

Navigating the headwinds to recovery

AT A GLANCE

OCTOBER 2011

US growth may have slowed significantly this year, but every cloud has a silver lining. In the midst of financial turmoil and sharp declines in confidence, data has begun to surprise on the upside again.

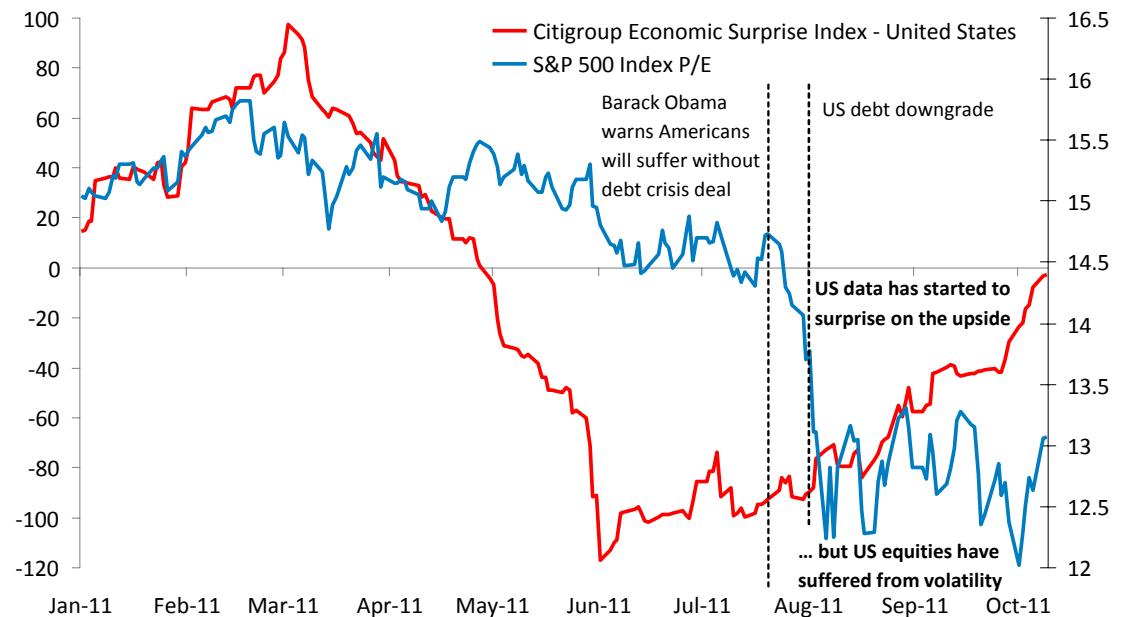
- Markets, consumers and businesses are already discounting the possibility of a recession, but this is not consistent with much of the economic data
- ISM data remains in expansion mode, leading indicators point to continuing growth, payroll numbers have been stronger-than-projected, vehicle sales have risen and economic surprise indices have ticked upwards

But there are lots of headwinds:

- Some survey-based measures are reflecting recessionary levels e.g. the Philly Fed index
- Real income growth has stalled – this implies a challenging outlook for consumption
- Recent data on consumer spending has been mixed
- Financial conditions have tightened as the European crisis spills over into the US

Looking forward, ultra-loose Fed policy, more fiscal support, greater political co-ordination and better capitalised banks will be critical to the US economy's resilience.

Economic surprises index has picked up, but risk sentiment remains weak



Source: Bloomberg, 12.10.2011

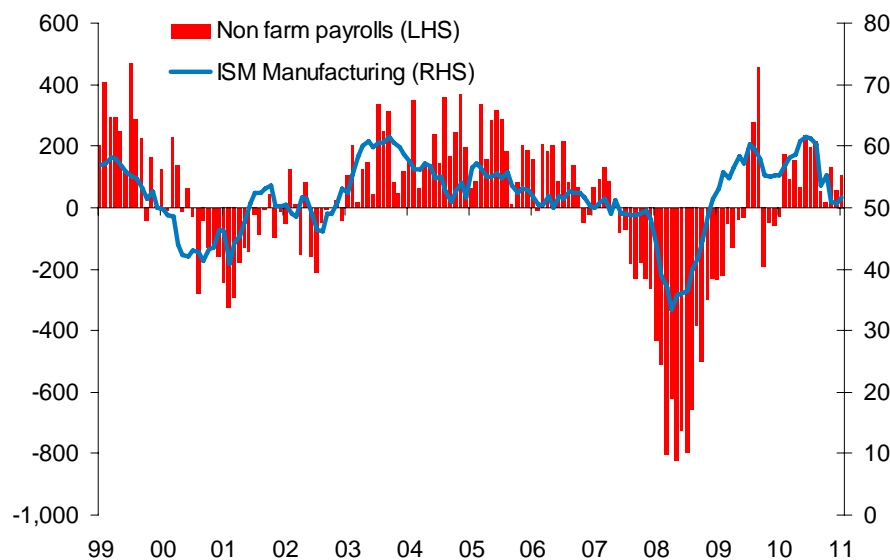
There is a disconnect between sentiment and reality

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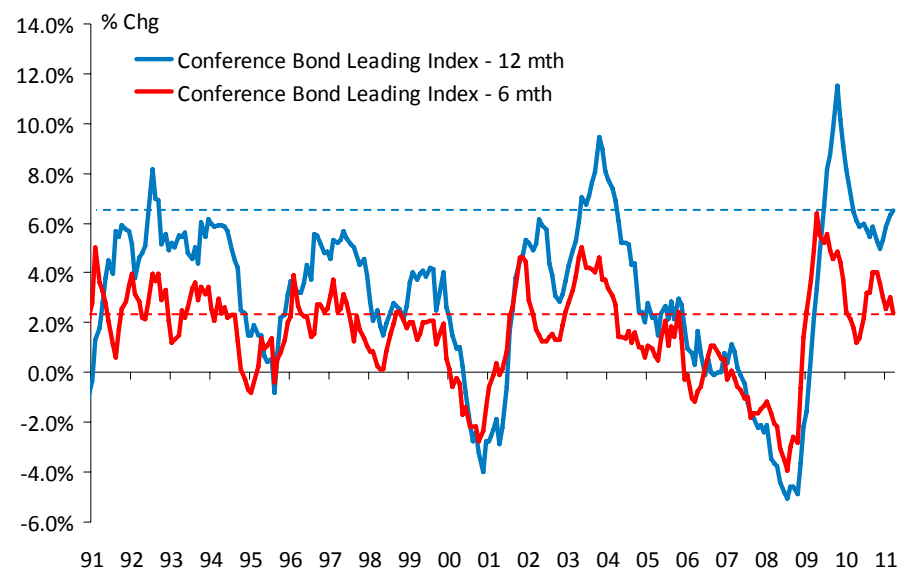
- Despite these headwinds, this could be an excellent entry point into US equities – markets, consumers and business are already discounting the worst even though data is starting to improve
- Ultra-expansionary monetary policy remains in place, but leading indicators are yet to show a major deterioration
- Economic activity is still expanding and the Fed remains committed to more stimulus if needed; these are important offsets to future equity market volatility and economic sentiment
- US companies are leaner and more robust than pre-2008 recessionary times: corporate balance sheets are cleaner, corporate borrowing costs are lower, earnings continue to confound the market with their strength and companies are still offering future earnings guidance
- The recent slide in economic confidence may have overshoot actual economic activity making this is a buying opportunity for investors prepared to look through the current uncertainty.

New jobs are being created and manufacturing is still expanding



Source: Datastream, 13.10.2011

Leading indicators are yet to show major deterioration



Source: Datastream, 13.10.2011

Final thoughts from our portfolio managers...

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Recently, sharp stock price moves have provided me with many attractive entry points. At present, my investment process is unearthing attractive valuations for stocks which have in many cases been unfairly punished. There are some good-quality defensive growth stocks whose fundamentals do not reflect the battering they have received by indiscriminate macro fears. There are also some great cyclical stocks (ones with long-term growth stories) which are exposed to segments of the economy that never really recovered since the 2008 recession, like housing and employment-related stocks. Even these, when using the framework of the 2008 recession, offer very attractive risk-return characteristics.

Adrian Brass, US Equities

In this environment, the US actually benefits from its defensive characteristics. Housing starts, car sales and capital spending are running well below normal levels and could become key drivers for the economy later this year. Following the recent rotation towards defensive sectors, areas like industrials and technology are becoming increasingly attractive.

Aris Vatis, US Equities

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