July/August 2013

Compass

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Tides of change: navigating emerging market opportunities in a new landscape

Wealth and Investment Management

Global Research & Investments

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A sea change and new era

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The events of the past several weeks have effectively inaugurated a new phase in the post-2008 recovery. Given the volatility – and declines – that accompanied the (long obvious) fact that $85 billion per month of asset purchases would not continue indefinitely and the news of their possible tapering this fall, it's worth taking a step back to determine where global markets might go from here.

While the recent market calm is more of a break in volatility, we are optimistic

As of this writing, markets appear to be settling into the notion that open-ended quantitative easing will eventually be drawing to a close. While we view this calm more as a break than an exit from the volatility (markets may succumb to periodic, short-term bouts of angst and will certainly react to each new bit of economic data), we are optimistic. The prospects for US economic growth have brightened. A key driver of the economy, business capital spending, appears to finally be awakening. Corporate investment plans improved for a third straight month in May, while orders for non-defense capital goods excluding aircraft – a good proxy for future business investment – also rose for a third straight month in May (See "US CapEx: The sleeping giant" *May Compass*).

Prospects for US economic growth have brightened…

Worried economists and commentators may argue that QE and low interest rates are all that stands between us and derailed US, and thus global, growth. True, the situation is complicated by the extent of the Fed's loosening (the central bank has purchased $2 trillion of bonds, and its benchmark rate is the lowest ever). But this just argues for a well communicated and gradual normalization process. The Fed is not planning to stop buying bonds overnight. Moreover, many of its developed market brethren do not appear to be on the brink of normalization. Indeed, the Bank of Japan just got started, while the European Central Bank and the Bank of England have signaled accommodative stances for some time to come. Finally, if US economic prospects appear to be dimming, then, as Bernanke made clear, the Fed's policy decisions will take that into account.

…and if they seem to be dimming, the Fed's decisions will take that into account

Markets were surprised by the Fed's announcement given the economy's apparent distance from key targets the central bank had set. In this month's *"The Fed and transparency: When will tapering begin"* article, Kristen Scarpa examines the facts more closely and finds the distance isn't as great as it might seem.

In light of the evident market distortions – bond spreads compressed to all-time lows, an 18% rise (at the S&P 500's May peak) in US equities on 2.5% earnings growth, high yield bonds trading higher than more senior, floating rate loans – we think Bernanke's announcement was well timed.

What to do?

For the first half of the year, the US equity market is still up a striking 17 percent,[1] while fixed-income investments have posted some sizeable losses in a very short period of time. Treasuries with maturities of 25-years or more, for example, declined 10.6% through July 9 (Figure 1). And volatility has risen, particularly in bonds (Figure 2). So what can we expect as we move into the second half of the year?

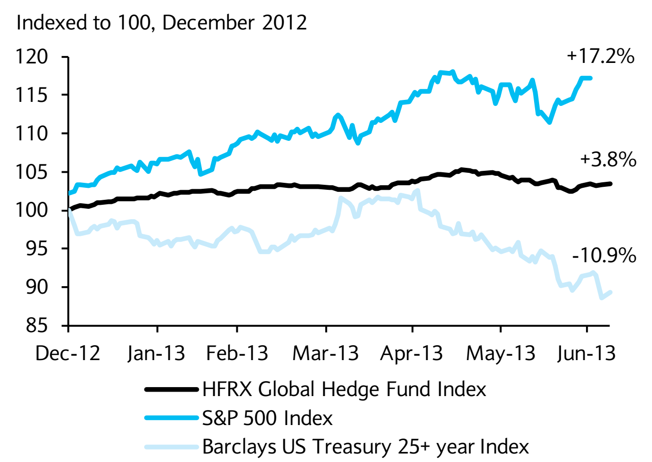
After a 30-year bull market in bonds culminating in nanoscopic interest rates, there is little to protect investors from price declines as rates rise. While the process will reverse in fits and starts, the golden age for fixed income appears to be coming to a close. That's twice as true for Emerging Markets Bonds as Laura Kane explains in this month's *"Tides of change: navigating emerging markets in a new landscape."* In anticipation of this, we've engaged in a systematic retreat from and rotation within these asset classes over the past nine months.

With volatility likely, Alternative Trading Strategies look more attractive than ever

We began the year with a year-end target of 1,595 for the S&P 500, and raised it in April to 1,650, based on a modest P/E multiple increase. When that target was exceeded in May, we recommended taking some profit and rotating proceeds into Europe, where valuations and dividend yields are attractive, and Japan, where another sea change is occurring. We're still overweight US equities based on valuation and return potential. Second-quarter earnings results will be pivotal as they will provide insight into whether our 2013 S&P 500 earnings-per-share target of $110 is achievable.

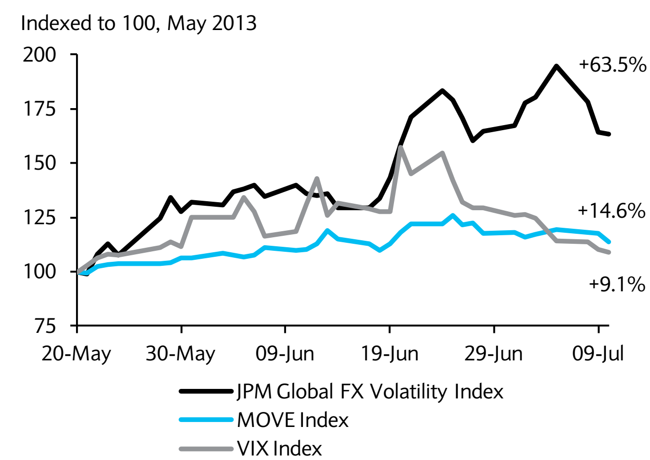
We maintain a neutral weight to Emerging Market Equities for reasons outlined in *"Tides of change: navigating emerging markets in a new landscape."*

Figure 1: YTD performance: US stocks, bonds, Alternative Trading Strategies



Source: Bloomberg, as of July 9, 2013. Past performance is not a guarantee of future performance. An investment cannot be made directly in an index.

Figure 2: Rising volatility in bond, stocks and currencies



Source: Bloomberg, as of July 10, 2013. Asset class volatility is represented by these indices: US stocks – VIX; Treasuries – MOVE; and currencies – JPM Global Currency. Definitions at end of document.

[1] Source: Bloomberg, as of July 10, 2013. YTD total returns 12/31/2012-7/10/2013: the S&P 500 Index – 17.2% and Russell 3000 Index –17.6%

With the recent spike in interbank repo rates highlighting the fragility of China's financial system after years of credit growth, China, a key engine of global growth, is on every investor's mind. In *"China's liquidity crunch,"* Wellian Wiranto shines a light on the country's shadow financing and the motivations of its central bank in allowing the rates in a critical bank funding market to surge as high as 30% before stepping in to help rates return to normal levels.

The combination of slower growth in China, the biggest component of global commodity demand, and stable, or even increased, supply prompted us to lower our Commodities allocation to underweight from neutral in early July; we believe further downward pressure on prices is possible (see *Tactical Asset Allocation Review* on page 20).

With increased volatility likely, Alternative Trading Strategies look attractive. The second half of the year will be one in which diversification really does matter, and active management is a differentiating factor in parts of the portfolio.

As always, we hope you enjoy this issue of *Compass*.

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Diversification does not guarantee a profit or protect against a loss.

The Fed and transparency: When will tapering begin?

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The answer, it seems, is: Sooner than many investors expected. Since the Fed chairman's first mention in May of slowing its asset purchases, the markets, especially fixed income, have been on a wild ride… but is it justified? Will the Fed actually taper this year? And what will it mean for markets and investors?

In the post-crisis recovery, central bank activity – unprecedented in its scale – has had a marked influence on the markets; so it has been especially important for investors to understand what central bankers will do when committing capital. In that context, it is useful to understand the key economic variables the Fed is examining as it determines the timeline of its current asset purchase program. The process may help investors read between the lines of the Fed's apparent shift in message.

If the economy continues tracking towards the Fed's targets, tapering could begin as early as September

After its June 19 meeting, the Federal Open Market Committee (FOMC), which sets US monetary policy, released new economic projections. The most notable revision was to the forecast for unemployment at the end of next year. In March, the Fed had expected unemployment to fall to 6.7-7.0% by late 2014. But in its June forecast, the central bank revealed a brighter outlook, estimating that unemployment would be as low as 6.5–6.8% by the end of 2014. The new forecast means the Fed's 6.5% target for unemployment would be attained earlier than anticipated. This would, in turn, bring forward by six months the central bank's multi-step process of reversing its massive post-crisis stimulus: first tapering the current $85-billion-a-month pace of bond purchases, then ending them, and finally, raising the benchmark interest rate. In the press conference after the FOMC meeting, Bernanke indicated that if the economy continues to track towards the Fed's targets, it could start tapering this September.

Figure 1: The Fed's unemployment rate forecasts: changes from Mar. to Jun. 2013

Forecast for	Yearend 2013		Yearend 2014		Yearend 2015	
Published in	March	June	March	June	March	June
Forecast rate	7.3-7.5%	7.2-7.3%	6.7-7.0%	6.5-6.8%	6.0-6.5%	5.8-6.2%

Source: Federal Reserve as of June 2013

Taper tantrum

Markets globally reacted violently to this shift in forecast. Bonds with maturities longer than five years bore the brunt of the rout, with interest rates moving materially higher in a matter of days, and volatility has spiked broadly as all asset classes have declined. Investors revolted against the possibility of earlier-than-expected tapering given a still-weak US economy, lower-than-comfortable inflation, and above-target unemployment. While Bernanke countered markets' reaction in the second week of July with more dovish comments, the uptick in volatility, particularly pronounced in the bond markets,[2] is likely

[2] For volatility, see Figure 2 on page 3 in *"A sea change and new era"*.

The Fed's 3%+ target for 2014 economic growth looks a bit optimistic – but not unattainable

to be a hallmark of the investing landscape through year end. Investors, especially fixed income investors, will be intently focused on – and highly sensitive to – the economic data the Fed is watching, as well as what Bernanke and various regional Fed bank presidents say about the data and policy. So the primary drivers of market volatility this year will likely be GDP, employment and inflation reports. Let's cover each in turn.

Economic growth – not too hot, not too cold…

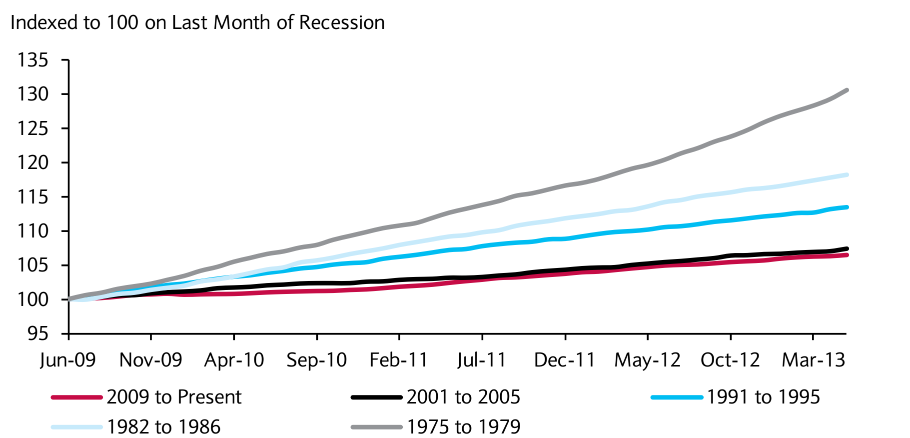
US GDP for the first quarter was revised down to 1.8% from the earlier-estimated 2.4%, largely because of changes in the PCE deflator and government spending.[3] Consumption still grew at a healthy rate of 2.6% annualized, while investment grew at 7.4%. Housing, a continuing bright spot, grew at 14%. The business sector's performance was much weaker, with only 0.4% growth. However, we believe that if business confidence increases, the sector can easily contribute meaningfully to growth. The inherent problem with the GDP measure is that it's a backward-looking indicator of activity, unlike confidence measures. Since the end of the first quarter, consumer confidence, homebuilder confidence and year-over-year home price gains have all hit multi-year highs. Collectively, this should drive better-than-expected consumer activity, which accounts for over 70% of the economy. Though the Fed's 3%+ target for economic growth in 2014 looks a bit optimistic, it does not seem unattainable.

Inflation has not risen as rapidly as in previous recoveries, but is there a deflation problem?

Inflation – is it really too low?

For almost six months now, inflation has been trending *well below* the Fed's explicit target of 2%. This is why, at first pass, it seemed odd that the central bank would be willing to taper its Quantitative Easing (QE) program when the battle against deflation is what prompted QE in the first place. Inflation, as measured by the Consumer Price Index,[4] has not risen as rapidly during this recovery as in the wake of previous recessions. No one wants 1970's style inflation (Figure 2), but a consistent 2% year-over-year increase would be good. If inflation is running closer to 1% than 2%, why would the Fed consider slowing purchases this year?

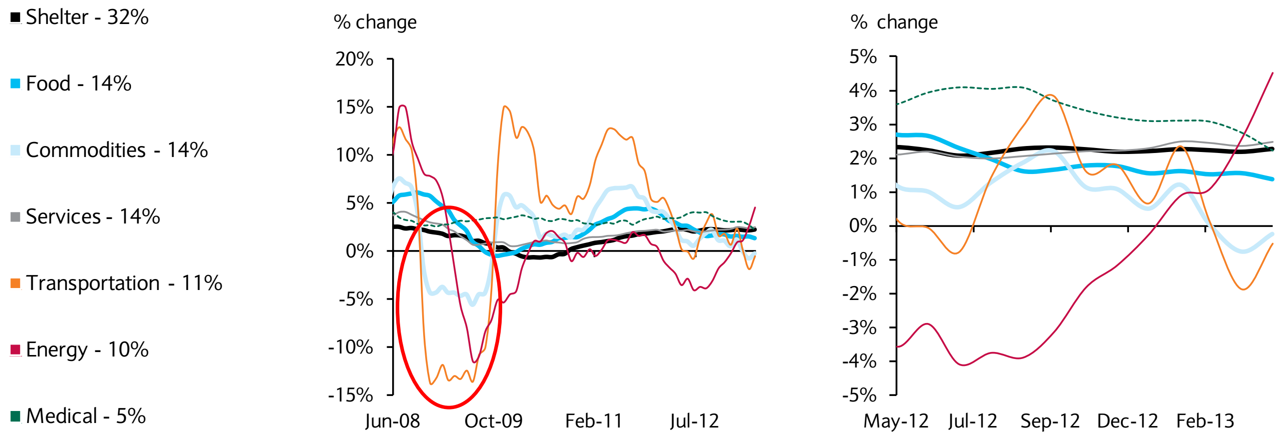
Figure 2: Core consumer price (CPI) index post-recession, 1975 – Present



Source: Bureau of Labor Statistics, Bloomberg as of May 2013

[3] Personal consumption expenditures. See next footnote for PCE definition.
[4] While the Fed often emphasizes the price inflation measure for personal consumption expenditures (PCE), created by the Dept. of Commerce, because it covers a wide range of household spending, the central bank also closely tracks the Dept. of Labor's consumer and producer price indexes.

Figures 3-4: CPI component year-over-year growth, 2008–2013 and May 2012–May 2013 respectively



Note: Legend for Figure 3-4, by weighting in CPI. Services includes: Services (Education & Communication) 6% and Services (Other) 6%; Transportation includes: Transportation (Commodities). Source for CPI Weightings: Bureau of Economic Analysis, Bureau of Labor Statistics as of May 2013. Source (Figure 3-4): Federal Reserve of St. Louis, Bureau of Labor Statistics as of May 2013

A deeper dive into inflation and its drivers helps us understand their reasoning.

For starters, the Fed looks at longer-term trends in inflation because, month to month, the data can vary significantly. Over the past year, the rate of inflation has actually averaged 1.7%, much closer to the Fed's target.

The Fed also examines the longer-term trends in the different subcategories of inflation, which are similarly more positive than might appear. While in 2008 and 2009, Shelter, Food and Beverages, and Energy, which collectively account for 56% of CPI, were actually negative (Figure 3), today Shelter and Energy inflation are above the Fed's target of 2%, as is Services (Figure 4). Food and Beverages, while below 2%, may only be temporarily low because the comparison is to last year when a summer drought artificially inflated food prices. The components of CPI that are, in fact, trending lower account for less of the index – transportation (12%) and commodities (14%) – and tend to be more volatile anyway. The more volatile components are excluded from 'core inflation', another measure the Fed evaluates, and over the past year, this has averaged 1.9% – almost perfectly on target.

Since most components of inflation are actually running close to 2%, it is unlikely the Fed will feel the need to continue asset purchases to fight deflation.

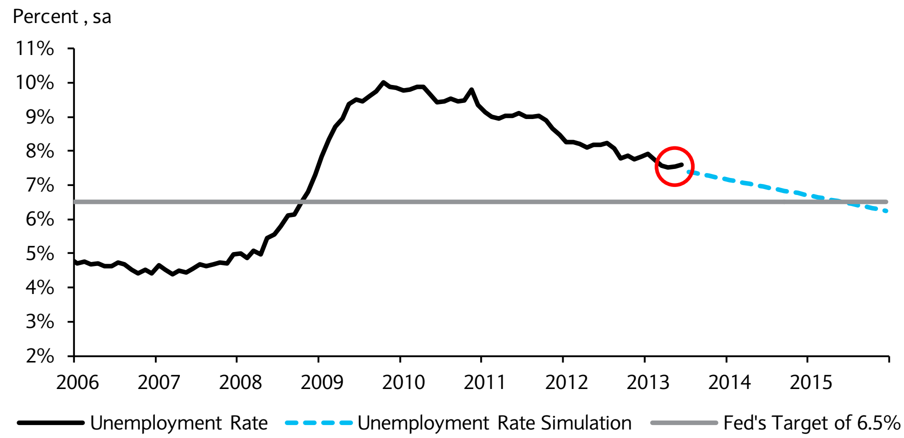
Unemployment – where might we be headed?

All eyes have been on the unemployment rate since the Fed released its explicit target of 6.5% in December 2012, though Chairman Bernanke has repeatedly indicated that this is a threshold, and not a trigger point for shifts in monetary policy. For argument's sake, though, let's assume that the Fed will begin to lift short-term rates when unemployment in the US declines to 6.5%. When might this reasonably be expected to happen?

To find out, we took a highly simplified approach to projecting the unemployment rate over the next 18 to 24 months. In order to calculate the unemployment rate, you need two series of data – the first is the number of unemployed people, and the second is the labor force participation rate. We took the average monthly decrease in the number of unemployed since the end of the recession and the average monthly increase in the labor force participation rate since the end of the recession, and projected the same rate of change over time. Our analysis indicates that the US unemployment rate will fall to 6.5% sometime in the middle of 2015 (Figure 5), which, ironically, is the point until which the Fed had *originally* intended to keep rates exceptionally low. We always knew that if the Fed was planning to start raising rates in mid-2015, it would have to taper and then end asset purchases before that time. If the Fed wants to end QE when unemployment reaches 7.0%, the purchases will conclude sometime in the middle of 2014, based on our projection (Figure 5). In that case, tapering could begin as early as later this year.

If the Fed was planning to start raising rates in mid-2015, we always knew it would have to taper and then end asset purchases before then…

Figure 5: Projected Unemployment Rate



Source: Bloomberg as of June 2013.
Note: Simulation calculation projects the decline in the unemployment rate based on the average monthly decrease in those unemployed since the end of the recession and the average monthly increase in the labor force since the end of the recession, beginning in April 2012.

The best laid plans…

What could derail the Fed's plan? The answer seems simple: slower growth, lower inflation, or more stubborn unemployment. Markets overshooting positively or negatively in anticipation of tapering could influence policy decisions as well. June's employment report painted a better-than-expected picture: Nonfarm payrolls were 17% higher than estimated, and revisions lifted the 3-month moving average by 20% to a much healthier 196,000. Yet the nation's unemployment rate, calculated from a different survey, stayed at 7.6% as more Americans entered the labor force.

Though the June employment release likely increased the chances that tapering will begin this fall, the Fed won't start based on a single new data point. Bernanke has made clear that he does not want to fall into a late 1930's-like double-dip recession. Fiscal policy is still tightening and the dollar has strengthened, which hurts US exports and our trade balance. In the late 1930's, fiscal policy tightened, regulation increased, and trade policy became more restrictive; combined with tighter monetary policy, these shifts pushed the country into a double dip recession in 1937. If expectations for increased fiscal prudence or a stronger dollar start to weigh on growth, it could affect the Fed's view on the role of monetary policy.

One last point to consider, it has become increasingly obvious that Bernanke plans to step down at the end of his term, in January 2014. In all likelihood, his successor will be Janet Yellen, an FOMC member with an even more dovish stance than Bernanke's.

With rates essentially at zero, communication of its intentions and thinking has been one of the few tools available to the Fed

Taking the Fed at its word

Since taking the reins at the Federal Reserve in 2006, Bernanke has sought to deliver Fed policy with a much greater transparency than ever before. With rates essentially at zero for most of his tenure, expansive communication has been one of the few tools available to him. Over the past four years, there have been several iterations of Quantitative Easing with various objectives, beginnings and ends, as the Fed evolved its stance relative to the data trends. And all along, the central bank has been forthcoming with its plans. We would expect the same transparency as it winds down purchases and, ultimately, considers raising rates. Market sensitivity to Fed commentary will be a tool Bernanke continues to wield carefully, if at times clumsily.

What's next?

Even if the Fed does stick to our interpretation of their plan, we do not believe that interest rates will continue a steady march higher. The 10-year Treasury yield rose over a full percentage point from its low in May by early July. A mid-2012 study by the Federal Reserve Bank of San Francisco suggested that $600 billion of asset purchases is equivalent to a 75-basis point cut in short-term rates. Given the current $85 billion in monthly purchases, the sharp rise in yields seems, in our view, overdone – more driven by sentiment than fundamentals. For example, the futures market even priced in the first rate cut as early as late 2014. That seems early – unless there is *material* improvement in the economy and labor market.

While we don't expect short-term rates will rise soon, we have long recognized that given moderate growth, the question for investors was when, not if, interest rates would rise. When thinking about where we might be headed in terms of interest rate normalization, the 10-year Treasury yield tends to move in concert with nominal GDP. With this in mind, nominal GDP has been tracking just above 3.0% indicating we may see further increases in yields from here. This means we could see some further declines in the prices of fixed rate debt instruments in the second half of the year.

Our concerns regarding the potential for rising interest rates have prompted us to continue our retreat from, and rotation within, the fixed income complex. We pared holdings to fixed rate Investment Grade Bonds last year, and fixed rate High Yield Bonds in advance of the Fed's June meeting. We have been underweight Emerging Markets Debt as yields and spreads fell to, in our view, unjustifiable levels. Our moderate portfolio has only 20% allocated to fixed income (see *Tactical Asset Allocation Review* on page 20), and we suggest utilizing shorter-duration securities, floating-rate loans, and private market lending. For clients in a diversified portfolio following our recommendations, the task is to do nothing - our diversified portfolios already express an underweight. For clients investing new money today, we suggest a phased implementation, allocating little or nothing to Developed Government and Investment Grade Bonds in a first phase.

Please reach out to your Barclays coverage team for additional information on our phase in strategy and recommendations for allocations within fixed income portfolios.

China's liquidity crunch

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After years of excessive credit growth, China's economy is being repositioned for an era of less-generous liquidity support. The recent spike in interbank market rates is an indication of how serious policymakers are about tackling the country's financial imbalances – not least in the shadow-financing system. Breaking the addiction to credit will not be easy, but it will be worth it.

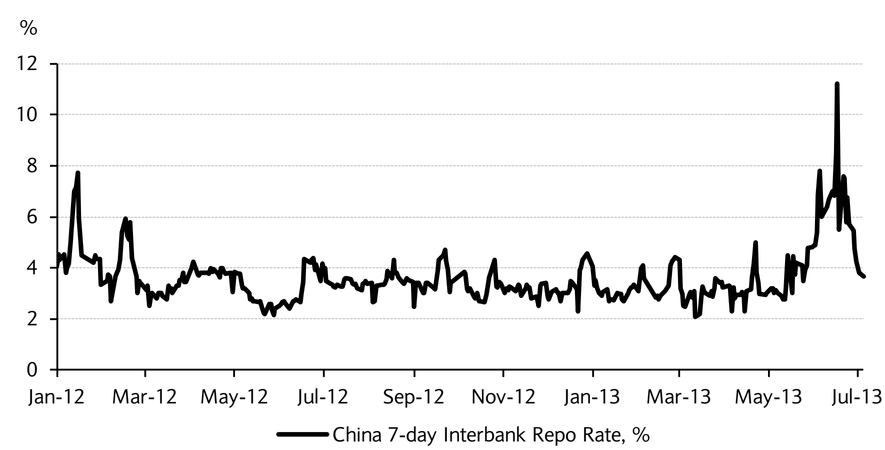
Here comes the squeeze

As investors were fixated on the Federal Reserve's comments on QE, interbank liquidity was drying up in China

While global investors were focused on the June 19 Federal Open Market Committee meeting and what it would mean for US interest rates, a credit crunch was already underway in China's interbank repurchase (repo) market (Figure 1). Indeed, the next day, China's 7-day repo rate jumped to 11.2%, the rate's highest level since 2003, and an almost 500-basis point increase from the previous week.

In the repo market, banks agree to sell securities temporarily to other banks, buying them back on an agreed-upon date and price. The rates effectively measure interbank liquidity – banks' willingness and ability to make short-term loans to their peers. High rates indicate that some banks are willing to pay a lot in order to get short-term funding from other banks, which in turn require high compensation to offset perceived risk. A rate spike of the magnitude seen in late June can be viewed as a sign that the liquidity in China's financial system fell sharply. The squeeze in this market, a key source of short-term liquidity for Chinese banks, illustrates what happens when a country's central bank – in this case the People's Bank of China (PBOC) – decides that enough is enough. The central bank appears to have allowed it to happen as a warning to domestic banks against assuming too much balance sheet risk through excessive lending.

Figure 1: China's interbank rate spiked recently to the highest in a decade



Source: Bloomberg, Barclays, as of July 8, 2013. End of day prices.

A punitive quality

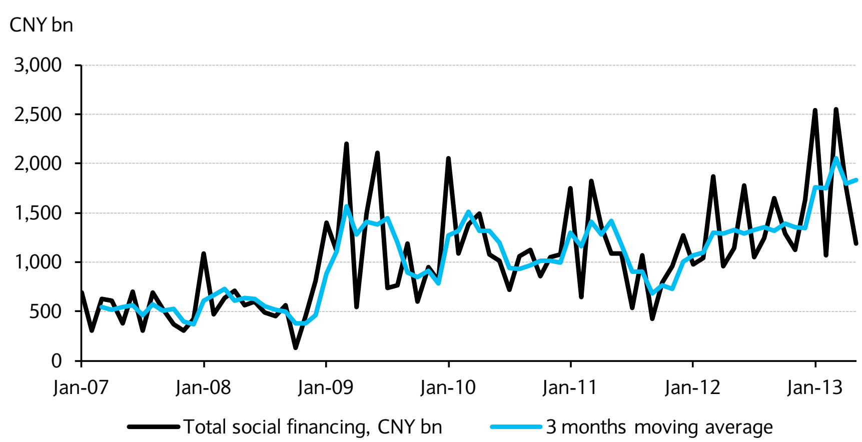
Despite expectations that the PBOC would quickly inject money into China's financial system to alleviate the cash crunch causing the spike in interbank repo rates, it kept the market waiting. By delaying its liquidity injection several days – and allowing repo rates to hit 30% intraday while publicly stating that there was plenty of money in the system, just not in the right places – the PBOC was effectively firing a shot across the bow, warning the country's banks that it will not support resurgent credit expansion in certain parts of the economy.

The central bank's delay in relieving the liquidity crunch had a punitive quality to it. Indeed, the authorities appear to have been targeting some of the banks that have overextended themselves. Smaller Chinese banks, which rely on repo market funding more than their bigger institutions, are seen as being conduits to a shadow-financing system that has grown significantly against the wishes of the central bank.

Lurking in the shadows

This shadow activity has been growing more intensively over the past year, as evidenced by total social financing (TSF), which measures overall liquidity in the financial system. At more than ¥1.8 trillion ($293 billion) on a three-month rolling average basis, the TSF is considerably higher than it has been over the past few years. In fact, as Figure 2 shows, it has more than doubled since late 2011. The recent and sizeable growth in shadow financing – despite little official monetary easing during the period – was of particular concern to policymakers. By engineering a squeeze on an important funding lifeline for smaller banks, the PBOC's ultimate goal was to slow the growth of shadow financing. Despite repeated official urging, smaller Chinese banks have continued to circumvent official banking regulations, actively helping to perpetuate the growth of non-bank credit through creative instruments and murky processes. Acceptance bills, for example, allow a bank to act as guarantor for short-term debt issued by a company. These bills are considered off-balance sheet items – and therefore don't appear on a bank's books as a normal loan; but the bank is still liable if the issuer defaults.

Figure 2: China's total social financing (overall liquidity) has been trending up



Source: Bloomberg, Barclays. As of June 2013.

It will take more than a liquidity squeeze to fix the shadow financing issue

Much like the US credit bubble, which involved vehicles that bought up loans and moved the liabilities off bank balance sheets, Chinese shadow financing includes plenty of off-balance sheet activity, such as bundling bank assets into trust loans or bonds and using 'wealth management product' investment funds to purchase bank loans. These products are sold to investors eager for yields higher than the 3% rate on bank savings accounts mandated by the government-set benchmarks.

Relatively unregulated and therefore opaque and uncontrolled, 'shadow financing' can bring substantial risk, as the world discovered in 2008 following its growth in the US. The PBOC, having tried moral suasion and regulation but still seeing shadow financing instruments continue to grow, decided that a harsher message needed to be sent – particularly to the smaller banks. Knowing they depend on the short-term liquidity of the interbank repo market far more than their larger peers, the central bank opted to send the message by making them pay a lot more for their funding than before.

It takes two to tango

While much can be said about how some banks are complicit in aiding the growth of shadow financing, the simple truth is that such instruments are popular because there is genuine demand for them. For every supplier of high-risk loans, there is a pack of yield-hunters on the other side of the transaction.

Just as the global liquidity on offer from the world's developed central banks has depressed yields and prompted investors to chase better returns in riskier assets, so China's domestic financial repression has also sparked growth in shadow banking. Investment options for Chinese with extra cash are limited. Bank deposit yields are tied to relatively low benchmark rates so banks cannot readily raise them to attract depositors, and access to investments outside of China remains largely closed. The hunt for higher yields has buoyed China's real estate market. It should come as no surprise that it has also fed the growth of shadow financing.

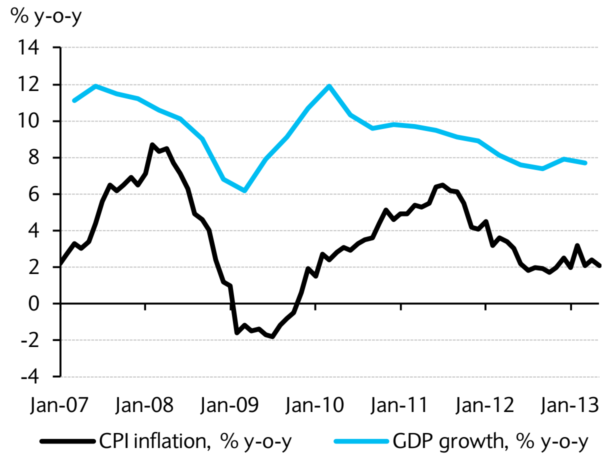
Structural reforms are needed

It will take more than a liquidity squeeze by the PBOC to fix the problem. It's therefore encouraging to see signs that top officials remain committed to resolving some of the underlying structural financial imbalances.

Financial liberalization appears to be a key plank of the reform agenda set out in May. The PBOC may raise the ceiling for banks' deposit rate, which would give them more leeway to compete for deposits. There have also been active talks about further capital account liberalization. A program called QDII2 may be launched to permit qualified individuals to invest in overseas securities. Allowing investors to seek investment opportunities abroad would help to curb enthusiasm for high-yielding, but largely unregulated, trust products that form a significant portion of shadow financing in China.

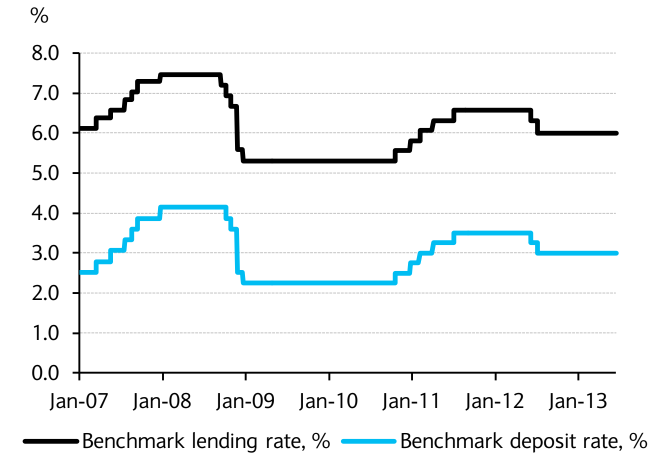
Reforms will take time, to be sure. However, judging from the harshness of the PBOC's warning to the market – via the interbank funding squeeze – the government appears to be creating a strong impetus for reform.

Figure 3: Both growth and inflation have come down



Source: Bloomberg, Barclays. As of June 2013.

Figure 4: Benchmark rates have been on hold recently



Source: Bloomberg, Barclays. As of June 2013.

A difficult trade-off

Tackling financial system's structural imbalances is not without risk. While the PBOC wants enough of a liquidity squeeze to send a strong signal, it cannot ignore the fact that too much of a squeeze could accelerate or extend the economic slowdown.

First-quarter GDP growth was below 8% – marking the first time in 20 years that China's economic expansion has been sub-8% for four consecutive quarters. Second-quarter GDP growth (out in mid-July) is also likely to be lackluster by Chinese standards. Our Barclays Research colleagues now expect China to grow 7.4% this year, down from their previous forecast of 7.8%. June year-over-year export and import data showed declines to well below the average for 2013.

Despite the fact that headline inflation remains subdued at around 2%, the central bank has refrained from lowering rates. In fact, the last time the PBOC adjusted its benchmark rates was in mid-2012, when it cut lending and deposit rates by a conservative 0.56 and 0.50 percentage points, respectively. Such restraint suggests that policymakers believe that while growth will be slower than before, the economy is not about to decelerate sharply. It also likely reflects policymakers' concerns about the negative effects of too much monetary stimulus, which have been highlighted by shadow-financing. Ultimately, however, PBOC opted to strike a delicate balance between a strong message and a perilous squeeze by injecting sufficient liquidity to bring the interbank repo rate back down to normal levels by early July.

The next phase of China's growth will not come easily. Gone are the days when the world's second-largest economy could clock double-digit expansion seemingly effortlessly. Now, the country must face the difficult trade-off between lower short-term growth and greater long-term sustainability.

China's new policymakers appear to be taking the view that seeking to cure the economy of its addiction to credit is perhaps worth the occasional severe measure. We concur.

Tides of change: navigating emerging market opportunities in a new landscape

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"There is a tide in the affairs of men.
Which, taken at the flood, leads on to fortune."

-Shakespeare, *Julius Caesar*

Imminent tapering in the US, a slowdown in China and a commodity slump have turned the tide for emerging markets

In the post-crisis period, as a wave of cash from developed economies' monetary stimulus washed over emerging markets, investors with healthy risk appetites made fortunes capitalizing on robust growth prospects and attractive yields abroad. From the beginning of 2009 to mid-2011, the MSCI Emerging Markets Index returned 116%, outperforming the S&P 500 by more than 60%.[5] This golden age for emerging markets was marked by strong growth in China, solid commodity demand, and rapid GDP growth across many developing economies. Now the tide is retreating as the Federal Reserve has signaled its intent to begin unwinding the unprecedented stimulus of the past four years (provided US economic data continues to be encouraging). With Treasury yields rising sharply in anticipation of a more normalized interest rate environment, investors are re-evaluating the risk-return profile of their investment options. The Fed's timing could not be worse as emerging markets have been hitting some speed bumps of their own: slowing growth in China, weaker commodity demand, and increased political instability. But for those who are willing to sail choppy waters, investment opportunities still exist. As investors shun emerging assets collectively, there are cheaper entry points into markets that exhibit characteristics which have historically favored long-term outperformance.

The fate of Rwanda's recent bond offering aptly illustrates the change in investor sentiment toward emerging market assets. Launched shortly before the Federal Reserve began hinting at scaling back its stimulus, the $400 million issue was met with fervent demand despite the questionable utility of its proceeds in increasing the country's economic growth (funds will be spent on, *e.g.,* a convention center and the fledgling national air carrier, not electric plants[6]). Priced at the end of April to yield 6.785%, the bond's value subsequently declined so much that by early July its yield was over 8%.

Clearly, the emerging markets investment landscape has changed. After a 15% gain in US dollar terms last year, the MSCI EM equity index has declined over 13 percent this year.[7] Emerging market bonds have fared just as badly, declining over 8% year to date as of July 10.[8] However, just as quantitative easing was not the only force behind the post-crisis emerging markets boom, so the specter of its elimination is not solely to blame for the recent underperformance. But investors' initial adjustments to US interest rate normalization may be affecting the breadth of the rout. From the time Fed began talking of tapering in May through the end of June, $35 billion flowed out of emerging market

[5] Past performance is not a guarantee of future performance.
[6] For more details, see *In Focus, June 7, 2013*
[7] Source: *MSCI.com*. YTD through July 10, 2013.
[8] Source: JPMorgan, JPM Global EM Diversified Bond TR Index. YTD through July 10, 2013.

The push of cash from monetary stimulus is drying up

Capital inflows to emerging markets are expected to decline over the next two years

debt and equity funds.[9] As we seek opportunities in this new environment, it is worth exploring the forces behind emerging markets' capital flows and investment performance to help identify potential winners and losers.

'Push' and 'Pull': forces behind the flows

A combination of cyclical and structural factors both push money from developed economies and pull capital into emerging markets. 'Push' factors, such as easy US monetary policy or higher investor risk appetite, typically refer to global factors that impact emerging markets broadly, whereas 'pull' factors are more country-specific, such as relative growth potential, market size, and economic stability.[10]

Figure 1: Examples of factors affecting capital inflows to emerging markets

	Cyclical	Structural
Push	▪ Low US interest rates ▪ Low global risk aversion ▪ Strained developed economy balance sheets	▪ International portfolio diversification ▪ Low developed economy growth potential
Pull	▪ High commodity prices ▪ High domestic interest rates ▪ Low domestic inflation	▪ Improved emerging market balance sheets ▪ High emerging market growth potential ▪ Trade openness

Source: R Moghadam, International Monetary Fund "Recent Experiences in Managing Capital Inflows" Feb. 2011

In the post-crisis run-up in emerging market assets, many push factors were at play: low US interest rates, lower investor risk aversion, and low developed economy growth potential. Now that the Federal Reserve is discussing the end of quantitative easing, at least one big push factor is gone and capital is flowing out of emerging markets. In addition, some pull factors have been diminishing over time. For the first time in two decades, China has registered four consecutive quarters of GDP growth below 8%. The slower growth has affected global commodity demand and has had a trickledown effect on other emerging markets' growth potential, especially on commodity-producing emerging economies as Figure 2 illustrates. The recent cheapening of the Japanese yen has hurt export-driven emerging economies as their goods have become more expensive relative to Japan's. Finally, increased political uncertainty in some emerging countries – riots in Turkey, protests in Brazil and Indonesia, and violence in South Africa – has dampened investor sentiment.

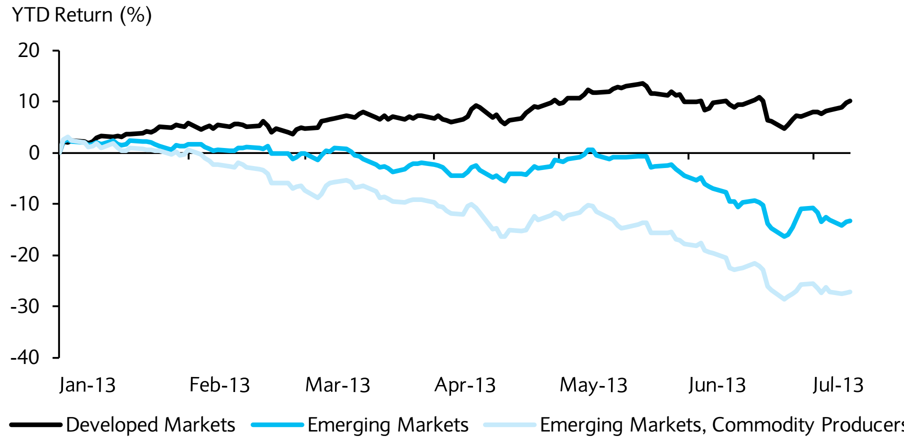
As a result of these shifting economic factors, the Institute of International Finance now forecasts net private capital inflows to emerging markets to decline by approximately 3% in both 2013 and 2014 – representing a total of $69 billion less in flows.[11]

With an understanding of what has driven recent emerging market asset underperformance, investors can identify how these forces have changed and which pull factors are likely to attract capital to specific emerging markets going forward. As we've outlined in the table in Figure 3, these factors translate into a checklist of measurable investment parameters that can help distinguish potential outperformers.

[9] *Financial Times*, June 29, 2013, "Central banks in record US debt sales"
[10] Reza Moghadam, 2011.
[11] Institute of International Finance Research Note, *June 26, 2013: Capital Flows to Emerging Market Economies.* IIF net capital flows to EM (in billions): 2012 estimate: $1,181bn; 2013 forecast $1,145bn; 2014 forecast: $1,112bn.

Slowing in China hurt commodity producers.

Figure 2: YTD markets returns: developed, emerging & commodity-producing



Source: GaveKal Research as of July 10, 2013. Developed: MSCI World Index; Emerging: MSCI Emerging Markets Index; Emerging, Commodity Producers: MSCI Emerging Markets Commodity Producers Index. Past performance is no guarantee of future results. An investment cannot be made directly in an index. For definitions, see back of document.

Figure 3: Checklist of key investment parameters for Emerging Markets

Parameter	What to look for
GDP Growth Forecast	The higher, the better.
Consumer (Domestic Demand)	A strong domestic consumer base will help offset weak global demand.
Foreign Direct Investment	Prefer countries with high levels of foreign direct investment (vs. primarily portfolio flows) which should stimulate growth.
Currency Value	Avoid countries with excessively volatile or overvalued currencies.
Debt Levels	Avoid countries with high debt levels relative to GDP and a high portion of sovereign debt held by foreigners.
Current Account Balance	Avoid countries that have a high deficit relative to GDP; these countries are spending more than they earn and are reliant on foreign capital flows for funding.
Political Risk	Avoid countries with elevated levels of internal unrest: riots, protests, violence, political uprising. Prefer countries with governments open to structural reform.

Source: Barclays Wealth and Investment Management, Americas Investment Strategy team

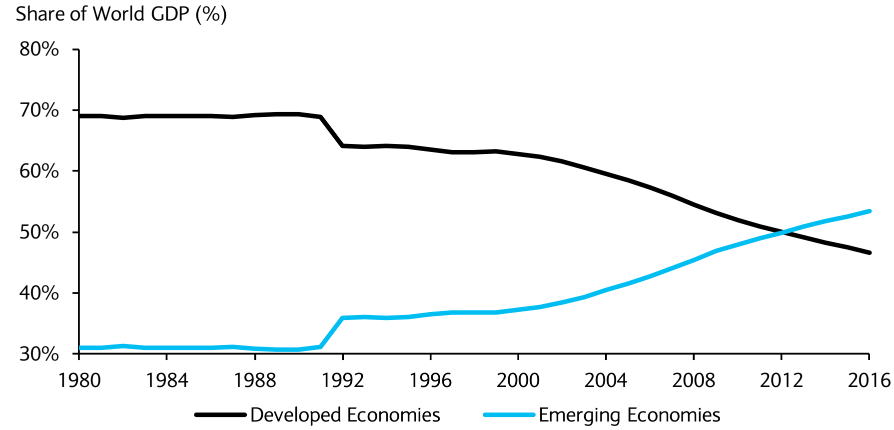
Picking winners and losers in a new global landscape

Emerging Markets Equities

Emerging markets account for 50% of global GDP

We maintain our neutral weighting to Emerging Markets equities. Despite recent underperformance and the weakening economic prospects of some economies, we view emerging equities as an important part of a diversified portfolio in the long term because of their greater growth potential than developed markets'. Emerging economies currently account for 50% of global GDP (Figure 4), a figure that is expected to increase to 53% by 2016. More important, these economies account for 80% of the world's *incremental* GDP growth, according to the International Monetary Fund (IMF). And, as Figure 5 suggests, investors may be under-appreciating the growth potential in some markets based on the

Figure 4: Developed vs. Emerging Economies' share of global GDP

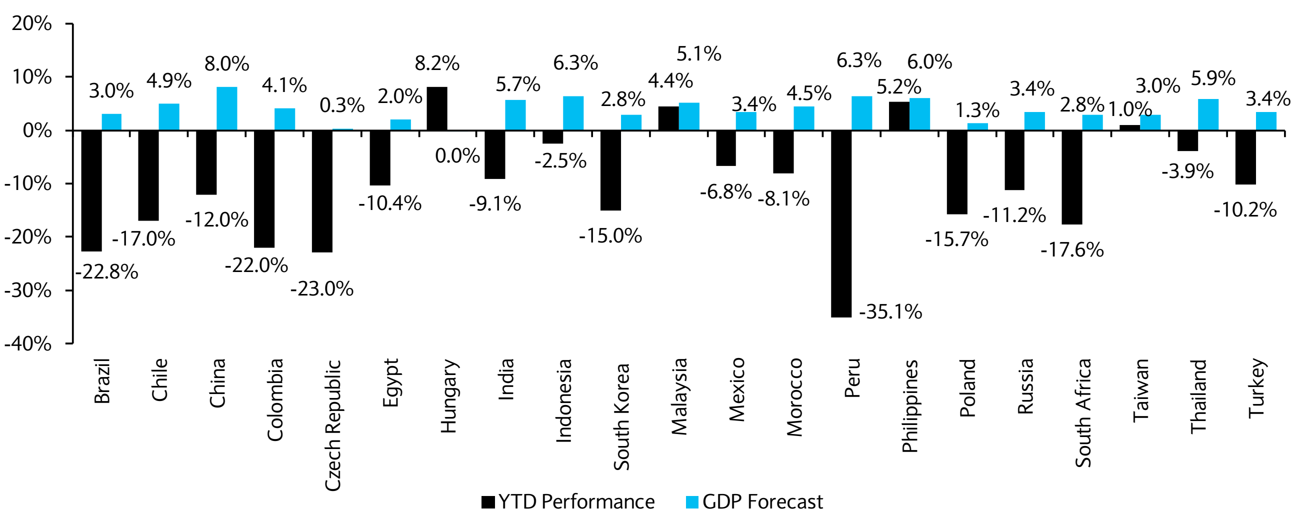


Source: GaveKal Research as of June 24, 2013

gap between the forecast for 2013 economic growth and year-to-date equity market returns. (While the forecasts may be slightly rosy – the IMF, for example, recently lowered its 2013 growth projections for a second time this year – the gap is still striking.)

Opportunities in emerging markets should be evaluated on a country-specific basis, as each exhibits its own unique 'pull' factors of varying strength. The weakening push of liquidity into emerging economies will expose which markets were most reliant on foreign capital flows, particularly countries with large current account deficits, such as Turkey and South Africa. Emerging markets with lower growth potential, volatile currencies and heightened political uncertainty are also more likely to underperform. In contrast, markets with strong growth potential and healthy domestic consumer demand, such as the Philippines and Thailand, have outperformed and we believe may continue to do so. Southeast Asian markets may also benefit from increased foreign direct investment from Japan.

Figure 5: YTD performance vs. 2013 GDP growth forecast



Source: YTD Return: Bloomberg as of July 10, 2013 (Emerging market countries' year-to-date equity returns are represented by MSCI indices) GDP Forecast: OECD (Organization for Economic Co-operation and Development) as of June 20, 2013. Past performance is no guarantee of future results. An investment can't be made directly in a market index.

Figure 6: Annual performance of nine asset classes (2003 – 1H 2013)

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013YTD
55.80%	38.00%	34.00%	41.80%	39.40%	9.10%	78.50%	19.60%	5.50%	27.70%	11.11%
40.70%	25.60%	21.40%	32.10%	16.20%	2.40%	37.10%	18.90%	4.80%	18.20%	3.77%
33.10%	14.70%	14.90%	20.10%	9.00%	-5.10%	36.00%	16.80%	2.90%	17.40%	3.65%
28.30%	12.10%	9.50%	11.10%	5.60%	-18.40%	30.00%	13.50%	0.10%	15.80%	0.00%
23.90%	9.10%	7.80%	9.30%	5.00%	-23.30%	18.90%	11.80%	-5.50%	10.90%	-1.87%
13.40%	5.50%	5.00%	4.80%	4.20%	-35.60%	16.60%	7.20%	-6.50%	4.50%	-3.68%
6.50%	4.80%	3.50%	3.60%	3.20%	-40.70%	13.40%	5.20%	-8.90%	3.50%	-5.17%
2.00%	2.70%	3.10%	3.30%	2.70%	-48.20%	1.00%	3.60%	-13.30%	0.10%	-8.45%
1.10%	1.20%	2.70%	2.10%	-7.40%	-53.30%	0.30%	0.20%	-18.40%	-1.10%	-12.12%

Cash and Short-maturity Bonds | Developed Government Bonds | Investment Grade Bonds
High Yield and Emerging Markets Bonds | Developed Markets Equities | Emerging Markets Equities
Commodities | Real Estate | Alternative Trading Strategies

Source: Bloomberg, Barclays, Wealth and Investment Management, The Federal Reserve, as of July 9, 2013.

Asset classes are represented by the following: **Cash & Short Maturity Bonds** – Barclays Global Treasury 1-3 year; **Developed Government Bonds** – Barclays Global 7-10 Year Treasury; **Investment Grade Bonds** – Barclays Global Aggregate Corporate; **High Yield & Emerging Markets Bonds** – a custom blended index consisting of: 40% Barclays High Yield 20% Barclays Global Emerging Markets 40% Barclays EM Local Currency Governments; **Developed Markets Equities** – MSCI World Net; **Emerging Markets Equities** – MSCI Emerging Markets Index Net; **Commodities** – DJ UBS Commodity; **Real Estate** – Nareit US RE All Equity Only; **Alternative Trading Strategies** – HFRX Global Hedge Fund Index.
Past performance is not a guarantee of future performance. Benchmarks are shown for illustrative purposes only, may not be available for direct investment, are unmanaged, assume reinvestment of income, and have limitations when used for comparison or other purposes because they may have volatility, credit, or other material characteristics (such as number and types of securities) that are different. Information is as of the date hereof unless otherwise indicated.

While we firmly believe emerging markets equities offer the potential for attractive returns over the long term, it's important to understand the volatility involved in this risky asset class. It was the worst or second-worst performing in *four* of the past 13 years and the best or second best-performing asset class in *eight* of the past 13 years.

It was a middling performer only in one. Over the period, returns, as represented by the MSCI Emerging Markets Index, ranged from negative 53.3% to positive 78.5% (Figure 6). We recommend investors use an active manager to help identify the markets with the best return potential.

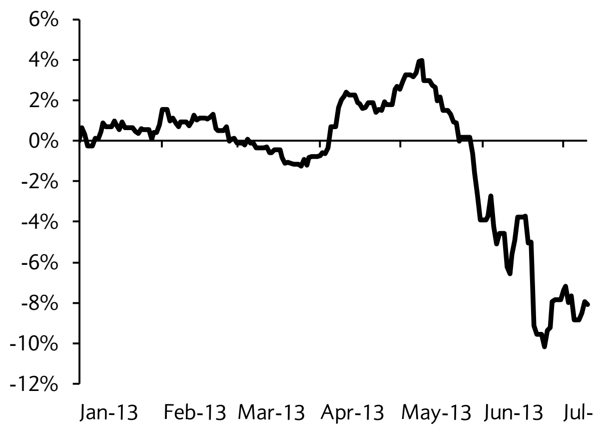
Rising Treasury yields and a strengthening dollar are pressuring local currency bonds

Emerging Market Bonds

We maintain our underweight allocation to emerging market bonds, as capital outflows are expected to continue as Treasury yields rise, making the risk-return profile of US fixed income instruments comparatively more attractive.

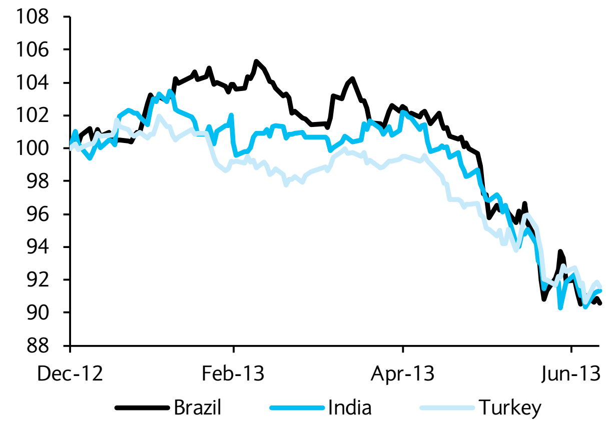
We are particularly bearish on local currency bonds, which combine the downside risks of debt in the new landscape with foreign exchange risk, as emerging market currencies decline against the strengthening dollar (Figure 7-8). The rapid influx of cash from developed economies after 2008 posed risks to financial stability in some emerging economies by pushing up the value of their currencies. The appreciation forced those countries' central banks to take action, such as building up reserves by buying US Treasuries, in order to control the rise in their currencies' value and maintain a healthy trade balance. As the tide flows out, the dollar is gaining strength while emerging market currencies are plummeting – the Brazilian real and Indian rupee have both fallen about 11% since May 1 (Figure 8) – requiring central banks to react. For instance, Brazil

Figure 7: Emerging Market Bonds YTD return (USD)



Source: Bloomberg as of July 10, 2013. JPM Global EM Diversified Bond TR Index. Past performance is no guarantee of future results. An investment cannot be made directly in an index.

Figure 8: Select Emerging Market currencies YTD returns



Source: Bloomberg as of July 10, 2013

Inherently more risky and volatile than other asset classes, some emerging markets have the potential for long-term outperformance

removed a tax on bond purchases by foreign investors, originally imposed to stem the inflow of foreign private capital. While a lower currency is helpful for export-driven economies, rapid declines can cause inflation to spike.

As it will take time for central banks to adjust to the new direction of flows, we recommend avoiding this asset class until currencies stabilize.

Any exposure to emerging market bonds should be through an active manager. The recent sell off of exchange-traded index-based bond funds after the Federal Reserve's comments are evidence of the perils of passive management.

Potential opportunities still?

While the anticipation of the end of quantitative easing has substantial implications for emerging market economies, it is but one factor that impacts the performance of this diverse group of markets. The powerful monetary stimulus of developed economies gave emerging market assets a collective push. As this force abates, investors should focus on the pull factors that are likely to differentiate winners from losers, particularly for equities. Emerging market assets are inherently more risky and volatile than other asset classes, but the potential for long-term outperformance for certain countries remains for discerning investors.

Investing in international markets is subject to additional risks and may not be suitable for all investors. Please read the risk disclosures for international investing and emerging markets in the back of this document.

Tactical Asset Allocation Review

Two major themes have informed our tactical allocation this year: (1) a bias towards Developed Markets Equities above all other asset classes as they offer attractive valuation and the most compelling return potential; and (2) a deliberate retreat from, and rotation within, fixed income – both because of valuation concerns and in anticipation of higher rates. In mid-June, we took the latest step in our fixed income retreat, cutting our overweight to high yield bonds in favor of cash as a capital reserve. We are underweight short maturity, investment grade and emerging markets bonds, and neutral weight developed government bonds (where we recommend a low strategic allocation) and high yield debt.

We still favor Developed Markets Equities and remain neutral on Emerging Markets Equities. Global markets are at the foothills of an inevitable rise in interest rates, and investor fears over the path to higher rates are likely to spark periodic bouts of volatility across asset classes. Volatility aside, the catalysts for equities in the medium-to-longer term continue to gather form: normalized economic activity in developed countries and relatively stronger growth in emerging markets. Active management in the latter asset class is particularly important.

More recently, our outlook for Commodities dimmed, prompting us to move to an underweight tactical allocation from neutral, in favor of cash. A sustained slowdown China, in the world's largest buyer of commodities, will mean further reduction in global commodity demand, which is unlikely to be replaced by developed economies' demand or offset by a pullback in supply. The imbalance could place additional downward pressure on prices. With this move, we have increased our overweight to cash, which provides a capital reserve for new opportunities in a changing landscape.

Although we maintain a neutral weight to Alternative Trading Strategies, the likelihood of greater volatility – as markets and investors adjust to less central bank liquidity and higher rates – provides opportunities in this asset class, which tends to mitigate volatility in portfolios. We also remain neutral on Real Estate, based on REIT valuations.

Figure 1: Strategic Asset Allocation (SAA) and Tactical Asset Allocation (TAA) by risk profile: asset class[12]

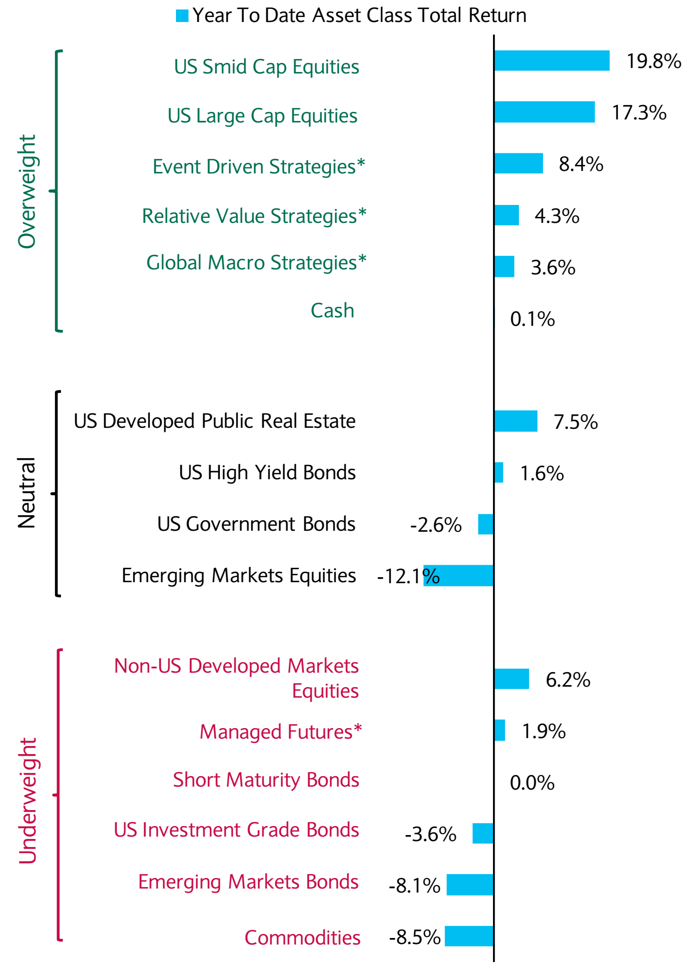
	Low		Medium Low		Moderate		Medium High		High	
Asset class	SAA	TAA	SAA	TAA	SAA	TAA	SAA	TAA	SAA	TAA
Cash and Short-maturity Bonds	46.0%	*48.0%*	17.0%	19.0%	7.0%	*10.0%*	3.0%	7.0%	2.0%	*6.0%*
Developed Government Bonds	8.0%	8.0%	7.0%	7.0%	4.0%	4.0%	2.0%	2.0%	1.0%	1.0%
Investment Grade Bonds	6.0%	*4.0%*	9.0%	*7.0%*	7.0%	*5.0%*	4.0%	*2.0%*	2.0%	*0.0%*
High Yield and Emerging Markets Bonds	6.0%	*4.0%*	10.0%	*8.0%*	11.0%	*8.0%*	10.0%	*8.0%*	8.0%	*6.0%*
Developed Markets Equities	16.0%	*19.0%*	28.0%	*32.0%*	38.0%	*43.0%*	45.0%	*49.0%*	50.0%	*53.0%*
Emerging Markets Equities	3.0%	3.0%	6.0%	6.0%	10.0%	10.0%	14.0%	14.0%	18.0%	18.0%
Commodities	2.0%	1.0%	4.0%	2.0%	5.0%	*2.0%*	6.0%	2.0%	5.0%	2.0%
Real Estate	2.0%	2.0%	3.0%	3.0%	4.0%	4.0%	6.0%	6.0%	7.0%	7.0%
Alternative Trading Strategies	11.0%	11.0%	16.0%	16.0%	14.0%	14.0%	10.0%	10.0%	7.0%	7.0%

Source: Barclays Wealth and Investment Management, As first published on 11 July 2013. Red indicates where our TAA is slightly underweight our SAA. Green indicates where our TAA is slightly overweight our SAA. Neutral weights are shown in black.

[12] 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.

Our **Strategic Asset Allocation (SAA)** models offer a baseline mix of assets that, if held on average over a five-year period, will in our view provide the most desirable combination of risk and return for an investor's degree of Risk Tolerance. They are updated annually to reflect new information and our changing views. Our **Tactical Asset Allocation (TAA)** tilts these five-year SAA views, incorporating small tactical shifts from one asset class to another, to account for the prevailing economic and political environment and our shorter-term outlook. For more on our SAA and TAA, please see our *Asset Allocation at Barclays* white paper and the February 2013 edition of *Compass*.

Figure 2: Year-to-date returns and TAA weightings for key asset and regional sub asset classes (by weighting)



Red = TAA is slightly underweight the SAA.
Green = TAA is slightly overweight the SAA.

Source: Bloomberg. As of July 9, 2013 unless otherwise noted. Diversification does not guarantee against losses. Past performance is not an indication of future performance.

Figure 3: SAA, TAA and tilts with key regional sub asset classes (Moderate Risk Profile)

Asset Class (including key regional sub asset classes)	Recommended Allocation SAA	Recommended Allocation TAA	Tilt SAA vs. TAA
Cash & Short Maturity Bonds	7%	10%	+3%
Cash	0%	7%	*+7%*
Short Maturity Bonds	7%	3%	*-4%*
Developed Government Bonds	4%	4%	0%
US Government Bonds	4%	4%	0%
Investment Grade Bonds	7%	5%	*-2%*
US Investment Grade Bonds	7%	5%	*-2%*
High Yield & Emerging Markets Bonds	11%	8%	*-3%*
US High Yield Bonds	5%	5%	0%
Emerging Markets Bonds	6%	3%	*-3%*
Developed Markets Equities	38%	43%	+5%
US Large Cap Equities	12%	15%	*+3%*
US Smid Cap Equities	5%	9%	*+4%*
Non-US Developed Markets Equities	16%	14%	*-2%*
Developed Private Equity	5%	5%	0%
Emerging Markets Equities	10%	10%	0%
Emerging Markets Equities	10%	10%	0%
Commodities	5%	2%	*-3%*
Real Estate	4%	4%	0%
Developed Public Real Estate	4%	4%	0%
Alternative Trading Strategies	14%	14%	0%
Global Macro Strategies	3.5%	3.85%	*+.35%*
Relative Value Strategies	3.5%	4.2%	*+.75%*
Event Driven Strategies	3.5%	4.2%	*+.75%*
Managed Futures	3.5%	1.75%	*-1.75%*

Red = TAA is slightly underweight the SAA.
Green = TAA is slightly overweight the SAA.

Source: Barclays Wealth and Investment Management, Americas Investment Committee. As first published on 11 July 2013.

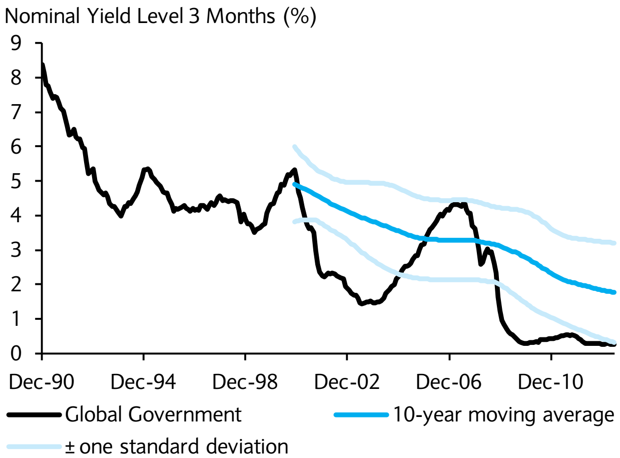
* Returns as of May 31, 2013 (latest available data) for: Event Driven, Relative Value, Global Macro and Managed Futures strategies.

Note to Figure 2: We consider private equity to be part of the overall Developed Markets Equities allocation; however, as a reliable performance index is not available, it has been excluded from year-to-date returns and TAA weightings bar chart above.

Total Returns in Figure 2 are as of July 9, 2013 unless otherwise noted and represented by the following indices: **Cash and Short-maturity Bonds:** Cash by Barclays 3-6 month T-bills; Short-maturity Bonds by Barclays 1-3 Year US Treasury; **Developed Government Bonds**: US Government Bonds by Barclays US Treasury; **Investment Grade Bonds:** US Investment Grade Bonds by Barclays US Aggregate Corporate; **High-Yield and Emerging Markets Bonds:** US High Yield Bonds by Barclays US Corporate High Yield; Emerging Markets Bonds by JP Morgan GBI-EM Total Return Diversified; **Developed Markets Equities**: US Large Cap Equities by Russell 1000 Index; US Smid Cap Equities by Russell 2500 Index; Non-US Developed Markets Equities by MSCI EAFE Net Return; **Emerging Markets Equities:** Emerging Markets Equities by MSCI EM; **Commodities**: Commodities by DJ UBS Commodity TR Index; **US Developed Public Real Estate:** US Real Estate by FTSE NAREIT US – ALL Equity REITs; **Alternative Trading Strategies** (*see note above): Relative Value Strategies by HFRI Relative Value Index; Event Driven Strategies by Dow Jones CS Event Driven Index; Managed Futures by Dow Jones CS 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; they 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.

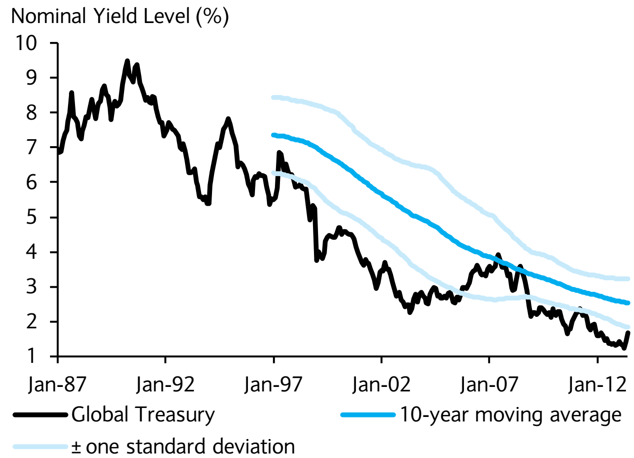
Interest rates, bond yields, and commodity and equity prices in context*

Figure 1: Short-term interest rates (global)



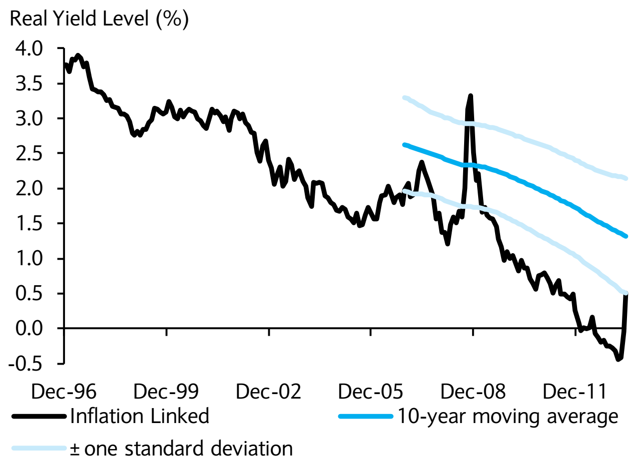
Source: FactSet, Barclays

Figure 2: Government bond yields (global)



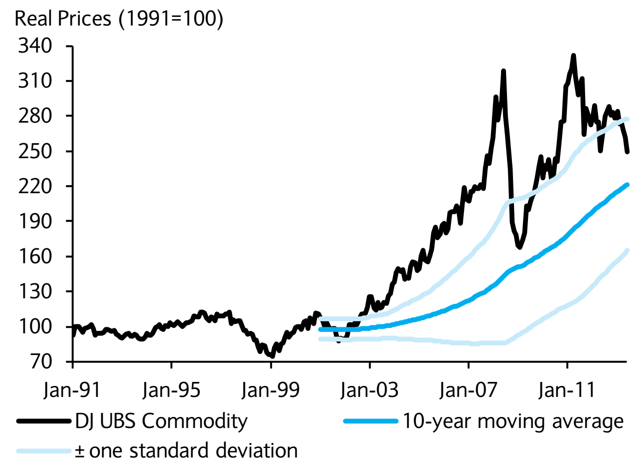
Source: FactSet, Barclays

Figure 3: Inflation-linked real bond yields (global)



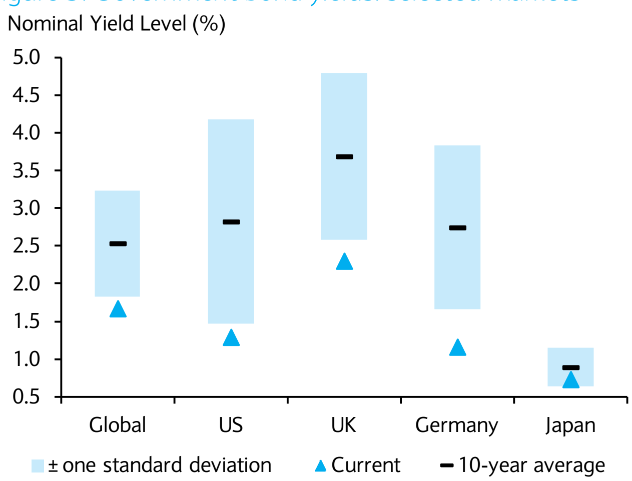
Source: Bank of America Merrill Lynch, Datastream, FactSet, Barclays

Figure 4: Inflation-adjusted spot commodity prices



Source: Datastream, Barclays

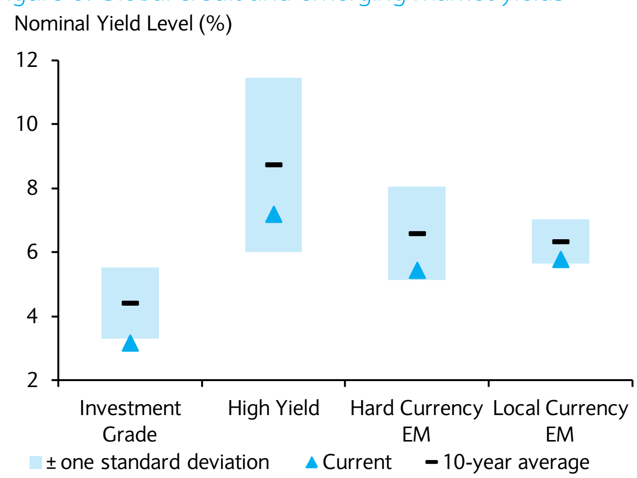
Figure 5: Government bond yields: selected markets



Source: FactSet, Barclays

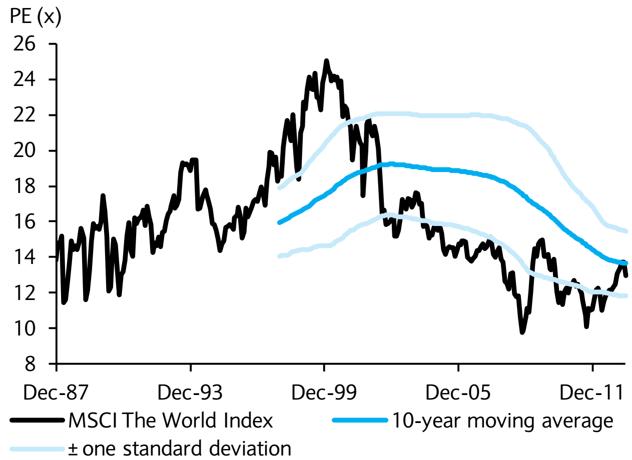
*Monthly data with final data point as of COB 24 June 2013.

Figure 6: Global credit and emerging market yields



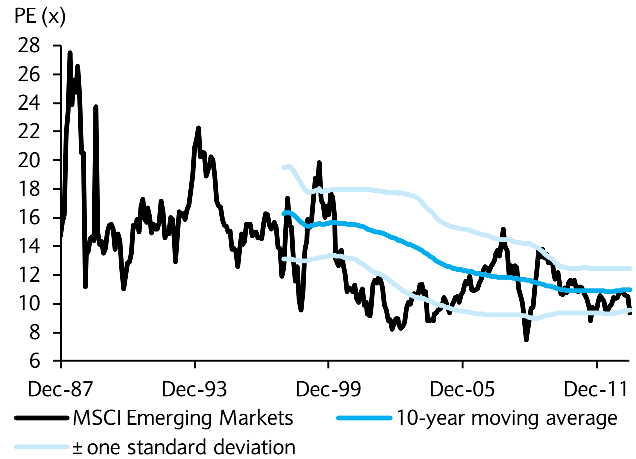
Source: FactSet, Barclays

Figure 7: Developed stock market, forward PE ratio



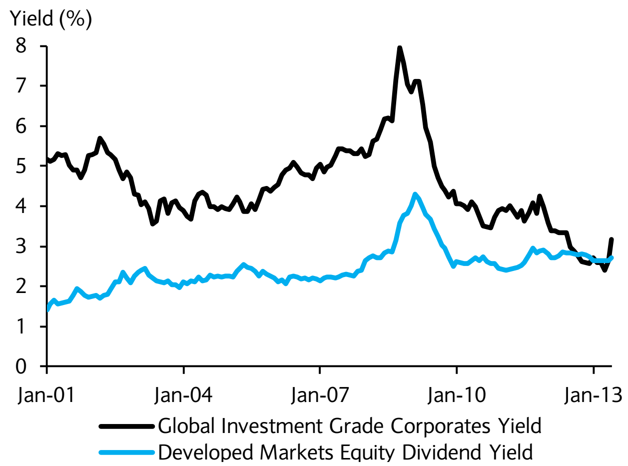
Source: MSCI, IBES, FactSet, Datastream, Barclays

Figure 8: Emerging stock market, forward PE ratio



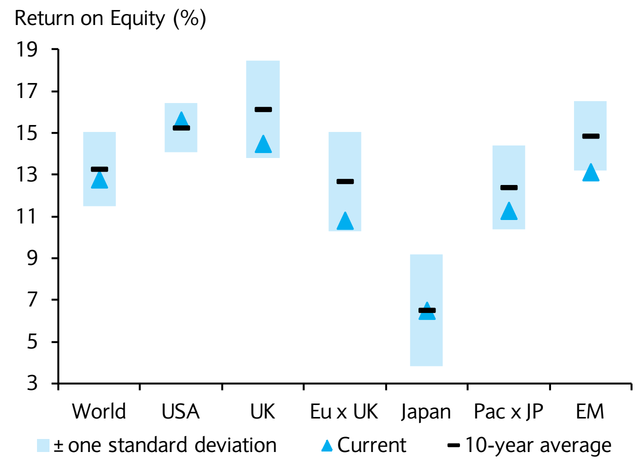
Source: MSCI, IBES, FactSet, Datastream, Barclays

Figure 9: Developed world dividend and credit yields



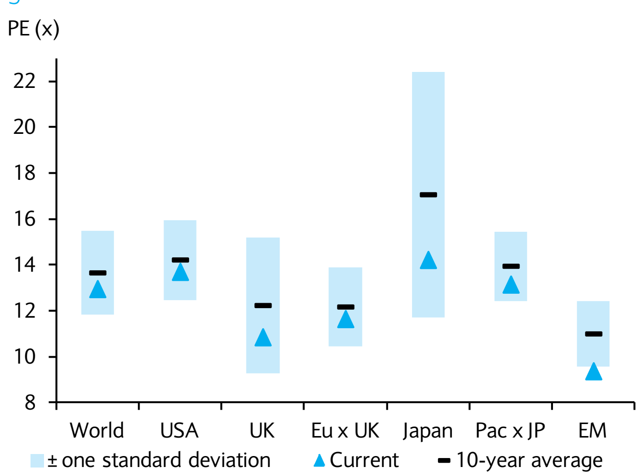
Source: MSCI, IBES, FactSet, Datastream, Barclays

Figure 10: Regional quoted-sector profitability



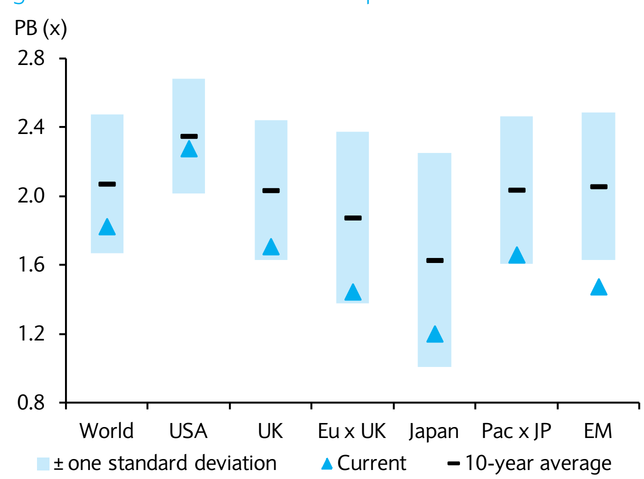
Source: MSCI, IBES, FactSet, Datastream, Barclays

Figure 11: Global stock markets: forward PE ratios



Source: MSCI, IBES, FactSet, Datastream, Barclays

Figure 12: Global stock markets: price/book value ratios



Source: MSCI, IBES, FactSet, Datastream, Barclays

Barclays' key macroeconomic projections

Figure 1: Real GDP and Consumer Prices (% y-o-y)

	Real GDP			Consumer prices		
	2012	2013	2014	2012	2013	2014
Global	3.1	3.0	3.8	2.9	2.6	3.0
Advanced	1.2	1.0	1.9	1.8	1.4	1.9
Emerging	5.0	5.0	5.6	4.6	4.6	4.8
United States	2.2	1.6	2.3	2.1	1.6	2.2
Euro area	-0.5	-0.5	1.3	2.5	1.5	1.4
Japan	1.9	2.1	2.1	-0.1	0.1	2.3
United Kingdom	0.2	1.1	2.1 ↑	2.8	2.7	2.2 ↓
China	7.8	7.4	7.4	2.6	2.6	3.5
Brazil	0.9	2.3	2.7	5.4	6.4	5.5
India	5.1	5.4	6.7	7.5	5.6	5.5
Russia	3.4	3.0	3.5	5.1	6.6	5.6

Source: Barclays Research, *Global Economics Weekly*, 5 July 2013
Note: Arrows appear next to numbers if current forecasts differ from that of the previous week by 0.2pp or more for annual GDP and by 0.2pp or more for Inflation. Weights used for real GDP are based on IMF PPP-based GDP (5yr centred moving averages). Weights used for consumer prices are based on IMF nominal GDP (5yr centred moving averages).

Figure 2: Central Bank Policy Rates (%)

Official rate % per annum (unless stated)	Current	Forecasts as at end of Q3 13	Q4 13	Q1 14	Q2 14
Fed funds rate	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
ECB main refinancing rate	0.50	0.50	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	0.50	0.50	0.50
China: 1y bench. lending rate	6.00	6.00	6.00	6.00	6.00
Brazil: SELIC rate	8.00	9.00	9.25	9.25	9.25
India: Repo rate	7.25	7.00	6.50	6.50	6.50
Russia: Overnight repo rate	5.50	5.25	5.25	5.00	5.00

Source: Barclays Research, *Global Economics Weekly*, 5 July 2013
Note: Rates as of COB 4 July 2013.

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Asset Class Risks

Alternative Trading Strategy – There are specific concerns related to alternative investment strategies with respect to private wealth clients. These include: investor taxability; suitability of funds that require long lock-up periods for investors with liquidity needs or multiple investment horizons; communicating complex strategies to a non-professional client; greater likelihood of decision risk (changing strategies at the point of maximum loss) and clients whose wealth stems from concentrated positions in closely held companies may not be suited to other illiquid investments.

Bonds – Bonds are subject to market, interest rate and credit risk; and are subject to availability and market conditions. Generally, the higher the interest rate the greater the risk. Bond values will decline as interest rates rise. Government bonds are subject to federal taxes. **Municipal bond interest** may be subject to the alternative minimum tax; other state and local taxes may apply. **High yield bonds**, also known as "junk bonds" are subject to additional risks such as the increased risk of default. Debt securities may be subject to call features or other redemption features, such as sinking funds, and may be redeemed in whole or in part before maturity. These occurrences may affect yield. Like all bonds, corporate bonds tend to rise in value when interest rates fall, and they fall in value when interest rates rise. The longer the maturity of the bond, the greater the degree of price volatility. If you hold a bond until maturity, you may be less concerned about these price fluctuations (which are known as interest rate risk or market risk), because you will receive the par or face value of your bond at maturity. **Distressed Debt** – Although distressed debt opportunities are cyclical, in that they multiply during economic slowdowns, the time taken to profit from them depends on how long a firm takes to restructure, which varies from one case to another. The process can be lengthy – for instance, if the negotiations between a firm's management team and its creditors start to drag. Event risk relates to unexpected company-specific or situation-specific events that affect valuation. Market liquidity risk arises because distressed securities are less liquid, and demand runs in cycles. J-factor risk relates to the judge presiding over bankruptcy proceedings. The track record in adjudication and restructuring can play a significant role in both the overall outcome and determining the optimum securities in which to invest.

Cash Equivalents – Portfolios that invest in very short-term securities provide taxable or tax-advantaged current income, pose little risk to principal and offer the ability to convert the investment into cash quickly. These investments may result in a lower yield than would be available from investments with a lower quality or longer term.

Commodities – Commodities are assets that have tangible properties, such as oil, metals, and agricultural products. An investment in commodities may not be suitable for all investors. Commodities may be affected by overall market movements and other factors that affect the value of a particular industry or commodity, such as weather, disease, embargoes, or political and regulatory developments. Commodities are volatile investments and should only form a small part of a diversified portfolio. Diversification does not ensure against loss. Consult your investment representative to help you determine whether a commodity investment is right for you. Market distortion and disruptions have an impact on commodity performance and may impact the performance and values of products linked to commodities or related commodity indices. The levels, values or prices of commodities can fluctuate widely due to supply and demand disruptions in major producing or consuming regions.

Equities – Large Growth and Value Stocks – Portfolios that emphasize large and established US companies may involve price fluctuations as stock market conditions change. **Mid-Cap Stocks** – Mid-cap stocks have limited marketability and may be subject to more abrupt or erratic market movements than large-cap stocks. This group of companies is considered to be more volatile than the large and mega-cap companies. Growth stocks represent a significant portion of the mid caps. **Small-Cap Stocks** – Small-cap stocks have limited marketability and may be subject to more abrupt or erratic market movements than large-cap stocks. These stocks may involve a higher degree of risk and volatility than investments in larger companies.

Exchange Traded Funds (ETF) shareholders are subject to risks similar to those of holders of other portfolios, such as mutual funds. In addition to these general risks, there are risks specific to each ETF, which are described in the relevant prospectus. Risks may include the following:

- The general value of securities held may decline, thus adversely affecting the value of an ETF that represents an interest in those securities. This could occur with equities, commodities, fixed income, futures, or other investments the fund may hold on behalf of the shareholders.
- For ETFs whose stated investment objective is to track a particular industry or asset sector, the fund may be adversely affected by the performance of that specific industry or sector.
- Fund holdings of international investments may involve risk of capital loss from unfavorable fluctuations in currency exchange rates, differences in generally accepted accounting principles, or economic or political instability in other nations.
- Although ETFs are designed to provide investment results that generally correspond to the price and yield performance of their respective underlying indexes, the trusts may not be able to exactly replicate that performance because of trust expenses and other factors. This is sometimes referred to as "tracking error".

International/Global Investing/Emerging Markets – International investing may not be suitable for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

Real Estate Investment Trusts (REITs) – The properties held by REITs could fall in value for a variety of reasons, such as declines in rental income, poor property management, environmental liabilities, uninsured damage, increased competition, or changes in real estate tax laws. There is a risk that REIT stock prices overall will decline over short or even long periods because of rising interest rates. Other risks include: **Sensitive to Demand for Other High-Yield Assets**. Generally, rising interest rates could make Treasury securities more attractive, drawing funds away from REITs and lowering their share prices. **Property Taxes**. REITs must pay property taxes, which can make up as much as 25% of total operating expenses. State and municipal authorities could increase property taxes to make up for budget shortfalls, reducing cash flows to shareholders. **Tax Rates**. One of the downsides to the high yield of REITs is that taxes are due on dividends, and the tax rates are typically higher than the 15% most dividends are currently taxed at. This is because a large chunk of a REIT's dividends (typically about three quarters, though it varies widely by REIT) is considered ordinary income, which is usually taxed at a higher rate.

Credit Ratings

A credit rating is not a recommendation to purchase, hold or sell an investment inasmuch as a rating does not comment as to investment return or suitability for a particular investor.

Moody's ratings represent the opinion of Moody's Investors Service as to the relative creditworthiness of securities. As such, they should be used in conjunction with the descriptions and statistics appearing in Moody's publications. Reference should be made to these statements for information regarding the issuer. Moody's ratings are not commercial credit ratings. In no case is default or receivership to be imputed unless expressly stated.

Standard & Poor's credit ratings express forward-looking opinions about the creditworthiness of issuers and obligations. More specifically, Standard & Poor's credit ratings express a relative ranking of creditworthiness. Issuers and obligations with higher ratings are judged by us to be more creditworthy than issuers and obligations with lower credit ratings. Creditworthiness is a multi-faceted phenomenon. Although there is no "formula" for combining the various facets, our credit ratings attempt to condense their combined effects into rating symbols along a simple, one-dimensional scale. Indeed, as discussed below, the relative importance of the various factors may change in different situations. The term creditworthiness refers to the question of whether a bond or other financial instrument will be paid according to its contractual terms.

Index Definitions

BofA Merrill Lynch Global Broad Market Corporate Index tracks the performance of investment grade debt publicly issued in the major domestic and eurobond markets, including sovereign, quasi-government, corporate, securitized and collaterized securities. Qualifying securities must have an investment grade rating based on an average of Moody's, S&P and Fitch.

The **BofA Merrill Lynch Global High Yield and Emerging Markets Index** tracks the performance of the below investment grade global debt markets denominated in the major developed market currencies. The Index is a capitalization-weighted blend of The Global High Yield Index, the Global Emerging Markets Sovereign Index and The Global Emerging Markets Credit Index.

Barclays EM Hard Currency Aggregate Index is broad-based index includes USD, EUR, and GBP denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. It reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set. Country eligibility and classification as an Emerging Market is rules-based and reviewed on an annual basis using World Bank income group and International Monetary Fund (IMF) country classifications. This index was previously called the Barclays Global EM Index.

Barclays EM Local Currency Governments is a broad-based index that measures the total return of 20 different local currency government debt markets spanning Latin America, Europe, the Middle East, Africa and Asia.

Barclays Euro-Aggregate Index consists of bonds issued in the euro or the legacy currencies of the 16 sovereign countries participating in the European Monetary Union (EMU). All issues must be investment grade rated, fixed-rate securities with at least one year remaining to maturity.

Barclays Euro-Aggregate Government Index is the Government component of the Euro-Aggregate Index and includes only treasury, agency, local authority issues.

Barclays Global Aggregate – Corporates – The corporates portion of the Barclays Global Aggregate index grouping.

Barclays Global Governments 1-3 years – The 1-3 Yr component of the Barclays Global Treasury Index. The Barclays Global Treasury Index tracks fixed-rate local currency government debt of investment grade countries. The index represents the Treasury sector of the Global Aggregate Index and currently contains issues from 38 countries denominated in 23 currencies. The three major components of this index are the US Treasury Index, the Pan-European Treasury Index, and the Asian-Pacific Treasury Index, in addition to Canadian, Chilean, Mexican, and South-African government bonds. The index was created in 1992, with history backfilled to January 1, 1987.

Barclays Global Governments 7-10 years – the 7-10 Yr component of the Barclays Global Treasury Index. The Barclays Global Treasury Index tracks fixed-rate local currency government debt of investment grade countries. The index represents the Treasury sector of the Global Aggregate Index and currently contains issues from 38 countries denominated in 23 currencies. The three major components of this index are the US Treasury Index, the Pan-European Treasury Index, and the Asian-Pacific Treasury Index, in addition to Canadian, Chilean, Mexican, and South-African government bonds. The index was created in 1992, with history backfilled to January 1, 1987.

The **Barclays Global Emerging Markets Index** represents the union of the USD-denominated US Emerging Markets Index and the predominately EUR-denominated Pan Euro Emerging Markets Index, covering emerging markets in the following regions: Americas, Europe, Middle East, Africa, and Asia. **Barclays Global High Yield** represents the US High Yield Index, Pan-European High Yield Index, High Yield CMBS Index, and non-investment grade portion of the Barclays Global Emerging Markets Index.

Barclays Global Treasury Index tracks fixed-rate local currency government debt of investment grade countries. The index represents the Treasury sector of the Global Aggregate Index and currently contains issues from 37 countries denominated in 23 currencies. The three major components of this index are the US Treasury Index, the Pan-European Treasury Index, and the Asian-Pacific Treasury Index, plus Canadian, Chilean, Mexican, and South-African government bonds.

Barclay Hedge Global Macro – Represents a measure of the average return of the macro geared/strategized hedge funds within the Barclay database whose positions concertedly reflect the direction of the overall market as attributed to major economic trends and events. The portfolios of these funds are comprised of an offering of stocks, bonds, currencies and commodities in the form of cash or derivative instruments. A majority of these index linked funds invest globally in both developed and emerging markets.

Barclays Pan-European High-Yield Index measures the market of non-investment grade, fixed-rate corporate bonds denominated in the following currencies: euro, Pounds sterling, Norwegian krone, Swedish krona, and Swiss franc. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. Inclusion is based on the currency of issue, and not the domicile of the issuer. The index excludes emerging market debt. It was created in 1999 and is part of the Global High-Yield Index.

Barclays Treasury Bill Index includes US Treasury bills with a remaining maturity from 1 month up to (but not including) 12 months. It excludes zero coupon strips.

Barclays US 3-6 Mo. Treasury – Comprised of all treasuries with 3-6 month maturities purchased at the beginning of each month and held for a full month. At the end of the month, issues with less than three months to maturity are sold and rolled into newly selected issues.

Barclays US Corporate High Yield Index measures the US corporate market of non-investment grade, fixed-rate corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

Barclays US Corporate Investment Grade Bond Index covers all publicly issued, fixed rate, nonconvertible, investment grade debt in US dollars.

Barclays US Treasury 25+Y Index – Securities in the Treasury Index (i.e., public obligations of the U.S. Treasury) with a maturity greater than 25 years. Must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch.

Dow Jones UBS Commodity Index measures price movements of the commodities included in the appropriate sub index. It does not account for effects of rolling futures contracts or costs associated with holding the physical commodity.

Dow Jones CS Event Driven – The Dow Jones Credit Suisse Event Driven Index is an asset-weighted hedge fund index derived from the TASS database of more than 5000 funds. The Index consists only of Event-Driven funds with a minimum of US $50 million AUM, a 12-month track record, and audited financial statements. Event-Driven funds invest in various asset classes and seek to profit from potential mispricing of securities related to a specific corporate or market event (e.g.,. mergers, bankruptcies, financial or operational stress, restructurings, asset sales, recapitalizations, spin-offs, litigation, regulatory and legislative changes etc.). Event-Driven funds can invest in equities, fixed income instruments, options and other derivatives. Many managers use a combination of strategies and adjust exposures based on the opportunity sets in each sub-sector.

Dow Jones CS Managed Futures – The Dow Jones Credit Suisse Managed Futures Index is an asset-weighted hedge fund index derived from the TASS database of more than 5000 funds. The strategy invests in listed financial and commodity futures markets and currency markets around the world. The managers are usually referred to as Commodity Trading Advisors, or CTA's. Trading disciplines are generally systematic or discretionary. Systematic traders tend to use price and market specific information (often technical) to make trading decisions, discretionary managers use a judgmental approach.

FTSE EPRA/NAREIT Global Developed Index is designed to track the performance of listed real estate companies and Real Estate Investment Trusts (REITs) worldwide. It incorporates REITs and Real Estate Holding & Development companies. Index constituents are free float-adjusted and screened for liquidity, size and revenue screened.

FTSE NAREIT – All Equity REITs – An index that consists of all Real Estate Investment Trusts that currently trade on the New York Stock Exchange, the NASDAQ National Market System and the American Stock Exchange. Equity REITs include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.

HFRI Relative Value TR is comprised of investment managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. Relative Value is further subdivided into eight sub-strategies: Asset Backed, Convertible Arbitrage, Corporate, Sovereign, Volatility, Yield Alternatives-Energy Infrastructure, Yield Alternatives-Real Estate, and Multi-Strategy.

HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund of funds that report to HFR.

HFRX Global Hedge Fund Index is comprised of all eligible hedge fund strategies including, but not limited to: convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

JP Morgan GBI-EM Total Return Diversified – The JPMorgan Government Bond Index-Emerging Markets (GBI-EM) indices are comprehensive emerging market debt benchmarks that track local currency bonds issued by Emerging Market governments. The Diversified version was launched in January 2006.

JPMorgan Global FX Volatility Index – The VXY and EM-VXY indexes follow aggregate volatility in currencies through a turnover-weighted index of G7 and emerging market volatility, based on three-month at-the-money forward options. The indexes are designed to allow investors to measure aggregate risk premiums in currency markets, calibrate trading strategies and express views on volatility as an asset class.

Merrill Lynch USD High Yield & Emerging Market Sovereigns Index tracks the performance of the below investment grade global debt markets denominated in US dollars. It has become the BofA Merrill Lynch **Global High Yield and** Emerging Markets Index.

Merrill Option Volatility Estimate (MOVE) Index – This is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the CT2, CT5, CT10, and CT30. `MOVE' is a trademark product of Merrill Lynch (weighted average of 1m2y, 1m5y, 1m10y and 1m30y Treasury implied vols with weights 0.2/0.2/0.4/0.2, respectively).

MSCI EAFE – The MSCI EAFE Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed equity. As of January 2012 the MSCI EAFE Index consisted of the following 22 developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

MSCI Emerging Markets Commodity Producers Index (MXEF0CMP Index) – The MSCI Commodity Producers Index is a free float adjusted market capitalization index designed to reflect the performance of the three underlying commodity markets: energy, metals, and agricultural products.

MSCI EM Index represents a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of February 2013, the MSCI Emerging Markets Index includes 23 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

MSCI World Index represents a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of February 2013, it includes 24 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

The **Standard & Poor's (S&P) 500 Index** represents a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States. The stocks included in the S&P 500 are those of large publicly held companies that trade on either of the two largest American stock market companies; the NYSE Euronext and the NASDAQ OMX. A selection committee selects the companies in the S&P 500 so they are representative of the industries in the United States economy.

VIX Index – is the ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. It represents one measure of the market's expectation of stock market volatility over the next 30 day period. The VIX is quoted in percentage points and translates, roughly, to the expected movement in the S&P 500 index over the next 30-day period, which is then annualized.

For MSCI Index definitions, including emerging market country indices, please see: *http://www.msci.com/products/indices/tools/*

An investment cannot be made directly in a market index.

www.barclays.com/wealth/americas

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