

Our Views on Global Markets

April 2008

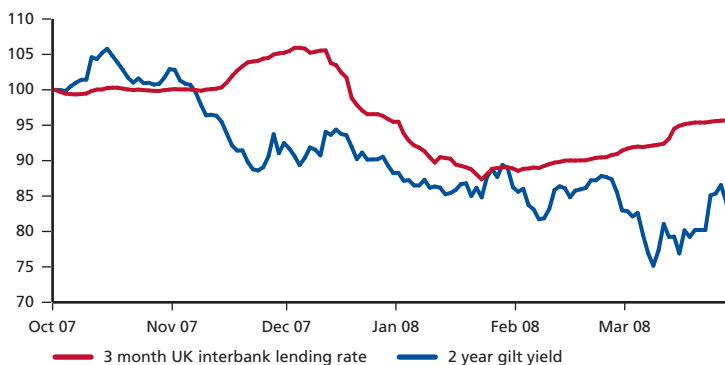


Katherine Garrett-Cox
Chief Investment Officer

Overview

- Equity markets experienced a very difficult first quarter as selling pressure dominated, often being driven by the unwinding of leveraged positions; this was exacerbated by some forced selling, most notably by Societe Generale, Bear Stearns and CSFB. Of greatest concern was systemic risk within the global financial system, and the high profile funding problems of the Peleton, Carlisle and Lehman hedge funds illustrated some difficult realities of the credit crunch. The reasonably orderly resolution of JPMorgan's takeover of Bear Stearns and the widening of acceptable collateral by central banks towards the end of the quarter improved investor confidence in central authorities.
- LIBOR (the rate at which banks lend to each other) remains at an elevated level. Over the quarter, LIBOR rose marginally to 6.01%. However, in late January the rate had improved to 5.5% suggesting that the interbank lending market was starting to function better. Disappointingly, this improvement has subsequently unwound. That LIBOR remains at these high levels in spite of rate cuts, a widening of acceptable collateral and a relatively acceptable UK banks reporting season is worrying.

Interbank lending still problematic



Source: Datastream

- Company results for 2007 were generally good with real profit and dividend growth the norm. However, outlook statements were more opaque and tinged with caution than has been the case at this point in recent years. Second order or real economy slowdown effects are clearly being anticipated by many executive management teams. Just how effectively they can avoid these contractionary forces remains to be seen. Aggregate expectations for earnings growth appear overly optimistic, in some markets these remain as high as 10%+. First quarter results could prove a watershed as companies and analysts take a more realistic view for 2008; this adjustment process is likely to be painful at a stock specific level at least.

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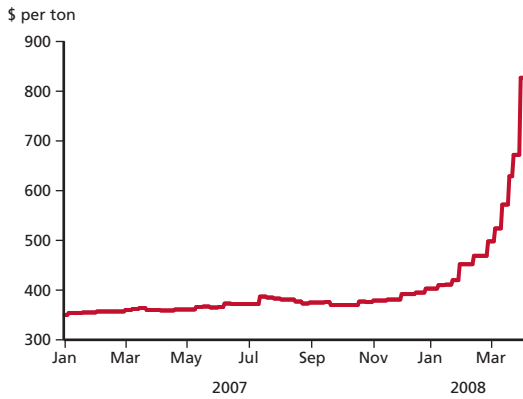
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Shona Dobbie
Head of Research Centre

Global Economy

Rice Price - 100% 1st-A Bangkok



Source: Reuters EcoWin

- The US sub-prime problem has resulted in a sharp pull back in lending, producing a credit squeeze which is having an impact all around the world. The economies with the highest level of indebtedness are most threatened by the squeeze.
- The decline in US growth has been accompanied by a drop in the value of the dollar. This has pushed up the dollar price of most commodities, adding to inflationary pressures around the world. In addition to fuel price increases, we are also seeing sharp price rises in many basic foodstuffs. The recent sharp acceleration in the rice price is already causing considerable problems in Asia.

United States

US House Price Growth - S&P Case-Shiller (Composite 20 cities)

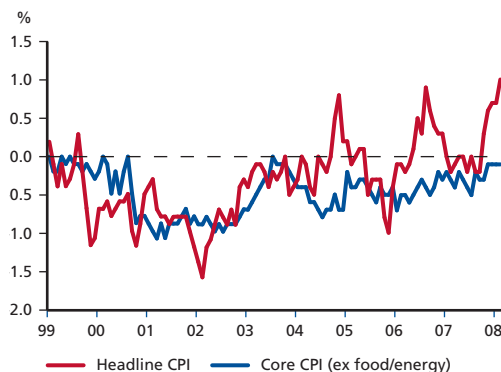


Source: Reuters EcoWin

- Significant falls in house prices have had a negative impact on consumer confidence and spending, causing the overall economy to weaken. Unemployment has started to rise, and a recession now looks likely.
- Policy makers are taking steps to ease conditions in both the housing market and financial markets, but these measures will take time to have an impact. It is too early to know how deep or long this downturn will be.
- Headline inflation has risen to over 4% but this is largely driven by increased fuel costs and the core rate of inflation is much lower at less than 2.5%. Inflation is expected to fall back as demand weakens over the next few months.

Japan

Consumer Price Inflation

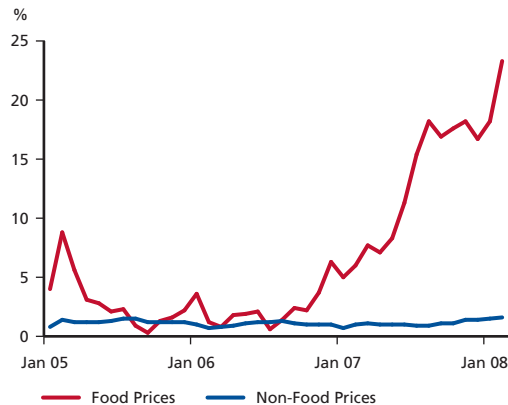


Source: Reuters EcoWin

- While its domestic situation is weak, Japan's economic growth depends heavily on the performance of its export sector. Although sales to the US have weakened noticeably, sales to other regions of the world have held up relatively well, despite the recent strengthening of the yen. Over the last quarter the yen has strengthened by 10% against the dollar but, more importantly for exporters, by only 3% against the euro.
- During Q1 headline inflation in Japan reached 1%, its highest level in almost 10 years. But the core rate of inflation, which strips out both food and energy prices, remained in deflationary territory, where it has been for the past 9 years. This twin problem poses a real dilemma for policy makers.

China

Consumer Price Inflation

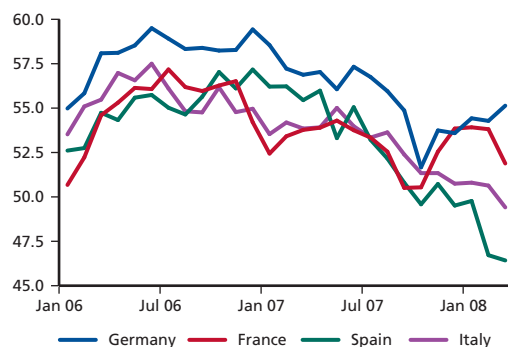


Source: Reuters EcoWin

- China's growth remains strong and this is important for the world economy as a whole. Investment is expected to cool later this year, following the Olympics, and export growth may be impeded by lower demand from other economies, but China is still expected to be one of the fastest growing economies in the world. China's performance over the rest of this year will be critical for global economic growth.
- Inflation is a big problem in China, and this is driven primarily by the high cost of food. Food price inflation is currently running at over 20% and has risen sharply in recent months, due to increased demand and supply shortages caused by poor weather conditions or disease. Policy makers are concerned about the high level of inflation and have taken steps to limit price increases for many basic goods.

Europe

Purchasing Managers' Indices: Manufacturing

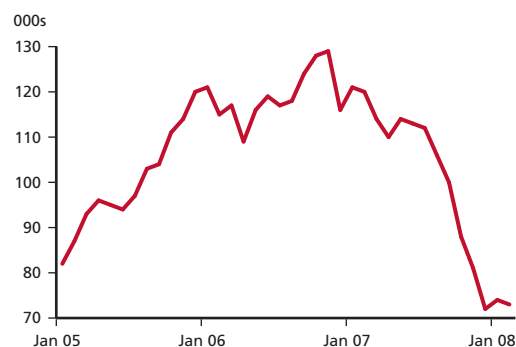


Source: Reuters EcoWin

- The euro has been one of the strongest currencies in recent months and appreciated by 8% against both the dollar and sterling during the first quarter of 2008. This move threatens the competitiveness of exporters, who have to seek to cut costs in order to maintain margins and profits.
- Strains are beginning to appear across Europe, as is evident by the growing divergence between the apparent 'winners' and 'losers'. Business conditions are holding up relatively well in Germany, and France, but are deteriorating quickly in both Italy and Spain.
- Inflation is relatively high across Europe, despite the strong euro which should help to contain import price rises. This situation is causing policymakers some concern and the ECB has left interest rates unchanged since June, despite signs of some softening in economic activity.

UK

Mortgage Approvals



Source: Reuters EcoWin

- The global credit squeeze is having an impact in the UK. Mortgage approvals have declined sharply and house price growth has softened - it may even turn negative within the next few months. This could be damaging to consumer confidence and spending.
- Headline inflation has started to rise once more due to further gains in prices for fuels, household utilities and food, and higher inflation is expected over the next few months. This could impede the ability of policy makers to cut interest rates as quickly as they would otherwise.
- The deteriorating outlook for the UK economy, and the prospect of further cuts in interest rates, have reduced the attractiveness of sterling which has depreciated by more than 5%, on a trade weighted basis, over the quarter.

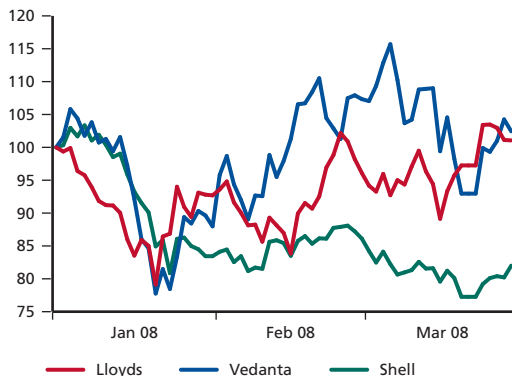
Equity Views



Neil Tong
Investment Manager

UK

Lloyds, Vedanta and Shell Ordinary Shares (Total Return)



Source: Datastream

- UK equities did not escape the global turmoil in financial markets and produced a very disappointing return in Q1 of -11%. Despite an oil price that stayed around U\$100/bbl both Shell and BP suffered from operational problems leading to large share price declines of over 17%. Telecoms also suffered from operational concerns causing both BT and Vodafone to fall over 19%.
- Real economy effects of the credit crunch are now being experienced, most notably in the availability of mortgages with some commentators claiming that product availability is around 30% of peak levels. When added to higher food and fuel prices, the outlook for the UK consumer is continuing to deteriorate.
- Commodity prices remain firm and severe supply disruption has caused some very strong price increases. Corporate activity continues but, with Vale walking away from Xstrata and Chinese stake building in Rio Tinto, straightforward takeovers appear less likely.



John Ewart
Investment Manager

UK Small Cap

PE ratio of engineering sector relative to market



Source: Datastream

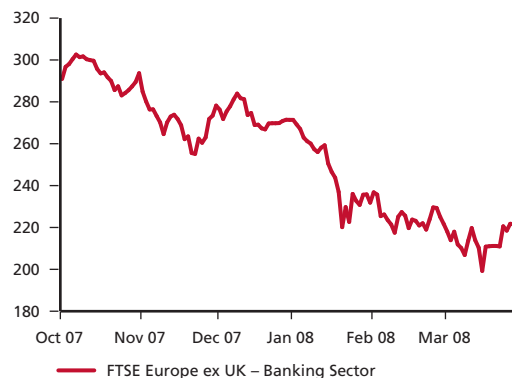
- Market volatility remains a feature of the small and mid cap universe. Disappointing results and commentary are being punished, but good results are not always being rewarded.
- The engineering sector suffered a sharp sell-off in December and January, but recent results have offered encouragement that the level of structural demand is sustainable. Valuations look attractive, but not all companies will be beneficiaries. Stock selection remains key.
- Investor resilience is being tested as the macro data continues to give cause for concern. Many stocks which have fallen out of favour look attractive, but we are inclined to wait until we see evidence of profit downgrades before being tempted to revisit.



Athole Skinner
Investment Manager

Europe

Less negative newsflow now expected from financials



Source: Datastream

- Incrementally, there is less negative newsflow now expected from the financials with respect to the size of write-downs likely to be taken. The recent improvement in asset-backed indices indicate that the value of high-risk mortgage portfolios appears to have stabilised.
- Although the reduced likelihood of increasing write-downs certainly helps sentiment, the operating environment continues to be extremely challenging for the banks in particular.
- In addition to the poor macro outlook and negative earnings momentum, the sector also faces challenges from the credit markets and the general de-leveraging of their business models.



Matthew Strachan
Investment Manager

North America

Decline in value of the dollar



Source: Datastream

- The first quarter of the year was one of the worst ever starts for equity markets, with the S&P 500 index falling 10%. Another wave of 'sub-prime' write-downs rocked the credit markets, but fears of default were alleviated when JPMorgan bought Bear Stearns with the assistance of the Fed.
- The distress in the credit markets is now making borrowing more expensive and difficult to obtain despite the lowering of Federal interest rates. This, in turn, is curbing economic growth and will put pressure on company earnings.
- The decline in the value of the dollar, however, is a boon to US companies with a large international presence. This should be a significant support to their profits and we continue to look for, and invest in, companies with strong export potential.



Harfun Ven
Investment Manager

Japan

Japanese market likely to remain volatile and range bound



Source: Datastream

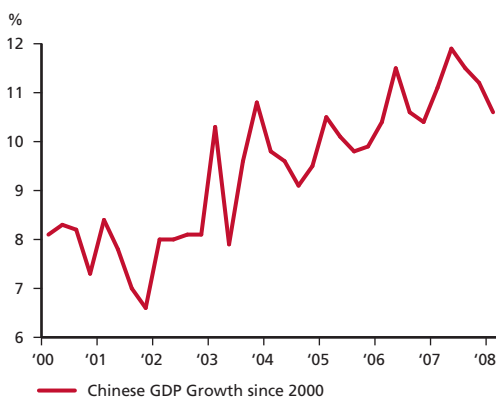
- We have held the view for some time that corporate earnings will come under tremendous pressure. The market has finally revised earnings forecasts downwards for fiscal year 2008 reflecting a stronger yen. However, the slowdown of top line growth may yet need to be factored in.
- Risk aversion and the reversal of the carry trade has accelerated the appreciation on the Japanese yen to below ¥100/US\$ in March. At this level, even competitive Japanese companies that are growing businesses in the Asian region will struggle to maintain profits.
- With a domestic environment that is facing cost pressures and both business and consumer sentiments at low points, the economy will again be swayed by external demand. Visibility has deteriorated and we believe the markets will remain volatile and range bound.



John Lee
Investment Manager

Asia-Pacific

Chinese GPP Growth



Source: Datastream

- While slowing economic activity, particularly in the US, is a source of concern, growth rates in Asia Pacific are still high.
- In Korea, new policies aimed at deregulation, particularly in the property sector, will most likely be passed in 2008.
- If the balancing act between inflation and growth can be maintained in China and India, then the prospects for a rally in Asian markets look good.

Year to date	% Change over First Quarter		% Change Over 2008
	Local	Sterling	Sterling
FTSE All-Share (UK)	-10.9	-10.9	-10.9
FTA British Govt Over-15 years	-0.6	-0.6	-0.6
FTSE All World (ex UK) (£)	-12.3	-9.4	-9.4
MSCI Europe (ex UK) (€)	-15.8	n/a	n/a
TOPIX (Japan) (¥)	-17.8	-7.6	-7.6
S&P Composite (US\$)	-9.9	-9.8	-9.8
Hang Seng Composite (HK\$)	-17.9	-17.6	-17.6
DAX 30 (Germany) (€)	-19.0	-12.1	-12.1
CAC 40 (France) (€)	-16.2	-9.0	-9.0
Australian All Ord (AUS\$)	-15.8	-12.3	-12.3

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 March 2008 (£)	% Apprec/ (Deprec) of £ over First Quarter	% Apprec/ (Deprec) of £ over 2008
US\$	1.99	-0.2	-0.2
Euro	1.25	-7.9	-7.9
Yen	197.83	-11.0	-11.0
HK\$	15.47	-0.3	-0.3
AUS\$	2.18	-4.0	-4.0

Source: Datastream (WMR)

Our View on:

UK Economy



Shona Dobbie
Head of Research Centre

The UK economy has enjoyed over 15 years of uninterrupted growth, with a strong labour market, record house prices and relatively benign inflation. But can this situation last? Although the Prime Minister and the Chancellor of the Exchequer have claimed that the UK will 'weather the global financial storms' there is no doubt this will only occur if the economy can overcome some major risks and hurdles. In this article we identify what we see as the five biggest challenges currently facing the UK economy in 2008 and assess the outlook for economic growth, inflation and interest rates.

1 The Global Credit Squeeze

During 2007, problems in the sub-prime mortgage market in the US quickly escalated into a global credit market squeeze. In the UK this resulted in the interbank rate (at which banks lend to each other) surging far higher than the policy rate (which is set by the Monetary Policy Committee). Under normal conditions the interbank rate would be around 35 basis points (bp) higher than the policy rate, but this spread increased to almost 100bp both in August and December and 75bp in March, reflecting fears about the scale of losses being incurred by some of the world's major financial institutions. This increase in the interbank rate of interest makes it more expensive to borrow, and banks have also been reportedly inactive even at these higher rates of interest. The era of cheap financing may be coming to an end. Borrowers are finding it more difficult to access funds, and this is

delaying investment or expenditure plans. The interbank rate remains at an elevated level and there is a real risk that this will impede consumer and corporate spending. Both of these are of high importance for the UK economy, as consumer spending accounts for over 60% of gross final spending, and investment spending for just under 20%.

2 Potential Slowdown in the Housing Market

The UK housing market has been in boom territory for the last few years, resulting in the average house price in the UK reaching almost £200,000 and making it almost impossible for first time buyers to get onto the property ladder. However, there is now a real risk that the global credit squeeze is bringing this boom to an end. Already there are reports that potential borrowers are finding it more difficult to access mortgage

financing and that mortgage lenders are becoming increasingly prudent in terms of the amount of finance which they will issue. Mortgage approvals have dropped sharply in recent months and house price growth is now slowing. There is a risk that the market slows further and that house prices fall, which could have a negative impact on consumer confidence and spending. In addition, many borrowers who had taken out fixed rate mortgages when interest rates were low in 2006, now face mortgage resets at a higher rate of interest, and this could also have a negative impact on consumer spending growth. The biggest risk to the outlook for the housing market is employment. If slower economic growth results in a rise in unemployment, there could be some forced sales of property, which would push house prices down and leave some late entrants into the market facing the prospect of negative equity.

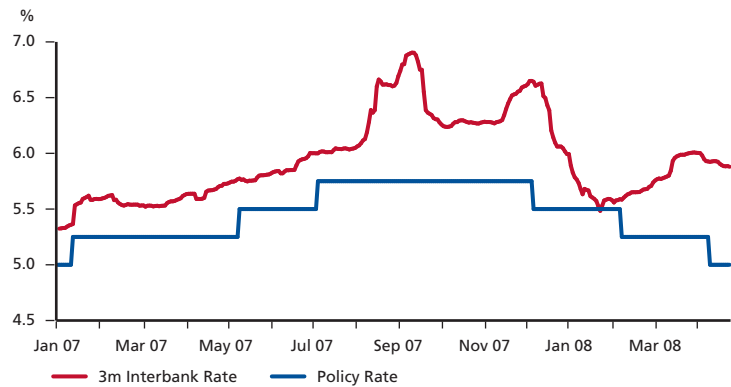
3 The High Level of Consumer Indebtedness

Low interest rates, and a willingness of lenders to give consumers access to cheap credit, produced unprecedented growth in consumer borrowing in the UK. Chart 3 on the right shows that net consumer lending has overtaken GDP, indicating that we owe more than we produce in any single year. This high level of debt leaves households with very little flexibility in the face of negative events, such as rising interest rates, loss of employment or house price falls. In addition, the global credit squeeze is likely to have some dampening effect on the extent to which consumer credit is issued, and those on low incomes, or with poor credit histories, may now find it more difficult to access credit. Much of the growth in consumer spending has been financed out of debt rather than income, so any move by consumers to retrench, and rebuild savings, will have a negative impact on personal consumption and GDP growth.

4 The Fiscal Deficit

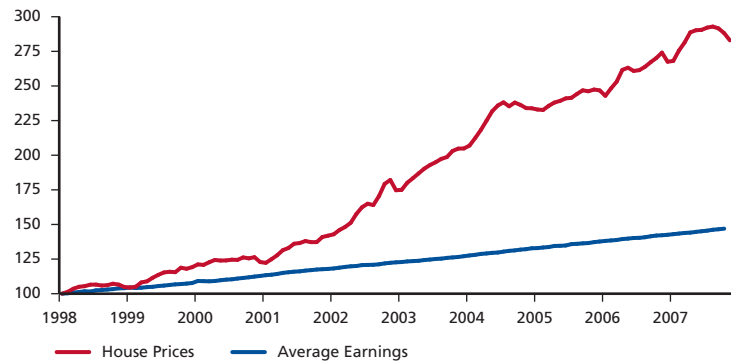
Although the UK has enjoyed an unprecedented 15 year period of uninterrupted growth, the government's finances do not look strong. Although tax revenue growth has been relatively robust, expenditure has been high and the government's budget remains in deficit. Recent projections by the Chancellor suggested that the government's deficit in the fiscal year to April 2008 was £7.9bn. Growth forecasts are now being revised downwards in the aftermath of the credit squeeze, and tax revenues could be hit as a result. The fiscal deficit is forecast to be equivalent to 3% of GDP (on a Maastricht basis) which could limit the government's flexibility to deal with any downturn in the economy. In the worst case scenario, the government could find itself having to cut spending, or even increase taxes, at a time when the economy is slowing and a loosening of fiscal policy would be more appropriate.

1 Interbank Rate v Policy Rate of Interest



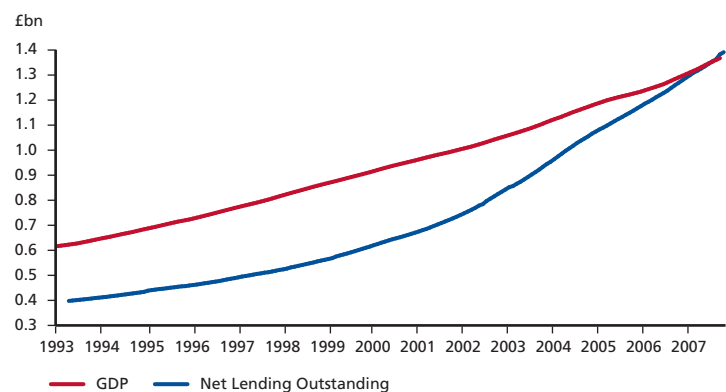
Source: EcoWin

2 House Prices v Average Earnings (Rebased to Jan 1998 = 100)



Source: EcoWin

3 Net Lending v Gross Domestic Product



Source: EcoWin

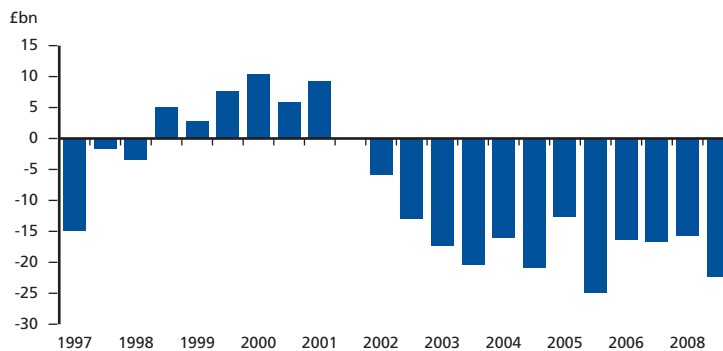
5 Inflation

There are signs of growing inflationary pressure in some sectors, particularly in food and energy. The rise in the oil price, to over \$100 per barrel, has pushed fuel costs higher, affecting both energy and transport costs across the whole economy. Any rise in distribution costs quickly feeds through into higher retail prices, with a direct impact on consumers. In addition, we have also been witnessing a steady rise in food prices, due to flooding, poor harvests and high levels of global demand. Food and fuel prices are now rising at a much faster rate than the headline rate of inflation suggests, and this can have a dampening effect on consumer spending, as households buy these basic goods but are left with less money to spend on more discretionary items. This increase in the rate of inflation might impede the ability of policy makers to cut interest rates quickly as economic activity slows. This could result in a downturn which is deeper and more protracted.

Summary and Outlook

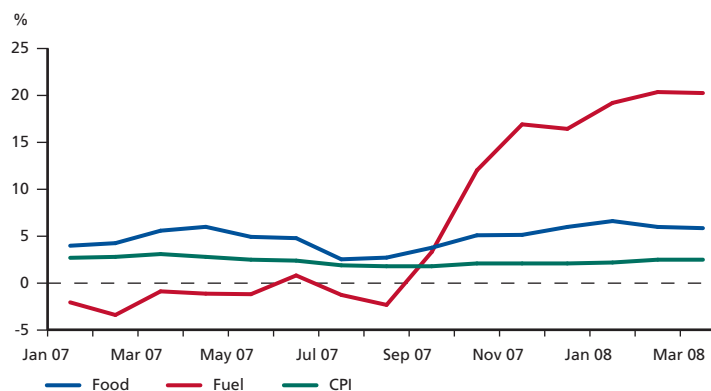
The UK economy has been strong in recent years, but several headwinds are now building and the question is whether the economy is going to be strong enough to escape unscathed. On balance, we expect that the credit squeeze, the current downturn in the housing market and record levels of consumer debt will result in weaker levels of consumer confidence and spending, pulling the headline rate of economic growth down to a much slower rate of growth. The actual extent of the slowdown will be determined by the labour market. If employment remains relatively strong then the slowdown might be contained, particularly if the monetary authorities are able to reduce interest rates speedily. However, if unemployment starts to increase rapidly then the slowdown could become much more pronounced, and the downturn in the housing market could also turn into a much deeper and more protracted event. The outlook for inflation is also critical, as inflationary pressures could prevent the monetary authorities from cutting interest rates as quickly and decisively as is needed. However, we expect inflationary pressures will be reduced once demand cools, and a more subdued labour market should help to eliminate any threat of serious wage inflation. Against this background of weaker growth and dampened inflationary pressure, the Bank of England could deliver the interest rate cuts over the coming year, which will be necessary to contain the slowdown in the economy.

4 Central Government Net Borrowing/Lending



Source: EcoWin

5 Inflation - Food and Energy



Source: EcoWin

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