

2010 Investment Outlook – Ireland & the World

The mood at the beginning of 2009 was very much doom and gloom. However, in March markets began to turn and by the end of the year stock markets had posted the biggest annual gain since 2003. In fact, nearly all risky asset classes rallied as central banks kept interest rates at historic lows and governments around the world enacted stimulus programs to halt the first global recession since World War II.

Economic Recovery

While the economic recovery is approaching its first anniversary in Asia, it is just gaining its footing in most of the developed world and policy measures have not changed very much from those that were put in place at the height of the crisis. The countries in Asia that have led the global economic recovery have completed the initial period of rapid growth and are now slowing. At the other extreme, the laggards (most notably Europe and the US) are just now entering the period of strong growth, which should continue through the first half of next year and keep global growth near its peak. Global growth is expected to slow later in 2010, as the pace of advance in the laggards settles back. Similarly, inflation risks are expected to be muted as excess capacity remains pervasive and inflation tends to lag the growth cycle. Overall, while 2010 may not provide the excitement of 2009, it could be another very favourable year for growth and inflation fundamentals.

For 2010, markets should be driven by a broader range of structural and intermediate-term issues rather than being dominated by the twists and turns of an all-powerful global financial crisis and the resulting economic cycle. Among the issues that investors will need to consider are the exit strategies to be taken by central banks, the debt dynamics resulting from severe budget deficits, regulatory responses to the financial turmoil and the intermediate-term consequences of the extreme liquidity measures employed by central banks.

Summary of Key Economic Projections for 2010

REGION	GDP GROWTH (%)	INTEREST RATES (%)	INFLATION (%)	CURRENCY PER USD	10 YEAR YIELDS (%)
Global	4.33	various	2.50	various	various
US	2.93	0.32	2.35	1	4.23
Europe (EU)	1.73	1.50	1.05	1.50	3.74
UK	1.63	1.25	2.30	1.67	4.28
Japan	2.00	0.10	-0.70	89.00	1.25
Asia	7.40	various	2.85	various	various
Latin America	4.40	various	6.60	various	various

Source: Goldman Sachs, Merrill Lynch, Barclays Capital, Nomura, JP Morgan

To date, the rally in most asset classes has been driven firstly by the sheer undervaluation at the beginning of the year and latterly by improving economic fundamentals. Meanwhile, much of the extreme policy stimulus remains in place. The combination of economic recovery and unusually low interest rates continues to provide strong support to asset prices of nearly all types in most regions of the world. Until signs emerge of a change in that environment, the outlook for risky assets remains bright.

Ireland

The Economic and Social Research Institute (ESRI) estimates that the Irish economy contracted by 10% on a GNP basis or 7.5% in GDP terms in 2009. A further contraction is expected in 2010 but this should be modest compared with 2009. Output is forecast to continue to fall during the first half of the year followed by a resumption of growth in the second half. While these are stark figures,

the true impact of the recession is probably better illustrated through the employment and unemployment figures. At the end of 2007, the rate of unemployment was just 4.6%. At the end of 2009 it was 12.5%. Unemployment is forecast to peak at close to 14% in the latter part of 2010.

On the public finances, the general Government deficit is expected to be 11.75% of GDP in 2009 and 11.5% in 2010. The general Government debt is forecast to reach 78% of GDP by the end of 2010. This figure does not include any net liabilities under NAMA as such liabilities will not be treated as part of the general government debt. Unlike many developed economies, Ireland has been ruthlessly purging the excesses of the bubble. In addition to this and given developments in the international environment, exports are expected to grow next year at a rate of 1.5%. By the end of 2010, there is potential for Ireland to surprise on the upside.

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Europe

In Europe, a progressive and gradual recovery is expected during 2010. While Europe shares some of the common positive forces with the US, several other negative factors may prevent the recovery from being above trend growth. First, a sharp deterioration in productivity in Europe suggests that the cyclical reaction of business was not as strong as that in the US. Second, a strong value of the euro contrasts with the weak dollar and puts particular pressure on the industrial sector in southern Europe. Third, a significant fiscal tightening already emerging in the more highly stressed countries (Greece, Ireland, UK) is likely to dampen the relative recovery of Europe. Finally, the construction sector is still retrenching in certain overextended economies (notably Ireland and Spain). Altogether, this justifies the expectation that the recovery of Europe will be weaker than that of the US. Within Europe, Germany is likely to lead the way of the major economies, whereas Spain is likely to contract somewhat further in 2010.



US

In the US, the retrenchment of the business sector turned out to be excessive and the collapse of demand for cyclical goods like cars, electronics and housing seems disproportionate to that of other sectors. This implies a return to spending levels in these goods below the troughs of previous recessions and underscores how little is needed for a recovery driven by these cyclical factors. Thus, the stability of retail sales and housing markets provides the underpinnings to see investment spending account for the bulk of the demand turnaround in 2010.

A key obstacle to improving confidence in the US recovery is the lacklustre employment picture which has shown clear signs of improvement. The rate of employment destruction has slowed rapidly and the trend in hours worked is improving, which suggests that the unemployment rate is close to its peak. With the activity data adding more pressure for businesses to expand, this suggests that the trend of improving employment is likely

to continue. Overall, businesses may have overreacted to the crisis and job gains could start in early 2010.



Japan

In Japan, initial estimates of strong growth in Q3 were subsequently revised sharply lower. Furthermore, growth is forecast to hit a soft patch in the first half of 2010 as the policy gap leaves public investment and consumption exposed to downward pressure and the economy too dependent on overseas demand. Further fiscal and monetary action is needed to address sluggish domestic demand and deflation as the output gap is still deep in negative territory. The Bank of Japan remains reluctant to boost demand by aggressively using its balance sheet and is counting on the Japanese government to boost demand through fiscal policy. If the government does introduce a large fiscal package, the Bank of Japan may follow with additional expansions. At this point, however, there is no reason to expect any change in fiscal policy and economic performance expectations in 2010 remain muted.



Emerging Markets

The MSCI Emerging Markets Index ended 2009 with a yearly gain of 74.50%, the biggest since records began in 1988. Emerging Market

equities have not reached their pre-crisis levels, but Asian and Latin American equities have recovered their value relative to developed market equities. There may be further room for gains, but this is likely to be more gradual compared with the violent market updraft of 2009.

All regions of the emerging world are now in recovery. Although investor anxieties continue to recede as the global economic recovery evolves, the market's reaction to the recent shock from Dubai World reveals an underlying edginess among investors. The wall of money is gradually coming off the sidelines but investor positioning still seems lighter than it should be in a normalised economic and financial context.

If Emerging Markets continue to rally as investors build positions, neither positioning nor valuations will remain as supportive. It is not hard to imagine the market becoming overextended and setting itself up for a correction sometime in 2010. In short, the market context will inevitably become more balanced as the rally matures. As it does, the broad, market-directional themes will need to be replaced by a renewed vigilance toward overshoots and corrections and an emphasis on relative value and asset selection.

Market Performance: 01.01.2009 to 31.12.2009

MARKET	INDEX	LOCAL CURRENCY	EURO
Ireland	ISEQ	24.9%	24.9%
UK	FTSE 100	17.2%	26.2%
Europe	FT/S&P Europe Ex. UK	22.1%	22.1%
US	S&P 500	40.2%	36.7%
Japan	Topix	4.0%	1.6%
Hong Kong	Hang Seng	47.2%	43.4%
Australia	S&P/ASX 200	24.9%	53.5%
Bonds	Merrill Lynch Euro over 5 yrs	5.6%	5.6%

Source: Bloomberg: 01.01.2009 – 31.12.2009

Diversify your Portfolio - Alternative Assets

The global economy remains in recovery mode. Equity markets have shown strong growth in the last 12 months but risks remain. In volatile markets, diversifying your portfolio by investing in alternative assets as well as traditional equities may help spread the risk and provide a return.

Currencies

The concept of currencies as an asset class has gained significant traction over the last few years. Currencies are slightly different to other asset classes in that not every investor in the foreign exchange market is motivated by profit maximisation. Market participants have different objectives and time horizons, creating market inefficiencies that investors can exploit. Foreign exchange is the most liquid and easily accessed market available thus making it attractive but also prone to fluctuations. Perception, interest rate differences and wider economic events can all influence the price of a currency. Below are 3 strategies currently proving successful with institutional investors:

1. Carry Trade Strategies: These take advantage of forward-bias inefficiency to generate returns. They do this by taking long positions in high yielding currencies and short positions in low yielding currencies.
2. Technical Analysis Strategies: This involves following trends and looks at historical currency performance to generate returns.
3. Value Strategies: These use purchasing power parity (PPP) as a benchmark for currency equilibrium in the long term.

In order to capture the potential benefits of currencies effectively investors may benefit from employing investment strategies, such as the 3 mentioned above, that manage volatility while maximising returns.

Currencies – Percentage Change 2009

	31.12.2009	31.12.2008	% CHANGE
EUR/USD	1.4548	1.3901	3.22%
EUR/CHF	1.4832	1.4796	0.24%
EUR/JPY	135.5680	126.0080	6.00%
EUR/GBP	0.8885	0.9669	-8.11%

Source: Financial Times

Commodities - Percentage Change 2009

	VALUE 31.12.2009	VALUE 31.12.2008	% CHANGE
Aluminium	2,206.00	1,455.00	51.82%
High Grade Copper	532.75	139.50	138.53%
Lead	2,390.00	948.00	152.11%
Zinc	2,569.00	1,120.00	129.38%
Gold	1,096.20	884.30	23.96%
Platinum	1,471.00	941.50	56.24%
Palladium	409.95	188.70	117.25%
Silver	1,683.40	1,129.50	49.04%
Crude Oil	79.36	44.60	77.94%
Heating Oil	2.12	1.41	50.73%
Natural Gas	5.57	5.62	-0.89%

Source: Bloomberg: 01.01.2009 – 31.12.2009

Commodities

The consensus view for 2010 is relatively cautious on commodities though commentators see the potential for some commodities to perform well. If efforts to drive recovery prove fruitful, there could be resurgent demand for certain commodities used in industry and other so called “soft” commodities. Economists are focusing on commodities that have uses in the real economy and the increased demand that is anticipated may drive prices for these commodities higher in the coming year. Market analysts believe other commodities such as gold may give up some of the gains that were made in the past 12 months as investor sentiment declines or the fundamentals that caused the recent price rise move against them.

When treated as a single asset class there can often be little to no correlation between individual commodities either sectorally or geographically. Therefore it is understood by strategists that one effective approach to

investing into commodities is to use strategies with both a long and a short element in order to capture the varying performances.

Real Estate

Real estate, as an asset class, was abandoned by many investors after a precipitous decline in the last 24 months. However, according to many asset allocation strategists we could be entering a time of excellent value in the real estate market.

As outlooks and economic forecasts become more positive, many commentators expect real estate to recover in the coming year. Recent research reports indicate commercial real estate investment globally has the potential to grow significantly from its current lows and some markets are showing signs of positive growth already.

Experienced market participants believe that one of the most effective ways to capture the performance of property investments is through Global Real Estate Investment Trusts (REITs). These instruments offer geographical diversification based on their underlying holdings and also have the potential benefit of having their dividends reinvested. They are also very liquid as they are listed and traded on major stock exchanges.

Potential Risks in 2010

After a shaky start, 2009 turned out to be a strong year for risk assets. Economic stimulus provided by government intervention stabilised the economic situation and provided the catalyst to bring back confidence to the financial markets globally. Looking ahead, there are some factors that will keep us speculating whether the worst is over and the sustainability of this economic recovery.

“Double Dip Recession”

The main risk to the world economy in 2010 is a “Double-Dip” recession. A “Double-Dip” recession refers to a recession followed by a short-lived recovery, followed by another recession. The cause for a “Double-Dip” recession could be that when the current government stimulus packages are withdrawn that there will not be enough growth in the global economy to make the recovery self-sustaining. There is then the danger that the global economy will move back into a deeper and longer recession that would be even more difficult to recover from. A useful analogy is that demand is like an aeroplane and the stimulus packages are the runway. The current stimulus packages are increasing the length of the runway but at some point demand needs to take off.

There is also the risk of a shock to the global economy that could derail this outlook. The careful economic and financial market predictions and projections of the world’s most authoritative economists and investment banks could prove meaningless should there be a significantly large shock in 2010. Shocks like 9/11, Enron (market failure) or the Credit Crisis (financial system failure) are by their nature entirely unpredictable. However, there are a number of threats to the global economy that could weigh on this outlook as follows:

Policy Mistakes

The primary potential threat to the recovery in the global economy in 2010 is a policy mistake. Both economic and market fundamentals are certainly supportive of most asset classes in the short term. With governments sensitive to the perceived fragility of the initial stages of the expansion, a broad consensus has emerged

that significant fiscal tightening should be delayed until the recovery is more firmly established.

A similar point applies to monetary policy. In the short run, inflation remains below trend in most economies, with disinflationary output gaps of indeterminate scale visible in the larger industrialised nations. The implication is that a globally synchronised policy tightening poses little imminent threat to either economic growth or buoyant asset prices.

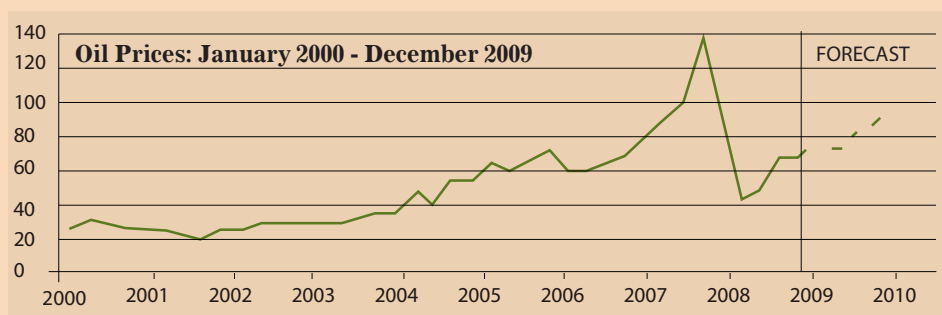
There is also the danger of a sudden attempt to sever the symbiotic relationship between Asia and the US. The US treasury market remains deeply dependent on central bank buying and Asian economies remain equally dependent on the US consumer. Over the long term this is an unhealthy relationship, but the time to change is when the healing process is well advanced. There is the risk of a serious escalation of protectionism or a sudden end to dollar asset accumulation by central banks which could have a detrimental effect on the recovery.

Oil Price Bubble

In the spring and summer of 2008 oil prices rose at an accelerating rate, despite a sharp

slowing in energy demand from the US. With asset returns low or negative, momentum investors piled into the commodity markets. A number of exaggerated arguments helped inflate the bubble: only Asian energy demand matters, a small decline in the dollar justified a surge in oil prices and “peak oil” had suddenly arrived.

Energy costs can have a big impact on US and global growth. An oil price increase acts like a tax on households, particularly when the rise is due to either rapid overseas demand or a supply disruption. Looking back over history, the sharp oil price spikes that occurred in 1973, 1975, 1979 and 1990 were largely due to supply disruptions. In contrast, the price increase over the 2003-2007 period was, to a large extent, induced by strong global economic growth. Investor or speculative rises in oil prices can also be thought of as an oil tax. In 2008, the oil boom turned into the oil bubble as strong growth in Asia, a weak US trade value of the dollar and strong investor demand spurred oil prices to a peak of \$147 a barrel in early July 2008. With low US interest rates and a weak dollar now, we could see a replay of 2008, with prices rising from the current spot price of circa \$79 a barrel to \$150 a barrel by year-end 2010.



Source: Wall Street Journal, Haver Analytics, BofA Merrill Lynch

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