

We will:

- use reasonable endeavours to enhance and improve shareholder value through constructive consultation with companies and other corporate governance initiatives
- always seek to vote our clients' shares in a manner consistent with their best interests
- use reasonable endeavours to influence the development of the corporate governance environment
- communicate our corporate governance principles, policies and guidelines to clients, intermediaries, companies and other interested parties
- within the constraints of professional confidentiality and legislative and regulatory requirements, be accountable to our clients.

Source: Standard Life Investments

obligation to our clients, the ultimate providers of capital, to protect not only their interests as shareholders but also the delivery of the returns we expect from the investment. However, in common with most investors, we have no appetite to run or micro manage the companies we invest in. We look to the board to govern the company on our behalf. It is the board that acts as the trustee of the company's assets and should manage them in a responsible manner in the interests of all stakeholders. It is the board we hold accountable for the protection of shareholder rights and the oversight of execution of its strategy, which is what will deliver the return. We expect to be informed of any material change to the company's risk profile that may have a bearing on the value of our investment and to be given an explanation about the actions the board are taking to mitigate these risks. Such discussions are expected to take place over and above the normal pattern of updates and disclosures required by company law and good practice. In order to facilitate effective engagement we set out our expectations of boards in our Corporate Governance Guidelines, which are reviewed on a regular basis and form an integral part of our investment process. We have also just published on our website an explanation of how we will apply the new UK Stewardship Code in our engagement with companies and their boards*.

It is important that both investors and boards recognise the failures that took place during the crisis and embrace the philosophy of stewardship. Investors will act in the best interest of clients by providing equity capital for companies that will deliver appropriate returns through the execution of their chosen strategy. Boards will act responsibly in the interests of all stakeholders in ensuring the effective governance and oversight of the delivery of strategy and return for investors. Stewardship, however, will only be effective if both investors and boards work together to deliver the long-term growth and returns that are so essential if the economy is to move out of austerity into an era of sustainable prosperity.

*<http://standardlifeinvestments.com/corporate-governance-sustainable-and-responsible-investing/the-uk-stewardship-code.html>

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House View

The following portfolio is based upon a global investor with access to all the major asset classes. For regional versions of the House View, please contact your Standard Life Investments representative.

Risk	The Global Investment Group has concluded that portfolios will take on moderate levels of risk, focusing on assets with high, yet sustainable, yield and looking for relative value opportunities, in view of continued economic and market volatility.	NEUTRAL
Government Bonds		
US Treasuries	Yields are supported by a backdrop of muted inflation pressures, opening the door for further Quantitative Easing, but valuations and the fiscal outlook are becoming more of a concern.	NEUTRAL
European Bonds	Safe haven flows into some European bond markets have pushed yields to expensive levels, but investors remain concerned about the outlook for fiscal consolidation in a number of countries.	NEUTRAL
UK Gilts	Quantitative Easing and a muted economic recovery provide strong support for the bond market, but there are long-term inflation risks depending on the eventual policy responses.	NEUTRAL
Japanese Bonds	Low Japanese government bond yields mean this asset class is increasingly being used as a funding source for other investments including overseas government bond markets.	MOVED TO LIGHT
UK Inflation-Linked Debt	There are inflation risks in the medium term from central bank Quantitative Easing, but valuations of inflation-proofed debt need to be examined carefully.	NEUTRAL
Corporate Bonds		
Investment Grade	Spreads over government bonds are still historically wide, although not as attractive as seen last year. Strong corporate profitability supports the improvement in bond default rates.	VERY HEAVY
High-Yield Debt	Benefiting from an attractive carry, improving corporate cashflow and a peak in the default cycle as the global economy recovers. Investors need to be wary of selective default risk and periodic risk aversion.	VERY HEAVY
Equities		
US Equities	Supported by improving corporate cashflow into 2011 on the back of strict cost control but the upside is limited by the consumer debt and housing market overhangs restraining domestic demand.	NEUTRAL
European Equities	Some sectors are supported by exports and their exposure to emerging market economies, but the economic recovery looks muted in the face of sizeable fiscal tightening.	LIGHT
Japanese Equities	Helpful exposure to the Asian and US economies offset by weak domestic dynamics and limited cost cutting; government action unsuccessful so far in stimulating consumer spending or ending deflation.	LIGHT
UK Equities	The market can make headway supported by valuations and the benefits of sterling's depreciation on overseas earnings, but faces headwinds from weak real income growth and fiscal tightening.	NEUTRAL
Developed Asian Equities	Selective on Asian economies, favouring areas benefiting from strong Chinese growth but wary of inflation pressures and speculative property bubbles building in some countries.	NEUTRAL
Emerging Market Equities	Some are benefiting from the upturn in commodity demand and upgrades to sovereign debt ratings, others still facing external financing problems or valuation concerns.	NEUTRAL
Property		
UK	Despite short-term yield pressures, we continue to expect strong relative returns over cash on a 3-year basis.	HEAVY
European	Key centres, such as Paris and Stockholm, are benefiting from the same positive demand and constrained supply factors that supported London's earlier yield rally.	HEAVY
North America	We see the best prospects in underdeveloped industrial locations in Canada and the cyclical US office markets where future supply is at 30-year lows.	NEUTRAL
Asia Pacific	Excessive supply in certain markets, e.g. China, will hold back growth, but office markets in Australia remain supported by a good demand/supply balance.	MOVED TO NEUTRAL
Other Assets		
Foreign Exchange	Interest rate differentials, divergent growth prospects and political and regulatory drivers are becoming important differentiators for global capital flows.	HEAVY \$ and £ vs LIGHT € and ¥
Global Commodities	Strong demand for industrial commodities, led by infrastructure projects in emerging economies, but oil and soft commodities will eventually see new supply come on stream.	NEUTRAL
Cash		
	Central banks in the major economies will keep monetary policy very loose into 2011 as inflation pressures remain weak due to excess capacity and high levels of unemployment.	VERY LIGHT