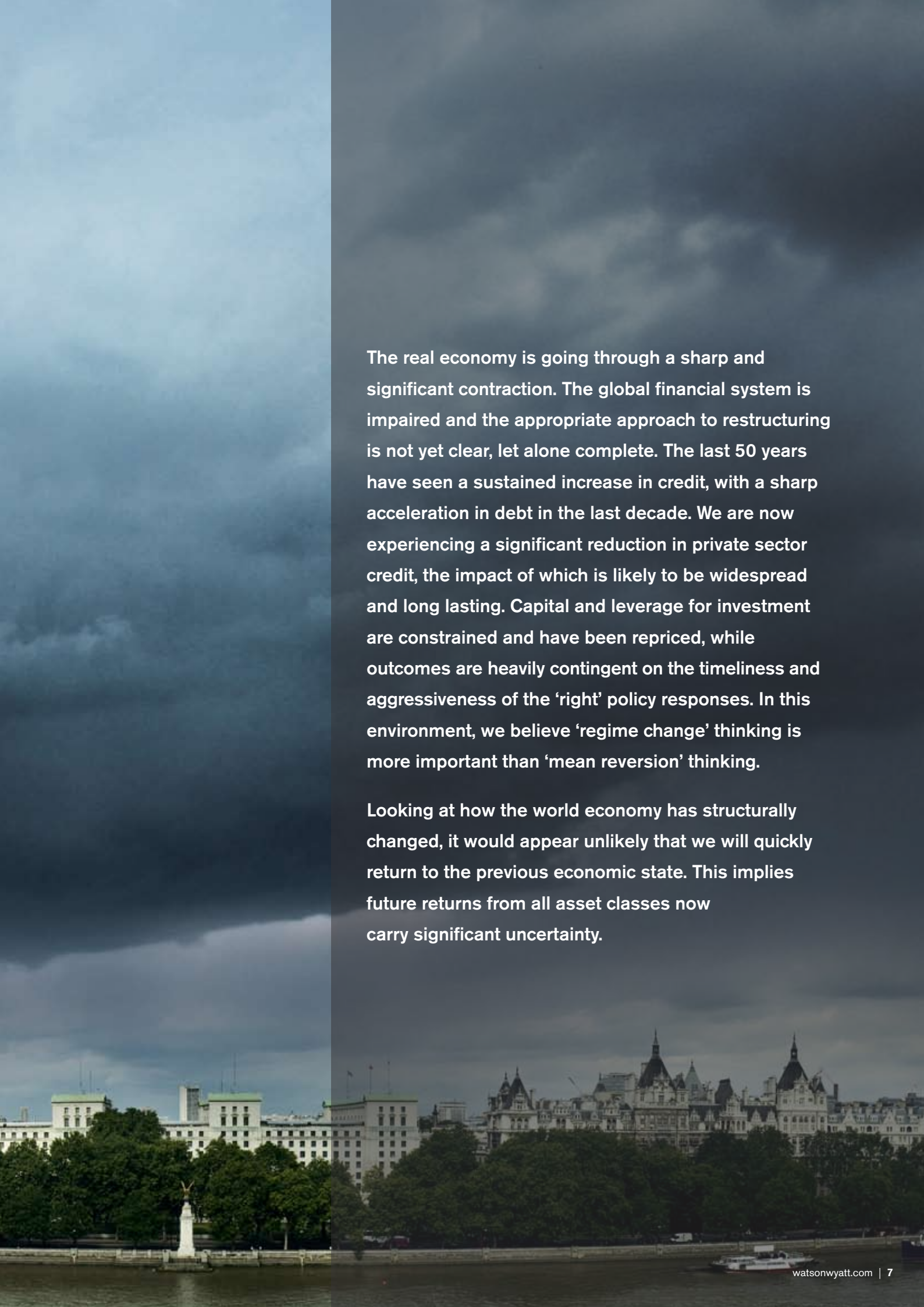


**The economic
world has**

changed

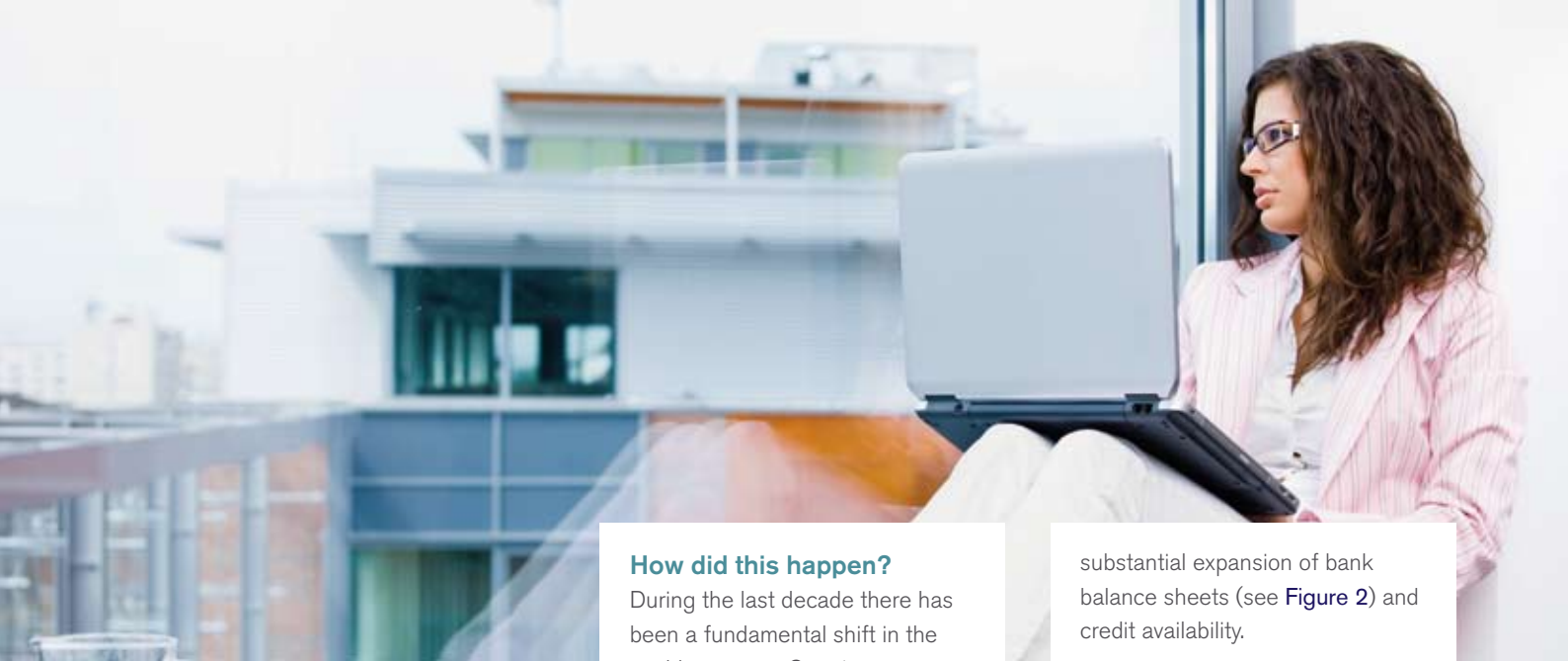
We need to revisit our asset allocation
thinking from the ground up





The real economy is going through a sharp and significant contraction. The global financial system is impaired and the appropriate approach to restructuring is not yet clear, let alone complete. The last 50 years have seen a sustained increase in credit, with a sharp acceleration in debt in the last decade. We are now experiencing a significant reduction in private sector credit, the impact of which is likely to be widespread and long lasting. Capital and leverage for investment are constrained and have been repriced, while outcomes are heavily contingent on the timeliness and aggressiveness of the 'right' policy responses. In this environment, we believe 'regime change' thinking is more important than 'mean reversion' thinking.

Looking at how the world economy has structurally changed, it would appear unlikely that we will quickly return to the previous economic state. This implies future returns from all asset classes now carry significant uncertainty.



How did this happen?

During the last decade there has been a fundamental shift in the world economy. Ongoing 'globalisation', that is the integration of highly competitive emerging countries (China especially) into world trade and capital structures, has allowed emerging economies to capture an increasing market share of aggregate exports and significant capital inflows. This has driven a secular transfer of real economic wealth from developed to emerging economies.

A fixed exchange rate with the US dollar helped to make China excessively competitive, which pushed its earnings to extremes and created large global imbalances (see **Figure 1**). High savings rates in emerging economies caused an abundance of liquidity and this money was used to purchase US-denominated assets (mainly Treasury, bonds and credit), suppressing yields.

Other secular and cyclical factors compounded the abundance of liquidity from emerging markets to create very easy monetary conditions. The US Federal Reserve dramatically cut rates to manage the collapse in the US equity market in 2000 following the 'tech-bubble'. Moreover, interest rates remained low as the supply of cheap labour from China kept a lid on inflation, despite strong global growth. Finally, financial innovation allowed a

substantial expansion of bank balance sheets (see **Figure 2**) and credit availability.

Cheap credit created a bubble in debt (see **Figure 3**), the counterpart of which was a sharp rise in consumer spending, and delivered housing and leveraged buyout booms. The imbalances in debt levels and household savings rates, imbalances with the rest of the world (as witnessed in the US current account deficit) and the rise in financial leverage are now unwinding.

The structural economic dynamics were compounded by a failure of regulation to keep up with the pace of change in the financial sector and the substantial misalignment of interests between those in some parts of the financial sector and their clients.

A decline in spending is a direct consequence of the unwinding of the debt boom

The scale of today's credit and financial crisis is not readily comparable with historic events, making its effects on the real economy difficult to gauge. However, housing and debt bubbles, banking system crises and excess leverage and balance of payments imbalances typically take considerable time to unwind. These will create significant multi-year headwinds for spending and economic growth. Savings rates have fallen well below historic 'equilibrium' levels and



higher savings rates imply a sharp pullback in spending if there is no boost to incomes.

Structural macro headwinds are a risk for many assets, given the frailty of the financial system and the spreading impact on the real economy in the US and in other parts of the world (especially Europe). In addition, there is still considerable risk from further large credit losses, tightening credit conditions and uncertain deleveraging of financial institutions' balance sheets.

Global financial markets have been under severe stress and have experienced elevated levels of volatility. We think this volatility will remain high due to ongoing macroeconomic uncertainty and continuing problems in the financial system.

Additionally, the 'usual' rules of capital markets have been suspended, with government intervention and elevated political involvement having a large potential influence on outcomes for different investments, making for unfavourable risk/reward trade-offs.

Figure 1 | US and China current accounts diverge

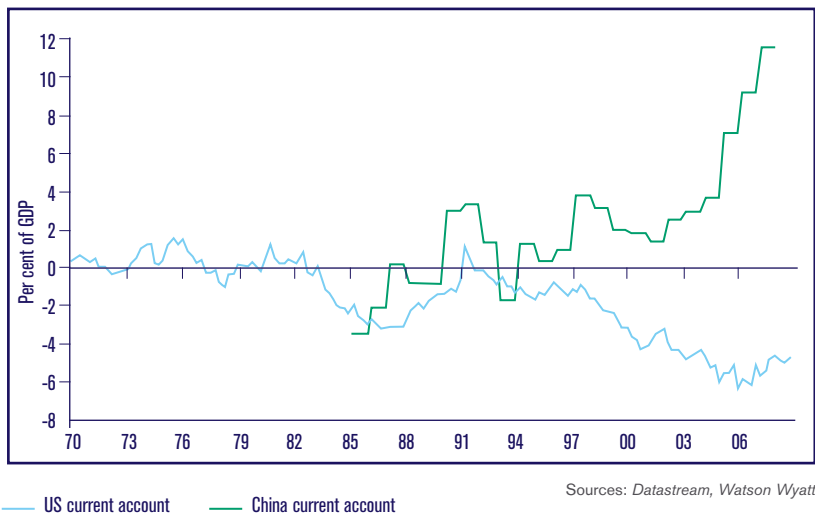


Figure 2 | Bank balance sheets expanded sharply in the last 10 years

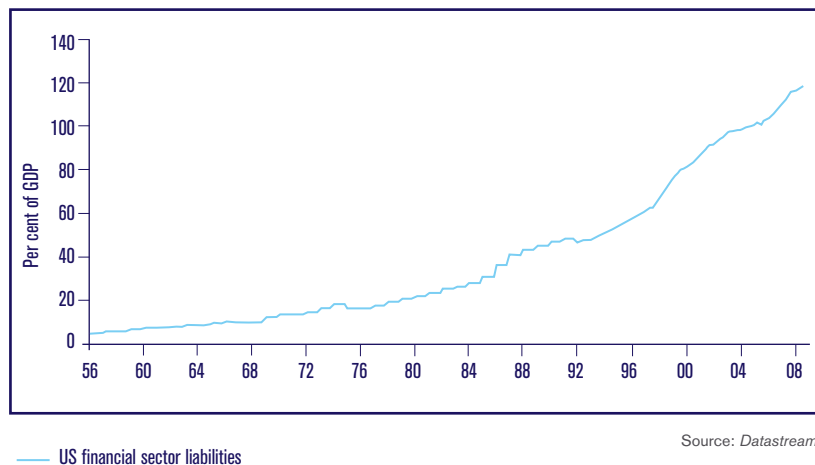




Figure 3 | Aggregate debt burdens in the US economy are too large relative to output, incomes and net worth

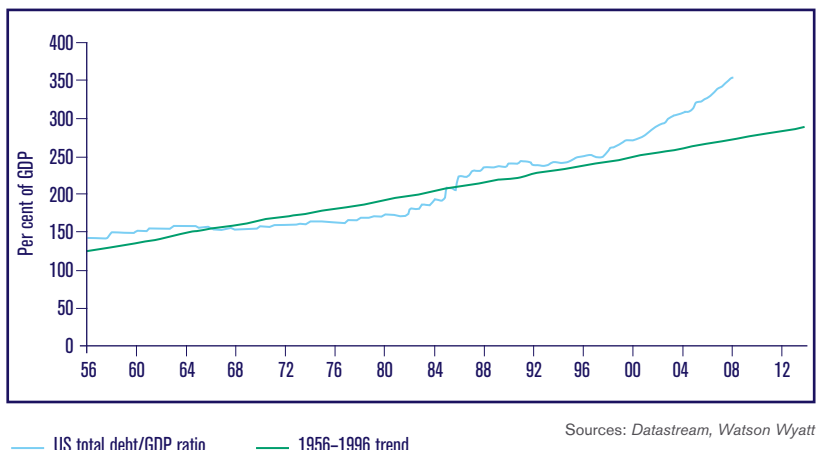


Figure 4 | Savings rates are too low and need to adjust to long-term norms



However, market participants continue to reduce leverage to conserve capital and reduce balance sheet usage. This is creating different market prices for cash and synthetic economic exposure, for example, cash investment grade bonds versus credit default swaps. This means that in bond markets there is a high yield premium for buying physical exposures whether corporate bonds or government debt. This premium for liquidity is typically elevated in uncertain times, but is especially high at the moment given global, economy-wide deleveraging dynamics. As a result, we believe there are attractive risk-reward opportunities in the area of credit.

A new financial landscape

The structural financial landscape altered dramatically in 2008, especially where investment banks are concerned. The process of financial deleveraging has had significant implications for the macroeconomy, the operation of capital markets, regulation and investment.

The US continues to suffer from a balance of payments problem and excessive consumer debt. The dislocation in financial markets is acute and uncertainty is high over how well the world economy will cope. Recent market events are the outcome of structural debt problems and will not be quickly fixed. Therefore, while various risk premia have risen, genuinely long

time horizons may be needed to benefit from some of them.

At the 'big picture' level, the cause-effect linkages are complex and it is hard to know which assets will be the main beneficiaries.

However, there is a high premium for liquidity in uncertain times and this is especially true at the moment, as market participants are forced to delever and deal with assets that are difficult to price and difficult to sell.

Recent significant events in economies and financial markets are the result of the unwinding of structural imbalances. Policy actions have been significant, but there is extreme uncertainty as to how the impact of these initiatives will play out.

Investors need to consider how they will deal with the possibility of extreme outcomes in a time of elevated uncertainty – 'regime change' thinking and understanding on a deterministic basis the impact of extreme outcomes would be a good place to start to determine investment strategy. Having said that, the current dislocation in markets is providing some interesting opportunities for investors with capital and long time horizons.

