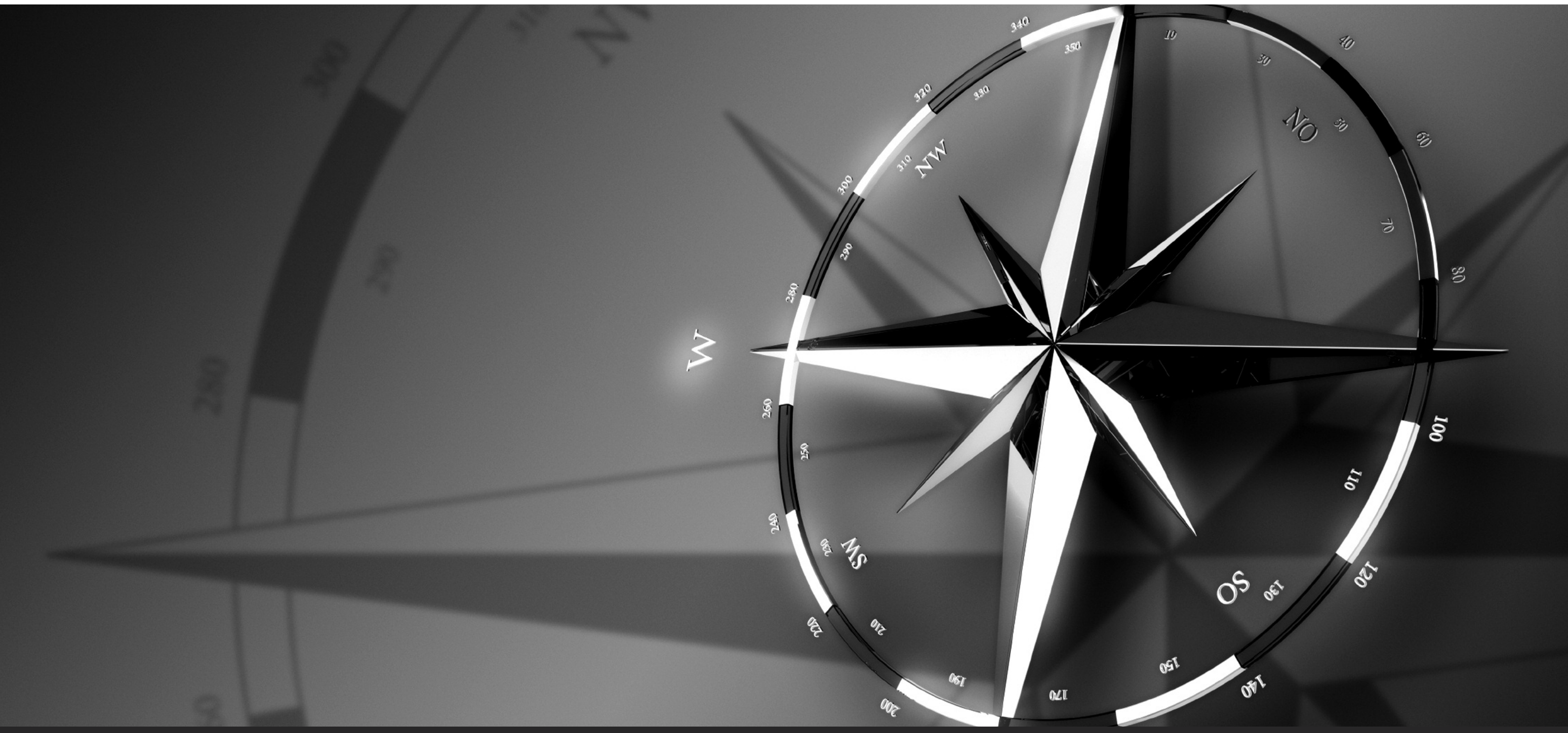

COMPASS

June 2012

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Wealth and Investment Management
Global Research & Investments

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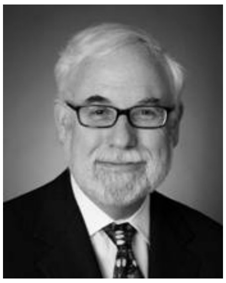

Aaron S. Gurwitz
Chief Investment Officer

How can I … my attention fix on … politics? *

Dear clients and colleagues:

Perhaps because, as an economist by training, I'm most comfortable analysing employment, consumer spending and corporate profit statistics as leading indicators of financial market performance, I tend to find political risk particularly unnerving. Recent weeks have provided plenty of grist for this economist's analytical mill. The news has been mixed but, taking one statistic with another, more encouraging than discouraging with respect to the outlook for stock market returns. Despite this, global equity markets are down by close to 10% from March's highs. The main reasons are political and, so far at least, mostly related to Europe. And as I assess the market outlook for the rest of the year, it looks like what happens will depend more on political developments than on the likely flow of economic statistics. Will one or more countries decide or be forced to leave the European monetary union? Will Congress and the Obama administration act in time to head off large tax increases and spending cuts scheduled to go into effect next January 1? Will Iran's nuclear ambitions lead to war and a recovery-killing spike in oil prices?

Why are political risks so uniquely problematic? After all, economic prognostication isn't at all easy; even with the best analysis of the most reliable statistics our ability to predict financial market performance is, at best, mixed. That's why we recommend holding a *diversified* portfolio at all times. Further, I don't think that political risks are particularly worrisome because our current cohort of government officials is much worse than average. (Although I will admit that, as the Lord High Executioner sings in *The Mikado*, "I've got a little list.") Political leaders in the major developed economies face fiercely daunting challenges right now, and the right answers are not at all obvious.

Political risks bother me a lot for two reasons. First, the outcome of a political process necessarily depends on the actions of a relatively small number of individuals. Our Behavioural Finance team continually reminds me that the average assessment of a situation by a large group of people is usually closer to correct than the perceptions of an individual or a small group. And it is easier to predict the average behaviour of a large number of people than what an individual or a small group will decide to do. But when trying to assess what a public entity is likely to decide we are necessarily dealing with a relatively small number of individuals – the United States has only one President and the Bank of England Monetary Policy Committee has only nine members – each with their own intellectual and ideological predispositions, blind spots, depth of understanding, wisdom, foolishness, etc. So assessing how a political process will work out involves making predictions about how some extremely high-powered and complex individuals are likely to react to a wide range of contingencies. I find this kind of analysis especially daunting.

The second reason why political risks are particularly problematic is that what politicians say has a complicated relationship with what they mean. It's not that politicians lie, although that has been known to happen from time to time. What I mean here is that politicians often say things for effect. Suppose a political leader engaged in a political process says, "If you do X, I will do Y." This may be a reliable basis for predicting the politician's behaviour under defined circumstances. Or it might mean that the politician is keeping his or her options open but wants us to think that if X happens, he or she will do Y to increase or decrease the likelihood that X will occur. Politicians are manipulative. This is not a criticism; it is a job description.

* Yeats, W. B., "Politics"

The problem from the point of view of investment strategy is that, if my investment decisions depend on whether a politician does one thing or another, I certainly want to know whether “If X, then Y” is a firm commitment or a negotiating ploy; the more skilled the politician, the harder it is to tell.

So this is why the current investment situation is particularly difficult to evaluate. Within the European monetary union a relatively small number of individuals, operating within highly-charged situations with very high stakes on the outcome, will be called upon to act in a way that either preserves the common currency or risks the repercussions of a break-up. Under these circumstances assertions that the Eurozone banking system could withstand a Greek exit without excessive damage might be taken as a reassuring assessment but also might simply be intended to signal to the Greek electorate that their bargaining power vis-à-vis the rest of the currency union is limited.

In the US to avoid a default on Treasury obligations Congress and the White House will have to reach an agreement to raise the debt ceiling some time later this year. Should we take House of Representatives Speaker John Boehner’s insistence on dollar-for-dollar matching of additional borrowing authority with new spending cuts as political posturing or as a serious credit risk for US Treasury bondholders?

In the case of Iran’s ambitions it’s very hard to tell whether one should take at face value either the speculation of Israel’s leaders regarding possible military attacks or ‘leaks’ suggesting diplomatic progress toward a peaceful resolution.

Clear answers to these and related questions would certainly help inform good investment decisions. But we are unlikely to get clear answers any time soon.

The ‘hard’ economic evidence we’ve been seeing should encourage prudent risk taking. The ‘soft’ political considerations might work out positively or negatively. So our basic outlook for the next 12 months is, as it has been, cautiously optimistic. But in the near term the upside and downside risks the market faces are largely political and, therefore, particularly difficult to evaluate. Hence, we’ve concluded that investors are well advised to reduce portfolio risk modestly – and briefly – until some of the outstanding public policy issues have been resolved one way or the other.

Sincerely yours,

Aaron S. Gurwitz
Chief Investment Officer

Markets held hostage

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Markets have again been taken hostage. The Greek election itself is too close to call, and further volatility seems very likely. We think that contagion would be containable, and that a sharp rebound in risk assets is possible at some stage, but as an insurance, Barclays Tactical Allocation Committee has reduced weightings in developed stocks and high-yield credit in favour of cash and core government bonds.

Postcard from the edge

The result of the second Greek election looming on 17 June is too close to call. Because of the many different parties and issues involved, Greek voters and politicians themselves can't offer much of a guide at this stage, even if they know their own minds (which in many cases will not be the case). The aggregate ranking of voter preferences is notoriously difficult at the best of times: there is a famous 'impossibility theorem' to this effect. And Churchill once quipped that, "democracy is the worst form of government – with the exception of all the others".

As a result, markets have effectively been taken hostage – again – by the Greek crisis. If the vote is not presented as a single issue referendum on euro membership on 17 June it may be difficult (again) to disentangle that issue from the various parties' claims and counter claims about jobs and living standards. The europhile Greek electorate could inadvertently push itself out of the euro by voting again to reject 'austerity' – thereby, ironically, doing more damage to the credibility of the single currency project than has been done by those who say they don't want it…

Sadly, austerity is what Greece will get for a while longer, even if it votes against it, and even if eventually leaves the euro and defaults more formally (and messily) on its obligations. Indeed, it could even rediscover one of those worse alternatives. In the meantime, we have to be braced for more market volatility.

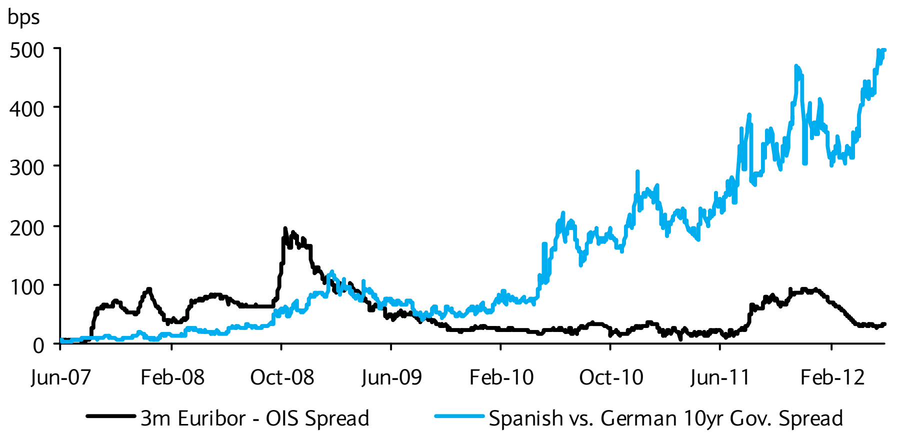
Could the global economy and capital markets continue to 'muddle through' a Greek exit? We'd prefer not to find out, but we think they probably could, albeit after a bumpy ride – provided the ECB, IMF and euro area politicians quickly circle the wagons around the euro area banking system. The key is thus the ability of the ECB to offer continuing support to the system, and to the Spanish and Italian banks in particular, while absorbing losses on its holdings in Greece.

Our investment bank colleagues estimate that euro area official sector exposure to Greece, through its direct lending, EFSF loans and the euro system itself, is of the order of €300bn, or roughly 3% of euro area GDP. However, after allowing for financial reserves and other buffers, they think that in practice, the increase in aggregate euro area government indebtedness might be more muted, at around 1% of GDP, even at low recovery rates. (Private sector exposure has likely been largely provided for alongside the restructuring of Greece's sovereign debt). Much more important than the direct impact of a Greek exit – which we see as possible, not yet probable – is the likely contagion risk to Spain and Italy that would follow. We think those wagons can be circled, and the risk would be containable: the dominoes do not have to fall.

Spain and Italy's economies, balance sheets and deficits are different to Greece's, and the ECB has shown itself to be agile and innovative. In an emergency we would expect to hear more about bond purchases, further LTROs, deposit insurance, IMF support and the like. As yet, neither interbank rates nor the euro itself are pointing to a major escalation of systemic risk – indeed, the euro area interbank spread has been stable in recent weeks, even as the Spanish bond spread has hit new highs and perceived bank creditworthiness has hit new lows (Figure 1).

The scale of potential fiscal drag in 2013 is daunting, but the much feared 'taxmageddon' is unlikely to materialise…

Figure 1: Euro area interbank & Spanish/German bond spreads



Source: Bloomberg, Barclays

We also think that the German government will soften its stance on 'austerity' generally (though not, perhaps, in time to offer any further assistance to Greece itself). Politicians of the Christian Democratic Union (CDU) are already talking constructively about 'growth' alongside their continuing commitment to the fiscal pact, an illustration in our opinion of the political imperative at the heart of the European integration project. The practical impact of any growth pact may be tiny in terms of GDP, but it would have wider significance.

Of course, it is possible that the result of the election is inconclusive. A new Greek administration may simply decide to stop servicing its debt but also to try to stay inside the single currency. If its partners feel unable to eject it – because the necessary legal protocols to do so simply don't exist – a prolonged stand-off could ensue. But even this would likely be accompanied by further volatility, for a while at least, as markets tried to come to terms with an ongoing euro participant being in default.

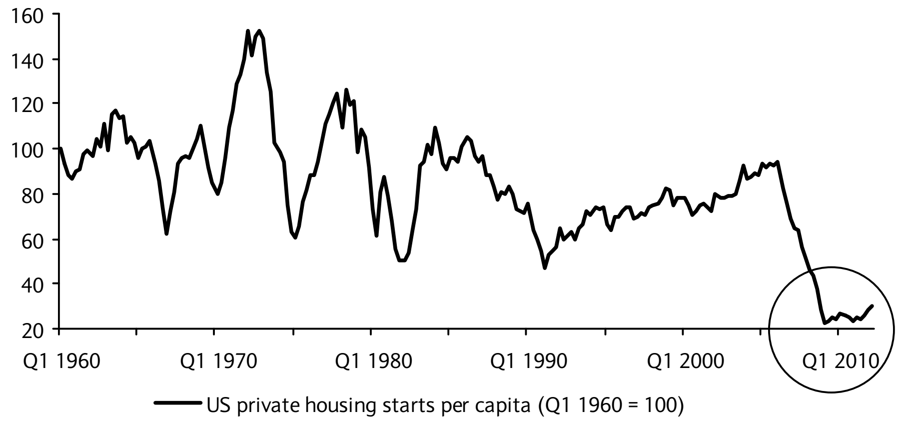
Mediocre economic expectations met

Meanwhile, the economic data released in the last month have been patchy: global growth is lacklustre, but still firmly positive.

In the US, our expectation of ongoing growth at around 2.5% has been supported by the latest ISM and retail spending data, with a stabilising housing market (Figure 2) continuing to balance the possibility that consumer and industrial confidence could take a knock from euro-related financial volatility. The scale of potential fiscal drag in 2013 is daunting, but the much feared 'taxmageddon' is unlikely to materialise in our view: fudge and delay is likely to remain the (last minute) order of the day.

A recovering US housing market represents a source of upside risk to many economic forecasts

Figure 2: US per capita private housing starts (index: Q1 1960 = 100)



Source: Datastream, Barclays

China's economic data point to further deceleration in the current quarter, but not on an alarming scale, and we still think this could be the low point for the year. Lower inflation is allowing the authorities slowly to ease monetary and fiscal policy, and the directed nature of much economic activity in China means that policy can be effective. We continue to see China growing by around 8% in 2012 as a whole.

Europe is, of course, the weakest part of the global economy. The data released here in the last month were actually mixed, but not sufficiently to soothe nerves. The latest batch of euro area survey data suggest that the economy has weakened in the second quarter, and may remain soft into the summer. However, that weakening follows an outcome for the first quarter that was less fragile than feared – instead of shrinking as expected, euro area GDP was flat. Meanwhile, in the UK the first quarter fall in GDP has been shown to be entirely driven by de-stocking: final demand strengthened. However, the chance of a noticeable rebound in the second quarter looks slim, not least because of the extra bank holiday.

Overall, we see the global economy continuing to grow, led by the US and the emerging world. This should be enough to keep corporate profitability firm, and defaults low, allowing us to take valuations for stocks and high-yield credit approximately at face value. However, the likely pace of growth leaves little room for disappointment, and investor risk appetite is fragile on account of those single currency concerns – a recipe for ongoing volatility.

Investment conclusion

Against the background of this ongoing mix of heightened policy risk and fragile economic growth, the only safe call thus seems to be that markets will remain skittish during the weeks ahead. The key investment question is the extent to which we try to fine-tune investor portfolios to try to dodge that volatility. Because we still see both the euro area banking system and the global economy avoiding disaster, and because stock and bond valuations are already reflecting a lot of potential bad news, we think there is a very good chance of a sharp rebound in risk assets at some stage – but it is quite possible that such a rebound will start from lower levels than today's.

Taking a perspective extending beyond the next three to six months, our convictions remain strongest in favouring stocks and many corporate bonds ahead of core government bonds and cash. However, the Barclays Tactical Allocation Committee is charged with taking a more tactical stance for investor portfolios managed in line with our nine asset class Investment Philosophy, and on 28 May it reduced recommended weightings in risk assets as an insurance against this near-term volatility.

For diversified portfolios run along these lines, developed equities are cut from a small overweight to a slightly larger underweight; the overweight in high-yield and emerging market bonds is trimmed; cash holdings are raised from neutral to a recommended overweight; and core government bonds are raised from an underweight to neutral. Detailed portfolio positions are summarised as usual on page 19.

Figure 3: Barclays TAC: (recommended asset allocation (moderate risks)

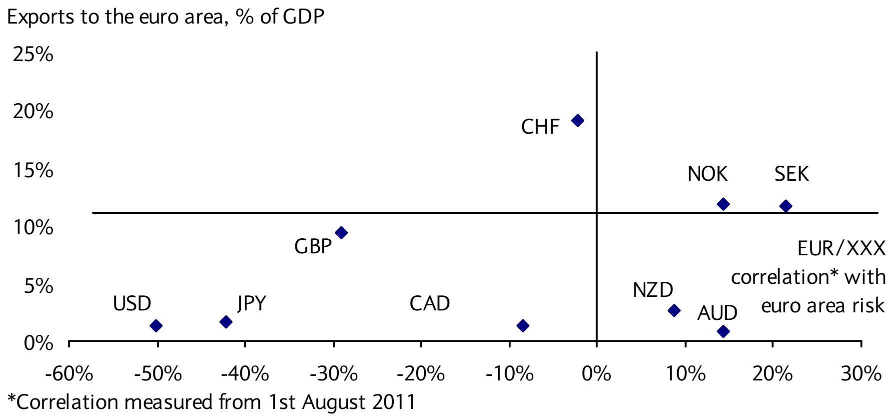
	Moderate			
Asset class	SAA	TAA	TAA vs SAA	Change vs prior TAA
Cash & Short Maturity Bonds	8.0%	12.0%	4.0%	*4.0%*
Developed Government Bonds	9.0%	9.0%	0.0%	*2.0%*
Investment Grade Bonds	4.0%	1.0%	-3.0%	0.0%
High-Yield & Emerging Markets Bonds	8.0%	10.0%	2.0%	*-2.0%*
Developed Markets Equities	38.0%	35.0%	-3.0%	*-4.0%*
Emerging Markets Equities	10.0%	10.0%	0.0%	0.0%
Commodities	5.0%	5.0%	0.0%	0.0%
Real Estate	4.0%	4.0%	0.0%	0.0%
Alternative Trading Strategies	14.0%	14.0%	0.0%	0.0%

Note: Prior TAA dated 16 January 2012. Source: Barclays

The possibility of taking avoiding action is not limited to multi-asset portfolios. While we expect the euro to remain intact – with or without Greece – we still see some further weakening in its value as one of the safety valves for the financial markets. Investors who wish to actively manage their exposure to euro area risk can do this tactically by using the foreign exchange markets, and focusing on currencies that outperform as that risk rises. Figure 4 suggests that these are not limited to the US and Canadian dollars and the yen – sterling too, despite its close engagement with the euro area economy, has been relatively uncorrelated with euro area risk.

Within the currency markets, the US and Canadian dollars, the yen – and sterling – have been relatively uncorrelated with euro area risk

Figure 4: Dollars, yen and pound show low correlation with euro risk



Source: Barclays

What happens when the music stops?

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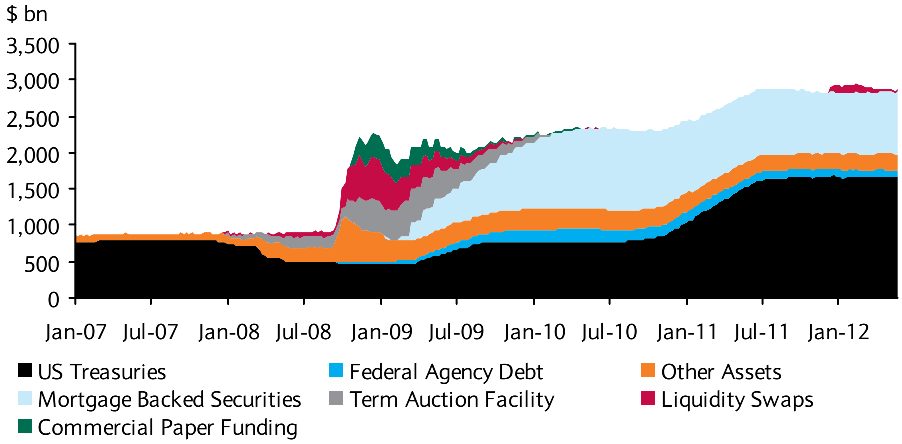
How will bond markets react when central banks are forced to change their tune and today's asset purchase programmes end? For one thing, a significant sell-off in US Treasuries is unlikely while fears as to the global economy keep a tight lid on yields.

Paying the piper

In response to the 2008/09 financial crisis, the US Federal Reserve (Fed) cut its policy interest rate aggressively close to zero. This alone was not sufficient to stimulate a stalling economy, so the Fed resorted to unconventional monetary policy and launched a series of asset purchase programmes from the end of 2008 (Figure 1). The first round of quantitative easing (QE) involved the purchase of around US$1.75 trillion of asset-backed securities and Treasuries; the second round involved the purchase of around US$600 billion of mainly Treasuries; and third programme – called Operation Twist – involved restructuring US$400bn of the Fed's Treasury holdings by switching from short-dated to long-dated bonds. The current size of the US Treasury market is around US$10.5 trillion, of which the Fed owns about 16% with foreign investors owning around 48%.

The current size of the US Treasury market is around US$10.5 trillion, of which the Fed owns about 16%…

Figure 1: US Federal Reserve asset purchases



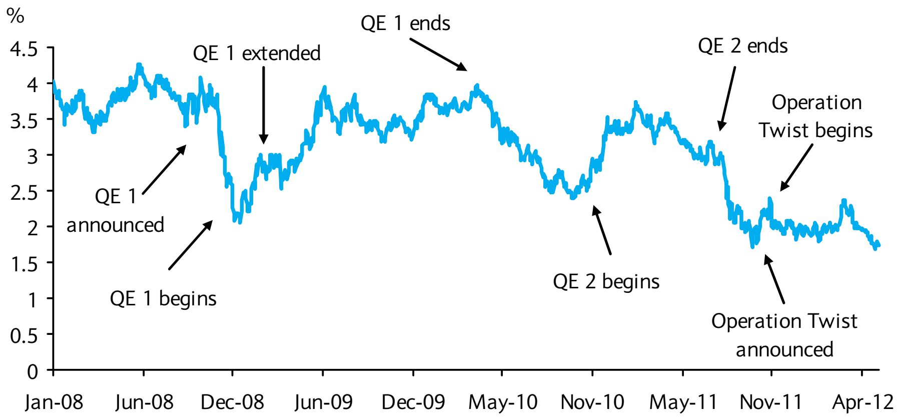
Source: Federal Reserve of New York, Barclays

The Fed's asset purchases have helped push bond yields lower since end 2008. Currently the 10-year US Treasury yield is trading around 1.7% (as we write) compared to 2.3% at the start of QE1 (Figure 2). But QE alone doesn't explain the current low yields on government bonds. Fear of a renewed global economic slowdown, the euro debt crisis, and geopolitical tensions – events that have led to a flight to quality – have also contributed to the decline of Treasury note yields to record low levels. At recent press conferences the Fed has indicated that further stimulus is not warranted as the risks (economic slowdown and a stressed banking system) that led to it previously are abating. But what will be the likely impact on bond markets if the Fed has, indeed, ended its quantitative easing programmes?

...even if the Fed has finished buying Treasuries, it is still likely to keep existing holdings on its balance sheet, preventing a major sell-off...

In order to address this, we must assess the fair value of bond yields. Our fair value model for the 10-year Treasury yield indicates that it's largely overvalued – we estimate the fair value of the yield currently to be around 3.5%, without taking into account the effect of QE and the extensive 'flight to quality'[1]. We estimate that the effect of asset purchases priced-in to the current 10-year Treasury yield to be about 70bps. By comparison, a study by the Federal Reserve Bank of San Francisco (FRBSF) shows that when the first phase of the programme was announced, the 10-year Treasury yield dropped by around 50bps[2], but the effect was short lived and dissipated over a couple of quarters. The San Francisco Fed also estimated that Operation Twist helped push yields lower again and had a more persistent effect than QE1. Other research estimates the effect of cumulative Fed actions on the 10-year Treasury yield of no more than 100bps, indicating that the historically low yields are rather driven by a flight to quality than just the asset purchases.

Figure 2: 10-year Treasury yield in the US and different asset purchase programmes



Source: Bloomberg, Barclays

Meanwhile, even if the Fed has finished buying Treasuries, it is still likely to keep existing holdings on its balance sheet, preventing a major sell-off in Treasuries in the near term. In addition, ongoing uncertainties in the euro area and geopolitical risk are also likely to restrain a potential sell-off in Treasuries any time soon. But in the medium to longer-term we expect the global uncertainties that are anchoring Treasury yields to subside; and that revived risk appetite and firmer economic growth in the US will gain the upper hand in setting the direction of bond yields for Treasuries as well as for developed government bond yields in general.

On the other side of the Atlantic, the Bank of England (BoE) and the European Central Bank (ECB) are likely to keep their options open for additional asset purchases. Further QE by the BoE is likely to be driven by how the growth story plays out over the next quarters in the UK, which is more in tone with the US Fed. The ECB is likely to re-activate its asset purchases via the Securities Market Programme in order to keep a lid on peripheral government bond yields if tensions reach unprecedented levels in the euro area.

[1] Our fair value model is an econometric model based on leading indicators for the 10-year Treasury yield in the US.
[2] *Estimating the Macroeconomic Effects of the Fed's Asset Purchases*, (2011) Hess Chung, Jean-Philippe Laforte, David Reifschneider, and John C. Williams, San Francisco Federal Reserves.

Striking the right note?

The US growth story is expected to continue over the course of this year. But, the question remains as to what degree the Fed's asset purchases contributed to the continuing recovery and whether their effect on the real economy will persist. Arguably, the Fed programmes delivered some of their objectives by supporting economic activity and the banking system (and reducing the risk of deflation).

The aim was for all this newly created money to circulate freely through the banking system to stimulate more lending to the real economy. At the same time purchases of asset-backed securities helped to ease tensions within the US banking system, especially after the Lehman bankruptcy.

But QE1 may not have had the full effect wished. This is mainly because the transition mechanism from monetary policy to real economic activity was broken. Banks were reluctant to extend credit while households and businesses were loath to borrow money, as all struggled to re-build their balance sheets.

But when QE2 and Operation Twist arose things had already moved a long way – the banking system and US households were in better shape, as reflected in improved bank liquidity and capitalisation, increased consumer spending, and a stabilising housing market. The San Francisco Fed study shows that both QE programmes are expected to raise the level of real GDP by almost 3% as well as improving labour market conditions by adding three million jobs in total by the second half of 2012. Moreover, the Fed intervention has also contributed to price stability by heading-off threatened deflation.

We take the Federal Reserve at its word when it says that no additional rounds of QE or twists are needed right now. But the US fiscal debate could still be a game changer. Potential deficit reduction in the near term, or even over the long term, could put additional strain on the US economy. Were this to happen, or were economic growth to falter for any other reason, we would expect to see QE3 or Operation Twist II.

Conducting business

Many market participants argue that the end of QE will leave a hole in the Treasury market. In our view, as long as the existing holdings of Treasuries on the Fed's balance sheet are not dumped into the market, the effect may be less dramatic than expected. Furthermore, the Fed could still reinvest the proceeds of maturing holdings as they roll off, a passive form of 'quantitative ease', if not of 'quantitative easing'. We continue to favour a short duration strategy (less, but not much less, than five years) for government bonds. This though is more driven by our expectations that economic growth will continue and possibly accelerate, not by any expectations of an end to quantitative easing.

Even if long-term interest rates start to rise on the back of the end of QE, the Fed funds rate is expected to remain at historically low levels (less than 1%) beyond 2013. Higher interest rate expectations may start to be priced into the short end of the yield curve, but we expect it to rise less than long-term interest rates. Cash (in this context deposits) may be a safer bet than short-term bonds. To keep yields on one's lowest risk investments above 0%, we recommend taking incremental risk via high quality corporate and/or covered bonds.

Shale and the energy balance

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The US shale boom revolution is widely expected to change global energy markets in the long term. Resources are vast and new efficient technologies have caused production to surge. But will shale really be the global game changer that everyone hopes?

The shale pursuit

The shale gas revolution, which started over a decade ago, revitalised the US energy industry. New technologies, substantial gas resources and the increasing use of horizontal drilling and hydraulic fracturing (also known as 'fracking'), caused production to surge, making the US relatively self-sufficient for domestic consumption of natural gas. Natural gas meets about 25% of the total energy needs of the US and of this, shale gas accounts for 23% of total gas production. The US Energy Information Administration (EIA) forecasts that shale gas production will more than double by 2035 (while total gas production is expected to rise about 30% over the same time period). In terms of its importance in the Dow Jones UBS Commodity Index, US natural gas accounts for about 10%, meaning that the gas outlook can affect the total returns of the index significantly.

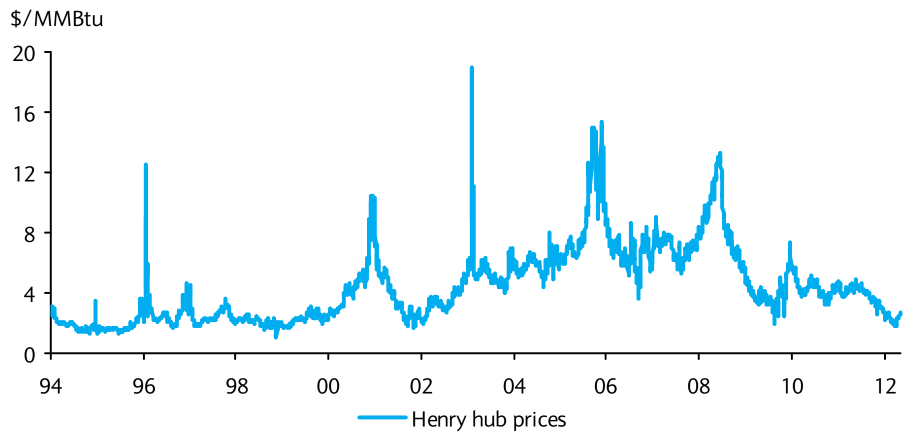
On a long-term view, prospects for natural gas appear favourable. Changing environmental policies will likely boost the use of cleaner power sources, in turn benefiting natural gas thanks to its fuel efficiency and low emissions. But on a shorter-term basis, the outlook for natural gas prices is quite different.

The current outlook

Natural gas and oil prices plunged by more than 75% between their peak in mid-2008 and trough in mid-2009. Since then, while economic growth boosted oil prices, US gas prices (known as 'Henry Hub') failed to gain momentum as persistent supply growth in an already oversupplied market took its toll. Gas prices fell 30% last year and are down a further 10% so far this year at around US$2.60/MMBtu (Figure 1). Although it's tempting to assume that prices won't fall any further – and they have ticked up significantly in recent weeks – there are still downside risks.

Natural gas and oil prices plunged by more than 75% between their peak in mid-2008 and trough in mid-2009

Figure 1: US natural gas prices



Source: Datastream, Barclays

The biggest downside risk for gas prices is the continuation of stable shale production growth. One might question why producers would continue to increase supplies when prices are already so low. The first (and predominant) reason has to do with the relationship between petroleum and natural gas production. While the disparity between oil and gas prices has seen exploration and production companies shift from gas-directed drilling to oil and liquids-directed drilling, these liquids-rich wells often also produce significant volumes of natural gas. So even though gas-directed rigs have declined about 25% so far this year and are now at a 10-year low (Figure 2), gas is continually being produced as a by-product from liquids-directed drilling. Inventories are now about 40% higher than the five-year average (Figure 3).

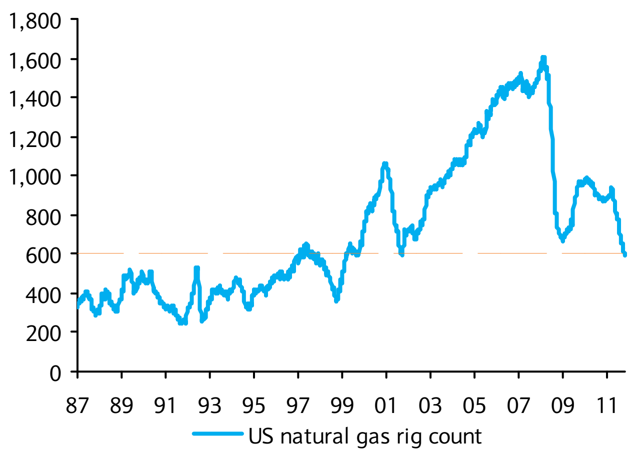
Another factor which affects producers' responsiveness to low prices is hedging. Producers are known for not being highly responsive to fluctuations in spot prices if they have hedged their exposure. This year, the majority of producers have already hedged against adverse movements in prices. The effects of hedging combined with the shift to oil-directed drilling (which produces higher revenues thanks to elevated oil prices), has provided a profit buffer for producers, despite gas prices being at such low levels. This has also helped production growth to remain stable regardless of price movements.

Looking ahead, a key concern in the coming months is that the US might breach full storage capacity before the next heating season. While this could weigh on prices in the short term, we expect demand from electricity generation to be sufficient to prevent an early storage fill. However, in the event that storage capacity is breached, gas pipeline operators could enforce pipeline tariffs. These tariffs are normally penalties shippers pay when there is an over-withdrawal of gas (due to an extreme demand event), but would work the same way if there was too much supply being delivered into the system. Indeed, if these tariffs were implemented, prices could (theoretically) go negative – ie shippers would rather pay someone else to take delivery of the gas, than pay the penalty for causing an imbalance in the system. In such an event, prices could fall significantly which may eventually force producers to shut-down some production.

Fundamentals to improve in the medium term

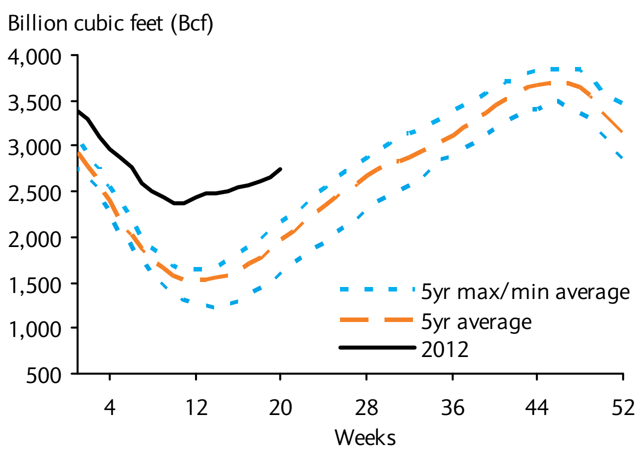
Going forward, we expect the producer cut backs in dry gas drilling this year to start supporting prices from the fourth quarter. Although the supply additions from liquids-directed drilling will partially offset this decline, we believe the cutbacks are sufficient to cause US output to decline next year, gradually tightening the market balance.

Figure 2: US natural gas rig count



Source: Bloomberg, Barclays

Figure 3: US total working gas in storage



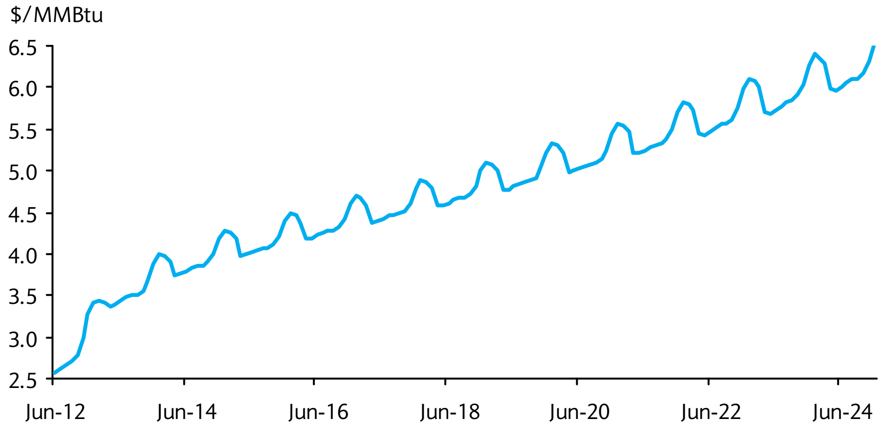
Source: Bloomberg, Barclays

On the demand side, low gas prices have encouraged electricity generators to shift from coal-fired to gas-fired generation, which is known as 'coal displacement'. This shift in electricity generation is a critical component for demand side prospects. While we expect this trend to persist this year (providing prices remain at low levels), operational constraints (such as power plants being locked into long-term coal contracts) will likely limit the impact to an extent.

Our annual average forecast is US$2.43/MMBtu for 2012 and US$3.25/MMBtu for 2013. With this in mind, current prices may appear attractive for long-term long positions. However, implementing a strategy to get direct exposure to gas prices can be complex. The main way to get exposure is via an index or an ETF, but as these reflect the performance of natural gas futures contracts, the shape of the futures curve can affect total returns. At present the natural gas futures curve is in a very steep 'contango' (meaning that longer-dated contracts are much more expensive than shorter-dated contracts), so the process of rolling from one futures contract to the next will have a significant negative impact on the total return. For example, with December 2013 contracts priced just below US$4/MMBtu, and with July 2012 contracts currently at US$2.6/MMBtu, prices would need to rise nearly 50% before the futures (or related) trade starts making money (Figure 4).

At present the natural gas futures curve is in a very steep 'contango'…

Figure 4: US natural gas futures curve



Source: Bloomberg, Barclays

Overall, while the outlook is starting to look up on a medium-term basis, this expectation already appears to be priced into the futures curve for the year ahead.

The longer-term implications of shale

The buzz surrounding shale and its potential to help shift the global energy balance is quite loud. But is this actually feasible? Yes, the US has substantial resources and new technologies have changed the market. But there are still many unknowns going forward.

Such unknowns include regulatory oversight and potential environmental issues. Contaminated water supplies and increased seismic activity are just some of the alleged side-effects from the fracking process. On top of that, the 'actual' amount of gas reserves is (crucially) a big unknown, as estimates for technically recoverable shale gas are being revised lower by the industry. The US Energy Information Administration (EIA) notably reduced its shale gas reserve estimates by 42% to 482tcf (trillion cubic feet) in the early release of its 2012 Annual Energy Outlook.

According to the EIA's *World Shale Gas Resources* report published last year, the US was originally estimated to have the second largest reserves in the world (after China). But taking into account these revised estimates, the US is now forecast to have the fifth largest. Of course, the scale of these reserves is still vast, but these estimates are a critical component in determining shale's long-term effects in the global energy market.

Last, the potential for North American LNG exports to be competitive in global markets could be a swing factor. In April, Cheniere Energy became the first company to receive federal approval to construct a US LNG export terminal out of the current import terminal. Providing financing arrangements are met, the facility is expected to start LNG exports by 2015 with the capacity to export up to 2.2bcf (billion cubic feet) of natural gas per day. With abundant supplies, many energy firms have followed suit by seeking approval for export capability. Still, the significance and influence of US exports on the global market is an uncertain one. First, not all of the planned export capability is bound to come to fruition as these long-term liquefaction projects are extremely capital-intensive. Second, with domestic prices likely to rise due to its price competitiveness in the natural gas market, there is a risk that policymakers could intervene by limiting the number of permits for some years to come. And third, robust demand for North American LNG will need to be met by increased production from fracking, which environmentalists will no doubt oppose.

All in all, constructive long-term (potential) prospects exist, but alongside that, so do many unknown factors. US natural gas could indeed be a long-term game changer for global markets. But with many unknowns still present, perhaps all the optimism surrounding shale gas should be taken with just a pinch of salt.

On a longer-term basis, there seems to be a mismatch between fundamentals and what futures markets are expecting in oil and gas markets. As we previously mentioned, energy companies have shifted from gas-directed to oil-directed drilling. This has caused US oil production to increase sharply and some market participants have extrapolated this strong supply growth into the longer term. As a result, this (alongside other factors) has depressed the back-end of the oil futures curve. While we expect oil shale production to grow strongly each year, we do not believe that it alone will be sufficient to offset the imbalance between strong demand growth from emerging economies and struggling non-OPEC supply. Finally, exposure to petroleum rather than natural gas prices, can serve as a hedge against geopolitical risk. Therefore, we continue to advocate an allocation to investments which would benefit from oil prices on a short and long-term basis.

The not-so-little engine that could

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The performance of the US economy reminds one of the children's tale: *The Little Engine that Could*. While not a little engine, the US economy continues to show determination to grow in the face of consumer deleveraging, tighter lending standards from the banking sector, and a challenged environment with its trading partners in Europe and Asia. Investors have taken notice and differentiated amongst regions awarding the US market a gain for the first five months of the year while retreating from Europe's markets[3].

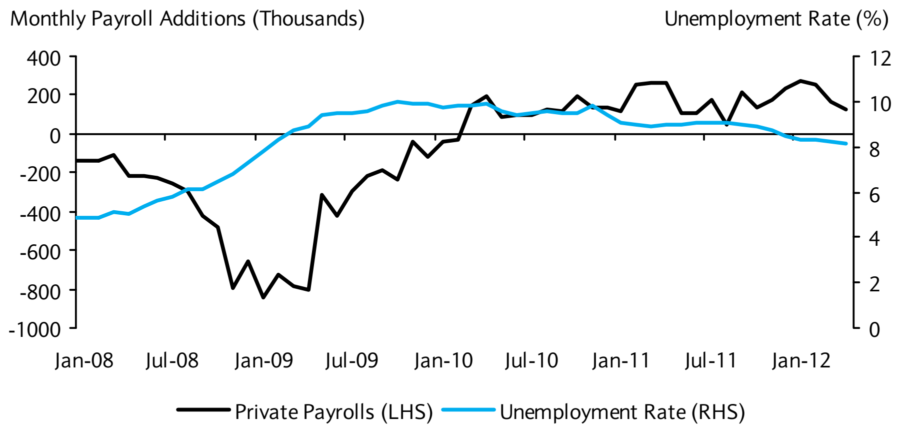
Chugging along

The unemployment rate continues to decline which helps sentiment…

Investor attention has been minutely focused on the continuing machinations in the euro zone. This focus is appropriate: the spectre of a member exit from the zone combined with the ongoing recession has provided investors with an interesting and unsettling clutch of electoral results to sort through. This has led to less clarity and therefore more uncertainty. China has not helped sooth investor fears as questions about growth in that important region have hung over market sentiment like a dark cloud over a summer picnic.

Yet against this unsettling backdrop, the US economy is chugging along (unfortunately, the emphasis is on chug) at a growth rate that continues to create private sector jobs and support some measure of consumer spending. Private payrolls have averaged a monthly gain of 200,000 for the first four months of the year. The unemployment rate continues to decline which helps sentiment as the optics around this measure of employment are more powerful than the insight it provides[4].

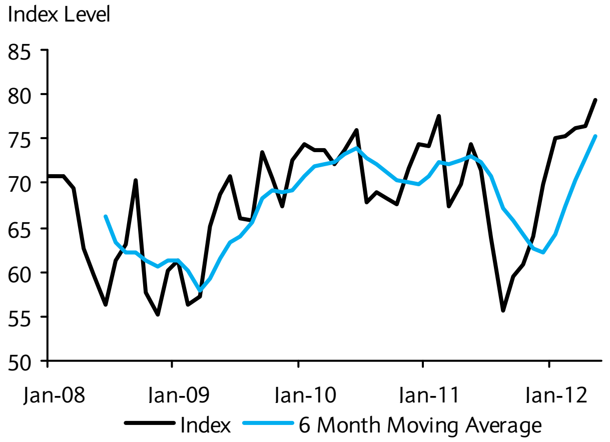
Figure 1: Private payrolls & unemployment



Source: Bloomberg

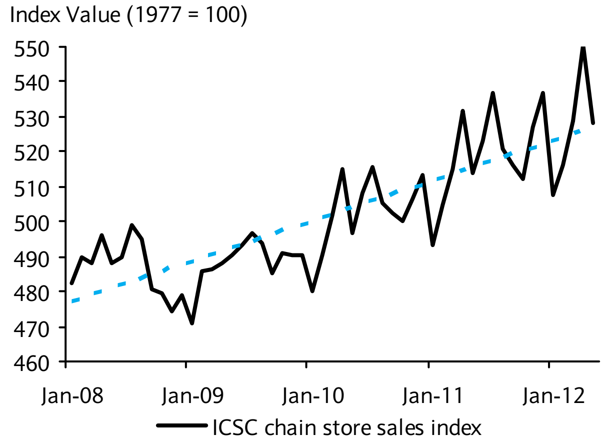
[3] Year to May 31 S&P 500 and Euro Stoxx 50 returns are 5.2% and -9.6%, respectively in US dollar terms.
[4] The unemployment rate in the Unites States is based on those who are looking for work. If you are unemployed and discouraged at not finding a position and stop searching, you are no longer deemed unemployed.

Figure 2: University of Michigan consumer sentiment



Source: Bloomberg

Figure 3: ICSC chain store sales



Source: Bloomberg

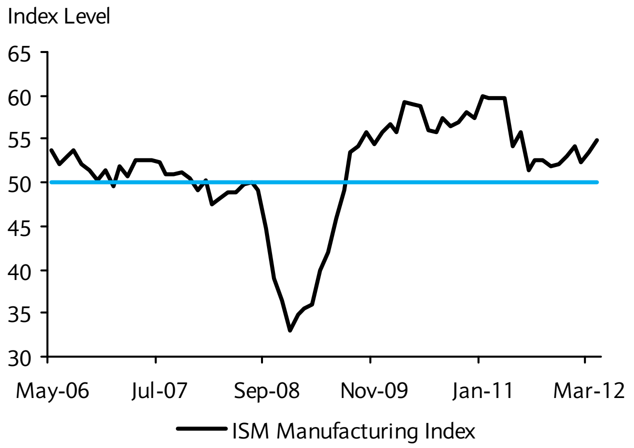
Consumer sentiment remains healthy and is improving (see Figure 2). Retail sales viewed through the lens of chain stores were quite robust in the first quarter slowing only in April (tax season) (Figure 3). This spending remains supported by growing personal income which grew an average of 3.4% over the prior year during the first three months of 2012.

On the business front, the important ISM Manufacturing Index has been resilient (Figure 4) against a backdrop of a more willing banking sector to finance commercial activity. To wit, industrial production continues to rise as capacity utilisation increases (Figure 5). The all-important small business sector, which accounts for roughly half of private sector GDP, is slowly improving as business optimism continues to rise and the willingness of business owners to hire increases.

A few words about small business in the US

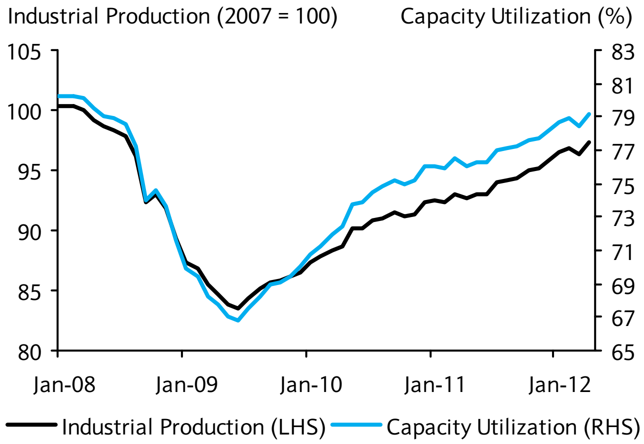
This portion of the US economy is critically important. The popular perception of the US economy is that it's large and driven by leviathan corporate entities. The difference between the perception and reality is vast.

Figure 4: ISM manufacturing index



Source: Bloomberg

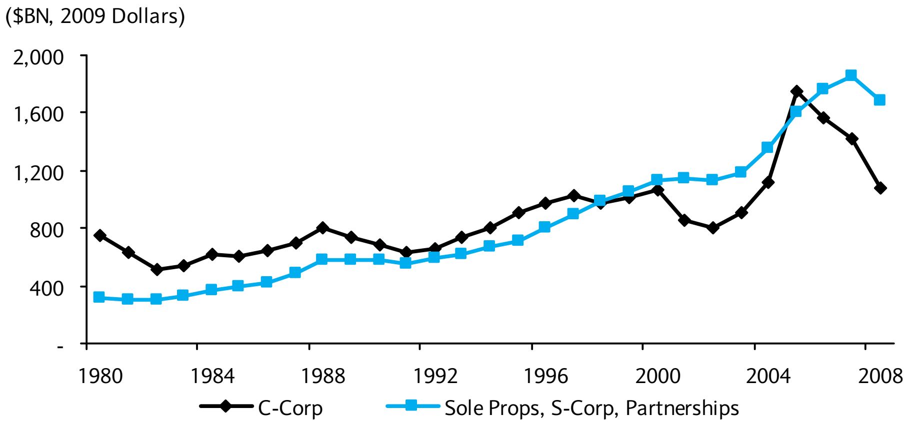
Figure 5: Industrial production & capacity utilisation



Source: Bloomberg

…roughly 60% of job creation comes from small businesses

Figure 6: Net income by business entity



Source: Strategas, IRS

According to the National Federation of Independent Businesses, roughly 60% of job creation comes from small businesses.

Looking at corporate earnings through tax filings reveals that small business income materially exceeds large business income[5] (Figure 6). Consequently, the tone and tenor to the small business sector will largely determine the velocity of the overall economy. To be sure, corporate profits continue to chug higher which will support continued hiring, spending, and therefore, economic growth but the engine is small business.

Huffing and puffing

The problem with debt is that it you have to pay it back…

While the US economy continues to move in the right direction, it does so at a tortuously slow pace. For a populace that is used to economic growth over three percent, growth averaging 2.4% three years after the end of the worst recession in modern times and trillions of dollars spent to ignite the recovery is cold porridge indeed. This anaemic growth should not surprise those who have been paying attention. The process of deleveraging is always a painful one wherein current spending suffers as debt is paid down. The problem with debt is that you have to pay it back, it can never be ignored. It demands attention. The private sector has been reckoning with its debt load while the public sector has yet to come to grips with funding its obligations.

That fiscal cliff: getting over the mountain

Moving into the second half of the year, more investor focus will be directed at the impending expiry of a bevy of tax cuts. The sum total of all these cuts is of the order of 3.5% of GDP. Using a little bit of arithmetic, it becomes clear that policymakers do not have the option of letting the full expiry occur as it would throw the economy into a moderate recession fairly quickly. So a deal will have to be cut. Unfortunately, there will be the political theatre that goes along with it which risks denting the recovering but still fragile confidence of business and consumers. Based on conversations that we've had with lobbyists and economists, the deal that gets eventually agreed upon is likely to be on the order of 1.5% of GDP. This estimate incorporates the various electoral permutations that can tumble out of the November elections.

[5] Small businesses tend to be organised as Chapter S companies whereas larger businesses are organised as Chapter C companies.

Pulling it all together

The US remains one of the growth engines of global GDP. While the growth has been less than satisfying, it appears durable as the heart of the economy continues slowly along the path of recovery. American equities remain one of the few markets that enjoy both attractive valuations and positive catalysts that have the potential to drive higher equity prices. We continue to expect US equities to register high single-digit to low-teen gains this year, making the recent pullback an attractive entry point for those who have yet to reach our target allocations. It appears that the US engine is slowly but surely getting over the mountain.

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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 discussed more fully in the article *Markets held hostage* by Kevin Gardiner on pages 4-7, our TAA weights were adjusted on 28 May 2012 in response to the increasing uncertainty in the euro zone. The core thesis behind the adjustments is that there are too many unknowns building in the euro zone over the coming few months, with no clear signal as to the direction events might take. As a result, we expect increased volatility, with significant downside potential. We are therefore looking to pull back on our risk exposures. At the tactical level, we are: 1) moving to a modest underweight in Developed Market Equities allocations; 2) trimming our overweight in High-Yield/Emerging Market Bonds; 3) restoring our Developed Government Bond weight to neutral; and 4) allocating the remainder to cash.

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.

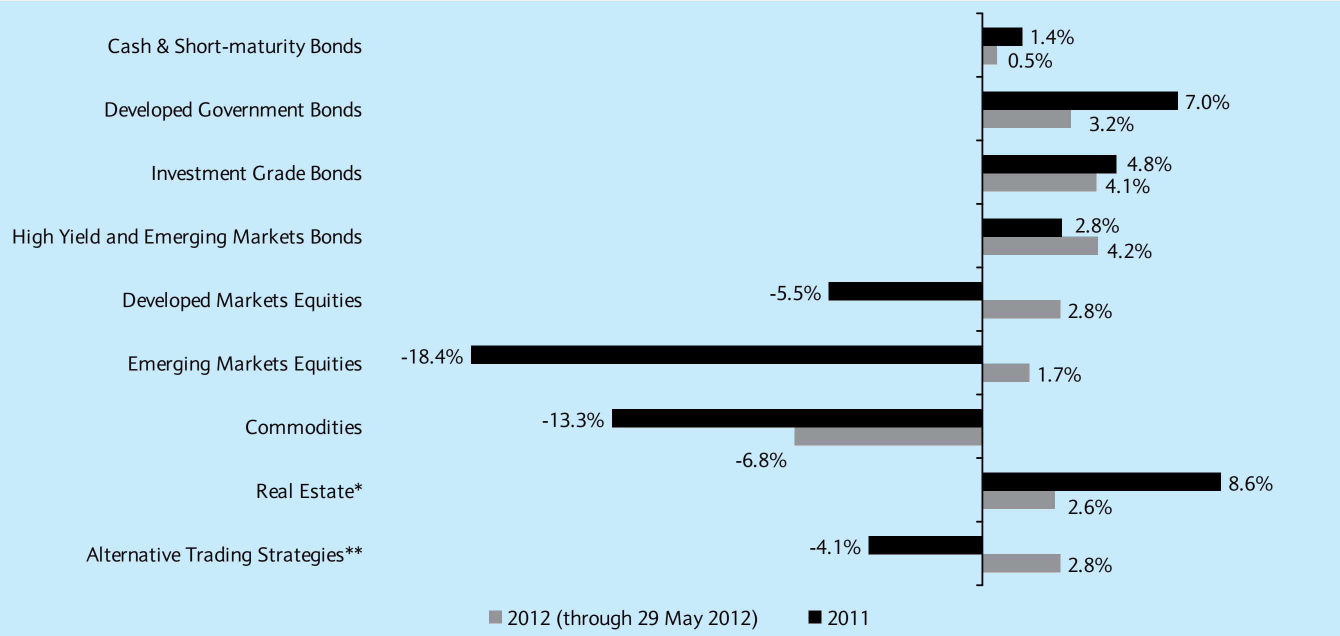
Figure 1: Current strategic (SAA) and tactical (TAA) asset allocation by risk profile

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%	10.0%	1.0%	5.0%	15.0%	4.0%	2.0%	7.0%	11.0%
TAA vs SAA	2.0%	0.0%	-2.0%	1.0%	-1.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	0.0%	*3.0%*	0.0%	*-1.0%*	*-2.0%*	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%	13.0%	1.0%	8.0%	27.0%	7.0%	4.0%	5.0%	16.0%
TAA vs SAA	4.0%	0.0%	-3.0%	1.0%	-2.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	*3.0%*	*3.0%*	0.0%	*-3.0%*	*-3.0%*	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%	9.0%	1.0%	10.0%	35.0%	10.0%	5.0%	4.0%	14.0%
TAA vs SAA	4.0%	0.0%	-3.0%	2.0%	-3.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	*4.0%*	*2.0%*	0.0%	*-2.0%*	*-4.0%*	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%	6.0%	1.0%	10.0%	42.0%	13.0%	6.0%	3.0%	11.0%
TAA vs SAA	3.0%	0.0%	-2.0%	2.0%	-3.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	*3.0%*	*2.0%*	0.0%	*-1.0%*	*-4.0%*	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%	4.0%	1.0%	8.0%	47.0%	17.0%	6.0%	2.0%	8.0%
TAA vs SAA	3.0%	0.0%	-1.0%	2.0%	-4.0%	0.0%	0.0%	0.0%	0.0%
Change vs prior TAA	*5.0%*	*1.0%*	0.0%	*-1.0%*	*-5.0%*	0.0%	0.0%	0.0%	0.0%

Note: Prior TAA dated 16 January 2012.
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 uncertainty has risen over the past month, returns from equity markets have turned negative. As a result, year-to-date returns across each of the nine global asset classes are now in the mid-to-low single digits, and fixed income returns are outpacing those of equities.

Figure 2: Total returns across key global asset classes



* As of March 2012
** As of April 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.

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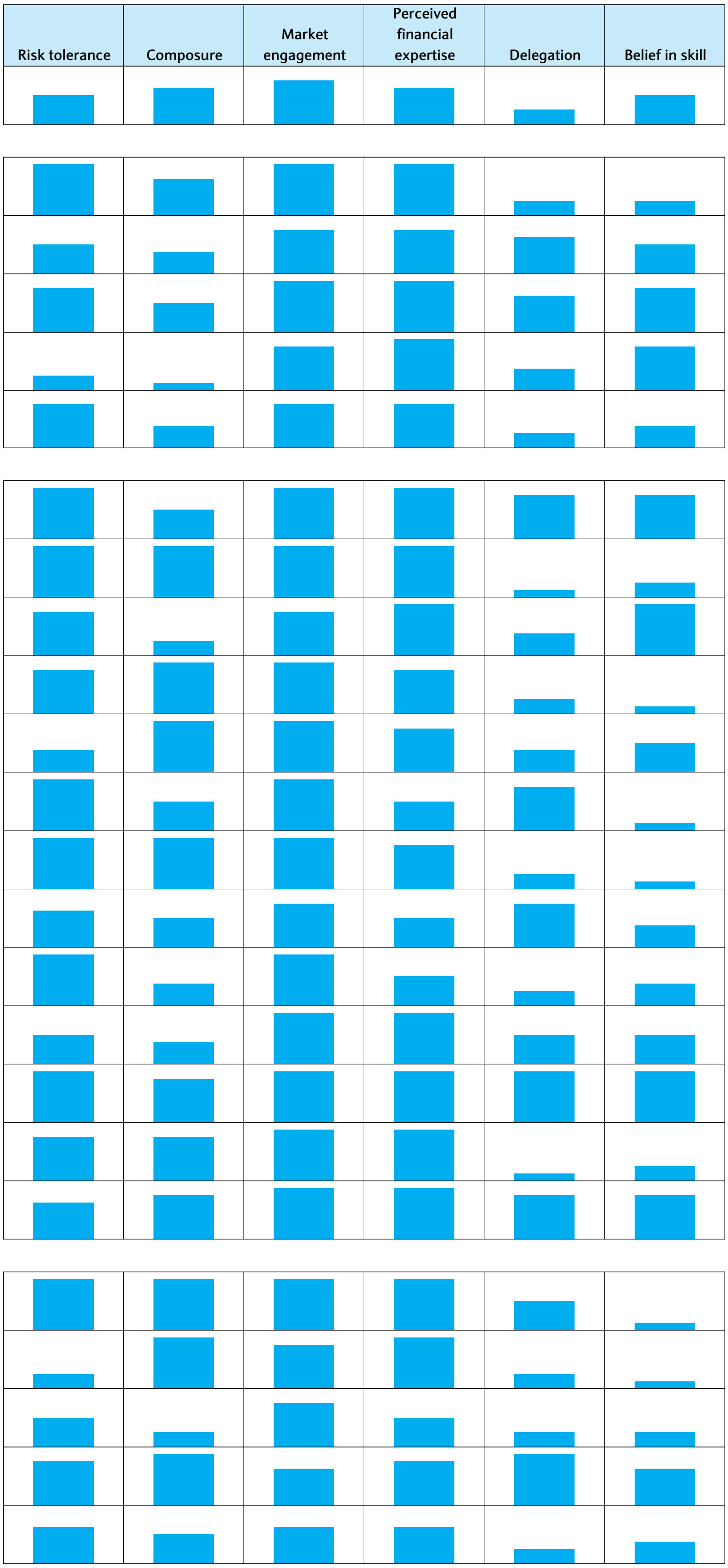

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Risk Tolerance

This is 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

The composure scale measures how emotionally engaged you tend to be with the investment journey.

Market Engagement

This measures 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

This dimension assesses how familiar and informed you feel you are with current financial circumstances, and how confident you feel in your financial knowledge and decision making.

Delegation

The delegation scale assesses how much you believe you can benefit from delegating day-to-day portfolio management decisions to someone.

Belief in Skill

This scale is used to determine how much you believe it is worth paying for an investment professional's potential to achieve above-market returns.

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