Investment Outlook
2010

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Overall

Strong earnings' growth should be supportive of equities, but risks remain.

After a near calamitous start, 2009 turned out to be a strong year for risk assets. Massive economic stimulus by almost all policymakers stabilised the economic situation and provided the catalyst for a strong rebound in financial market sentiment. Looking ahead, the main support for equity markets is likely to be the significant recovery in corporate profits expected during 2010. There are still some questions, however, over the sustainability of the economic recovery.

Economic Growth

Will developed economies gain traction as the stimulus dial is turned down?

- Massive fiscal deficits and unprecedented central bank action have brought economies back from the brink, helping to reverse a downward spiral that threatened a repeat of the Great Depression.
- Employment levels have fallen sharply and will continue to lag positive developments in the real economy.
- Strong growth in Asian economies, such as China, was also a hugely important support in 2009. Some concerns have emerged that risks of overheating may have to be countered by policy action.
- In more developed economies, policymakers have a delicate operation to perform - preventing risks of a double-dip without fuelling concerns over long-term fiscal sustainability.

Equity Markets

While policy error remains a risk, equities could progress further on the back of stronger earnings.

- Strong Asian economies and stabilised-to-improving developed economies provide the backdrop for better corporate earnings.
- While the current consensus is for earnings' growth around 20% for 2010, better operating leverage and strong cost control could generate positive surprises.
- Valuations are reasonable, provided earnings' growth materialises as expected.
- Merger & acquisition activity - which was quiet last year - could provide additional support during 2010.
- Equity markets could be challenged by policy adjustments during the year, meaning that volatility could re-emerge.
- These adjustments could be in the form of rising long-term interest rates or premature withdrawal of liquidity.

Interest Rates & Bonds

Interest rate hikes are expected in Q2 and Q3, although there is a risk that rates will be left unchanged for longer.

- Currently, US and UK base rates are forecast to rise in Q2, with the ECB expected to move during Q3, 2010.
- The risks are that interest rates stay lower for longer. The received wisdom is that Japan hiked rates too quickly during its slump and western central bankers are not likely to do the same.
- It is likely that there will be periodic sell-offs in interest rate markets due to strong economic data and increased bond issuance. However, central banks will keep rates accommodative for longer to ensure a self-sustaining economic recovery.
- Long-end rates have risen relative to the short end and that spread is now at an all-time high in the US.
- Inflation expectations will be very much on the radar screen during 2010, with investors weighing short-term inflation dynamics - which are still relatively benign - versus the long-term consequences of easy money and high fiscal deficits.

Currency Markets

Will the euro remain strong in 2010?

- The US dollar was broadly flat versus the euro during 2009, but that fact masks plenty of volatility. The dollar rallied in the last quarter due to position squaring and concerns about the fiscal situation in Greece. A lack of liquidity leading into Christmas exacerbated this move. This trend is likely to continue in the early part of 2010.
- Over the medium term, the strength of the euro could well reassert itself. The desire for a strong currency is part of the ECB's DNA, while the closed nature of the US economy enables it to live with a weaker currency. The fiscal issues facing the US are also a headwind to dollar strength in the longer term. A test of the 2008 €/$ highs would not be a surprise at some stage during 2010.
- The UK economy more closely resembles that of the US than Europe. In that vein, €/£ can be expected to follow a similar trajectory to €/$ but the magnitude of moves will be smaller.
- The demand for a revaluation of the Chinese renmimbi continues by central banks and governments around the world. The Chinese have so far been unwilling to move and they are not expected to change in the short-term.

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