Global Investment Outlook

July 2002

Investor confidence collapses

Aberdeen
ASSET MANAGEMENT

Global Economic Outlook

• The major theme of global economic recovery in 2002 and 2003 remains unchanged.

• Leading indicators for all major regions remain firmly in positive territory although there are signs of stabilisation rather than further acceleration in these indicators.

• Our global growth forecasts remain largely unchanged although we have re-allocated some growth away from Europe and added it to the US. Japanese growth has also been raised, reflecting the stronger than expected start to the year.

• We have lowered near-term growth expectations and raised late year growth expectations, in part reflecting financial market instability now and interest rates that are expected to be lower for longer.

• However, there are two major influences we have assessed this month, in particular the impact on macro forecasts of a weakening US dollar and the macro influence of a collapsing stockmarket through the June quarter.

• The current environment is potentially dangerous for the global economy because a weakening US dollar passes the responsibility for global macro policy control to central banks in Europe and Asia. Will they manage the business cycle as effectively as the Federal Reserve?

• In the near term the danger is that the weakening US dollar could depress consumer activity by undermining confidence in financial assets and heightening risk aversion. Generally, we have seen global equity markets weakening when the US dollar has weakened.

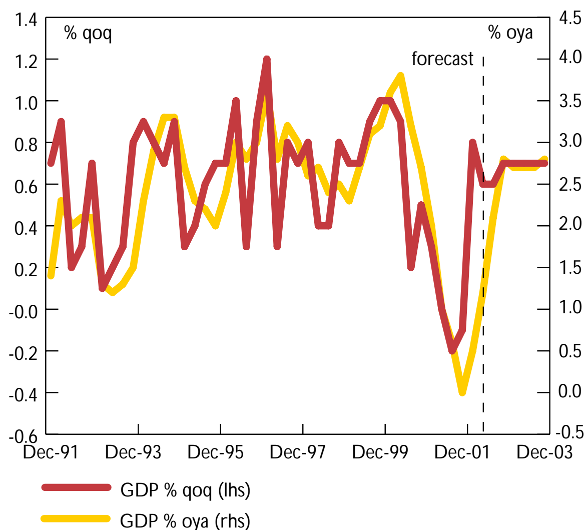
• It is our expectation that central banks, having eased policy in 2001 following the 11 September terrorist attacks, will stand ready to underpin economic growth in 2002 if it is threatened.

Aberdeen economic forecasts

	2002 GDP	2003 GDP	2002 CPI	2003 CPI
US	2.5	3.5	1.7	2.3
Eurozone	1.1	2.5	2.2	1.2
UK	1.4	2.5	2.2	2.5
Japan	0.0	0.9	-0.7	-0.5
Global	2.0	3.2	3.1	2.5

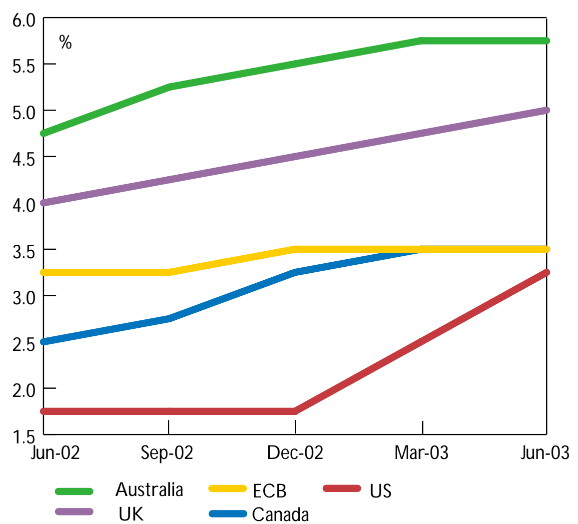
Source: Aberdeen Asset Management

G7 growth recovery



Source: Datastream and Aberdeen Asset Management

Monetary policy tightening delayed



Source: Aberdeen Asset Management

Bond and Currency Markets

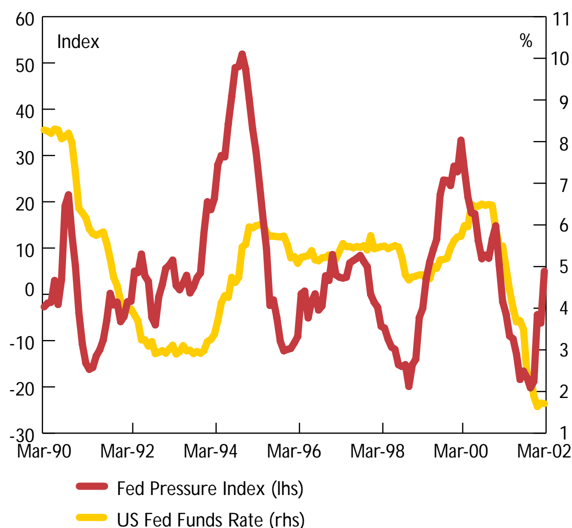
• We think that there is a good chance that the Federal Reserve will now have to wait until the year-end or even early 2003 before it has a window in which to tighten policy. This raises the risk of markets believing that the Federal Reserve is getting increasingly behind the curve as the recovery continues. A weakening US dollar could make life even more difficult for the ECB.

• A sharp appreciation of the euro will depress inflation and raise real interest rates. In such an environment, if the ECB does not respond with an actual easing of interest rates then the risk is that eurozone growth will be hurt. We are not confident that the ECB will react to the euro rise by cutting rates.

• The Bank of England has a less severe problem with at least a weaker sterling/euro rate allowing some gain in competitiveness against the eurozone. However, the sterling/US dollar gain suggests that the Bank of England should be cautious about tightening too aggressively.

• We expect that major central banks will defer their tightenings through to late 2002 / early 2003, with the exception that the Bank of England could still move later in the September quarter.

Fed pressure index now rising



Source: Datastream and Aberdeen Asset Management

10 year sovereign bond forecasts

	Yields 3 month forecast	Yields 12 month forecast	Returns 3 month forecast	Returns 12 month forecast
US	5.5	5.6	-1.35	2.03
Euro	5.3	5.4	0.45	4.07
UK	5.5	5.5	0.07	4.07
Japan	1.6	2.6	-0.10	-7.47
Australia	6.3	6.5	1.60	4.85
Canada	5.6	5.8	1.26	4.31

Source: Aberdeen Asset Management

Currency forecasts for 2002/2003

vs US $	18 July 2002	3 month forecast	12 month forecast
UK £	1.532	1.53	1.59
Euro	0.9847	1.00	1.10
Japanese Yen	118.72	120.00	110.00
Australian $	0.563	0.59	0.60
Canadian $	1.521	1.50	1.46

Source: Aberdeen Asset Management

• US bond yields have fallen by 50 basis points since the end of March, most of which has been driven by the recent move to risk aversion. The macro cycle favours higher not lower bond yields however and we expect a rise in yields in the coming months.

• Investment grade bonds underperformed gilts marginally as the new issue calendar weighed on the secondary market, particularly in the telecom and utility sectors. However, new pressure from regulatory sources for life companies has boosted allocations to bonds, a significant proportion of which will find its way into investment grade.

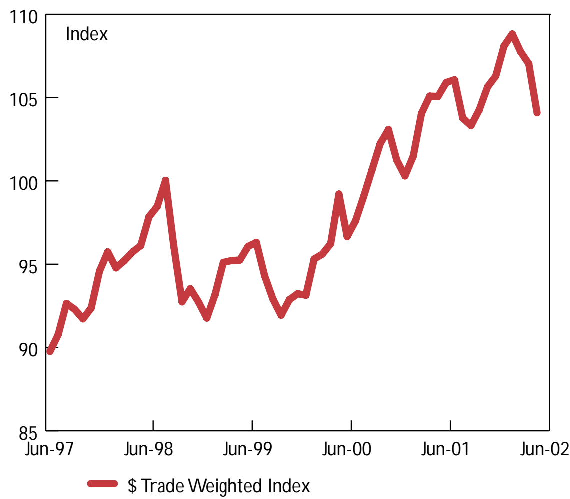
• The US dollar index has broken the rising trendline that has been in place since June 2000. Global investors are likely to continue to shun the US dollar in favour of those economies where interest rates are rising at a greater pace than Fed funds, such as the eurozone and Asia / Pacific. We have lifted our currency forecasts for these regions.

• The fall in the US dollar has been moderate to date, and should be a positive development for all economies and markets. However, an uncontrolled US dollar

collapse would create significant volatility in asset markets and bring with it heightened fears of a double dip in global economic growth

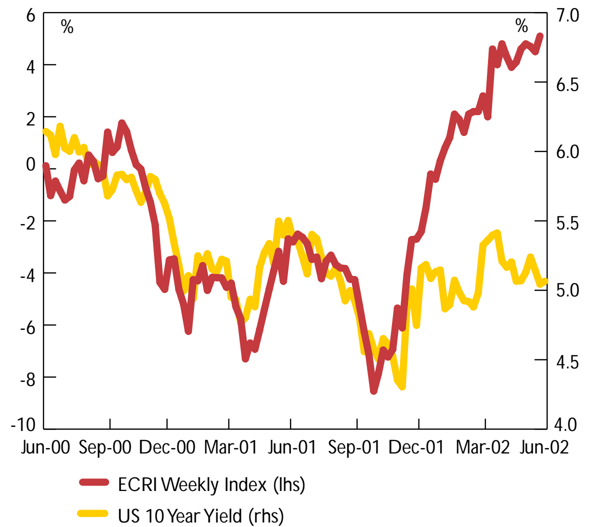
• Having taken the lead in the early stages of the dollar sell-off, the yen has not rallied as much as the Asia /Pacific currencies, the euro or sterling during the past month. This relative underperformance has reflected the impact of the Bank of Japan intervention in foreign exchange markets to stem the yen's appreciation. Manufacturing and export activity in Japan has been more brisk than had been envisaged only a few months ago, although the domestic structural problems remain substantial. The Bank of Japan can therefore ill-afford an excessive strengthening of the yen for fear of stalling export performance.

US dollar trend has broken down



Source: Datastream and Aberdeen Asset Management

US economic momentum still good



Source: Datastream and Aberdeen Asset Management

Equities

US

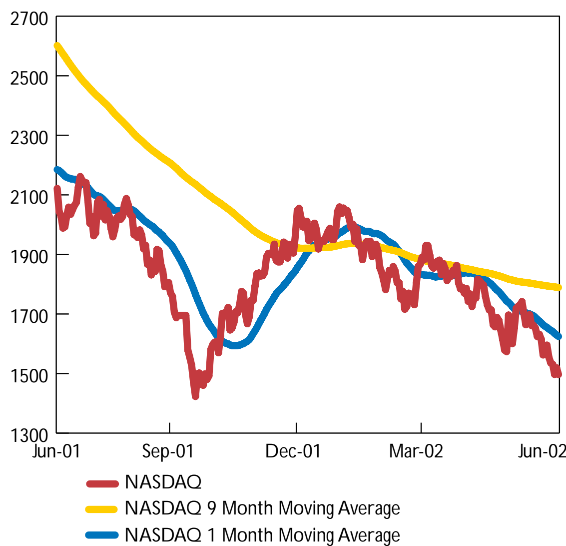
• The market is weighed down by the triple concerns of corporate earnings quality, the timing and strength of the coming earnings recovery and the ongoing threats of terrorism.

• The Enron and Worldcom issues have sparked a national debate and management changes have been hastened at some companies.

• The economy continues to show signs of recovery: the consumer remains the focal point - spending steadily while the manufacturing sector is beginning to recover.

• Our US funds remain underweighted in pharmaceuticals, technology, media and telecoms stocks. We are overweight industrial cyclicals, energy and materials.

Nasdaq breaches Sept 2001 lows



Source: Datastream and Aberdeen Asset Management

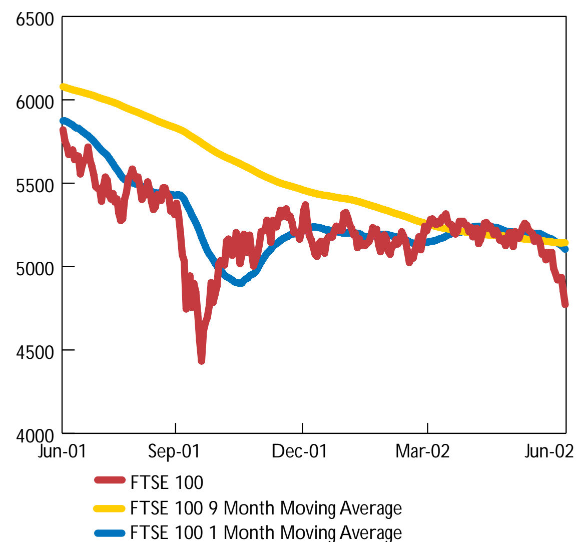
UK

• Conditions for the consumer remain favourable. Housing price inflation remains firmly in double digits raising concerns about overheated valuations, however, at this time affordability is supportive. Consumer confidence remains positive, underpinned by unemployment rates at 26-year lows and mortgage rates at their lowest levels in 38 years.

• The outlook for the manufacturing sector is beginning to brighten, with actual activity data now beginning to reflect the improvement seen in recent sentiment surveys. Industrial production rose in April for the first time in eight months, helped by a sharp jump in exports.

• Our UK funds remain overweight banks, telecoms and pharmaceuticals and underweight defensive consumer stocks and energy.

UK equities sliding



Source: Datastream and Aberdeen Asset Management

Equities

Europe

• European equity valuations are now approaching the attractive levels of autumn 2001 when viewed in terms of a bond/earnings yield ratio. We expect corporate earnings improvements to come through during 2002.

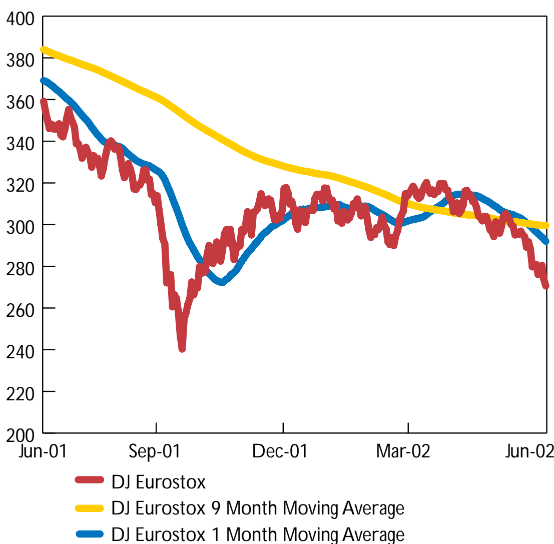
• Lack of institutional demand, corporate supply via placings and forced selling by insurance companies due to pressure on their balance sheets have resulted in a poor liquidity backdrop.

• There is a risk that the ECB could raise interest rates during the third quarter due to the persistent rise in core inflation. We are hopeful this could be offset by the stronger euro pushing any rate rise to late in 2002.

• We remain optimistic on European equity market prospects given global economic recovery and attractive valuations.

• We continue to favour economically sensitive sectors such as industrial cyclicals and media over the more defensive earnings growth sectors. We have recently added to weightings in banks and pharmaceuticals.

Euro zone markets under pressure



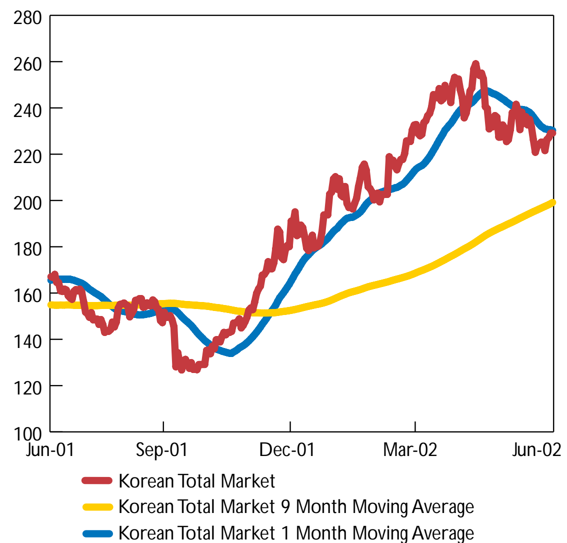
Source: Datastream and Aberdeen Asset Management

Asia Pacific

• We are bullish on Asia ex Japan, reflecting both the leverage benefit that Asia enjoys during global recovery and the increasing signs of domestic recovery in many economies within the region.

• Most global investors have been significantly underweight the region since the Asian crisis of 1997 and valuations look relatively attractive still.

Korea gives back some gains



Source: Datastream and Aberdeen Asset Management

• Relatively better corporate governance is also a positive.

• In Hong Kong, the macro story remains difficult with the deflationary cycle continuing. Unemployment and the associated job insecurity fears are dampening consumer sentiment.

• Asia ex Japan remains our largest overweight position within global equity portfolios.

Equities

Japan

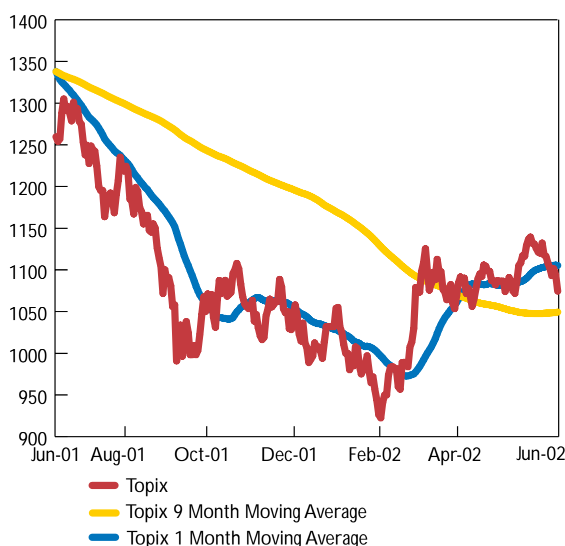
• Our Japanese position has been maintained at neutral to slightly underweight.

• We expect domestic demand to remain sluggish in the current year due to cost-cutting efforts aimed at boosting profits and to the drag on wages and capital investment stemming from excess employment, capacity and debt.

• However, there are signs of an improving economic tone in Japan.

• As profits recover this year, domestic demand should revive. Japan's recovery therefore will remain extremely dependent on external demand for the foreseeable future. However, evidence is growing that much of the turnaround in Japan's inventory position and production cycle is linked to intra-Asian trade.

Japan gives back gains post March 2002



Source: Datastream and Aberdeen Asset Management

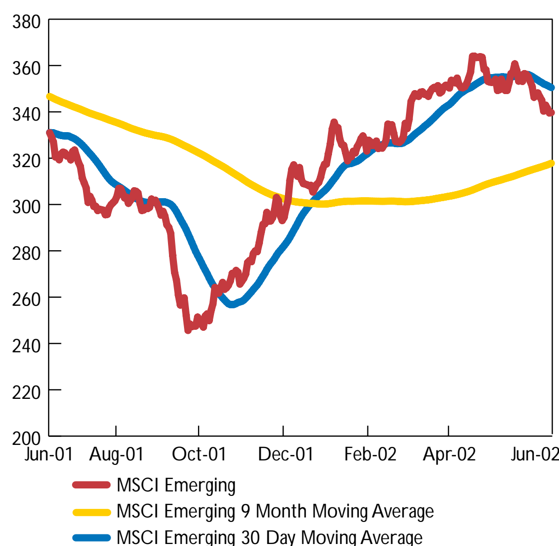
Emerging Markets

• Brazil and Turkey have been weak of late. Both face a potential change in government, which puts the current fiscal discipline and market friendly polices at risk.

• Economic news has been positive coming out of Asia, both domestically and in terms of exports as global demand begins to show signs of life.

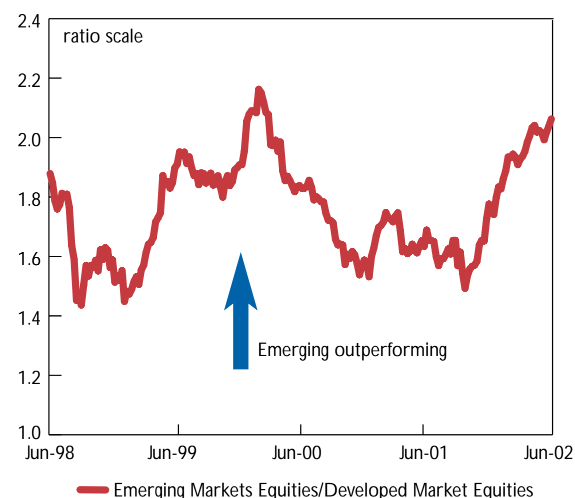
• Emerging markets continue to be favoured on valuation grounds and in terms of the potential benefit from global recovery.

Emerging markets stall



Source: Datastream and Aberdeen Asset Management

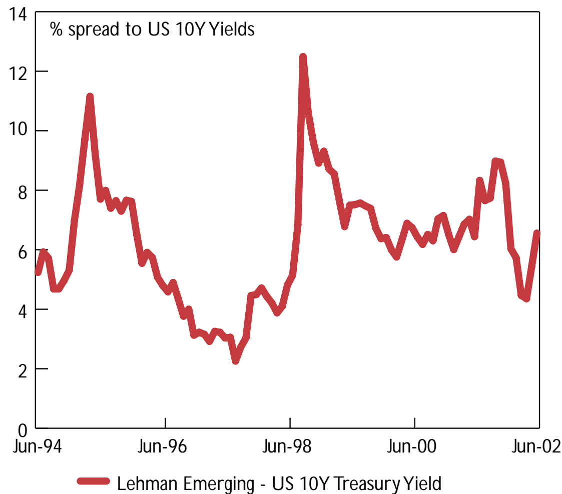
But still doing relatively well



Source: Datastream and Aberdeen Asset Management

Emerging Markets and Property

Credit spreads wider on Brazil/Turkey concerns

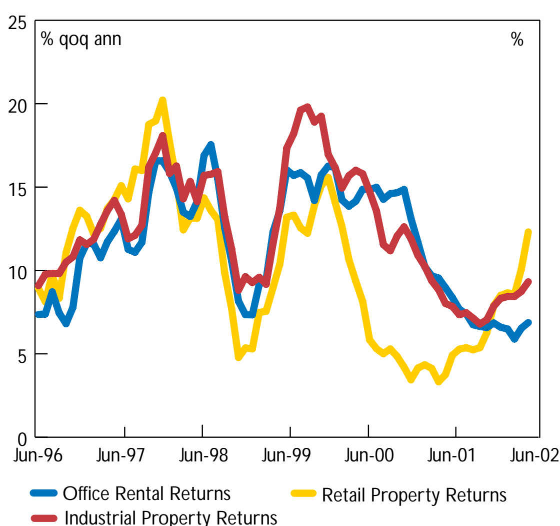


Source: Datastream and Aberdeen Asset Management

Property

• Tenant demand for office and industrial space remains subdued, reflecting the sluggish performance of these sectors of the economy. A marked pick-up in rental growth is unlikely before next year.

Retail property outperforming



Source: Datastream and Aberdeen Asset Management

• By contrast, the continued boom in consumer spending has enabled some retailers to increase profit margins. A number of major UK and overseas chains are looking to acquire new space, especially out-of-town, and accordingly rental growth has kept pace with inflation.

• The weakness of the equity market has forced many investors to reassess their view of property investment as it has continued to outperform. Rather than re-balancing by taking profits on property investments, many are now looking to increase exposure further, and there has been an increase in net investment.

• With commercial property's high yield relative to other assets, despite the prospect of higher interest rates, it remains attractive to debt-financed buyers, including private purchasers.

• The combination of strong institutional demand and debt-driven interest in property has translated into a buoyant investment market, and with demand exceeding supply, capital growth is accelerating. We have raised our total return forecast for the year to 10%, compared with 7.9% for the 12 months to the end of May (IPD Monthly Index, 'All property').

• The lack of rental growth will limit the extent of any sustainable re-pricing in the short term, but increased support from fundamentals holds the prospect of three year returns at a similar level.

• We expect retail to be the top performing market sector this year, for the first time since 1997.

Asset and Equity Allocation Strategy

• An improving global macro backdrop favours a moderate overweighting of equities over bonds.

• Developed market valuation, while not spectacular value, is improving and the earnings cycle is turning positive. Developing markets however offer the best value – we are overweight relative to developed markets.

• Excluding the technology and telecom sectors, the broader equity markets have generally performed much better, with some cyclical recovery stories playing out over recent months.

• Technology and telecom performance has, however, disappointed with valuations under pressure with no sign of an earnings upturn as yet.

• Smaller and mid-cap sectors have continued to outperform the larger cap parts of the market, reflecting better relative valuations and high sensitivity to the global recovery. We have maintained a mid cap bias in our portfolios.

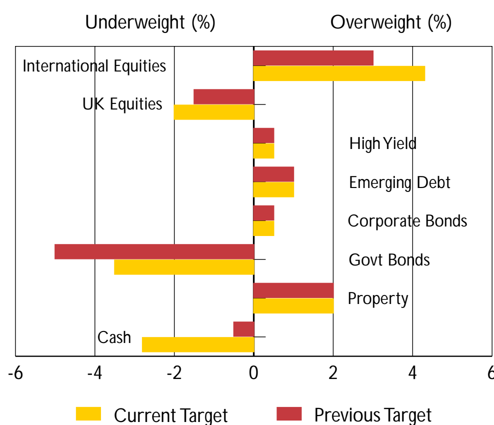
• Potential dollar softness is another concern. Upcoming monetary tightening is adding further uncertainty. Overall, developed market equities are seen as performing in line with earnings with little multiple expansion.

• Asia ex Japan remains our most preferred region at this time, reflecting its high sensitivity to the global economic upswing.

• Emerging markets generally should also benefit and are overweight within our portfolios.

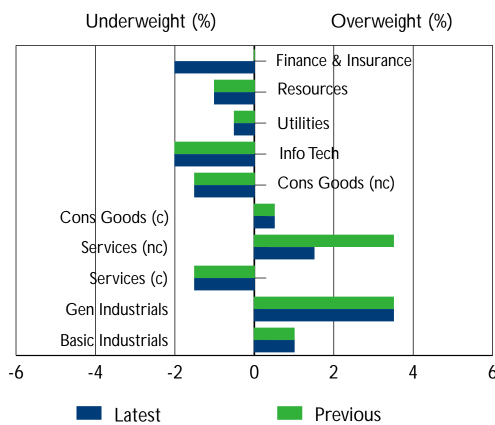
• Of the developed markets Europe is the preferred region due to its more attractive valuations.

Asset Allocation



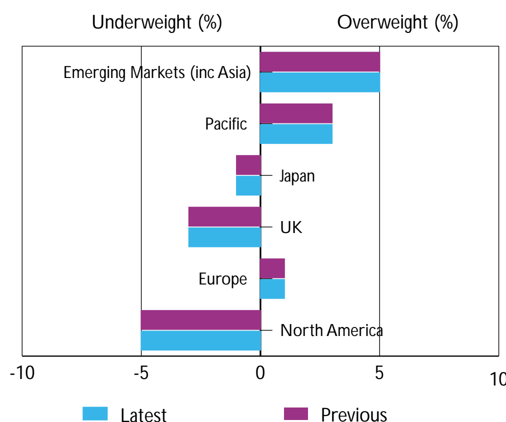
Source: Aberdeen Asset Management

Equity Sector Allocation



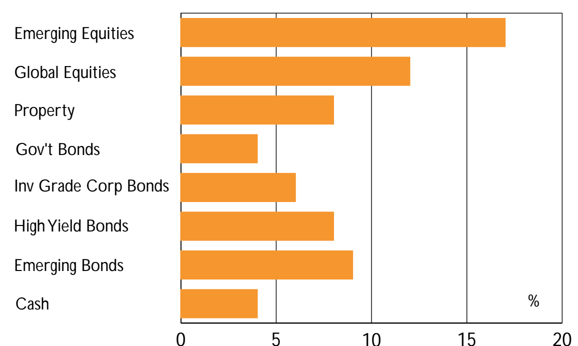
Source: Aberdeen Asset Management

Global Equity Allocation



Source: Aberdeen Asset Management

Asset Sector Expected Returns - 12 months

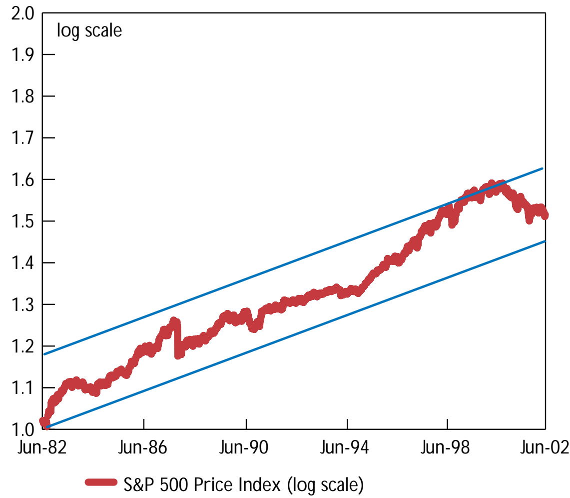


Source: Aberdeen Asset Management

- The relatively more expensive US and the defensive UK market are our primary underweights.
- An improving global growth environment with steep bond yield curves favours cyclical sectors, particularly industrial cyclicals.
- We remain underweight bond exposure. This remains a significant underweight for us although we have been gradually reducing this.
- We remain significantly overweight credit (investment grade, high yield and sovereign high yield) at this stage of the investment cycle. In the face of rising bond yields, a further compression of credit spreads should result in an attractive running yield.
- Property is a further overweight for us, offering good returns and risk control. We see this as an under-invested asset class.
- Rising concerns about geopolitical risk, the weakening US dollar and earnings concerns have all served to heighten the global investment risk premium, causing some investors to move back into more defensive assets (such as bonds, cash and gold).
- With signs of economic recovery still quite apparent, we see this impact as temporary and expect risk markets to come back into favour in the coming months.
- As a result, we have used this period of equity market weakness to boost exposure to riskier asset classes and reduced exposure to defensive assets.

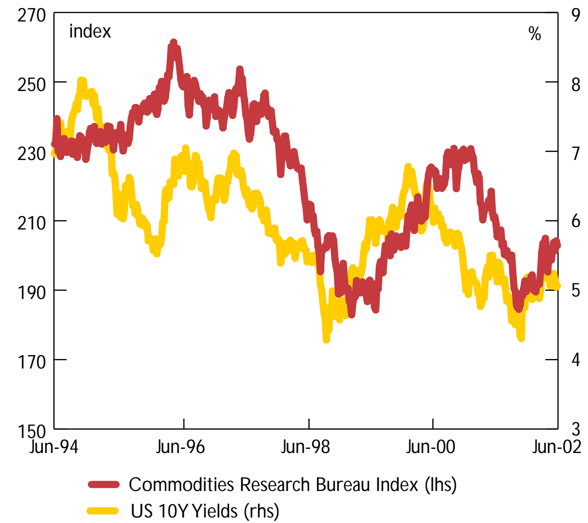
Charts of the Month

S&P on long term support



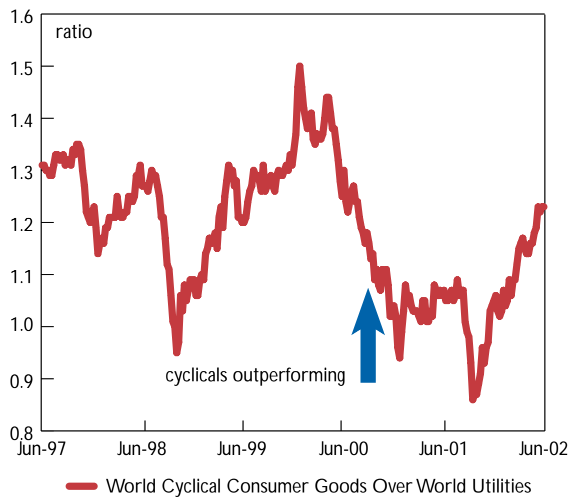
Source: Datastream and Aberdeen Asset Management

Commodity prices recovering at last



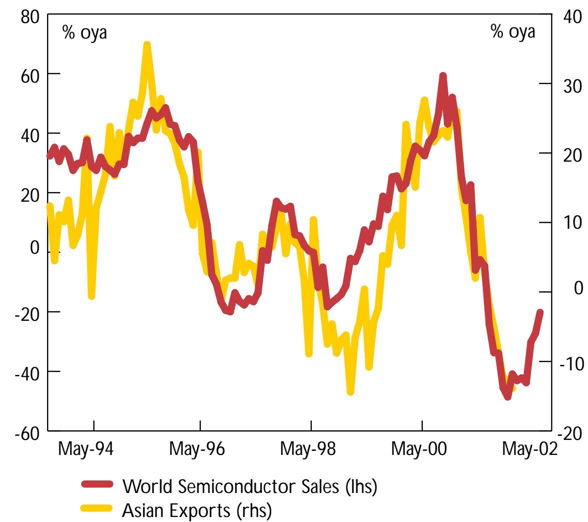
Source: Datastream and Aberdeen Asset Management

Some cyclicals doing well despite sell-off



Source: Datastream and Aberdeen Asset Management

Semiconductor sales starting to recover



Source: Datastream and Aberdeen Asset Management

What does a weakening US dollar mean for Equity markets

By John Bocchino, Strategist, and Michael Karagianis, Head of Global Strategy at Aberdeen Asset Managers.

As the main reserve currency in the international financial system, any explosive weakness in the US dollar can be destabilising for financial markets. We believe this has been one of the main drivers for the recent weakening in equity markets.

Since the end of February 2002 the greenback has fallen by 9% and 7% against the euro and yen respectively. On a trade-weighted basis, the US dollar has now fallen by around 9%-10% since the end of February.

Given such a significant currency move it is worth looking at similar periods in history and the resulting impact on equity markets. We examine two particular periods – 1989 /90, when the US$ fell by around 15% on a trade-weighted basis and 1994 when the US dollar fell by around 12%.

In both cases these periods represented an abrupt break from the trend persisting up until that point and were coincident with significant financial market instability.

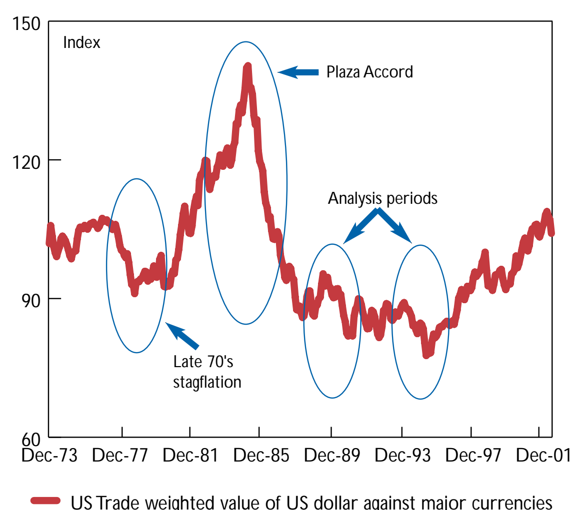
Some common observations from these periods are that:

US dollar weakness is associated with weakening equity markets. This is not just restricted to the US equity market as it generally produces weaker global markets. Sharp US dollar weakness heightens investor risk aversion resulting in a sell down of risky assets such as equities and buying of relatively risk-free assets such as US government bonds.

As risk aversion increases, correlations between world equity markets increase sharply – the result being that global equity markets fall in tandem with the greenback.

The second observation is that as global market indices weaken with the dollar the US stockmarket tends to initially underperform non-US markets. However, as the economic benefits of a devalued currency are realised (stronger economic performance and corporate profitability) the US market begins to outperform non-US markets in local currency terms.

Trade weighted value of the US dollar since Dec. 1973



Source: Datastream and Aberdeen Asset Management

While significant dollar weakness occurred in both August 1977 and March 1985, these periods were structurally quite different to the present – and are not included in our analysis.

Stagflation, an environment characterised by low growth and high inflation and precipitated by the oil price shocks of the 1970s, produced the dollar correction seen towards the end of that decade. The present US economic environment, meanwhile, is characterised by moderate growth and benign inflation – starkly different to 1977.

The 1985 Plaza Accord – an agreement between the Federal Reserve, Bank of Japan and Bundesbank to weaken a systemically overvalued dollar – resulted, during the mid 1980s, in a sustained and manufactured devaluation of the greenback.

The US dollar depreciated over a two-year period to the end of 1987 by approximately 40%, resulting in a massive stimulative boost to US growth, ultimately precipitating the stockmarket bubble (and subsequent

crash) in the US in 1987 and Japan in 1989.

The US dollar correction of both 1989/90 and 1994/95 – periods that bear certain similarities structurally with the present – allow us to gain historical perspectives on how world equity markets may react should the greenback continue to depreciate over the coming months.

What they show is that periods of sharp dollar weakness often coincide with stress events and credit shocks – with heightened risk aversion the result. Instability in the international financial system leads investors to seek safe haven assets – such as government bonds – instead of risky investments.

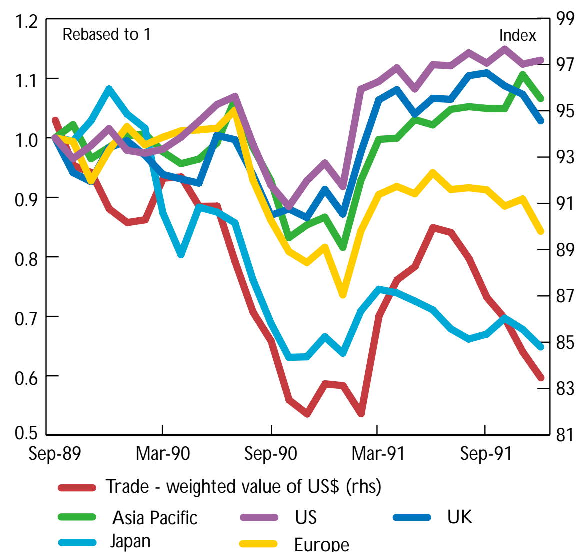
However, once the US dollar stabilises or begins to recover, the historical evidence suggests that global equity markets also start to recover as risk premia start to decline again.

In 1989/90 and 1994/95, a sharp weakening of the US dollar had a destabilising effect on global financial markets. World equity indices tumbled along with the greenback. Equities bottomed as the dollar troughed – only recovering as the trade-weighted value of the greenback rose. This is an interesting observation as it shows the susceptibility of all equity markets, not just the US market, to a weakening US dollar.

Following the 1987 stockmarket crash, money flowed out of equities where expectations had deteriorated and into property. The weakness in the US dollar took hold in 1989 and accelerated this trend.

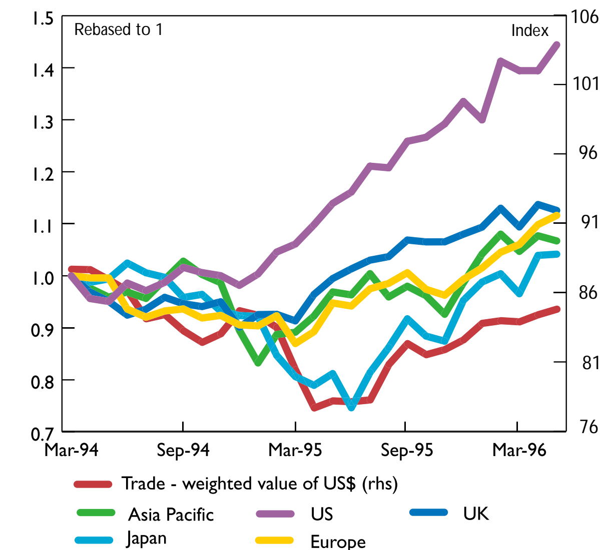
The US dollar's weakening in 1994 coincided with the collapse in global bond markets with investors fleeing to cash. Equities weakened in line with bond markets and the US dollar.

1989/90 US dollar correction – world equity indices fall in tandem



Source: Datastream and Aberdeen Asset Management

1994/95 World equity indices fall in tandem with the dollar



Source: Datastream and Aberdeen Asset Management

This followed a period from 1991 to 1993 where US economic recovery was sluggish and corporate balance sheet turmoil was extreme, similar to what we are currently seeing. Interest rates had reached multi-decade lows in most economies, again in line with current experience.

It is no coincidence that equity markets follow the downs and ups of the dollar during such stress event periods. Stocks are risky assets, and thus sold across the board as the dollar falls and risk aversion increases. As the dollar rises, and risk aversion abates, risky assets are ascribed a more normal risk premium and tend to rally.

A further important observation can be made of global equity markets' performance in periods of US dollar weakness. While the perception may be that a weaker

What does a weakening US dollar mean for Equity markets

US dollar will adversely affect the US equity market more than global markets, the evidence is somewhat different.

If we look at the history of relative performance of US versus non-US markets during periods of dollar weakness then we find that US local equity market returns initially lag non-US local equity market performance (Japan, Asia ex-Japan, Europe ex UK, and the UK).

However, this relative performance switches around and ultimately we find that over the medium to longer term the US equity market tends to relatively outperform non-US markets, in local terms, as the devaluation continues.

In both periods of dollar weakness in 1989/90 and 1994/95, the MSCI EAFE – an index comprising all developed markets excluding the US – initially outperformed the MSCI US for a period of between three and six months respectively.

Following initial underperformance, the US market – during the 1989/90 and 1994/95 periods – managed to outperform the MSCI EAFE by a substantial margin in local terms.

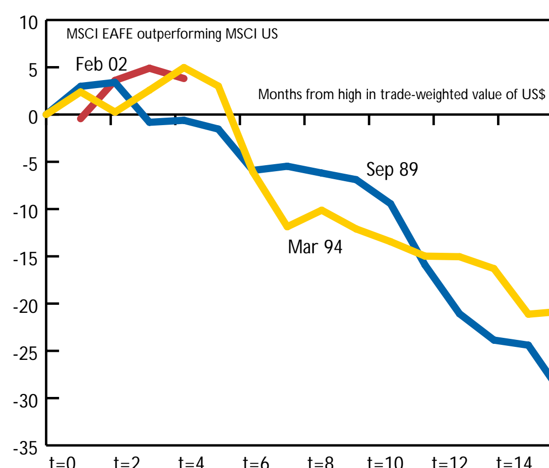
The logic of this is that the relative gain in competitiveness from a currency depreciation acts as a spur to corporate profitability and growth for many corporates competing in foreign markets or against importers.

Initial US underperformance is most likely to be a short-term psychological change in investor perceptions of US growth. US equities are sold, with capital flowing to overseas markets – where growth prospects are initially relatively more attractive.

Over time, however, sustained dollar weakness allows the US to become more competitive vis-à-vis its global trading partners. Local US industry becomes more competitive, and exporters offer more competitive pricing in foreign markets. Additionally, profits from overseas subsidiaries of US companies are translated back to more US dollars – which is very supportive for US earnings.

The cycle of US dollar weakness in 2002 is still relatively immature. However, some observations to date include the fact that since February 2002, when the US Trade Weighted Index peaked, the US equity market has underperformed non-US markets by around 4% in local terms. This initially weak relative performance is roughly similar in both magnitude and duration to the US market's performance during 1989 and 1994.

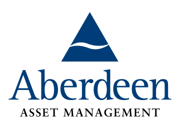
US initially underperforms, then outperforms MSCI EAFE



Source: Datastream and Aberdeen Asset Management

However, should the dollar weaken further or remain around recent levels for an extended period, we might start to see the US market outperforming its overseas rivals. The evidence of the past few weeks suggests that the US market is not losing any relative ground against its non-US rivals.

In conclusion, until there is a bottoming out in the US dollar global equity markets remain vulnerable to further selling pressure and a further elevation in risk premia. The US is initially most susceptible to a plunging dollar, yet over the medium term should benefit vis-à-vis non-US markets as the competitive aspects of a devalued currency are realised. When the dollar does eventually stabilise, a wholesale shift in risk perceptions should enable investors to push down the equity risk premium – boosting global equities.



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