

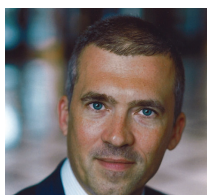
20 October 2010

## RCM Global Investment Outlook with Andreas Utermann and Christina Chung



**Roger Miners:** It's a pleasure to welcome you to our fourth RCM Global Investment Outlook call of the year. And I am pleased to be joined by Andreas Utermann, our Global Chief Investment Officer and Christina Chung, who is Head of the Greater China team.

With that I would like to hand over to Andreas. Andreas.



**Andreas Utermann, Global Chief Investment Officer:** Yes, thank you very much Roger.

For those of you who were on the last call you may remember that at that time we were pretty much in a 'risk off' phase of the market, the market being very concerned about deflation and double dip scenarios in the United States. Consequently the market was very weak and our recommendation at the time was to buy into that weakness as we expected the market would swing back to a more positive mood and risk would be on again. And that's indeed what happened over the past six weeks, it having been the strongest September for a long time for risk assets and notably for equities and October also so far being a pretty good month.

What are the reasons for that renewed strength in risk assets, and will this continue? The reasons are really three fold, first of all growth over the summer period continues to surprise on the upside for most economies. Certainly the case for the Eurozone where the German economy, the motor of the European economy, continues to do much better than expected. Growth was stronger, exports were stronger, consumption was stronger and employment rose to levels not seen for last 20 years. That's quite surprising and Germany now has recovered and regained the levels of production, output and unemployment pre the crisis.

A number of other European peripheral countries notably Sweden, Holland, Belgium also surprised on the upside. And then even the countries that led the Eurozone into the debt crisis in the spring such as Greece also came up with much better than expected fiscal numbers, and therefore overall growth in Europe was much better than expected.

The same can be said for India and China and Brazil and the United States did not disappoint. But revisions to growth and consumption in the United States for the second quarter were certainly stronger

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than expected, so therefore overall there was a greater confidence as we exited the third quarter that we would not go into a double dip. At the same time and that's very important for monetary policy obviously inflation continue to be very well behaved. Some might say actually too low but certainly there weren't any signs of inflation on the horizon.

The second factor always important for equity markets was that earnings were much better than expected. That obviously helped sustain or promote the equity market rally and particularly high beta sectors such as the technology sector did very well and surprised on the upside.

Finally and most importantly are the signs the Federal Reserve of US will engage in aggressive forms of quantitative easing also dubbed QE2. The market seems convinced that basically Bernanke and the Fed will do whatever it takes to get the United State back on the growth path while at the same time depressing interest rates through further bond purchases as long as necessary to get people to borrowing again, get banks lending to the corporate sector and the medium sized enterprises to start creating jobs.

That broadly explains why we are in the current much better market environment compared to three, four or five months ago. The question is will this continue? And indeed there are some clouds on the horizon which may mean that we may get another phase of 'risk off' sometime between now and the first quarter of next year.

First of all and again most worryingly is this whole discussion around currencies. Clearly currency volatility has been very significant over the past few months. The dollar first rallying very strongly against the euro then depreciating again against the euro. The yen rising to unsustainable levels against the dollar but also on a trade weighted basis. And the Chinese apparently not doing enough to depreciate their currency fast enough certainly not in nominal terms although there is an argument to be said that the Chinese have been devaluing quite a bit in real terms and perhaps that's something that Christina will comment on in a minute.

Anyway the concern is that if this currency volatility continues imbalances will not clear as quickly as the market would want them to, that is global trade and global current account imbalances. And more importantly this might actually lead ultimately to currency and then trade wars which would be very bad news for risk assets and could indeed precipitate a double dip. We don't anticipate that this is the major scenario. We think the most likely outcome is some form of managed currency system perhaps along the lines of the Louvre Accord in the 80s which would we think be good news. And therefore we think that ultimately given the market's concerns about this the resolution of this will boost market sentiment further. But there is a risk and it is not negligible.

Secondly quantitative easing II: clearly markets are expecting a further round of aggressive unlimited quantitative easing. Were it not to happen for whatever reason in the next month or two then markets will be sorely disappointed and the current rally will probably come to a halt. As we go through this quantitative easing round there will be increased concerns about stabilisation of monetary stimulus and inflation further out. Now clearly that's exactly what the Fed wanted, it wants inflation expectations to be fed back into the economy and into expectations.

But clearly the concern of some market participants is that once inflation is out there, once inflation reactive forces have taken hold it is going to be difficult to rein back in.

Earnings we think are going to continue to be on a good growth path globally. Finally perhaps in terms of the major issues to look at is the impact of the fiscal restrains that is going to happen in Europe. We have seen today very strict fiscal measures applied in the United Kingdom with the spending review. We are seeing similar movements in France and Germany and other European countries. And the question is how will this effect consumption and growth in Europe. The jury is very much out on that and we will have to see what the coming three to six months bring.

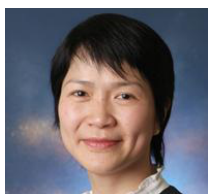
Connected to this is a bit of good news which is a fiscal debt management resolution mechanism that is currently been discussed in Europe which until a few days ago was given very long odds of success. It now looks that the Germans have persuaded the French and perhaps also the British to let a fiscal resolution mechanism indeed be introduced in Europe, this would require EU treaty changes which now apparently most governments are up for and that would allow for potentially an orderly debt restructuring for any countries within the Eurozone that might flout the newly established rules.

That I think would be good news for the euro, the risk that emanates from that were it to be adapted would be clearly that the euro would strengthen too far against the dollar which is why we hope very much that some kind of managed form of exchange rates will indeed emerge over the next year or so.

What does all this mean for investment strategy? We have turned more positive over recent weeks on equities on a tactical basis. We favour Asian European equities over US equities of which we are underweight and Japan equities which we are neutral. We would avoid all government bond markets beyond maturities of two to three years as we think that the yield curve will steepen very much as inflation expectations will be built into expectations. And we continue to believe that emerging market currencies will appreciate relative to OECD currencies.

These are the key strategic bets that we are placing on an asset allocation basis. Within equity markets we continue with the themes that we have been running with for some time which is we prefer commodities both for growth reasons as well as an inflation hedge. We continue to like growth stocks of large companies that have good balance sheets and can potentially buy assets on the cheap. And we also like dividend stocks as many dividend stocks continue to exhibit higher dividend yields than the corporate bonds of the same issuer.

I will leave it at that and look forward to any questions you might have in a few minutes and hand over to Christina.



**Christina Chung:** Yes, thank you Andreas. If you remember last year China went through a period of aggressive credit expansion and fiscal pump-priming. At the end of last year it is obvious that this cannot be continued for too long and we should see some form of policy normalisation and tightening in 2010. And it is what exactly had happened so far this year.

It is also important to note that this year is the final year of the current five year plan, so before I go into the shorter-term outlook on the market I think it is important for me to highlight our longer-term view on the China economy particularly given what has been stated as the goals for the next five years for China. Then I will also focus on the shorter-term perspective and also touch on our strategy and where we see the biggest opportunities in the China market. And finally I will also comment on the China property market.

In terms of the longer-term outlook on the China economy we believe that economic growth will slow down over the next couple of years as China goes through restructuring from export-led to domestic-driven expansion. The focus of the next five year plan from 2011 to 2015 will not be in driving economic growth but in achieving sustainable growth through a shift in economic structure. Accelerating the growth of household income, shifting the focus of economic development from the coastal to the inland regions, reducing the adverse environmental impact from economic expansion and enhancing energy efficiency, increasing technological advancement and also promoting the development of services industry.

While economic growth will moderate we believe that economic growth rate can still be sustained at 8% to 9% in the medium-term as consumption and investment demand will continue to underpin growth at a time when exports will grow at a very moderate rate. We believe that the Chinese economy is at the early

stage of going through a multi-year transition to support consumption, household income will grow at a much faster rate than economic growth. And this is trying to narrow the gap between household income growth and GDP growth over the past so many years. This faster rate of wage increase is already evident in 2010.

Given the high domestic savings rate there is also a potential increase in interest rates to improve household interest income. Coupling this with continued although slower rates of urbanisation consumption will continue to support economic growth. Other longer-term policy includes liberalising the controls that restrict migrant workers to settle in particular cities in China. There were serious talks about liberalising this control but I think to implement this will take a very long time. Although all these policy moves are positive we believe that the increase in private consumption is still a very long-term process. In the short-term overall consumption growth will remain steady but will vary across different geographical regions with much stronger growth in central and western China which are benefiting from a more rapid rate of economic development.

On fixed asset investment we believe that it will remain quite resilient. Obviously it has slowed down from the unsustainably high rate in 2009. We believe that fixed asset investment will remain resilient mainly because China needs to accelerate economic development in the inland regions. Infrastructure project for example the railway network is a long-term building process in China.

Exports are also likely to go through a period of adjustment. With rising labour and other production cost, China cannot rely on low end exports. Hence, the technological upgrade to higher valued ended goods will also be an important policy direction. We believe that China has the potential to improve product quality in selective sectors like machinery and equipment. China is still going through a rapid rate of industrialisation, so domestic demand for machinery equipment remains strong and the scale benefits together with improvements in quality in certain products will present a potential for some Chinese companies to emerge as a major player in the global market. All these are the longer-term structural trends in China. In the shorter-term after credit normalisation and the introduction of the series of property market tightening measure we believe that policy will tend to be relatively neutral.

The interest rate hike announced yesterday was a surprise to us as well as to the market. We believe that this move could be driven by various considerations. CPI inflation remains relatively high level more importantly underlying inflationary pressure persist in view of property prices being sticky downwards. And also there is a resumption of price boom for commodities mainly driven by the weak US dollar. The move may also suggest that the Chinese authorities will allow higher flexibility in terms of exchange rate movements in the face of mounting pressure from the US.

I think the trading band may be allowed to widen and hence allow for a faster rate of currency appreciation. However I believe that renminbi appreciation will still be a gradual process; that is to say we do not expect a one-time sharp appreciation. In terms of timing the Chinese authorities have taken the opportunity to tighten liquidity after the domestic A-Share markets have already rebounded strongly. That is from a market perspective I think it is a good timing to cool off the bullish market sentiment.

For the overall market I believe the market correction will be mild as investors are generally focusing on a longer-term outlook particularly with the potential of a faster rate of renminbi appreciation. The market would take this interest rate hike as an excuse to consolidate recent gains. In particular, I would expect share price correction in the cyclical sectors including commodity, property, etc. For banks, as the latest interest rate hike is not entirely asymmetrical. It is not as negative as the market initially thought hence I would expect banks to hold up relatively well.

Other sectors that would be relatively more resilient include insurance, consumer, IT services, telecom and selective industrials. With the exception of telecom which we are still cautious our portfolios have relatively high exposure in all these sectors including consumer, IT services, insurance and also selective industrials particularly relating to environment and also relating to renewable and clean energy as well as machinery and equipment sectors. Therefore the latest interest rate hike will not have a major change on our portfolio strategy. We would therefore continue to focus on

bottom up stock picking in these sectors that we believe will continue to grow relatively strong growth relative to the market.

Very quickly on the property market: yes, I think the risk of asset bubble is always there in China. I think the bubble will grow bigger and bigger before we actually see the risk of the bubble burst. I don't think we are at this stage of the risk of asset bubble bursting.

Another thing I want again to highlight is the first tier cities and the coastal cities in China certainly is an area I think the asset prices have gone up too fast and therefore we should expect some correction. Whereas in the other lower tier cities in the Central and Western part of China, we actually continue to see very resilient and strong property prices and also property transaction will continue to remain quite strong. Actually in China we should not see just one single property market – rather it is multiple markets because different regions are at different stages of development.

But overall I think the government is very determined to cool off the property market particularly in the first tier cities, so given property prices remain strong we do not expect any easing of property market measures. And yet I think there will be no major new property measures from the central government. I think the focus is more on the local government to announce and implement specific measures to cool off the property market. The government will also accelerate the development of socialised housing, particularly low rent housing, to provide support to low income group and whilst continuing to suppress speculative demand. And that's why we have continued to maintain an underweight on China property but we actually prefer exposure through the materials sector particularly for companies with exposure in the Central and Western part of China.

**Roger Miners:** Thank you very much, Christina. Let's move to our questions and the first is to Andreas: do you think banking regulation across the UK and US will become even more restrictive in the future?

**Andreas Utermann:** Clearly what's in the pipeline right now is not fully implemented yet, be that for insurance companies, Solvency II, be that the capital requirements for BASEL 3 that have now been announced or indeed all the regulatory restrictions that are being mooted some to do with compensation, the structure of banks and so on.

Do I think it is going to go beyond what is currently being implemented and or discussed? I don't think so but it will have a significant impact. It has a significant impact in terms of the banks lending ability, it has a significant impact in terms of the attraction of talent and certainly I think most importantly it has significant competitive impact.

I am pretty certain that emerging market banks for example will be much less restricted in terms of the structure of their banks, the structure of their remuneration and so on and therefore may compete for very significant chunks of business much more effectively than they have in the past. Western OECD banks may well over time move much more of their business to the emerging markets. I think the current restrictions that are being implemented have not had the full impact yet but will certainly lead to very significant structural change in the banking industry in the world.

Longer-term I think probably as the world recovers and the financial market crisis of 2006, 2007, 2008, 2009 recedes into memory most likely given the competitive pressures that I talked about will be loosened to a significant degree in the future, not necessarily capital adequacy ones but many of the other ones that prohibit banks from engaging in a number of activities which they would like to engage in. The long and short of this is that probably the return on equity of the financial sector in total will be lower than it was pre-crisis for some considerable time to come and certainly for the period of the planning horizon for any sensible investors.

**Roger Miners:** Thank you, Andreas. The second question is, how will equities fair in 2011 and what happens if interest rates start to rise? Christina.

**Christina Chung:** Thank you for the question. I am positive on the outlook for 2011 mainly because I think the economic growth in China should be quite well supported by domestic demand. And also I mentioned earlier renminbi has a chance to appreciate at a faster rate and therefore this will continue to attract fund flows to China equity.

In terms of the potential risk of interest rate increase I think that the increase in interest rates will certainly have an impact

on liquidity which will have a negative impact on the equity market. However given a lack of investment alternatives in China and the high domestic savings rate, unless interest rates rise sharply we do not expect a significant impact on the market.

In terms of sectors I think this will be quite different. Obviously certain sectors will be affected more in particular for example the property sector as well as some cyclical sectors including commodities may react more negatively. For other sectors for example those I mentioned just now they continue to rise on very strong structural growth. The consumer sectors, the domestic demand related sector I think will continue to do quite well.

**Andreas Utermann:** Globally I'd just refer to what I said earlier in the GPC discussions that we have been having. We are fairly positive on equities both short-term as well as probably looking to the end of 2011. I think interest rates if they were to rise would probably be viewed as a good signal as the beginning of the end of the crisis and the recovery to a more normal economic environment. They would rise because growth would be stronger, they would rise because inflation expectations would be higher. And as long as inflation doesn't exceed 4% or 5% annualised equity markets would probably see that as a very good sign for future earnings growth potential and therefore would probably go up.

**Roger Miners:** Thank you Christina, Andreas and all of you for joining us for the call. We look forward to speaking to you on our next calls as we outline our outlook for 2011 in the New Year. Thanks very much.

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