July 2012

Compass

Getting used to it

Euro fatigue

Opportunities in oversold euro area bank bonds

Are European stocks cheap?

Euro diversification strategy

Real behaviour reveals limits of public policy

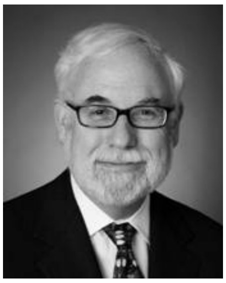
An alternative to traditional fixed income: Private senior secured loans

Wealth and Investment Management

Global Research & Investments

BARCLAYS

Contents



Aaron S. Gurwitz
Chief Investment Officer

Getting used to it

Life is as tedious as a twice-told tale, vexing the dull ear of a drowsy man.

King John, Act 3, Scene 4 - Shakespeare

Dear clients and colleagues:

The phrase "the new normal" refers to a situation in which economic growth in the developed world continues at what is, by historical standards, a slow pace, unemployment remains elevated, central banks keep interest rates low, and stock market returns, while positive on average, feel disappointing

By these criteria, 2012 to date has been a "new normal" year. First half economic growth in the US looks set to come in below 2%, and Europe will struggle to grow at all. US unemployment is stuck above 8% and I see no signs that it's headed a lot lower any time soon. Yields on high-quality 10-year government bonds have fallen below 2%. Finally, global equities, as measured by the FTSE All Country Local Currency Index, returned about 7% for the first six months of the year. This is actually higher than what we would usually expect over such a period, but few colleagues or clients would suggest that 2012 to date feels like a good year for stocks. Most tellingly, even amidst the latest eruption of the euro debt crisis this spring, market volatility rose by less than might have been expected. Investors almost seem to be getting used to things.

I'm not particularly surprised by this. Our expectations for US and European economic growth, though not quite this subdued, have never been stellar. And in the euro area, what's happening is consistent with our expectations about how the euro zone was likely to deal with its fiscal challenges, as set out in last October's edition of this publication. Our belief was and is that Europe would most likely continue to "muddle through" its difficulties: never allowing the situation to deteriorate into a Lehman-like catastrophe but never quite solving the problem in a satisfactory way.

A subdued risk-off cycle is also consistent with the January update of our strategic asset allocation recommendations. At the time I expressed the view that short-term interest rates would remain extremely low for a very long period of time. We also pointed out that in a world in which yields on the lowest risk investments were at or close to 0%, absolute returns would seem low by historical standards even if the excess returns on riskier investments such as equities – their "risk-premiums" – turned out to be a bit higher than in the past. Bond and stock market performance through 2012 so far have played that script to the letter.

Subdued volatility suggests that investors expect more of the same: more muddle, more "disappointing" absolute returns.

One temptation under such circumstances is to disengage from financial markets by avoiding risk entirely. Another is to give up the search for promising investment strategies and attractive opportunities. I think both would be a mistake. We believe risk will be rewarded by generous excess returns over a three- to five-year horizon. And, as we aim to communicate in this edition of *Compass,* we believe there are plenty of good worthwhile investments to make right now.

Sincerely yours,

Aaron S. Gurwitz
Chief Investment Officer

Euro fatigue

Kevin Gardiner
+44 (0)20 3555 8412
kevin.gardiner@barclays.com

The latest EU summit shows that euro politicians increasingly 'get it'. Volatility may nonetheless persist for a while, and Barclays' Tactical Allocation Committee remains tactically cautious, with its largest overweight call in cash. Strategically, however, we still see valuations favouring risk assets.

Another false summit? Not quite

We still think disaster for the euro will be avoided – but so too will triumph. A lasting resolution requires more fiscal, banking and political integration – not necessarily complete integration, but more than is visible today. It also requires convincing structural reform, and not just in the periphery: there is plenty of work to do in France too.

These things will take years, not days, to deliver – not least because political leadership is weak, and voters are currently sceptical. At least one rather important participant has stated recently that she does not expect to see a potentially significant component of that integration during her lifetime.

This doesn't mean that investors will be on the edge of their seats for however many years it will take. The flaws in the euro's architecture have been visible from its inception, but haven't always mattered to markets, and we can imagine investors' preoccupations shifting again – in the right circumstances.

Those circumstances require that the euro area authorities show themselves willing to stand behind Spanish and Italian banks if necessary. Those countries are in our view solvent – Spain's consolidated sovereign and banking balance sheet is well within the realm of plausible arithmetic sustainability, and Italy's is capable of being tackled reasonably quickly through a combination of budgetary discipline and asset sales. But for the ECB et al to act in support of these solvent states in turn requires that politicians do just enough to demonstrate publicly that they 'get it'.

The latest summit (28-29 June) shows that they do. There were two components to the summit news: a palliative economic initiative involving the European Investment Bank, and (more importantly) a package of financial proposals from the Council aimed at stabilising the euro area markets and banking systems. Both hint at some modest willingness to compromise by Germany – the softening in stance that we'd expected to see at some stage.

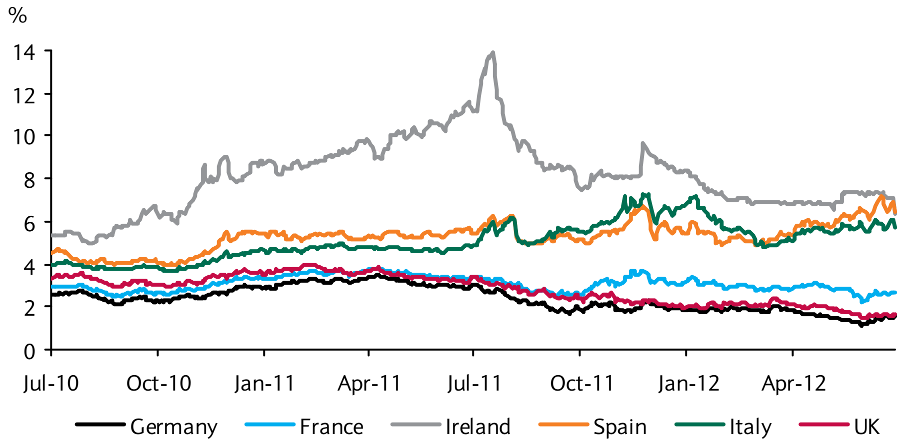
Germany's principles are understandable, and arguably admirable – but if the euro is to survive, as we think it will, some compromise is inevitable. A break-up of the euro could damage German banks as well as others, because the national central bank assets being accepted by the bundesbank as a counterpart to the inflows of deposits from the periphery would likely fall sharply in value. In the last resort, a German Chancellor would be unlikely knowingly to place the national money stock at risk again – even if they were willing to countenance the break up of the euro to begin with, which we doubt.

The summit's economic initiative involves a small capital increase for the EIB that, when levered and accompanied by unused structural funds, could reportedly result in €120bn (roughly 1% of area GDP) of infrastructure projects in the next year or two. This is hardly transformative, but may at least offer some modest cyclical and political support to the weaker economies.

The Council's package has three important elements. First, it tasks the politicians with considering quickly proposals for a "single supervisory system" for euro area banks, which will allow future banking crises to be quickly dealt with centrally, breaking the "vicious circle" between banks and sovereigns. Second, it makes it clear that the Spanish banks in particular will be recapitalised by the EFSF (the short-term rescue fund) and eventually the ESM, and that this will occur without the rescue funds gaining seniority to other lenders (the statement also refers to Ireland being viewed favourably by the Eurogroup, the only other country mentioned by name). Thirdly, it affirms that EFSF and ESM funds will be used, if necessary, more widely to "stabilise markets for Member States", with the ECB acting as agent.

We see this as the beginning of the "circling of the wagons" around the systemically important banks and markets that we've been expecting. As noted, there are still many unresolved issues that could cause further volatility, but progress is slowly being made, albeit no doubt in a two-steps-forward-one-step-back fashion. Spanish and Italian bond yields have fallen back (Figure 1) and equity markets have rallied on the news.

Figure 1: Selected 10-year government bond yields in Europe (%)



Source: Datastream, Barclays Research

One of the things that could yet unsettle markets again would be renewed uncertainty in Greece – whose predicament tellingly did not feature in the summit news. The election result there, which so overshadowed the last issue of *Compass*, was as benign from an investor viewpoint as could have been wished, but it is still questionable whether the new government will be able to negotiate much more slack with the troika: Greece's partners may be losing patience. Our working assumption remains that Greece will stay within the single currency, but it is a very close call. However, we doubt whether renewed market volatility on this account would last long, given the visible support now being marshalled for the Spanish banks, and the small size of residual direct exposure to Greece.

Treble double dip debate?

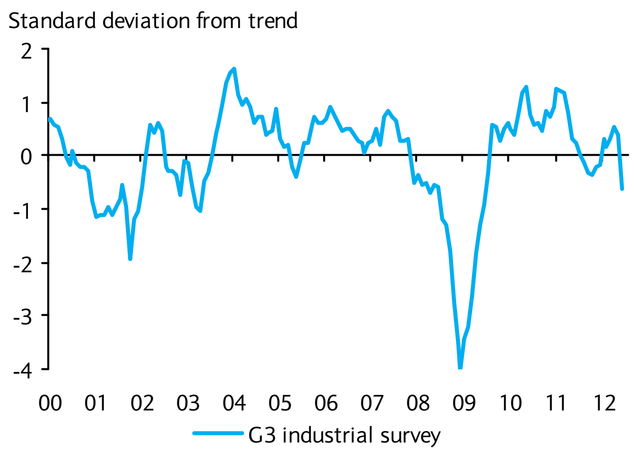
For the third consecutive summer investors are starting to worry about a possible 'double dip' in the US economy. Our economists' own tracking estimate for second quarter GDP growth is currently running below 2%, after a similarly-disappointing first quarter, and the likely full-year outturn is now closer to 2% than the 2.5% at which we started the year.

There are certainly good domestic reasons for expecting some serious headwinds for US growth in the year ahead – even if, as we expect, the 'fiscal cliff' in early 2013 is successfully turned by last-minute political fudge. And in the short-term, the enfeebling impact of the euro crisis on corporate spending and international trade is clearly being felt in US manufacturers' order books, which fell very sharply in the latest ISM survey and have contributed to a pronounced fall in our composite developed world cyclical indicator (Figure 2). But we still feel that the US consumer in particular is in qualitatively better shape than many fear, and see the housing market as a source of potential support. The monthly data there can be volatile, but building permits and housing starts have been trending higher (Figure 3).

Economic data in Europe have actually been closer to (downbeat) expectations. Indeed, for the euro area, the prospective shrinkage in GDP in 2012, at 0.3%, is no larger than we thought likely at the start of the year, and some recovery still seems likely in 2013 as the initial impact of fiscal tightening fades. Intriguingly, this means that as the US sees its long-awaited fiscal retrenchment beginning in 2013 – even if that cliff is indeed largely turned – the gap between US and euro area growth could be set to narrow markedly, a development that has often been associated with outperformance by the euro area stock market. The US stock market has of course outperformed Europe markedly in the last few years, and some partial reversal at least is arguably overdue.

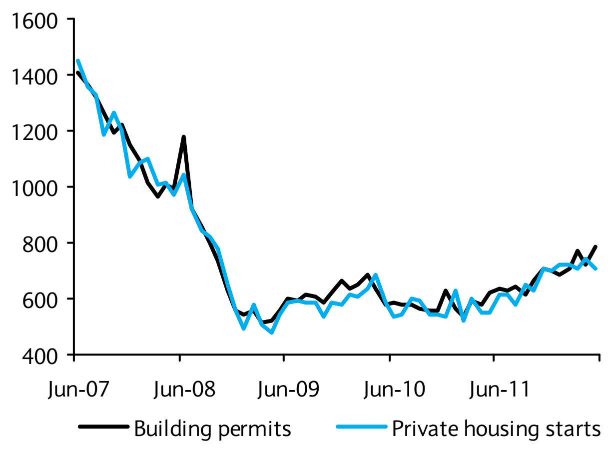
Meanwhile, the slowdown in China we think may have just about run its course. The hard/soft landing debate continues to rage, but we think it is misplaced: the impact on the rest of the world of Chinese growth at 6% as opposed to 8% could be less than feared, at least outside the commodity markets. China's net exports are still firmly positive and growing. That said, we do still see 8% as the most likely outcome – which would correspond to the 'soft landing' side of that debate – and would point to the loosening of monetary policy underway, with interest rates having been cut twice since the last *Compass*, as a supporting factor. The fact that much of China's economy – and banking system – is under direct government control means that policy initiatives there often have a good chance of succeeding.

Figure 2: Industrial confidence: forward-looking survey data (US, EU, Japan; standard deviations from trend)



Source: Datastream, Barclays Research

Figure 3: US building permits and housing starts (000)



Source: Datastream, Barclays Research

Tactical caution, strategic optimism

As noted above, it may be too soon to extrapolate the 'beta bounce' that has followed the latest euro summit through the summer months. There are many sources of potential volatility: the unresolved issues in the euro area (for example, will the EFSF and ESM's resources be adequate to the task of stabilising the Spanish banking system? Will Greece decide to go it alone after all?) and the risk of a confidence-related standstill in US corporate spending.

But our Tactical Allocation Committee's (TAC) recent caution on developed equities is focused near-term, over the next 3-6 months, only. Strategically, we expect neither the euro nor the global economy to meet with disaster, and if risk appetite starts to stabilise, and investors begin to look more thoughtfully at valuations, then it is those risk assets that will appeal most.

Those valuations of course can not be taken for granted, as we note in the essay on European stocks below: euro area profits are falling, and even in the US the level of forward earnings projected by analysts looks too high. As a result, PE ratios can't be gauged with precision. But it would take a very large (of the order of one-third) fall in developed market profits to wipe out that valuation edge. And there is less uncertainty surrounding the valuation of core government bond markets: yields there fall well short even of the more pessimistic assessments of trend nominal economic growth, making them rather expensive unless global deflation looms (which we doubt).

In fact, in the latest TAC meeting the Committee felt able to take off some of the portfolio insurance added to the recommended asset mix in late May. Neither the second Greek election nor the latest European summit disappointed in the way that the Committee had worried they might, suggesting that on some fronts at least the immediate outlook may be a little less tense. With this in mind, the Committee reversed its earlier move on government bonds, moving back down to an underweight position, and with the funds released opted to close a long-standing underweight in investment grade corporate credit. This is only a marginal addition to portfolio risk, and still leaves us in a more 'risk off' than 'risk on' position tactically (as usual, full portfolio details can be found in the table on page 26 below). Most bonds look expensive currently, but corporate bonds look less so than government bonds, and the added yield will we think prove helpful to the overall mix of returns.

Not all investors' circumstances or financial personalities are such as to make a fully-diversified portfolio in line with the Barclays Investment Philosophy appropriate. For investors looking for individual, stand-alone investment ideas, our strategy team has identified a number of opportunities in its weekly publication *In Focus*. These include: a long-term focus on the relative performance of equities over bonds, and the attractions of income-yielding and Blue Chip equities in particular, which might appeal to investors with 'average' risk appetite; a medium-term positive call on US bank stocks and oversold European bank bonds (for investors with higher risk tolerance); and a portfolio of carefully-chosen defensive bonds with relatively short duration as a way of safely augmenting the yield on cash (for investors with lower risk tolerance).

Opportunities in oversold euro area bank bonds

Fadi Zaher, PhD
+44 (0)20 3134 8949
Fadi.zaher@barclays.com

Amie Stow
+44 (0)20 3134 2692
amie.stow@barclays.com

The sell-off in European Banks has been indiscriminate. We believe a regime shift in rating levels is underway and investors need to adapt to global Banks having lower credit ratings. We argue the case for gaining exposure to a basket of subordinated debt.

Refuelling

The European banking system has been thrown into the spotlight as tensions around the sovereign crisis in the euro area have escalated. Banks' exposure to peripheral countries has cast some doubt over the viability of the banks in Europe. This is not helped by challenges facing the real economy as banks form an integral part of the transmission mechanism.

Pressure on banks' funding costs, visible in widening credit default swap spreads, reflects battered sentiment. It has also fuelled a heightened perception of risk by the market, causing investors to overlook healthier balance sheets, the possibility of policymaker support and perhaps the systemic importance of the banking system for the economy.

If anything was learned from the credit crunch in 2008/2009 it is the importance of liquidity and banks' ability to access the wholesale market and short-term funding. The European Central Bank (ECB) recognised this, and its Long-Term Refinancing Operations (LTRO) have provided access to cheap funding for euro area banks for the next 2-3 years (though there are few signs that the liquidity is feeding into the wider economy).

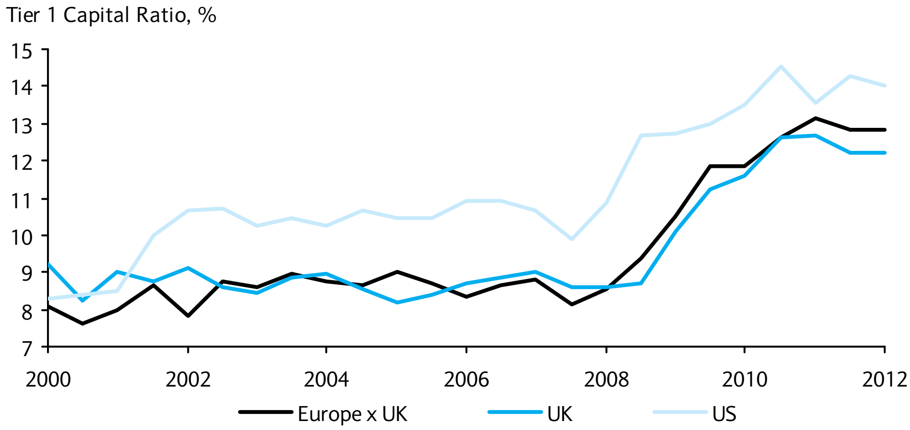
Figure 1: Peripheral exposure has declined and coverage ratios increased

	Peripheral exposure		Liquidity*	
€mn	Core T1 cap	QoQ Change	Coverage 1Q12	Coverage 4Q11
BBVA	162%	0%	1522%	n/a
Santander	112%	8%	n/a	909%
UniCredit	108%	8%	83%	72%
Commerzbank	45%	-8%	129%	117%
BNP Paribas	23%	-21%	106%	85%
Credit Agricole	18%	2%	109%	87%
Deutsche Bank	11%	7%	n/a	n/a
Societe Generale	9%	-31%	89%	73%
Credit Suisse	4%	67%	181%	100%
HSBC	3%	-6%	n/a	n/a
RBS	1%	-37%	191%	152%
Lloyds	0%	-15%	245%	179%

Source: Barclays Research
*(Liquidity/S-T Funding)

In general, we believe Central Banks are likely to remain accommodative: the US Federal Reserve has extended its Operation Twist; the Bank of England has committed to more asset purchases; and the ECB has cut rates by a further 25bps. Furthermore, the ECB still has more tools in its armoury in the form of further LTROs or a reactivation of the securities market program (SMP). The effects of Central Bank support are clearly visible on banks' balance sheets with coverage ratios (liquidity/short term funding) increasing substantially over the quarter - UK banks have shown the most substantial improvement (Figure 1).

Figure 2: European core tier 1 capital ratios continue to improve (%)



Source: Bloomberg

While liquidity is a stepping stone, capital forms an integral part in assessing the banking sector's medium and longer-term strength. European banks are much better capitalised than in the 2008/2009 episode (Figure 2). Helped by new regulatory regimes we have seen banks increasing core tier 1 capital (often comprised of retained earnings and shareholders' funds) to provide a meaningful buffer against losses in the event of crisis. In addition as part of Basel 3, which is expected to be implemented in 2019, banks are required to issue new loss absorbing debt that could help banks to recapitalise in the event of distress (also referred to as the concept of bail-in – i.e. the bank is bailing out itself) . Although the loss absorbing bonds may form a minor part of a bank's capital they are likely to provide a premium over the traditional subordinated debt. Furthermore we believe they add an additional layer of protection for senior debt holders.

A regime shift?

Some of our short term concerns focus around how deleveraging via tighter lending conditions, as well banks' increasing addiction to Central Bank liquidity, will evolve. In Q1 2012 the wholesale funding of banks was at a historical low – far beyond expectations. Yet we believe the UK banks and larger continental European banks are better positioned to manage their balance sheets through the rocky journey.

Another concern is the level of exposure that European Banks have to the euro area periphery. While we recognise this is a possibility we assign a small likelihood that some of the larger economies in the periphery will follow the same destiny as Greece; our central view is that Spain and Italy will remain solvent. Furthermore, the flagship European banks have been actively managing peripheral exposure, keeping it stable or shrinking it over the past quarter (Figure 1).

Weakening of the sovereign outlook was at the core of the recent round of banking downgrades by rating agencies. In our view, the wider worries over the euro area are unlikely to dissipate overnight and, like in 2008/2009, investors will have to grow accustomed to a regime shift where banks carry lower ratings (Figure 3). In an interesting quirk to this shift Santander is now rated higher than Spain, indicating the strength of robust fundamentals due to a revenue stream that is largely outside Europe.

Figure 3: Market implied default indicates selected issuers have been oversold

Moody's Rating	Issuer	Price	Rating implied default probability	Market implied default probability	Difference
Baa2	CO-OPERATIVE BANK PLC	90.6	2.41%	6.40%	3.99%
Baa2 /*-	LLOYDS TSB BANK PLC	79.9	2.85%	10.46%	7.61%
Baa1	SANTANDER ISSUANCES	82.0	1.67%	12.38%	10.71%
Baa3	UNICREDIT SPA	81.0	3.70%	8.75%	5.05%
Baa3 /*-	BNP PARIBAS	61.0	4.33%	6.74%	2.41%
Baa3 /*-	CREDIT AGRICOLE SA	61.1	4.33%	7.45%	3.12%
Baa3	FRIENDS LIFE GROUP PLC	61.6	4.33%	10.34%	6.01%
Ba1	BBVA INTL PREF UNIPERSON	71.8	4.33%	13.84%	9.51%

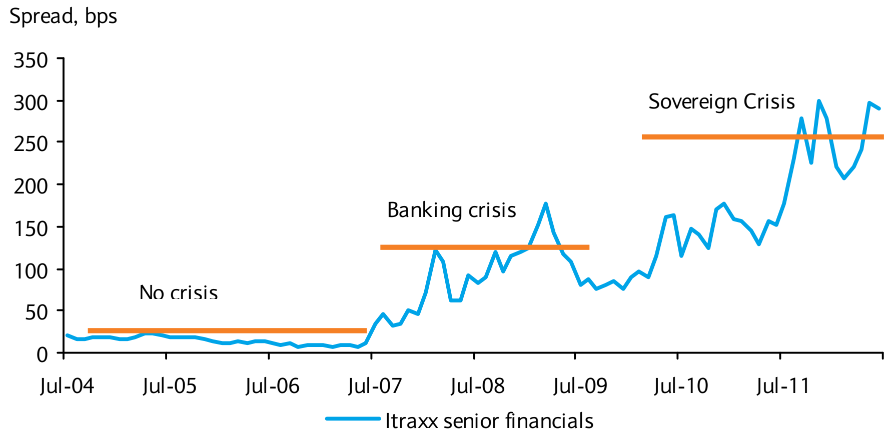
Source: Bloomberg, Moody's

For the brave of heart

Few investors have focussed on the fundamentals. Instead bank debt has been oversold, especially at the lower end of the capital structure, with the market pricing in a default probability of at least twice the historical average (Figure 4).

Regulatory changes further support our view. Under the proposed capital structure of Basel 3 there will no longer be the same definition between layers of the capital structure and ahead of the expected implementation in 2019 banks will have to call subordinated debt as it will no longer qualify as tier 1 capital. This is why our exposure to European banks is through a basket of our high conviction names with 65% allocated to lower tier 2 debt and 35% to tier 1 debt. Coupons are protected on lower tier 2 debt and are typically less volatile compared to tier 1 debt, which is highly correlated to the equity.

Figure 4: A regime shift is apparent



Source: Bloomberg, Moody's

This idea is not for everybody, but for investors who have both high risk appetite and composure the basket provides a good opportunity to play the European bank story by buying bonds whose prices have fallen, in our view, too far. Within fixed income portfolios we are currently advocating a barbell thesis with covered bonds sitting alongside these oversold subordinated European financials in order to mitigate some of the risks.

Are European stocks cheap?

William Hobbs
+44 (0)20 3555 8415
william.hobbs@barclays.com

Jim Davies
+44 (0)20 3555 8397
jim.davies@barclays.com

European equities have been hit hardest by the euro crisis, and have underperformed the US market markedly in the last few years. They look inexpensive to us, but how sure can we be?

Europe continues to provide a very uncertain investment backdrop, and investors are nervous. A seemingly relentless barrage of media and pundit gloom is doing little to reassure them. At such times, investment decisions can be influenced more by liquidity and risk than by valuations – not least because valuations themselves become highly uncertain when banking systems and economies are potentially volatile.

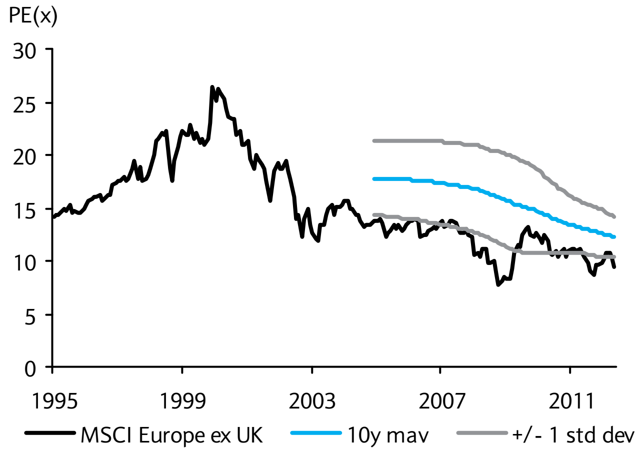
However, if the mood stabilises – perhaps because politicians eventually manage to convince investors that they do indeed 'get it' as far as the euro crisis is concerned, as noted above – then valuations will start to matter more. And in our view, even allowing for some uncertainty, those valuations point reasonably clearly to European equities being inexpensive. Conversely, core government bonds look to be expensive. In this essay we take a quick look at those equity valuations, and how they might be stress tested for some of that uncertainty.

Refocusing on valuations

The first three Figures show that Continental European equities are trading around one-and-a-half standard deviations more cheaply than their 10-year trends. Figure 1 shows the prospective PE ratio (current stock prices divided by consensus forecasts of the next twelve months' earnings); Figure 2 shows a trailing price to book ratio (current share prices divided by the latest outturn for the value of shareholders' equity at balance sheet valuations); Figure 3 shows dividend yields (the latest annual dividend divided by the share price – here a higher number denotes cheapness).

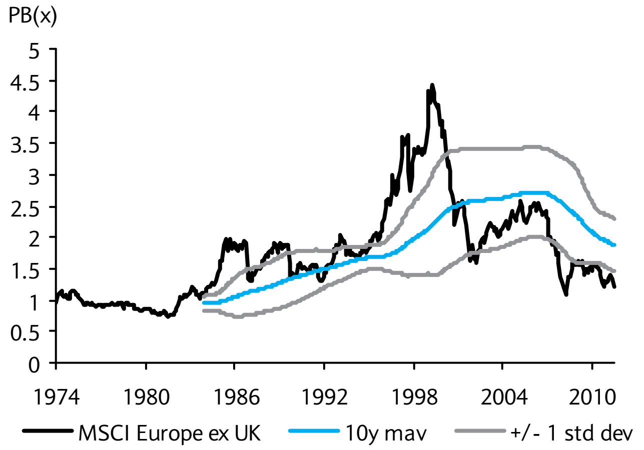
Of these three ratios, the most susceptible to uncertainty is the prospective PE ratio. Earnings – both estimated and actual – are much more volatile than dividends or book value, and this is the ratio we should stress-test.

Figure 1: Continental European stocks: forward PE



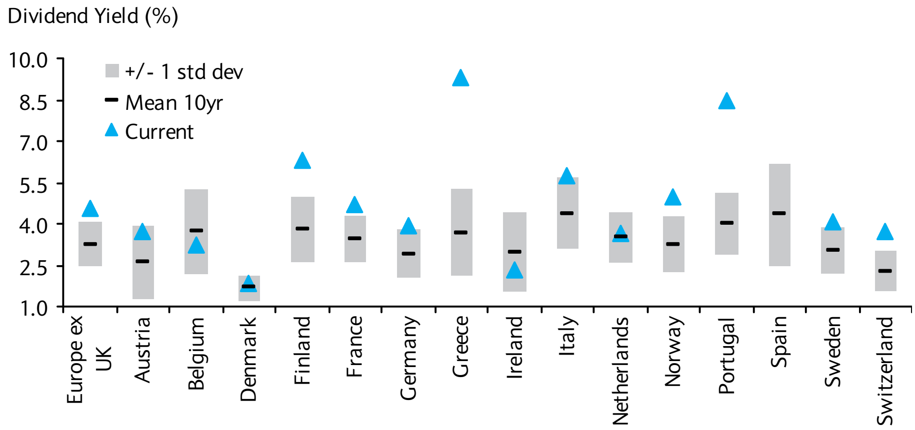
Source: FactSet

Figure 2: Continental European stocks: price/book value



Source: FactSet

Figure 3: Continental European stocks: trailing dividend yield

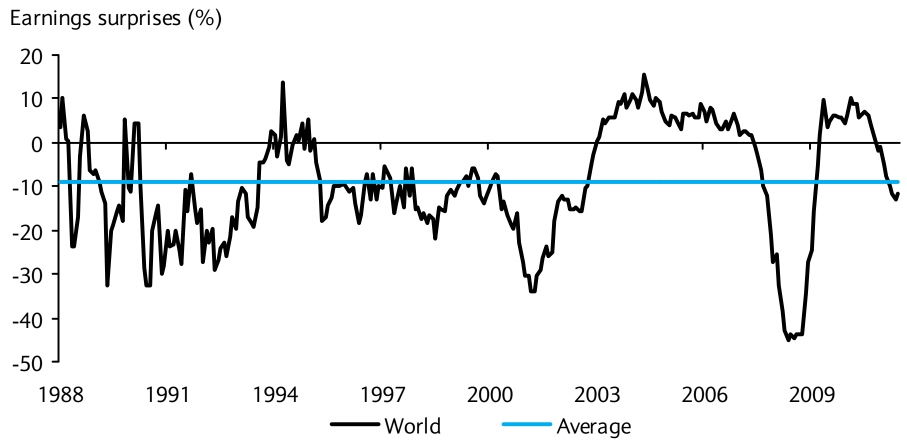


Source: FactSet

How reliable are analysts' forecasts?

History has taught us that equity analysts' forecasts – like anybody's – should be treated with caution. Earnings surprises – the extent to which companies' results diverge from forecasts – tend to conform to a pattern that might be expected by our behavioural finance colleagues. Analysts are bad at spotting turning points: they have a tendency to become too optimistic and overshoot at the top of the earnings cycle before becoming overly pessimistic at the other end. And since disappointments in earnings tend to be much larger, this has led to analysts being almost 10% too optimistic on average for global stock market earnings over the last two decades or so. At the risk of stating the obvious, of course, stock markets themselves have not fallen over this period – suggesting immediately that earnings surprises are not the only driver of market returns.

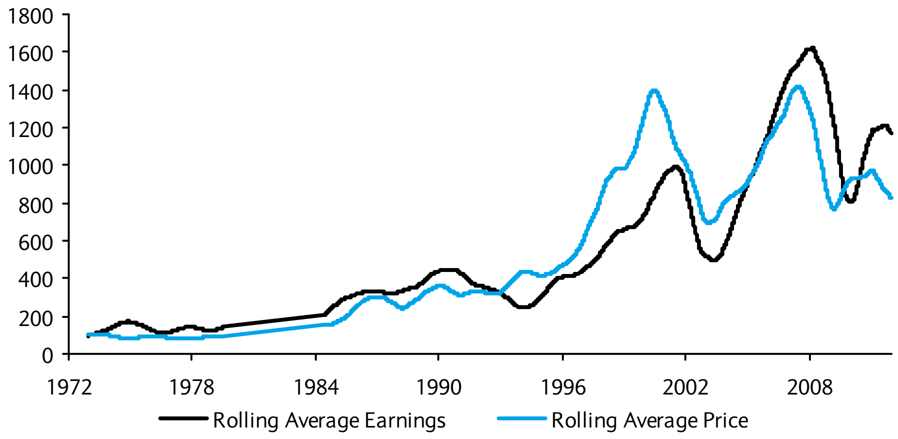
Figure 4: Global earnings outturns compared to analysts' forecasts



Source: Datastream, IBES, MSCI Developed World Index

To be fair to the analysts, cyclical downturns in earnings can be large. Figure 5 shows the actual, rolling 12-month level of historical (trailing) earnings on an MSCI definition for the Continental European market (in local currency terms). There have been three pronounced falls in earnings since 1990, averaging 45% on this basis (the different data-gathering agencies have different definitions, mostly to do with the extent to which erratic items are taken into the bottom line, and the MSCI definition can be volatile. Ominously, trailing earnings have begun to fall again in the last year. What should we be braced for now in stress-testing that forward PE ratio?

Figure 5: Rolling 12-m EUX trailing earnings and stock price (indices, 1973=100)

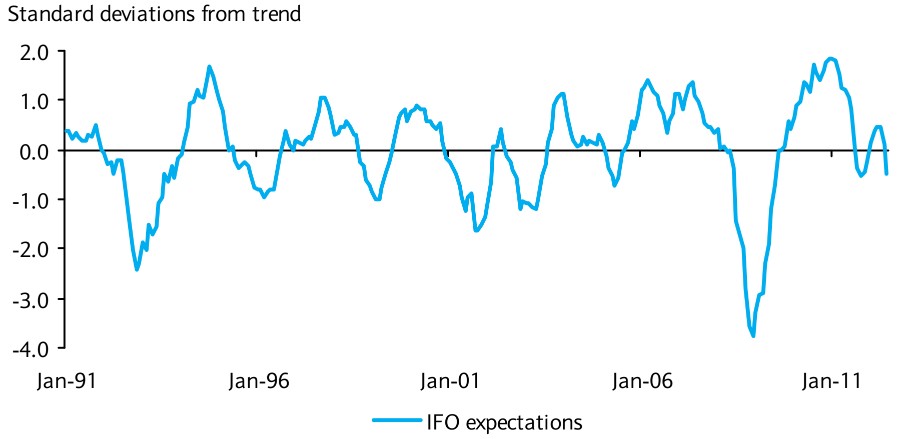


Source: FactSet

Each of those dramatic falls in earnings was associated with major economic and market trauma. The downturn in earnings in the early 1990s was associated with currency turmoil and recession, all in the context of the shock received by a recently-unified Germany faced with combining suddenly a dysfunctional DDR (East) with the efficient FDR (West). The collapse in 2002 was the product of a mild US recession with the wrenching asset write-downs that followed the telecom/media/technology (TMT) craziness. And most recently, the slump in 2008-2009 reflected both the severe economic downturn and massive bank write-downs that followed the Lehman bankruptcy.

As yet, the economic data are not pointing to as severe a setback (Figure 6). And the chances of major balance sheet write-downs of either goodwill (as after the TMT boom) or bank assets (as after Lehman) are we think small currently – especially if, as we expect, the euro authorities succeed in inoculating the major banks against contagion.

Figure 6: German business confidence, 1991-2012



Source: Datastream, Barclays Research

What if earnings fall short?

Continental European companies are not tied closely to the European economy. It is difficult to be precise – not least because a geographical analysis of sales is not a mandatory reporting item – but perhaps around two fifths of the revenues for the quoted European corporate sector are derived from outside the region. Roughly 15% of revenues emanate from the US with a further 20% generated in emerging markets, and these are two regions where economic conditions are more resilient than in Europe.

Analysts currently expect Continental European earnings to grow by around 8% in the next 12 months. Suppose this is too optimistic by a third (so that earnings fall by around 28% in the next 12 months instead of growing by 8%: 0.67*1.08 = 0.72). The Europe ex UK equity market would then still be trading on a prospective price-to-earnings ratio of a little over 13x, more or less in line with its 10 year historic average.

This is not to suggest that stock prices wouldn't react to such a shortfall: of course they would, possibly quite sharply. But the volatility might prove short-lived, particularly when investors begin to anticipate an eventual rebound in earnings. And as we've already noted, the link between the published earnings forecasts and stock market returns is a loose one, and we believe that some significant shortfall in earnings is likely priced in to start with. And this analysis of valuations takes no account of the historically-subdued level of interest rates, or of the historically respectable levels of profitability and liquidity, which further flatter more sophisticated analyses based on discounted cashflow.

The story so far this year…

In the first half of the year, European equities were up by around 1%, though this masks broad divergences across both countries and sectors. The German equity market was up by around 5%; Spain was down by about 17%. In terms of sectors, some may be surprised to learn that it is not the financials that have been the worst performer so far during 2012 but actually the telecommunications sector, with utilities companies not faring much better. These latter sectors have traditionally been seen as havens which investors have used to seek shelter from macroeconomic headwinds, but a worsening regulatory environment has taken its toll. That these sectors have performed so badly at a time when they'd usually do well illustrates how difficult a task investors face currently. Since we see risk appetite eventually stabilising in our "muddle through" scenario, we are not too disappointed to see such relatively defensive sectors underperforming – and expect it to continue in H2.

Is now the time to invest in European equities?

Within developed markets, we have favoured the US ahead of Europe, but also Europe ahead of the UK, Japan and the rest of the world on a medium term view. US equities currently face a better economic outlook, but as we noted earlier, the US' relative growth advantage may fade somewhat as we approach 2013, and since Europe has been hit the hardest, when valuations begin to matter again there is potential for European stocks to outperform their US counterparts. They started to do so in the 'risk on' climate in Q1, and tentatively began to do so again in the 'beta bounce' in June.

It is likely too early to actively invest in this expectation (the US also, to be fair, looks pretty inexpensive by its own standards). For the time being, we would direct investors with moderate risk appetite towards high quality companies with sustainable business models and broad geographic exposures of the sort found in the strategy team's *Regional Portfolios* or *Blue Chips* investment idea. Alternatively, companies that have a consistent record of paying an above average and stable dividend, such as those suggested in our *Gaining Exposure to Income Stocks* investment idea, can also offer defensive characteristics. Please contact your Barclays representative for further details.

Euro diversification strategy

Petr Krpata
+44 (0)20 3555 8398
petr.krpata@barclays.com

We expect the euro to remain intact, and the possibility of a near-term break-up has faded. Nonetheless, many euro-based investors remain concerned about developments in the region and seek a diversified currency hedge for their euro exposure.

We have put together a currency hedging strategy that caters for investors who remain concerned about the euro (EUR). The keys we think are of course to diversify (to avoid placing all eggs in one basket) and to keep risk broadly comparable (for example, by not including emerging market currencies in the hedge).

As a starting point, a 'neutral' G10 currency portfolio might be nominal GDP-weighted, as shown in the first row of Figure 1 (equivalent to the Strategic Allocation for an investor with no specified base currency). However, this obviously gives the euro itself a large weight, and gives some of the other currencies inconsequentially small weights.

Figure 1: Portfolio weightings

Allocation	USD	EUR	JPY	GBP	CAD	AUD	CHF	SEK	NOK	NZD
GDP weighted	38%	31%	14%	6%	4%	3%	1%	1%	1%	0%
Tilted	40%	0%	20%	12%	12%	4%	6%	0%	0%	6%
Deviation	2%	-31%	6%	6%	8%	1%	4%	-1%	-1%	6%

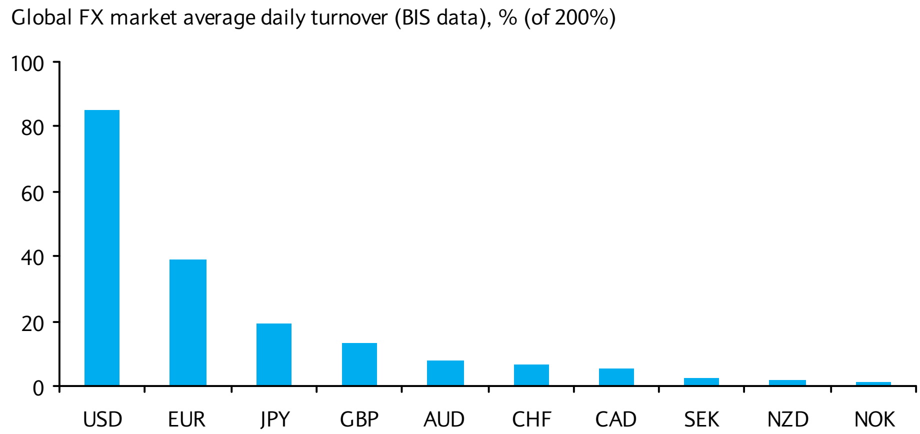
Source: Barclays/Reuters EcoWin

To build a diversified portfolio that has the potential to do well in an environment of heightened concerns about the euro area, we look at the following factors to tilt/deviate from the strategic or neutral allocation:

Liquidity favoured…

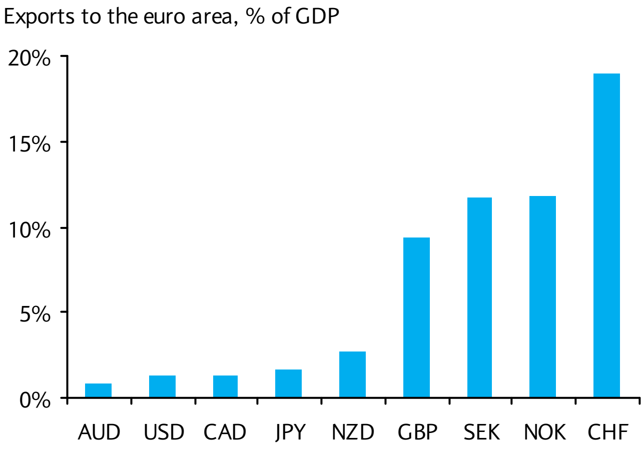
More liquid currencies should benefit in a risk-off environment, which would be caused by further deterioration in the euro area (while those less liquid are vulnerable to sell-offs).

Figure 2: Liquidity of G10 currencies



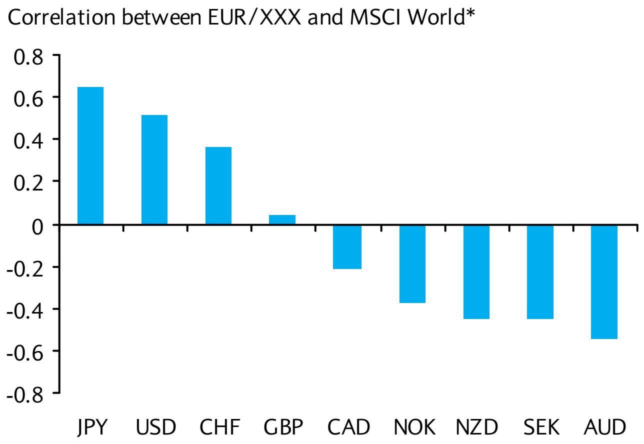
Source: Bank for International Settlements

Figure 3: Economic exposure to the euro area



Source: Reuters EcoWin

Figure 4: Currency correlation with risk



*Correlation of daily returns since 2008. Source: Barclays/Reuters EcoWin

… trade links with the euro area shunned…

The higher the proportion of exports to the euro area (as % of GDP), the larger the economic impact of a weakening in euro area economic prospects on the nation's economy.

… correlation with risk avoided…

The euro area sovereign debt problems and concerns about the region's banking system now affect all markets globally and further escalation is likely to weigh on markets. Therefore, the lower a currency's correlation with risk (proxied by the MSCI World equity index), the better.

… and track record scrutinised.

Given that we are concerned about the downside risk to the euro, we also look at the instances of general euro weakness over the past three years to assess currency performance against the euro.

Result: a quantitative ranking

We rank the currencies based on the above factors and divide the outcome into three blocks: top 2, bottom 2 and the 'middle' (as ordered in Figure 5). The top 2, in line with our expectation, are represented by current safe haven top picks: USD and JPY. Compared to the initial GDP weighted portfolio, we increase their weightings judgementally. Bottom 2 are represented by currencies with relatively high exposure to the euro area, low liquidity and lack of safe haven properties. We remove them from the portfolio. The 'middle' represents currencies which have scope to outperform EUR and at the same time offer diversification to the portfolio. We allocate the rest of the portfolio to these five currencies and optimise their allocation based on expected return and implied volatility.[1]

Figure 5: Currency ranking

Ranking	1	2	3	4	5	6	7	8	9
	USD	JPY	GBP	CHF	CAD	AUD	NZD	NOK	SEK

Source: Barclays

[1] We start from an equal allocation to all five currencies (20%) and optimize to maximize potential return (measured by our forecast v forward) for a given level of volatility. Each optimization is subject to max +/- 10% deviation from initial 20% allocation.

Safe haven cushion

The large allocation of USD and JPY provides a hedge against a worst case scenario. Indeed, the two currencies are the most sought after during the periods of stress. USD benefits from its status as the global reserve currency, highest liquidity (85% of daily fx turnover is in USD), while the proxy for a risk free asset, US Treasuries, is denominated in USD (helping the currency to benefit from defensive inflows). In addition, economic exposure (in terms of exports as % of GDP) of the US to the euro area is small. Furthermore, even if the euro area situation gradually improves, we expect the euro to remain fundamentally weak against the US dollar as both growth and monetary prospects still favour the dollar for the time being.

The Japanese yen also tends to benefit during periods of stress. The currency has the lowest correlation with risk among all G10 currencies and tends to outperform USD in a risk off environment. Although Japan has the highest debt to GDP ratio among the G10 currencies, the vast bulk of Japanese government bonds are owned domestically, and internationally Japan is of course the largest net creditor nation, not a borrower. This means even with a deteriorating fiscal position, pressure on JPY is limited (as domestic investors tend to stick to their domestic holdings). In addition, the yen also benefits from repatriation flows during a risk off climate, as domestic investors tend to scale back some of their exposure to foreign assets (such as high yielding Brazilian and South African bonds). Hence, JPY forms a valuable addition to a well diversified portfolio that caters for euro area risk.

Scaling back exposure to Europe

We do not want take exposure to NOK and SEK in the hedging basket. The two big Scandinavian currencies rank lowest in our score card as they have relatively meaningful exposure to the euro area, are highly correlated with risk and tend to suffer from low liquidity (for example, NOK has the lowest liquidity among G10 currencies). Although we remain very constructive on both currencies' prospects, they are unlikely to do well during periods of persistent euro area induced stress. While both of them exert strong fundamentals (such a healthy fiscal position), history suggests that this is not enough for the currencies to do well when investors take risk off the table.

Diversification benefits

Having allocated 60% to the safe haven currencies and taken exposure away from NOK and SEK, we statistically optimise the rest (40%) among CAD, GBP, AUD, NZD and CHF.

Although we expect CHF to weaken against the euro over the long-term, we see it as a valuable addition to the well diversified portfolio whose main aim is to hedge against euro risk. Should the situation in the euro area deteriorate, the franc is unlikely to lose value against the euro, while a potential break through the Swiss National Bank's floor for EUR/CHF cannot be ruled out (although we do not expect that).

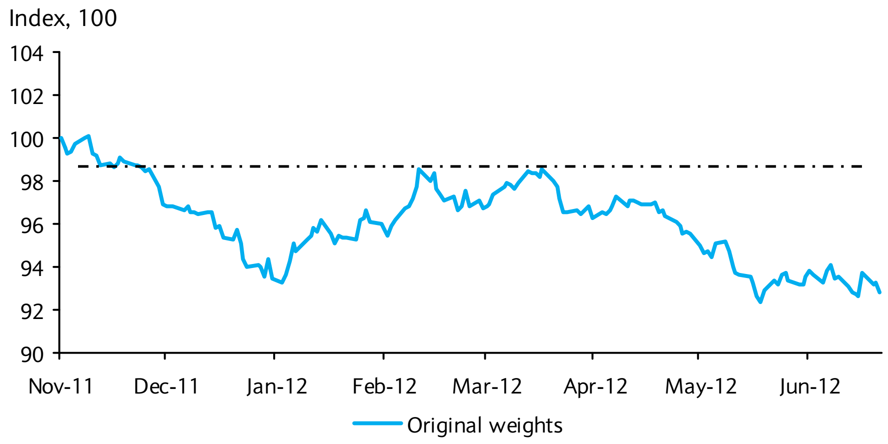
In Europe, we expect sterling to benefit more from relative safe haven status (due to the limited upside for EUR/CHF, and the credible deficit reduction plan and deep bond market in the UK). Moreover, although the UK's economic prospects remain clouded and the BoE has (as expected) added further to its QE in July, the issues that the euro faces are more pressing. The ECB is embarking on more pronounced monetary easing, and UK growth prospects remain a little better than those in the euro area.

We include developed commodity currencies (CAD, AUD, NZD) as part of the diversified portfolio. Although commodity currencies are, by nature, more risky, they do not have a material economic exposure to the euro area (unlike SEK and NOK). Canada's largest trading partner is the US, while the currency exerted negative correlation with the euro area risk (meaning that it can do well against the euro if things deteriorate). In the case of AUD, China is Australia's largest trading partner. As noted, we think the Chinese authorities can steer the economy towards what might be characterised as a 'soft landing', supporting AUD (which should also benefit from the largest carry – the highest interest rates – in the G10 GX space). NZD has done relatively well against the euro in periods of euro weakness during the past three years and we remain constructive on the currency's prospects over the quarter ahead.

Conclusion

The idea is intended to enable nervous euro-based currency investors to benefit from periods of heightened euro area risk, as well as offering diversification benefits (i.e. it is not just a pure 'risk-on, risk-off' play). It was first rolled out in mid-November and since inception has gained around 6%. Although the primary aim of the portfolio is a hedge against euro risk, we would expect the portfolio to record positive returns even if the worst case scenario is avoided. We expect the euro to remain fundamentally weak against the US dollar (which forms the last part of the portfolio), while the inclusion of cyclical currencies (CAD, NZD and AUD) means that portion of the portfolio would do well in a global risk-on environment.

Figure 6: Portfolio performance (units per euro, ie a fall implies a gain in value)



Source: Barclays/Reuters EcoWin

One risk to the trade is that the specific issues in the euro area might improve (both on the economic side and the risk premium side), in which case the euro is likely to rebound. Another is that both USD and JPY weaken materially, due to large scale monetary easing by both central banks and/or a more risk-on environment.

Real behaviour reveals limits of public policy

Peter Brooks, Ph.D.
+65 6308 2167
peter.brooks@barclaysasia.com

Consumers', business people's, and investors' emotions can affect responses to macroeconomic policies. In this essay we examine how psychology might reduce the effectiveness of monetary and fiscal policies.

Austerity or growth?

Since the current economic crisis began in 2008 policymakers in the developed world have been debating the relative merits of "austerity" versus "stimulus" as ways of setting their economies on the right course. Our aim in this essay is not to resolve this debate but to point out how natural, human psychological predispositions can limit the effectiveness of any policy option.

Efforts to stimulate economic growth can take the form of either fiscal policy (tax cuts or spending increases) or monetary policy (central bank operations that reduce interest rates).

Fiscal stimulus aims to expand demand by substituting government expenditures for the private sector spending that is missing during a recessionary period. The intention is that the initial beneficiaries of increased government spending, such as construction workers on infrastructure projects, will spend a large part of their incremental income, and this newly-created demand will lead private sector firms to hire new employees, who will then spend their income and create additional jobs.

Monetary policy usually seeks to encourage more business people and portfolio managers to put money to work by raising the opportunity cost of holding cash. But with short-term interest rates still close to 0%, the room for them to fall further is small, and quantitative easing (QE) may again be the policy of choice for struggling economies.

The success of both fiscal and monetary policy depends heavily upon the responses of consumers and businesses. But those responses can also be affected by a number of psychological responses, such as decision fatigue, our perceptions of the debt burden, and risk compensation. Consequently, expansionary policies may not have a large effect upon economic growth if these cognitive factors present a barrier. Put simply, expanding the demand for goods or the supply of money will not necessarily mean anyone will increase spending or be willing to borrow money, even at extremely low interest rates.

Are you suffering decision fatigue?

It is common to hear investors suggest they are fatigued and disillusioned by the continuing Eurozone malaise. They often prefer to sit on the sidelines rather than get invested, particularly since there is no clear end in sight to the Eurozone crisis.

Decision fatigue refers to the deteriorating quality (and perhaps rationality) of decisions when previous decisions have depleted your mental energy. This is especially true of mentally challenging decisions involving trade-offs – such as the trade-off between risk and return across multiple investment options. Decision fatigue can also lead to decision paralysis, where we simply do not make any decision.

For either fiscal or monetary policy to be effective, investors need to maintain their willpower to stay invested or have the emotional resolve to get invested when long-term buying opportunities present themselves. Unless you have set up investment strategies in periods of calm this can be difficult – you will likely be faced with countless nervous moments where you have to decide what to do with your investments. Each time you face this decision your willpower is eroded slightly and decision fatigue can set in.

Fatigued investors have two options: either stop following the markets' response to current events so closely to reduce the potential for further decision fatigue or get out of the markets to remove the main source of fatigue. The first requires emotional resilience and is the more likely reaction of high-composure investors. The second is more typical of low-composure investors, who are more sensitive to short-term market movements. Either way, the fatigued investor is unlikely to commit more money to risky assets no matter how attractively priced from a longer-term perspective.

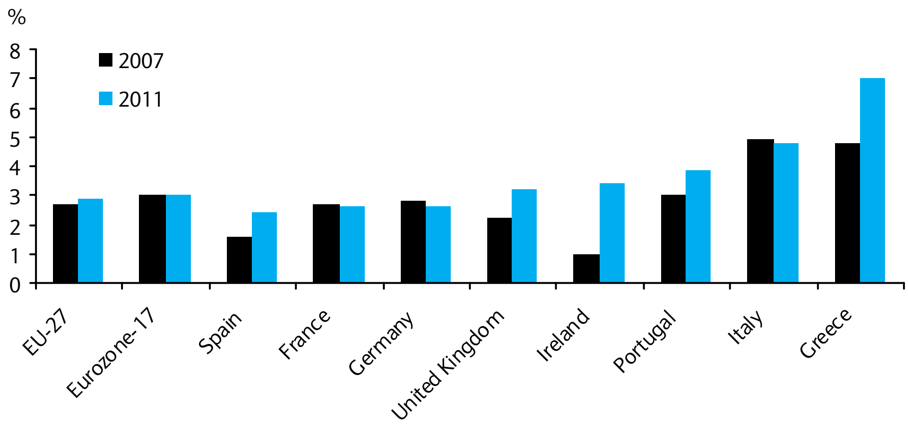
For those that are looking to get invested, many agonise over the perfect moment – constantly monitoring the markets for the dip that will be their trigger to enter. This also increases the potential for decision fatigue and, more importantly, for decision paralysis, since you are never sure whether tomorrow will provide a better buying opportunity. You may be so paralysed that you never actually get invested.

A high level of decision fatigue in the economy leads to assets being held in cash rather than being invested. The low returns on cash, created by QE, are not enough to compel the fatigued investor to put their cash to productive use. They simply want to avoid additional cognitive effort, and consequently, it is less likely that there will be an aggregate positive effect on the demand for money.

How large is my share of the debt burden?

Fiscal stimulus increases government borrowing and, at least in the short-term raises public debt burdens. For the policy to add more to total demand than just the amount of additional government spending, businesses and consumers need to look past the impact on the additional borrowing on longer-term tax burdens. At present, the level of government borrowing has been an intense focus of the Eurozone crisis and taxpayers are more acutely aware of their increasing responsibilities to service that debt than they may have been during previous economic cycles. Taxpayers are somewhat removed from the debt of their governments inasmuch as they indirectly service that debt

Figure 1: General government debt interest payments as a percentage of GDP



Source: Eurostat

through taxes. It is not easily apparent how much of those taxes are used for debt service. However, debt cannot increase rapidly without placing a greater burden on taxpayers – whether they perceive it immediately or not.

Figure 1 shows the level of debt interest payments as a percentage of GDP from 2007, before the global financial crisis, and the most recently available figures from 2011. The effect of the financial crisis on the debt service burden is clearly seen for the 'PIIGS'. Although Italy's debt service has not risen as a percentage of GDP, it is much higher than the Eurozone average and this increases the sensitivity to paying higher interest rates when it refinances – which of course increases the potential servicing burden.

The media have highlighted the growing tax burden of some European economies. This has arguably increased our collective knowledge of the taxpayer cost of servicing national debts – and how taxes may have to rise to service additional debt. This has a negative effect on confidence and economic activity through a reduction in perceived future income and wealth.

The same phenomenon can reduce the effectiveness of austerity. For austerity to be successful consumers and business need to gain confidence that long-term fiscal imbalances are being addressed effectively and that taxes will not increase without limit in the future. But if large tax increases and spending cuts cause economies to contract, as they have in much of southern Europe, debt burdens as a percentage of GDP may continue to increase. If this fosters a sense of hopelessness, it may be self-defeating.

Do you feel compensated for taking risk?

When considering any investment, we implicitly trade-off our expectations for risk and return. The uncertain economic conditions have likely increased the risk expectation and extremely low risk-free rates lowered the expectations for the level of absolute returns.

For much of the last year, markets have cycled through successive periods of relative calm and solid returns and times of extreme turmoil and large market declines. Economies have slipped back into or towards recession and equity markets have provided a bumpy ride. For many, the world feels more uncertain and risky. Additionally, the expectation of sluggish growth means that potential returns may also appear dampened.

Some will argue now is the time for long-term investors to adopt a countercyclical approach – i.e. the falling markets have increased long-term return potential for the emotionally resilient investor. At times of uncertainty, we tend to focus on our short-term comfort, which many feel is maximised by holding cash.

Despite the significant opportunity cost of holding cash – inflation adjusted, 'real' yields are currently negative across all the developed markets with the exception of Japan, where deflation has taken hold – our tendency to think about wealth in nominal rather than real terms (called money illusion) will reinforce the nervous investor's desire to protect nominal wealth. For many it feels better to protect the value of nominal wealth in current markets rather than deploying capital into investments that might lose money in the near-term, despite the fact that they are making a sure loss after inflation.

What is the correct policy response?

Policymakers continue to search for the right mix of austerity and stimulus and for the right combination of fiscal and monetary policy. No doubt finance ministers and central bank governors are well aware that they are operating in a fraught political environment. We would also counsel them to be sensitive to the likely psychological responses to what they decide to do, which could go a long way to determining which combinations of policies can be effective.

An alternative to traditional fixed income: Private senior secured loans

Seth Katz
+1 212 526 2801
seth.katz@barclays.com

Continued uncertainty and extraordinarily low interest rates have fixed income investors wondering where to turn for yield. Private senior secured loans offer an attractive investment opportunity.

A less competitive environment

Floating rate loans to non-investment grade companies have long been a core part of banking. However, traditional debt providers in Europe and the US have receded from the loan market as they wrestle with the aftermath of the financial crisis. A number of non-traditional lenders historically participated in the middle market[2] loan market alongside banks, including CLOs, specialty finance companies and hedge funds. However, like the banks, these entities substantially retreated from the market in recent years. CLO volume decreased significantly post-2007 and 2009-2011 saw less than EUR 3 billion of new CLO volume issued in Europe.[3] Many specialty finance companies have, post-crisis, either been acquired, gone bankrupt or shrunk their balance sheets. Lastly, hedge funds learned a hard lesson from their investments in middle market corporate loans in 2008-2009 as liquidity constraints posed by client redemptions forced them to liquidate loans below par. Those funds trading in more liquid and larger credits faced volatile marks to market, which, when combined with leverage, resulted in a toxic mix.

Despite the shakeout among firms issuing private loans, there continues to be demand for such financing as companies seek capital for capital expenditures, recapitalizations, the financing of acquisitions, growth capital, etc. A key demand driver for the senior loan market is the private equity industry. Estimates suggest over $400 billion of equity capital in buyout fund coffers that will ultimately require at least $500 billion of senior debt capital for transactions (assuming a roughly 45% equity contribution).

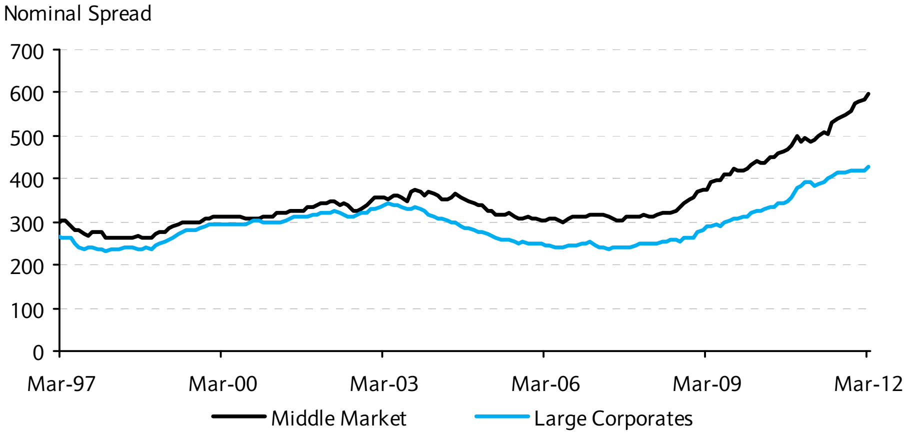
Filling the gap

Conversations with large cap buyout firms suggest a relatively healthy leverage market for large deals. The senior loan supply/demand imbalance is most pronounced in the middle market. A number of barriers to entry limit the number of active players targeting this strategy, including (i) underwriting smaller credits is often more time consuming than that for large companies, (ii) financial and legal due diligence must be extremely thorough due to the relative opacity of these companies compared to publicly listed companies, (iii) loan documentation and financial covenants are rarely uniform across credits thereby requiring high levels of specialization, and (iv) the strategy is based on fundamental analysis rather than trading-oriented technical analysis.

Investors in middle market senior secured loans typically expect an unlevered yield ranging from LIBOR plus 4.5% to LIBOR plus 6.5% with a LIBOR floor of 1.5% to 2.5%. The floor protects investors from LIBOR rates that dip below it by providing a minimum base yield in a low interest rate environment.

[2] The middle market is defined here as companies with EBITDA less than or equal to US$50 million.
[3] S&P LCD Global Leveraged Lending Report Q4 2011

Figure 1: Average Nominal Spread of Leveraged Loans



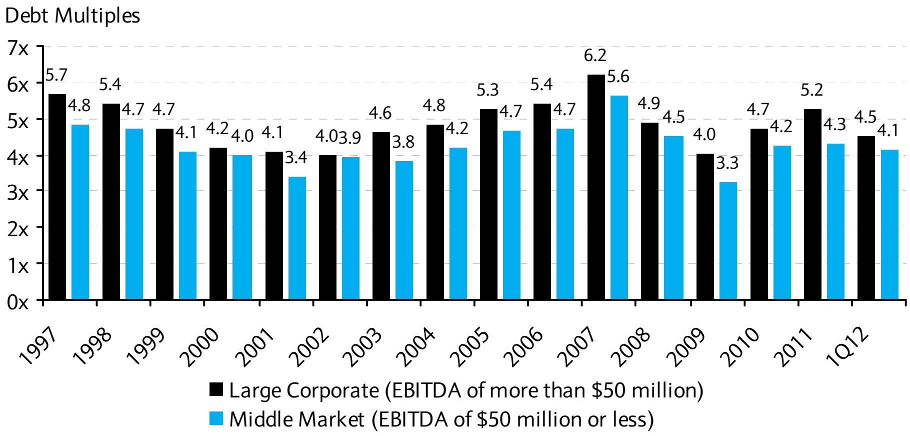
Source: S&P Capital IQ LCD and S&P/LSTA Leveraged Loan Index

Since 1997, the average premium for loan spreads of middle market loans has been about fifty-five basis points higher than the average spread of broadly syndicated loans. The current spread gap is at historically wide levels with middle market loans earning 170 basis points more than broadly syndicated loans as of March 31, 2012 (Figure 1). The tenor of the loans ranges from four to seven years but principal is often returned in fewer than four years as companies are refinanced or sold.

Risk profiles are attractive. Middle market companies acquired in a leveraged buyout have had total debt multiples consistently lower than larger peers (Figure 2). Data from Standard & Poor's show historical default rates among middle market loans that hover around 4.0% while larger loans have had rates in excess of 7.0% (Figure 3). Not only do middle market loans have lower defaults, but they also have a 500 basis point higher recovery rate over large cap loans and more dramatic spreads against bonds (Figure 4).

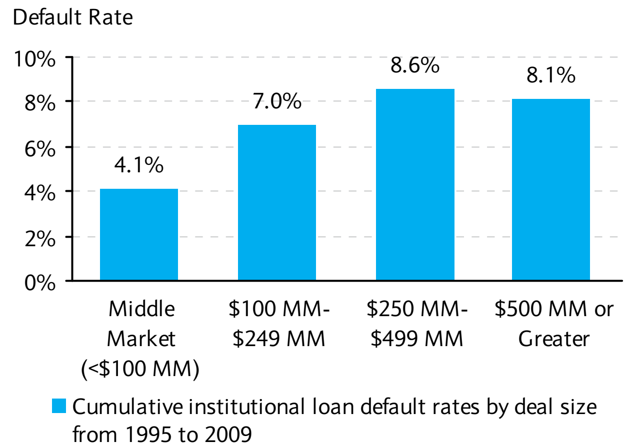
There are a number of explanations for the relatively higher recovery rates and lower default rates of middle market loans. Private middle market loans usually involve a small creditor group which allows for better communication and coordination among lenders. Additionally, creditors and target companies are better able to tailor covenant and default provisions, rather than following a standardized and inflexible approach. Senior secured loans have the first claim on a company's assets and in case of a borrower's diminished ability to service debt may invoke covenants that allow for the senior creditors to ultimately assume control of the company (Figure 5).

Figure 2: Total Debt Multiples of LBO Loans



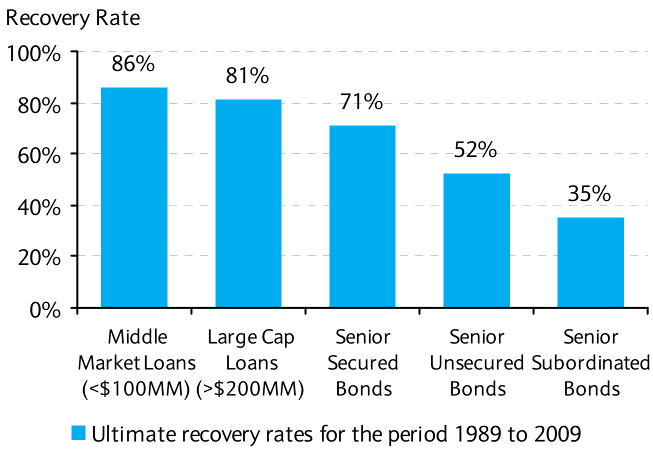
Source: Standard & Poor's

Figure 3: Default Rate by Loan Size



Source: S&P LSTA

Figure 4: Recovery Rate by Loan Class

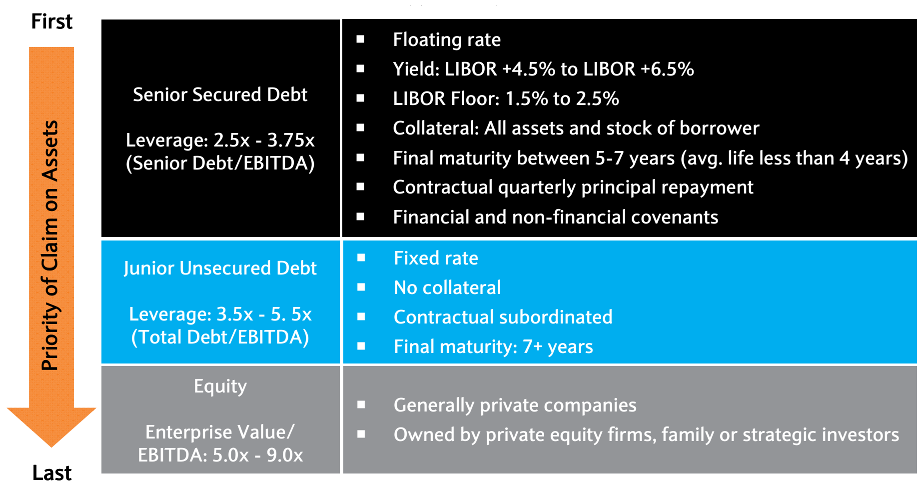


Source: S&P LSTA

The high yield comparison

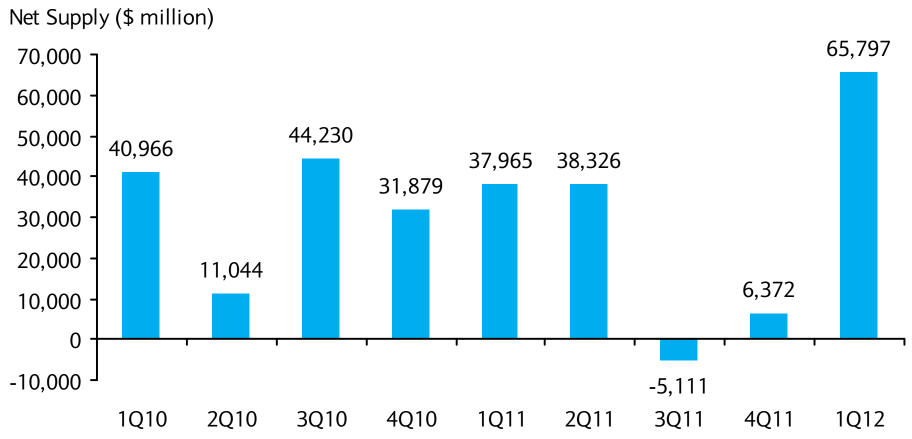
Investors likely will compare private middle market senior secured debt to high yield. The principal benefit of high yield compared to private senior loans is its liquidity. Investing in private debt requires high tolerance for a relatively illiquid investment format that is partially mollified by a regularly distributed current yield. However, whereas private debt can be seen as patient capital, high yield new issues ebb and flow. For example, both European and US high yield volumes dropped precipitously in the second half of 2011 (Figure 6). Also, the increasing size of tranches of debt required (Figure 7) can put high yield out of reach of middle market companies. High yield investors bear daily volatility in contrast to private debt which is not publicly traded. The European high yield market is particularly delicate as liquidity levels are lower than in the US. As a result, pricing may be more sensitive. Additionally, high yield typically has weaker debt covenants in place, more limited interaction with company management and many more participants in the debt syndicate. High yield's fixed rates expose investors to rising rates in greater proportion than the floating rate senior secured loans.

Figure 5: Typical Capital Structure for a Middle Market Company



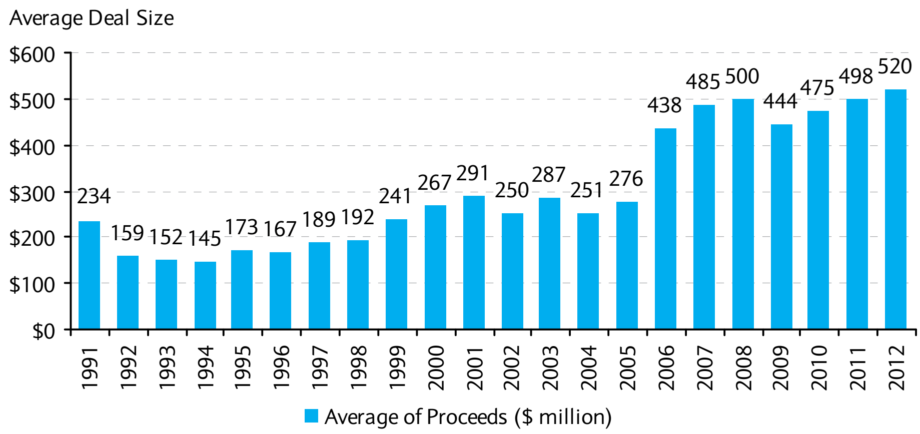
Source: Barclays Research

Figure 6: US High Yield Net Supply



Source: Barclays Research

Figure 7: Average Deal Size of High Yield Issuance



Source: Barclays Research

A worthy diversifier

Private senior secured loans offer generous yields with an attractive risk profile when compared with other debt instruments (Figure 8). The continuing refinancing/debt maturity dilemma faced by Europe and the US combined with substantial equity capital in search of new leveraged buyout transactions and a broader lack of attention paid to the middle market suggests an auspicious time to consider a private loan allocation.

Figure 8: Various Asset Class Yields

Asset Class	Index	Yield
Cash and Short Maturity Bonds	Barclays Global 1-3 Yr Treasury (Hedged)	0.8%
Government Bonds	Barclays Global 7-10 Yr Treasury (Hedged)	1.9%
Investment Grade Bonds	Barclays Global Agg Corporate	3.3%
HY and EM Bonds	Barclays Custom Global HY & EM	6.5%
Senior Secured Debt	***Estimated Market Average***	***8.0%****
Developed Equity	MSCI World Net Return	2.9%
Emerging Equity	MSCI EM	3.2%
Commodities	DJ UBS Commodity	0.0%
Real Estate	NAREIT Global RE Hedged	3.9%

*LIBOR Floor (~1.5%) plus ~6.5% as of June 27, 2012. Source: Bloomberg, Barclays Research

Additional Sources: Audax Group, Monroe Capital and Partners Group

Snapshot of allocations and asset class returns

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

As noted in the article 'Euro fatigue' above, Barclays' Tactical Allocation Committee has adjusted slightly its tactical (3-6 month) tilts in response to the more balanced tenor of euro area news – specifically, in light of the relatively constructive outcome of both the second Greek election and the latest euro summit, the need for portfolio insurance has lessened slightly. The Committee has decided to move government bonds back down to a modest underweight, and to raise Investment Grade bonds (high quality corporate credit) to neutral. Valuations also point in this direction: most bonds look expensive, but corporate bonds less so than government bonds..

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

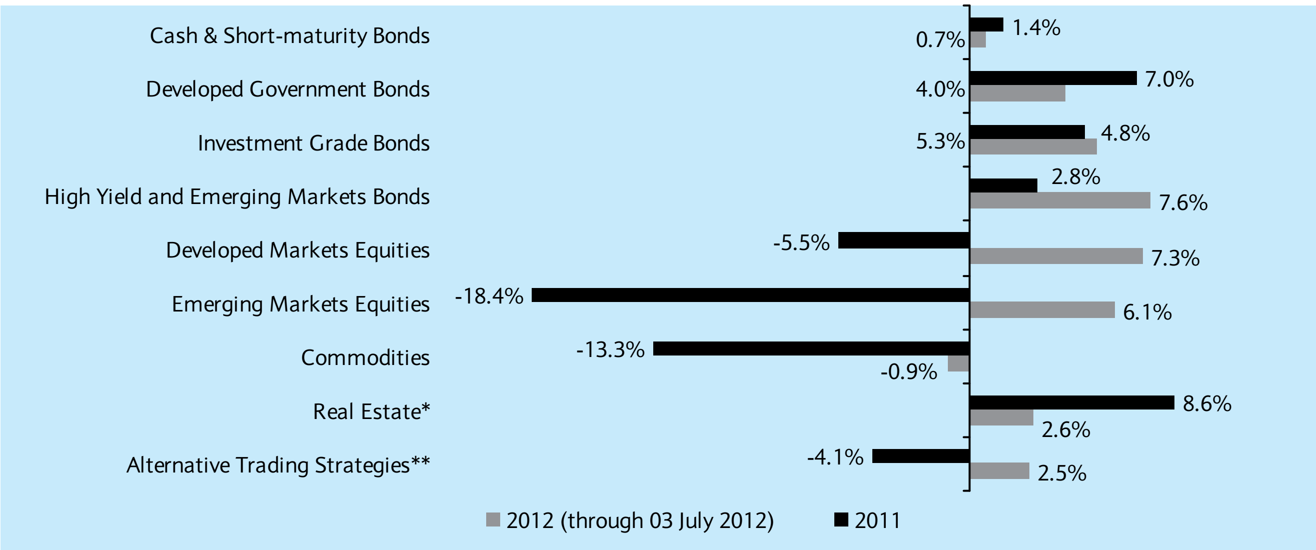
Figure 1: Current strategic (SAA) and tactical (TAA) asset allocation by risk profile

Risk Tolerance Level	Cash & Short Maturity Bonds	Developed Government Bonds	Investment Grade Bonds	High-Yield & Emerging Markets Bonds	Developed Markets Equities	Emerging Markets Equities	Commodities	Real Estate	Alternative Trading Strategies
Low									
SAA	43.0%	10.0%	3.0%	4.0%	16.0%	4.0%	2.0%	7.0%	11.0%
TAA	45.0%	8.0%	3.0%	5.0%	15.0%	4.0%	2.0%	7.0%	11.0%
TAA vs SAA	2.0%	-2.0%	0.0%	1.0%	-1.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	0.0%	*-2.0%*	*2.0%*	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Medium Low									
SAA	15.0%	13.0%	4.0%	7.0%	29.0%	7.0%	4.0%	5.0%	16.0%
TAA	19.0%	10.0%	4.0%	8.0%	27.0%	7.0%	4.0%	5.0%	16.0%
TAA vs SAA	4.0%	-3.0%	0.0%	1.0%	-2.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	0.0%	*-3.0%*	*3.0%*	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Moderate									
SAA	8.0%	9.0%	4.0%	8.0%	38.0%	10.0%	5.0%	4.0%	14.0%
TAA	12.0%	6.0%	4.0%	10.0%	35.0%	10.0%	5.0%	4.0%	14.0%
TAA vs SAA	4.0%	-3.0%	0.0%	2.0%	-3.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	0.0%	*-3.0%*	*3.0%*	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Medium High									
SAA	5.0%	6.0%	3.0%	8.0%	45.0%	13.0%	6.0%	3.0%	11.0%
TAA	8.0%	4.0%	3.0%	10.0%	42.0%	13.0%	6.0%	3.0%	11.0%
TAA vs SAA	3.0%	-2.0%	0.0%	2.0%	-3.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	0.0%	*-2.0%*	*2.0%*	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
High									
SAA	4.0%	4.0%	2.0%	6.0%	51.0%	17.0%	6.0%	2.0%	8.0%
TAA	7.0%	3.0%	2.0%	8.0%	47.0%	17.0%	6.0%	2.0%	8.0%
TAA vs SAA	3.0%	-1.0%	0.0%	2.0%	-4.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	0.0%	*-1.0%*	*1.0%*	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

* Prior TAA dated 28 May 2012.
† Diversification does not protect against loss.
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

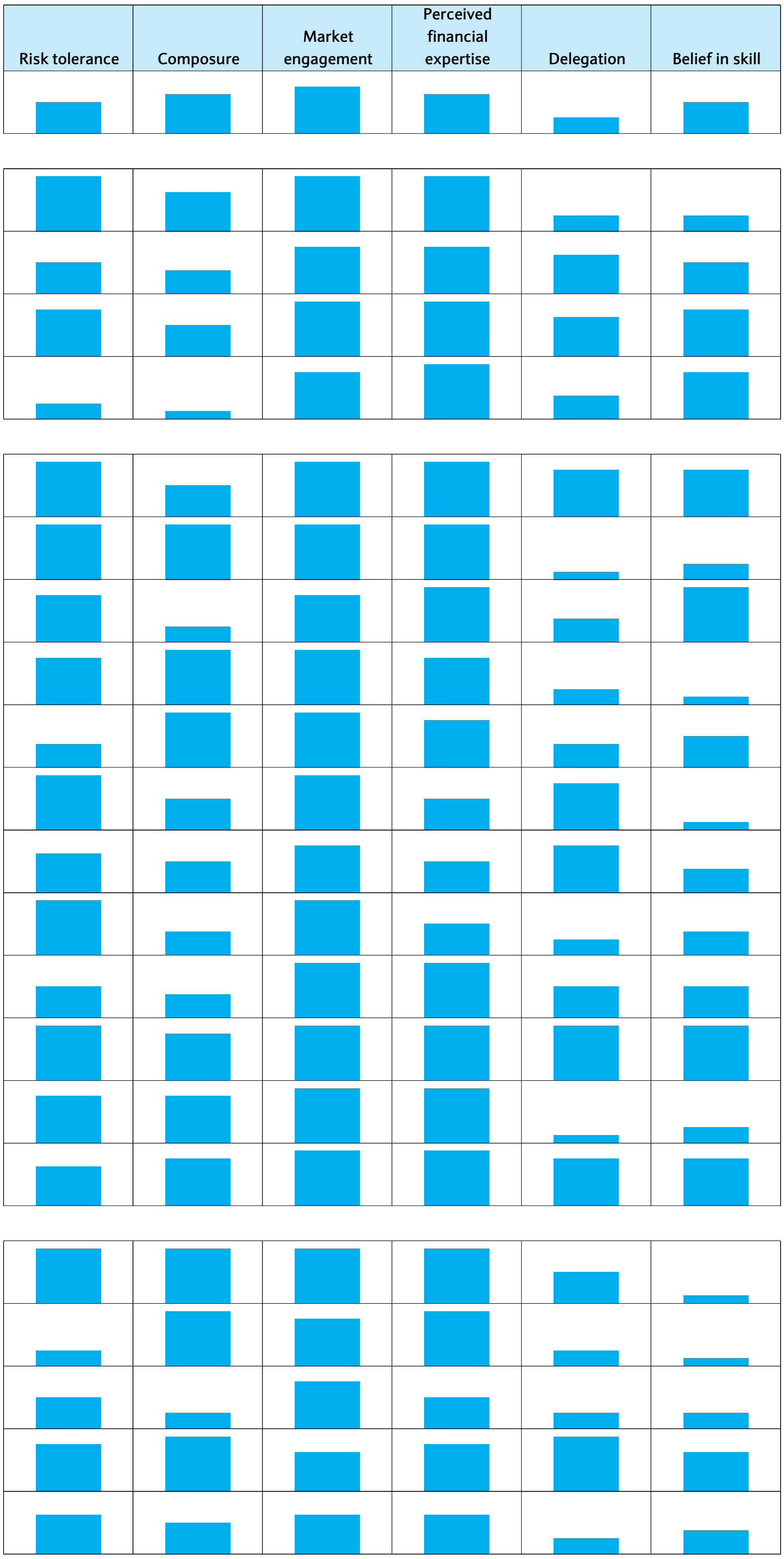
As markets have stabilised in the wake of the Greek election and the euro summit, developed equities have rallied and are once again outpacing government bonds year-to-date. Commodities continue to lag a little behind other risk assets.

Figure 2: Total returns across key global asset classes



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

Global Investment Strategy Team



AARON GURWITZ, PhD Chief Investment Officer
aaron.gurwitz@barclays.com +1 212 526 9255

US

DANIEL EGAN Head of Behavioral Finance, Americas
daniel.p.egan@barclays.com +1 212 526 0549

ELIZABETH FELL Fixed Income
elizabeth.fell@barclays.com +1 212 526 2589

HANS OLSEN Head of Americas Investment Strategy
hans.olsen@barclays.com +1 212 526 4695

KRISTEN SCARPA Macro
kristen.scarpa@barclays.com +1 212 526 4317

UK

FRANCESCO CAPPONI Macro
francesco.capponi@barclays.com +44 (0)20 3555 8401

GREG DAVIES, PhD Head of Behavioural and Quantitative Finance
greg.davies2@barclays.com +44 (0)20 3555 8395

JIM DAVIES Equity Strategy
jim.davies@barclays.com +44 (0)20 3555 8397

KEVIN GARDINER Head of EMEA Investment Strategy
kevin.gardiner@barclays.com +44 (0)20 3555 8412

RYAN GREGORY Macro
ryan.j.gregory@barclays.com +44 (0)20 3555 8403

EMILY HAISLEY, PhD Behavioural Finance
emily.haisley@barclays.com +44 (0)20 3555 8057

WILLIAM HOBBS Equity Strategy
william.hobbs@barclays.com +44 (0)20 3555 8415

TANYA JOYCE Commodities
tanya.joyce@barclays.com +44 (0)20 3555 8405

PETR KRPATA FX
petr.krpata@barclays.com +44 (0)20 3555 8398

AMIE STOW Fixed Income
amie.stow@barclays.com +44 (0)20 3134 2692

CHRISTIAN THEIS Macro
christian.theis@barclays.com +44 (0)20 3555 8409

FADI ZAHER, PhD Fixed Income
fadi.zaher@barclays.com +44 (0)20 3134 8949

SINGAPORE

PETER BROOKS, PhD Head of Behavioural Finance, Asia
peter.brooks@barclaysasia.com +65 6308 2167

KUNSHAN CAI Equity Strategy
kunshan.cai@barclaysasia.com +65 6308 2985

EDDY LOH Equity Strategy
eddy.loh@barclaysasia.com +65 6308 3178

WELLIAN WIRANTO Asia Investment Strategy
wellian.wiranto@barclaysasia.com +65 6308 2714

BENJAMIN YEO Head of Asia Investment Strategy
benjamin.yeo@barclaysasia.com +65 6308 3599

Risk Tolerance: an expression of the long-term trade-off between risk and return in your portfolio. Higher risk tolerance indicates a higher risk, higher return portfolio.
Composure: how emotionally engaged you tend to be with the investment journey.
Market Engagement: the degree to which you are inclined to avoid or engage in financial markets. It shows whether you have a mental hurdle to investing.
Perceived Financial Expertise: how informed you feel you are with current financial circumstances, and how confident you feel in your financial decision making.
Delegation: how much you believe you can benefit from delegating day-to-day portfolio management decisions to someone.
Belief in Skill: how much you believe it is worth paying for an investment professional's potential to achieve above-market returns.

www.barclays.com/wealth

Printed July 2012
UK0012