September 2012

Compass

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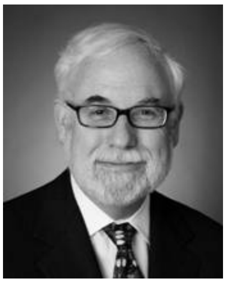

Aaron S. Gurwitz
Chief Investment Officer

Count (but don’t count on) your blessings.

Dear clients and colleagues:

> When I'm worried and I can't sleep
> I count my blessings instead of sheep,
> And I fall asleep counting my blessings.
>
> -Irving Berlin

The first two lines of these lyrics describe my feelings about investments right now. The last line is a warning.

I’m worried. The condition of the global economy remains fragile, and the sustainability of the post-2009 recovery depends, more than usual and too much for comfort, upon the good intentions and skills of politicians. The long list of worries would not cause insomnia if it made sense just to sit in cash and nod off, knowing that at least I wouldn’t be any poorer when I awakened. But risk assets are too cheap for that to make sense in my view, and if I did cut risk sharply, I’d probably lie awake worrying about potential missed opportunities.

I count nine blessings. Year-to-date returns are positive on all nine of our strategic asset classes and some have done very well indeed. After the experiences of the last few years and in the context of a growing list of serious risks, a low-volatility uptrend in stock and high-yield bond prices counts very much as a blessing. So, one cure for sleeplessness may be to keep a copy of one’s last account statement by one’s bedside.

A restful night’s sleep is a fine thing, but complacency is not. Positive returns are a blessing, to be sure, but not an entirely unambiguous one, I think. For one thing, two-thirds of the way through the year the returns on stocks and high-yield bonds are higher than we might have expected for the full year, especially in a world where the risk-free interest rate is close to 0%: after the summer’s rally, some markets may have “gotten ahead of themselves.” Further, the whole idea behind a diversified asset allocation is that some pairs of asset-class returns should be uncorrelated; they should not all be going up or down at the same time. Finally, given all the risks evident today in the world, a rebound in market volatility would not be at all surprising. So, while I’m glad that almost all investments are doing well, I can’t shake a queasy feeling that markets are not behaving normally. And that in itself is another worry.

Many of the political/economic/financial risks we continue to face have been with us for a long time. It is easy, for example, for the euro zone sovereign debt saga to become ambient background noise.

So complacency is a real risk. However, it is a risk we can control by our own actions. Count your blessings, but remain vigilant. If particular investments have appreciated so much that they’ve become too large a proportion of one’s portfolio, trim them. If your bond portfolio’s average maturity has drifted to become too short to provide protection against disappointing economic growth, do some extension swaps. If you can, in effect, lock-in gains by hedging downside risk with options, you may wish to consider doing so.

And pleasant dreams.

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Chief Investment Officer

The relief rally

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Markets have been less volatile than feared through the summer. Some very visible dangers remain in place, and a tactical setback in risk assets seems overdue. But our confidence that disaster will be avoided is a little higher, and strategically we continue to prefer stocks to bonds, and corporate to government securities.

After an inconclusive summer, the two big risks facing investors remain the business cycle and the fate of the euro. We still believe that the global economy is not about to stall, and that the euro – and its banking system – will stay largely intact. We also think that capital markets are still priced for more pessimistic outcomes.

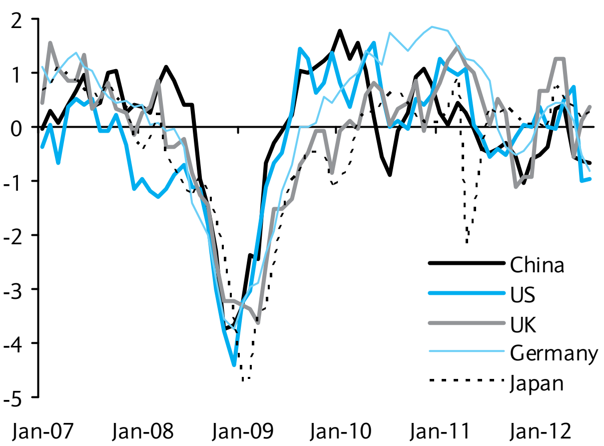
Global economy facing headwinds…

Key business surveys are pointing to lacklustre growth at best in the developed bloc. The unfolding euro area recession, though still moderate in scale, is hindering peripheral countries' attempts to control budgets and reassure creditors. Greece is still finely balanced on the brink of euro secession, and (much more importantly – see comments below) the possibility of Spain formally requesting a bailout is growing.

The UK economy is likely growing as we write, but recent data have been so erratic – influenced by bank holidays, poor weather and a large sporting event in the East End – that few investors will be reassured by that. In the US, where growth may be firming a little more convincingly, the approaching *'fiscal cliff' (see page 9)* is likely to damp corporate spending and overshadow capital markets towards year-end.

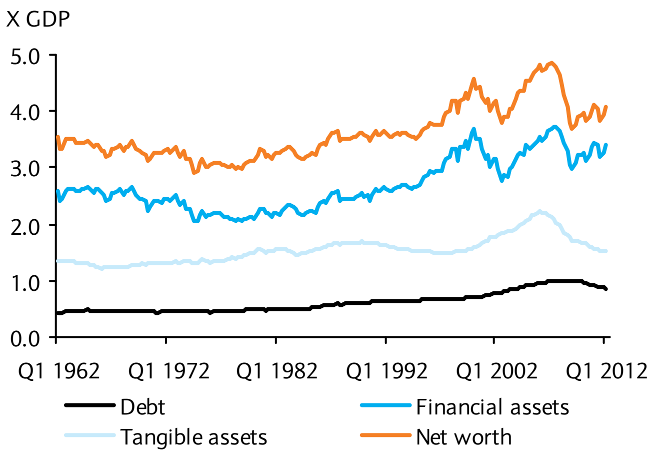
The emerging world has seen its exports fall as domestic spending in Europe and the US has faltered. South Korea, Taiwan, Singapore and Brazil amongst others have all slowed sharply, and China's growth numbers have dipped below (still-high) expectations. Meanwhile, the weather-related rebound in agricultural commodity prices – roughly 10% since end-May – is squeezing real incomes disproportionately in the emerging world, where food is much more important to family budgets.

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



Source: Barclays Research, Datastream, Bloomberg

Figure 2: US households' aggregate net worth still firmly positive



Source: Barclays Research, Federal Reserve

…but moving forwards nonetheless

We still think, however, that the global economy will not stall. The impact of fiscal austerity itself in Continental Europe and the UK may be peaking as the biggest cuts in structural deficits move into the past. Monetary conditions – real interest rates – are supportive. It is likely confidence, not bank finance, that is the key missing ingredient.

It is difficult to identify a catalyst for that confidence – one may not be needed, of course – but American consumers still play a big global role. If they continue to spend more, the largest economy will likely continue to grow, and European and Asian exports will get some support. We believe they are in better financial health than is generally realised, and that there can be 'life after debt' for the highly-leveraged US economy, as we noted more carefully in the October 2011 *Compass*.

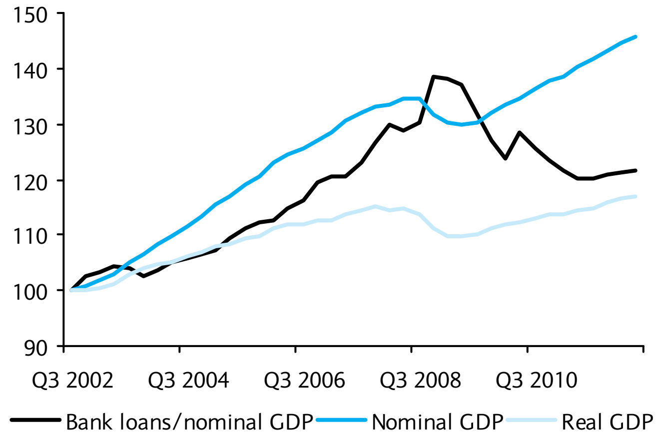
Allowing for the fact that households own most government and corporate debt, and for the existence of tangible assets (most notably, houses), US households' aggregate net worth has not altered materially in the last half century. It was volatile in the 'noughties, but at roughly 4 times GDP. This is of course not to suggest that debt doesn't matter, simply that its aggregate importance can be overstated. Meanwhile, low interest rates have pulled the cost of servicing US household debt down to the lowest level since 1994.

As a result, we haven't seen the need for the wholesale deleveraging urged by many commentators. Outside the financial sector itself, the deleveraging to date has indeed been modest, and has not prevented the US economy from growing again, albeit slowly. US bank lending has now begun to revive – mostly to the corporate sector, but if the housing market continues to find its feet consumer loan demand will follow.

A positive supporting role is also being played by US business investment, which has risen at an average annualised pace of 8% since end-2009. US Inc is profitable and has cash to spare on its balance sheet, and in contrast to the last recovery (2003) does not have to work off an overhang of new capacity. The threat posed by the 'fiscal cliff' could prove brief if the squabbling politicians cobble-together another last-minute deal (again, see essay on *page 9*). We do not expect strong US growth – but markets expect worse.

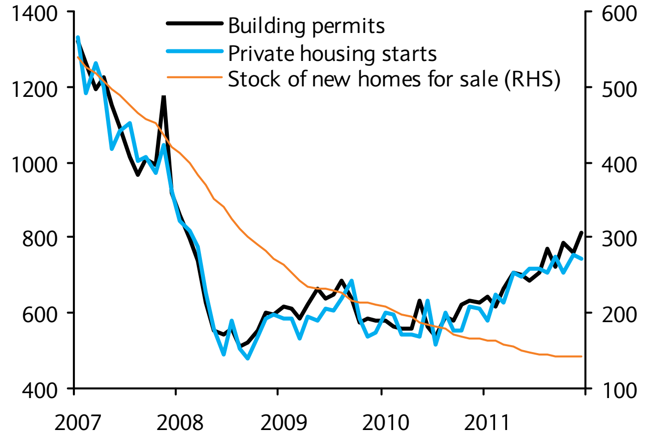
If US private spending does falter, the Federal Reserve will likely introduce a third wave of Quantitative Easing, and buy more government bonds and mortgage backed securities (MBS) to pull long-term interest rates still lower. It might boost markets, but would not

Figure 3: US deleveraging has been modest, and hasn't stopped growth (indices, Q3 2002 =100)



Source: Barclays Research, Datastream

Figure 4: US housing market finding its feet (000)



Source: Barclays Research, Datastream

galvanise the economy. Our view of US growth assumes that QE3 is not necessary, and we'd be less positive on risk assets if it were.

European economies are weaker. We expect more aggressive monetary actions, both conventional (lower interest rates) and unconventional, at the ECB and Bank of England. A weaker euro may act as a safety valve for the euro periphery at least (though it will not help the UK). We also see China's authorities loosening policy further, and stabilising growth. As the Chinese economy rebalances around domestic consumption, structural growth will slow – but moderately, from perhaps 9-10% to 7-8%.

Overall, then, we still see the global economy avoiding disaster, and with some room to spare. Our economists estimate currently that the slowest quarter for global growth in 2012 will turn out to have been the second quarter: growth seems likely to have accelerated modestly in Q3.

We don't think we're wearing rose-tinted spectacles in making this call. Amidst current gloom it is easy to forget two points. First, growth is the norm, not the exception, and it is usually driven not by governments or balance sheets but by ongoing productivity gains – which in turn are driven by experience (learning by doing) and technological and organisational innovation. Workers and businesses slowly get better at what they do.

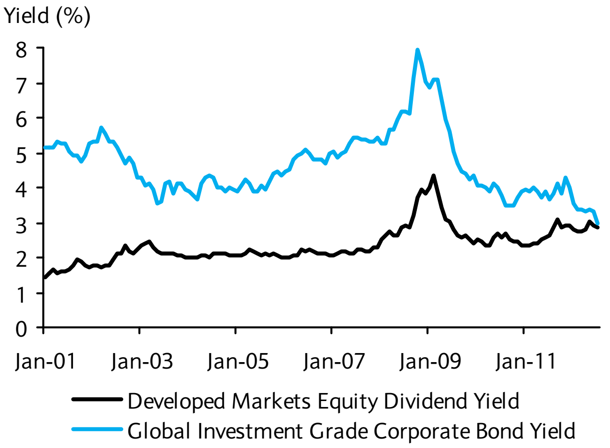
Second, all business and investment cycles are shaped by sentiment. Currently, fear is dominant, but at some stage greed or self-interest will reassert itself. Consumers with cash or credit may decide that US house prices look attractive. CEOs may realise that the cash on their balance sheets would be more profitably used in expanding their business. CFOs and private equity groups may realise that many corporate bonds yield less than the equity backed by the same assets (the *average* developed market stock yields almost as much as the average investment grade bond currently – Figure 5).

Euro crisis: two steps forward…

There has been further tentative progress towards the long-term integration and economic reform needed to settle the euro's existential nerves – just enough, in our view, to allow the ECB to continue to play its short-term role of financial backstop.

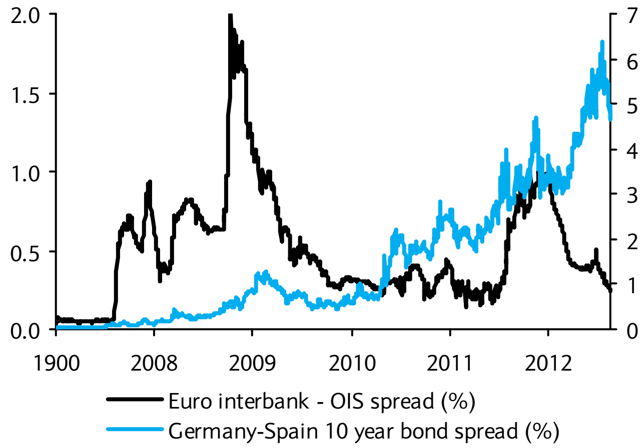
In July's *Compass* we argued that the end-June EU summit showed European politicians beginning to 'get it' where the banking system is concerned. Subsequently, a further step forward has been taken with Mr Draghi's statement that *"within our mandate we*

Figure 5: Developed equity dividends almost match investment grade credit yields



Source: Barclays Research, MSCI

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



Source: Barclays Research, Bloomberg

will do whatever it takes" to keep the euro together: this is the sort of commitment to potentially large and innovative action that we thought could be made at some stage. The phrase "within our mandate" need not be a big constraint: a euro area banking crisis would be deflationary, and clearly within the ECB's monetary purview.

The offer is conditional: the ECB will act only when a member government (in practice, probably Spain) formally requests assistance from the rescue facilities, the EFSF or its successor the ESM. Whether this occurs depends on complex psychology – if markets believe the ECB's offer, they may not push governments to apply. Potentially unlimited ECB support for peripheral bonds, even if indirect and at the short end of the yield curve, could buy a lot more time – allowing that integration and liberalisation to continue. As we write there are reports that the ECB is considering targeting particular yield levels – which might deliver a *de facto* implicit degree of mutuality if borrowing costs converge. Meanwhile, Figure 7 reminds us that the periphery is at least starting on the long road to labour market flexibility in particular (Ireland got there many years back).

Figure 7: Selected labour market reforms in the euro area periphery

Country	Proposed reforms	IMF's assessment
Spain	■ Altered collective bargaining system to give firms more flexibility to adapt to economic conditions ■ A 7% cut in central government workers' salaries (this follows a 5% cut and freeze of wages in 2010) ■ Maximum compensation for dismissals reduced to 33 days from 45 days per year worked	Solid progress in reducing labour market rigidity, but further action to reduce unemployment is urgently needed
Portugal	■ Public sector pay freeze to cut wage bill by 1.6% of GDP ■ Reduce public sector employees by roughly 10,000 ■ Cut to severance payments to 20 days per year worked from 30, with maximum payment of 12 months	Significant progress in labour reform implementation. End-2012 fiscal target remains within reach
Italy	■ Easier dismissal of workers for economic reasons ■ Compensation for unfair dismissal reduced to 12 months' salary with automatic reinstatement ■ Requirement to greatly increase the number of apprenticeship contracts, tax benefits for hiring women and youths	Good start, but further improvements in labour market flexibility and business environment are urgently needed
Greece	■ Reduce the public sector wage bill by 0.5% of GDP and the workforce by 150k (15k in 2012) ■ Cut minimum wage by 22% (32% for under 25s) ■ Introduction of short term contracts aimed at helping the youth gain work experience	Reform implementation is far off course. The Troika has undertaken a new review due to complete by September 2012

Source: Barclays Research, IMF

…one step back

Stumbling blocks remain. We think it is in Greece and its partners' interests for it to remain within the euro, but as we noted in July's *Compass*, the outcome is too close to call (it may become clearer as the troika updates its assessment in the weeks ahead). We think the wider system could withstand Greece's possible exit – residual private sector exposure to Greece is likely small – but at the cost of renewed contagion fears.

More importantly, the Spanish government has to decide whether to swallow its pride and trigger that ECB intervention. And many German officials and politicians are unhappy at the potentially inflationary consequences of widespread money creation (as they see it), and are very capable of unsettling markets with their comments. The German Constitutional Court will pronounce on September 12th on the ESM itself.

Overall, then, renewed market nerves are quite likely. But as we write the 10-year Spanish bond yield is down more than 100bp from its July high, the euro itself is again trading more strongly than we'd expected, and Ireland continues to fade from the market's radar screen (as we'd thought it could). A quick definitive solution to the crisis is not likely – or possible – but we continue to see the politicians and ECB 'muddling through' it.

Investment conclusions: tactics and strategy

The 'beta bounce' – the rebound in risk assets – that we noted in July's issue, has continued through the summer. It has not been without foundation: the euro debate has moved forward fractionally, corporate results have surprised positively (and are arguably better than they look, because the biggest shortfall was partly attributable to lower oil prices), and in recent weeks US consumer resilience has been a little more visible.

But with developed equities up by 11% since June's low, there are profits potentially to be taken – and plenty of possible triggers for that, as noted above. The failure of core government bonds (including US Treasuries, UK gilts, bunds and OATs) to sell off more markedly as stocks have rallied testifies to a continuing intense risk aversion. Barclays' Tactical Allocation Committee has not altered its tactical (3-6 month) caution, recommending that investors hold a little more in cash (our preferred 'safe haven' asset) and high yield bonds than usual, and a little less in developed stocks and government bonds *(page 18)*.

Taking a medium and longer-term view, however, we continue to believe that the eventual avoidance of economic and euro area disaster will deliver respectable corporate profitability – return on book value, say, trending in the low double digits – and also a modest degree of inflation risk. If so, developed stocks in particular look moderately inexpensive (even after the rally), while government bonds remain very expensive. The relative valuation of the two assets of course looks more extreme still, and our strongest conviction remains that on a multi-year view, equities will likely deliver better risk-adjusted returns than bonds – a belief baked into our Strategic Asset Allocation. We continue tactically to favour both the US and euro area stocks ahead of those in Japan, the UK and the rest of the developed bloc, simply because we think that is where expectations have become most overly pessimistic.

On the multi-year view, stocks will also likely deliver better risk-adjusted returns than corporate bonds (whether investment grade or high yield), not least because corporate bonds do face potential interest rate risk at some stage. However, spreads are likely wide enough, and the economic outlook benign enough, to offer some support when interest rates and government bond yields do start to rise materially (which currently feels unlikely this side of 2014). Hence our strategic preference for corporate securities generally ahead of government bonds.

Meanwhile, despite the ongoing short-term challenges, 2012 has so far provided a useful reminder of the benefits of taking a balanced approach to investing (financial personality and circumstance permitting, of course). As our CIO notes on page 2, while all asset classes have delivered positive returns in 2012 to date, some have fared markedly better than others. For an investor with moderate risk appetite – our risk profile 3 – we estimate that the weighted basket of nine asset classes that constitutes Barclays' Strategic Asset Allocation has delivered a total return of around 7% in dollar terms, with monthly volatility of 10%. An investor shunning risk entirely and sheltering in cash and short term bonds would have received perhaps 1%, while an investor who'd bet the ranch on developed equities would have received 10%, but at the cost of a roller-coaster ride during the second quarter at least.

Main economic assumptions

The link between economic and investment performance is an important one, but also a rather imprecise one. Many other things affect portfolio performance, including valuation and investor risk appetite. Meanwhile, the decimal points in the table below should not be viewed as indicating any greater precision than the general comments in the text above: the general profiles of growth and inflation are more important than their absolute levels.

Our 'muddle through' scenario is reflected in global growth and inflation rates that seem unlikely to us to dip below 3% in 2012, and may firm up a little in 2013. And the possibility of the US' growth rate slowing in 2013 while that in the euro area accelerates could eventually turn out to be more important for the relative performance of the euro area and US stock markets than the probability that US growth will remain faster than that in the euro area.

Figure 8: Real GDP and Consumer Prices (% y-o-y)

	Real GDP			Consumer Prices		
	2011	**2012E**	**2013F**	**2011**	**2012E**	**2013F**
Global	3.8	**3.3**	**3.8**	3.9	**3.0**	**3.2**
Developed	1.3	**1.3**	**1.5**	2.6	**1.9**	**2.0**
Emerging	6.5	**5.3**	**6.1**	6.4	**4.9**	**5.2**
US	1.8	**2.3**	**2.0**	3.2	**2.1**	**2.3**
Euro area	1.5	**-0.4**	**0.5**	2.7	**2.6**	**2.3**
Japan	-0.8	**2.7**	**1.4**	-0.2	**-0.1**	**0.2**
United Kingdom	0.8	**-0.4**	**1.6**	4.5	**2.8**	**2.7**
China	9.2	**7.9**	**8.4**	5.4	**2.9**	**4.0**
Brazil	2.7	**1.7**	**4.5**	6.6	**5.2**	**5.7**
India	7.5	**5.6**	**7.1**	9.5	**7.4**	**6.3**
Russia	4.3	**4.3**	**4.0**	8.6	**4.6**	**5.7**

Source: Barclays Research, *Global Economics Weekly*, 24 Aug 2012
Note: Numbers in bold indicate forecasts; non-bold numbers are actuals.

Figure 9: Central Bank Policy Rates (%)

	Central Bank Rates				
	Current	**3Q 12**	**4Q 12**	**1Q 13**	**2Q 13**
Fed funds rate	0-0.25	**0-0.25**	**0-0.25**	**0-0.25**	**0-0.25**
ECB main refinancing rate	0.75	**0.50**	**0.50**	**0.50**	**0.50**
BoJ overnight rate	0.10	**0-0.10**	**0-0.10**	**0-0.10**	**0-0.10**
BOE bank rate	0.50	**0.50**	**0.25**	**0.25**	**0.25**
China: Working capital rate	6.00	**5.75**	**5.75**	**5.75**	**5.75**
Brazil: SELIC rate	8.00	**7.50**	**7.00**	**7.00**	**7.00**
India: Repo rate	8.00	**7.75**	**7.50**	**7.00**	**7.00**
Russia: Overnight repo rate	5.25	**5.25**	**5.25**	**5.25**	**5.25**

Source: Barclays Research, *Global Economics Weekly*, 24 Aug 2012
Note: Numbers in bold indicate forecasts; non-bold numbers are actuals. Rates as of 24 August 2012.

Bungee jumping from a fiscal cliff

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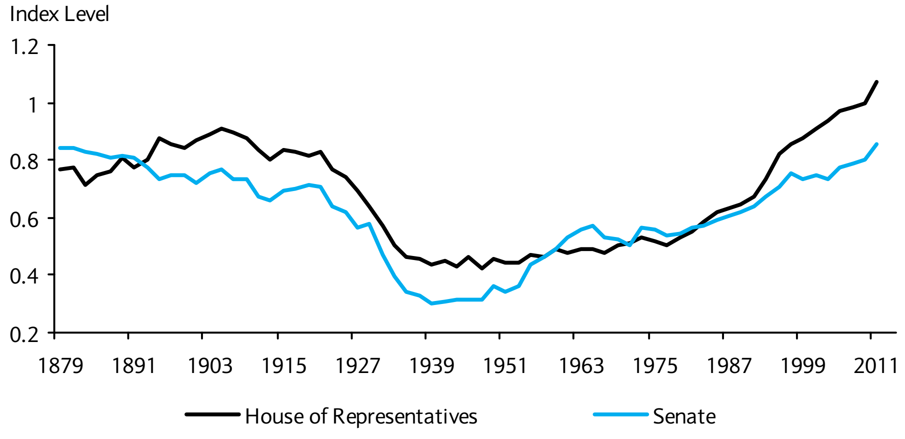
- Extreme partisan conflict in the US Congress threatens the global economic recovery and raises investment risks.
- Unless Congress acts before January 1, 2013, taxes will rise substantially and federal government spending will be cut sharply on that date. Non-partisan analysts believe that this fiscal contraction, if not mitigated, could lead to a US recession next year.
- It is unlikely that Congress will do anything before the election in early November. Action between then and year-end is possible, but is looking less and less likely.
- The more likely scenario, we believe, is that Congress and the (Obama or Romney) administration will agree on a course of action in the first quarter, and the effects of that remediation will be made retroactive to January 1.
- Until that resolution occurs, we expect political histrionics on the issues and much higher financial market volatility, particularly after the election.

By many measures, the level of disagreement between the two US political parties is at a record high (Figure 1). Such extreme partisanship could have serious adverse effects on the US and global economies and consequently on financial markets in the near future. Tax cuts enacted during the G. W. Bush administration expire on the first of January, at the very same time that government spending faces sharp automatic reductions.[1] In short, a major fiscal tightening looms on the horizon for the US—that is, unless both Houses of Congress and the president can cooperate sufficiently to enact countervailing legislation.[2]

Figure 1: Index of Polarization in the U.S. Congress



Source: *http://voteview.com/political_polarization.asp*

Just how major would the fiscal tightening be? About half a trillion dollars or 25% of the annual US government budget. According to (non-partisan) US Congressional Budget Office estimates, the federal government deficit for calendar 2013 will be approximately

[1] The automatic reductions in spending are to comply with deficit-limitation constraints enacted in 2012 as part of the debt ceiling negotiation.
[2] To be enacted into law in the US legislation must be approved by both houses of Congress, the 435-member House of Representatives and the 100-member Senate, and be signed by the President. The House of Representatives acts by majority vote, but, as a practical matter in most cases, 40 senators can block approval of legislation.

5% of US GDP smaller, other things equal, with the automatic tax increases and spending cuts than it would be without them. While it is clear to almost everyone that US budget deficits must be reduced over time, immediate tax increases and spending cuts of this size could abort the economic recovery. Indeed, the Congressional Budget Office estimates that a quick deficit reduction of the magnitude projected would lead to a 1.3% decline in real US GDP over the first half of 2013. Needless to say, a new US recession in the context of the continuing European sovereign debt crisis and the threat of higher food prices could lead to precipitously large declines in equity and other risk asset prices.

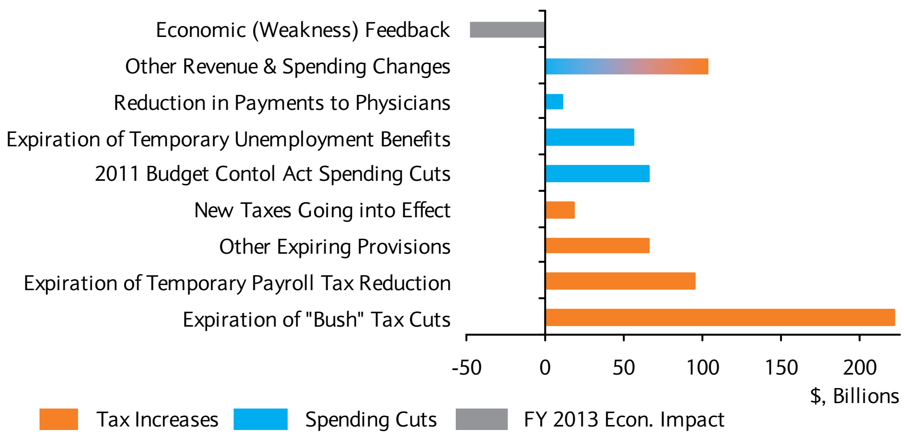
That the US economy might fall off of the upcoming “fiscal cliff” has featured on our list of worries all year. But since we recognized that any action to avert the problem would be politically impracticable before the November election, we viewed our concern as a “fourth quarter issue.” Now, with the year’s last quarter almost upon us, it seems prudent to consider how a tumble off the fiscal cliff might actually play out.

How the US got to the brink

As Figure 2 indicates, the scheduled expiration of the Bush-era tax cuts enacted in 2001 and 2003 would have the largest impact on the 2013 deficit. US Senate procedures make it easy for individual Senators to block tax and spending legislation that would raise projected fiscal deficits beyond 10 years in the future. Since the Bush tax cuts would have done just that, the legislation included “sunset “provisions: Tax rates would automatically revert to pre-2001 levels on January 1, 2011. With the US economy still very weak at the end of 2010, Congress and the Obama administration agreed to a two-year extension of the tax cuts. (The president would have preferred to allow top-bracket tax rates to revert to the higher pre-2001 levels, but Republicans prevailed and post-2001 tax rates remained in place for all brackets.) That two-year extension expires at midnight on December 31. The president has indicated that he will not approve further postponement of “sunset” for taxpayers earning more than $250,000 a year. The Republicans, who control the House of Representatives, have indicated that they will only enact legislation that benefits all taxpayers, regardless of earning level. An impasse.

Spending cuts account for about 20% of the deficit reduction required by current law. Most of these cuts were enacted in 2011 as part of a last-minute compromise to raise the US debt ceiling. Failing to raise the statutory cap on total federal government borrowing would have forced the United States Treasury to default on its full faith and credit obligations, probably leading to an unimaginably severe global financial crisis. But congressional Republicans refused to approve a debt ceiling increase unless it was

Figure 2: Impact on the FY ’13 Budget Deficit



Source: Congressional Budget Office

accompanied by a firm commitment to reduce future borrowing. The two parties could not agree on whether the deficit reduction should come from a combination of spending cuts and tax increases (the Democrats) or solely from spending cuts (the Republicans). The two parties were finally able to agree on a set of large, automatic spending reductions to domestic and military programs, effective January 1, 2013. The idea was that, because the Democrats would want to preserve the domestic spending and the Republicans would want to protect the defense budget, the two parties would be forced to agree on a less draconian way to reduce future fiscal deficits. But as it turns out, the two parties are as far apart on the issue of how to achieve fiscal balance as they were last year, when agreement proved impossible. Another impasse.

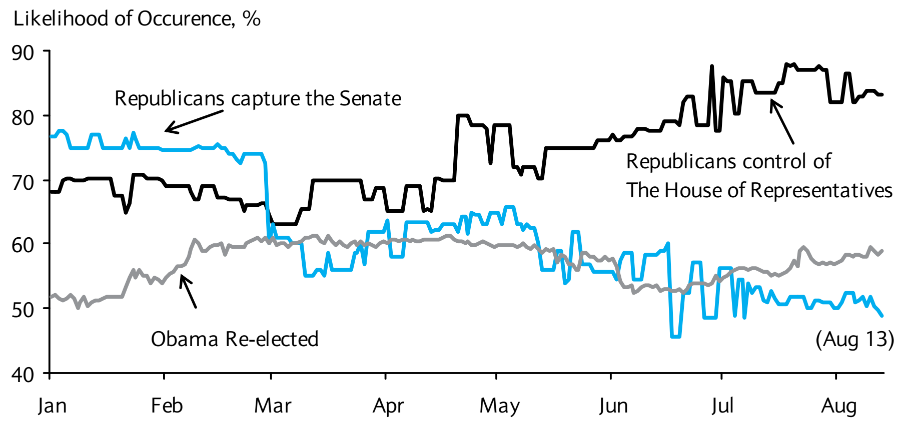
Finally, the increase in the debt ceiling agreed to last year was only enough to carry the government through the end of this year or so. While it isn't clear exactly when the Treasury will run out of borrowing capacity, it is clear that later this year or early next the US government will again be faced with the prospect of default absent another vote by both houses of Congress. Likely a third impasse.

Will the US fall off the cliff?

Whether Congress and the Obama administration are able to reach an agreement on taxes and spending before year-end will depend, to some extent, on the results of the general election. If US voters send a clear message that they want their representatives to eschew ideological conflict and reach a compromise, then it could be relatively easy to extend some, though not all, of the Bush-era tax cuts, and agree to certain longer-term spending reductions in lieu of the more damaging immediate cuts enacted in 2011. How might voters convey such a message? If, for example, a large proportion of the most ideological – "Tea Party" – Republican congressmen elected to their first terms in 2010 lose their bids for re-election, the survivors might return to Washington more ready to compromise and reach agreement.

It's possible to avoid falling off the fiscal cliff, but doing so before year end is unlikely. What is more probable is that the election will deliver another "grid-locked" political configuration. As of mid-August, the polling data and the online "prediction markets" were indicating that the Republicans were very likely to retain control of the House of Representatives, President Obama would probably be re-elected, and that neither party would control the 60 Senate seats required to enact controversial legislation (Figure 3). So we're likely to remain at an impasse.

Figure 3: On-line Betting Election Results, 2012



Source: Intrade.com

What happens if the US does fall off the fiscal cliff?

The immediate economic impact of a tumble off the cliff would not be devastating. Early January paychecks would be a bit smaller than they would have been otherwise as more would be withheld for income and payroll taxes. Some number of furloughed federal government employees might reduce their spending. But the impact on aggregate demand, and consequent macroeconomic drag, might be small if taxpayers and government employees reduced their savings to make up for the shortfall in income. Would they do so? They might, if they anticipate that the reductions to their cash flow were only temporary because Congress and the administration were likely to agree quickly to reduce tax rates and restore some of the curtailed spending. The tax cuts could be made retroactive to January 1. This scenario could easily unfold, especially if the broad-based tax increases and government service cuts proved to be extremely unpopular – which would be likely.

So falling off a fiscal cliff will not necessarily be followed by a crash landing. The economy and the markets will remain tethered to the top of the cliff by the possibility of reasonably prompt legislative action early in 2013. But this kind of bungee jumping will hardly be a relaxing leisure activity. There will be sharp ups and downs in the process of negotiations, with extreme positions staked out, threats issued, "deadlines" missed and so on. And until a deal is sealed, investors will continue to worry that the cord tethering the economy and markets might snap (i.e., compromise might turn out to be impossible), with potentially devastating consequences for the global recovery and risk asset values.

Conclusion

So we do expect that the US will fall off the fiscal cliff, because the requisite action before yearend, while possible, looks unlikely. But we don't expect the impact to be devastating because we expect remedial legislation to be enacted early in 2013. At the end of the day the most likely effect on financial markets will be to generate higher volatility starting after Election Day and continuing until Congress and the Administration reach an agreement.

At present, market volatility, as measured by the VIX index and in option prices, remains very low by post-2008 standards. Investors who won't find pleasure in fiscal bungee jumping and who are inclined to use options or structured notes as investment tools should consider looking for ways to establish positions that could dampen the "thrills and chills" likely around the turn of the year.

Asian infrastructure

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Conditions are in place for Asian countries to embark on the next wave of infrastructure growth, regardless of their level of development. To take advantage of the potential long term gains, investors can build exposure to companies that are beneficiaries of this growth.

Bright lights

Given the lacklustre growth outlook in Europe and the US, the trajectory of global growth is likely to be bolstered by the emerging Asian economies. However, they too face headwinds; one of the most prominent is domestic infrastructure. Growth is currently either export or import driven but given the weakness elsewhere (especially in Europe) focus is shifting to the domestic market where infrastructure projects are essential to expand geographic influence and capture the booming Asian middle class.

This is most visible in China, but Indonesia, South Korea and Malaysia are all in the "ballooning stage" of infrastructure growth where demand outstrips supply. China recognised this early and since 1994 has invested heavily in infrastructure spending with a compound annual growth rate in excess of 19%. However it still trails other economies in terms of stock and quality, and so in their current 5 year plan, the government committed to providing $3.14tr to infrastructure spending during 2011-2015.

Its next development phase should see an emphasis on improving inter-city linkages. Only last month, China's Ministry of Railways announced it will spend $74 million on railroads and bridges this year, exceeding its investment last year. Earlier, Changsha (the capital of the Hunan province) announced plans for several large scale infrastructure and urban development projects amounting to $130 million. Other local authorities may follow suit, particularly since provincial leadership transitions have largely taken place and new governors are beginning to prepare for their own five-year plans. The timing of these announcements reflects China's willingness to use investment spending to support near-term growth.

Indonesia is also midway through an ambitious four year development plan worth $1.6bn after it underinvested in infrastructure following the Asian financial crisis. Recent developments in Indonesia have been encouraging: land acquisition laws have been enacted, and several infrastructure related organizations have been established. However, success will largely depend on the quality of the execution.

Malaysia has a similar story to Indonesia, but being further along its development cycle has made more noteworthy progress. Investments are expected to be a key growth driver in the medium term, dominated by the oil and gas industry and major urban development projects such as Iskandar Malaysia. Opposite Singapore, Iskander Malaysia is modelled after China's Pearl Delta economic zone and has attracted over $27 billion of cumulative investments as at December 2011. The first stage of infrastructure is already in place and several projects comprising highways, hotels and universities are scheduled to be completed later this year.

Give way

Improved infrastructure can benefit businesses directly and indirectly. Direct beneficiaries include companies that provide infrastructure or related services considered as basic necessities for homes and integral to fostering economic growth. Power grids, water treatment plants and gas pipelines are classic examples of such infrastructure.

Energy consumption in Asia has already grown strongly and is likely to continue to do so. Due to the supply and demand gap, traditional sources of energy may prove to be insufficient. This should drive demand for alternatives such as gas, wind, and even nuclear power and also benefit transportation assets like railways, toll roads, ports and airports.

Large scale investment spending can have significant multiplier effects, reaching sectors other than their intended primary recipients. These secondary beneficiaries are often important supporting pillars, like the financial firms that provide the funding for capital intensive projects. Companies operating in the materials, industrials and telecommunications sectors are also indirect beneficiaries. For example, the proliferation of social media and the constant need for instantaneous online connectivity is a major trend that is likely to fuel demand for advanced telecommunications infrastructure.

For EMEA-based and risk tolerant investors, we currently advise taking advantage of this theme through credit rather than equity. Due to the fast-growing nature of some of these companies, the equity prices are likely to be particularly volatile and influenced by the market and regulatory environment. However, as infrastructure companies are usually able to generate steady cash flow to meet the defined coupon and principle payment schedule, the bond market has been an important funding platform for infrastructure projects to date with issues being well-received by investors. We advise holding a basket of bonds to avoid concentrating risk: a USD-denominated basket can be constructed to offer an average yield of around 6% (Figure 1).

Figure 1: Asia Infrastructure Bond Portfolio

Issuer Name	Trading Currency	Maturity Date	Coupon Rate (%)	Mid Yield (%)	Moody's/ S&P Rating
Korea Hydro & Nuclear Power	USD	13/07/2021	4.75	3.05	A1/A
Cikarang Listrindo	USD	21/02/2019	6.95	5.87	Ba2/BB-
West China Cement	USD	25/01/2016	7.5	13.10	Ba3/BB-
China Shanshui Cement	USD	27/04/2017	10.5	9.41	NR/ BB-
China Oriental Group	USD	18/08/2015	8	10.71	Ba2/NR
China Resources Gas	USD	05/04/2022	4.5	3.65	Baa1/NR
Beijing Enterprises	USD	12/05/2021	5	3.72	Baa1/A-
KT Corporation	USD	03/05/2016	5.875	2.02	A3/A
Telekom Malaysia	USD	01/08/2025	7.875	3.55	A3/A-
Average			**6.77**	**6.12**	**Baa2/BBB**

Source: Barclays, Bloomberg (data as of 28.08.12)

The case for high yield bonds

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We remain tactically positive on high yield credit, as it continues to offer an attractive total return in a low-interest-rate environment. This essay focuses on the US market: this is the bulk of the global benchmark, and many of the themes carry directly over into the European segment.

We are tactically overweight high yield bonds

High yield bonds have been one of the best performing asset classes in 2012. As of mid-August this year, high yield mutual funds had received $43bn in inflows, three times the amount in the same period in 2011. This investor demand has helped narrow the spread of US corporate high yield debt over US Treasuries by 127 basis points this year.[3]

High yield bonds are one of the few assets currently providing a solid income stream to investors.

Despite their strong performance, we remain overweight high yield bonds in our tactical asset allocation because they provide a relatively safe income stream in a historically low interest rate environment. Barclays US Corporate High Yield Index yielded 6.78%, or 572 basis points above Treasuries, as of August 23. By comparison investment grade bond spreads were just 171 basis points above Treasuries. We believe that interest rates are likely to remain low for at least the next 12 months. We also expect US high yield bond default rates to remain low: Corporate balance sheets are the strongest they've been in years, and the US economy continues to show signs of a gradual healing. Year-to-date performance notwithstanding, we believe the fundamentals continue to support our overweight to high yield debt in a broader portfolio.

Interest rates are likely to remain low

On December 16, 2008, the Federal Reserve lowered its benchmark interest rate to 0%-0.25%, noting in its press release that weak conditions would warrant an exceptionally low Fed funds rate "for some time". Some time indeed. Three and a half years on, the Fed's target rate has not budged. The 10-year Treasury reached an all-time low of 1.39% on July 24, 2012, and the Fed has stated its intention to keep rates exceptionally low until 2014.

The market also expects rates to remain low for the foreseeable future. There is less than a 5% probability implied by the futures and options markets that the Fed will have raised its benchmark interest rate to 0.5% (from 0%-0.25%) one year from now. The probability that it will have raised rates to 0.75% by next summer is even slimmer, at less than 1%, according to the market.

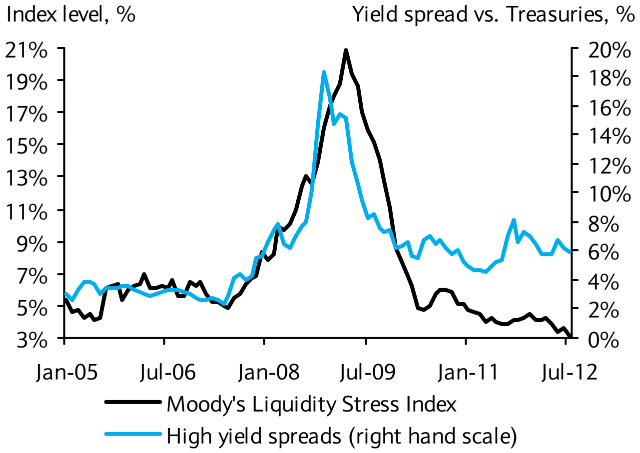
Yields are high, despite robust balance sheets

Spreads of high yield bonds to Treasuries remain well above pre-crisis levels.

The spread between high yielding bonds and Treasuries remains well above pre-crisis levels, even as corporate liquidity has improved. As of August 23, the yield on the Barclays US Corporate High Yield Index was 6.78%, corresponding to a 572 basis point (bp) spread above equivalent Treasuries. Figure 1 depicts high yield spreads vs Treasuries and the Moody's Liquidity Stress Index, which falls when corporate liquidity improves and typically leads corporate bond default rates. The Index is now at its lowest point since 2005, yet high yield spreads at 572 basis points remain well above their pre-

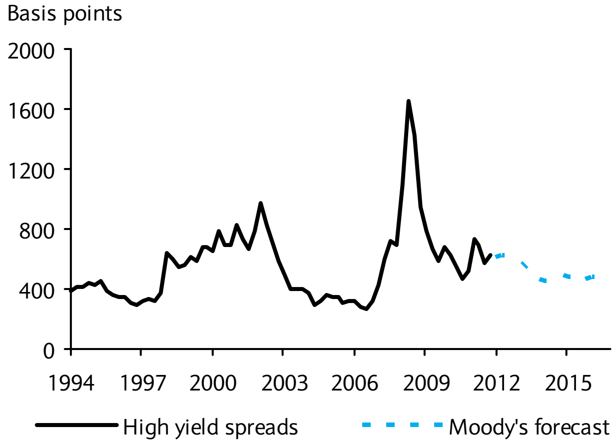
[3] Unless otherwise noted, all data as of August 23, 2012.

Figure 1: High yield spreads to Treasuries remain historically wide despite improving corporate liquidity



Source: Moody's; Bloomberg; Barclays US Corporate High Yield Average OAS

Figure 2: US high yield spreads



Source: Moody's

crisis average of 320bps. According to Moody's, high yield spreads will remain stable at today's levels for the next 12 months before tightening further to approximately 460 bps by 2014 (Figure 2).

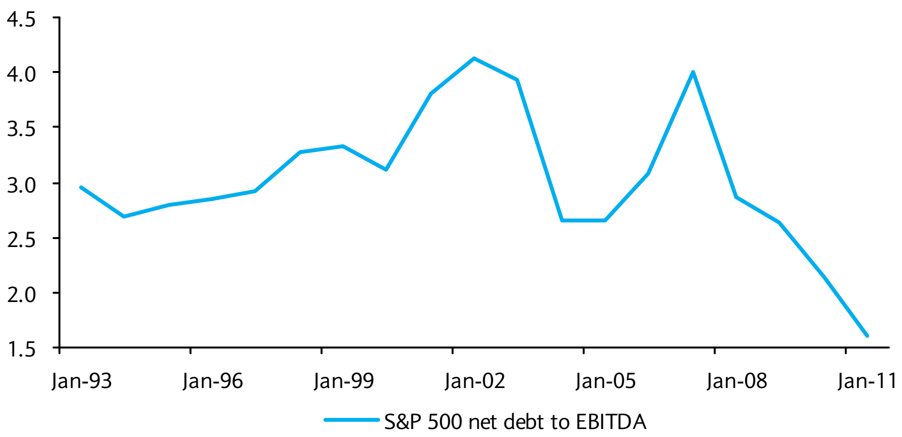
US corporations appear to be in a good position to meet interest payments, as corporate profitability remains strong and leverage has declined. S&P 500 net debt to EBITDA has declined to 1.6x, its lowest level in almost 20 years (Figure 3). Moreover, cash on S&P 500 balance sheets is almost \$300 per share, its highest level in 14 years and well above the average since 1998 of \$183.

Correspondingly, default rates on US high yield bonds are expected to remain stable over the next 12 months, according to Moody's (Figure 4).

High yield is attractive on a total return basis

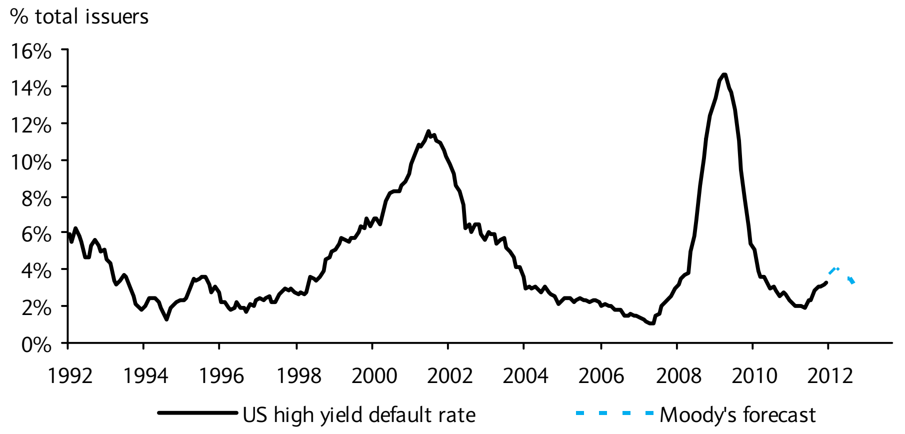
With high yield bonds having performed so well this year, should investors be worried that future gains will be harder to come by? Not necessarily. First, the coupon on corporate high yield bonds is a major contributor to total return. Year-to-date, US high yield returns of 10.3% have been comprised of 5.42 percentage points from the coupon and 4.89 percentage points from price return. Even without any price appreciation in

Figure 3: S&P 500 net debt to EBITDA at lowest level in almost 20 years



Source: Standard & Poor's

Figure 4: US high yield default rate



Source: Bloomberg

high yield bonds, in the absence of default, investors can expect to collect a robust coupon. Second, high yield bond spreads may still compress further, as Moody's forecasts. It is worth noting, however, that we would consider reducing our overweight tactical allocation to high yield bonds if their spreads over Treasuries were to fall to the low 500's from their current level of 572 bps.

The risk: an economic slowdown

The bigger risk, in our view, is a sharp slowdown in the US economy, which could cause a surge in default rates. However, recent US economic data has been encouraging, with the July payrolls report and the Index of Leading Economic Indicators both exceeding consensus expectations.

Moody's expects the US speculative grade default rate to rise to 4% by October 2012, up modestly from July's 3.3%, however Moody's expects that the rate will then fall steadily back down to 3% by March of 2013.

Implementation

We recommend investors access this theme via a high yield bond fund

We recommend European investors implement this tactical overweight using a high yield bond fund. Active management in this space can add value by taking both a top down and bottom up approach to investing. In addition, we prefer to diversify exposure in order to avoid concentration risk. By following this strategy investors avoid the risk of one counterparty defaulting; if this does happen, the return on other issuers should help to mitigate the loss.

More generally, from a sector perspective in the US, Moody's projects the lowest default rates over the next 12 months in the Oil & Gas, Banking, and Real Estate sectors. We would be wary of the Advertising, Printing & Publishing sector, Consumer Services, and the Wholesale and Retail sectors, which Moody's anticipates will have the highest default rates over the next 12 months. As always, it is important to be careful when selecting sub-investment grade bonds, as they carry a greater risk than bonds with higher credit ratings. Please contact your Barclays Investment Representative for further details.

Performance assessment

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How do we experience "good" performance? How can we know if we are in the right or wrong portfolio? Unfortunately, we're not naturally equipped to answer this question easily. What our minds naturally look for to measure performance, and what they actually should be looking for, are two different things.

How did I do?

One of the core insights of behavioural finance is that the journey matters as much, if not more, than the destination. For many investors, dealing with the journey in order to reach the destination is often the hardest part. And throughout that journey, we'll try to make sense of whether or not we're in the right investment portfolio. Unfortunately, correctly assessing investment performance is difficult, whether you're using advanced statistics or your intuition.

Let's say an investor can choose between portfolios A and B, but has no idea which one will be better. As omniscient experimenters we know Portfolio A will have an average annual return of 3%, and B will return 6%, and they will have the same volatility. Clearly B is better. As the investor observes the portfolio through time, they can begin estimating the probability that B is better. Suppose our investor looks at performance monthly – it can take up to 22 months to have 80% confidence that B is better.[4] Clearly, 2 years is a long time for most of us to wait, and we'll likely make decisions on our investment over far shorter time horizons.

Absolute and relative perspectives

But it's not just a matter of objective performance; it's also how it feels. How we perceive our portfolio's performance can be strongly influenced by what we compare it to. For example, let's consider two extreme cases: Allison, who only cares about absolute returns (i.e., she has no idea what markets did), and Ricardo, who only cares about return relative to the market. Below we detail how Allison and Ricardo will perceive returns in different market environments. You may be tempted to say that Ricardo is crazy - only caring about relative returns is not intuitive – but none-the-less, this is how we sometimes think. Roughly 27% of individuals come out as more "Market Focussed", like Ricardo, roughly 27% more "Absolute", like Allison.

Figure 1: Qualitative assessment of portfolio returns depending on benchmark

	Allison		Ricardo	
Portfolio Return	Positive	Negative	Positive	Negative
Underperform market	Good	Bad	Bad	Bad
Outperform market	Good	Bad	Good	Good

Source: Wealth and Investment Management

[4] Technically, this is a the p-value of a one-sided t-test checking that B has higher mean returns than A. 80% confidence means if they were actually the same average return, we'd expect to see this level of difference 1 out of 5 times due purely to luck.

Allison and Ricardo agree that beating the market in good times is good, and that underperforming a falling market is bad. However, they disagree on underperformance in rising markets, and outperformance in falling markets.

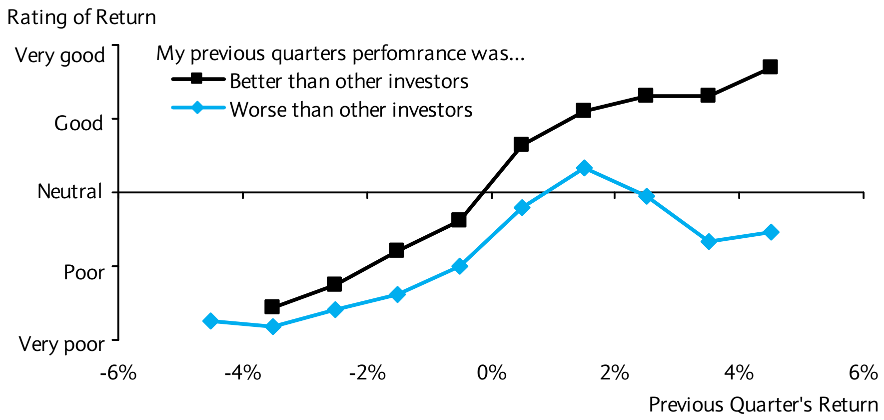
Unfortunately, odds are we won't be as happy as Allison OR Ricardo. Many of us will oscillate between these two focuses– caring about absolute numbers in negative markets (i.e., not losing any money) and relative performance in positive markets. As a result we are only happy when we outperform positive markets, and condemn ourselves to dissatisfaction at all other times.

Beating, not just keeping up with the Joneses

But do real people consistently use absolute or relative reference points? Does it influence how we perceive returns? Fortunately we are uniquely placed to answer these questions. For two years beginning in September 2008 we tracked a sample of our online brokerage clients[5], and asked them if they were market or absolute focussed, and how they would rate their returns every quarter.

What we found is revealing. First, people *do* vary in how much they say they use an absolute versus relative benchmark. Some people care a lot about beating the market, and this significantly influences what returns they define as being "good". However, while other people say they don't care about how the market or others have done, we can actually detect the influence of relative underperformance in how they rate their returns. Believing you beat one's other investors influences your perception of returns.

Figure 2: Rating of returns by relative and absolute outcomes



Source: Barclays Research

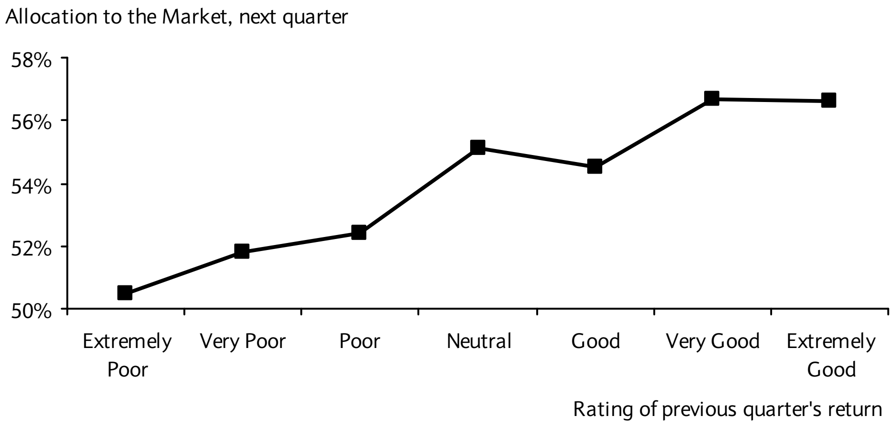
Figure 2 shows that investors always rate returns more highly if they believe they have done better than others investors, no matter what benchmark they use. As we'd expect, investors tend to rate higher returns better than lower ones. However, the benefits from a positive return are almost completely eroded if we believe other people have done better than us. Conversely when markets have fallen beating other investors helps us somewhat, but does not prevent us from feeling the pain of a loss – we know our return was bad, just not as bad as others'.

[5] Note that these clients do not receive any investment advice from Barclays.

Happiness today, risk-taking tomorrow

This might be of purely academic interest, except that how we perceive our returns influences our investment decisions. In the same surveys, we asked individuals how much of a hypothetical $100,000 they would invest in the market over the next three months, with the rest left in a risk-free asset. While most individuals anchored on just over 50%, a more positive feeling about the past three months returns lead them to take greater risk in the next three months. Figure 3 below shows that the better we feel about last quarters returns, the more we are willing to invest in the stock market. This is likely because we infer future riskiness from recent experience, but how we feel about the recent past is never the best reason to be making significant asset allocation shifts – it leads to buying higher and selling lower.

Figure 3: Market Allocation by rating of previous return



Source: Barclays Research

Lemons out of lemonade

Given the facts above – we are naturally prone to assess investment returns such that we are dissatisfied with them, and our assessment of the past influences our future risk-taking decisions - what can we do to ensure we are acting intelligently for the future?

First, we should bear in mind that what really matters is the absolute growth in our wealth over the long-term. Examining performance relative to benchmarks may be useful to assess whether short-term performance is due to skill, or just luck (either our own, or that of managers), but does not tell us much about whether we're in the right portfolio. And even the right portfolio will have periods of short-term loss – risk is inherent in investing.

However, since relative performance is likely to affect us, when assessing our portfolios performance we should ensure we use a blended benchmark that matches the level of risk appropriate for our Risk Tolerance, and never pure equity markets. We should know our levels of Risk Tolerance and Composure, to understand the correct level of long-term risk, and how we're likely to react to the short-term under or over-performance of our portfolio. And ideally, we should always discuss asset allocation changes with an independent advisor, who is less likely to suffer from exuberance and despondency with us, to help us focus on long-term future growth.

And finally, we should remember that there is little value in monitoring our portfolios from month-to-month, but a lot of danger in how excessive monitoring can make us behave.

Snapshot of allocations and asset class returns

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

Barclays' TAC has not altered its tactical (3-6 month) tilts since July 3rd. The frustratingly slow and setback-prone evolution of the euro area crisis, together with the continuing uncertainty regarding global economic growth (with the US 'fiscal cliff' looming at year end), suggest that renewed market volatility is likely in the weeks and months immediately ahead. The Committee thus has a tactical underweight in developed stocks, and an overweight in cash. However, it also has a tactical preference for corporate bonds ahead of government bonds, which look very expensive: it advises a small overweight in high yield credit, and an underweight in developed government bonds.

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

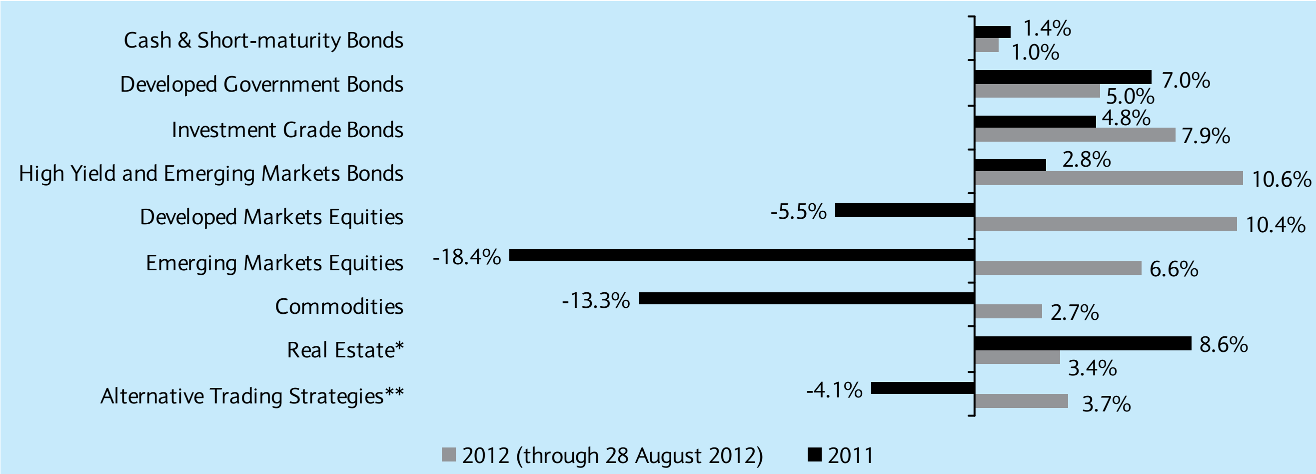
Figure 1: Current strategic (SAA) and tactical (TAA) asset allocation by risk profile

Risk Tolerance Level	Cash & Short Maturity Bonds	Developed Government Bonds	Investment Grade Bonds	High-Yield & Emerging Markets Bonds	Developed Markets Equities	Emerging Markets Equities	Commodities	Real Estate	Alternative Trading Strategies
Low									
SAA	43.0%	10.0%	3.0%	4.0%	16.0%	4.0%	2.0%	7.0%	11.0%
TAA	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%	0.0%	0.0%	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%	0.0%	0.0%	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%	0.0%	0.0%	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%	0.0%	0.0%	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%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

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

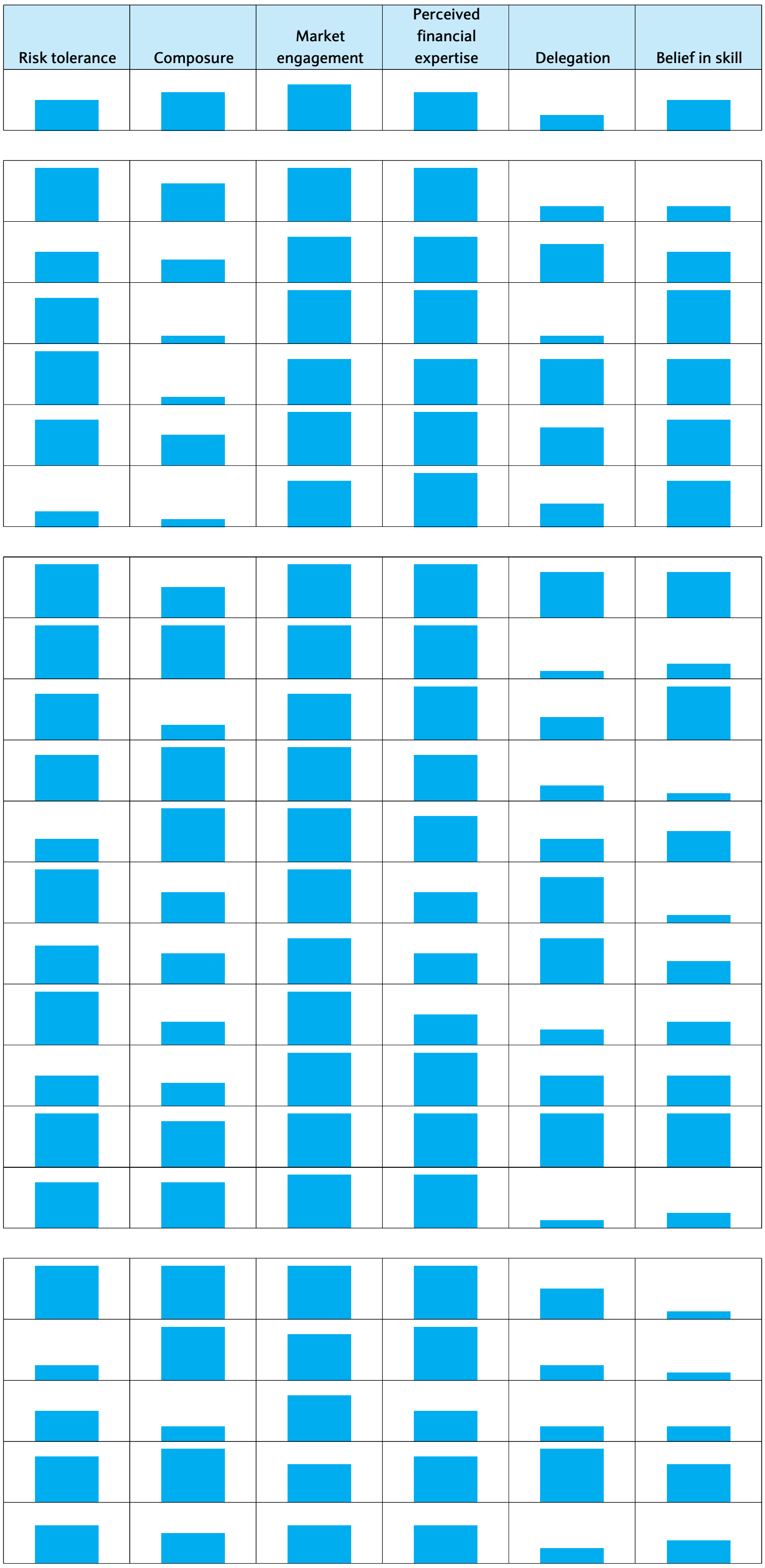
Developed equities have rallied further in anticipation of more substantial action from the ECB, and in response to a run of better-than-expected US economic data: they are almost back to their March highs, and together with high yield credit are once again the best-performing asset class year-to-date. Commodities continue to lag behind other risk assets.

Figure 2: Total returns across key global asset classes



* As of June 2012
** As of July 2012
† Diversification does not guarantee against losses.
Note: Past performance is not an indication of future performance. Index Total Returns are represented by the following: Cash and Short maturity bonds by Barclays Global Governments 1-3 years; Developed Government Bonds by Barclays Global Governments 7-10 years; Investment Grade Bonds by Barclays Global Aggregate - Corporates; High-Yield/Emerging Markets Bonds by Barclays Global High Yield, Barclays Global EM & Barclays EM Local Currency Governments; Developed Markets Equity by MSCI World Index; Emerging Markets Equity by MSCI EM; Commodities by DJ UBS Commodity TR Index; Real Estate by MIT TBI Index and IPD UK for January-March 2011 and NCREIF TBI Index and IPD UK Index for April 2011-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



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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 confident you feel in your financial knowledge and 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.

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