

2010 will show the real strength of the global economy, says RCM

As 2009 draws to a close we have experienced both the worst and possibly the best of times, as global equities fell to decade lows, followed by one of the sharpest equity market rallies in history. What does this mean for markets in 2010 as the world economy stabilises and recovers? Fund managers at RCM, a company of Allianz Global Investors, provide insight into the key issues for investors to consider in the year ahead.

Neil Dwane, CIO Europe for RCM, provides a global overview:

- Emerging markets will power the global economy from here
- USA and other OECD countries will see a dull return to growth, below historic trend levels
- The end of quantitative easing threatens the stability of all financial markets if handled badly

“The theme of decoupling has re-emerged and we continue to see more fundamental support for an emerging markets-led global economy in the next few years. Contrast the over leveraged and fiscally weak G7 countries, reliant on consumer spending and housing markets and just trying to stay afloat, with the very robust country finances in emerging markets and the growing affluence of their citizens, albeit from a low base. The prospects for those G7 economies with high unemployment and large output gaps remains disinflationary and frankly dull at best. Moreover, this dullness could be exacerbated by too fast a fiscal retrenchment by governments or by a fall in bond markets, reminiscent of the 1994 bond collapse, where investors lost around 20 per cent in nearly 6 months.

“Whilst the BRICs have been able to reignite economic growth through aggressive stimulus packages, they have also had to recognise that their mercantilist reliance on the US consumer must decline and thus they are beginning to rebalance their economies towards their own consumers. China looks set to reach nearly 10 per cent GDP growth again soon and Brazil is rapidly recovering its economic growth prospects as well.

“The prognosis for the USA looks tougher, with unemployment – according to some commentators* - nearly 17% and the scale of debt within the consumer sector only just starting to decline, whilst the budget deficits from the Obama administration continue to grow. Indeed it’s becoming moot if Obama can afford a second stimulus package as well as the healthcare reforms. All of this is increasingly undermining the US Dollar.

“Europe remains a very mixed picture with the stronger, less property-leveraged economies showing much less economic distress. The Euro will remain strong as the European Central Bank has not resorted to quantitative easing as

forecast and will be one of the most proactive in responding to threats of inflation. The strength of the Euro will also mitigate imported inflation, unlike in the UK and the US.

“The UK’s economy looks caught in a multi-year trap as indebtedness remains high, for both the government and the consumer. The UK will find the end of the massive Bank of England quantitative easing policies very difficult at a time of low yields and a weak Pound.”

Christina Chung, manager of the Allianz RCM China fund, gives her outlook for China:

- The next couple of years will see a period of slower growth
- Longer term we are bullish and see Chinese growth as sustainable

“Following an economic recovery in the second half of 2009 and Q1 of 2010, we expect growth momentum in China to moderate towards the second half of 2010 against the backdrop of the slow pace of global economic growth that will undermine China’s export performance.

“Fiscal policy will remain accommodative and hence this will support fixed asset investment. However, with weak export performance, we do not expect a strong recovery in private sector investment, particularly in the manufacturing sector. As a result, we would expect a slowdown in fixed asset investment in 2010.

“While consumption will continue to increase, it will not be sufficient to offset the structural slowdown in exports. We would therefore expect China to undergo a period of slower growth over the next couple of years. Given this macroeconomic backdrop, investors need to adjust growth expectations in the short to medium term and hence this could limit the market upside in the short term. Yet, market valuations are not excessive and hence, we would not expect significant downside risk. Overall, China equities are likely to be range-bound.

“Longer term, we are still very bullish on the market as we believe that the transition from export-led to consumption-driven growth will reduce its sensitivity towards the global cycle leading to more sustainable growth. On currency, we believe that the Renminbi will face appreciation pressure in 2010 as while it has been relatively stable against the US Dollar in 2009, it has depreciated significantly against the Euro. Hence, on a trade-weighted basis, the Renminbi has depreciated given that the EU has already become China’s major trading partner.

“In terms of sector preference, we would favour domestic sectors and those that benefit from Renminbi appreciation. We favour consumer, banks, telecom equipment and IT services. Following a period of consolidation undermined by the large numbers of IPOs in the property sector, we would also accumulate property stocks on weakness. We are cautious towards telecom, materials, global cyclical and export-oriented sectors or stocks.”

Peter Anderson, Co-CIO US Equities at RCM, discusses the outlook for the US:

- The decline in fiscal stimulus and rising taxes will impact consumption
- While a correction is likely in the first half of 2010, we still expect market growth
- The consumer is key to the US recovery

“Over the next four quarters ending September 30, 2010, growth in real GDP is projected at 3 to 3.5 per cent. We anticipate a deceleration in the economy by late 2010 and further moderation in growth in 2011 as a decline in fiscal stimulus and rising Federal, state and local taxes weighs on consumption. Capital spending is likely to steadily accelerate from its current deeply depressed levels reflecting robust corporate profits and rising capacity utilisation. Exports will continue to be one of the strongest sectors of the US economy propelled by a depressed dollar and strong demand from emerging markets. While spending on goods and services at the Federal level will grow unabated, state and local spending will remain under pressure as budget problems persist.

“Interest rates are likely to remain at extraordinarily low levels reflecting modest inflationary pressures, stubbornly high unemployment and a sub par economic recovery. Profits will prove very robust as corporations relentlessly reduce costs and modest volume increases produce outsize profits. This is both good news and bad. While strong profit growth is terrific, cost reduction will likely result in only moderate improvement in wage growth and hence consumption.

“Given the uninterrupted advance from the March 2009 lows, a meaningful correction is likely in the first half of 2010. Nevertheless, we expect market appreciation of 5 to 10 per cent in 2010 reflecting very strong earnings and continued low interest rates.

“The real key to both the US economy and the market is the consumer. If the growth rate of consumer spending revives in 2010 and then stabilises in 2011, the economy will generate sufficient momentum to propel the equity market significantly higher. If consumer spending turns anaemic in late 2010, both the economy and the market are likely to produce disappointing results.”

Simon Gergel, Director of UK Equities at RCM, comments on the prospects for the UK:

- Economic growth in the medium term will be below par
- In 2010 the UK equity market will go back to fundamentals
- It will favour higher quality companies, those with above average growth rates and high yields

“In 2009, the market has bounced back sharply, initially in response to the rescue of the banking system and then on signs of economic recovery. The change in sentiment has been overpowering and indiscriminate, lifting almost all cyclical stocks, especially in industries like mining and banking. Easing credit markets have also relieved the pressure on highly indebted businesses with many seeing dramatic share price recoveries.

“As we look into 2010, we would expect investors to focus on the reality of a world with a large debt overhang. High budget deficits will constrain government spending and will lead to public sector job losses, whilst high consumer debt combined with rising interest rates and higher taxes will constrain consumption. Economic growth in the medium term is likely to be below the long term trend. In this environment it will become harder for companies to maintain robust cash flows and deliver growth.

“The stock market is likely to differentiate to a greater extent between the potential winners and losers in a more difficult trading environment. We see three key attributes:

“Quality: Those companies with the strongest technology, brands and market positions will be more able to hold onto customers, maintain or raise prices and deliver robust profits and cash flows. Strong management teams and appropriate incentivisation and control structures also become more important in tough times.

“Growth: When economic growth is constrained, those businesses that are able to grow their revenues consistently should trade at a significant premium. At the moment, many higher growth businesses are trading at very reasonable valuations and are likely to be rerated next year.

“Dividend yields: Valuation has arguably been neglected in the wild swings in the markets over the last 18 months. As economic conditions settle down, a greater focus on valuation is likely to permeate. With share price moves less polarised by the wholesale move into defensives, cyclical or highly geared stocks, investors will have to increasingly differentiate on other criteria and valuation will be key. In particular, we would expect a renewed focus on dividend yields, where sustainable, as interest rates are likely to remain relatively low and there is a dearth of real assets offering attractive income levels for institutions like charities and for individual investors.”

Neil Dwane concludes:

- The easy money has been made
- Opportunities abound for stock pickers

“Equities have rallied hard in 2009 and are no longer cheap, although not at the top of their valuation ranges either. Market appreciation in 2010 will probably be derived from the earnings growth and dividends available rather than a further expansion of PE ratings. Accordingly, the easy money of this rally has been made and investors should increasingly focus on higher quality companies with good business models, sound cash flows and management, and good dividend yields. There are lots to choose from since this rally has been very polarised.

“M&A globally will continue to drive some industry segments as markets mature, such as staples and technology. Many companies will be focusing on product and market opportunities to access the growing emerging consumer. With a

predominance of emerging market growth, the world will see a further tightening of demand for commodities and oil which will act as a tax on consumption in particular in economies like the USA, and will drive further investment into clean energy and alternative power solutions.”

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Notes to Editors:

* Source: Shadow Government Statistics/ http://www.shadowstats.com/alternate_data. The U.S. Bureau of Labor Statistics broad U6 measure of unemployment, similar to the European methodology.

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Photographs

High-resolution photographs of our investment professionals are available to download here:

http://www.rcm.com/london/press_professionals.php

Awards

- RCM named winner of Active North American Equity at Pensions & Investment Provider awards 2009. RCM US Large Cap Select Growth is managed by Scott Migliori, Co-CIO for US Equities, RCM.
- RCM named No.1 leading fund management firm for SRI Research by Thomson Reuters Extel 2009.
- Global CIO of RCM, Andreas Utermann, named CIO of the Year by Funds Europe magazine 2008.
- Winner of European Investment Trust of the Year by Investment Week magazine, 2008, for the RCM-managed Charter European Trust.
- Allianz RCM Global EcoTrends Fund named winner Best Climate Change Investment fund 2008, by Holden & Partners/ Incisive Media.

About RCM (all data source: RCM as at 30/09/09)

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