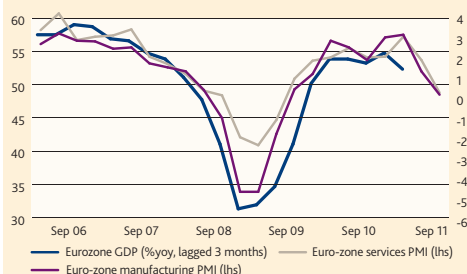


Global Investment Outlook

The monthly investment outlook from Aberdeen's multi-asset team



Leading indices clearly signal recession for the euro-zone



Source: Bloomberg

Italy's entry into the euro destroyed its industries' competitiveness



Source: Datastream

Key forecasts	US	Japan	Euro-zone	UK	China	Global
GDP rolling						
12m forecast	1.9	1.3	0.8	1.4	8.7	2.4
Consensus	1.9	1.8	0.8	1.4	8.7	2.5
CPI rolling						
12m forecast ^A	1.8	-0.7	1.4	3.0	4.7	1.8
Consensus	2.3	-0.2	1.9	3.0	4.2	2.1
Current Base	0	-	-	-	-	-
Rates	0.25	0.10	1.50	0.50	6.56 ^B	-
Monetary Policy (3m)	0.25	0.10	1.50	0.50	6.81 ^B	-
Monetary Policy (12m)	0.25	0.10	1.00	0.50	7.06 ^B	-

^A headline rate ^B PBOC 1 year Yuan Lending Rate

Source: Aberdeen Asset Managers Ltd

Executive Summary

Financial crisis continues to dominate the political agenda

- A credit crunch looms as Europe's banks shrink balance sheets
- Growth momentum is diverging amongst different regions
- Investor focus on global fiscal policy will intensify in 2012
- Abundant liquidity via central bank easing likely to prevail for some time

Economic data has tended to surprise analysts over the last few weeks, encouraging the view that growth may not be as weak as some were predicting only a month ago. However the picture is very different amongst different regions around the world. The US economy for example seems to be benefiting from a rejuvenated consumer due to falls in energy prices and lower mortgage rates. Fiscal policy also remains expansionary for now. In Asia and the emerging world however, a tighter policy environment in combination with slower export demand has led to some slowing of activity. In contrast the situation in Europe remains precarious; with fiscal austerity now a prerequisite for further lending or any other form of capital commitment to over-indebted countries. The euro's very existence is seen to depend on it. The threat to the European and indeed the world's banking system has created such substantial pressures within the funding markets that Europe is likely to flirt with recession as we enter 2012. This all begs the question, which region's outlook will dominate the global picture? For now we feel that the size of the US economy, and the ability of global central banks to further stimulate activity (however modestly), may prevent global growth from repeating its travails of 2008/9. The challenges that policy makers face though are surely the most daunting we have faced in generations, and so far investors' confidence has not been reinforced by the initiatives taken. The investment environment therefore remains highly uncertain and likely to witness sustained volatility.

Consequently we remain sceptical that we are on a sustained upward path for risk appetite. It is possible that growth still surprises on the positive side, but it is hard to see where that impetus may come from as we enter the new year. Whilst markets remain relieved that Greece will not necessarily exit the euro in the immediate future this must remain a significant risk throughout 2012 and beyond. The October rally in risk assets may have produced all of the returns we are likely to see within the fourth quarter, and in order to convince us that the first part of next year will still produce positive results the S&P500 must make a sustained push through the recent high of 1285. Otherwise we are in danger of revisiting the lows of last summer, and possibly even beyond.

Mike Turner

Head of Global Strategy & Asset Allocation, and manager of Aberdeen Multi-Asset Fund

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Europe heading into recession

Economic and monetary policy outlook

Improving data from the US and China is reducing the risk of a synchronized global recession. Visible improvements in US and Japanese manufacturing are a small consolation for the grim news-flow out of Europe. Evidence that global inflationary pressures are receding is also good news. This should give central banks room to ease monetary policies. Europe though, shows every sign of heading into recession now that austerity has locked the wheels of growth. It is facing a credit crunch because its banks are expected to have to shrink their balance sheets by more than €1.5 trillion in the next 18 months. By failing to put a firewall in place, the G20 left Italy – and its biggest creditor, France - exposed to contagion. Indeed, with liquidity drying up in Europe, a breakup of the euro now looks likely unless the ECB is prepared to act as a lender of last resort. With the crisis continuing to escalate, the threat of financial chaos is very real.

A modest recovery in the US

US

The US economy accelerated in the third quarter, to an annualised rate of 2.5%. For months we have maintained that hard economic numbers are a better gauge of the underlying strength of the US economy and its forward path than sentiment indices like consumer confidence and the Philly Fed, which may have been skewed by the negative news coverage of the debt ceiling debate at the start of the summer and the euro-zone news flow. However, the economic data shows that US consumers are spending again and the economy is growing. Jobless claims, in particular, are holding up very well, and consumer confidence is rising. While we are not seeing the sort of hiring that would bring down unemployment quickly, the labour market is signalling modest recovery – as long as the payroll tax cut is extended for another year. This brings the Fed closer to normalising monetary policy. It has ruled out further quantitative easing for now because it has got to “keep inflation under control.”

Fears about the solvency of Europe's banking system are growing

Europe

The recession being flagged in core Europe will make it harder than ever to find a steady state solution to the euro-zone debt crisis. By resorting to quick fixes, and forcing banks to shrink their balance sheets, Europe's leaders continue to increase the cost of the crisis. Fears about the solvency of Europe's banks are growing, with yields on Italian debt reaching levels which shut Greece and Portugal out of the market. The degree to which Italian-based banks experience a run on deposits may now settle the fate of the euro. Or perhaps it will be Spain, some of whose banks may be insolvent. Finding a backstop for Italy and Spain is a hopeless task as long as Germany refuses to commit any of its taxpayers' money. The only truly credible solution to the question of sovereign solvency is for the ECB to become the lender of last resort. However, the new ECB president Mario Draghi has been at pains to point out that mass bond purchases are outside the remit of the ECB. No wonder that France and Germany are said to be discussing fiscal union between a breakaway group of euro-zone members, in a last ditch effort to preserve European integration.

UK is at the mercy of events

UK

The UK economy is at the mercy of events on the continent. Its vulnerability to a European banking crisis, given the role the City plays in the economy, is perhaps the primary concern. The lack of credit available to small and medium sized enterprises had already been blamed for the weak UK recovery. But now a much bigger credit crunch threatens the UK. Already, the looming slump in Europe is threatening the UK's exports: manufacturing grew in September, but orders suggest growth will be much softer in the fourth quarter. A further drag on the economy has been rising energy costs, which pushed inflation to 5.2% from 4.5% in August, hitting consumers in the pocket. However, inflation should ease next year. While the European Commission now expects the UK to slow to 0.6% because of a fall in investment, it should be able to avoid a double-dip recession, unless the euro breaks up.

Japanese recovery continues

Japan

Corporate sentiment has really improved on the back of the recovery in supply chains. Total manufacturing volume has recovered to 91% of its pre-earthquake level, and GDP is expected to have grown 6% in the third quarter. But there is also considerable wariness regarding the global economic outlook and the prospect of a domestic demand pullback. There should be further improvements in business conditions through December as economic activity continues to return to “normal”. However, while trade volumes have picked up, recent weak sentiment among global

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manufacturers could weigh on exports in coming months. Japan has also been forced to intervene to prevent excessive yen strength from hurting its economy. However, with post-quake rebuilding activity set to accelerate, and the Thai floods looking unlikely to impact on overall output, economists expect Japan to carry on growing through the first quarter of 2012.

Asia and emerging economies

Asia will not be immune from the West's macro challenges, dependent as it is on global trade and European capital. This is evident in slowing export growth in countries such as Singapore, Taiwan, Malaysia, and the Philippines. Chinese exporters are also facing difficulties; and India's aggressive monetary policy tightening, high inflation, and challenging political environment have taken a toll on consumption. Automotive supply chains, which have only just recovered from the Japanese tsunami, have been disrupted by the floods in Thailand. But if China can engineer a "soft landing" in 2012, despite sharp falls in property prices, then further improvements in intra-regional trade and a domestic-driven consumption cycle will help Asia ride out the tough times ahead. Consumption is being supported by full employment and robust wage growth in countries like Indonesia and China. Easing inflation may also give the Chinese monetary authorities room to manoeuvre.

Equities

Equity markets rebounded strongly in October on the back of the planned bailout package. This encompassed the three key elements of bank recapitalisation, voluntary Greek debt restructuring, and sovereign bond market support. We suspect that market positioning was the main driver for the remarkable performance achieved in October (which proved the best month for returns for some years), but we do not think investors felt this would be a panacea. However, global stocks did appear cheap based on consensus forecasts for earnings growth over the next twelve months, and indeed even if we allowed for some reduction in those forecasts, PE valuations were still undemanding. So it is perhaps unsurprising that equities reacted so well to the news that lessened the chance of recession. In fact, markets still do not represent bad value despite the recent rally; though a lot depends on the macroeconomic outlook.

In this context how Europe's travails impact on global growth will be crucial. Data emanating from the euro-zone will be scrutinised in great detail as we enter the new year. The sustainability of the euro will depend on it, and with it risk appetite for stocks. On the positive side though, the corporate sector is still displaying resilience, with 70% of companies in the US exceeding profits forecasts in the latest reporting season. Balance sheets incorporate a tremendous amount of cash as well lending considerable robustness to businesses in an economic downturn. Thus, any fallout from poor economic news may not be that cataclysmic for price performance.

The recent fall in stocks during September actually approached levels of valuation on a price to book basis which were nearing extremes. This could prove some support if markets fall once again. Alternatively, if the economic news does not turn out bad, or if a more radical solution to the euro-zone's woes are initiated - such as debt monetisation by the ECB - equities could continue to perform. The range of potential market outcomes is very polarised, but we suspect that the eventual market direction will be one of weakness as we enter the new year. At the moment the Germans are vehemently opposed to committing more and substantial capital to the euro-zone's problems, and fiscal issues elsewhere (US) will start to grab attention. The key levels we are watching are 1285 to 1295 for the S&P500. If these are surpassed we would then call into question our scepticism, but until that happens we prefer to remain cautious in our stock specific stance and indeed our allocation to equity risk overall.

Bonds & currencies

Treasuries and gilts continue to appear overvalued, and a stronger US economy should eventually drive both Treasury and gilt yields higher. However, for now, with the yield on Italian 10-year bonds breaching the 'unsustainable' 7% barrier, and European politicians showing little sign of being capable of presenting a credible solution to the sovereign debt crisis, the demand for safe haven assets outweighs any other concerns. But this means the UK's cost of borrowing could rise sharply once the euro-zone crisis has come to a head, or if the crisis damages the coalition. The government probably has enough credibility for now, but this could change if growth weakens. Bunds are similarly set up for a correction should the crisis' potential fiscal impact change Germany's status

Interesting times for Asia as it navigates turbulent markets

We remain cautious on equities

Safe haven sovereigns set up for a correction

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Commodities soften as global economic outlook weakens

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as a safe haven. Like France, Germany could be engulfed by escalating debts if they did eventually chose to offer support. Not surprisingly, the euro has fallen against the dollar and the yen, and is vulnerable to further weakness.

Emerging markets have been exposed to a lot of volatility recently, but conditions remain favourable from a debt perspective. Inflation should fall next year, whilst companies in Asia are in rude health and should continue to focus on reducing leverage. On the sovereign side, debt to GDP ratios for many developing countries are below 40% and fiscal balances are much more favourable than for developed markets – which is why local currency debt is seen as a credible safe haven. It will not be plain sailing though, as tighter lending conditions, slowing global growth, and FX volatility could keep volatilities in emerging market bond funds elevated. Falling inflation also means there is less need for central banks to support their currencies. There is therefore a risk that investors could pull money out of some markets. However, the fundamental health of most emerging markets, and our view that Chinese growth will be sustained, means that Asian currencies and bond markets should remain supported.

Commodities

Global economic leading indicators and the cooling Chinese property market suggest commodities may soften. Resilient US growth has recently improved sentiment, but banking troubles have begun to spill over into the commodity trade, as the euro-zone crisis sucks liquidity out of financial markets. European banks, which dominate trade finance, are becoming ever more reluctant to provide finance to Chinese commodity importers, say leading mining companies – which may explain why shipping is in a downturn. Another bearish sign is the “head and shoulders” topping pattern in copper. A fall in base metals and oil – which is highly correlated with risk appetite – would clearly be a positive factor for equities, providing some support for earnings (we estimate a 10% fall in average oil price benefits European EPS by c.4%, other things being equal).

After falling sharply in September, to just above the \$1600/ounce level, gold is still vulnerable to weakness in global stock markets, as some investors may be selling out of gold to cover losses elsewhere. But this may prove temporary given the fears about a euro breakup and growing counterparty risk. There are signs of reviving interest in gold as a relatively safe store of value in uncertain times, and it should remain well supported – possibly even by central bank buying – in the near term. Chinese New Year should see Chinese demand pick up again in the coming weeks.

Real Estate

There should still be demand for high quality institutional assets over the coming months and capital values should stabilise, underpinned by a wide premium of property yields over bond yields. But while prime property continues to outperform secondary assets in most regions, demand is showing signs of cooling, as concerns over the global economic climate have grown. Major office markets, which may have overheated, could be vulnerable though. At this stage of the cycle, we favour de-risking office portfolios. Institutional retail and industrial assets though are fairly or underpriced in most advanced economies, and continue to offer stronger prospective returns to medium term investors.

Institutional property in the US has the best potential, in this global context, given that values have yet to show a significant bounce from their financial crisis lows. But with much of Europe seemingly headed into recession, southern Europe should underperform sharply, though northern Europe may not be immune either if Germany slumps. Property market prices in the advanced economies of the Asia Pacific region do not seem significantly out of line with fundamentals, and we expect capital values to be supported into 2012 by low interest rates and high levels of liquidity.