

# Our Views on Global Markets

January 2008

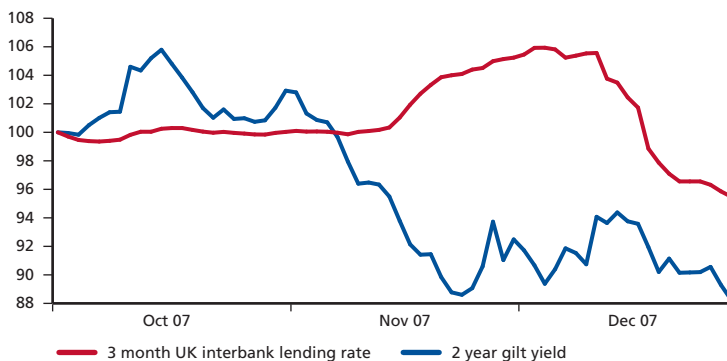


**Katherine Garrett-Cox**  
Chief Investment Officer

## Overview

- Equity markets struggled over the final quarter of 2007, faced by the headwinds of the credit crunch, rising oil prices and fears that the US economy could slip into recession. The contagion effect of the US sub-prime mortgage meltdown is still not yet fully quantified and the scale of write-downs from the banking sector will only begin to emerge in the first half of 2008.
- Banking shares have been hit hard with relatively reassuring trading updates failing to inspire any meaningful recovery. Central Banks have taken preliminary measures to break the log jam in the interbank lending markets. However, as shown in the graph, while interbank lending rates have fallen other market rates have also fallen leaving an uncomfortable gap.

**An uncomfortable gap in lending rates**



Source: Datastream

- The FTSE Global Index fell 2% over the fourth quarter. What was notable was a marked divergence in performance from global stock markets with Japan having a grim quarter, down 9%, while India was up 24%. Looking forward, 2008 will not be an easy year with the scale of slowdown in the US yet to become apparent. The consumer, particularly in the West, will have a tough time exacerbated by problems in the financial sectors. Even though the corporate sector, excepting financials, will go into a slowdown relatively strongly financed, profits will come under pressure.

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## Global Economy

### WTI Light Crude Oil Spot Price (\$)

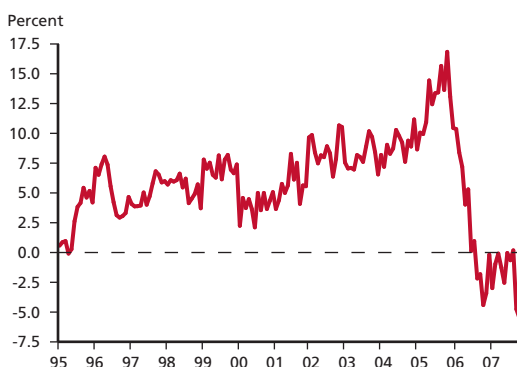


Source: Reuters EcoWin

- There is growing evidence to suggest that the problems experienced in the US sub-prime mortgage market have now broadened out to impact the consumer and the economy as a whole. As a result, we believe that there is now a large risk that the US economy may fall into recession this year. Although this would undoubtedly dampen activity across the world, there are some signs that the impact will be lessened by the recent increase in intra-regional activity in both Asia and Europe.
- A complicating factor is the recent rise in the oil price. This is having an inflationary impact across the global economy, which may restrict the flexibility of central banks to cut interest rates in an effort to underpin economic growth.

## United States

### US Existing Home Sales Median Price



Source: Reuters EcoWin

- The correction in the US housing market still appears to have some way to run. There are clear signs that problems in the sub-prime sector have now broadened into the wider market and house price growth remains negative. This is beginning to have an impact on consumer confidence and spending is expected to slow as a result.
- In addition to the headwinds from the housing market, there are emerging signs that the labour market is weakening. Slower employment growth, rising unemployment and downward pressure on wages would all dampen consumer spending further.
- The Federal Reserve has already cut interest rates four times in its fight to maintain economic growth. Financial markets expect the Federal Reserve to deliver more rate cuts over the next few months.

## Japan

### Japan Housing Starts (6 Month Moving Average)

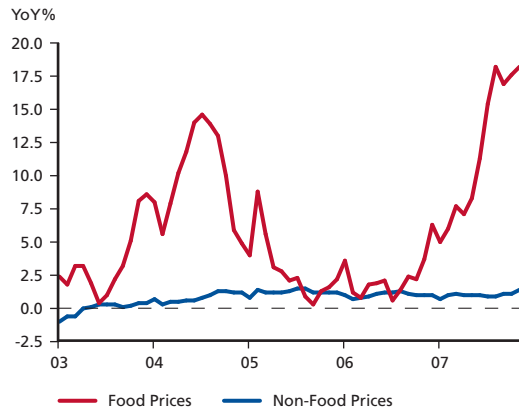


Source: Reuters EcoWin

- A change in the law governing building standards made it much more difficult to obtain housing permits and this has had a major impact on both residential related investment and headline GDP. Although this situation will ease, there may still be some negative impact during Q1 of 2008.
- The labour market appears to be weakening and recent data shows that there are now fewer jobs available than applicants. This, combined with the fact that both wage growth and bonus payments continue to disappoint, gives little hope of a significant recovery in consumer demand over the next few months.
- The yen has appreciated over the last quarter, gaining almost 6% against sterling and 3% against the US dollar. The trend of yen appreciation and gradual unwinding of the carry trade is likely to continue.

## China

### China - Inflation



Source: Reuters EcoWin

- Economic growth remained strong in 2007 driven primarily by investment spending and exports. We expect investment spending to cool slightly this year. Export growth is also expected to slow, particularly if the US economy goes into recession. However, despite this, China is still expected to be one of the fastest growing economies in 2008.
- Inflation in China remains a significant problem and is largely due to food prices which have risen almost 20% over the last year. This is a source of concern for policy makers and moves are being made to limit future price rises for basic goods.
- Chinese exports have undoubtedly benefited from the relatively low level of the yuan in recent years. International pressure for an upwards revaluation of the yuan continues to build and we expect further appreciation over the course of this year.

## Europe

### Germany - Unemployment Rate

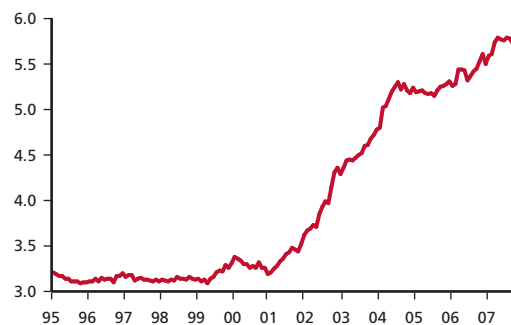


Source: Reuters EcoWin

- Inflation within Europe has risen sharply in recent months, driven higher by rising costs for both food and energy. This is occurring just ahead of the spring wage round and could result in higher claims and longer negotiations.
- The euro has risen to record levels against both sterling and the US dollar, putting pressure on export competitiveness. In addition, businesses are facing higher input costs which also threaten margins. Business confidence is continuing to decline, raising fears that the rate of economic growth may soften.
- Although export activity may be threatened by softer world economic activity or by the recent appreciation of the euro, there is some encouraging progress in domestic activity, given the recent improvement in labour markets and the sharp declines in unemployment recorded in several countries.

## UK

### UK - House Price/Earnings Ratio (HBOS)



Source: Reuters EcoWin

- The global credit squeeze has had an impact on the UK's property market, as mortgage lenders become more prudent in terms of issuing finance. Any further decline in house price growth could have negative repercussions for consumer confidence and spending.
- The Bank of England quickly reversed its interest rate policy by cutting the base rate by 0.25% in December, taking this to 5.5%. Although there are still inflationary pressures, we expect the Bank of England to deliver further rate cuts.
- Sterling reached a record high, on a trade weighted basis, during 2007. However, the currency has more recently experienced rapid depreciation as the first interest rate cut was delivered and on the prospect of more cuts to come.

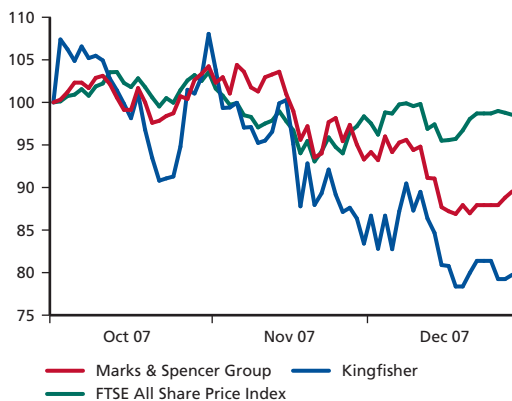
## Equity Views



**Neil Tong**  
Investment Manager

### UK

#### M&S and Kingfisher vs the FTSE All Share Index



Source: Datastream

- The UK equity market has continued to be volatile, pulled between optimism, regarding interest rate cuts and supportive historic valuations, and pessimism, regarding recession and the difficulties this could bring.
- The outlook for the consumer is particularly fraught and consumer-exposed stocks have been sold aggressively. This appears warranted at this stage with trading updates from retailers commenting on difficult conditions and with banks still much less willing to lend than even 6 months ago.
- The outlook remains challenging particularly in the shorter term. Financial markets are reflecting much of the negative outlook but little confidence exists in forecasting the trough. Positive impetus should be provided by ongoing growth from Asia and rate cuts from US and UK.



**John Ewart**  
Investment Manager

### UK Small Cap

#### UK Retail Sector vs FTSE All Share Index



Source: Datastream

- UK small cap is seen as more sensitive to an economic slowdown than the larger cap segment. Positive trading statements from companies have not been enough to prevent the selling of certain sectors.
- Domestically, the retail sector has suffered a challenging start to the year but the share price declines have been indiscriminate. Value is emerging but renewed consumer confidence may be required to tempt the public to part with their cash.
- Specific company valuations look compelling. New management teams, new products, and greater international exposure have yet to convince investors that a repeat of previous economic slowdowns is inevitable.



**Athole Skinner**  
Investment Manager

### Europe

#### Appreciation of the euro



Source: Datastream

- Conditions in Europe are likely to become tougher in the coming year on the back of the tighter credit markets, slowing economic growth and a strengthening currency.
- Wage negotiations in the first quarter are likely to test the ECB's nerve and will initially restrict any response to a slowing domestic environment.
- With the increasing likelihood of aggressive rate cuts from the Fed, there is further risk to exports from a strengthening euro. Continued appreciation of the euro would create a headwind.



**Matthew Strachan**  
Investment Manager

## North America

### Corporate earnings growth slowing down



Source: Datastream

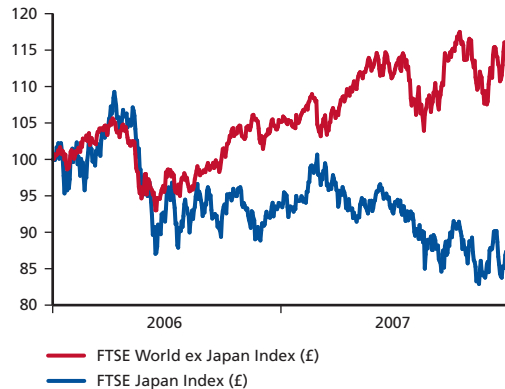
- The US presidential elections are fast approaching. While the last half of a presidential term has often been associated with a strong equity market, this time it looks unlikely. There is uncertainty over what the new president will bring and the sub-prime crisis has yet to be fully worked through.
- Losses sustained in the financial sector from sub-prime losses and write-downs have led to a series of capital raising exercises, often from foreign sources. However, uncertainty about potential further losses is leading to a tightening of lending standards and some companies to cut dividends and stop share repurchases.
- Aggregate US company earnings have now turned down as financial losses mount. Currently, consensus earnings growth for 2008 is forecast to be 15%. Given the economic outlook, this looks wildly optimistic. Earnings growth will be at a premium this year.



**Harfun Ven**  
Investment Manager

## Japan

### Japanese market underperforms



Source: Datastream

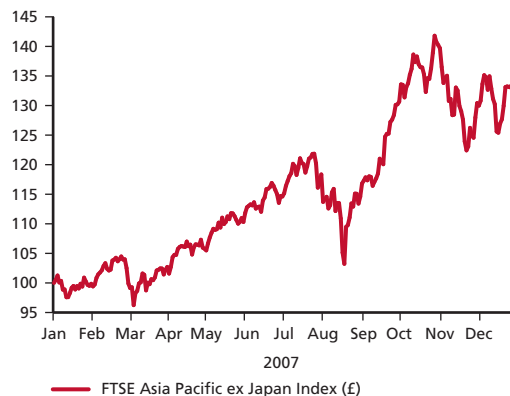
- The Japanese market has underperformed the world markets for 2 years as investors have become frustrated with weak consumption, a lack of progress in management attitudes, various scandals and collapses evident in the consumer finance and construction industries.
- The Japanese market is trading on a low valuation and dividend yields are on par with Japanese government bond yields. However, we remain cautious as growth decelerates in other developed economies, taking an inevitable toll on exports.
- Challenges remain ahead for Japanese corporations as they continue to grapple with higher costs and an inability to pass on these costs as consumers tighten their wallets.



**Tathagata Guha Roy**  
Investment Manager

## Asia-Pacific

### Asian Pacific Markets - a good year in 2007



Source: Datastream

- Sub-prime losses at major global financial institutions dampened the traditionally strong fourth quarter in Asia. Concerns continue as there is little visibility as to when and how the sub-prime related problems will be resolved.
- The fundamentals of Asia remain strong but growth should slow from high levels as economic growth in the US and Europe slow.
- The Asian markets ended the year up 37%. We continue to be mindful of valuations and prefer larger, liquid names and companies which are not wholly dependent on exports to the US and Europe.

## Market Moves - 31/12/07

Year to date	% Change Fourth Quarter		% Change Over 2007
	Local	Sterling	Sterling
FTSE All-Share (UK)	-0.9	-0.9	+2.0
FTA British Govt Over-15 years	+3.9	+3.9	-1.9
FTSE World (ex UK) (£)	0.0	0.0	+7.4
MSCI Europe (ex UK) (€)	-2.5	+2.6	+12.2
TOPIX (Japan) (¥)	-8.7	-3.8	-7.9
S&P Composite (US\$)	-3.8	-1.6	+1.8
Hang Seng Composite (HK\$)	+0.4	+2.3	+37.7
DAX 30 (Germany) (€)	+2.6	+8.0	+33.3
CAC 40 (France) (€)	-1.8	+3.3	+10.4
Australian All Ord (AUS\$)	-2.4	-0.9	+24.6

The equity indices are price index returns and make no allowance for income.

The fixed interest index includes reinvested income.

Source: Datastream

Exchange Rates	31 Dec 2007 (£)	% Change Fourth Quarter	% Change Over 2007
US\$	1.99	-2.3	+1.7
Euro	1.36	-5.0	-8.3
Yen	222.37	-5.1	-4.6
HK\$	15.52	-1.9	+2.0
AUS\$	2.27	-1.5	-8.7

Source: Datastream (WMR)

## Our View on:



**Neil Tong**  
Investment Manager

## UK Equities

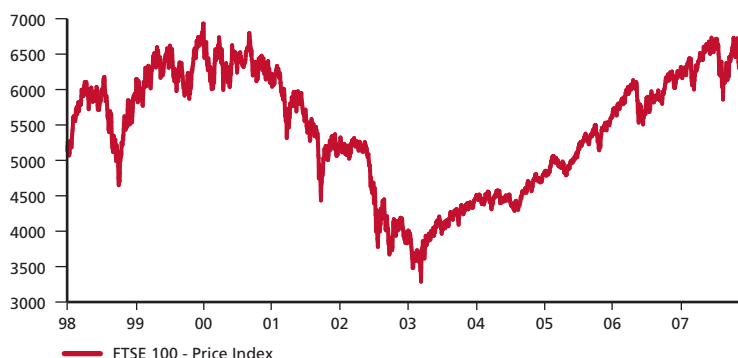
Looking forward, 2008 appears more difficult than ever with global banking at best in the earliest phase of workout and quite possibly still to experience the worst of the US housing downturn. We do expect at least a shallow technical recession in the US but are hopeful that the rest of the world will avoid recession through a combination of Chinese demand and interest rate cuts. In this scenario, the UK stock market should muddle through. However, with

uncertainty and volatility continuing to move hand in hand the early part of the year appears likely to be similar to the second half of 2007.

### Valuations are undemanding

The graph below of the FTSE 100 index shows the stock market is valued at close to the same level as 8 years ago, even though corporate profits have risen by over 70% since then.

**FTSE 100 - Price Index**



Source: Datastream

### Bond vs Equity Yield Ratio



Source: Datastream

This would indicate a significant de-rating of the valuation currently placed on UK equities. The ratio of price to earnings supports this view - UK equities are currently on about only 11 times historic earnings.

UK equities also look good value against other asset classes, including bonds and property. The graph shows the ratio between the 10-year gilt yield (currently 4.5%) compared with the FTSE 100 index (currently 3.2%). Unless the risk premium placed on equities compared to bonds is going to rise further this should provide support for the stock market. In our view, this leaves plenty of scope for UK equities to deliver attractive returns, provided careful stockpicking is backed by a sound economy.

### Where to find value

At the sector level, UK financials do look interesting, more bad news is likely but much is already discounted in current share prices. If capital is not undermined significantly further then dividends should be at least maintained. There are some very attractive yields available from UK financials but they are not risk free and we are carefully analysing balance sheets and exposures to try to find some solid high yielding investments. Lloyds, for example, is out of favour with talk of possible dividend cuts. We believe this is misplaced and some deterioration in returns is already priced in.

We are also currently staying with our positions in resource stocks because the drivers of Chinese demand, supply constraint and consolidation all remain in place. Even if there is a slowdown in hard commodities in 2008, China and the rest of Asia will continue to buy up large amounts as they no longer need the UK or US as an export market. Investors could also benefit from the potential mega-merger between BHP Billiton and Rio Tinto.

It feels too early to increase exposure to the UK consumer. Nonetheless, where companies have solid asset backing and sound business models there may be some bargains for the long-term investor, with housebuilding and retailers looking likely areas to focus on. Defensive stocks like Diageo and Reckitt Benckiser are close to being fully valued on a short-term basis. The reliability of their earnings streams remain attractive but high PE ratios make their shares vulnerable to downgrades. In pharmaceuticals, a lack of new products and negative regulatory environment make it hard to be over optimistic on the sector.

Companies with sustainable yields remain attractive – in the utility sectors for example, some of the yields available compare well with those on bonds and strong cashflows mean future dividends are likely to rise. In telecoms, BT offers one of the highest yields outside the financial sector while Vodafone should benefit from strong trends in mobile data and a stable competitive environment.

Sterling has lost value against other currencies in recent months, a trend we expect to continue as interest rates come down. Against this background, companies with high levels of overseas earnings should benefit.

### What are the main risks

To some degree, the future of equity markets remain linked to fortunes in the US. Stock selection is likely to remain crucially important in 2008. Economic risks are undoubtedly increasing with current account and fiscal deficits both rising, inflation threats lurking and corporate profits under pressure. Financing has become more difficult and consolidation and merger activity has tailed off. Offsetting this in the UK, valuations are not demanding, further rate cuts should help sentiment and company balance sheets remain strong. ■

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