February 2013

Compass

Strategic Asset Allocation update

Market outlook

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A pro-cyclical US dollar?

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Strategic Asset Allocation update

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Our Strategic Asset Allocations (SAA) provide the baseline combination of asset classes that we believe investors should hold over the next five years to most effectively extract expected returns relative to the level of risk that their financial circumstances and personalities suggest is appropriate. Because these SAA model portfolios look a long way ahead, they are intended to be stable over time, and not change in response to the immediate economic or market environment. However, we fine tune them each year. As part of this year's update, we have adjusted our SAA model portfolios to reflect our view that slightly higher relative returns in different assets make it worth taking a bit more risk. We outline our process for developing the SAA models and results of our update below.

What's involved in the update?

We revisit our Strategic Asset Allocations each year *not* because we expect dramatic revisions in the allocations, but because good investment practice requires that we:

- Review our assumptions to make sure they still hold;
- Update our data with the outcomes of the previous 12 months;
- Incorporate what we've learned, and how the world has changed, in the intervening year;
- Look for ways to improve our quantitative modelling by building in any advances from the best thinking of the industry and academic world;
- And capture afresh the opinions of our market experts.

No one has a crystal ball enabling a view into the future – if we did, we'd just invest in the assets we knew would rise the fastest. But the world is inherently uncertain, and to arrive at the best allocation between risky alternatives requires us to think very carefully about what we know about these assets. This knowledge comes from two crucial sources: current market data and historical data on how assets have performed (objective); and expectations of how they will perform (subjective). Effective asset allocation combines both sources of information to arrive at the clearest understanding of the risks and expected returns that investors face today.

To ensure this isn't mere opinion and guesswork, both of which can be hugely dangerous when setting a course for the future, we use a methodical and robust process. This requires setting in advance how data are used; how we ensure expert opinions are captured systematically, and discussed extensively; and how these are combined to arrive at expectations for future returns that are grounded neither too much in the past, nor too much in subjective opinion. Of course, in arriving at this process there are always choices to be made. But by making all the assumptions explicit and testable, by revisiting them on a regular basis, by demanding consistency from year to year, and by documenting any changes, we get some comfort and confidence that our allocations have been tested to the highest standard, and use the best thinking available.

This year we've just completed the process. The percentage allocations don't change much, and nor do many of our fundamental assumptions. However, we have upgraded our process in a few key areas, as well as reassessed the returns that we anticipate over the next five years.

What do we expect?

Our long-term views on returns: Capital Markets Assumptions

The Capital Market Assumptions, or 'views', are the forward looking but subjective part of our overall return assumptions. We asked a wide panel of Barclays' investment professionals for their best estimates of a number of factors crucial to driving the returns of our asset classes, such as inflation, GDP growth, or yield. Our global team of investment strategists and portfolio managers found some cause to update our opinions, but, broadly, they concluded that our long-term views on the world had not changed dramatically since our last update in February 2012.

We develop our five-year views by eliciting the input of a wide range of research and investment professionals across Barclays globally. Our process uses a top down, building-block approach which includes the key macroeconomic variables that drive the return of each asset class. As a result of this, our five year outlook for equity returns remains positive and has risen slightly from last year. For developed market equities, we combine granular forecasts on global developed core inflation (around 1.7%), real earnings growth (2.3%), dividend yields (2.5%), changes in valuations (1.6%) and FX (-0.2%)[1] to reach a total expected annual return of around 7.9%. These inputs reflect our belief that developed markets' inflation will remain under control due to pressure from muted wage increases and economic growth will be weak but positive. For emerging markets, we see inflation and real earnings growth remaining higher than in developed ones, though the *pace* of growth may begin to slow as wage inflation puts pressure on margins. At the same time, emerging markets equities may benefit from increased valuation multiples, reflecting their relatively higher growth.

Expectations that growth and employment in the developed economies will remain sluggish for a while are likely to keep interest rates at their current low level in the near term. Continued economic weakness could also result in further monetary easing. That said, when rates do normalise (our expectation is that they will within the next five years) there is the potential for them to do so sharply and unexpectedly. On balance, we have reduced our average expected risk-free rate of return for the next five years to 1.5%, reflecting sustained low rates in the near term, then rising rates in a few years' time. This expected rise in interest rates implies a negative headwind for bond prices. With duration highest, and yields lowest, in the government bond markets, these bonds will suffer the most. However, for high yield and emerging market debt, healthy corporate balance sheets and growth in emerging economies should reduce default risk and support low spreads – and could even compress them further – potentially pushing prices up despite the downward pressure from rate increases.

[1] Valuation impact: the effect on total return of expected changes in, say, stock price-to-earnings multiples. Foreign exchange impact: the effect on total return of expected changes in currency values.

Expected returns implied by the market: Equilibrium Returns

Once we have built our subjective long-term views for each asset class, we combine them with what we term 'equilibrium' returns. These reflect something akin to a return implied by the market, using information embedded in current market and historical market prices.[2] We obtain these equilibrium returns by using a 'Black-Litterman' process. Instead of starting with returns, risk assumptions and then optimising to get a portfolio, we use that market portfolio along with risk assumptions to imply the returns.

Blended Returns: Our final five-year expectations for asset class returns

Once we have the equilibrium returns implied by the market, we combine them with our long-term subjective views (Capital Markets Assumptions) to create 'blended returns' – our official expectation for the compounded annual return of each asset class over the next five years. The 'blended returns' reflect a combination of our best thinking and that of the wider investment community on the likely pattern of future returns (Figure 1) and feed into our expected excess and total returns for the SAA models in Figure 3. When reviewing the expected and excess returns, it is important to do so in the context of what is today a *very* low risk-free rate of return by historical standards. For example, the 6% expected return for the moderate risk profile may seem somewhat muted in absolute terms, but it represents an excess return over the risk-free rate of 4.5%, higher than last year's 3.5%.

Figure 1: Asset class definitions , benchmarks and expected returns

Asset Class	Asset Class Definitions	Capital Markets Assumptions on Expected Total Returns*	Overall Blended Expected Total Return (annual)**	Benchmarks***
Cash and Short-maturity Bonds	Fixed-income investment with a final maturity of less than three years and credit ratings of AA- or better	1.5%	**1.5%**	Barclays US Treasury Bills
Developed Government Bonds	Fixed-income instruments with maturities of three years and above, issued by: Sovereigns with credit ratings of AA- or better	-0.1%	**1.4%**	Barclays Global Treasury
Investment Grade Bonds	Fixed-income securities with maturities greater than one year issued by: - corporations with credit ratings of BBB- or higher, - governments with credit ratings between BBB- and A+	1.2%	**2.3%**	Barclays Global Aggregate – Corporates
High Yield and Emerging Markets Bonds	High yield: Debt issued by companies with low credit ratings (BB+ or lower); Emerging markets: Bonds issued by Sovereigns, government-related agencies and corporations with a rating of BB+ and lower, denominated in major currencies and local currencies	5.3%	**5.0%**	40% Barclays High Yield/ 20% Barclays Global EM/ 40% Barclays EM Local Currency Governments
Developed Markets Equities	Equities within the MSCI World (developed) benchmark	7.9%	**7.9%**	MSCI World
Emerging Markets Equities	Equities within the MSCI Emerging Markets benchmark	12.5%	**10.6%**	MSCI EM
Commodities	Commodities held as a diversified investment within a fund or other investment vehicle	4.1%	**4.8%**	Dow Jones-UBS Commodity Index
Real Estate	Both direct real estate and REITs	5.3%	**8.0%**	FTSE EPRA/NAREIT Developed
Alternative Trading Strategies	ATS aims to generate profits by actively taking long and short positions in a wide range of markets. Strategies include Global Macro, Relative Value, Event Driven, some long/short equity, and other.	5.3%	**3.5%**	HFRX Global Hedge Fund

* Views drawn from Barclays experts.
** We expect these annual returns to be compounded over the next five years. Overall blended views fuse Barclays expert and equilibrium views.
*** New benchmarks as of Feb 2013 appear in red. For High Yield and Emerging Markets Bonds, the previous blended benchmark was 39% Barclays High Yield/ 20% Barclays Global EM/ 41% Barclays EM Local Currency Governments.

[2] The idea is that a 'market portfolio', to the extent it reflects the implicit views of all market participants, is a consensual view of all publicly available information. If this 'market portfolio' is informationally efficient and in equilibrium, it tells us something about expected available returns in the market place.

Improving our benchmarks

We reassess each year our expectations not only for return but also for risk. One of the pillars of our Investment Philosophy is that the asset classes we recommend are accessible. This year we have changed two of the benchmarks we use to proxy the return and volatility of each asset class, enabling us to better reflect the risks inherent in how investors actually access Real Estate and Alternative Trading Strategies (ATS).

For Real Estate, we have replaced the previous benchmark of direct real estate with an index of REITs. The benchmark change does not mean that we discourage direct real estate investment. On the contrary, for investors with the right liquidity profile, it is the purest representation of the asset class. But it can be harder to access and potentially carries higher concentration risk than a more indirect investment. So our benchmark change reflects two facts: (1) the difficulty of tracking the performance of such investments on a day-by-day basis (the relatively illiquid, opaque and heterogeneous nature of real estate makes real-time performance difficult to monitor effectively); and (2) the reality that REITs, as one of the most liquid and easily accessible investment options for this asset class, are commonly used to gain exposure to it. It is important to note, however, that the tradability and leverage associated with REITs means they are subject to factors such as market sentiment. They are effectively part of the quoted equities universe, and so can be correlated with it.

For Alternative Trading Strategies, we made a similar change to a more liquid, accessible index: HFRX Global, which represents a number of strategies and funds that are directly investible and characteristic of the wider ATS universe. This index also tends to demonstrate a higher correlation to equity markets.

Determining the optimal allocations for this year

After we create our overall 'blended' returns, we use a statistical optimisation procedure to draw these expectations and our risk assumptions together with our understanding of how clients both experience and trade-off expected returns against risk. As we have no crystal ball, during this process we also stress our assumptions using realistic data with fat tails and extreme events. We do not make the standard assumption that everyone views 'risk' as volatility. Instead, we actually evaluate 'risk' slightly differently for each of the five asset allocations below. It is this process that amalgamates how we understand our clients with how we understand markets.

Across all the risk profiles, we see a small overall increase in risk – as each profile views it – as slightly higher relative returns in different assets make it worth taking slightly more risk across the spectrum.

The main shifts from last year are: (1) a continued tilt out of Developed Government Bonds with their allocations dropping across all of our models, and (2) a continued increase in allocations to High Yield & Emerging Market Bonds. This shift is most clearly visible in our Low to Moderate Risk Profiles.

For the Low and Medium-Low profiles, the shift from government bonds into Investment Grade, High Yield and Emerging Markets debt increases slightly each model's overall risk. To counterbalance *part* of that increase, we lower allocation to some of our riskier assets, namely real estate and equities, while raising allocation to Cash & Short- maturity Bonds.

For the Moderate, Medium-High and High Risk profiles, an even greater increase in overall risk is viewed as beneficial. Lower allocations to Developed Government Bonds and Cash & Short-maturity Bonds are replaced by increases to riskier fixed income (High Yield & Emerging Markets Bonds), equities (Emerging Markets Equities) and Real Estate.

Figure 2: Strategic Asset Allocation models – changes in allocation from 2012

	Risk Tolerance Level				
	Low	Med-Low	Moderate	Med-High	High
Cash and Short-Maturity Bonds	3%	2%	-1%	-2%	-2%
Developed Government Bonds	-2%	-6%	-5%	-4%	-3%
Investment Grade Bonds	3%	5%	3%	1%	0%
High Yield and Emerging Markets Bonds	2%	3%	3%	2%	2%
Developed Markets Equities	0%	-1%	0%	0%	-1%
Emerging Markets Equities	-1%	-1%	0%	1%	1%
Commodities	0%	0%	0%	0%	-1%
Real Estate	-5%	-2%	0%	3%	5%
Alternative Trading Strategies (ATS)	0%	0%	0%	-1%	-1%

Source: Barclays

Figure 3: 2013 Strategic Asset Allocations with expected five-year annual return

	Risk Tolerance Level				
Asset Class	Low (RP1)	Medium-Low (RP2)	Moderate (RP3)	Medium-High (RP4)	High (RP5)
Cash and Short-maturity Bonds	46%	17%	7%	3%	2%
Developed Government Bonds	8%	7%	4%	2%	1%
Investment Grade Bonds	6%	9%	7%	4%	2%
High Yield and Emerging Markets Bonds	6%	10%	11%	10%	8%
Developed Markets Equities	16%	28%	38%	45%	50%
Emerging Markets Equities	3%	6%	10%	14%	18%
Commodities	2%	4%	5%	6%	5%
Real Estate	2%	3%	4%	6%	7%
Alternative Trading Strategies (ATS)	11%	16%	14%	10%	7%
Expected excess annual returns (over cash)*	2.0%	3.4%	4.5%	5.3%	5.9%
Expected total annual returns*	3.5%	4.9%	6.0%	6.8%	7.4%

Source: Barclays
* Note: We expect these average annual returns for each Risk Profile to be compounded over five years. There is no guarantee that these estimated returns will be achieved.

After an extensive process of due diligence, then, we conclude that the key themes of our existing SAA remain intact with some small changes warranted. Overall, we still expect nominal GDP to continue to trend higher; interest rates and most bond yields to start to normalise; and emerging economies to continue to grow fastest. As a general theme, when we compare our recommended strategic weightings with those embedded in current market values, we continue broadly to favour corporate over government securities, stocks over bonds, and emerging over developed economies.

Market outlook

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While the world's major central banks may be finally working from the same cookbook, they're unlikely to serve up a great deal of economic growth this year. Despite this, capital markets appear unwilling to give up their gains anytime soon.

Europe: Austerity investing: the region edges forward

Europe's economies will lag in 2013, but its capital markets needn't. Low expectations are more easily beaten. In line with our global views, we prefer corporate to government securities, and stocks to bonds, but the main continental indices for both stocks *and* bonds could outperform their respective global benchmarks.

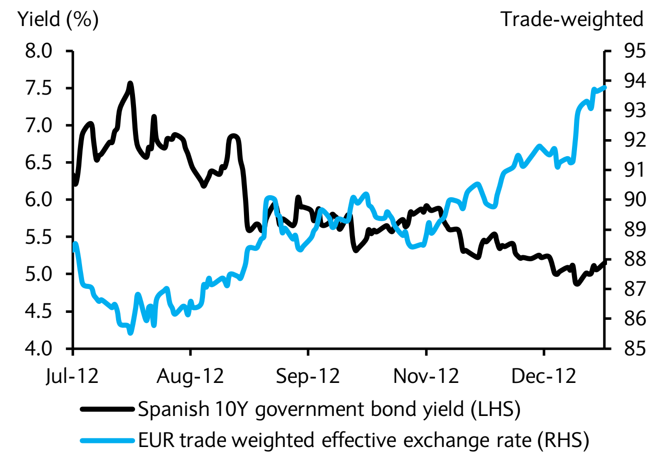
The euro crisis: too soon to celebrate, too late to despair

Sometimes no news is good news, and the relative quiet in euro area political circles over recent weeks would be a case in point. It has allowed capital markets to ponder the practical meaning of the European Central Bank's promise to do 'whatever it takes' to keep the euro intact. For the time being, they seem to have concluded – as we'd thought they could – that the promise is a credible one. Market tensions have abated further, most visibly in the level and spread of peripheral bond yields and in the value of the euro itself (Figure 1).

The euro crisis has not gone away – but its intensity is diminished

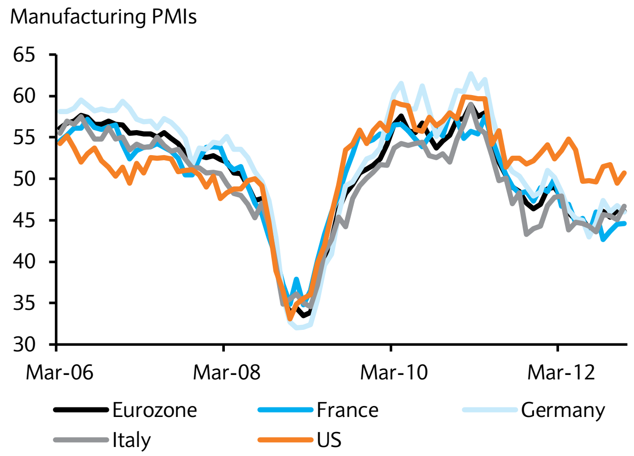
The crisis has of course *not* been resolved – a convincing solution, as we've often noted, requires greater fiscal, banking and political union, and convincing structural reform in the most sclerotic euro area economies (Greece, Italy, Portugal, Spain – and, arguably most importantly, in France). This will take years, not months. Meanwhile, Spain's budget deficit is not falling as quickly as it could, and we detect an element of complacency creeping into some public officials' comments of late. Another bout of existential angst for the single currency in the weeks ahead would not be a surprise: That official champagne should be kept on ice.

Figure 1: Euro tensions have faded further



Source: Datastream, Barclays Research

Figure 2: Euro zone manufacturing surveys are showing signs of stabilising



Source: Bloomberg, Barclays Research

The credibility of the ECB's promise to help further if asked has helped stabilize markets

Nonetheless, progress was made in 2012. Budget deficits are moving in the right direction at least. The importance of the banking system has been recognized, and moves towards a common supervisory body have begun. Labor market liberalization is slowly proceeding – even in France, where the headline-grabbing tax and pension-age changes should not obscure the government's attempt to introduce more flexible hiring and firing arrangements. As a result of all this, the European Central Bank (ECB) has been able to make that pragmatic promise, and stands ready to act as a safety net should a troubled government ask for official support. In the last month or two, even the economic indicators are showing signs of stabilizing, albeit at low levels (Figure 2). We doubt that market tensions will (re)intensify to the extent that they did in 2012.

The major short-term talking point remains whether Spain will apply for a formal bail out. It may not be that important. If we believe the ECB's conditional promise to support the secondary bond markets if asked, it may not be needed: the deterrent effect on would-be sellers of bonds may be enough to stabilize the markets. In effect, the credibility of the promise effectively secured Spain's funding: an application for assistance now will simply shift the sourcing of that funding from the private to public sector.

We continue to expect the euro to remain intact, then. However, this doesn't mean the value of the euro will stay at currently elevated levels. Its rally has reflected both a warranted fading of existential concerns and, more recently, those signs of stability in the economic data. The latter have fostered a slightly more hawkish tone at the ECB, and we no longer expect a further reduction in interest rates.

The ECB has always tried, with admittedly mixed results, to distinguish between its day-to-day monetary policy and its crisis management. Inflation is currently a bit too firm for its comfort, and the economy is stabilizing, so it is not cutting rates – and it sees no contradiction between this stance and its ongoing willingness to provide support for individual countries should they ask for it. Of course, in the last resort, a banking collapse would be a pretty deflationary event, requiring a monetary response – in which case the ECB would no doubt revert to its more pragmatic mode of operation.

As the year progresses, we expect the foreign exchange markets to shift their attention away from the ECB's relatively hawkish monetary stance and focus instead on the euro area's relatively sluggish growth prospects, at which stage the euro is likely to weaken. But that weakness should not be extrapolated into fragmentation. If anything, a more competitive single currency might have an even better chance of staying the course.

That sluggish growth – and, eventually, a weaker euro – is unlikely to prevent euro area stocks from performing strongly again in 2013. Even after rallying, continental European stocks generally still look to be pricing-in levels of profitability that are too low, in our view. The European corporate sector will be supported by overseas earnings (in faster-growing Asia, Latin America and the US). We also think that risk appetite globally will improve over the year as a whole, favouring the higher-risk continental European indices.

Sluggish growth is also unlikely to prevent European government bond indices from underperforming other asset classes. Bunds and OATs are expensive, and are effectively pricing in even weaker growth and disinflation, alongside continuing widespread risk aversion. But it could limit the potential underperformance when compared with (say) the US treasury or UK gilt market, where growth and inflation will be a little firmer. More importantly, the big euro area bond indices include Italian and Spanish bonds which, by virtue of their de-facto status as risk assets, may continue to rally. Thus, while euro area bond indices may underperform local equity indices, they will likely outperform US and UK bonds.

The adverse impact of UK fiscal austerity on growth has peaked

The UK stays the course

Reports of a double, or even triple, dip in the UK economy are a little misleading. Growth has certainly been disappointing, but the 'dips' in quarterly GDP during 2012 owed a lot to some visibly erratic factors (such as extra bank holidays, and the unfolding of the Olympic Games), rather than to a renewed downturn in final domestic spending.

The main headwinds for UK economic growth have of course been the government's fiscal austerity programme and the impact of weak domestic spending in the euro area (its main trading partner) on exports. As far as austerity is concerned, there are grounds for optimism. The UK's fiscal tightening has been pronounced. The IMF estimates the UK's structural budgetary adjustment at almost 6% of GDP between 2009 and 2013, comfortably more than in the euro area, the US or (of course) Japan. However, the main adverse impact on growth is now behind us. And, as we noted in the December/January *Compass*, there is a precedent for the UK getting through a big fiscal tightening without being pushed into reverse. We refer to the early 1980s, when the economy proved more resilient than feared, partly because (1) the private sector was running a financial surplus (so was able to reduce its savings rates to maintain spending) and (2) the monetary climate was able to draw some of the fiscal sting.

Indeed, of the larger economies, the UK seems poised to experience the biggest improvement in growth in 2013. The arithmetic is flattered, however, by the base effects provided by 2012's erratic numbers. Even if it weren't, the relevance for the UK stock market (still the second largest individual country market in the global indices) would be limited, given the international nature of the UK-quoted corporate sector. The market looks inexpensive, and we strongly prefer it to local bonds (gilts), but we suspect it will continue to lag the US and continental Europe, where local concerns – and hence the room for relief rallies – have been greater, and are more relevant to locally-quoted stocks.

Monetary policy, as noted, is accommodative. From here, however, our central view is that the BoE will likely keep interest rates – and its stock of gilt purchases – on hold. Inflation is too high, and the growth outlook not grim enough, to warrant further easing at present. UK inflation is relatively high in the international context too, and it is quite likely that gilts will underperform US treasuries and German bunds in 2013 (markets that we expect to underperform other asset classes).

Two banks, one governor

On July 1, the BoE's new governor, Mark Carney (current governor of the Bank of Canada) takes up the reins. We think he is unlikely to materially change the bank's monetary stance. The governor's role on the UK Monetary Policy Committee (MPC) is not as influential as that played, for example, by the Fed chairman on the US Federal Open Market Committee (or, for that matter, that played by Mr. Carney in his current job). Some pundits have extrapolated Mr. Carney's relatively hawkish stance at the Bank of Canada into a similar stance at the BoE, but the UK economy – and its banking system – is very different from Canada's.

The new governor may want to introduce some technical changes to the way the bank operates. He is reportedly in favour of targeting nominal GDP, and offering more public guidance on the path of interest rates. But it is the government that decides on the bank's mandate. And securing more detailed forward-rate guidance from the independent minds on the MPC might be a little like the monetary equivalent of herding cats.

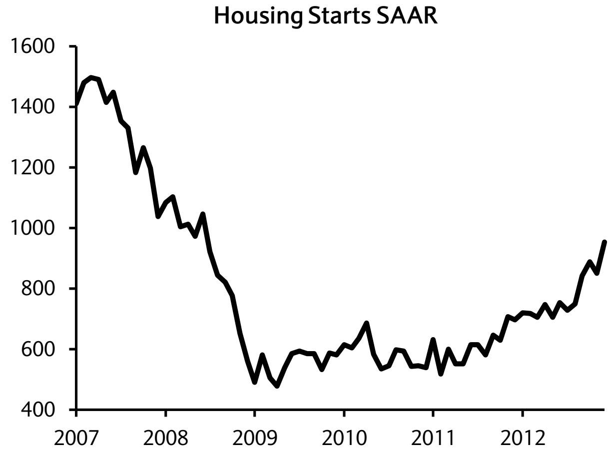
US: Beta on

Cheered by the prospects of a new year, investors have warmed to equities in the Americas region. This cheer is fed by global central banks increasingly harmonizing their policy response to weak growth. The Federal Reserve (Fed), the ECB, the BoE and recently the Bank of Japan are all working from the same policy cookbook. While each central bank is working with a slightly different recipe, the product is the same: print lots of money in support of their respective economies. Investors seldom have to be told twice, and they have reacted by buying equities of all flavours. Large and small companies alike are off to a strong start to the year. A quick tabulation of the 67 market indices Bloomberg tracks in the Americas section of its World Equity Index monitor indicates only two are showing negative returns to date.[3]

In addition to the exertions of global central bankers, the resolution of the fiscal cliff's first act and the delinking by Congress of any debt ceiling increase to an immediate and corresponding cut in government spending have also cheered Investors. Congressional Republicans appear set to throw the Democrat-controlled Senate into the spotlight by requiring the passage of a budget (something the Senate has not achieved during the last four years): Failure to pass one will result in the withholding of pay for the offending house of Congress. Whether this novel, pay-for-performance approach to getting a budget passed is constitutional is unclear; however, it is a refreshingly new twist for jaded spectators of Washington's foibles.

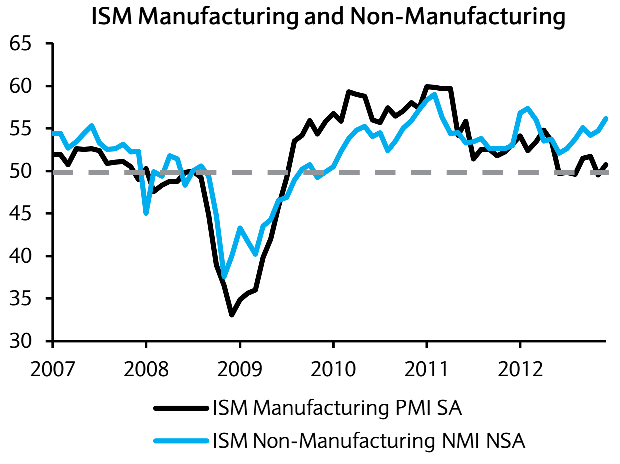
The back story for US equities remains positive in the early days of the fourth-quarter results season. With approximately 40% of companies in the S&P 500 Index reporting, sales gained roughly 4.5% while earnings rose 12%, driven by impressive operating results in the financial and energy sectors.[4] Adding to this positive back story are several elements of economic momentum: Housing starts continue to rise; retail sales remained strong despite fiscal and tax uncertainty; industrial and service activity continues to move in the right direction; and employment continues to rise.

Figure 3: US housing sector continues to recover



Source: Bloomberg, as of December 2012

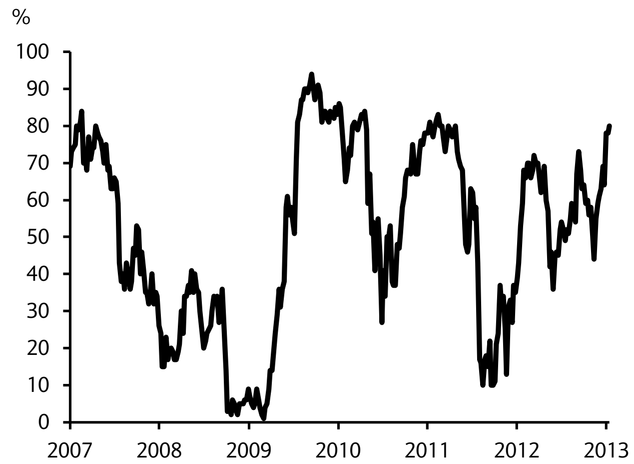
Figure 4: US industrial and service activity continues moving in right direction



Source: Bloomberg, as of December 2012.

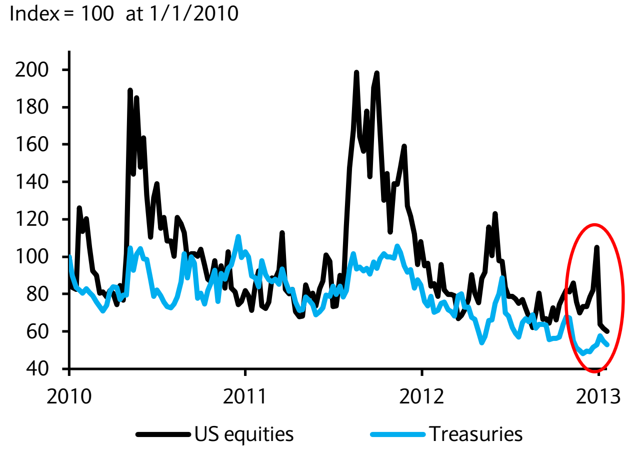
[3] Bloomberg as of January 22 at 1:40 pm EST. Market returns are price only and not factoring currency impact.
[4] Bloomberg's accounting of fourth quarter results for the S&P 500 as of January 30.

Figure 5: Percentage of NYSE Stocks closing above 200-day moving average



Source: Bloomberg, as of January 2013

Figure 6: Stock and bond volatility is declining



Source: Bloomberg, as of January 2012
US Equities Volatility = VIX Index, Treasuries Volatility = MOVE Index

Ominously, signs of complacency have become manifest as stock and bond volatility has fallen (Figure 6), and the number of S&P 500 companies trading above their 200-day moving average is back at levels last seen early in 2008 (Figure 5). With the budget battles still ahead and the extent to which higher taxes will cut into consumer willingness to spend as yet unknown, guarding against complacency is effort well spent. Our forecast of the S&P 500 Index rising approximately 12% for the year remains unchanged; however, we will likely have to contend will bout of serious volatility ahead.

Asia: Scope to expand

Although the whole world will be seeking an increase in growth this year, the theme is likely to be realised most strongly in Asia, bolstered by rising intra-Asian trade and stable domestic demand. Investors with an appetite for risk are likely to find interesting ideas emerging from the region, and should consider opportunities to broaden their exposure to cyclical sectors.

A call on global recovery versus Asian exports

With a sustainable global recovery in sight, position for cyclicality

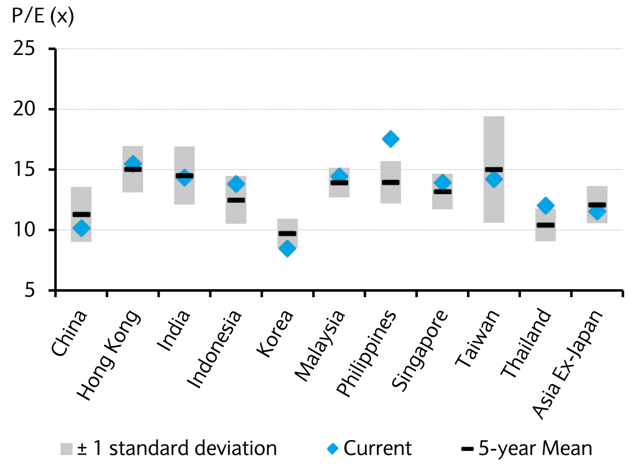
Given the improving economic data, particularly from China, the recent rebound in risk assets seems sustainable. Indeed, any further improvement in the Chinese economy will stoke intra-Asian demand and trade, which will, in turn, buoy the region's markets. In addition, a strong US economy will directly benefit the more-cyclical, export-orientated Asian economies, such as Taiwan and South Korea. Technology and commodity companies could also start to outperform.

Under this scenario, the North Asian markets (namely China/Hong Kong, Taiwan and South Korea) will continue to play catch-up in terms of growth, performance and valuations having underperformed their ASEAN peers over the past few years.[5] There is also a strong likelihood that Asian equities – as a leveraged play on the global economy – could outshine global equities.

Even with a weaker-than-expected global growth recovery, Asia's economies still have scope to expand, albeit at a slower rate than forecast. In this case, the ASEAN countries (which are perceived to be more defensive) may continue to outperform the

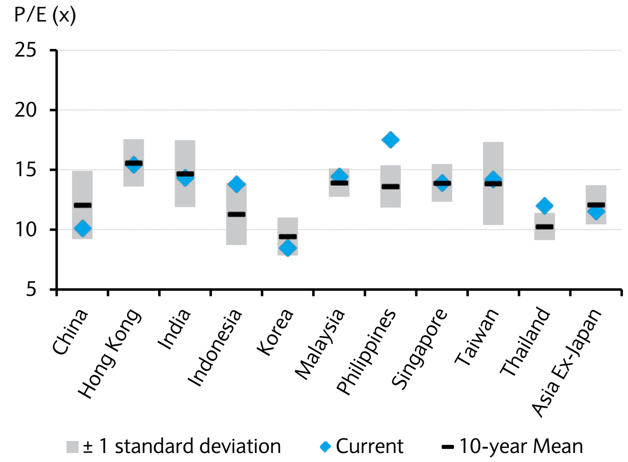
[5] ASEAN: Association of Southeast Asian Nations includes Singapore, Indonesia, Thailand, Malaysia, Vietnam, the Philippines, Laos, Myanmar, Cambodia and Brunei Darussalam.

Figure 7: Valuation of Asian equity markets – P/E versus 5-year history



Source: MSCI Indices, Datastream as at 18 Jan 2013

Figure 8: Valuation of Asian equity markets – P/E versus 10-year history



Source: MSCI Indices, Datastream as at 18 Jan 2013

North Asian markets. However, in view of the large valuation gap between the two regions' markets – with North Asian markets as a bloc still trading below historical averages and ASEAN above (see Figure 7 and Figure 8) – the magnitude of North Asia's underperformance may be slightly more muted.

Asian investment strategy and stance

In the medium term, build one's exposure to risk assets in Asia.

At this pivotal point in the market, we believe investors would benefit from increasing their exposure to risk assets in Asia, particularly equities. We would, however, recommend lowering exposure to fixed-income assets, especially sovereign and investment grade. In terms of execution strategy, investors with a shorter investment time horizon may seek to capitalize on any market weakness by building up their Asian equity portfolio, especially in North Asian markets and more cyclical sectors. Longer-term investors, on the other hand, may benefit from focusing on the structural growth of the larger economies of China, Indonesia and India.

Barclays' key macroeconomic projections

Figure 9: Real GDP and Consumer prices (% y-o-y)

	Real GDP				Consumer prices			
	2011	2012	2013	2014	2011	2012	2013	2014
Global	3.8	3.1	3.3	4.0	3.9	2.9	2.9	3.2
Advanced	1.4	1.3	1.2	1.9	2.5	1.8	1.6	2.1
Emerging	6.5	5.0	5.5	6.0	6.4	4.7	5.1	5.0
United States	1.8	2.3	2.0	2.5	3.2	2.1	1.8	2.4
Euro area	1.5	-0.4	0.1	1.5	2.7	2.5	1.8	1.7
Japan	-0.6	2.1	0.8	1.0	-0.3	-0.1	0.1	1.8
United Kingdom	0.9	0.0	1.0 ↓	2.1	4.5	2.8	2.8 ↑	2.6
China	9.3	7.8	7.9	8.1	5.4	2.6	3.2	3.5
Brazil	2.7	0.9	3.0	3.6	6.6	5.4	6.0	5.7
India	7.4	5.3	6.5	7.2	9.5	7.6	6.7	5.8
Russia	4.3	3.7	3.3	3.5	8.9	5.1 ↓	7.5 ↑	5.3

Source: Barclays Research, *Global Economics Weekly*, 25 Jan 2013
Note: Arrows appear next to numbers if current forecasts differ from that of the previous week by 0.5pp or more for quarterly annualized GDP, 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 PP.

The real distinction between good investing and bad is what the background asset allocation is while one waits to make a decision.

Figure 10: Central Bank policy rates (%)

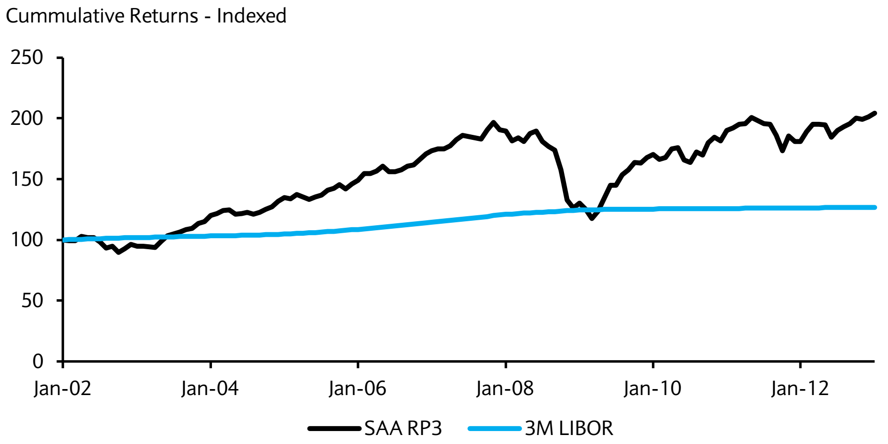
Official rate % per annum (unless stated)	Forecasts as at end of				
	Current	Q1 13	Q2 13	Q3 13	Q4 13
Fed funds rate	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
ECB main refinancing rate	0.75	0.75	0.75	0.75	0.75
BoJ overnight rate	0.10	0-0.10	0-0.10	0-0.10	0-0.10
BOE bank rate	0.50	0.50	0.50	0.50	0.50
China: 1y bench. lending rate	6.00	6.00	6.00	6.00	6.00
Brazil: SELIC rate	7.25	7.25	7.25	7.25	7.25
India: Repo rate	8.00	7.50	7.00	7.00	7.00
Russia: Overnight repo rate	5.50	5.50	5.50	5.50	5.50

Source: Barclays Research, *Global Economics Weekly*, 25 Jan 2013

What is your wealth doing while you're waiting for the right moment?

Investing for the long-term is always uncomfortable; instead the comfortable thing is almost always to wait. Last year, many investors continued to sit on the sidelines, wary of making a decision before the resolution of some or all of the uncertainty, waiting for: the next big central bank announcement; the results of the US elections; a deal on the fiscal cliff; or the direction of the euro crisis to become clearer. But after any development, there is always another around the corner, other things to worry about and plausible reasons why *now* is *not* the best time to invest. As a result, between March 2009 and the end of 2012, many investors missed out on upside returns of around 70% from a diversified portfolio, whilst waiting in cash for the comfort they needed to invest.

Figure 11: A diversified portfolio vs sitting in cash



Strategic Asset Allocation – Risk Profile 3 (SAA RP3): See footnote on this page.[6]
Source: FactSet, Bloomberg, Merrill Lynch and Barclays. Past performance is no guarantee of future results.

The returns depicted above do *not* represent *actual* portfolios, nor do they reflect trading or the impact of material economic and market factors including fees. Hypothetical illustrations and performance have certain inherent limitations. No representation is being made that any client will or is likely to achieve the hypothetical return represented in the illustration on this page.

[6] The SAA RP3 **is represented as the following mix of indices:** 7% Barclays US Treasury Bills Index; 4% Barclays Global Treasury Index; Investment Grade Bonds 7% Merrill Lynch Global Broad Market Corporate Index; 11% Merrill Lynch Global High Yield and Emerging Markets Index; 38% MSCI World Index; 10% MSCI EM Index; 5% Dow Jones UBS Commodity Index; 4% – FTSE EPRA/NAREIT Developed Global REITs Index; 14% HFRX. The weightings are rebalanced monthly to maintain the same mix over time. An investment cannot be made directly in an index.

Here in 2013 we still have the political and economic uncertainty, but in addition there is the nagging feeling that we've *already* missed out on a substantial bit of the upside. Surely, we ask ourselves, it's now best to wait until the markets drop? In the face of all this uncertainty, how do we ever overcome our discomfort sufficiently to take advantage of the long-term rewards for investing?

Avoiding the issue doesn't mean you're not taking an investment decision. You are. Every person with investible assets has an asset allocation, whether they think in those terms, or not. You may not have one intentionally, but you have assets, and they are allocated. If you wait, and hold nothing but cash, you have an asset allocation…just one that dramatically sacrifices long-term returns for short-term comfort. Appropriate if you need to spend your assets in the near future; a very expensive way of getting to sleep at night otherwise. Even if you shun the notion of asset allocation altogether, and instead just hold individual investments, you still have an asset allocation – one that places a huge bet on concentration and investment skill at the expense of diversification and risk reduction.

The question is not whether you have an asset allocation, but rather whether the one you have is efficient, sensible, and rewards you for the risks you're taking…or not.

What investors really want are *anxiety*-adjusted returns: the best possible returns without having to endure too much stress and discomfort. We're all affected by the emotional discomfort of uncertainty and tempted to postpone risky decisions until too late. But the real distinction between good investing and bad is what the background asset allocation is while one waits. What is your default position? Your status quo?

Because of a strong behavioural tendency – the *status quo bias* – the portfolio an investor is actually in affects anxiety levels far less than decisions that change the status quo.

Two investors might both wait anxiously for the right moment to make an investment, but will end up with completely different anxiety-adjusted returns if for one the status quo is to remain un-invested, whereas for the other the status quo is maintaining a diversified asset allocation. They may be equally nervous about the markets, and they may make the same decisions, good or bad, along the journey; but the latter investor has the huge advantage of a portfolio that is, on average, expected to earn an additional 4.5% per year over cash over the long-term, without much difference in anxiety.

Make a diversified stable asset allocation your status quo, rather than cash, and your wealth will work for you in the background, regardless of your ongoing anxiety about the best investing decision.

TAA: Some tactical views become strategic

We still believe that both the economic backdrop and investor risk appetite are slowly improving, and that the positive start to the year for risk assets still leaves plenty of room for further gains during the rest of 2013. We continue to be wary of government bonds, which remain historically expensive even after their New Year sell-off. The lows seen in bond yields in the last year have us more convinced than ever that on a five-year view, the trend in yields is likely to be upwards. This has been reflected in a reduced Strategic weighting for government bonds following the annual review of our strategic asset allocation (SAA) described in the essay above; thus an additional Tactical underweight is no longer necessary.

A greater portion of long-term portfolio insurance is provided by corporate bonds in our new Strategic weightings, and the bigger Strategic role that High Yield and Emerging Markets Bonds play means that a tactical overweight there is no longer necessary. In the case of Investment Grade corporate bonds, their raised Strategic weighting leaves us feeling that a modest Tactical under-weight is appropriate; this, together with an underweight in cash, funds the ongoing Tactical overweight in Developed Markets Equities (where there is no change in Strategic weightings). The New Year has seen stock markets rally further, but not sufficiently to make us worry about valuations. The current US results season, combined with more visible signs of stabilisation in euro area economic indicators, suggests that our expectations for profits growth may be a little too conservative. As things stand, those expectations still leave prospective PE ratios below most relevant moving averages.

We remain tactically neutral in commodities, real estate and ATS. No change in their Strategic weightings resulted from our annual review, and we see no pressing case for a short-term directional view on what are essentially diversifying asset classes. Commodities are currently the subject of much positive market commentary: we accept that they can play an important role at times of enhanced geopolitical risk, but supply can be more elastic than the Malthusian caricatures suggest, and prices have been historically expensive for some time now.

Figure 12: 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	46.0%	8.0%	6.0%	6.0%	16.0%	3.0%	2.0%	2.0%	11.0%
TAA	45.0%	8.0%	4.0%	6.0%	19.0%	3.0%	2.0%	2.0%	11.0%
TAA vs. SAA	-1.0%	0.0%	-2.0%	0.0%	3.0%	0.0%	0.0%	0.0%	0.0%
Change vs. prior TAA	3.0%	1.0%	1.0%	1.0%	0.0%	-1.0%	0.0%	-5.0%	0.0%
Medium Low									
SAA	17.0%	7.0%	9.0%	10.0%	28.0%	6.0%	4.0%	3.0%	16.0%
TAA	15.0%	7.0%	7.0%	10.0%	32.0%	6.0%	4.0%	3.0%	16.0%
TAA vs. SAA	-2.0%	0.0%	-2.0%	0.0%	4.0%	0.0%	0.0%	0.0%	0.0%
Change vs. prior TAA	1.0%	-1.0%	3.0%	2.0%	-2.0%	-1.0%	0.0%	-2.0%	0.0%
Moderate									
SAA	7.0%	4.0%	7.0%	11.0%	38.0%	10.0%	5.0%	4.0%	14.0%
TAA	4.0%	4.0%	5.0%	11.0%	43.0%	10.0%	5.0%	4.0%	14.0%
TAA vs. SAA	-3.0%	0.0%	-2.0%	0.0%	5.0%	0.0%	0.0%	0.0%	0.0%
Change vs. prior TAA	-2.0%	0.0%	1.0%	1.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Medium High									
SAA	3.0%	2.0%	4.0%	10.0%	45.0%	14.0%	6.0%	6.0%	10.0%
TAA	1.0%	2.0%	2.0%	10.0%	49.0%	14.0%	6.0%	6.0%	10.0%
TAA vs. SAA	-2.0%	0.0%	-2.0%	0.0%	4.0%	0.0%	0.0%	0.0%	0.0%
Change vs. prior TAA	-1.0%	0.0%	-1.0%	1.0%	-2.0%	1.0%	0.0%	3.0%	-1.0%
High									
SAA	2.0%	1.0%	2.0%	8.0%	50.0%	18.0%	5.0%	7.0%	7.0%
TAA	1.0%	1.0%	0.0%	8.0%	53.0%	18.0%	5.0%	7.0%	7.0%
TAA vs. SAA	-1.0%	0.0%	-2.0%	0.0%	3.0%	0.0%	0.0%	0.0%	0.0%
Change vs. prior TAA	0.0%	1.0%	-2.0%	1.0%	-4.0%	1.0%	-1.0%	5.0%	-1.0%

As first published on 1 February 2013. The prior TAA was published on 30 November2012.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

Asset allocation, diversified portfolios and finding the right path

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A primary objective in developing a customized portfolio is finding the mix of asset classes which a particular investor can stick with over market cycles, while also generating the best return for the risk the investor is willing to assume. The goal is to find the right path for that investor. In short, it's about the investor experience.

This process is informed by insights from both behavioural finance and portfolio theory. Downside volatility can undermine the most composed investor's ability to withstand market cycles, inclining him or her to withdraw from the investment, resulting in lower realized returns. Finding the right asset allocation is critical to ensuring that an investor is on a path they can maintain. Diversification, we believe, is the best way to achieve maximum risk-adjusted returns.[7] It also helps protect investors against having to pick which asset classes will be the best performing in any given time period.

The benefits of diversification – lower volatility, guarding against the need to pick winners, maximizing risk-adjusted return – have come under some attack since the financial crisis. This disillusionment with diversification is, in our view, largely misguided. It is a concept worth revisiting for what it *is* and *is not*.

In this article, we try to explain a few core investing concepts and dispel some of the misconceptions which can lead to poor investment choices. Given the voluminous literature on asset allocation and diversification, our examination begins with the impact of the path of return.

The path (and measurement) of return matter

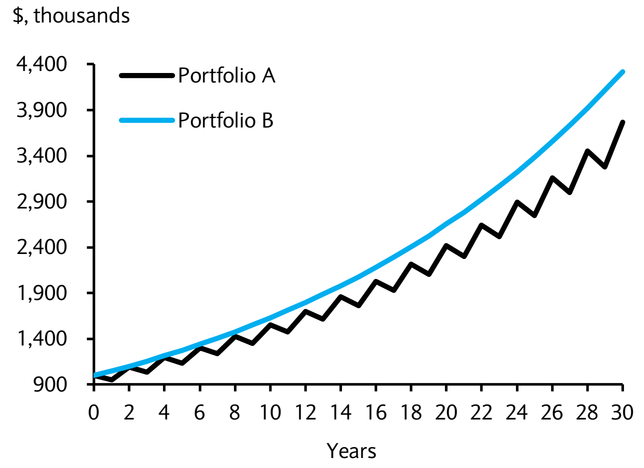
Both the path of a portfolio's performance over time, and how its return is measured, matter to an investor's end result in ways that merit exploration.

For the sake of illustration, take two $1-million-dollar portfolios, A and B, that return 5% per year (a simple average) over 30 years. How that average is actually achieved in each case has a material effect on the growth of the assets invested because it results in differing compounded annual returns – and therefore different wealth at the end of the period.[8] Furthermore, the different paths to that average are likely to trigger divergent investor responses.

In the simplified illustration in Figure 1, Portfolio A's performance swings from negative 5% one year to positive 15% the following year, over three decades. Portfolio B steadily posts a positive 5% return each year. Although the simple average return is the same, the compound return is not. After 30 years, Portfolio B is worth almost 15% more than Portfolio A. The difference in volatility translates to a 0.5% difference in compounded

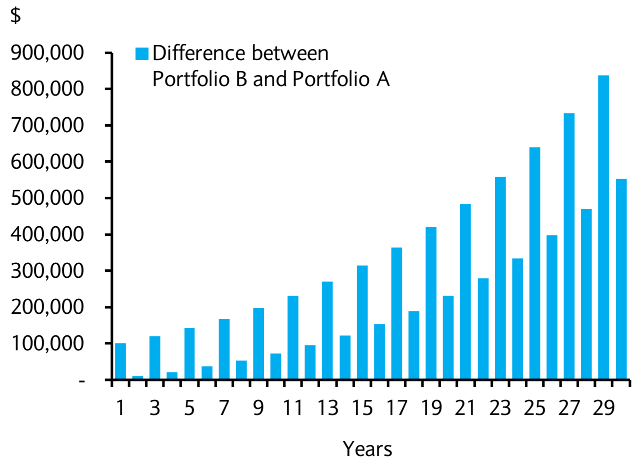
[7] We use both risk and return analysis along with behavioural finance-related qualitative characteristics to build diversified portfolios for our clients.
[8] An arithmetic average return is the sum of annual returns divided by the number of periods – 30 years in this case. A geometric average is used to determined compounded average return. It is calculated as the n^{th} root of (1+ annual return for period-1) x (1+ annual return for period-2) x (1+ annual return for period-n), where *n* is the total number of periods, in this case, 30.

Figure 1: The path impacts the type of return



Source: Barclays

Figure 2: The effect grows over time



Source: Barclays

The illustrations in Figures 1 and 2, and their results, are hypothetical. They do not represent actual portfolios, trading or the impact of material economic and market factors. Hypothetical illustrations and performance have certain inherent limitations. No representation is being made that any client will or is likely to achieve the hypothetical return represented in the illustration on this page.

annual return: 4.5% for Portfolio A versus 5.0% for Portfolio B. After declining only 5% in year 1, Portfolio A struggles to catch up with Portfolio B, despite climbing 15% in year 2. The differential between the portfolios' values only widens over time (Figure 2).[9]

This simplified scenario serves to illustrate a couple points about the impact over time of downside volatility on return and on behaviour. Portfolio A is the investment equivalent of traversing the Rockies, Alps or Himalayas, while Portfolio B is akin to a slow and steady climb. As Siegel's paradox[10] implies, climbing one's way out of a performance hole is always difficult because it requires a higher positive return to make up for the depletion in portfolio value wrought by the prior year's negative return. The mathematical problem is worth examining for its implications to portfolio risk management. Say you invested $1 million and at the end of a year, your portfolio was down 5%, for a value of $950,000. Now, to get back to $1 million, you need more than just a 5% return in the second year. That's because 5% on $950,000 yields just $47,500, which would only increase your portfolio's value to $997,500. To return to where you started, you'd need to gain 5.26% in the second year. The relationship is exponential: If a portfolio lost 10%, it would need an 11.11% gain to get back to where it started. If it lost 20%, a gain of 25% would be needed.

Figure 3: Siegel's Paradox: It requires a higher return to overcome a loss

Year	Return	Balance
Initial value		$1,000,000
1	-5.00%	$ 950,000
2	+5.00%	$ 997,500
2 – alternate	+5.26%	$1,000,000

Source: Barclays. This chart is for illustrative purposes only and does not reflect the actual results of any investments.

[9] To achieve the same net result (compound return) after 30 years, the pattern of Portfolio A's performance needs to change only slightly so that downside volatility in alternate years is 4.1% instead of 5%.
[10] If a fixed fraction of a given amount of money is lost, and then the same fraction of the remaining amount is gained, the result is less than the original and equal to the final amount if a fraction is first gained, then lost.

An investor may find it hard to stick to an investing program whose path of return is akin to traversing a mountain range, regardless of whether its compounded annual return, and thus end result, was identical to a more steady return path. So a portfolio whose asset allocation is likely to dampen volatility may be the most efficient path to achieving long term results.

Asset allocation: To what extent does it matter?

How big a role does asset allocation actually play in performance? Isn't it just markets? This question was first answered in the '80s by Gary Brinson, L. Randolph Hood and Gilbert Beebower in "Determinants of Portfolio Performance." Frequently misquoted as 90% of a portfolio's performance is due to strategic asset allocation, the study actually found that 93.6% of the *variability* of a portfolio's performance across time, i.e., its ups and downs, is due to asset allocation. Subsequent studies[11] found that asset allocation accounted for 40% of the *difference* in returns across portfolios.

The variability of a portfolio's return – its volatility – matters for the reasons explained above. If asset allocation determines a good portion of that variability, then clearly it's a very important, if not the most important, step in investment decision making. Asset allocation determines what path an investor is on and, most often, whether they're able to remain on it.

With this in mind, it is imperative that investors are true to themselves when assessing their risk and return objectives. Each individual's financial personality[12] should play prominently in the asset allocation decision making process.

The power of staying invested

Let's go back to our originally discussed return paths to highlight the power of staying invested. For Portfolio A, with the volatile return path of -5% /+ 15%, let's assume that the investor had much lower composure and lower risk tolerance than reflected by the portfolio.[13] If after every 5% loss, imagine the investor pulled their money out of the market, only to gather up the courage to reinvest one year later for a 15% gain in the third year (illustrated as Portfolio C). The difference in end result is stark. At the end of 30 years, Portfolio C, which had fully allocated to cash after years in which there was a loss, would be worth over 35% less than even the suboptimal Portfolio A (Figure 5).[14]

This is precisely why it is so important to get your allocation right the first time. If you only consider risk and return objectives, you are potentially opening yourself up to a much bumpier path – one you might not be able to withstand given your investing stamina and financial personality. This could result in pulling money out of the market at precisely the wrong time, or undue investing stress.

Simply put, you have to be in it to win it.[15] But physically you wouldn't set out to scale Mount Everest if you weren't prepared for it, and investing is no different.

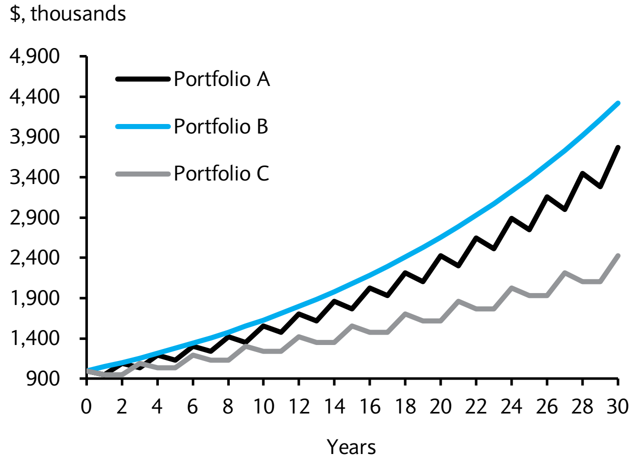
[11] See "The True Impact of Asset Allocation Returns, Roger G. Ibbotson from "Does Asset Allocation Policy Explain 40, 90 or 100 Percent of Performance?" Roger G. Ibbotson and Paul D. Kaplan, *Financial Analysts Journal*, Jan/Feb 2000.
[12] Our Financial Personality Assessment™ (FPA) is based on the science of behavioral finance and provides insight into an investor's attitudes to risk, investing and investment decision making. For more on our FPA, please visit *www.investmentphilosophy.net*.
[13] Composure is one of six dimensions measured on our Financial Personality Assessment™. It indicates how emotionally engaged with, and affected by, short-term results an investor is. A "low composure" investor is highly affected emotionally by, and likely to act upon, current results and market behavior.
[14] Even if we adjust Portfolio A's pattern to -4.1%/+15% so that the compounded average annual return is the same for both portfolios, the end result, brought about by damaging investor behavior in response to volatility, is equally stark.
[15] For more on this topic, see *"What is your wealth doing while you're waiting for the right moment?"* on page 13 of this *Compass*.

Figure 4: The (de)composed investor

	Returns		
	Portfolio A	Portfolio B	Portfolio C
Year 1	-5%	+5%	-5%
Year 2	+15%	+5%	0%
Year 3	-5%	+5%	+15%
Year 4	+15%	+5%	-5%
Year 5	-5%	+5%	0%
Year 6	+15%	+5%	+15%
…	…	…	…
Year 28	+15%	+5%	-5%
Year 29	-5%	+5%	0%
Year 30	+15%	+5%	+15%

Source: Barclays

Figure 5: You have to be in it to win it



Source: Barclays

The illustrations in Figures 4 and 5, and their results, are hypothetical. They do not represent actual portfolios, trading or the impact of material economic and market factors. Hypothetical illustrations and performance have certain inherent limitations. No representation is being made that any client will or is likely to achieve the hypothetical return represented in the illustration on this page

Diversification and its benefits

Since the financial crisis with its corresponding sharp downturn across many asset classes, and the longer-term rise in asset class correlation, the allure of diversification has dimmed somewhat. This core investing concept merits revisiting.

Diversification *is*:

- the most effective way to seek the best risk-adjusted returns over time
- a way to help reduce a portfolio's overall volatility

Diversification *is not*:

- a method for achieving the highest annual returns, or alpha
- protection against declines in times of market turmoil – although it does tend to dampen the volatility

Having already covered the benefits of lower volatility in the context of finding the right asset allocation at a personal level, we are now ready to examine the potential benefits of diversification. First, we briefly discuss the concept of maximizing risk-adjusted returns. Second, we compare concentration with diversification to demonstrate that, while concentrated positions can drive higher returns, they can also drive higher drawdowns as well. Third, we examine the annual performance of different asset classes versus a diversified portfolio over several years, highlighting just how difficult it is to time which asset classes will be the top performers in any given period. Finally, we track the performance of these asset classes and the diversified portfolio during severe market drawdowns and the ensuing recovery.

The purpose of diversification in a portfolio is to help an investor get the best long-term returns for the lowest risk possible. It's the most bang for the buck, the greatest return you can buy given your personal risk budget. Portfolios whose individual asset classes have very different variation in returns are less volatile; by diversifying across many imperfectly correlated assets, risk from any one asset (unsystemic risk) is greatly reduced. Risk from the overall markets – think 2008 – is not.

Concentration risks

Let's assume that the power of lower volatility over time and setting the right asset allocation doesn't have you compelled to diversify yet. Perhaps you still favour concentrated positions, because, after all, no one has ever gotten rich by diversifying. Consistently outperforming while holding concentrated positions assumes that you will be able to pick the right asset class(es) with regularity. Going the route of a concentrated portfolio also assumes that you'll have the ability to pick the right entry and exit points to take full advantage of the outperformance, as the star performer from last year may be this year's biggest loser. No one knows with certainty where the market is headed and, as a result, when which asset classes will be the best performers. Diversification protects us against our own overconfidence and helps us seek the best risk-adjusted returns. Concentration, while it can create wealth, can also destroy it.

This is best illustrated by the patchwork quilt of investment returns since 2000 (Figure 6). As is evident from the varied patterns of coloured blocks, each of which represents one of nine asset classes or a diversified portfolio, no one asset class or portfolio stays at the top of the quilt indefinitely. In fact, in many cases, the best performers from one period become the worst performers of the following period. Take, for example, Emerging Markets Equities, represented by the MSCI EM Index and depicted in light blue. After being at or near the bottom from 2000 through 2002, Emerging Markets (EM) Equities were among the best performing asset classes from 2003 through 2007, only to again be the worst performer in 2008. The same pattern continues from 2009 to 2011with EM Equities surging back to the top for two years,

Figure 6: Nine asset classes and a diversified portfolio

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
31.84%	8.86%	25.91%	56.28%	37.96%	34.54%	42.35%	39.78%	9.14%	79.02%	20.40%	3.80%	28.65%
14.29%	8.67%	8.42%	40.69%	25.95%	21.36%	32.59%	16.23%	2.44%	56.49%	19.20%	2.98%	19.39%
13.84%	6.14%	8.02%	33.76%	15.25%	15.35%	20.65%	**9.60%**	-4.84%	38.26%	16.83%	0.98%	18.63%
10.41%	4.43%	4.72%	29.34%	**12.61%**	**10.47%**	**16.07%**	9.57%	-23.25%	30.79%	15.63%	0.14%	16.54%
9.16%	1.70%	2.82%	**26.40%**	11.71%	10.02%	12.12%	5.64%	-25.30%	**30.68%**	12.34%	**-4.89%**	**16.03%**
6.21%	-2.37%	1.80%	23.93%	9.15%	5.35%	9.26%	5.01%	**-31.33%**	18.91%	**11.71%**	-5.00%	10.79%
2.84%	-3.81%	1.27%	13.38%	5.46%	4.98%	4.82%	4.23%	-35.65%	16.30%	7.35%	-6.70%	4.49%
-2.91%	**-5.07%**	**-5.15%**	6.31%	4.84%	3.69%	3.78%	3.36%	-40.33%	13.40%	5.19%	-8.48%	3.51%
-12.92%	-16.52%	-6.00%	1.98%	2.69%	3.05%	3.32%	2.50%	-47.72%	1.03%	3.61%	-9.95%	0.12%
-30.61%	-19.51%	-19.54%	1.11%	1.24%	2.72%	2.07%	-6.96%	-53.18%	0.29%	0.22%	-17.18%	-1.06%

- 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
- Diversified Portfolio

Source: FactSet, Bloomberg, Merrill Lynch and Barclays. Past performance is no guarantee of future results.
The individual asset classes are represented by index total returns as follows: **Cash and Short Maturity bonds** – Barclays US Treasury Bill Index; **Developed Government Bonds** – Barclays Global Treasury Index; **Investment Grade Bonds** – Merrill Lynch Global Broad Market Corporate Index; **High yield and Emerging Markets Bonds** – Merrill Lynch Global High Yield and Emerging Markets Index; **Developed Markets Equities** – MSCI World Index; **Emerging Markets Equities** – MSCI EM Index; **Commodities** – Dow Jones UBS Commodity Index; **Real Estate** – FTSE EPRA/NAREIT Developed Global REITs Index; **Alternative Trading Strategies** – HFRX Global Hedge Fund Index.

The **Diversified Portfolio is represented as the following mix of the above indices**: 7% Barclays US Treasury Bills Index; 4% Barclays Global Treasury Index; 7% Merrill Lynch Global Broad Market Corporate Index; 11% Merrill Lynch Global High Yield and Emerging Markets Index; 38% MSCI World Index; 10% MSCI EM Index; 5% Dow Jones UBS Commodity Index; 4% – FTSE EPRA/NAREIT Developed Global REITs Index; 14% HFRX. The weightings are rebalanced monthly to maintain the same mix over time.

An investment cannot be made directly in an index. The returns in the above quilt do *not* represent *actual* portfolios, nor do they reflect trading or the impact of material economic and market factors including fees. Hypothetical illustrations and performance have certain inherent limitations. No representation is being made that any client will or is likely to achieve the hypothetical return represented in the illustration on this page only to fall to the bottom in the third. The less volatile asset class of investment grade bonds, depicted in medium gray, was among the best performers in 2001 and 2002, but became the third- or fourth-worst from 2003 to 2007. Given the randomness of the pattern shown over the last decade, it is safe to say that it is difficult to predict not only which asset class will generate the best returns in a given year but also how long the outperformance will last.

And, when things get rough, concentrated allocations can be dangerous.

Performance in Drawdowns

Take, for instance, the severe equity-market declines listed in the chart below (Figure 7). In the five worst 90-day periods for Developed Markets Equities since 2001, the asset class lost, on average, about 25%. By contrast, in *each* of these periods, the returns on Cash and Short-maturity Bonds and Developed Government Bonds were positive. Returns on Investment Grade Bonds were positive 60% of the time, Commodities 40% of the time, and Alternative Trading Strategies, 20% of the time. Other risky assets such as High Yield and Emerging Markets Bonds declined, but not nearly as much Developed Markets Equities. In certain cases, Emerging Markets Equities were down more than their developed counterparts, but in other cases less so.

Figure 7: Asset class performance during five 90-day decline periods for equities

	Drawdown Period (90 days each)				
	1	2	3	4	5
Peak	18-Jul-08	21-May-01	22-May-02	1-Jun-11	18-Sep-07
Trough	20-Nov-08	21-Sep-01	24-Sep-02	4-Oct-11	21-Jan-08
Cash and Short-maturity Bonds	0.88%	1.47%	0.61%	0.04%	1.46%
Developed Government Bonds	5.53%	3.08%	5.45%	4.00%	3.87%
Investment Grade Bonds	-5.67%	3.42%	4.54%	0.03%	2.97%
High Yield and Emerging Market Bonds	-28.66%	-5.53%	-9.77%	-9.39%	-1.14%
Developed Markets Equities	**-42.84%**	**-26.32%**	**-24.69%**	**-18.89%**	**-11.15%**
Emerging Markets Equities	-54.13%	-26.05%	-22.89%	-27.80%	-3.07%
Commodities	-44.74%	-9.69%	8.86%	-16.13%	8.75%
Real Estate	-54.13%	-15.34%	-10.12%	-20.81%	-16.05%
Alternative Trading Strategies	-19.31%	2.54%	-0.59%	-8.19%	-1.99%

Source: FactSet, Bloomberg, Merrill Lynch and Barclays. Past performance is no guarantee of future results.

Bounce back

Let's dig deeper into the two worst scenarios above. In a severe market drawdown, a diversified portfolio tends to fall less and rebound faster than a concentrated one. In the market downturn of 2001, a diversified portfolio fell approximately 20%, compared with a maximum decline of about 45% for Developed Markets Equities (Figure 9). Even more interesting, the diversified portfolio recovered its starting value (as of Jan 1, 2001) by late 2003 – a solid year earlier than the 100% Developed Markets Equities portfolio.

In the decline of 2007-2008, the difference in the performance of a diversified portfolio versus the developed equity market is shown again. In this instance, a diversified portfolio was down approximately 40%, while the developed equity market lost almost 55% of its value. It took approximately three years to recoup the losses in a diversified portfolio. Two years later – more than five years from the beginning of the drawdown – investors are still waiting to get back to prior peak values in Developed Market Equities.

Figure 8: Bounce, bounce…[16]

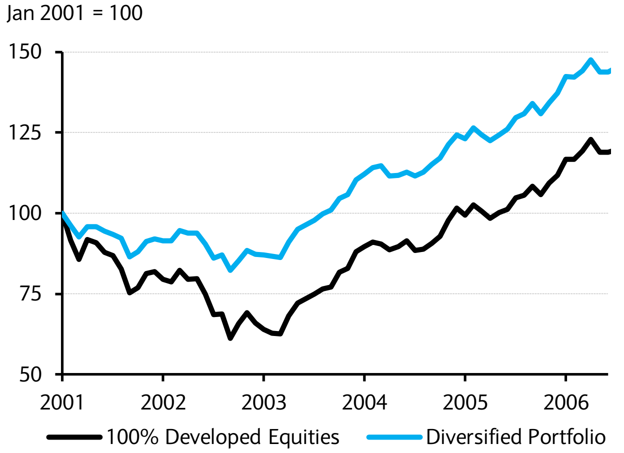
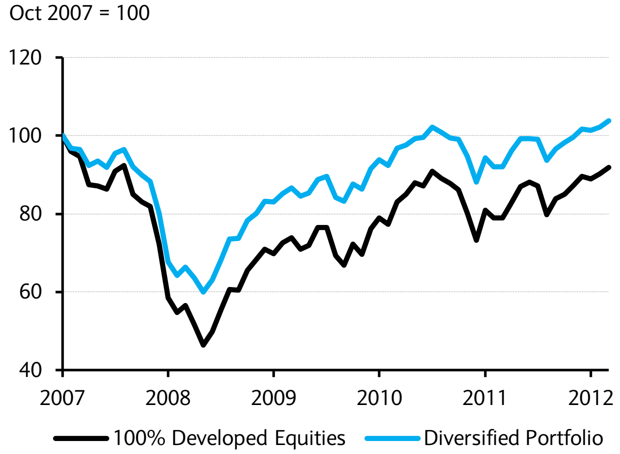


Figure 9: … bounce, bounce…[16]



Source for both charts: FactSet, Bloomberg, Merrill Lynch and Barclays. See footnote 10 for indices representing Developed Equities and the Diversified portfolio. Past performance is no guarantee of future results. An investment cannot be made directly in an index. The returns in the above charts do *not* represent *actual* portfolios, nor do they reflect trading or the impact of material economic and market factors including fees. Hypothetical illustrations and performance have certain inherent limitations. No representation is being made that any client will or is likely to achieve the hypothetical return represented in the illustration on this page.

Over the long haul

Hopefully, by this point you agree that volatility and finding the right asset allocation matter, and that there is some merit to diversification. It is still important to keep in mind what diversification is – and more importantly – what it isn't. Diversification does not protect against losses or ensure that your assets will not be correlated in times of stress. However, after market downturns, diversification has helped investors achieve prior peak portfolio values faster than concentrated positions. Diversification is not a cure to avoid the drawdown all together. If you have met anyone who has the investing equivalent of a crystal ball, please do let us know; as mentioned in our Strategic Asset Allocation article we at Barclays have no such device. What we do have is a global team of investment strategists who seek out the best areas of opportunity in the market, while trying to avoid the least compelling, on both a strategic and tactical basis.

This is only half the battle, as emotions also play a significant role in whether an investor is in the right diversified portfolio *for them*. Given the adverse consequences of getting out of the market at the wrong time, it is imperative that individuals have a diversified asset allocation that best represents their investing tolerance *for the long term*. In order to guard against the equivalent of an emotional 'asset allocation' breakdown, an analysis into the investment psyche of each individual is warranted. To this end, we have a team of behavioural finance professionals who analyze each client situation with the express purpose of finding the best portfolio from a risk and return perspective while considering several qualitative aspects of an individual's financial personality. This analysis produces a portfolio allocation that, we believe, a client can maintain over various market cycles. It is not a flavour of the week and it does not bet the ranch on any single asset class or investment idea because it is alleged to be the next great performer. Instead, it seeks to find the slow and steady path for each individual client that is uniquely right for them. The investing journey needn't cause any undue stress – and if your path is manageable – the hike should prove to be as enjoyable as possible.

[16] Figures 8 and 9: **Developed Markets Equities** is represented by MSCI World Index total returns. The **Diversified Portfolio** is represented with the following mix of indices: 7% Barclays US Treasury Bills Index; 4% Barclays Global Treasury Index; 7% Merrill Lynch Global Broad Market Corporate Index; 11% Merrill Lynch Global High Yield and Emerging Markets Index; 38% MSCI World Index; 10% MSCI EM Index; 5% Dow Jones-UBS Commodity Index; 4% – FTSE EPRA/NAREIT Developed Global REITs Index;14% HFRX. Monthly total return. The weightings are rebalanced monthly to maintain the same mix over time.

A pro-cyclical US dollar?

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We challenge the conventional wisdom that USD cannot do well in rising markets. As has been the case in the past, we think that USD may become pro-cyclical again. The growing US economy, attractive investment opportunities, and normalisation of yields should lead USD higher over the medium to long term (one to three years). In the near term, however, the opposite may be true.

Challenging the received wisdom

Positive views on equity markets and the global economy have recently been considered incompatible with a similarly positive outlook on the US dollar. The argument runs as follows: As a safe haven currency, the US dollar can only appreciate in an environment in which investors are hesitant to add risk to their portfolios – as has been the case in the past few years. By this logic, rising equity markets, indicative of investor willingness to add risk, will lead to falling USD. This has also been the case for some years.

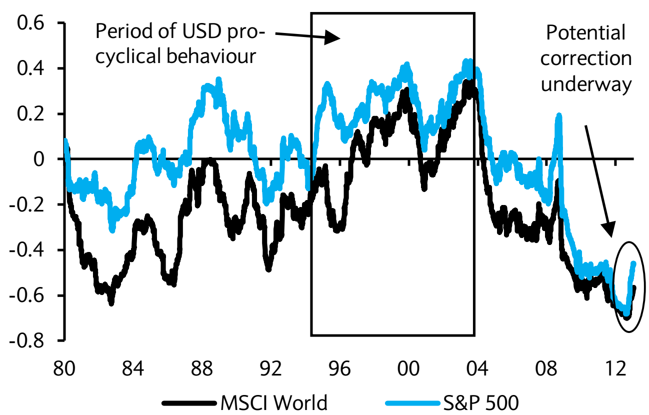
In our opinion, the argument oversimplifies the issue, and the dollar has potential to do well as stocks rise. It would not be the first time that the currency has behaved in a pro-cyclical way. As Figure 1 shows, the dollar was *positively* correlated with risk during late 1990s and early 2000s. During both periods, equity markets were up and so was the US dollar.

What made the dollar pro-cyclical in the past?

It is important to understand what factors drove the pro-cyclicality of the dollar in the past, in order to understand the likely recurrence of these drivers. As is often the case, fundamentals and economic growth provide a good starting point. We find that when the dollar's path was pro-cyclical, the US economy was also growing at a significantly faster rate than its peers (see Figure 2).

Figure 1: USD was positively correlated with risk…

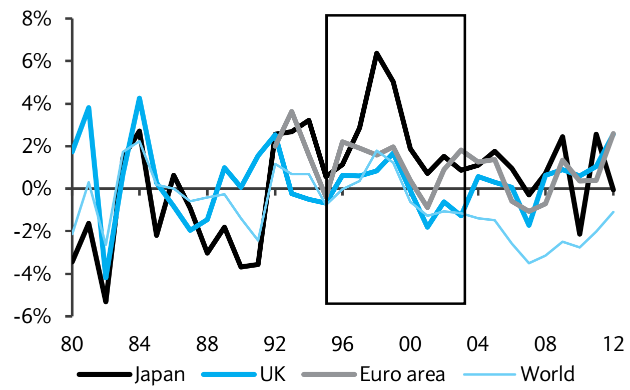
USD/EUR 260-day rolling correlation of daily returns with risk



Source: Barclays, EcoWin

Figure 2: … when US GDP growth was relatively robust

Real GDP growth differentials (US real GDP - other countries/regions)



Source: Barclays, EcoWin, IMF

Economic growth affects currencies in two major ways (direct and indirect):

- Having a higher GDP growth rate than other economies makes a country's investment opportunities appear more attractive to investors. It tends both to attract inflows from abroad and to stem material outflows to foreign markets from domestic investors who find local opportunities more compelling. Take the late 1990s, one of the periods when the dollar was pro-cyclical. Then, US equity markets outperformed not only most major developed stock markets but emerging equities markets as a whole as well – in both dollar (Figures 3) *and* local currency terms.
- Strong domestic growth often translates into tighter monetary policy by a country's central bank. This means higher interest rates and rising yields, which, in turn, makes deposits and fixed-income investments in that country's currency attractive. This also benefits the currency. The late 1990s and early 2000s bear this out. During those periods, the relatively high US growth was accompanied by rising yield differentials in favour of the US (Figure 4).

Will the same factors unfold again?

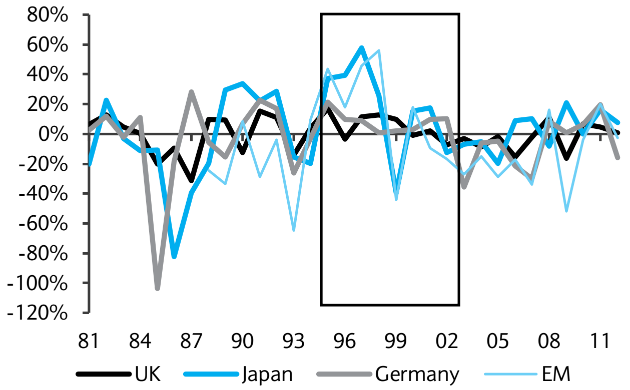
Economic growth …

The US economic environment is clearly not the same as it was at the close of 20th century or the beginning of this one. Still, although US growth is not outpacing that of other developed economies and regions to the same extent as previously, it remains, in most cases, comfortably higher. Moreover, our economists forecast the trend to continue, with the US likely to outpace the euro area, the UK and Japan. This suggests that more attractive investment opportunities may be found in the US compared to other major economies.

Moreover, as Figure 5 illustrates, the growth differential between the US and various emerging regional economies (Latin America, Middle East and North Africa, Asia) has been narrowing over the past four years. We retain a broadly constructive view on these emerging markets, both for equities and fixed income, and see scope for funds moving from developed into emerging economies as investors search for yield. However, our expectation that these growth differentials will not widen too

Figure 3: Higher growth led to equity outperformance

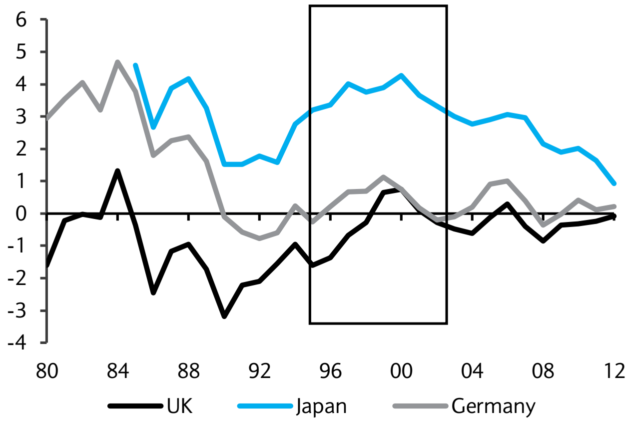
Differential between US gross equity annual returns and other markets, (all MSCI equity indices, in USD)



Source: Barclays, EcoWin
MSCI US, MSCI Japan, MSCI Germany, MSCI EM

Figure 4: USD benefited from rising yield differential

10y nominal yield differentials (US - G5 country)



Source: Barclays, EcoWin
United States, Government Benchmarks, Bid, 10 Year, Yield, Close, USD
United Kingdom, Government Benchmarks, Bid, 10 Year, Yield, Close, GBP
Japan, Government Benchmarks, Bid, 10 Year, Yield, Close, JPY
Germany, Government Benchmarks, Bid, 10 Year, Yield, Close, EUR

extensively again (as they did in 2007), coupled with our constructive outlook on US equities, suggests that it is unlikely that a wall of money will leave the US, putting downward pressure on the dollar.

… and monetary policy

While underlying economic growth is an important driver of investment opportunities, how this growth impacts monetary policy is integral to currency exchange rates. Indeed, the Federal Reserve's extraordinarily loose policy since 2008 has prevented the dollar from benefiting from the stronger US economic growth. The good news is that the quantitative easing (QE) programme's negative impact on the dollar appears to be waning as each additional round has had less effect on the currency.

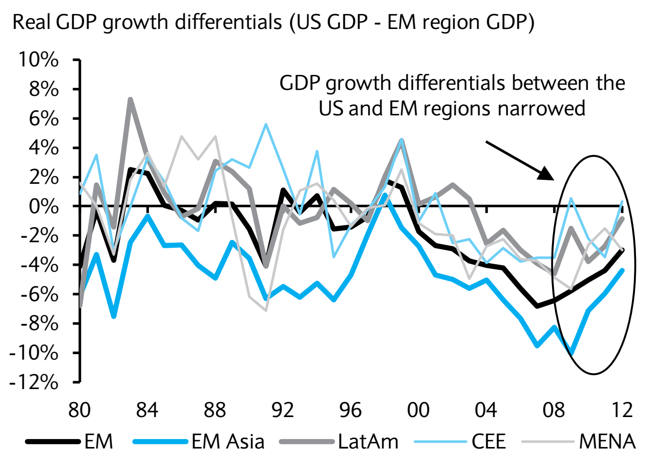
Moreover, the Federal Reserve's move towards economic indicator-based monetary guidance – away from date-based guidance – has potential to unlock further USD strength. The Fed is now targeting specific levels of economic variables, such as 6.5% unemployment. As the US unemployment falls towards this level, the market will start anticipating tighter monetary policy which should benefit the dollar (even before this 6.5% unemployment is reached – as markets tend to be forward-looking).This could occur sooner than the previous calendar-based guidance had suggested. But this is not currently our expectation. That said, the more conditional nature of the Fed's guidance introduces the possibility of an earlier rise in rates that was previously missing.

Overall, resilient US economic growth is the factor that could shift the US dollar to being pro-cyclical, correlating positively with increased investor risk appetite again. Indeed, we are currently seeing tentative signs of USD's correlation with risk normalising from overstretched levels (Figure 1).

Long-term valuation

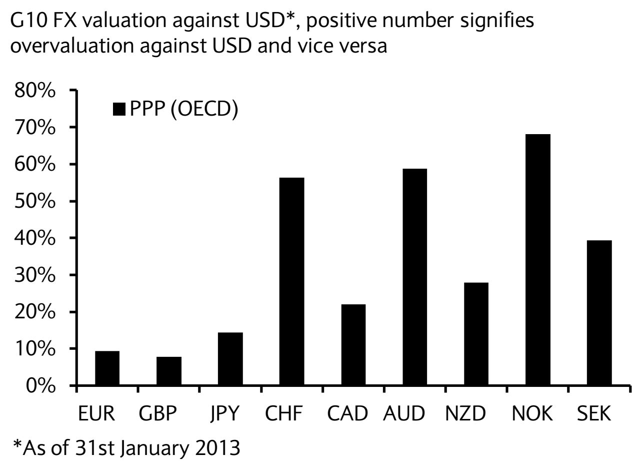
In terms of valuation, the dollar's prospects also look appealing. In terms of purchasing power parity – which values currencies based on relative price levels over time – the currency looks undervalued versus all major ones in the G10 (Figure 6). The same picture emerges in looking at valuation models that take into account economic variables other than inflation, such as productivity or terms of trade. Based on our Behavioural Equilibrium Exchange Rate model (BEER), the outlook is similar, with the

Figure 5: The gap between the US and EM narrowed a bit



Source: Barclays, EcoWin

Figure 6: USD valuation looks attractive



Source: OECD

only difference being the British pound which appears modestly undervalued against the dollar. Hence, based on various longer-term valuations measures, the dollar appears broadly inexpensive and has scope to appreciate.

USD slowly getting there

In our view, improving US economic growth prospects are translating into attractive investment opportunities in the US. It also raises the potential for the Fed to eventually start unwinding its over-accommodative monetary stance, which would help to turn USD from a counter-cyclical currency into a currency that could do well in rising markets. This, coupled with its inexpensive valuations, increases the long-term attractiveness of USD, at least when compared to other major currencies such as the Japanese yen, the euro and the British pound.

However, the above is a story for the medium to long term, the next one to three years. For now, the US needs to deliver sustainable growth to trigger a change in its currency's behaviour to pro-cyclical. In fact, in the immediate months ahead, we do *not* expect the dollar to outperform materially the euro – as the euro benefits, for now, from improving euro area financial conditions and funds returning back to EUR denominated assets.

In terms of other major currencies, we expect USD to continue strengthening against the Japanese yen over the quarters ahead, as market expectations of aggressive monetary easing from the Bank of Japan (and its likely delivery) should undermine the yen further. We also expect the Swiss franc to weaken against USD as the safe haven trade of the past years (i.e., being long CHF) starts to unwind as existential concerns about the euro area gradually dissipate.

Where will Japan's rally go next?

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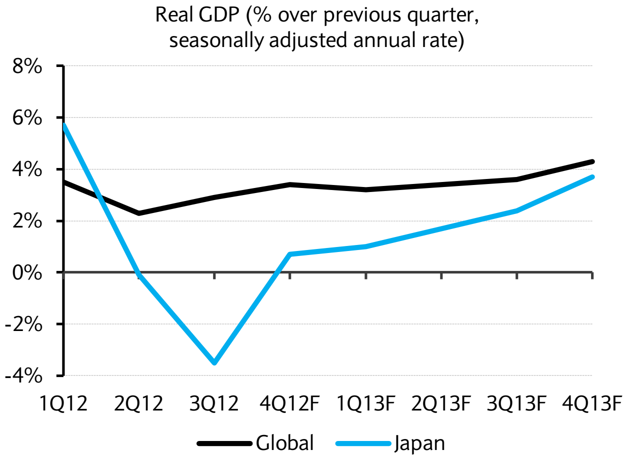
While the momentum in Japan's equity market may be discounting a cyclical rebound, it will take more to sustain the current rally. Issues including the lack of leadership continuity, growing public debt, and deteriorating demographics have yet to be tackled.

Japan's economy contracted in the second and third quarter of 2012, during which period the country's woes were exacerbated by a global cyclical slowdown. Amid a bilateral spat with one of its closest export partners, China, the strength of the yen (JPY) further dented export competitiveness at a time when global trade was itself going through a slow patch. However, following recent stimulus measures from the Japanese government as well as the Bank of Japan (BoJ), the near-term outlook for the country's economy has brightened. Signs suggest that the economy may have bottomed out in the fourth quarter of last year, with growth likely to pick up in the first half of 2013 (Figure 1). Unsurprisingly, the Nikkei225 has rebounded from its November lows on anticipations of a return to growth and a weaker yen (Figure 2). However, questions continue to weigh on investors' minds: Is the rally sustainable or will it, once again, fade away as quickly as it came? Can we reasonably expect an economic recovery on the back of stimulus measures proposed by the new government?

What has changed?

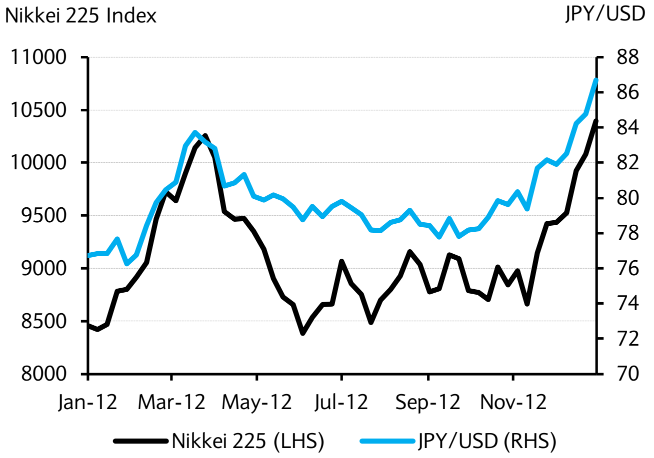
Since Shinzo Abe's Liberal Democratic Party (LDP) swept to victory in December, optimism has gradually returned to the market. Alongside the improving investment environment, the new administration has announced a JPY10.3trn stimulus – equivalent to approximately 2% of Japan's GDP. In addition, the new leadership has exerted pressure on the BoJ to adopt more monetary easing and to raise the inflation target from 1% to 2%. In tandem with the improving global outlook, the Japanese economy has continued to show signs of cyclical recovery. On the back of recent developments, our Barclays Research colleagues have raised their forecasts for real GDP growth in Japan for this year and next: from 0.3% to 0.8% for 2013 and from 0.7% to 1.0% for 2014.

Figure 1: Stronger GDP growth projected



Source: Barclays, Cabinet Office

Figure 2: Rising equities amidst weaker yen



Source: Barclays, Bloomberg

Fiscal stimulus: More growth or debt?

Of the JPY10.3trn stimulus package announced in January, JPY5.2trn has been sequestered for public works, which incorporate post-earthquake reconstruction projects (outlined in Figure 3). Certainly, these measures – if executed in a timely fashion – will have a positive impact on growth, hence the upward revision of our GDP forecast. However, as is often the case with planned projects, the outcomes are not without risks, particularly from the point of view of implementation and possible delays.

Figure 3: Emergency economic measures of JPY10.3trn stimulus package

Emergency economic measures	Expenditure (JPY trn)
1. Measures for post-quake reconstruction and disaster prevention	**3.8**
- Acceleration of reconstruction efforts	1.6
- Disaster prevention and mitigation	2.2
2. Creation of wealth through growth	**3.1**
- Stimulating private investments for stronger growth	1.8
- Measures for small and medium-sized enterprises, small scale businesses, and agriculture, forestry and fishery	0.9
- Facilitating the expansion of Japanese businesses in overseas markets	0.1
- Measures for human capital development and employment	0.3
3. Ensuring a sense of security in daily life and revitalizing the region	**3.1**
- Ensuring a sense of security in daily life	0.8
- Revitalizing the regions	0.9
- Supporting local governments' funding	1.4
4. Obligatory assurance of national subsidization for a multi-year construction project	**0.3**
Total amount	**10.3**

Source: Cabinet Office, Barclays

The nation-wide shortage of construction workers that has plagued the industry since the Great East Japan Earthquake in March 2011 remains a particular risk and may delay the commencement of planned projects. Furthermore, the jury is still out on whether or not these projects can generate the desired economic return. As it is, Japan already faces a serious deficit problem with the debt-to-GDP ratio exceeding 200% (see Figure 4). Needless to say, having taken more than a decade to unwind some of its past real estate excesses, the last thing Japan needs is more ‘white elephants’.

Weaker yen may bolster exports

The recent adoption of a higher inflation target by the BoJ will invariably translate to a more aggressive monetary policy stance to reflate the sluggish economy. With the benchmark policy rate at 0.1%, the BoJ has limited room to reduce rates further. Tellingly, the bank may be left with few options other than to ratchet up its asset purchasing program (APP) to meet the inflation target. The BoJ has introduced an open-ended APP, which will start in 2014 upon completion of the current JPY101trn APP.

A desired outcome of monetary easing is a depreciation of the yen against major currencies (which would bolster the competitiveness of Japanese exports). That said, a weak yen is no panacea for Japan’s exporters. The sector faces a long list of additional concerns. For instance, Sony and Sharp have faced increased competition – particularly from Korean firms such as Samsung – which has continued to eat away at their market share. While a weaker currency may enhance their cost competitiveness, Japanese exporters would need to regain their leading edge in terms of product offering relative to their competitors.

Furthermore, the ongoing tensions with China, Japan's largest trading partner, remain a key concern. China currently accounts for about 30% of Japan's total exports. The dispute over the contested islands – called Senkaku in Japanese and Diaoyu in Chinese – has affected trade. As Asia's two largest economies, the stakes involved are high, and long-term cooperation between the two countries could be affected. In the near term, any stalemate in the dispute may further hamper the recovery of Japanese exports to China.

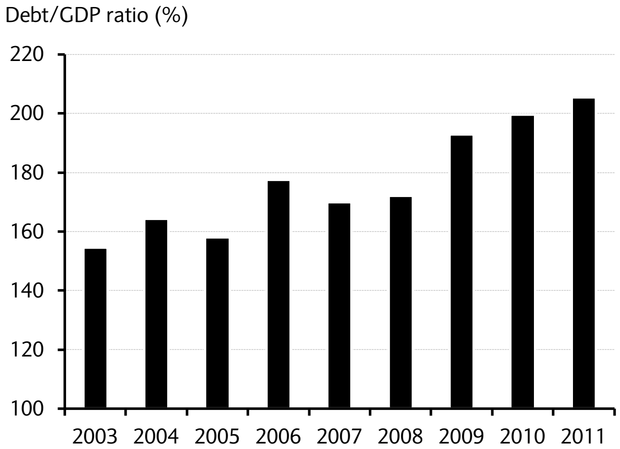
Japanese politics: When will the musical chairs stop?

For any economic policies to be effectively implemented, political stability is essential. Unfortunately, stable leadership is something that has been missing in Japan in recent years. Since Abe took over from Junichiro Koizumi in September 2006, Japan has witnessed a rotation of six different prime ministers (Figure 5). As Abe regains the leadership helm for the second time, the expectations of the Japanese electorate are far greater than they were the first time, given the current economic challenges the country faces. His party – together with its coalition partner the New Komeito Party – has already scored a convincing win in December's Lower House elections. It is imperative for them to regain a majority in the Upper House in order to secure the policy mandate they need. The market will be closely monitoring the outcome of this vote, due to take place in the summer of 2013.

Rising dependency ratio

In the last 10 years, Japan's population has hardly grown due to low fertility and immigration inflows. Meanwhile – as life expectancy rises – the percentage of the population aged 65 and above has increased from 9% (1980) to 23% (2011) (Figure 6). Apart from politics, the issues of an ageing population – compounded by the declining supply of labour – would structurally limit Japan's long-term economic potential, raising questions about the sustainability of the recovery. To date, there have been few signs to suggest that the trend will reverse.

Figure 4: Increasing Japan's Debt/GDP ratio



Source: Bloomberg

Figure 5: Prime Ministers of Japan

Prime Minister	Party	Period
Junichiro Koizumi	LDP	26 Apr 01 – 26 Sep 06
Shinzo Abe	LDP	26 Sep 06 – 26 Sep 07
Yasuo Fukuda	LDP	26 Sep 07 – 24 Sep 08
Taro Aso	DPJ	24 Sep 08 – 16 Sep 09
Yukio Hatoyama	DPJ	16 Sep 09 – 8 Jun 10
Naoto Kan	DPJ	8 Jun 10 – 2 Sep 11
Yoshihiko Noda	DPJ	2 Sep 11 – 26 Dec 12
Shinzo Abe	LDP	Current (since 26 Dec 12)

Note: Liberal Democratic Party (LDP); Democratic Party of Japan (DPJ)
Source: Prime Minister of Japan and His Cabinet Website

Where next for the rally?

With Japanese equities trading below their long-term historical average, the market could remain supported, in the short term, by government stimulus measures, as well as improving corporate earnings growth. For example, engineering and construction companies could benefit from higher public sector investments while companies in the export-oriented sectors, such as technology, auto and machinery, could enjoy stronger volumes as a result of a weaker yen.

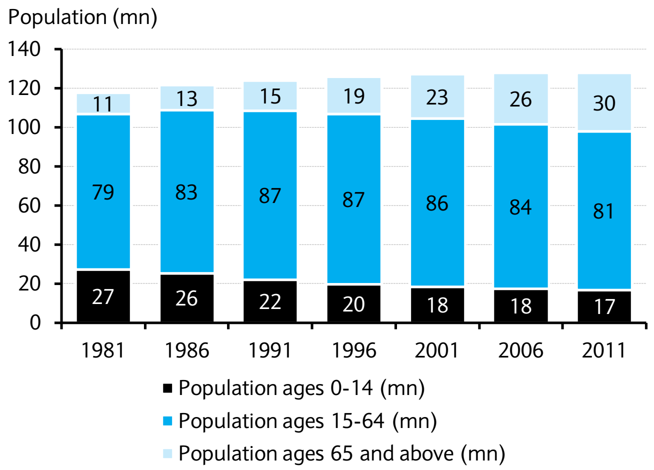
Nevertheless, investors in the Japanese market should be aware of the currency risks. This is because the total returns, when translated to foreign currencies, may be eroded by a weaker yen. As reflected in Figure 7, the Nikkei 225 appreciated 22.9% in JPY terms – but by only 10% in USD terms – in 2012. While it may be possible to hedge the currency exposure, in reality, the hedge is neither perfect and nor without significant cost.

Longer term, market performance may be capped by ongoing structural issues: the ageing population, leadership continuity, and growing public debt. In order to convince the market that this economic recovery is sustainable, Japanese authorities must make progress in addressing the challenges above.

Conclusion

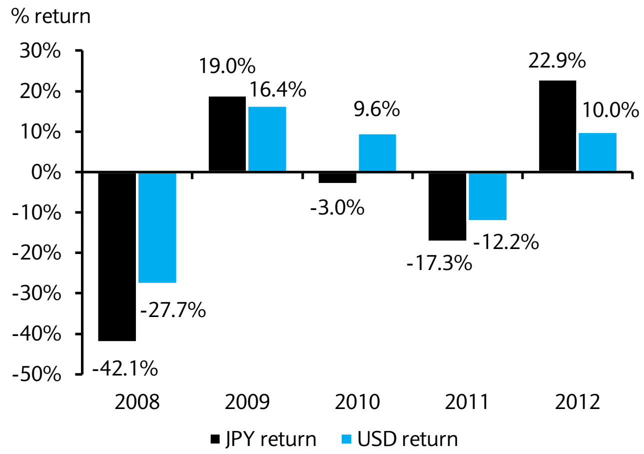
While we are constructive on the country's near-term economic recovery, we maintain our neutral stance on Japan. The market's strong momentum may appear attractive but its recent outperformance may have already discounted, to some extent, the cyclical rebound. For short-term investors, there may be pockets of opportunity – sectors and stocks that have yet to price in the recent positives. However, with few indications that Japan is overcoming its long-term challenges, we would caution about being over exposed to the market. For now, the US and Europe remain our preferred developed markets while, within Asia, our bias is towards China and Indonesia.

Figure 6: Japan's deteriorating demographics



Source: World Bank, Barclays

Figure 7: Nikkei 225 annual performance (2008-12)



Source: Bloomberg, Barclays

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