

For professional investors only

Schroders

Global Market Perspective

Economic and Asset Allocation Views Q1 2009



Schroders

Introduction
– Market
slump
prompts
less
negative
stance on
risk assets

Equity and credit markets went from bad to worse during the fourth quarter such that the S&P500 now looks set to record its second worst calendar year performance since 1871. The fall out from the bankruptcy of Lehman Brothers in September was far greater than imagined, resulting in a sharp rise in risk aversion.

Investors fled to cash, driving the interest rate on US Treasury bills to zero and even negative at one stage. Meanwhile, government bond yields around the world fell to their lowest levels for fifty years. The drive for liquidity led to the wholesale dumping of risk assets with hedge funds under particular pressure to cut their leverage and meet redemptions. Gold returned to vogue, but commodity prices generally plummeted with crude oil falling below \$50 per barrel having been above \$140 only in July.

The flight to safety was given added impetus by the news that much of the world economy had fallen into recession. Business surveys showed that firms were slashing output and employment aggressively. In response, central banks have cut interest rates sharply with the Federal Reserve in the US openly discussing means of reducing interest rates on Treasury bonds and Mortgage Backed Securities. Fiscal policy is also being deployed to boost growth with a series of tax cuts being announced or promised around the world. Government's have also taken stakes in banks in an attempt to restore Tier 1 capital ratios to pre-crisis levels.

Against this backdrop, the challenge for asset allocation has been to assess whether the deterioration in the outlook has been adequately matched by the fall in value of risk assets. In our view equity and credit markets are now discounting a major slump in economic activity and while this is still a risk it is not our central case. There is scope for positive surprises on growth given the scale of policy action and low level of sentiment. Consequently, we have moved from an underweight to neutral position on equities and remain overweight credit. Overall, we have become slightly less negative on risk assets, however, we remain defensively positioned within equities preferring the US to the more cyclical, higher beta Emerging or European markets.

Keith Wade, Chief Economist and Strategist, Schroders

Contents

Global Asset Allocation Committee and Cyclical Market Forum	2
Asset allocation – Global Overview	3-5
Economic view – Executive Summary	6
Economic outlook – Central View: Global Recession	7
Economic outlook – Alternative 1: Recovery	8
Economic outlook – Alternative 2: Slump	9
Strategy View	10-16
Regional Equity Views – Key Points	17
Equity Markets	18-23
Fixed Income – Key Points	24
Fixed Income – Bond Markets	25-26
Alternatives – Key Points	27
Alternatives – Hedge Funds, Commodity, Property & Private Equity	28-31
Appendix - Quantitative Framework	32-33
Disclaimer	Back Page

Global Asset Allocation Committee

Members



Alan Brown
Chief Investment Officer



Simon Doyle
Head of Fixed Income and
Multi-Asset, Australia



Keith Wade
Chief Economist and Strategist



Johanna Kyrklund
Head of Multi-Asset,
World ex Asia



Richard Coghlan
Head of Hong Kong Multi-Asset

Cyclical Market Forum Committee

Generalists



Nicholas Gartside
Global Head of Fixed Income



Virginie Maisonneuve
Head of Multi-Regional
Equities

Alan Brown and **Keith Wade** are also on this committee.



Robert Farago
Head of Multi-Asset,
Private Bank

Asset Allocation

Global Overview

Economic View: World economy slips into recession

Since the last quarter, the global economic environment has continued to deteriorate, with central banks slashing interest rates further while governments have been quick to put together significant fiscal stimulus measures. Against that, we have trimmed back our growth forecasts further, with the world economy likely to slip into recession in 2009.

Much of the slowdown is expected to emanate from the OECD where annual growth is expected to fall by 1% — its worst year of growth in the post war period. Emerging markets should fare a little better at 3.5%, but still experience their weakest year since the Asian crisis. However, we should see a subdued recovery coming through in 2010, as policy action starts to feed through to the real economy, but the ongoing de-leveraging in the banking system will continue to act as a major headwind on the global economy.

On the inflation front, we expect CPI to continue to fall sharply, helped by lower commodity prices and the slack created by the downturn. This, in turn, should result in interest rates worldwide declining further and staying low for an extended period. In the US, the Federal Reserve's (Fed) dramatic move to cut rates to near zero and its commitment to use 'all available tools to promote the resumption of sustainable economic growth' confirms that we are moving into the realm of quantitative easing.

Across the Atlantic, we also expect the European Central Bank (ECB) and the Bank of England (BoE) to cut interest rates further with the risks for growth on the downside. Meanwhile, the Bank of Japan is expected to keep rates unchanged at 0.1% throughout 2009.

The marked change in central banks' attitude reflects the intensification of the credit crunch post the bankruptcy of Lehman Brothers and the downturn in inflation. Indeed, a fear of deflation now seems to be at the forefront of policymakers' minds. Recognising that this would cause monetary policy to lose its effectiveness, central banks are acting aggressively to support activity. The ongoing credit crunch / de-leveraging process means that they are fighting against a considerable drag on demand.

Implications for Markets

Our cyclical asset allocation model remains in the recession phase — a stage that is usually good for risk assets in general. However, we remain cautious given that monetary policy is still struggling for traction, thus limiting earnings visibility and presenting a hurdle for a recovery in equities and risk assets in general. However, there is undoubtedly significant value to be found in equity markets so we have moved to a neutral position in the belief that policy action should support markets in the months ahead.

That said, our positioning in risk assets is mainly via an overweight in investment grade and high yield bonds given that there are reasons for thinking credit may lead in the current cycle. For example, we have emphasised the importance to a recovery in risk assets of the policy transmission mechanism working such that lower rates at the central bank feed through to the real economy. One of these channels is the money and credit markets, and this appears to be the focus of Fed policy. This suggests that a recovery in credit markets may be a pre-requisite for a recovery in equities.

Asset Allocation

Global Overview (continued)

Intra-Regional Equity Market Views

The US remains our most preferred market, underpinned by its defensive qualities. The determination of the Fed to improve the monetary environment through cutting interest rates aggressively and introducing various measures to improve liquidity in the market suggests that the US will be one of the first to emerge from the crisis. Valuations also remain attractive.

We remain neutral on UK equities. While the economy continues to deteriorate, the recent weakness in sterling and the likelihood of further interest rate cuts should provide some support. Dividend yields are also currently above gilt yields, suggesting that equity valuations are looking relatively cheap. The UK, however, remains the least favoured market to overweight amongst international investors. In contrast, the somewhat cyclical and high beta nature of the European market suggests that equities look particularly vulnerable to a deterioration in the economic fundamentals. Furthermore, revisions to prospective earnings growth in the region continue to disappoint, keeping us cautious on European equities.

Elsewhere, emerging markets remain susceptible to further weakness in the global economy as well as falling commodity prices. Investors' sentiment towards the region has also soured in recent months, such that it is no longer the most favoured place to overweight amongst investors, while revisions to prospective earnings continue to trend downwards. We remain underweight, though we are more optimistic about emerging Asia where economies have stronger balance sheets, are more broad-based and less exposed to commodity production.

Over in Japan, we remain neutral. Although Japan does not face the same structural problems as the rest of the developed world, it is still heavily exposed to the global economy. Prospective earnings continue to be downgraded, but the extent of the revisions is not as large compared to other markets. Judging by recent investor surveys, Japan is also one of the most preferred equity markets to overweight relative to its peers.

Intra-Sector Bond Views

We remain positive on bonds, with a preference for investment grade, high yield and inflation-linked over conventional government bonds. Government bonds have continued to rally over the past month on global recessionary fears, but they appear unconvincing on valuation grounds. On the other hand, investment grade and high yield valuations are looking attractive given that spreads are at historically wide levels. Although there is the risk of spreads widening further, we believe that the market has discounted most of the bad news. We have turned positive on index-linked bonds, which have been oversold on deflation fears, and now offer attractive real returns.

Other Assets

Our cautious stance on commercial property, hedge funds and private equity remains in place. We are also negative on commodities given the gloomy prognosis for the world economy, particularly with China joining the slowdown. In contrast, we are positive on infrastructure, as governments across the world are likely to increase their infrastructure spending in order to prop up faltering growth.

Asset Allocation

Global Overview (continued)

Currencies

The co-ordinated easing of monetary policy by global central banks has had limited impact on interest rate differentials. Carry trades have been unwound, with high yielding currencies enduring most of the falls as investors have moved to the perceived safety of currencies such as the yen and the Swiss franc. The US dollar has also benefited from the general trend of risk reduction, falling commodity prices and the impact of the slowdown in the emerging markets. However, we think that this rally looks overdone for now. The outlook on the pound sterling remains poor given the twin deficit problem facing the economy.

Asset Allocation Grid

Equity	0			Bonds	++	Alternatives	--	Cash	0
By region		By Style		By Sector		By Sector			
US	++	Small	0	Government	-	Property	--		
Europe ex UK	--	Large	0	Inflation-Linked	+	Commodities	-		
UK	0	Value (UK)	+	Investment Grade Corporate	++	Infrastructure	+		
Pacific ex Japan (Australia, New Zealand, Hong Kong & Singapore)	0			High Risk: Emerging market debt High yield	0 +				
Japan	0								
Emerging Markets	-								

Currencies	
USD	0
GBP	-
EUR	-
JPY	0
CHF	+
AUD	0
EM	-

Key: +/- market expected to outperform/ underperform (maximum +++ minimum ---) 0 indicates a neutral position.

The above asset allocation is for illustrative purposes only. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability and riskiness of individual asset classes in different regions. For alternatives, due to the illiquid nature of the asset class, there will be limitations in implementing these views in client portfolios.

Economics

Executive Summary

Introduction

Each quarter we present three alternative scenarios. These are debated and a central scenario is adopted. Our current central view is that a global recession is the most likely outcome for the world economy over the next 12 months. In terms of the risks around this view, the main threat to our forecasts is a slump scenario where there is downward spiral in activity and the US experiences deflation. The other key risk is that we enter a recovery scenario where policy traction to the real economy is more rapid such that confidence returns and growth is revived.

Central View: Global recession

The world economy is expected to be in recession in 2009 with the majority of the OECD economies experiencing the worst year for growth in the post war period. Against this backdrop, as we move into 2009, global inflation is expected to fall sharply helped along by lower commodity prices. Central banks worldwide are assumed to ease policy further with interest rates falling to record lows in the US and UK.

Alternative 1: Recovery

Activity in the world economy is expected to be weak in 2009, however, global growth makes a come back by 2010. In this scenario, the impact from various measures by central banks and fiscal policy worldwide is more rapid than expected. This leads to confidence returning to the markets, which in turn boosts credit creation. However, the revival in growth prospects of the world economy comes at the expense of the unwanted rise in inflation.

Alternative 2: Slump

The credit crunch continues to be a drag on global activity as consumers and corporates are forced to retrench. The downward spiral in activity eventually results in a global slump. Policy easing has little effect on activity as interest rate cuts by central banks are offset by headwinds from de-leveraging. Facing a similar experience to Japan in the early 1990s, akin to a liquidity trap, the response of central banks is to cut policy rates dramatically and use unconventional means to support activity.

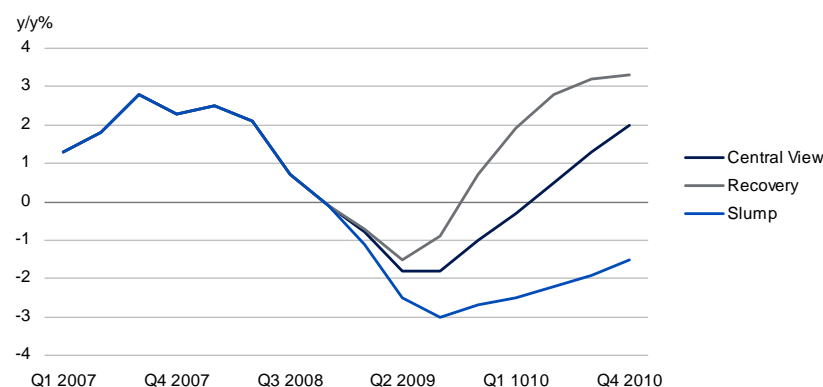
Economic central and alternative views – global summary

	2008	Central View		Recovery		Slump	
		2009	2010	2009	2010	2009	2010
Growth	2.5	0.1	1.8	0.8	3.4	-1.0	-0.9
Inflation	4.7	1.7	2.3	2.0	2.7	1.0	1.2
Interest Rates*	1.2	0.9	1.6	2.0	4.0	0.4	0.1

Key: Growth – GDP y/y%, Inflation – CPI y/y%, interest rates – 3 month, %.

*Q4 interest rate, OECD average

US GDP Profile: Central view and scenarios



Source: Schroders

Economics

Central View: Global Recession

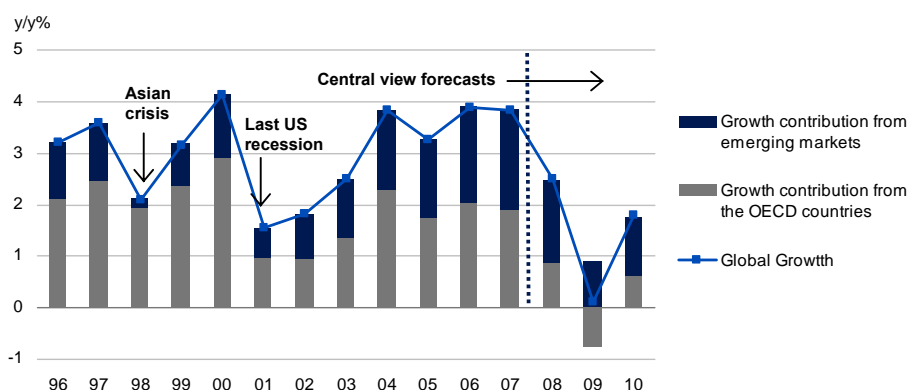
GDP y/y%	2009	2010
US	-1.4	0.9
UK	-2.0	0.5
Eurozone	-0.7	0.8
Japan	-0.6	0.8
Australia	1.5	2.0
OECD	-1.0	0.8
China	7.0	8.0
Emg mkts	3.5	4.5
World	0.1	1.8
CPI y/y%	2009	2010
US	0.9	1.9
UK	2.0	1.5
Eurozone	2.0	2.0
Japan	-0.2	0.4
Australia	0.0	2.2
OECD	1.2	1.7
China	3.0	4.0
Emg mkts	3.4	4.0
World	1.7	2.3
In. rates %	2009	2010
US	0.25	1.00
UK	1.50	2.50
Eurozone	2.00	2.50
Japan	0.10	0.50
OECD	0.93	1.57

All figures are calendar year average, except interest rates which are end year

The return of the "R" word

The world economy is expected to be in recession in 2009 with the majority of the OECD economies experiencing the worst year for growth in the post war period. Although emerging markets should fare a little better, we believe that they will face their weakest year since the Asian crisis of 97 (chart).

Worst year for OECD GDP



Source: IMF, Consensus Economics, Schroders

In the US, we assume that growth will be hit in 2009, as the credit crunch forces a de-leveraging of household and corporate balance sheets. Although, tax cuts and lower inflation should lift consumer spending in the second half of the year. A modest sub par recovery is expected by 2010 as the credit crunch eases and monetary policy begins to take effect.

Amongst the OECD, the UK is forecast to experience the greatest fall in GDP next year, a reflection of the scale of adjustment required in the housing and debt markets. Growth forecasts for the Eurozone and Japan have also been cut in 2009, largely to reflect weaker external demand although both are affected by the credit crunch to some extent. For the emerging markets, growth is hit by weaker external demand and pressures on those economies with balance of payments deficits.

Against this backdrop, global inflation is expected to fall sharply helped along by lower commodity prices. Although Inflation picks up in 2010 in line with higher commodity prices, core rates drift lower as slower growth creates slack and squeezes pricing power. Meanwhile, central banks worldwide are assumed to ease policy further with interest rates falling to record lows in the US and UK. Efforts to free up money markets continue, while the forecast of weak growth and lower inflation means rates stay lower for longer than expected. OECD rates do not return to current levels until the end of 2010.

Implications for markets

Given the current level of markets, a recovery albeit modest, would support a rally in risk assets (see strategy view for more details).

Economics

Alternative 1: Recovery

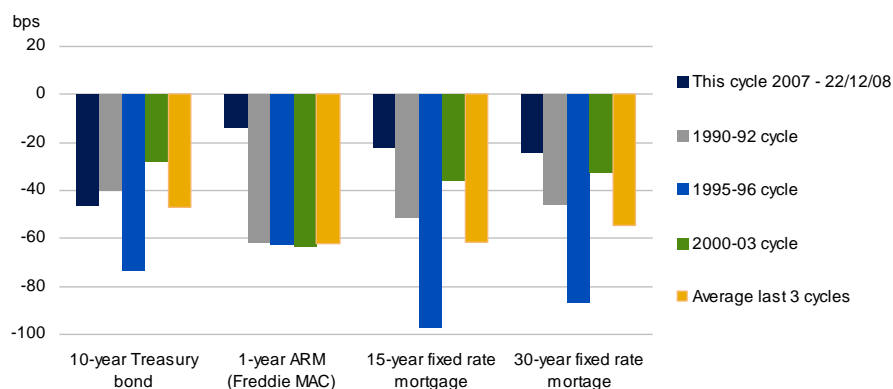
GDP y/y%	2009	2010
US	-0.6	2.8
UK	-1.2	1.5
Eurozone	-0.4	2.3
Japan	0.0	1.8
Australia	2.2	3.0
OECD	-0.4	2.4
Emg mkts	4.5	6.5
World	0.8	3.4
CPI y/y%	2009	2010
US	1.0	2.9
UK	2.3	1.8
Eurozone	2.3	2.3
Japan	0.1	0.7
Australia	3.7	2.7
OECD	1.5	2.3
Emg mkts	3.4	4.0
World	2.0	2.7
In. rates %	2009	2010
US	2.00	5.00
UK	2.25	4.50
Eurozone	2.50	3.75
Japan	0.50	1.00
OECD	1.98	3.96

All figures are calendar year average, except interest rates which are end year

Policy makers succeed in regenerating growth

The combination of interest rate cuts, special liquidity provisions, asset purchases by central banks and fiscal policy serve to boost growth worldwide. Policy traction becomes visible with the easing of bank lending conditions and mortgage rates (chart). Confidence rises and rather than a downward spiral, the global economy moves into a virtuous circle as rising markets support the balance sheets of banks. This facilitates further credit creation.

Fed easing starts to make an impact



Note: Response of bond yields and mortgage rate to 100bps of Fed easing. Source: Thomson Datastream, Schroders

Given the very weak starting point, average growth in 2009 is likely to be poor with the US and UK experiencing mild recessions. However, by the end of the year, global growth is accelerating and by 2010 has returned to trend at 3.4%. Growth in the emerging markets is also expanding at more than 7% in Q4 2010.

However, the downside of this is that the improvement in inflation is confined to 2009 as stronger growth eventually drives prices higher. Against this backdrop, commodity prices are expected to rise more rapidly. After falling to 2% in 2009, global CPI inflation rises to nearly 3% in 2010.

On the monetary policy front, central banks worldwide have to start backpedalling to reverse the earlier stimulus put in place. After initially cutting interest rates, the Fed, BoE and ECB begin to tighten again in 2009. By the end of 2010, interest rates have risen back to previous highs as central banks lean against the pick up in inflation.

Implications for markets

The return of growth is likely to stimulate an increase in risk seeking behaviour. Equities and credit are likely to rally strongly whilst government bonds sell off.

Economics

Alternative 2: Slump

GDP y/y%	2009	2010
US	-2.3	-2.0
UK	-2.8	-2.0
Eurozone	-1.7	-1.7
Japan	-1.6	-1.2
Australia	-0.5	-0.5
OECD	-2.0	-1.8
Emg mkts	2.0	1.5
World	-1.0	-0.9
CPI y/y%	2009	2010
US	-0.4	0.4
UK	1.5	1.0
Eurozone	1.5	0.5
Japan	-1.0	-0.4
Australia	1.7	0.7
OECD	0.4	0.4
Emg mkts	2.9	3.5
World	1.0	1.2
In. rates %	2009	2010
US	0.00	0.00
UK	0.50	0.25
Eurozone	1.00	0.25
Japan	0.10	0.00
OECD	0.40	0.11

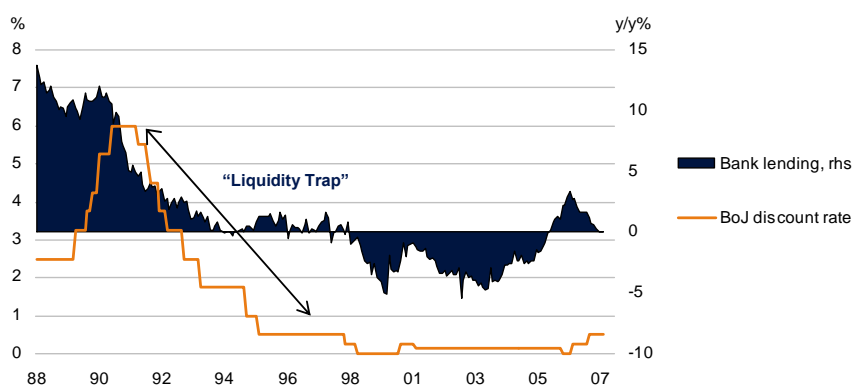
All figures are calendar year average, except interest rates which are end year

Multi-year fall in output and deflation in the US

The credit crunch drags on as higher unemployment and an increase in defaults prompts banks to tighten lending conditions further. This results in further weakness in the global economy and a downward spiral in activity as consumers and firms are forced to retrench. Although all economies are weak, the worst affected are the US and UK given the high level of debt in these economies.

In response, central banks worldwide reduce interest rates aggressively with the Fed looking at other means of supporting activity through unconventional policies such as quantitative easing. At the same time, fiscal policy is eased, but the headwind from de-leveraging offsets this resulting in a slump. In effect, the desire to hoard cash means that policy has little effect and the economy falls into a liquidity trap. This is similar to the experience of Japan in early 1990s where interest rate policy was ineffective at boosting growth (chart).

The experience of Japan in the 1990s



Source: Bloomberg

While growth in the emerging region is expected to remain in positive territory, it is significantly weaker when compared to historical standards. Hence, global output dips by 1% in 2009. The main difference between this scenario and the central view is that activity remains weak in 2010 falling by another 1% and there is no recovery.

In this environment, inflation drops sharply with global CPI inflation falling to 1% as oil prices drop below \$40 per barrel. The weakness of activity provides a further drag on inflation such that the US and Japan fall into deflation in 2010.

Implications for markets

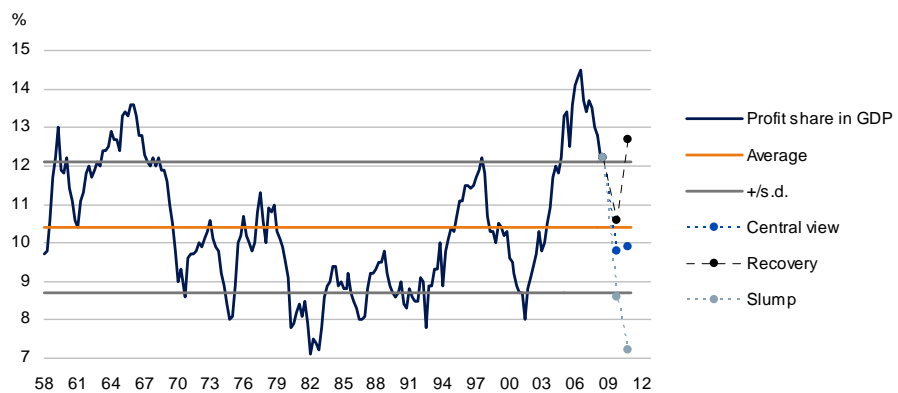
Government bonds are the preferred asset, as weaker growth will undermine equities and credit.

Strategy View: Market implications of the central view & scenarios

In this section, we assess the impact of the different economic scenarios on earnings and valuations. We also look at the implications of deflation and give our view on the timing for a recovery in risk assets.

In the central view, the US profit share falls sharply in 2009 before stabilising in 2010 at around 10%. This would leave earnings per share (eps) nearly 25% lower than today by the end of 2010. In the recovery scenario, we get a similar fall in year 1 of the forecast, but then a bounce back in 2010. With the economy growing at an above trend rate the profit share and eps end the period above its current level. Finally the slump scenario results in a halving in eps over the next two years as the profit share hits levels last seen in the recession of the early 1980s.

US profit share projections



Source: Thomson Datastream, Schroders

These forecasts and the implications for valuations are shown in table below. Assuming the market remains at its current level, under the central view the price earnings ratio (PE) rises to 23.2 by the end of 2010, falls to 16.8 in the recovery and rises to 33.7 in the slump.

Table: S&P500 eps and PE rating under different scenarios projections

	EPS			PE		
	Today	End '09	End '10	Today	End '09	End '10
Base	100.0	80.9	75.5	18.9	21.6	23.2
Recovery	100.0	86.8	103.9	18.9	20.1	16.8
Slump	100.0	72.3	51.9	18.9	24.2	33.7

PE based on S&P500 level of 870 as at 4th December 2008

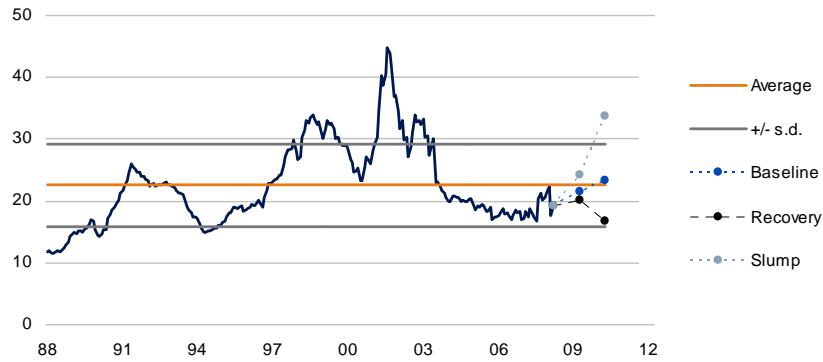
Source: Schroders

The US equity market is only 'expensive' on the slump scenario

Putting these in context, relative to the past 20 years the central view puts the PE in the middle of its range and the recovery one standard deviation below average (chart on next page). By contrast, the PE under the slump goes into expensive territory. Adjusting these results for inflation, does not alter this conclusion (chart on next page).

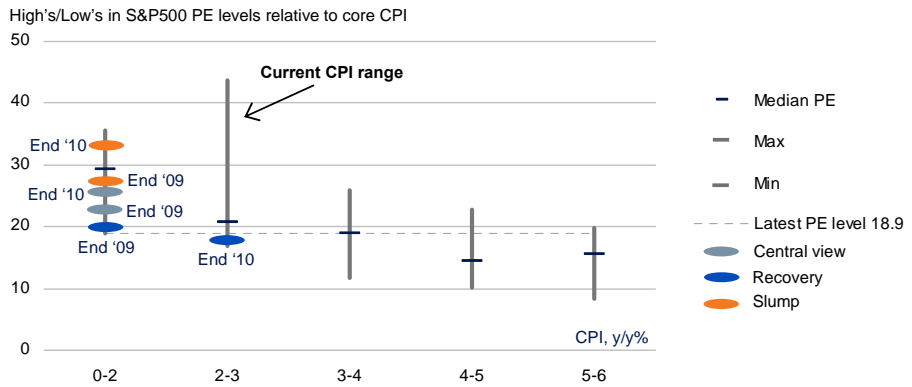
Strategy View (continued)

US S&P500 PE projections



Source: Thomson Datastream, Schroders

US S&P500 PE versus US core CPI



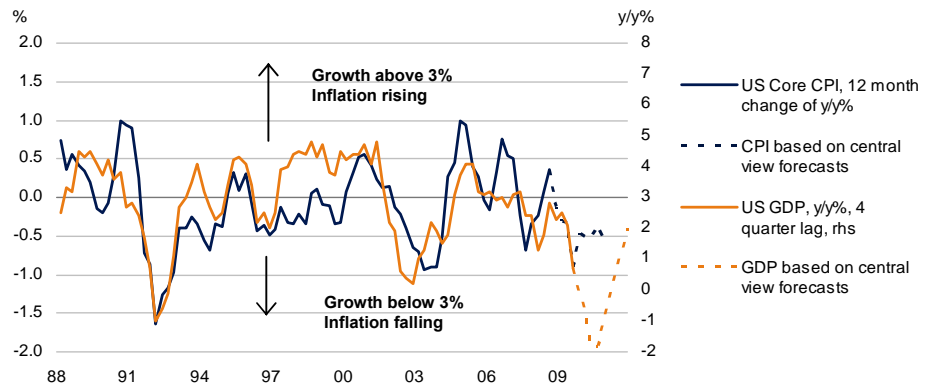
Note: Here we are assuming that the S&P500 price level is at 870.
Source: Thomson Datastream, Schroders

In our cyclical model, the recession (disinflation) stage of the cycle is characterised by a re-rating of equities, so that the central and recovery scenarios are plausible if not conservative. However, it is unlikely that the market would tolerate a PE above 30, as in the slump, indicating further downside for the equity market in this scenario.

An important characteristic of the slump is the move into deflation. We believe this could become a theme in the markets next year. Much of the fall in inflation next year will come from the base effect of lower food and oil prices and as such lower inflation acts as a tax cut. Our concern is that the weakness of growth is consistent with a greater fall in core inflation (CPI excluding food and energy) than is currently built into our forecast (chart on next page).

Strategy View (continued)

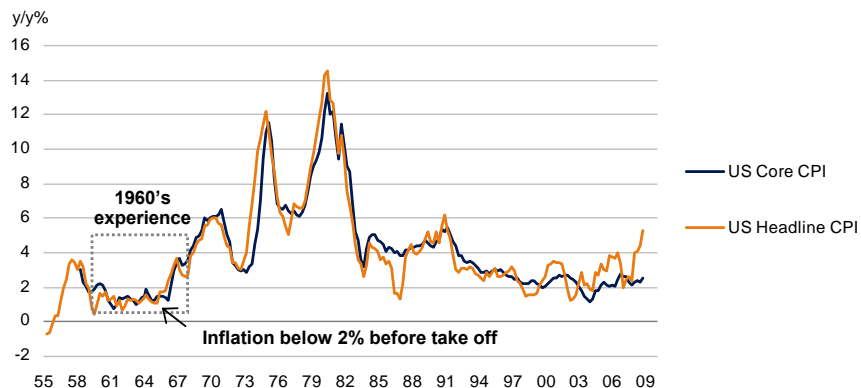
Growth and inflation trade-off in the US



Source: Thomson Datastream, Schroders

Looking further out, we still believe there is a risk of inflation due to the pressure from higher government spending and debt as well as the continued growth of the emerging economies. This suggests a scenario for the US and world economy which is similar to the US in the 1960s (chart). On this basis US TIPs would be extremely good value, given that they are currently discounting an extended period of deflation.

Headline and core inflation, 1955-2008



Source: Thomson Datastream, Schroders

Equity sectors in deflation: the Japanese experience

The poor growth outlook in the slump accounts for much of the fall in profits, but the decline is exacerbated by the move into deflation, which puts added pressure on corporate margins. Companies with limited pricing power would suffer badly in this environment and it was noticeable that in Japan (the last major economy to experience deflation) small firms have underperformed large for a considerable period.

Whilst the Japanese equity market enjoyed a number of rallies during the deflation of the 1990s, the only asset to consistently perform has been JGB's (Japanese Government Bonds). The large exporters did well as this was the main source of growth in an economy where domestic demand is subdued. Sectors dependent on credit suffered, as of course did the banks.

Strategy View (continued)

Timing the recovery in risk assets

At some point in every downturn, investors gain enough confidence to look beyond the immediate downturn to the recovery beyond. However, with widening of credit spreads and the worst equity market declines since World War II, this prospect appears to be some way off. In the past, the conversion from cynicism to hope usually came at the moment of “maximum gloom.”

Traditionally, this moment has been a signpost pointing to economic renewal. Our research of major bear markets where eps have fallen significantly shows that in nine of the ten downturns since 1900, market turnarounds have preceded economic turnarounds. We found an average lag of 11 months between the trough in the Standard & Poor’s 500 and the trough in earnings. The one exception was when the 2003 economic turnaround led the market by five months, but that was attributed to unique circumstances including the tension created by the build up to the Iraq war (see table at end of note).

In this cycle, however, there have been so many potential points of maximum gloom, each of which has been superseded by another point of maximum gloom. Hence, it is difficult to say when, or if, pessimism will bottom out. It did not occur in March when Bear Stearns collapsed, or in September, when Lehman fell, or, more recently, the government bailout of Citigroup. It appears that the moment of maximum gloom will only become clear in hindsight.

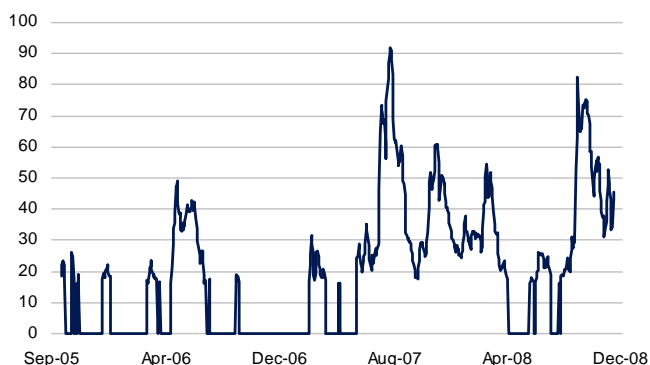
For most of the last 100 years, markets have bet on monetary policy doing its job. The problem in the current cycle is that monetary policy is struggling for traction. The central banks have reduced their policy rates such as the Fed funds in the US, but there has been little impact on the economy because banks are not passing on rate cuts to their customers. Had they done so we would have seen the first signs of recovery around September 2008.

The transmission mechanism is not working and after more than \$900 billion of write-offs, banks in the US and Europe are focussed on conserving capital and rebuilding their balance sheets. To do this they are looking to increase their margins and raise the quality of their assets rather than expand the loan book. They have rediscovered risk, but such action is offsetting the efforts of the central banks to reduce the cost of borrowing.

This dislocation is borne out by fluctuations in Schroders’ panic index (chart on next page), which captures the stress in money and credit markets as well as volatility across equity and fixed income. Having eased a little recently, the index is now heading back towards the levels experienced in the wake of the bankruptcy of Lehman.

Strategy View (continued)

Schroders Panic Index - 02/12/08



Source: Schroders

From a macro perspective, the panic index signals that the cost of capital to companies and households remains high. Since the market sets the price for a range of loans, we know that the cost of all credit remains tight, a view confirmed by surveys of bank lending from the Federal Reserve, European Central Bank and Bank of England.

To regain control of the cost of capital the authorities are set to bring in unconventional policy measures. For example, the Fed is about to start buying asset backed and mortgage backed securities, and they have also discussed buying long dated US Treasury bonds.

Mortgage rates are starting to respond with fixed rates coming down, but the impact has been far less than in previous cycles (chart on page 8). Nonetheless, the level of 30-year mortgage rates is such that we could see a wave of refinancing in coming months. Estimates from Morgan Stanley suggest that 90% of holders of these loans would benefit from refinancing at current rates. In the past, this has been an important part of the monetary transmission mechanism and should help in this cycle. However, it is quite likely that a large chunk of any saving from lower mortgage rates is used to pay down existing debt rather than increase spending.

Strategy View (continued)

Equity versus credit

There has been some debate as to whether equity will recover ahead of credit or vice-versa. In theory, there is no particular reason why one should lead. Being further down the capital structure, equity is more risky, but that should only imply a higher return over the long run, not a lead over credit. Nor does it imply that equity should outperform in every period.

The historical evidence is in favour of equity, but only just. Using figures on the performance of equities and credit coming out of 16 official NBER (National Bureau of Economic Research) recessions since 1919, the median lead of equity is four months while credit leads by three.

This encompasses a wide range of experience with equities lagging the end of the recession by as much as 15 months (in the last recession) and leading by the same amount in the 1919 episode. The range around credit is consistently tighter and credit always recovers before the end of the recession. However, in a straight race, equities recover ahead of credit on 8 occasions while credit leads equity on 5, there were three ties. Note that post war, equities tended to beat credit, whereas pre-war the opposite was the case.

Table: Equities and credit coming out of recession

End of recession	Recession duration in months	Equities		BAA - 10yr spread		Hit rate
		Mths leads (-) or lags (+) from end of recession	Peak to trough % change	Mths leads (-) or lags (+) from end of recession	Spread at cycle peak in %	
Nov.2001	8	+15	-30	-1	3.36	Credit
Mar. 1991	8	-5	-16	-2	2.56	Equity
Nov. 1982	16	-4	-20	-1	4.05	Equity
Jul. 1980	6	-4	-10	-3	3.44	Equity
Mar. 1975	16	-7	-38	-2	3.37	Equity
Nov. 1970	11	-5	-29	-1	2.11	Equity
Feb. 1961	10	-4	-13	-7	1.32	Credit
Apr. 1958	8	-4	-15	-4	1.82	-
May. 1954	10	-8	-9	-4	1.23	Equity
Oct. 1949	11	-3	-13	-2	1.58	Equity
Oct. 1945	8	No obvious data	N/A	-3	1.63	-
Jun. 1938	13	-2	-40	-2	3.92	-
Mar. 1933	43	-9	-97	-9	7.24	-
Nov. 1927	13	-2	-7	-5	2.21	Credit
Jul. 1924	14	-2	-13	-9	3.06	Credit
Jul. 1921	18	+1	-41	-3	3.29	Credit
Mar. 1919	7	-15	-35	-1	2.5	Equity
Median	11	-4	-18	-3	2.56	

Source: Royal Bank of Scotland (RBS), Schroders

Strategy View (continued)

Given the small sample though, this is not a conclusive result and in our own cyclical model we have found no significant difference between the performance of the two assets in the Schroders defined recession phase of the cycle. The difference occurs later, in the expansion phase, where equities outperform credit (table).

Table: Asset performance by stage of the cycle

Phase/Asset	Statistics	Recovery	Expansion	Slowdown (Stagflation)	Recession (Disinflation)
Equity	Excess returns*	8.6	8.8	-8.1	9.9
	Volatility	13.7	12.4	17.4	14.6
Government Bonds	Excess returns*	1.3	-1.0	-0.2	1.7
	Volatility	6.9	4.7	8.7	8.8
High Yield	Excess returns*	6.4	1.8	-10.3	11.6
	Volatility	6.4	4.0	9.8	8.5
Investment Grade	Excess returns*	3.8	-0.1	-4.2	5.1
	Volatility	6.0	4.2	9.9	8.0

*All risk return figures are in % and annualised for each phase of the cycle. Risk return numbers are relative to cash.

Data: Equity S&P 500 TR & US 10yr Govt. bonds from 1950 to 2008, Lehman US High Yield from 1983 -2008, Lehman US Corporate Investment Grade from 1973 -2008.

Source: Thomson DataStream, Schroders

In the current cycle there are reasons for thinking credit may lead. For example, we have emphasised the importance to a recovery in risk assets of the policy transmission mechanism working such that lower interest rates at the central bank feed through to the real economy. One of these channels is the money and credit markets and, as discussed above, this now seems to be the focus of Fed policy. This suggests that a recovery in credit markets may be a prerequisite for a recovery in equities.

Regional Equity Views

Key Points

++	US	<ul style="list-style-type: none"> - We continue to favour the US, underpinned by its defensive qualities. Relative to other regions, the US is a low beta market and has greater exposure to defensive sectors. - The determination of the Fed to improve the monetary environment through cutting interest rates aggressively and introducing various measures to improve liquidity in the market suggests that the US will be one of the first to emerge from the crisis. - Investors' sentiment towards the region remains elevated compared to history. At the same time, US equities remain the distinctly favoured region to overweight by institutional investors - While the US market has seen downgrades to its prospective earnings, it looks attractive relative to other markets that are expected to have even weaker outlook on earnings
0	UK	<ul style="list-style-type: none"> - While the economy continues to deteriorate, the recent weakness in sterling and the likelihood of further interest rate cuts should provide some support. - Dividend yields are currently above gilt yields, suggesting equity valuations are looking cheap relative to bonds. - UK remains one of the least preferred regions to overweight amongst institutional investors.
--	Europe ex UK	<ul style="list-style-type: none"> - The somewhat cyclical and high beta nature of the European market suggests that equities look particularly vulnerable to a deterioration in the economic fundamentals. - Revisions to prospective earnings growth in the region continue to disappoint, and it is the least compelling relative to other markets - Investors' sentiment towards Europe ex UK remains bearish and is now the least favoured region to overweight.
0	Japan	<ul style="list-style-type: none"> - Although Japan does not face the same structural problems as the rest the developed world, it is still heavily exposed to the global economy. We therefore expect export growth to suffer further compounded by the continued strength in the yen. - Japanese government bond yields are currently below dividend yields, and this suggests that equity valuations are cheap relative to bonds. - Judging by recent surveys, Japan is still one of the most preferred equity markets to overweight relative to its peers.
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	<ul style="list-style-type: none"> - Pacific ex Japan is likely to respond well to a loose US monetary policy, as well as central banks in the region cutting interest rates to the stem the weakness in their economies. At the same time, the decline in commodity prices should feed through into lower inflation rates, which should increase the scope for further monetary easing by these central banks. - Relative to last quarter, prospective earnings growth in the region has continued to trend downwards such that it has turned unattractive relative to other markets. - While there is a real risk to earnings, the region does not face the same financial risks as the West as it has already undergone its own de-leveraging process after the Asian financial crisis.
-	Emerging markets	<ul style="list-style-type: none"> - Emerging markets remain susceptible to further weakness in the global economy as well as falling commodity prices. - Investors' sentiment towards the region has also soured in recent months, such that it is no longer the most favoured place to overweight amongst investors, while revisions to prospective earnings continue to trend downwards. - We remain underweight, though we are more optimistic about emerging Asia where economies have stronger balance sheets, are more broad-based and less exposed to commodity production.

Key: +/- market expected to outperform/ underperform (maximum +++ minimum --) 0 indicates a neutral position

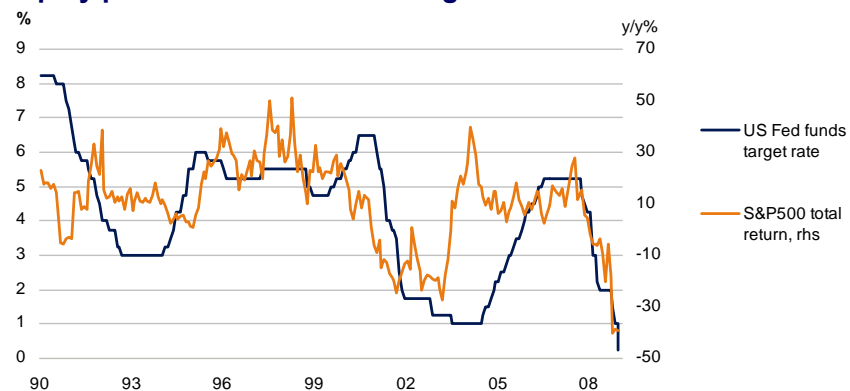
Equity Markets

US

US equities have experienced a volatile quarter with the US Treasury coming to the rescue of one of the largest US banks, Citigroup towards the end of November. Meanwhile, large US automakers Ford, Chrysler and General Motors lobbied the government for a rescue package, as they attempt to head off the prospect of bankruptcy. Such a culmination of events had pushed the S&P 500 index below the 800 level during November. On the macro front, the National Bureau for Economic Research (NBER) declared that the economy had entered recession in December 2007. Looking ahead, we expect that growth in the US to remain weak, as the credit crunch forces a de-leveraging of household and corporate balance sheets. Although, a fiscal package rumoured to be more than \$500 billion (3.5% of GDP) and lower inflation should lift consumer spending in the second half of the year.

US equities look to the Fed

Equity performance and the trough in interest rates

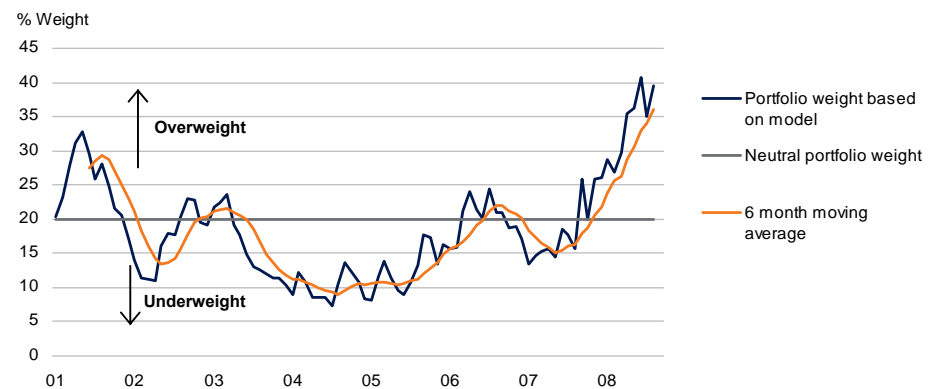


Source: Thomson Datastream

History suggests that US equities tend to rally following a trough in interest rate cuts by the Fed. The latest dramatic interest rate moves seen in the US is likely to be supportive of the market.

US remains the favourite with global investors

Investors' sentiment towards the US



The model is based on responses to the Merrill Lynch Fund Manager Survey and anticipates where funds are likely to flow within the regional equity markets. Source: Schroders

Our model continues to indicate that the US is the distinctly favoured region to overweight by institutional investors. Such that the weight in our sentiment model continued to be elevated compared to history.

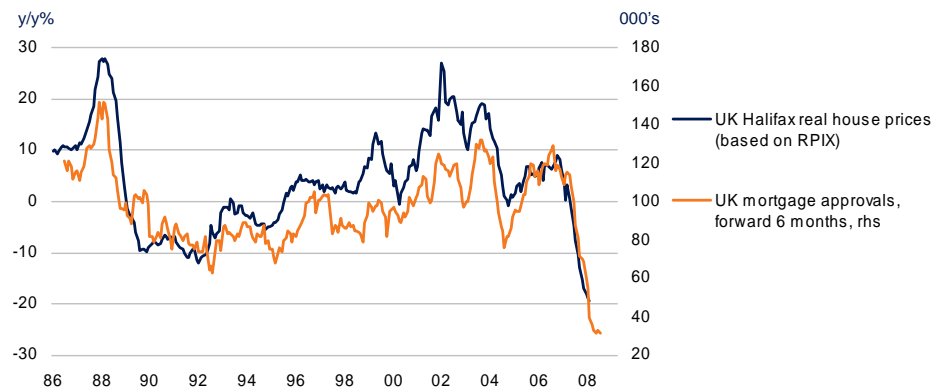
Equity Markets

UK

UK equities have sold-off sharply over the past quarter, as further weakness in the economy and disappointing corporate news have weighed on the market. The FTSE All share index saw the biggest single day fall in mid-November when it approached the lowest level since 2003. Look ahead, the UK is expected to experience the greatest fall in GDP next year amongst the OECD economies. This is a reflection of the scale of adjustment required in the housing and debt markets. However, the UK economy will benefit from a fiscal package of £20 billion (around 1% of GDP) over the forthcoming year. Meanwhile, UK equities appear to be supported by benign monetary conditions as well as attractive valuations. Although an offset to this is that investors' sentiment towards the region continues to be poor. Thus, on balance, we remain neutral on UK equities.

Housing market under pressure

Further adjustments to mortgage approvals signals lower house prices

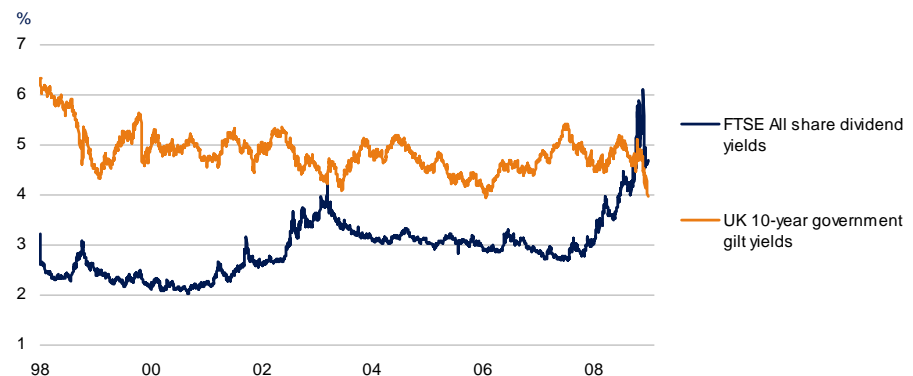


Source: Thomson Datastream, Schroders

Evidence of weakness in the UK economy is most aptly demonstrated by the significant adjustment in the housing market over the past year. Recent mortgage approvals have plunged to an unprecedented 22-year low, which suggests there could be further house price pain to come.

Valuations are looking attractive

Mind the gap - dividend yields and gilt yields



Source: Thomson Datastream

UK dividend yields are currently trading above 10-year gilt yields, which suggest that equity valuations are looking cheap relative to bonds. The last time this has occurred was in 2003, ahead of a sustained period of equity outperformance.

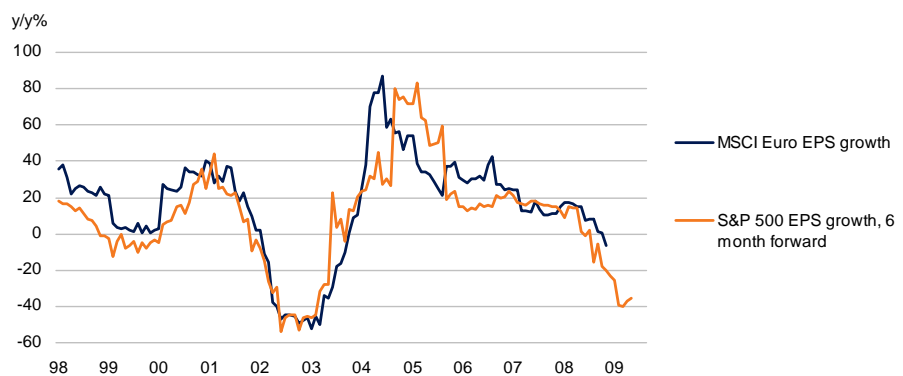
Equity Markets

Europe ex UK

European equities have plunged since the start of September with the MSCI Europe ex UK index down by 28.9% over the quarter. Despite the ECB cutting interest rates and co-ordinated measures by the governments across the region to bailout the banks (such as guaranteeing bank deposits and injecting Tier 1 capital) in October, the market continued to tumble. Meanwhile, the Eurozone has entered recession based on the definition of two consecutive quarters of negative growth. This has coincided with sharp falls in business and household surveys, which confirm the deceleration in the region's activity. The ECB has responded by reversing previous rate hikes in the summer with a slew of cuts taking interest rates to 2.5%. However, relative to other central banks, the ECB has arguably been less forthcoming with monetary easing given their concerns over inflation and its impact on labour costs.

Pessimistic outlook on earnings

Corporate earnings growth in the US and Europe

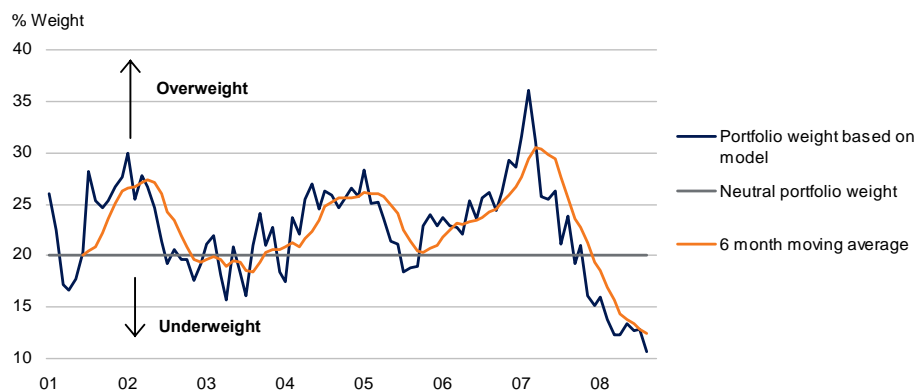


Source: Thomson Datastream

The gap between the growth in labour costs and output prices has narrowed over the quarter. This suggests that profit margins will be squeezed further and therefore extend the slowdown in earnings growth, which has already shown weakness. Reinforcing this view is the sharp fall in earnings growth in the US, which indicates further weakness in European earnings over the forthcoming months.

Sentiment remains poor

Investors' sentiment towards Europe ex UK equities



The model is based on responses to the Merrill Lynch Fund Manager Survey and anticipates where funds are likely to flow within the regional equity markets. Source: Schroders

Judging by the latest surveys, investors' sentiment towards the region has become even more bearish than in the previous quarter, such that the weight derived from our sentiment model has reached an all-time low. Consequently, Europe ex UK is now the least favoured region relative to elsewhere.

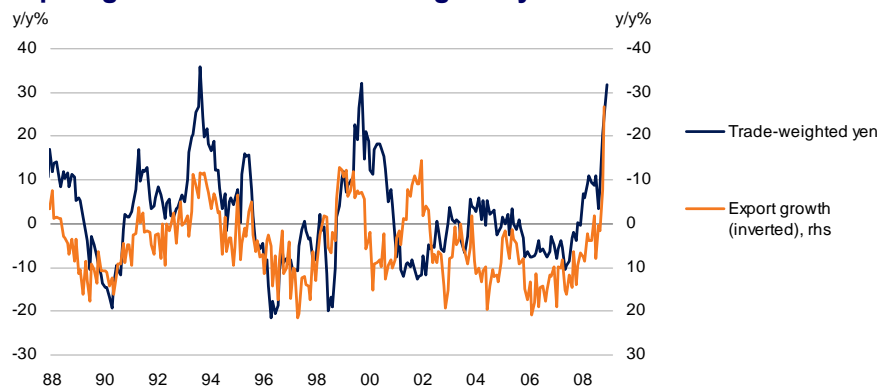
Equity Markets

Japan

The Japanese market has suffered heavy losses over the quarter as concerns over the domestic and world economy, as well as significant earning downgrades from large corporates, hit investors' sentiment. On the domestic front, the Japanese economy entered into a recession after recording two consecutive quarters of negative growth. Although Japan does not face the same structural problems as the rest of the developed world, it is still heavily exposed to the global economy. At the same time, the yen has continued to strengthen as investors unwind the carry trade, while others sought the perceived safety of the currency. Against this backdrop, we have cut our growth forecast for Japan with export growth expected to take a hit. We have already started to see this take shape with recent shipments to China falling sharply at a double digit pace.

The strength in the yen has taken its toll on exports

Export growth and the trade-weighted yen



Source: Thomson Datastream

Relative to last quarter, Japanese export growth has fallen sharply with exports down 26.7% y/y in November. This has coincided with a significant strengthening of the yen as investors look to the currency as a safe haven whilst others unwind the carry trade. Going forward, a stronger yen will not bode well for Japanese exporters.

Relative to bonds, valuations appear cheap

Dividend yields are trading above bond yields



Source: Thomson Datastream

JGBs (Japanese government bonds) are currently trading below dividend yields, and this appears to indicate that equity valuations are cheap relative to bonds. In the past when this has occurred, equities have subsequently tended to outperform.

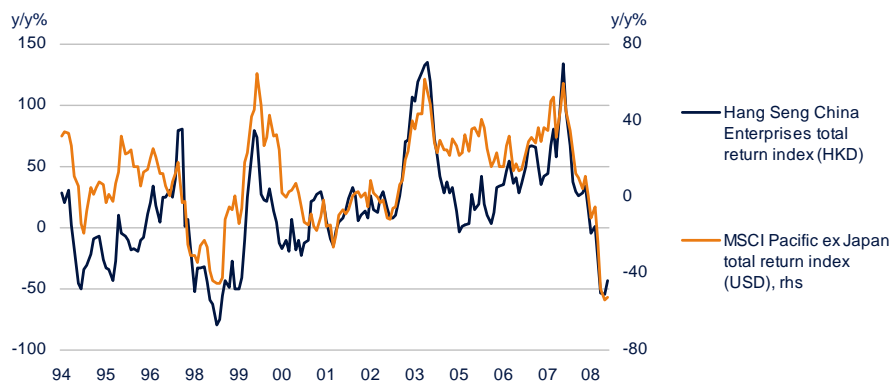
Equity Markets

Pacific ex Japan

Like markets elsewhere, Pacific ex Japan consisting of Hong Kong, Singapore, Australia and New Zealand has succumbed to a similar fate to its peers with market underperformance. Within the region, the markets of Singapore and Hong Kong saw the greatest sell-off compared to New Zealand over the quarter. This has been driven by the culmination of the continued difficulties in the credit markets, and concerns about the deepening recession in the global economy. This aside, the domestic picture in the majority of these economies have significantly weakened over the quarter, with only Australia left to turn out two negative quarters of GDP growth. We expect that the deterioration in activity in the region is set to continue as the downturn in the global economy, particularly the slowdown in China, hits the export-dependent economies such as Hong Kong and Singapore.

Performance in the region vulnerable to headwinds in the China market

Setbacks in Chinese equities hits performance in Pacific ex Japan

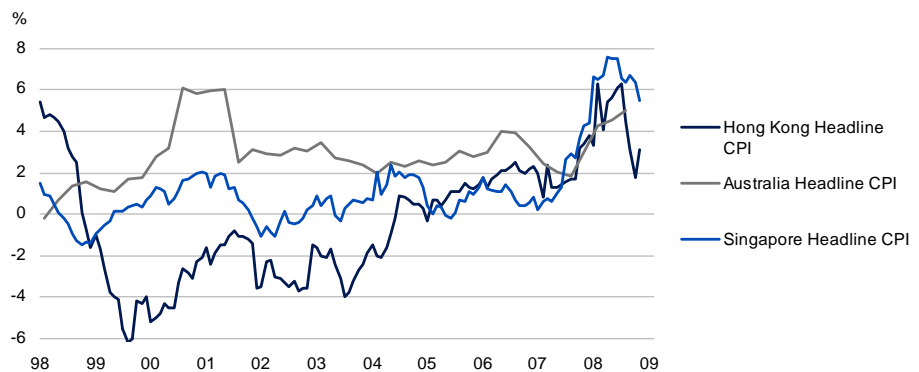


The Hang Seng China Enterprises Index is a benchmark for the stock price performance of the China companies listed in Hong Kong. Source: Thomson Datastream

Recent performance of the Pacific ex Japan has tended to move in a similar fashion to the China market. This suggests that the region is particularly exposed to any reversal of sentiment or economic outlook towards China.

Lower inflation should provide central banks with some extra breathing space and help consumers

Headline inflation rates



Source: Thomson Datastream

The unwinding of commodity prices should start to feed through into lower inflation rates. This should provide central banks in the region with greater scope for further monetary easing and at the same time help consumers.

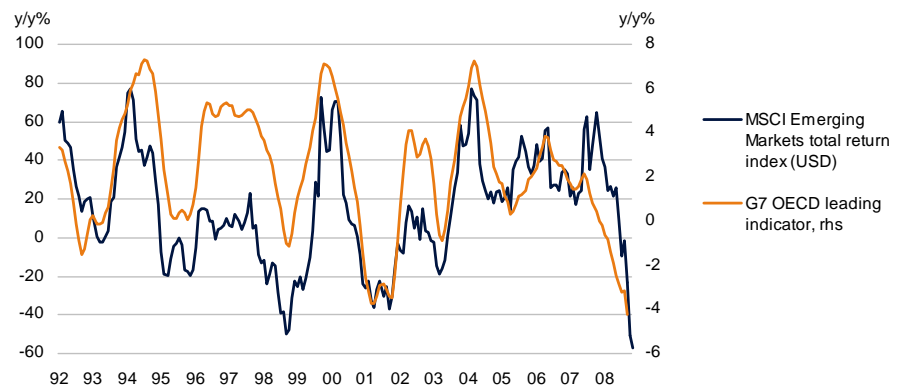
Equity Markets

Emerging

Against a worsening global macro backdrop and an environment of heightened risk-aversion, emerging equities was the worst performer over the quarter. Such that the MSCI Emerging Markets index, in local currency, was down 33.6% from September to the end of November. Meanwhile, MSCI Emerging Europe halved in value over the same period. Looking ahead, we expect growth in the region to fare better relative to their developed peers and remain positive at 3.5%. Nonetheless, the emerging markets could still experience their weakest year since the Asian crisis of 1997. Underlying this view is that the region remains susceptible to further weakness in the global economy as well as falling commodity prices. Although, a positive offset is that inflation should ease and provide the added breathing space for domestic monetary authorities to cut interest rates.

Emerging equities vulnerable to headwinds in global activity

Emerging markets taking the lead from the G7 OECD indicator

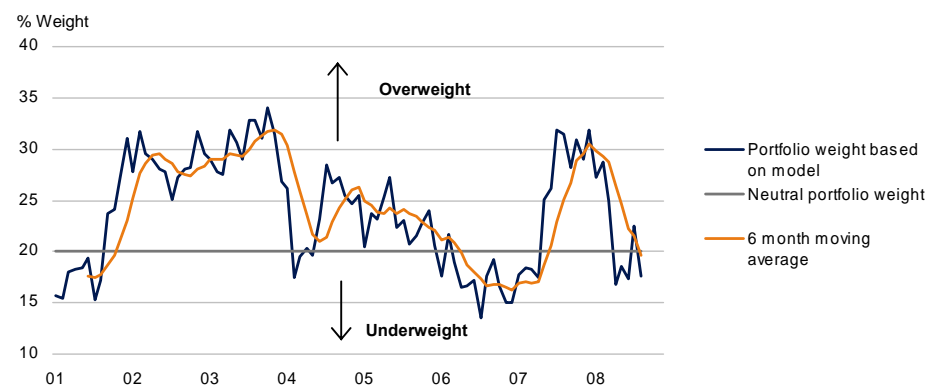


Source: Thomson Datastream

As the re-coupling theme takes centre stage, the performance of the emerging markets is susceptible to further weakness in the global economy. This view is underscored by the return of the cyclical relationship between the G7 OECD leading indicator, a measure of global activity, and the performance of the emerging markets.

International investors have remained cool towards the region

Investors' sentiment towards the emerging markets



The model is based on responses to the Merrill Lynch Fund Manager Survey and anticipates where funds are likely to flow within the regional equity markets. Source: Schroders

Having been the favoured market to overweight at the start of the year, the emerging markets has fallen out of favour, as institutional investors trim their holdings of the region in their portfolios.

Fixed Income

Key Points

Fixed Income

-	Government	<ul style="list-style-type: none"> - Government bonds have continued to rally over the past month on global recessionary fears, but they appear unconvincing on valuation grounds. - While the short-end in the US has benefited from the recent interest rate cuts, further upside in price could be limited as the Fed nears the end of its monetary easing path. - At the same time, further upside in yields from the long-end could be limited given a weakening US economy and deflation being priced in by the market. Although, we could see further upward pressure in yields at the long-end as higher fiscal spending raises long run inflation expectations.
++	Investment Grade Corporate	<ul style="list-style-type: none"> - Investment grade continue to offer an attractive yield with spreads at historically wide levels. - While there is a risk that spreads could widen further as the default rate picks up, we expect this has already been priced in by the market. - The US government's rescue package should eventually bring greater certainty about the value of mortgage backed securities, such that confidence in banks' balance sheets should rise, helping to reduce interbank borrowing costs. - Further rate cuts and a steeper yield curve should be supportive, but risk appetites need to be restored in the banking system such that lending picks up again before conditions normalise.
(0/+)	High Risk (Emerging market debt/ high yield)	<ul style="list-style-type: none"> - High yield continues to look attractive on valuation grounds given that spreads have widened to historical levels. According to the Schroders high yield fair value model, the market is looking extremely cheap. - That said, default rates will likely pick up over the next 12 months and spreads widen further as investors demand a bigger risk premium, however, this has already been priced into the market to a certain extent. - Emerging market spreads have risen sharply over the quarter such that it is looking attractive in terms of valuation.
+	Index-Linked	<ul style="list-style-type: none"> - Index-linked are looking oversold on deflation fears, thus giving us the opportunity to buy inflation protection cheaply. At some point, inflation expectations will return on the upside given that central banks will be reluctant to ignore their inflation objectives. - Real yields in the US and UK are looking attractive in terms of valuation, as both markets have seen yields increase in the last few months. - There is the risk that liquidity in this segment of the market could deteriorate further, as leveraged players are forced to liquidate positions in this tougher economic environment.

Key: +/- market expected to outperform/ underperform (maximum +++ minimum ---) 0 indicates a neutral position

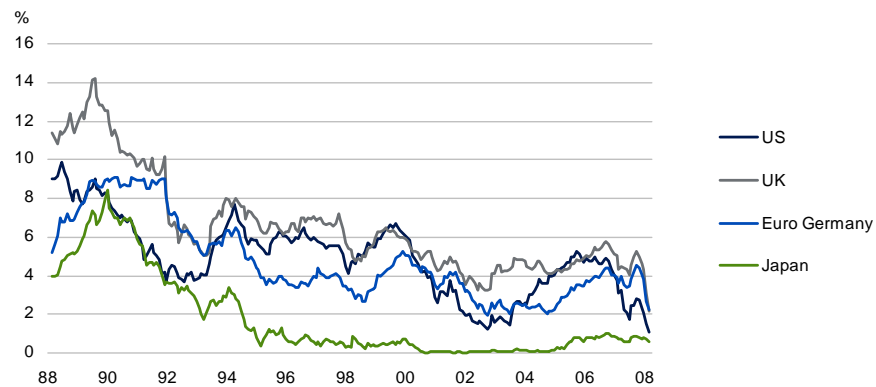
Fixed Income

Government and Inflation-Linked Bonds

Government bonds have rallied strongly over the quarter driven by deep concerns over the economic health of the global economy. This has prompted a rapid decline in bond yields, particularly at the short-end, as investors seek the perceived safety of government fixed income assets. Yield curves across the board except in Japan have steepened sharply. At the same time, spreads of emerging market debt have risen sharply over the quarter and are now looking attractive in terms of valuation. However, this sector been hit as investors shun riskier fixed income instruments. Meanwhile, real yields for US and UK inflation-linked bonds have risen sharply whilst break-even inflation rates have fallen to record lows, as the market discounts the prospect of deflation. Investors now predict that US inflation (based on the 10-year break-even rate) will average just 0.1% per annum over the next 10 years. This sea change in inflation expectations has been driven by the decline in commodity prices and the deterioration in the growth outlook of the world economy.

Government bonds yields decline to record lows

Two-year government bond yields

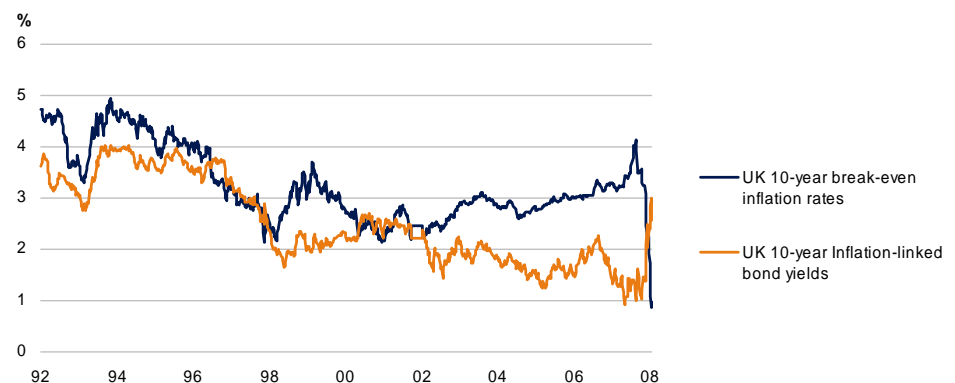


Source: Bloomberg, Thomson Datastream

Since the last quarter, yields have fallen significantly, as central banks worldwide undertook an aggressive rate cutting policy following the collapse of Lehman Brothers. In the US, the short-end has benefited from the recent interest rate cuts, but a further rally in price could be limited as the Fed nears the end of its monetary easing path.

Break-even inflation rates have fallen to record lows

UK 10-year break-even rates and inflation-linked bond yields



Source: Bloomberg

While Inflation is likely to undershoot on the downside, record low levels in break-even rates suggests that at some point, inflation expectations will return on the upside given that central banks will be reluctant to ignore their inflation objectives.

Fixed Income

Investment Grade and High Yield

Since the last quarter, the deteriorating macroeconomic backdrop and increasing fears over the financial viability of number of corporates have prompted investors to shun high yield and to a lesser extent investment grade. Total returns from both the Merrill Lynch global high yield index and the broad market corporate index were down 26.6% and 7.6% respectively from September to the end of November. At the same time, both sectors have seen spreads widen to distressed levels as investors demand higher risk premiums.

Spreads widen to record highs

US investment grade spreads

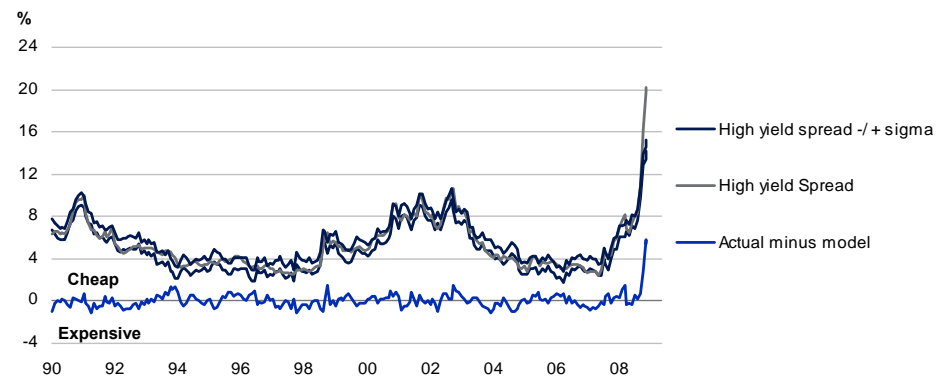


Source: Bloomberg,

Relative to the last quarter, the spreads of investment grade bonds over equivalent government bonds have widened significantly to historical highs. This suggests that the sector is looking attractive in terms of valuation given that spreads are at 572bps versus a 20-year average of 111bps.

High yield looks attractive on valuation grounds

Schroders high yield fair value model



Source: Schroders

High yield continues to look attractive on valuation grounds given that spreads have widened to record levels. According to the Schroders' high yield fair value model, based on fundamentals, the market is looking extremely cheap.

Alternatives

Key Points

Alternatives

--	Property	<ul style="list-style-type: none"> - The commercial direct property markets continue to weaken with transaction prices occurring below the valuation levels quoted by IPD. Property derivatives are also pricing in continued declines in the UK property market until 2010. - The yield gap between UK secondary properties outside metropolitan locations and prime/core properties in central city locations is widening. This yield gap may widen further as risk is re-priced with prime properties benefiting from demand that is more resilient. - Our quant models continue to signal an underweight in commercial property in the UK and continental Europe.
-	Hedge Funds	<ul style="list-style-type: none"> - De-leveraging and the raising of hair-cut rates by prime brokers will keep the sector under pressure. - Tough market conditions may continue to present opportunities for some strategies such as dedicated short-biased managers.
-	Private Equity	<ul style="list-style-type: none"> - With the cost of leverage rising and the secondary market for private equity offload getting smaller, the sector will find it tougher to increase net asset values (NAV). - US endowment funds are starting to unload their private equity stakes onto the secondary market. This should flood an already strained market and will drive prices even further downwards. - Funds of funds with significant over-commitments are starting to renegotiate terms in order to ease their liabilities. However, punitive measures are usually imposed which may not be attractive to their investors. - Many listed funds now have very high levels of investments and low levels of cash.
-	Commodities	<ul style="list-style-type: none"> - We are also negative on commodities given the gloomy prognosis for the world economy, particularly with China joining the slowdown. This is particular apt for more growth-dependent commodity sectors such as energy and industrial metals.
+	Infrastructure	<ul style="list-style-type: none"> - Governments across the world are likely to increase their infrastructure spending in order to prop up faltering growth.

Key: +/- market expected to outperform/ underperform (maximum +++ minimum ---) 0 indicates a neutral position

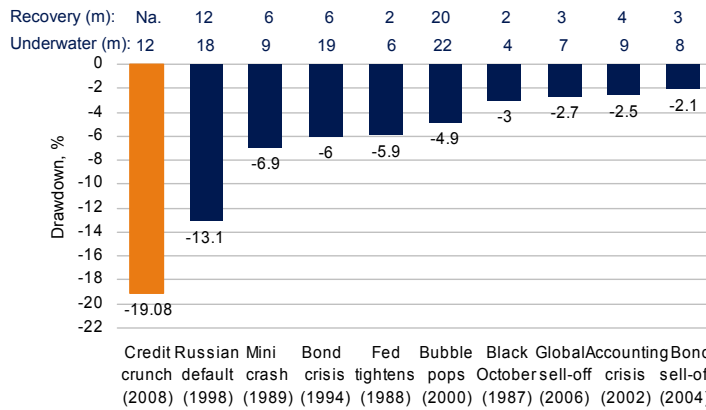
Alternatives

Hedge Funds

Most hedge fund strategies registered deep losses from September to November. The collapse of Lehman Brothers, the ban on short selling of financials, the rapid fall in commodity prices and the retreat from emerging markets all had dire results for hedge fund performance. Disappointingly, Fund of Hedge Funds and Multi-Strategy managers have not been able to provide shelter from the storm. Any gains from profitable strategies were eclipsed by the disproportionately larger losses elsewhere in the portfolio. The collapse of the global credit markets was especially painful for Distressed Opportunities, Fixed Income Arbitrage and other credit-related strategies. However, there are still strategies that have obtained positive returns year to date. They are the momentum players - Managed Futures and Systematic Diversified along with Macro managers which seek to exploit changes in macroeconomic variables. Predictably, in such falling markets, Short Bias strategies have also done well. In contrast to the relatively decent inflows into hedge funds during the first half of 2008, the second half witnessed unprecedented outflows. The recent discovery of the alleged \$50 billion fraud by Bernard Madoff will only add to investors' anxiety. Looking ahead, we expect that the significant reduction in leverage, the increase in haircut rates and the latest negative headlines will keep the sector under pressure well into next year.

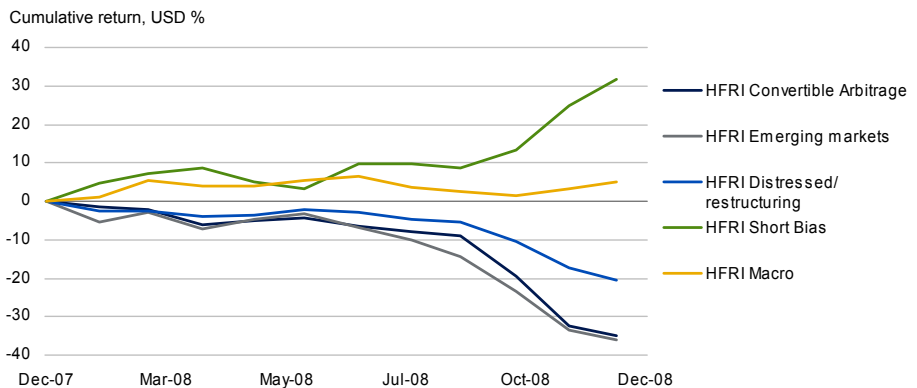
Record hedge fund drawdowns seen so far

Historical drawdowns of the HFRI Fund of Funds composite index



Note: m = months, underwater = peak-to-trough decline. Source: RBS, Corazon Capital, Alternative Investment Solutions, Thomson Financial, UBS, Bloomberg, November 2008. 2008 is on track to be the worst performing year for hedge funds as the HFRI Funds of Funds Composite Index registered a fall of 19.1% to end of November. Judging from historical drawdowns, the latest episode is set to continue with a recovery looking an unlikely prospect in the near-term.

Performance of Hedge Fund Strategies



Source: Thomson Datastream, November 2008. The backdrop for hedge funds will remain difficult next year given the worsening global economic outlook, the continued dislocation of the credit markets and the significant reduction in the ability to employ leverage.

Some hedge fund strategies are looking vulnerable to further losses

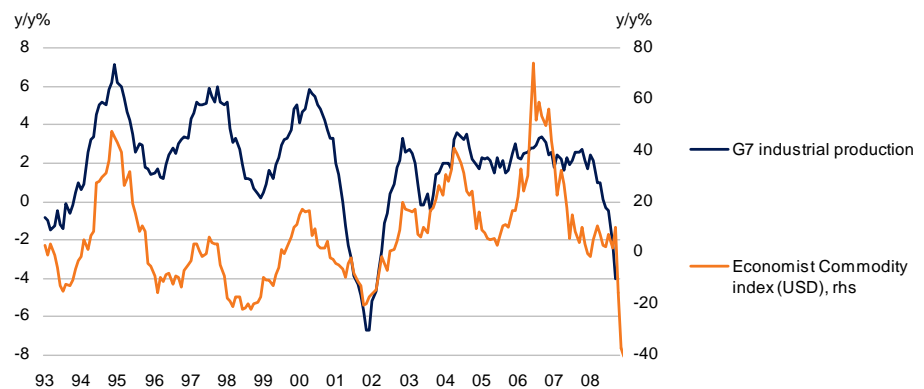
Alternatives

Commodity

The retreat of commodity prices across the board, which started in July, continued unabated into November. Investors' fear of a prolonged global recession and collapsing demand for commodities drove prices lower. Energy prices almost halved from September to November this year, as weaker economic data from the US and the inability of OPEC to agree on production cuts drove prices lower. Meanwhile, industrial metals saw the biggest losses as most of the developed world entered into recession territory. However, the fall in the price of precious metals was more subdued due to their perceived safe haven status during times of market turbulence. In terms of the agriculture sector, grains registered a slightly higher decline compared to livestock and softs. Arguably, this could be due to the collapse in demand for corn to produce bio-fuels and bumper wheat harvests. With the deterioration in the world economy set to continue, commodity prices are expected to weaken further. This is particular apt for more growth-dependent commodity sectors such as energy and industrial metals. Although, precious metals may find some support if the financial crisis continues to deepen. Finally, there is the prospect that agricultural prices could stabilise if supply does not expand further especially for grains.

Further headwinds in global activity could be a setback for commodities

Performance of commodities and G7 industrial production

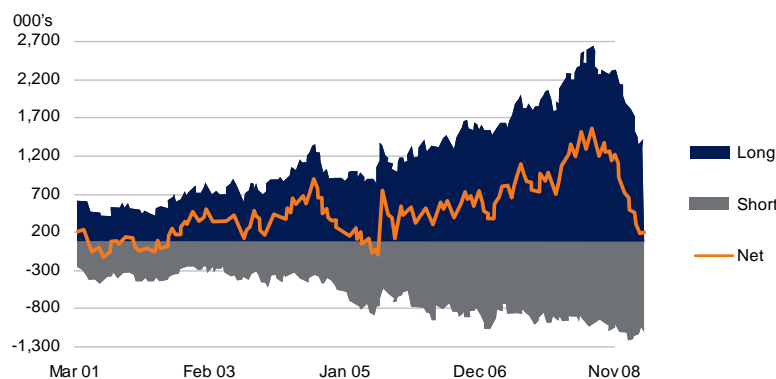


Source: Thomson Datastream

Historically, the performance of commodities has shown a good correlation with G7 industrial production and this trend has continued in recent times. This suggests that further weakness in global activity could be a setback for commodities.

Speculative positions are no longer as heavily net long as before

CFTC non-commercial positions in all major US commodity futures



Source: CFTC (Commodity Futures Trading Commission), Barclays Capital

According to the latest CFTC data, speculative positions in commodity futures have increased significantly in 2008 compared with previous years. During the first half of 2008, these positions were heavily net long but have rapidly fallen since July and may have already turned net short.

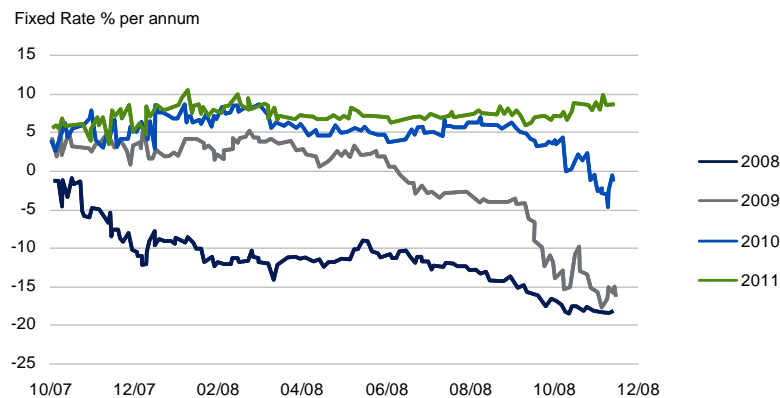
Alternatives

Property

Our outlook on property remains negative given the lack of financing for property transactions and the inherent illiquidity of the asset class. The UK market has witnessed a pronounced dip in valuations with property returns down 18% year to date.¹ As the UK heads into a recession, valuations could continue to spiral downwards until the end of 2009. Elsewhere, investment activity in most of Europe has retreated sharply this year. Spain, Ireland and financial centres such as Frankfurt are enduring most of the property downturn. This has been driven by the low availability of bank financing, weak investor sentiment and a mismatch between buyers and sellers' price expectations. At the same time, the significant levels of leverage used by the European property funds indicate more losses to come. However, these funds tend to have lower levels of debt compared to the UK, which suggest that they may not suffer to the same extent. Meanwhile, export-oriented economies such as Singapore and even China are seeing property values coming off their highs. The most dramatic falls were seen in Australia and New Zealand due to the knock-on effects of the global slump in commodity demand. Although property markets in Japan and India are on firmer footings, they too may not escape the current financial crisis unscathed.

Commercial property is vulnerable to further weakness

Derivatives predicting UK commercial property to fall further

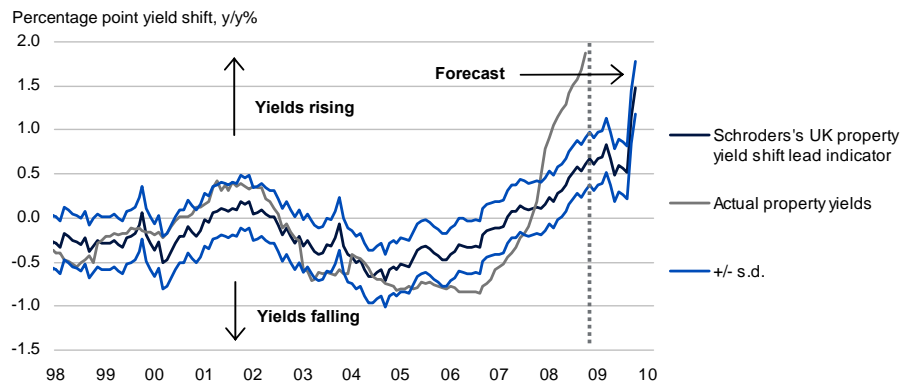


Source: GFI - CB Richard Ellis

Property derivatives, based on year-end IPD UK Property Index, indicate that the UK commercial property market is to decline by more than 15% in 2009, but start to stabilise in 2010.

Property yields are looking up

Schroders UK property yield shift lead indicator



Source: Schroders, IPD Property Databank

While the Schroders' model has not incorporated the recent shift in actual yields, which has been higher than predicted by the model in recent months, it does suggest that yields will be higher by the end of 2009.

¹ The IPD UK Monthly All Property index have returned a cumulative -18% from January to November 2008.

Alternatives

Private Equity

The private equity market, particularly the listed sector, has visibly deteriorated since the last quarter. For the UK-listed sector, the average discount to net asset value is now about -65%.² This is more than double the levels seen in the last bear market. Looking ahead, the recent sharp falls in markets worldwide is expected to result in further valuation markdowns of unquoted holdings, which uses the earnings multiple of comparable quoted companies to determine their valuation. At the same time, the significantly lower earnings expected next year of the underlying holdings of these funds could profoundly impact on their ability to service debt. Meanwhile, many UK and European-listed private equity funds have high exposures to 2006 and 2007 vintage years, which were acquired at the peak of the economic cycle. This suggests that any realisation will be lower than in previous years. Finally, there is a huge discount to par value of around 32% in the leveraged loans market.³ Such that senior secured bank loans are trading at levels consistent with high default rates, low recovery rates with little intrinsic value left in the equity of the transactions.

UK private equity trading at a significant discount

UK-listed private equity – discount to NAV (Net asset value)

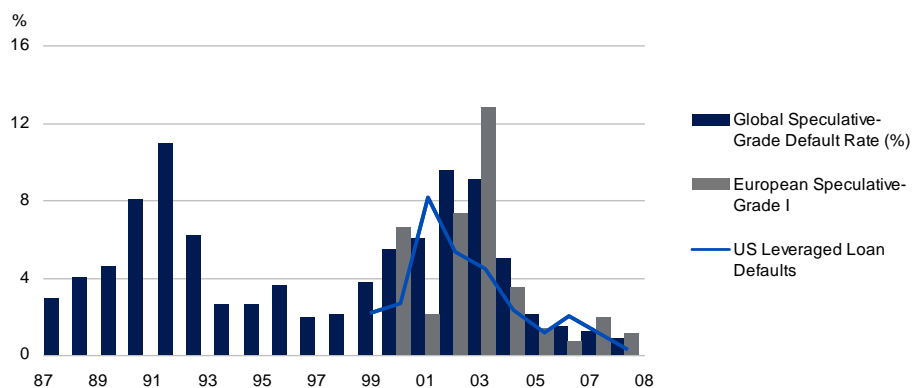


Source: Thomson Datastream, Cazenove

The reversal in the availability of cheap credit over the past year has hit the UK listed sector. Such that the average discount to NAV is more than double the levels seen in the last recession of 2002. This theme is set to continue with credit availability been constrained over the forthcoming year.

Leveraged loan market faces higher default rates

US leveraged loan default rates



Source: UBS, Standard & Poor's (S&P) GFIR; S&P LCD; S&P CreditPro®

US leveraged loan defaults in 2007 was about 1% with a 10-year average of around 4%. With the US now in recession, defaults in the leveraged loan market is expect to rise in 2009 although many of the covenant 'lite' deals of 2006 and 2007 have more room to manoeuvre.

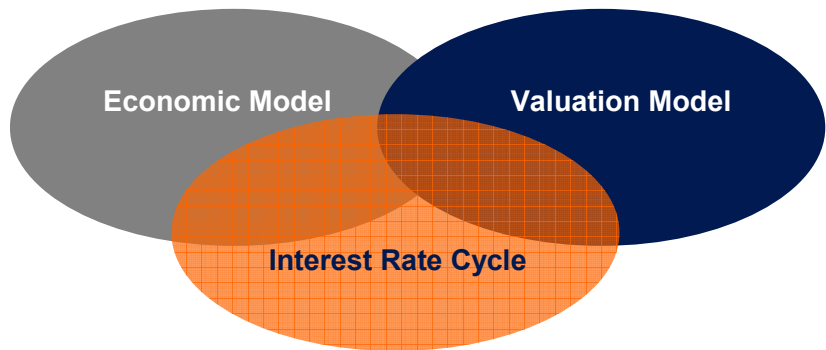
² Source: UK Datastream Investment Trust Private Equity excluding 3i

³ Source: Cazenove, Credit Suisse – Western Europe Leverage Loan Index, Hedged to Sterling

Appendix

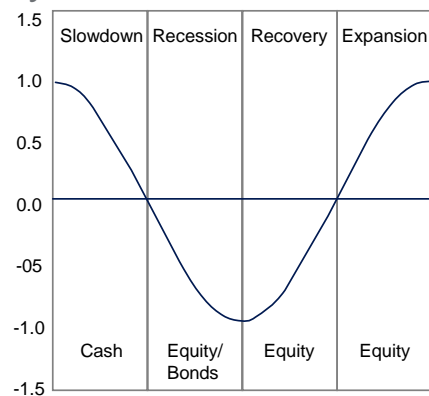
Quantitative Framework

Analysis of past cycles shows that market performance varies with the state of the economic and interest rate cycle and the valuation of markets. This information can be used to derive a model which picks the optimal mix of equities, bonds, and cash on a monthly basis. The model is used to assist in our asset allocation process and can be varied according to the degree of risk an investor wishes to take (see the strategy views section for more discussion on the current signals from the model).

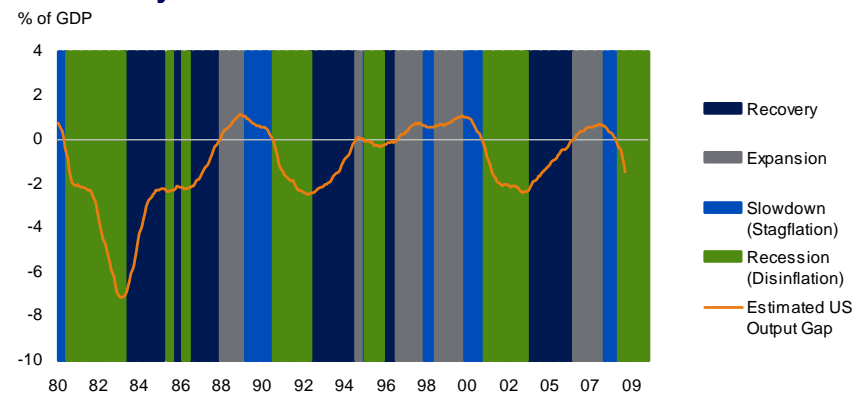


We break the economic cycle down into four phases based on the level and strength of activity relative to trend. Statistical tests show that market return and volatility varies in each stage and that there are differences across asset classes in each phase. Adjusting returns for volatility then helps determine the best risk adjusted asset allocation mix. The table overleaf summarises the main results using US data for the period 1950 to today. The diagram below is a stylised representation of the cycle and the preferred asset in each phase.

Market performance varies through the cycle



Economic cycle in the US



Source: Schroders

In conjunction with the economic cycle model, we have added information on the valuation of equities relative to bonds. This model helps to capture periods when equities appears extremely cheap or expensive relative to bonds. The metric used is the gap between earnings yield and bond yield (chart overleaf).

Appendix

Quantitative Framework (continued)

Valuation of equities relative to bonds



Source: Thomson Datastream, Schroders

Integrating information from the economic cycle and valuation models

Information from the economic model determines the prevailing phase of the cycle. In the case where the model signals it is a critical stage for the equity markets, this information is overlaid with that of interest rates to determine the overall asset allocation decision. The interest rate cycle is primarily used in timing the switches into bonds, which delivers the best performance during periods of monetary easing.

Meanwhile, information on the valuation model becomes important when the economic model signals a favourable environment for the equity markets. The valuation model is used to compare equities relative to bonds. Finally, information from the valuation model is overlaid with that of interest rates to determine the overall asset allocation decision.

Asset performance in different stages of the economic cycle

Phase/Asset	Statistics	Recovery (16) ³	Expansion (11)	Slow (Stagflation) (7)	Recession (Disinflation) (10)
Equity	Excess Return ¹	8.55 (100%)⁴	8.79 (83%)	-8.06 (22%)	8.95 (88%)
	Volatility	13.69	12.42	17.41	14.67
Bond	Excess Return ¹	1.30	-1.02	-0.23	1.86
	Volatility	6.90	4.67	8.69	8.79
Cash	Absolute Return	4.66	4.84	5.93	5.59
	Absolute Volatility	0.68	0.61	0.84	1.17

- All risk/return figures are in % and annualised from monthly data. Equity and bond risk return figures are relative to cash.
- Figures in bold refer to the best performing risk adjusted asset relative to the stage of the cycle.
- These numbers refer to the average consecutive length of each phase (in months). Average length of one complete cycle defined recovery – slowdown is about 5 to 6 years.
- The figures in brackets refer to the number of times the equity markets outperformed cash on average during each phase of the cycle since 1950.

Definition of Asset Class

Equities	- S&P 500 Composite
Bonds	- US 10 year treasury bonds
Cash	- US 3 month treasury bills
Total return indices (nominal), starting in 1950 -2008, monthly data	



Schroders

For professional investors and advisors only. This document is not suitable for private customers. This document is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. Information herein is believed to be reliable but Schroder Investment Management Ltd (SIM) does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that SIM has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Schroders has expressed its own views and opinions in this document and these may change. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. Issued by Schroder Investment Management Limited, 31 Gresham Street, London EC2V 7QA, which is authorised and regulated by the Financial Services Authority. For your security, communications may be taped or monitored. w32973