



VIEWPOINT

Newsflash

A new month and the 57th issue of Viewpoint from FP.

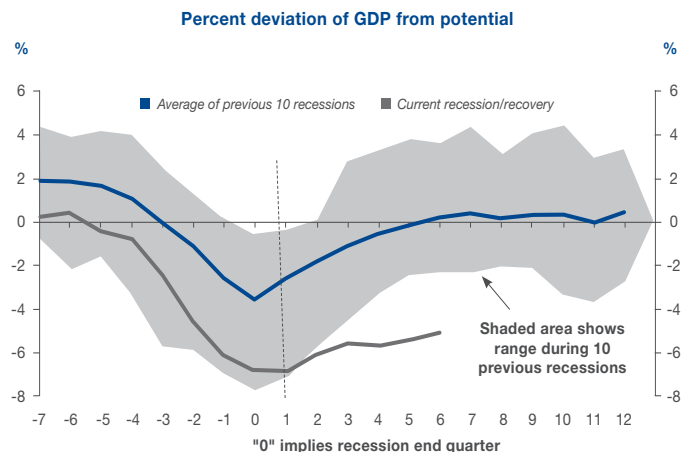
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The global economic recovery from the 2008/09 recession has been disappointing thus far. Recoveries following financial crises tend to be uneven and slow, and this recovery has proven no exception in this regard. It has been a case of two steps forward, one step back since the world officially returned to growth in 2009. Where the current recovery (specifically in the United States) shows a marked difference from those gone before is in its magnitude: the expected recovery following an output gap (the difference between current and potential GDP) of around 7% would typically be in the order of 6% growth per annum in the two subsequent years. The actual recovery has been much more muted; coming in at less than half this expectation. The chart below shows the margin by which the current recovery lags the typical path set by the last ten recessions.



Source: BLS, CBO, DB Global Markets Research

To exacerbate this situation employment has not recovered to anything close to its pre-recession levels, and the output gap remains around 6% of GDP. What is also of concern is that every time the year on year growth in the U.S. economy has fallen below 2% a recession has soon followed; the consensus forecast for year-on-year growth to the end of June currently stands at 2.4%. The Institute of Supply Management (ISM) index paints a comparable picture: since 1950 the ISM has broken through 53.5 (as it did in May) 27 times. In nearly four out of five instances it then receded to below 50 (i.e. the economy contracted) within half a year.

All may not be as dire as the latest economic data releases suggest. The light(s) at the end of the tunnel include a softening in oil prices and the recovery of the Japanese supply chain following the earthquake in March (which shaved at least 0.5% of US GDP growth in the second quarter). Although deleveraging is a multi-year process and still ongoing, its current pace has slowed which has the potential to increase consumer spending down the line. Unemployment levels, whilst still hovering at uncomfortably high levels in the United States and United Kingdom, have shown signs of improvement on a global level. Most of Asia and parts of Europe (Germany in particular) are enjoying very strong economic growth and fairly high employment levels compared to history. Another factor that warrants some confidence in the future path of the recovery is the fact that most of the fiscal constraints, which have been announced by various governments around the world, will in all likelihood be implemented later and in smaller magnitude than originally intended. This will have a positive knock-on effect on public sector spending and subsequently the strength of the economy.

The second big worry that investors may have, aside from the health of the U.S. economy, is the unfolding European government debt drama. There have been many meetings between various European policymakers, but a decisive rescue plan is still lacking. It has been a slow process getting weaker economies (Greece et al) to agree to and implement fiscal austerity measures, before the rescuers (mainly Germany) agree to mop up more of the mess. Until

a likely outcome emerges market participants will continue to fluctuate between bouts of extreme pessimism (default is imminent) and cautious optimism (all's well that ends well). As the (paraphrased) Chinese saying goes: in danger [risk] lies opportunity. On the topic of risk, the final major concern that has global investors scratching their heads is whether the brakes that Chinese policymakers are applying to their economy is sending it into a hard landing or are merely the prelude to an elegant slowdown. The former seems unlikely given the low probability of a U.S. style banking crisis, and their net government debt is close to zero (50% debt to GDP ratio is offset by USD 3 trillion in foreign reserves).

Market performance in the near future will therefore likely depend on whether (i) the most recent (negative) economic surprises prove to be temporary, (ii) the debt crisis in Europe is contained to its periphery, and (iii) the Chinese economy is managed so as to merely pause for breath instead of spiralling into a crash landing.

News flow in June centred on two significant events in Greece. The first was the survival of the current government in a vote of no confidence. The second, coming barely a week later, was parliament's ratification of a five year austerity budget – a necessary condition of the impending second round of bailout packages. On the other side of the Atlantic Ocean, the United States' second bout of Quantitative Easing, or QE2, came to an end on the last day of the month. Although this event was not a surprise for the markets, it was interesting to observe the lack of fanfare that accompanied the end of this latest round of government spending. The withdrawal of the initial bout of QE preceded a market slump which was seemingly reversed by the advent of QE2. Finally Christine Lagarde was appointed head of the IMF, providing a degree of stability to an institution of significant importance in the ongoing European Sovereign crisis.

Equity market performance in June reflected the disappointing economic news, as the MSCI World index dipped by nearly 6% before a strong final two weeks of the month helped it to a return of -1.6%. Year to date emerging markets have

underperformed largely due to higher valuations in the second half of last year, but June saw these markets perform in line with their developed counterparts with a return of 1.5%. Pockets of the bond markets demonstrated strength as risk aversion increased, with investors willing to forego the potential for anything other than muted capital gains in the long term in order to bolster their capital preservation potential. The JP Morgan Global Government Bond index returned 0.2% and the Citigroup Broad Investment Grade index 0.1%. Broad commodities were weaker (-6.0%) with gold holding up somewhat better as it dropped by only 2.0% for the month. The yellow metal's price is still 6.7% higher year to date, illustrating investors' demand for this perceived safe haven asset in times of turmoil.

Finally in the currency markets, the U.S. Dollar was broadly weaker against the other major currencies, with the exception of Sterling which gave up around 2.5% against the greenback. The weakness in the British currency follows the dovish stance that the Bank of England's monetary policy committee seems to have taken.

As we move into the second half of the year there are reasons for optimism and others for concern regarding the strength of the global economy. In the absence of a plan B, the persistence of the current economic malaise may be hard to arrest, which would not augur well for markets. Volatility can be expected; it will of course throw up opportunities at the same time.

Asset Class Performances

Asset Class/Region	Index	Currency	To 30 th June 2011	
			Month %	Year to date %
Equities				
United States	S&P 500 NR	USD	-1.7	5.7
United Kingdom	FTSE All Share TR	GBP	-0.5	3.0
Continental Europe	MSCI Europe ex UK NR	EUR	-2.3	2.5
Japan	Topix TR	JPY	1.4	-4.4
Asia Pacific (ex Japan)	MSCI AC Asia Pacific (ex Japan) TR	AUD	-2.3	3.0
Global	MSCI World NR	USD	-1.6	5.3
Global Emerging Markets	MSCI World Emerging Markets TR	USD	-1.5	0.9
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-0.3	2.3
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.8	5.8
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	-0.9	3.2
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	-1.0	5.0
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-0.7	1.7
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	-1.1	2.9
Euro Government Bonds	Citigroup EMU GBI TR	EUR	-0.4	0.0
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-0.4	1.5
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	-1.6	4.8
Australian Government	JP Morgan Japan Government Bond Index TR	AUD	0.4	0.6
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.7	4.4
Global Government Bonds	JP Morgan Global GBI	USD	0.2	3.9
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.1	4.4
Global Convertible Bonds	UBS Global Convertible Bond	USD	-1.2	4.7
Global Emerging Market Bonds		USD	1.3	5.0

Asset Class/Region	Index	Currency	To 30 th June 2011	
			Month %	Year to date %
Property				
US Property securities	MSCI US REIT TR	USD	-3.4	9.7
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	1.0	16.3
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	-1.8	7.5
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	-2.8	-5.0
Australian Property securities	FTSE EPRA/NAREIT Australia TR	AUD	-0.4	7.4
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	-2.5	6.1
Currencies				
Euro		USD	0.9	8.1
Sterling		USD	-2.5	2.5
Yen		USD	0.6	0.4
Australian Dollar		USD	0.5	4.4
Rand		USD	0.7	-2.4
Commodities				
Commodities	RICI TR	USD	-6.0	0.8
Agricultural Commodities	RICI Agriculture TR	USD	-8.3	-6.9
Oil	ICE Crude Oil CR	USD	-3.4	18.5
Gold	Gold index	USD	-2.0	6.7
Interest rates				
	Last meeting		Current rate	Change at meeting
United States	22 June 2011	USD	0.25%	-
United Kingdom	7 July 2011	GBP	0.50%	-
Eurozone	7 July 2011	EUR	1.50%	+0.25%
Japan	12 July 2011	JPY	0.10%	-
Australia	5 July 2011	AUD	4.75%	-
South Africa	12 May 2011	ZAR	5.50%	-

Focus: does diversification work?

A core tenet to multi asset investing is the fact that, through the cycle, there is a benefit derived from diversification of a portfolio away from single, idiosyncratic, risks. By combining imperfectly correlated assets an investor may achieve superior returns: either elevated returns for a particular risk budget or reduced riskiness for a particular realised return.

The potential for diversification is regularly expressed through correlation coefficients. Correlation is a useful measure in that it shows the tendency of two data sets to move together i.e. it expresses the degree to which there is a 'linear relationship' between the two variables. Correlation coefficients are bounded by ± 1 , with +1 representing perfect positive correlation, -1 perfect negative correlation and 0 no correlation whatsoever.

During the recent financial crisis a regularly cited issue was that diversification had 'failed'. The reasoning behind this assertion is that assets that were supposed to be lowly or negatively correlated in fact demonstrated a degree of positive correlation. The data below shows that this was not necessarily true. In reality asset managers did not have sufficient holdings in the asset classes that would have provided diversification benefit (in particular government bonds).

Focus has undertaken to show how correlation between a number of different asset classes has changed over time. The indices used to demonstrate these patterns are:

- US Equities
- US Treasuries
- Commodities

US indices were chosen because they are well diversified and the returns are not affected by currency translation effects. Had more asset classes been included in the analysis, the period over which returns data is available for comparison would have been shortened due to limited available time series.

The following graphs show the rolling 52 week correlation between each pair of these three asset classes, meaning that there are three different data sets included in total. Chart 1.

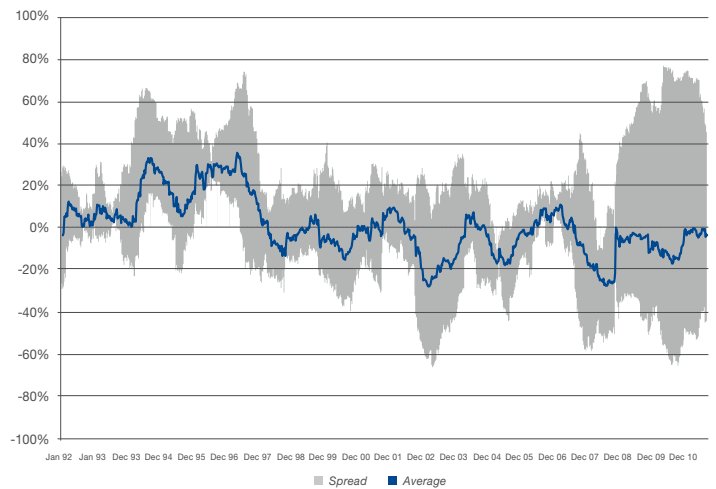


Chart 1. Maximum and minimum correlation spread
Source: Bloomberg

shows that the spread between the maximum (lowest source of diversification benefit) and minimum (highest source of diversification benefit) will vary over time. That is to say that there are periods where there are large dispersions in the levels of correlation between pairs of assets, whilst in others all correlations are fairly consistent. According to Chart 1. there appear to be two particularly interesting periods during the past decade. The first is in 2005 - 2006, where none of the asset classes included in the analysis demonstrated any meaningful degree of correlation; neither positive nor negative. During this period the results suggest that the returns patterns from the three asset classes bore no relation to each other (bounded by approximately ± 0.2). The opposite may be seen in the 'post Lehman' period. Here the maximum and minimum correlations became highly polarised, meaning that the opportunity to use negatively correlated assets to enhance the efficiency of returns increased, as did the potential for inadvertently using highly correlated assets as an ineffective 'hedge'. Diversification did not breakdown but rather asset allocation, if anything, became an even more crucial facet of the portfolio construction process as the chances of inadvertently picking highly correlated asset classes increased. Making incorrect asset allocation calls post Lehman could have resulted in the concentration of risks in what became, in essence, an increasingly binary market. Another point to observe is that the simple average of the three pairs does not deviate far from zero, and is unrelated to the size of the range between the maximum and minimum correlations. As

such the aforementioned benefits of diversification, which exist in lowly related returns streams, have been available to investors throughout the period shown. The table below contains the maximum and minimum range data. The narrowest spread is a mere 5.6% and the maximum is nearly 140%, nearly 25 times larger than the former.

	MAX	MIN	AVG	SPREAD
02/07/10	73.4%	-65.6%	-16.5%	139.0%
23/07/93	6.4%	0.8%	3.1%	5.6%

Chart 2. attempts to elicit the detail beneath the simple distribution of correlations in Chart 1.

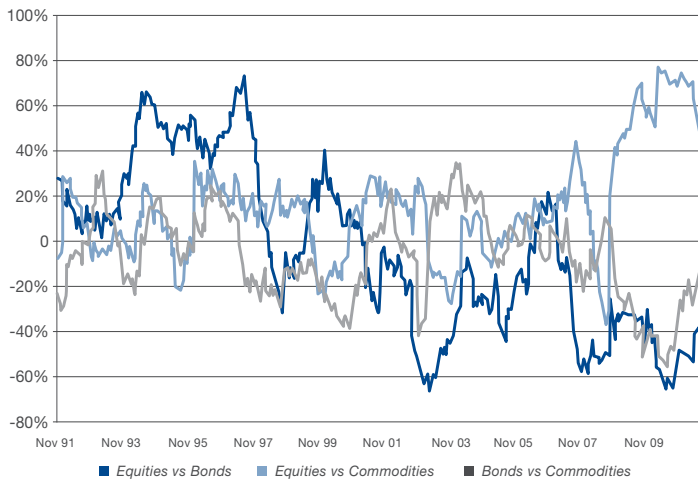


Chart 2 Correlation pairings through time
Source: Bloomberg

The rolling 52 week correlation between equities and bonds has twice recently moved to significant lows, suggesting that equities and bonds have tended to move in opposing directions over the last three years. Intuitively this is correct: bonds have indeed rallied whilst equities have sold off. Although this relationship is consistently negative, it rarely strays as low as has been observed over the preceding three years to date and even then rarely below -50% correlation. Another notable relationship to emerge post the financial crisis is the high correlation between equities and commodities. Historically these two data series have not demonstrated any consistent relationship, but in the years 2009 and 2010 the correlation of this pair has remained stubbornly above +50%. The high correlation between equities and the commodity

markets is further corroborated by their comparably negative correlations with bonds. These two pairs (equity vs. bonds and commodities vs. bonds) have followed very similar paths in the post financial crisis world.

Interpreting these results reveals that investors should avoid being overly reliant on 'old' or 'stale' correlation data: adding commodities to a portfolio of equities as a diversifier is less suitable presently than in the past given prevailing trends. Commodities and equities are currently beholden to similar factors, implying that far from a diversification tool the use of commodities may actually mean the 'doubling up' of the same bet.

This research demonstrates the potential dangers in referring to correlation pairings as constants; no single number is able to adequately express the dynamics of the relationship between asset classes. It is patently clear from this data that correlations are not static. They ebb and flow through time as different market conditions tend to make different asset classes more or less responsive to the same prevailing conditions. The fact that correlations between asset classes are variable is an important consideration for active managers. Asset allocators should aim not only to look at expected risks and returns of different asset classes when constructing portfolios, but also at how individual holdings are likely to be similar – or different – to the other elements within the portfolio.

The picture becomes somewhat muddled if more asset classes are introduced to the research. Chart 3. (overleaf) displays the maximum, minimum and average correlations for the enlarged group of asset classes over a necessarily truncated period of time. The asset classes included are:

- Global equities
- Global emerging markets
- Global government fixed Income
- Global investment grade bonds
- High yield bonds
- Emerging markets debt
- Hedge funds
- Commodities

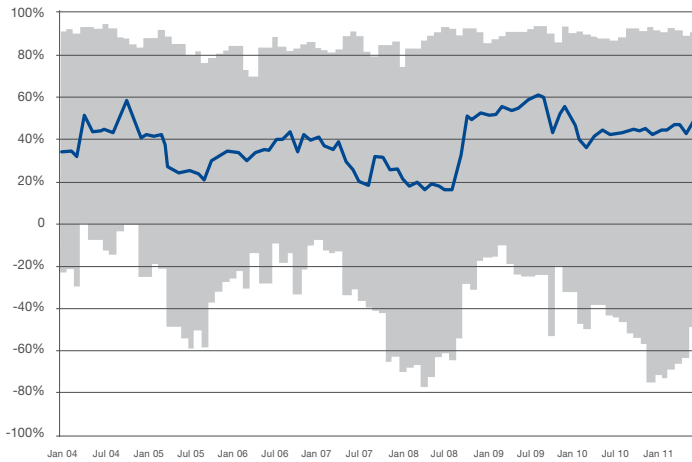


Chart 3 Maximum and minimum correlation spread
Source: Bloomberg

The upper bound of the potential correlation pairs increases, whilst the downside of the distribution also has lower troughs. During the period in question the asset classes added have tended to be more highly positively correlated than negatively correlated. As a result the average line shows an increase of the correlation pairs, in aggregate, to almost 40%. Comparing this data with the previous set is not without difficulties however; for example, the latter set has a higher degree of currency effects to be borne in mind, although a domestic currency based investor (in this instance US Dollar) will experience these translation effects as a component of performance and would therefore be interested in the data. The enlarged cohort demonstrates that increasing the investable universe is not, in and of itself, a panacea with respect to diversification benefits. These additional 'asset classes' may not in fact provide the distinct return characteristics that investors are looking for.

Finally, the volatility in these new correlations is also worth considering. Chart 4. demonstrates the five most volatile pairings over the new time period. The variation of the simple correlation coefficient within these sets is remarkable and again highlights the need for investors to not rely on a single historical correlation statistic to construct portfolios. These time series demonstrate the extremes through which correlations may change through time, providing diversification enhancements at some points and reductions in others.

Correlation alone does not provide a complete insight into diversification benefit, it ignores volatility for example, but it is a useful tool for understanding the co-movement of pairs of asset classes. The data suggests that active management of asset allocation is imperative if investors are to avoid falling into these traps as market conditions change. In summary, diversification does work, but it needs to be managed.

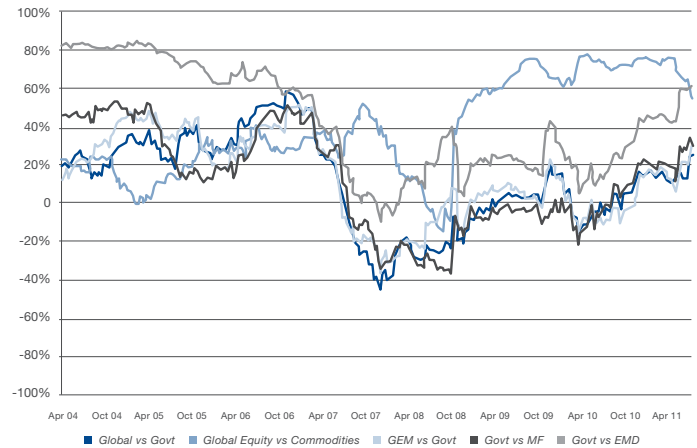


Chart 4 Correlation pairings through time
Source: Bloomberg

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