

- 2009 was an extraordinary year for global equities. Investors initially witnessed the continued collapse of global equity markets to decade lows followed by one of the sharpest equity market rallies in history. Heading into 2010, as the world economy stabilises and recovers, we are cautiously optimistic with regards to the prospects for global equity markets. We note that while corporate recovery continues and valuations have risen risks still remain, which may restrain the continued market rally.
- Following the most severe global recession for decades we expect a sustained but uneven recovery. Almost all major economies exited the recession in the second or third quarter of 2009; Spain and the UK were the most notable exceptions. Nonetheless, economic growth in the major developed economies, although positive, is likely to remain below potential in 2010 as consumption is held back by private sector deleveraging, a process that has only just begun. Government spending, which is currently taking up the slack and supporting economic growth, will be limited by the fact that US debt is already expected to rise by around \$5 trillion (1/3 of GDP) as a consequence of the financial crisis. The area of strongest potential for spending recovery in the major economies is the corporate sector, where profits have held up well and balance sheets have been repaired.
- Emerging market countries are expected to see more fundamental support and should lead the global economy over the next few years. The BRIC (Brazil, Russia, India, and China) countries have been able to restart economic growth through aggressive stimulus packages. As a result of recognising that their reliance on the US consumer must decline they are rebalancing their economies towards their own consumers, although this is a complex and time-consuming process.
- Entering 2010 we continue to expect global central banks to remain relatively accommodative, which is supportive for asset markets in general. Significant output gaps combined with high unemployment and ongoing consumer deleveraging should keep inflationary pressures under control (RCM's forecast for US CPI is 1.9%) and allow loose policy to be sustained. The price that investors must eventually pay for an improving economic outlook led by the massive monetary and fiscal aid is higher rates but, before rates are raised, we expect central banks to start absorbing some of the extra liquidity they have injected into the financial system, i.e., withdrawal from Quantitative Easing. Our current expectation is for interest rates in the US and Europe to begin to rise in mid 2010 if the economic recovery appears to be robust at that time.
- In line with our economic growth outlook, we think that earnings growth will pick up from low levels in early 2010 and will increase only modestly thereafter. According to our longer-term earnings models, we might have to wait for a more markedly earnings increase until 2012. Given the vigorous corporate cost-cutting we have seen, we believe that earnings expectations for 2010 are reasonable but do recognise that, in the short term, earnings momentum has peaked. This feature has been a major support to the rebound of the equity markets since March and has passed its strongest point.
- Valuations within the markets look fair. We continue to prefer equities over bonds as we do not believe that the future risks to bonds (e.g. sovereign debt uncertainties) are fully priced in. Within equities, we believe US stocks are no longer looking as attractive as they were in early 2009. For Europe and Japan, valuations are more attractive on historical comparison. After a very strong run our analysis shows that Emerging Markets now look less inexpensive relative to developed markets. With their stronger future growth prospects and fundamentals, however, we do not imagine an early derating of Emerging Market stocks.
- In terms of the risks to be aware of in 2010, we are cautious about the increased possibility of governments or government supported institutions defaulting on their debt. Dubai and Greece have already given warning signs of this, while the large amount of fiscal stimulus that has been provided by debt ridden developed countries may lead to funding crises in the future, the UK, Spain and Ireland all are facing these issues. The fall-out effect of these issues can be seen in the currency market as the British Pound Sterling and US dollar were very weak during 2009. This could also lead to crowding out of equity capital, particularly if financial institutions are required to hold more fixed interest securities in the future.
- Fiscal policies such as the 'cash for clunkers' and tax rebates, especially in the US, targeted the consumer and gave a much needed boost to car manufacturing and retail in particular. We are not going to see these policies

renewed in 2010 and this could lead to disappointment not only in these specific sectors but across the market as investors worry that the already over-leveraged consumer is not as resilient as first hoped.

- Finally, as more importance is placed on the strength of Emerging Markets and the BRIC countries any signs of measures to restrain growth and inflation in these areas could cause concern. It is important that growth in these countries is seen to be self sustaining in the medium term, rather than as a warrant on US and European consumption.
- Overall, with the extreme style rotations and stock correlation seen in 2009 subsiding, we expect a more favourable backdrop for stock picking as markets begin to evaluate and reward individual companies on the basis of fundamentals. Our bottom up, fundamental stock picking investment process is more suited to this environment and in terms of our positioning entering 2010, we are concentrating on three main areas focused around sustainable growth in a below trend growth environment: Companies with the ability to grow organically, restructuring candidates and corporate spending beneficiaries.

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