October 2012

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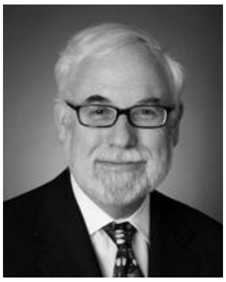


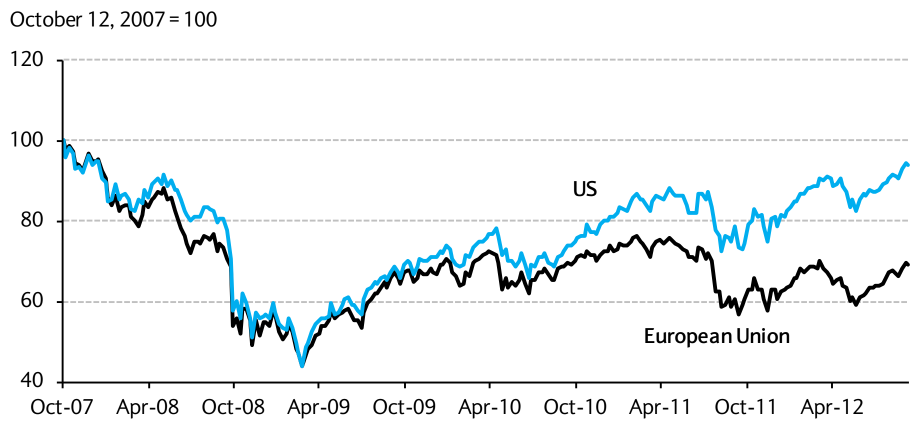
Aaron S. Gurwitz
Chief Investment Officer

American (central bank) exceptionalism

Dear clients and colleagues:

Moves on major global equity markets remain highly correlated; they all tend to move up or down synchronously. But this doesn't mean that returns have been similar across the various market groups. In fact, as the figure below indicates, despite some recent catching up, the US market has done far better than Europe over the past three years. The path of least resistance in the US has been upward; prices tend to rise during periods when investors get no unambiguously bad news. The path of least resistance for European stocks seems to be meandering for the present.

Figure 1: Post peak equity market performance



Source: MSCI Local Currency Indexes via Bloomberg

Why is this happening?

It is not because the US economy has recently been performing much better than the European economy. Second-quarter 2012 real GDP growth in the US was 1.8 percentage points higher than in the euro zone. That outperformance isn't materially different from the average over the past decade: US GDP grew at an average annual rate of 1.42 percentage points faster than euro zone GDP. Unemployment in the euro zone has increased recently, while in the US it has held steady at an elevated level. But that hasn't changed the relative rates much. US unemployment is currently 2.30 percentage points lower than the euro zone rate. The 10-year average is 2.17 percentage points lower.

Nor do differences in listed companies' earnings performance explain the wide disparity. Through 2011 earnings for the S&P 500 Index grew by 15.9%. For the Bloomberg European 500 Index, the growth rate over the same period was 22.2%.

Nor can we attribute the performance differential to the euro zone sovereign debt crisis. To be sure, Europe is grappling with complex economic, fiscal and political challenges. But so is the US, as it approaches a fiscal cliff in a political environment of extreme partisanship. And the US is more indebted than the euro zone; general government net financial liabilities total about 80% of US GDP compared to 63% for the euro zone.

I believe that what accounts for most of the difference between the US and European stock markets performance is the fact that the Federal Reserve has been much more aggressive in its monetary policy than the European Central Bank (ECB). The Fed has now initiated *three rounds* of quantitative easing and has communicated its intention to err on the side of keeping rates too low for too long after the economic recovery starts to accelerate. The ECB, by contrast, has been much more cautious—despite the fact that it is dealing with both a sovereign debt crisis *and* an economic recession. The comparatively greater caution is in part because the two central banks have different mandates: The ECB is responsible only for price stability, while the Fed's responsibility is to keep both unemployment and inflation low.

We should expect that at some point European equities will reverse their relative underperformance. This could occur in the context of a sharp sell-off in the US market, but barring extreme post-election political gridlock, we do not anticipate that. More likely, the adjustment will take the form of a vigorous rally in European equities.

When will this happen? Any near-term turn-around would have to follow a decisive shift of ECB monetary policy into a higher gear. ECB President Mario Draghi has signalled his willingness to do "whatever it takes" to preserve the currency union. That seems like a necessary condition for a rally, and indeed European equities have started to recoup some of their lost ground. A sufficient condition might be an indication that European policymakers will *also* do what it takes to foster a robust economic recovery. Is that likely to happen soon? Probably not. So, an overweight in lagging European stocks relative to the US doesn't seem appropriate right now. Could it happen sooner than anyone expects? Yes, because a more aggressive growth policy might be the only way to keep the currency zone together. Therefore, avoiding European stocks *altogether* while concentrating developed market equity risk *solely* in US equities—a tack many investors seem to have taken recently—is probably a mistake.

Sincerely yours,

Aaron S. Gurwitz
Chief Investment Officer

With a little help from our friends

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Policymakers have probably reduced investment risk a little further in the last month, and the long-awaited tactical setback for stocks could be more muted than we'd thought. Strategically, we continue strongly to prefer stocks to bonds, and corporate to government securities.

The business cycle, the US fiscal cliff, and the fate of the euro are still the biggest uncertainties facing investors. The latest actions by the Fed and the ECB may provide some further implicit portfolio insurance against all three. We still think capital markets are pricing in outcomes that are too pessimistic, despite the further rally in stocks in the last month: stocks continue to look inexpensive, and the investors we meet are anything but 'complacent' about growth and the euro.

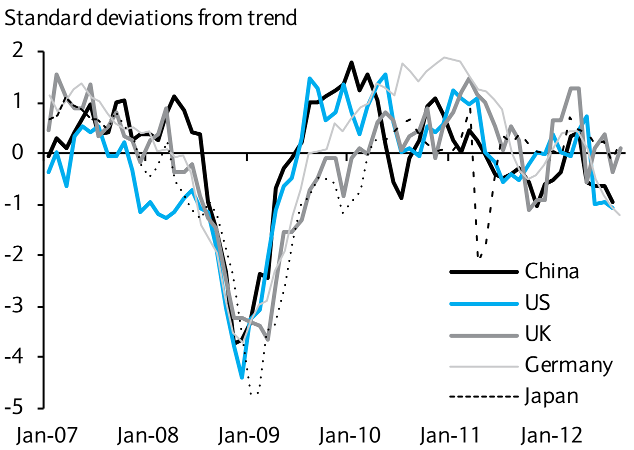
Growth: still a pause, not a reversal

The most closely-watched business surveys (Figure 1) are continuing to point to below-trend economic growth, but have not weakened decisively further in the last month. Indeed, some components seem to be pointing to a tentative stabilisation.

We think this sub-par growth largely reflects a response to the macro uncertainties posed in recent months by (for example) the ongoing euro crisis and the political stalemate – and approaching 'fiscal cliff' – in the US, and not a new cyclical downswing.

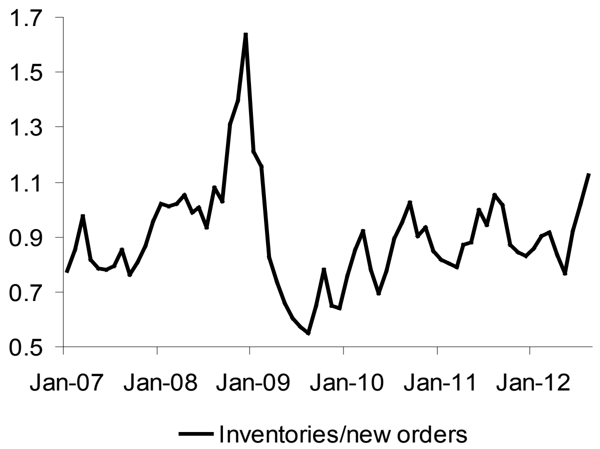
With the exception of the unwanted inventories (Figure 2) that have built up as part of this response, there are few recent excesses needing to be purged in the global economy currently. Nor is policy likely to tip the world into a more severe downturn: fiscal austerity in Europe is a constraint on growth, but not one that has tightened materially in the larger countries in recent months, while monetary policy is supportive on both sides of the Atlantic (and becoming more so in Asia).

Figure 1: Selected forward-looking business surveys: standard deviations from trend



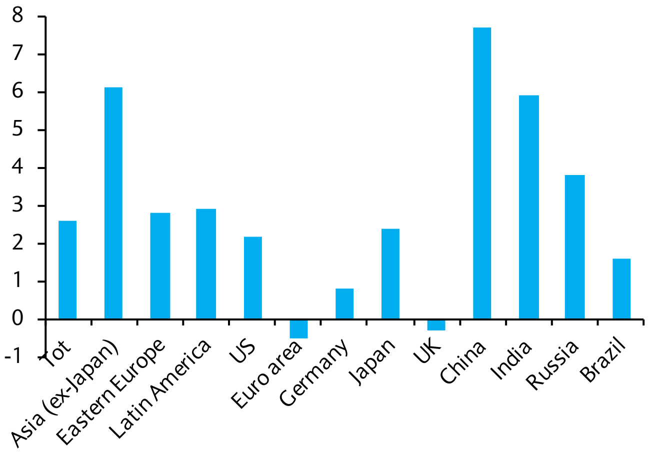
Source: Datastream, Bloomberg, Barclays Research

Figure 2: US manufacturers' inventories have risen relative to new orders (ratio of survey responses)



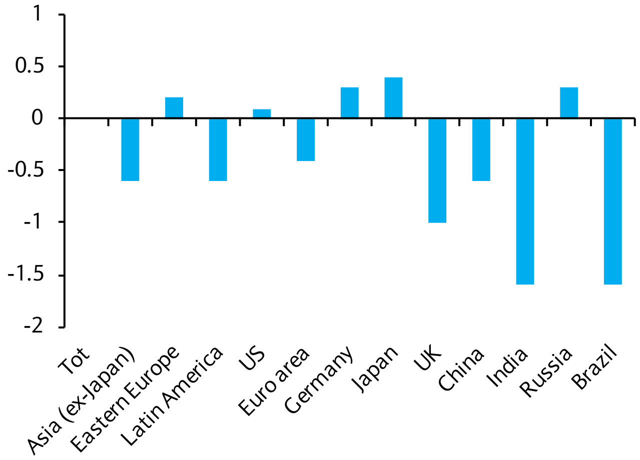
Source: ISM, Datastream, Barclays Research

Figure 3: Consensus 2012 GDP growth forecasts (%)



Source: Consensus Economics, Barclays Research

Figure 4: Changes in Consensus since Dec 2011 (%)



Source: Consensus Economics, Barclays Research

Euro crisis and US fiscal cliff notwithstanding, the biggest downgrades to growth in 2012 to date have in fact come from the emerging world, in particular from Asia and Latin America. Of course, trend growth rates there are much higher to start with, but proportionately the downgrades have still been significant. This reminds us that talk of 'decoupling' of the emerging world is premature, because the export-driven nature of many of these downgrades is telling us that when the US sneezes, the rest of the world still catches cold.

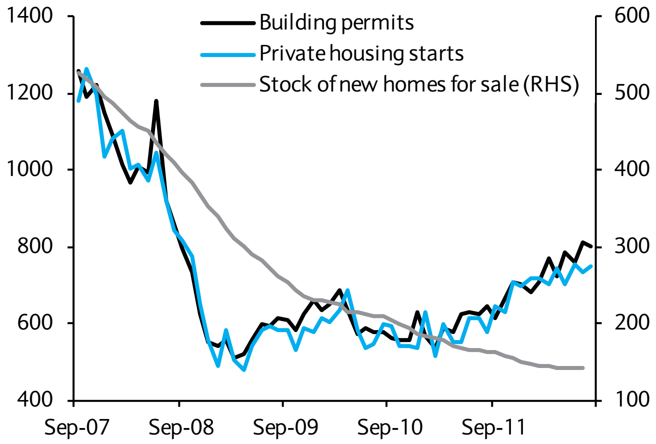
We think US consumers in particular will surprise markets with their resumed resilience in the months ahead, just as they have in the last two 'double dip' debates that were triggered by slowdowns in 2010 and 2011, and if we are right this will help place a floor under global growth expectations. We have written often here about our view of the US consumer's balance sheet: we think the widespread belief that it needs to be comprehensively deleveraged is wide of the mark, and the modest deleveraging that we expect – and which seems to be playing out – is not sufficient to prevent some ongoing growth in spending.

Indeed, there are signs that US households are beginning to move back into the housing market, where (as we'd expected) a tentative recovery is looking steadily more convincing. A stronger housing market raises the possibility of a virtuous circle for consumer finances and confidence, and underpins much of our positive strategic view on risk assets, as well as more specific tactical calls on (for example) US banks and consumer discretionary stocks.

The Fed's latest wave of 'quantitative easing', QE3, may help this process, particularly since it is focused on agency Mortgage Backed Securities rather than Treasuries. However, as we saw it the housing market was turning already, and QE3 is likely more of a financial event than an economic one – we view it as providing further portfolio insurance rather than a jump-start for growth (more on this below).

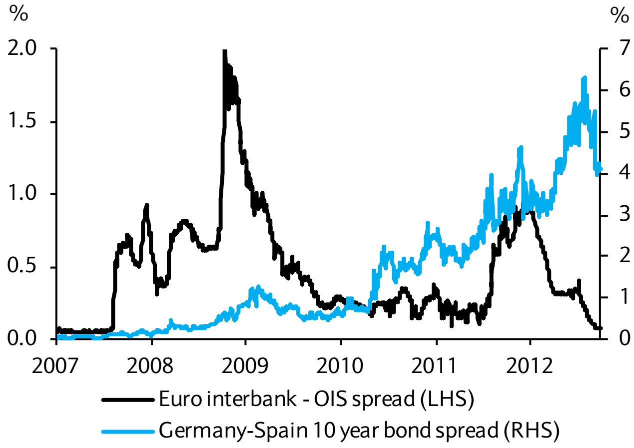
If US consumer spending continues to hold up, supported by residential and business investment, then the emerging world may see a sizeable portion of its exports stabilise and eventually revive – particularly in Asia. In terms of investment opportunities, however, we think the most straightforward way of playing this theme for the time being may be to continue to focus on the developed world first – despite the emerging downgrades in 2012, the developed world is where investors' expectations are still lowest, and so easiest to beat.

Figure 5: US housing market is recovering (000s)



Source: Barclays Research, Datastream

Figure 6: Euro area crisis – ECB kept a lid on interbank tension even as Spanish bond spreads rose



Source: Barclays Research, Bloomberg

Figure 7: Real GDP and Consumer Prices (% y-o-y)

	Real GDP			Consumer Prices		
	2011	2012E	2013F	2011	2012E	2013F
Global	3.8	3.1	3.5	3.9	3.0	3.2
Developed	1.3	1.3	1.3	2.6	1.9	1.9
Emerging	6.5	5.1	5.6	6.3	4.8	5.3
US	1.8	2.3	2.0	3.2	2.2	2.3
Euro area	1.5	-0.5	0.3	2.7	2.5	1.9
Japan	-0.8	2.1	0.9	-0.3	0.0	0.2
United Kingdom	0.8	-0.4	1.3	4.5	2.8	2.7
China	9.2	7.5	7.6	5.4	2.9	4.0
Brazil	2.7	1.5	4.1	6.6	5.3	5.6
India	7.4	5.4	6.7	9.5	7.7	7.1
Russia	4.3	3.9	3.6	8.6	5.1	6.5

Source: Barclays Research, *Global Economics Weekly*, 21 Sep 2012
Note: Weights used for real GDP are based on IMF PPP-based GDP (5yr centered moving averages). Weights used for consumer prices are based on IMF nominal GDP (5yr centered moving averages).

Figure 8: Central Bank Policy Rates (%)

	Central Bank Rates				
	Current	3Q 12	4Q 12	1Q 13	2Q 13
Fed funds rate	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
ECB main refinancing rate	0.75	0.75	0.50	0.50	0.50
BoJ overnight rate	0.10	0-0.10	0-0.10	0-0.10	0-0.10
BOE bank rate	0.50	0.50	0.25	0.25	0.25
China: Working capital rate	6.00	6.00	5.75	5.75	5.75
Brazil: SELIC rate	7.50	7.50	7.25	7.25	7.25
India: Repo rate	8.00	8.00	8.00	7.50	7.00
Russia: Overnight repo rate	5.50	5.50	5.75	5.75	5.75

Source: Barclays Research, *Global Economics Weekly*, 21 Sep 2012
Note: Rates as of market close 20 September 2012.

The euro: the ECB lends a hand (again)

The ECB continues to play a leading role in offering the financial backstops that will buy more time for the politicians to slowly put in place the needed fiscal and structural reforms.

We won't pretend that we foresaw precisely the shape of the 'Outright Monetary Transactions' (OMT) programme announced in early September when we first adopted our 'muddle through' scenario almost two years back, but it is exactly the sort of innovative, large-scale intervention that we thought the ECB capable of making. In conditionally offering to buy potentially unlimited amounts of short-dated bonds, albeit in sterilised form, ECB President Draghi may have effectively followed through with his promise to do whatever is necessary to save the euro.

We say "may" have, because it is still not clear whether the ECB's support will be triggered. That requires a formal request for assistance from the current bail-out fund the EFSF (or its imminent successor, the ESM) by a troubled member government, and such assistance will in turn be conditional upon the government concerned adopting an externally-invigilated adjustment programme. But of course, if the ECB promise is credible enough, investors may not push troubled governments to apply. As we write, the Spanish government is poised to deliver its latest budget, and this could pave the way for a formal request for help from the EFSF in early October. But it is the credibility of the ECB's promise, not its formal implementation, that matters most.

Meanwhile, another potential obstacle to euro integration was smoothed by the German Constitutional Court's ruling that the ESM and the fiscal pact would not be unconstitutional, though their judgement was, as expected, a qualified one. And the latest reports on the troika's ongoing review of the situation in Greece suggest that some further loosening of the conditionality attaching to its bail-out may after all be forthcoming. Whether it is or not, we doubt that Greece now threatens the wider markets with more than some renewed short-term volatility, though again we would rather not find out (we still think Greece will remain a euro member, but it remains too close to call confidently).

The net result of the ECB's announcements to date has been a continuing reduction in liquidity tensions in the interbank market, and a marked narrowing of the Spanish/German bond yield spread (Figure 6). The experience of the last two years tells us that it would be foolhardy to suggest that market sentiment has definitively turned a corner, but we do think that further progress has again been made.

Investment conclusions: tactics and strategy

Stock markets rallied further in September, and the developed bloc has been flirting with the post-Lehman highs seen in early 2011 (the US market has already hit a new one). Returns of around 15% on developed equities look big, and are above the long-term annualised expectations built into our strategic assumptions. Is it too late to buy?

There are certainly plenty of risks out there, with a lacklustre business cycle, unresolved euro issues and the US fiscal cliff to contend with, as noted above. Moreover, geopolitical risk has become a renewed concern in the last month, albeit a secondary one: the simmering tensions in the Gulf, and around the Senkaku/Diaoyu islands in the East China Sea, both have the capacity to unsettle risk appetite, and in the former case, to push crude oil prices higher.

Advice tailored to individual financial circumstances and personalities is a cornerstone of our Investment Philosophy. But for investors with moderate risk appetite (our Risk Level 3), and able to take a view beyond the next few months, this could still be an attractive long-term entry point. Market indices may be approaching levels last seen in 2007/8, but valuations are generally not – even allowing for likely further downgrades by analysts – and the balance of risks is more even than it was then (not least because US bank balance sheets are not loaded with the complex, toxic exposures that were there in 2007/8: the risk of similar write-offs now is smaller).

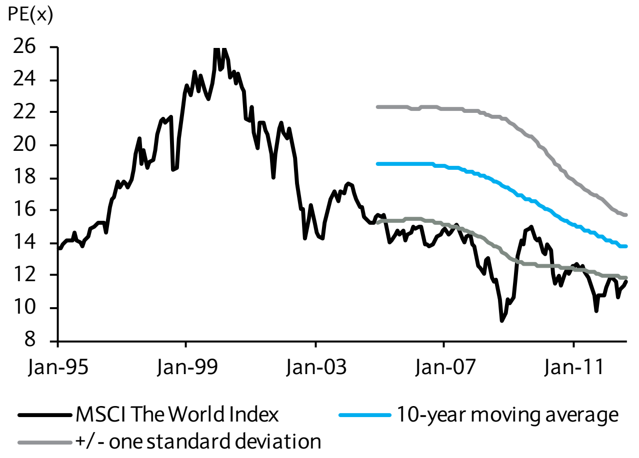
Indeed, the balance of risks is more evenly balanced than it was back in late May, when our Tactical Allocation Committee moved to a short-term underweight stance on developed equities. As noted, there have been some positive developments in recent months – not least the effective provision of further portfolio insurance by the big central banks – while some of the risks that seemed earlier in the summer likely to trouble markets have not materialised (a less constructive ruling from the German Constitutional Court, for example). The TAC is thus closing that underweight position, funding it from a reduced tactical overweight in cash and short-term bonds.

We have been focusing on nothing more than that 'muddle though' scenario in the last year or two. However, risks are not all tilted downwards: we can imagine a scenario in which earnings forecasts (for example) are too low, not too high. It may not be our central view, but as a possibility it at least offsets some of the remaining downside risk.

The call on government bonds, as we see it, is more straightforward: on both a strategic and tactical basis we remain wary, as they look fiercely expensive unless inflation and/or growth falls significantly short even of current downbeat consensus forecasts. Investment grade credit is also expensive, but we prefer it to government bonds because if we are right about corporate finances being in rude health, spreads will likely fall further, muting any capital loss, when/if underlying government bond yields rise.

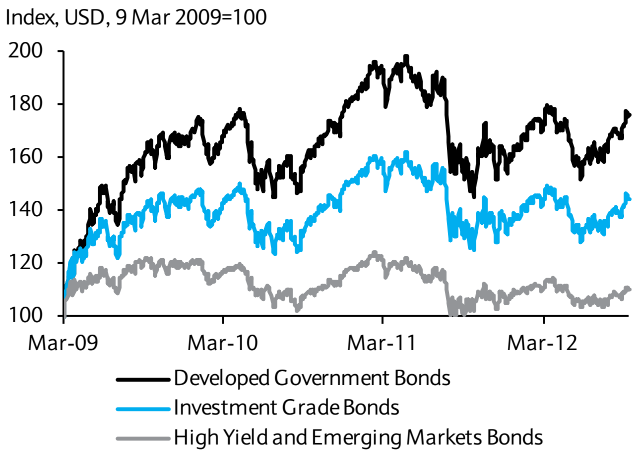
High yield credit and emerging market bonds, our favoured risk asset tactically, is running out of headroom. Its yield is still attractive, and we stay overweight for that reason, but we see little chance of further significant capital gain from here. In 2012 to date, it has been one of the best-performing asset classes, particularly on a risk-adjusted basis, and has almost matched stocks in absolute terms since the low point for risk assets in March 2009. Strategically, we expect developed stocks eventually to outpace it, even on a risk-adjusted basis, as ownership risk becomes preferable to creditor status.

Figure 9: Developed equities still inexpensive: forward PE ratio



Source: MSCI, IBES, Barclays Research

Figure 10: Developed equities vs. selected bonds, March 2009 low to date, cumulative relative total return



Source: MSCI, Barclays Research

Financially repressed

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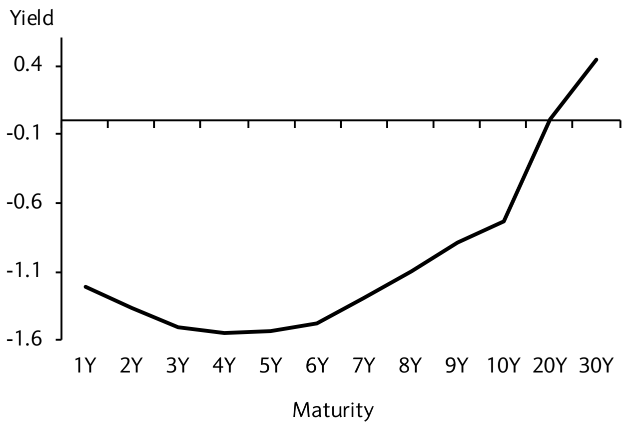
The Federal Reserve has once again put its shoulder to the wheel to get the US economy moving at a faster pace. The latest monetary confection is perhaps the central bank's most ambitious yet as it is "open ended". For those who have not been paying attention, the Fed has begun a $40-billion-per-month program of buying government agency bonds and mortgage-backed securities (MBS).[1] Accompanying this program is a pledge to keep the Federal Funds Target Rate between 0.0% and 0.25% until the middle of 2015—a full year longer than announced in the Fed's prior news release.

The impetus for this latest effort is straightforward: three years out of the Great Recession and the economy remains painfully below its potential. Growth has slowed once again, pulling down job gains and leaving unemployment woefully high. Failing to meet its full employment mandate, the central bank is this time targeting the housing market by buying mortgage-related debt, in the hope that this will help spur growth. The thinking goes like this: if money is cheap enough, someone will eventually use it and when they do, it will help generate demand, thereby increasing economic activity. Forget for a moment that money is already epically cheap. Whether this round of new money actually completes the circle by creating demand and boosting activity is another question.

It is clear with this new effort that the Fed has truly adopted a program of quasi financial repression in the service of ginning up the economy. Strictly defined, financial repression occurs when a government channels to itself funds that would normally go to the private sector.[2] A foundational feature is the deliberate maintenance of interest rates lower than where the market would set them. The current US Treasury yield curve depicts a near perfect picture of financial repression: taking into account inflation, it is negative almost entirely across the maturity spectrum. This has a dual effect. It makes mortgages cheaper in real terms, encouraging real estate buyers, and it erodes the

Repressed interest rates

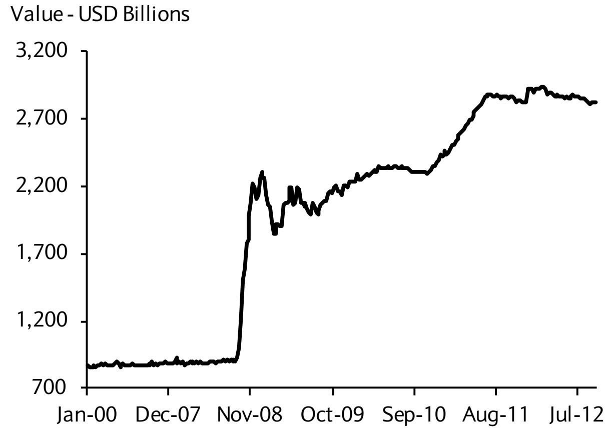
Figure 1: US Treasury inflation-indexed yield curve



Source: Bloomberg

The Fed's balance sheet

Figure 2: US Federal Reserve total assets



Source: Bloomberg

[1] Fannie Mae and Freddie Mac Mortgage-Backed Securities
[2] See Financial Repression Redux, Reinhart, Kirkegaard, Sbrancia Finance & Development June 2011

value (burden) of US government debt. It also has the potentially unintended consequence of 'crowding out' the average investor from the very assets the Fed is purchasing, forcing them along the risk spectrum into investment grade bonds, high yield debt and, ultimately, riskier investments such as equities and real assets.

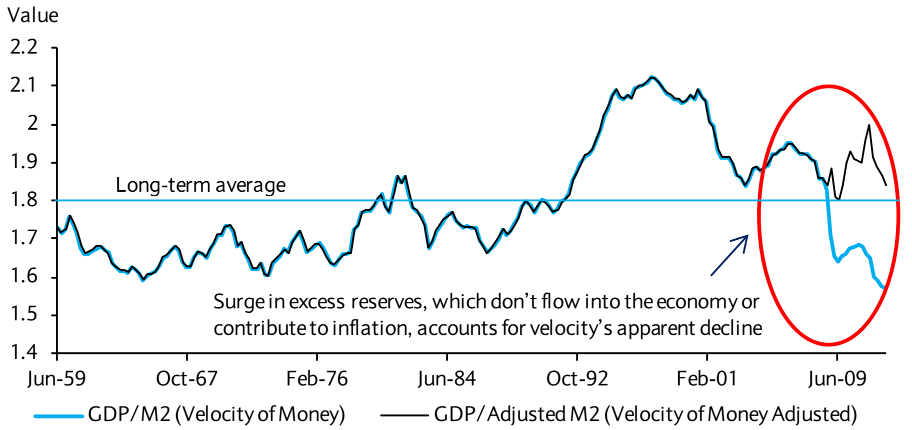
The speed of money

A rising point of interest is whether such aerobic creation of money will eventually fuel higher inflation. Such concerns are understandable. Inflation, as the saying goes, is too much money chasing too few goods and services. A veritable mountain of money has been created over the last four years; the expansion of the Federal Reserve's balance sheet is Exhibit A (see Figure 2).

Despite the growing size of the money supply, the rate at which money has been moving through the US economy (known as the velocity of money[3]) has been plummeting over the last several years. A significant driver of the below-depicted decline in velocity has been the actions of the Fed itself. While all the money the central bank has printed has entered the money supply, it was never really destined for the "real" economy. Simply put, the central bank created money to buy government and now agency debt and MBS, but the cash from these purchases ended up back on the Fed's balance sheet because the central bank pays an interest rate on these balances.[4] Consequently, there is no pressure on banks to lend this "new money."

Attempting to tease out the Fed's influence, we recomputed money velocity by stripping out these excess reserves. The result is meaningful. While velocity has declined in the past several years, it is higher than it appears with the conventionally calculated measure. Rather than being below its long-term average of 1.8, money velocity is actually *above* it.

Figure 3: Inflation? Money *is* moving more quickly than it might seem

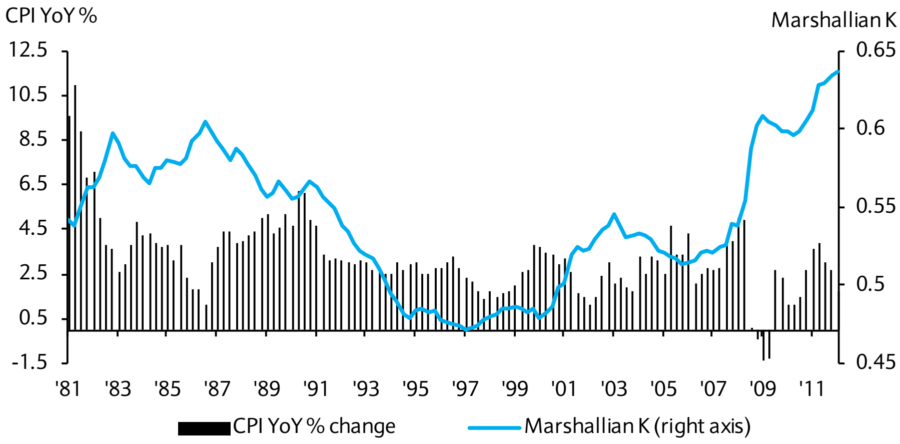


Source: Bloomberg

With that in mind, it is easy to understand the spike in inflation expectations and corresponding sell-off in long-dated Treasury securities triggered by the Fed's latest quantitative easing announcement. Though not misplaced, these concerns may be premature. Growth in the money supply in excess of growth in the economy has not necessarily forecasted an inflation tear. Looking at money supply growth relative to GDP growth (an economic term known as the Marshallian k) and comparing that to inflation in Figure 4 actually shows little correlation between the two.

[3] A measure of the rate at which money changes hands through various transactions in a given time period. Velocity of Money = Nominal GDP/Money Supply (M2).
[4] The deposit balances are "Excess Reserves," money that banks hold with the Federal Reserve above what they are required to hold under regulation.

Figure 4: Correlation between excess liquidity and inflation



Source: Bloomberg

Given the weak pace of economic growth and the interest earned on excess reserves, it is hard to see how the economy is at risk for even a bout of moderate inflation—let alone one of the Weimar flavour. However, given an economy that still has a relatively healthy turn of its money stock, investors and policymakers cannot be complacent about inflation's potential to appear as the margin of error is smaller than the numbers would suggest.

What is an investor to do?

If quantitative easing has demonstrated anything over the last several years, it has shown that such programs are a boon for asset prices if not economic activity, as investors seek compensatory return on their capital.

Developed and Emerging Equities

Equities in general have performed well during prior periods of quantitative easing. Emerging markets equities have been a stand out, garnering the highest total return of our nine asset classes during QE1 and the fourth highest return during QE2, advancing 100% and 20%, respectively. These assets benefitted not only from a rise in the prices of stocks in the countries, but also a rise in the value of their currencies.

Developed markets equities were not left far behind. The US equity market did quite well, even in the face of a weakening dollar, with large cap equities up 45% and 30% in each QE program. Non-US developed equities kept up advancing 44% and 23% over the same periods. Looking forward, dividend-paying equities should continue to perform well. The yield component will likely lure investors seeking to make up for a shortfall in the yield from their fixed income portfolios. Complementing the income offered, these companies also look attractively valued from a P/E perspective, compared to the broader equity market.

Investment Grade, High Yield and Emerging Markets Debt

Corporate bonds will likely capture more attention as investors continue their quest for yield. A cautionary note: valuations of these securities have become significantly less attractive since QE3 was announced.

Emerging market local currency bonds should benefit, due to appreciation in local currency attributable to the sell-off in the US dollar.

Commodities, Real Estate and Alternative Trading Strategies

If the past is prologue, alternative investments should perform well as investors seek prophylactic inflation protection. Commodities are an expected beneficiary of QE regimes as investors seek the haven of assets that cannot be printed and therefore devalued. Gold and Oil were notable performers in the last series of QE programs with gold advancing 36% and 20%, respectively in QE 1&2, and Brent Crude Oil rising 64% and 47%, respectively.

Despite a challenged real estate market, REITs have performed well, returning 68% to investors during QE1 and 22% during QE2. Investors flocked to REITs as they offered attractive yields and depressed prices. Sadly, valuations are no longer attractive in this sector. Some Alternative Trading Strategies performed very well during QE1 and QE2, particularly credit/relative value and global macro hedge funds. Credit hedge funds were able to take advantage of all-time wide spreads and benefitted from spread compression as yields came in. Savvy macro hedge funds traded the trends, such as a weakening dollar or rising price of gold, and secured attractive risk- adjusted returns for their investors.

Cash and Developed Government Bonds

The likely loser is in this latest QE regime is, of course, cash, and those investors who continue to hoard it while it earns negative real interest rates.

The other likely loser is government debt. At the current “managed” interest rates, buying it represents a capital-eroding subsidy to the government.[5] This is typically thought of as risk-free asset but it actually bears considerable price risk. With yields at, or near, record lows, any rise in yields brings a commensurate hit to investors’ capital, driven by the duration of their securities.

Total return investing

With interest rates expected to remain low for the next several years and the US central bank digitizing money[6] at ever-faster speeds, total return investing is more important than ever. It is important to be mindful of where your returns are coming from within your portfolio. Equities are typically known for their price appreciation potential, yet dividends provided an important contribution to return. On the fixed income front, bonds are known for their income-producing feature, yet a significant portion of the return has come from price appreciation due to falling interest rates. In financially repressed environments, successful investing is a product of maintaining purchasing power of assets. The astute investor will recognize this by diversifying the source of return in each investment he or she makes.

[5] This is especially the case for US investors.
[6] A technical point: The Federal Reserve does not actually print money to make the bond purchases; it creates a credit to banks from whom the purchases are made. If only people could do the same.

Figure 5: Asset class returns during the Federal Reserve's QE1 and QE2*

TAA asset class total returns in USD	Return during QE1
Emerging Markets Equities	108%
High Yield Bonds & Emerging Markets Bonds	76%
Real Estate	68%
Developed Markets Equities	44%
Investment Grade Bonds	24%
Alternative Trading Strategies	23%
Commodities	9%
Developed Government Bonds	6%
Cash & Short-maturity Bonds	4%

Source: Barclays via Bloomberg
Note: All Assets except Alternative Trading Strategies (ATS) returns are calculated from 11/25/2008 to 3/31/2010. ATS returns calculated from 11/30/2008 to 3/31/2010.

TAA asset class total returns in USD	Return during QE2
Developed Markets Equities	26%
Real Estate	22%
Commodities	21%
Emerging Markets Equities	21%
High Yield Bonds & Emerging Markets Bonds (Jan Mix)	9%
Alternative Trading Strategies	7%
Investment Grade Bonds	1%
Cash & Short-maturity Bonds	0%
Developed Government Bonds	-2%

Source: Barclays via Bloomberg
Note: All Assets except Alternative Trading Strategies (ATS) returns are calculated from 8/27/2010 to 6/30/2011. ATS returns calculated from 8/31/2010 to 6/30/2011.

*Total Returns are represented by the following: Cash and Short maturity bonds by Barclays Global Governments 1-3 years; Developed Government Bonds by Barclays Global Governments 7-10 years; Investment Grade Bonds by Barclays Global Aggregate - Corporates; High-Yield/Emerging Markets Bonds by Barclays Global High Yield, and Barclays Global Emerging Markets; Developed Markets Equity by MSCI World Index; Emerging Markets Equity by MSCI EM; Commodities by DJ UBS Commodity TR Index; Real Estate by EPRA/NAREIT Developed Market Total Return Index; Alternative Trading Strategies by Barclays ATS Equally Weighted Composite Index (25% Barclay Hedge Global Macro; 25% HFRI Relative Value TR; 25% Credit Suisse-Dow Jones Event Driven & 25% Credit Suisse-Dow Jones Managed Futures Index).

The benchmark indices are used for comparison purposes only and this comparison should not be understood to mean that there will necessarily be a correlation between actual returns and these benchmarks. It is not possible to invest in these indices and the indices are not subject to any fees or expenses. It should not be assumed that investment will be made in any specific securities that comprise the indices. The volatility of the indices may be materially different than that of the hypothetical portfolio.

The US election: counting on Congress

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From investors' perspective, the more interesting political contest in the US this November may be the congressional elections as opposed to the presidential race. Results in a number of constituencies may matter more than which party controls the House of Representatives or the Senate.

This essay presents our analysis of near- and medium-term *investment implications* of different outcomes of the US elections on November 6. It is not intended to offer an evaluation of different parties, candidates or policy options. Indeed, although good public policy may be associated with good investment returns over very long horizons, the "right" policy from a longer-term perspective can often have an adverse near-term impact on financial markets, and vice versa.

Because the public policy issues affecting financial markets vary so much over time, and because governments have only a finite number of policy tools they can deploy, it is difficult to know in advance which political party's success will be best for investors over the long term. While it is true that the economy and financial markets have, on average, fared slightly better under Democratic than Republican presidential administrations from 1949[7] - 2011 (Figure 1), the differences, largely statistically insignificant, can be explained by luck rather than policy. For example, Republican presidents had the bad luck of being in office during the first years after oil prices surged in 1973 and during the 1987 stock market crash, while a Democrat had the good fortune to serve a term which largely coincided with the 1990s technology boom.

Figure 1: *Don't* draw conclusions from the observation that the economy and the stock market have fared slightly better under Democrats than Republicans

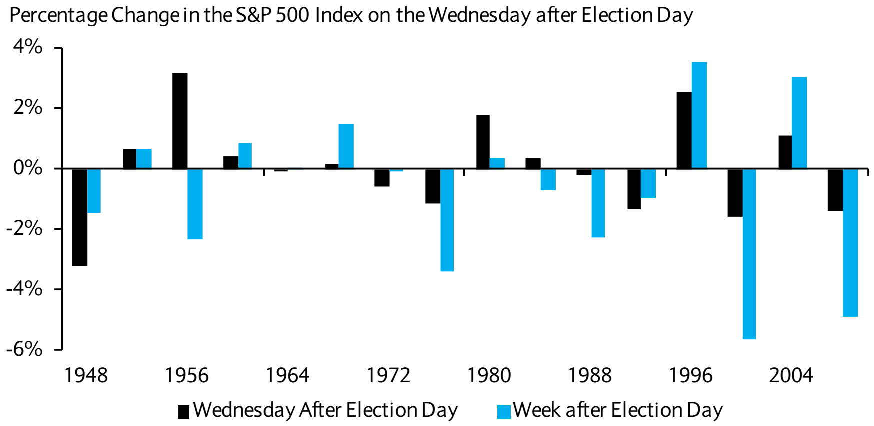
	Presidential administrations 1949[1] to 2011		
	Democratic administrations	Republican administrations	Difference Dem - Rep
Real GDP growth	3.8%	2.7%	1.1%*
Unemployment rate	5.6	5.9	-0.3
S&P 500 total return	13.9	10.0	3.9

*Statistically significant at the 5% level on a two-tailed test.

On occasion, however, the period immediately after the election has witnessed relatively high levels of market volatility and, as illustrated in Figure 2, this tendency seems to have become more pronounced in recent years.

[7] We start the analysis in the first full year of a post-World War II presidential term.

Figure 2: Markets occasionally react to election results



Source: Bloomberg

This election could be one of the ones that leads to a substantial market move over subsequent days and weeks.

Why this election matters for investors.

The immediate challenges that face Congress after the election involve the fiscal cliff (discussed in *September 2012 Compass)* and the debt ceiling. Clumsy handling of either issue could easily lead to a renewed economic downturn and severe portfolio losses.

From a longer-term perspective, the next Congress and Administration will have to deal with high unemployment and the fiscal imbalances facing the US Federal Government, as large numbers of the "baby boom" generation (born between 1946 and 1964) retire and as health care costs continue to rise faster than nominal GDP. They will have to walk a fine line between risking triggering another economic downturn or a prolonged period of weakness by imposing too much austerity, and failing to adopt longer-term deficit reduction policies, which could jeopardize the United States' reputation as a secure place to invest.

Investors' willingness to add risk to their portfolios and, therefore, the tone of financial markets in the aftermath of this election, will depend, in some substantial part, on whether they expect US fiscal policy to be a source either of risk or of stability over the next few years. And that, in turn, will be influenced by whether "resolution" or "gridlock" prevails in the new 113th Congress.

So will Wednesday, November 7, 2012, be the start of a "risk-on" or "risk-off" period? Election night headlines about the presidential race and control of the House or Senate probably won't provide the answer. Rather, in my opinion, whether to "buy" or "sell" in the election's aftermath will depend upon a detailed analysis of the results of some individual congressional elections as a key to whether a tone of resolution or gridlock may prevail. The purpose of this essay, therefore, is to provide readers with a "score card" for evaluating the results from a market perspective.

Why the congressional elections matter more

To be sure, the next president – be it Obama or Romney – will have some influence over if and how the fiscal issues are handled. But passage of legislation requires a majority vote in the House of Representatives and, as a practical matter, the acquiescence of at least 60 (out of 100) senators. US political party discipline is weak today compared to the past, so passing each individual piece of important legislation requires the formation of an *ad hoc* coalition drawn from different ideological perspectives and political interests.

Because both Republicans and Democrats will retain at least 40 Senate seats in Congress, any winning coalition will have to include more than just a few Republicans ***and*** more than just a few Democrats. When it comes to securing such bi-partisan support for the fiscal initiatives most likely to affect near-term investment performance, successful legislation will have to include both spending reductions — partly in the form of smaller social welfare ("entitlement") benefits — and some increase in tax revenues paid by high-income taxpayers. While the details will obviously be important to potential coalition members, all bi-partisan deficit-reduction plans put forward thus far — including the proposals of the National Commission on Fiscal Responsibility and Reform (Simpson-Bowles Commission)[8] and the agreement reportedly reached by President Obama and US House of Representatives Speaker John Boehner in the summer of 2011 — have incorporated these two elements.

There is, however, a certain subset of legislators who believe strongly that tax increases *should not* and *will not* be part of any deficit reduction plan. Americans for Tax Reform, a conservative advocacy group, asks candidates running for public office to sign a "Taxpayer Protection Pledge," promising to:

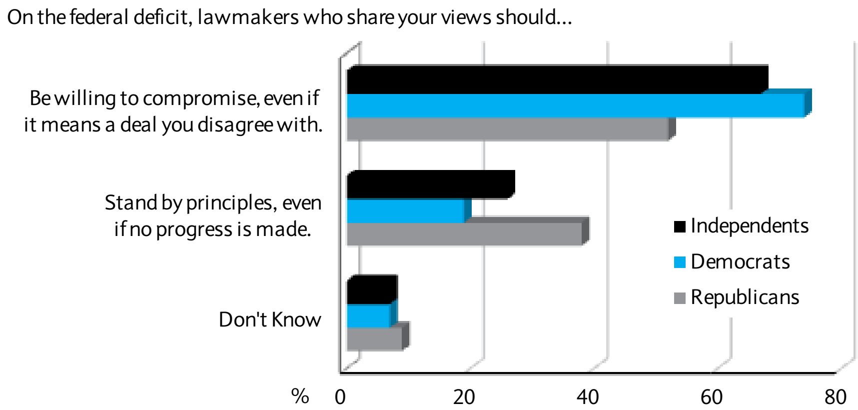
- "ONE, oppose any and all efforts to increase the marginal income tax rate for individuals and/or businesses, and
- "TWO, oppose any net reduction or elimination of deductions and credits, unless matched dollar for dollar by further reducing tax rates."

All but six of the 242 Republican members of the House of Representatives and all but seven of the 47 Republican Senators have signed this pledge. As direct consequences of this belief—that tax increases *should not* form part of any deficit reduction plan—the Simpson-Bowles proposal was not accepted by enough of the Commission's members to be transmitted to Congress for review, and the Republican majority in the House balked at supporting the agreement that Boehner, their leader, had negotiated with President Obama. While Democrats support relatively larger tax increases and smaller entitlement cuts to achieve deficit reduction, they lack an equivalent pledge to bind them.

In this regard, Congressional legislators reflect the different attitudes of their parties' membership. Figure 3 depicts the results of a survey taken by the Pew Research Center in November 2011, when the debt ceiling controversy was absorbing Washington's and the markets' attention. While majorities in all political categories favoured compromise, twice the proportion of Republicans as Democrats wanted their representatives to hold fast to principles, even if no progress was being made.

[8] This bi-partisan Commission was created by Congress in 2010. Under the authorizing legislation, proposals supported by 14 of the 18 Commission members would be subject to an up or down vote by Congress, with no amendments allowed. The Commission, however, was unable to agree: Democrats would not approve a proposal that did not include some substantial tax increases, while many of the Republican members would not support anything that did.

Figure 3: There's a strong Republican "no compromise" constituency.



Source: Pew Research Center, November 2011 Survey

Republicans who wish to be elected to, or remain in, Congress must win the support of this "stand by principles even if no progress is made" constituency, which tends to be more active and more likely to vote in primary elections. But under ordinary circumstances, Republican candidates must also be able to attract enough of "willing to compromise" voters, either independents or more-flexible Republicans, to win a general election. However, in the 2010 election, the Republicans had the wind to their backs and the subset of party members adhering to the no tax increases as part of deficit reduction principle was very active in the party primaries; consequently, the process delivered to the House of Representatives a large class of freshmen Republicans who owed their seats predominantly to this "stand by principles" constituency.

What followed in Washington was unprecedented gridlock. Congress was unable to agree to a long-term solution, and, to avoid default as borrowing hit the debt ceiling, adopted the set of automatic, across-the-board spending cuts to be implemented on January 1, 2013 which rendered the "fiscal cliff" even more treacherous.

Reading the results: a "score card"

In my view, therefore, whether the results of the 2012 election will lead to continuing political gridlock —with the risk of a crash-landing at the bottom of the fiscal cliff and chronic, confidence-sapping fiscal imbalances—depends on whether the Republicans in the new 113th US Congress are of the "stand by principles even if no progress is made" variety or they are of the "willing to compromise" ilk, open to some tax increases in any deficit reduction process.

How will one know what the election results yield in this regard? I, for one, will have my eye on a small number of key Congressional races: one for the Senate and seven for the House of Representatives.

The earliest indication will come on election night between 7:00 p.m. and 8:00 pm Eastern time when the results emerge from what appears to be a relatively close Senate race in Indiana. The Republican candidate, current State Treasurer Richard Mourdock, won his party's nomination in a hard-fought primary election in which he repeatedly criticized long-serving Indiana Republican Senator Richard Lugar for his record of working with Congressional Democrats. Mourdock is running against Democratic candidate US Representative Joe Donnelly who, as of this writing, is given an even chance of winning. If Donnelly were to win in this historically heavily Republican state, it would appear, given Mourdock's previous anti-compromise rhetoric, that Indiana voters prefer their representatives in Washington to be of the "willing to compromise" variety.

There are seven freshman Republicans in the House of Representatives whose re-election is considered "too close to call" by the non-partisan Real Clear Politics web site[9] (Figure 3). If Democrats capture a large proportion of these contested seats, the remaining Republicans in the House, even if they still command a comfortable majority, may take the results as a message that a "willing to compromise" stance offers the better path to political longevity.

Figure 3: US House of Representative races to watch on election night

District	Incumbent
Texas - 8	Quico Canseco
Minnesota - 8	Chip Cravaack
Illinois - 10	Robert Dold
New Hampshire - 1	Frank Guinta
Nevada - 3	Joe Heck
Illinois - 11	Adam Kinzinger
Florida - 18	Allen West

Source: Barclays Wealth and Investment Management

Conclusion

It is difficult for investors to evaluate political results with a completely candid eye, especially when one's own government is being elected. It can help objectivity to remember that the "best" outcome for financial markets in the near term is not necessarily the best policy from a broader perspective. In 2012, I believe, markets would welcome a political configuration in Washington that would lead the country away from the ledge of the fiscal cliff and onto a gradual path toward fiscal balance. Achieving those results will of necessity involve compromise on both sides of the aisle. Voters in several specific jurisdictions are positioned to send the message that compromise is what they want. We will probably know by some time on Wednesday, November 7 whether that is the message actually conveyed. If it has and it is clear that the 113th Congress will have many fewer representatives who believe they must "stand by their principles even if no progress is made" than the 112th did, then—all else being equal—November could be a good time to increase portfolio risk. Otherwise, because the cost of political gridlock to the US economy will increase sharply next year, a much more cautious approach may be required. We will aim to communicate our assessment of the results as soon as we know them.

[9] *http://www.realclearpolitics.com*

European opportunities

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A determined and proactive ECB continues to make it easier to invest in European assets. In spite of a strong rally since the beginning of the summer, we see further upside for European markets in general, given still undemanding valuations. We have assembled a basket of beaten-up European equities which we believe will benefit from a continued unwinding of the European "break-up discount".

More cheap portfolio insurance

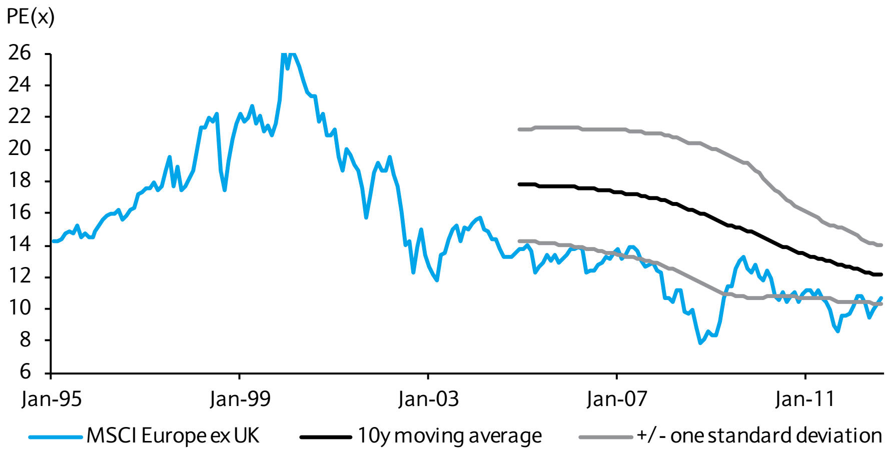
European Central Bank president, Mario Draghi, has now articulated what he meant when he famously said back in July that the ECB was willing to do "whatever it takes" to save the euro. With this declaration of intent and the ECB balance sheet to back it up, Mario Draghi has further reduced the risk of a euro-zone break up.

Whilst underpinning the longer term survival of the euro area and reducing near term funding pressure for the periphery, the ECB has also made investing in undervalued European equities an easier task. We may now assess companies and markets on their fundamental merits rather than trying to factor in the incalculable. Clearly, there is much work for the policymakers to do and there are likely to be stumbles along the way, but the ECB's willingness to act as conditional lender of last resort means that we may be past the worst point in terms of investor pessimism on the euro crisis.

Is it too late?

European equities have performed well this summer and are now sitting on returns that exceed our expectations from the beginning of the year. Set alongside this, there has not been a noticeable improvement in the health of the underlying economies in question. Data from the periphery and even France remains mixed at best and even Germany could be flirting with technical recession in the second half.

Figure 1: European equities continue to look inexpensive



Source: Barclays, Factset

With all this in mind, is it too late for those investors sitting on the sidelines? Not necessarily. We still see plenty of opportunities as the 'breakup discount', which is still depressing European equity markets, continues to unwind unevenly. Valuations provide room for equity investors to be handsomely rewarded, even if analysts turn out to be too optimistic about earnings (Figure 1), with European PEs still trading around one standard deviation below 10 year averages.

That is not to say that there will not be setbacks ahead, just that the ECB's apparent willingness to use its balance sheet provides investors with a degree of inexpensive portfolio insurance, against the continuing risk of a Greek exit, for example.

How?

Europe's highest quality stocks have persistently outperformed in the last four years. While this has not necessarily left their valuations stretched by historical standards, we believe investors should take an actively managed approach which looks to buy the best companies in the more oversold areas of the market.

Very simply, this involves looking for stocks that have underperformed the wider index, but have been rated positively by our colleagues at the investment bank. We have further filtered the list by looking for companies where we believe the stock market is overestimating the threats that the business faces, based on a range of factors such as the balance sheet, the resilience of revenue streams and the ability to generate cash flow. The resulting list should provide clients with stocks from a range of sectors that have defensible cashflows and robust balance sheets.

This is not an idea for clients unfamiliar with equity risk though, as the value of the stocks in the portfolio can go down as well as up. In a portfolio context, this basket should complement broader European and global equity exposure.

Figure 2: European opportunities basket

Company	Sector	Price to Book (x)	5 Year Average Price to Book (x)
Eutelsat Communications	Consumer Discretionary	3.1	3.1
Television Francaise 1	Consumer Discretionary	0.9	3.0
ZON Multimédia	Consumer Discretionary	3.6	8.2
Galp Energia	Energy	1.9	4.2
Repsol	Energy	0.7	1.7
CNP Assurances	Financials	0.5	1.5
ICADE	Financials	1.2	2.5
Alstom	Industrials	1.9	9.2
Infineon Technologies	Information Technology	1.5	1.7
Temenos	Information Technology	3.1	10.0
K+S	Materials	2.2	4.7
voestalpine	Materials	1.0	3.2
Tele2	Telecommunication Services	3.1	2.2
Telecom Italia	Telecommunication Services	0.7	1.6
Vivendi	Telecommunication Services	1.0	1.7
Endesa	Utilities	0.8	3.7
Enel Green Power	Utilities	1.0	No Data
Veolia Environnement	Utilities	0.6	5.2

Source: Factset, Barclays

Snapshot of allocations and asset class returns

We advocate that clients pursue portfolios that are diversified† across nine global asset classes, in proportions tailored to each investor's specific risk profile and Financial Personality. We have defined a long-term view of the mix of assets suited to five prototypical risk profiles, what we call our Strategic Asset Allocation (SAA). Our Tactical Allocation Committee (TAC), comprising senior members of our investment leadership, regularly assesses the markets to discuss how those SAA weights might need to be adjusted to reflect more tactical views, which we call our Tactical Asset Allocation (TAA).

Barclays' TAC is today (September 28) altering its tactical (3-6 month) tilts, for the first time since July 3rd. The summer's rally in developed equities has not been without foundation, as we note above, and the balance of risks facing markets has become more even. Some renewed volatility is still possible if investors refocus on the still-unresolved issues in the euro area, or begin to worry more about the approaching US 'fiscal cliff', but it is also possible that the actions of central banks in providing portfolio insurance, together with the failure of some of the risks facing us earlier in the summer to materialize (such as a less constructive decision by the German Constitutional Court, for example) will foster a bigger revival in risk appetite. The Committee is thus closing its tactical underweight in developed stocks, funding it by reducing its tactical overweight in cash. It retains a tactical preference for corporate bonds ahead of government bonds, which look very expensive (even with the Federal Reserve embarking upon QE3): it continues to advise a small overweight in high yield credit and emerging market bonds, though increasingly for reasons of portfolio yield enhancement than for likely capital gain, and an underweight in developed government bonds.

Our current TAA views, and how those differ from our prior TAA, are detailed for each of the five risk profiles below in Figure 1. Investors can discuss how these might affect their particular circumstances with their Barclays representative.

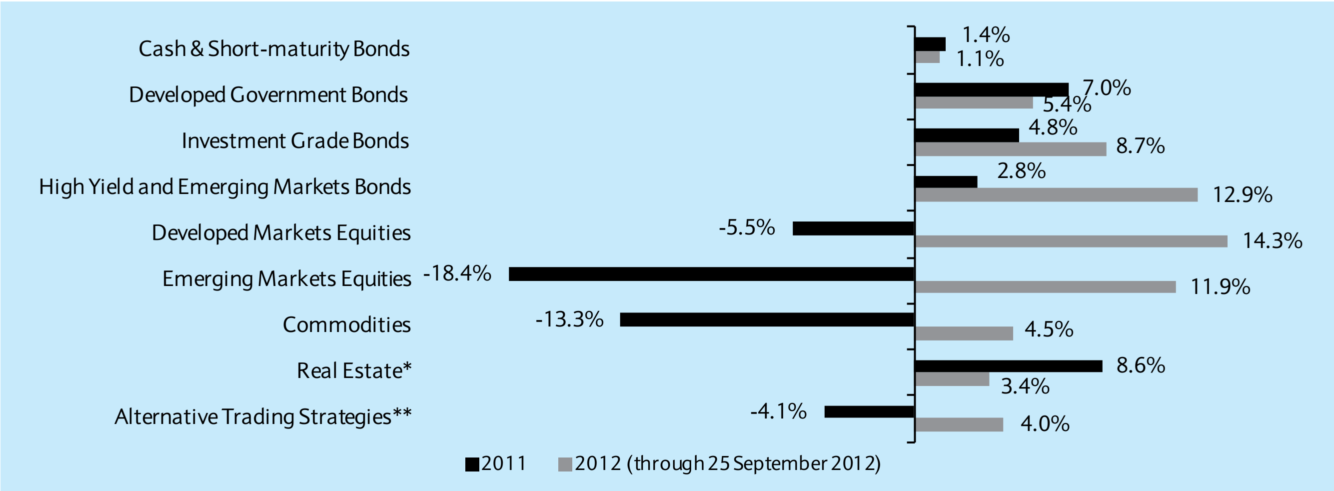
Figure 1: Current strategic (SAA) and tactical (TAA) asset allocation by risk profile

Risk Tolerance Level	Cash & Short Maturity Bonds	Developed Government Bonds	Investment Grade Bonds	High-Yield & Emerging Markets Bonds	Developed Markets Equities	Emerging Markets Equities	Commodities	Real Estate	Alternative Trading Strategies
Low									
SAA	43.0%	10.0%	3.0%	4.0%	16.0%	4.0%	2.0%	7.0%	11.0%
TAA	44.0%	8.0%	3.0%	5.0%	16.0%	4.0%	2.0%	7.0%	11.0%
TAA vs SAA	1.0%	-2.0%	0.0%	1.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	-1.0%	0.0%	0.0%	0.0%	1.0%	0.0%	0.0%	0.0%	0.0%
Medium Low									
SAA	15.0%	13.0%	4.0%	7.0%	29.0%	7.0%	4.0%	5.0%	16.0%
TAA	17.0%	10.0%	4.0%	8.0%	29.0%	7.0%	4.0%	5.0%	16.0%
TAA vs SAA	2.0%	-3.0%	0.0%	1.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	-2.0%	0.0%	0.0%	0.0%	2.0%	0.0%	0.0%	0.0%	0.0%
Moderate									
SAA	8.0%	9.0%	4.0%	8.0%	38.0%	10.0%	5.0%	4.0%	14.0%
TAA	9.0%	6.0%	4.0%	10.0%	38.0%	10.0%	5.0%	4.0%	14.0%
TAA vs SAA	1.0%	-3.0%	0.0%	2.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	-3.0%	0.0%	0.0%	0.0%	3.0%	0.0%	0.0%	0.0%	0.0%
Medium High									
SAA	5.0%	6.0%	3.0%	8.0%	45.0%	13.0%	6.0%	3.0%	11.0%
TAA	5.0%	4.0%	3.0%	10.0%	45.0%	13.0%	6.0%	3.0%	11.0%
TAA vs SAA	0.0%	-2.0%	0.0%	2.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	-3.0%	0.0%	0.0%	0.0%	3.0%	0.0%	0.0%	0.0%	0.0%
High									
SAA	4.0%	4.0%	2.0%	6.0%	51.0%	17.0%	6.0%	2.0%	8.0%
TAA	4.0%	2.0%	2.0%	8.0%	51.0%	17.0%	6.0%	2.0%	8.0%
TAA vs SAA	0.0%	-2.0%	0.0%	2.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	-3.0%	-1.0%	0.0%	0.0%	4.0%	0.0%	0.0%	0.0%	0.0%

* Prior TAA dated 3 July 2012.
† Diversification does not guarantee against losses.
The recommendations made for your actual portfolio will differ from any asset allocation or strategies outlined in this document. The model portfolios are not available to investors since they represent investment ideas, which are general in nature and do not include fees. Your asset allocation will be customized to your preferences and risk tolerance and you will be charged fees. You should ensure that your portfolio is updated or redefined when your investment objectives or personal circumstances change. Source: Barclays

Developed equities have again rallied further as both the ECB and the Federal Reserve have offered more support for the financial system, and as investors' worst fears about the euro crisis, and US consumer spending, have failed to materialize. In recent days they have been flirting with the post-Lehman highs seen in 2011, and together with high yield credit are the best-performing asset class year-to-date (though in risk-adjusted terms, high yield credit would have the edge). Commodities still lag behind other risk assets, but are showing solid returns year-to-date – as are developed government bonds, particularly in risk-adjusted terms.

Figure 2: Total returns across key global asset classes



* As of June 2012
** As of August 2012
† Diversification does not guarantee against losses.
Note: Past performance is not an indication of future performance. Index Total Returns are represented by the following: Cash and Short maturity bonds by Barclays Global Governments 1-3 years; Developed Government Bonds by Barclays Global Governments 7-10 years; Investment Grade Bonds by Barclays Global Aggregate - Corporates; High-Yield/Emerging Markets Bonds by Barclays Global High Yield, Barclays Global EM & Barclays EM Local Currency Governments; Developed Markets Equity by MSCI World Index; Emerging Markets Equity by MSCI EM; Commodities by DJ UBS Commodity TR Index; Real Estate by MIT TBI Index and IPD UK for January-March 2011 and NCREIF TBI Index and IPD UK Index for April 2011 onwards; Alternative Trading Strategies by Barclays ATS Equally Weighted Composite Index (25% Barclay Hedge Global Macro; 25% HFRI Relative Value TR; 25% Credit Suisse-Dow Jones Event Driven & 25% Credit Suisse-Dow Jones Managed Futures Index). The benchmark indices are used for comparison purposes only and this comparison should not be understood to mean that there will necessarily be a correlation between actual returns and these benchmarks. It is not possible to invest in these indices and the indices are not subject to any fees or expenses. It should not be assumed that investment will be made in any specific securities that comprise the indices. The volatility of the indices may be materially different than that of the hypothetical portfolio.

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