Global Investment Outlook

September 2002

Recovery or Double Dip?

Aberdeen
ASSET MANAGEMENT

Global Economic Outlook

• The weakness of equity markets in the past three months and the dip in certain key economic indicators globally in the past month have raised market concerns about the potential for a double dip particularly in US activity.

• The risk of an economic double dip has increased, with the shock to confidence from equity market declines a key contributor. The actual negative wealth effects are seen as offset by the strong property market, both in the US and the UK.

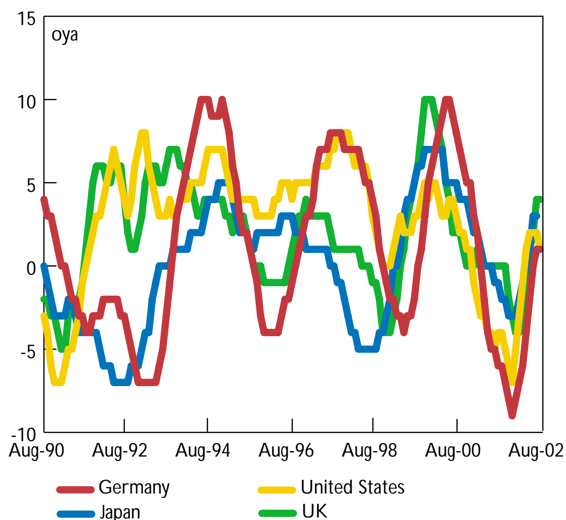
• Given the ongoing low inflation backdrop this also raises the risk of outright global deflation.

• At this stage, however, we believe that while global economic momentum is encountering strong headwinds, growth is more likely to slow for a period, before recovering later in the year.

• Recent data have pointed to the likely subdued nature of the economic cycle over the coming year. We expect that the economic recovery will be irregular, with sub par growth continuing well into 2003. This makes this environment very similar to the early 1990s.

• We have therefore reduced our growth numbers for the US and Europe. Asian, Japanese and UK forecasts are kept steady at this stage, reflecting still reasonable economic momentum in these areas.

Level indicators starting to roll over



Source: Datastream and Aberdeen Asset Management

2003 economic forecasts

	2002 GDP	2003 GDP	2002 CPI	2003 CPI
US	2.0	2.8	1.6	2.2
Eurozone	0.7	2.0	2.2	1.2
UK	1.2	2.4	2.0	2.4
Japan	0.2	1.1	-0.7	-0.5
Global	1.8	2.9	3.5	2.7

Source: Aberdeen Asset Management

Aberdeen's monetary policy forecasts

	July 2002	Change from last month	Sep-02	Dec-02	Mar-03
US	1.75	0.00	1.75	1.75	1.75
Eurozone	3.25	0.00	3.25	3.00	3.00
UK	4.00	0.00	4.00	4.00	4.25
Japan	0.01	0.00	0.00	0.00	0.00
Australia	4.75	0.00	4.75	5.00	5.25
Canada	2.75	0.25	2.75	3.25	3.50

Source: Aberdeen Asset Management

• In the absence of an acceleration in business investment and employment, both of which are factors unlikely to be notable contributors to growth any time soon, the pressure falls squarely on consumption demand.

• Consumers, particularly in the US, are still being called upon to carry a disproportionate share of the demand load. Outside of the US, the only obvious pockets of demand are seen in the Anglo economies (UK, Canada, Asia and Australia).

• The coming year is expected to see continued high levels of corporate bankruptcy and debt defaults, which will act as a headwind against accelerating growth. This nevertheless is an essential consolidation process that must be completed before growth can resume at a healthy pace once again.

• We believe that there is little chance of higher interest rates in the next six to 12 months, a view based on the likely growth profile and sensitivity to higher interest rates seen this year.

• We therefore maintain Funds rate for now but with a bias towards further easings if economic data and credit markets deteriorate again in the next month or so.

• We see the US Federal Reserve and other central banks as increasingly focusing on the risks of slower growth in their policy settings. They stand ready to ease if necessary.

Investment Strategy

• Assuming that a double dip recession does not occur, then equity markets appear to be good value, particularly against government bonds. The levels to which we saw equity markets fall in July produced value in many sectors. Not surprisingly, we have seen a solid bounce into August.

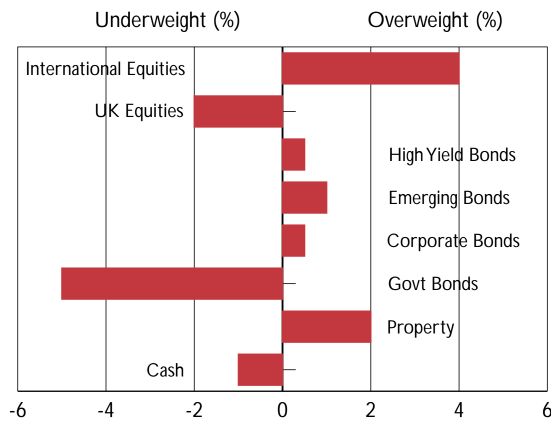
• Value is a key factor for markets now. A lack of confidence on earnings, however, has undermined sentiment but other valuation measures are also now becoming more favourable. Dividend yields, for example, are now at 30-year highs versus cash rates in the UK and US.

• Concern over geopolitics, earnings quality, credit default and economic weakness have all led to heightened investor risk aversion but this is also a generally positive signal for future risk asset performance, assuming that risk aversion starts to decline. This is in fact what AAM's Risk Appetite Model has been signalling recently.

• With regard to equities, Europe remains the preferred developed region, although dollar weakness could change the balance somewhat back towards US markets.

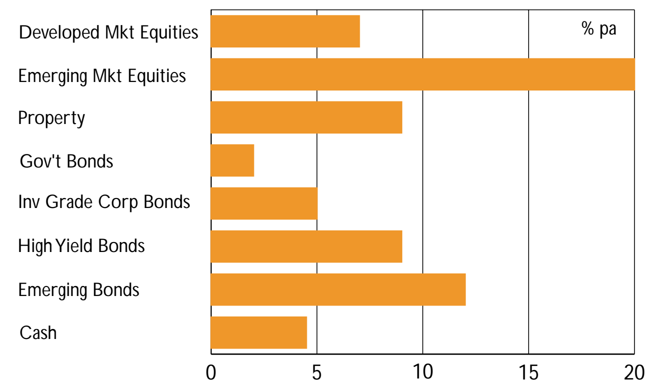
• Emerging, particularly Asian, equities continue to be preferred over developed markets. They are relatively attractive compared to developed regions in the event that global growth stabilises and valuation is not problematic. In addition, outside of Latin America, debt overhang is less of an issue.

Asset Allocation



Source: Aberdeen Asset Management

Asset Sector Expected Returns - 12 months



Source: Aberdeen Asset Management

Investment Strategy

• That said, in the event of a double dip global recession, emerging markets would be likely to underperform as investors seek safer havens. That concern has seen these markets hurt in the past month. We see this as a buying opportunity.

• Bond markets have priced in a renewed downturn for the global economy. In the event of a double dip recession bonds will rally again and equities will be further crushed. However, if global growth is maintained then bond yields should rise over the next 12 months.

• Credit is expected to outperform government bonds in a recovery scenario but spreads have widened dramatically in the past month as the double dip risk is priced in.

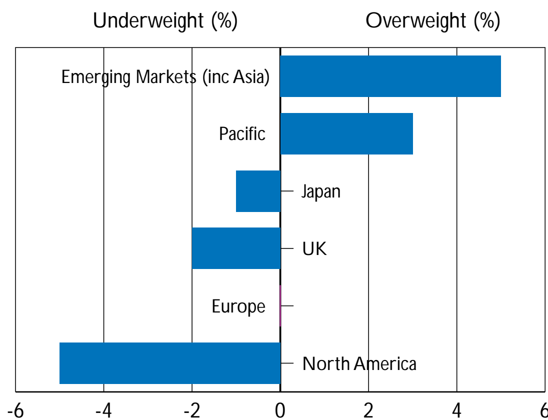
• In the event of a double dip credit should be avoided. If global growth is maintained then credit spreads are attractive.

• Within equity markets we anticipate a further cut to earnings expectations globally over the coming months. Particularly at risk would be high P/E stocks with a lack of earnings visibility. We are therefore maintaining a focus on earnings surety in either better quality early to mid cycle cyclicals or cheaper defensives.

• In a low nominal GDP, disinflationary economic environment companies with high debt burdens may find it difficult to service their financial liabilities. We are avoiding these types of companies.

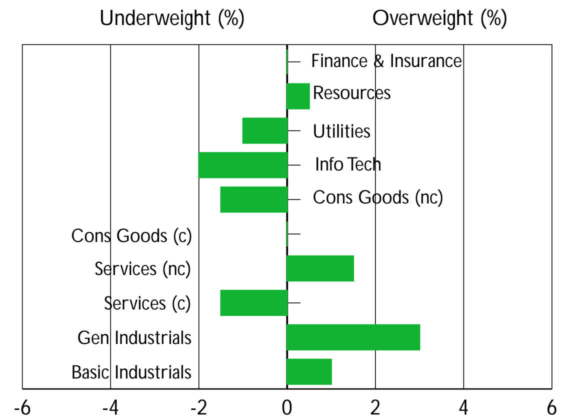
• Low borrowing costs continue to support UK property and increased demand is putting downward pressure on yields. The asset class remains attractive with an economic double dip the major risk to projected returns.

Global Equity Allocation



Source: Aberdeen Asset Management

Equity Sector Allocation



Source: Aberdeen Asset Management

Bond and Currency Markets

• Perceptions have changed dramatically about the timing and magnitude of any global interest rate tightening cycle. Expectations for future short-term interest rates have fallen in almost every developed market as a result of continued equity and credit spread weakness. Along with evidence that the momentum of recovery in US demand is slowing the probability of a double dip has increased.

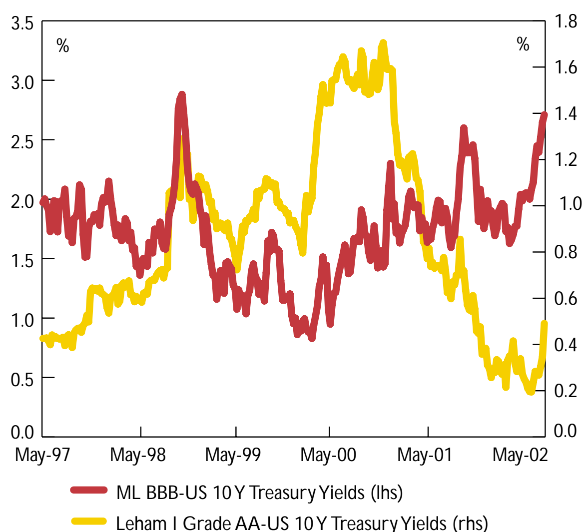
• We believe that central banks will stay on hold or possibly ease by the end of the year. Short rates will be lower for longer. This re-pricing of short rate expectations has allowed the whole bond term structure to move lower with a continuation of the prevailing steepening bias.

• The recent GDP downward revisions have increased the risk of the 1990s disinflationary trend.

• Government bond valuations are rich - traded real yields and inflation expectations are now at or below the post 11 September lows seen in November 2001. However, the near term risk is that they could rally further.

• Credit spreads have continued to widen due to weak economic data, risk aversion and distress. The tiering of the market continues to be evident as lower-rated credits continue to underperform high-grade credits.

Credit spreads widening again



Source: Datastream and Aberdeen Asset Management

10 year sovereign bond forecasts

	Current	Yields 3 month forecast	Yields 12 month forecast	Returns 3 month forecast	Returns 12 month forecast
US	4.01	4.00	4.75	1.45	0.04
Euro	4.45	4.20	4.75	2.99	2.50
UK	4.53	4.40	4.90	2.01	2.01
Japan	1.27	1.45	2.20	-0.83	-4.31
Australia	5.53	5.40	5.95	2.29	2.82
Canada	5.02	4.50	5.00	6.34	6.66

Source: Aberdeen Asset Management

Currency forecasts for 2002

vs US $	20 Aug 2002	3 month forecast	12 month forecast
UK £	1.520	1.582	1.642
Euro	0.979	1.000	1.100
Japanese Yen	118.6	120.0	115.0
Australian $	0.538	0.555	0.600
Canadian $	0.640	1.520	1.465

Source: Aberdeen Asset Management

• Gilt yields will track US Treasuries in the short term but we are looking for a much flatter curve in a year's time, straddling 5% across the curve with 30 year issues maintaining their premium.

• Our bearish US dollar forecasts remain the same despite the recent resilience of the dollar which we put down to a correction to the longer term trend.

• The euro is likely to be one of the major beneficiaries of the dollar malaise over the medium term.

• We have revised up our sterling forecasts (especially for the near term) against the US dollar and the euro as EMU entry seems to be fairly distant currently.

Equities

US

• The market is weighed down by the concerns over earnings quality and corporate malfeasance, the timing and strength of the earnings rebound and economic uncertainty.

• The problems created by the bankruptcies of Enron and WorldCom and SEC investigations into accounting issues at AOL and Tyco have undermined investor confidence and led to regulatory and governmental reforms as well as management upheaval.

• However, large caps including Procter & Gamble and Cisco Systems have recently reported earnings which were ahead of expectations.

• Evidence of economic recovery remains uneven. Consumer confidence has softened of late but the manufacturing sector continues to improve.

• Our US funds remain underweight technology, telecoms and pharmaceuticals. We are overweight industrial cyclicals, energy and basic materials, although we have scaled back the degree of cyclicality within our portfolios in recent weeks.

UK

• The GDP outlook has been tainted by June's shock industrial production numbers, which represent 'lost' growth. This probably overstates the slump in activity, however, with the World Cup and Jubilee weekend both having likely overly depressed growth data.

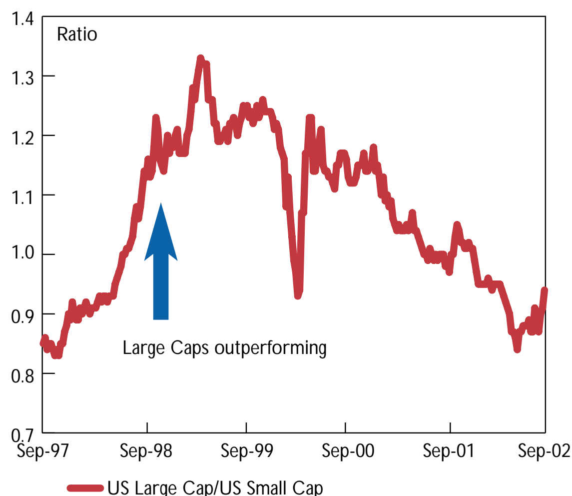
• We remain at a below consensus growth forecast of 1.2% in 2002, while 2003 is expected to improve towards 2.4%. We expect the BoE will prefer to leave policy unchanged for the foreseeable future, until the global environment becomes clearer.

• House price inflation is a significant offset to equity deflation, with price rises of 20%. While this will likely slow, it should help put a floor under confidence and spending.

• The reporting season has continued to reassure investors on balance with recent positive results from companies including BOC and BHP Billiton helping cyclical sectors.

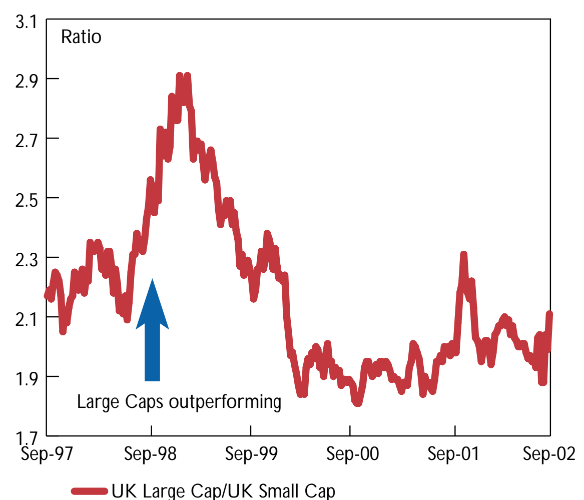
• We are continuing with a pro-cyclical and anti-defensive stance in portfolios and have moved overweight oils and reduced our position in banks to neutral.

Large cap stocks outperforming again



Source: Datastream and Aberdeen Asset Management

Relative large cap outperformance following US trend



Source: Datastream and Aberdeen Asset Management

Equities

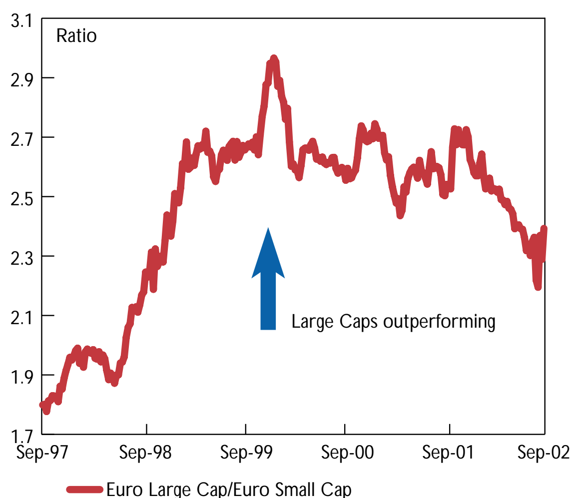
Eurozone

• We have revised down our forecasts for European growth in both 2002 and 2003. We are reducing the 2002 forecast from 1.1% to 0.7% growth and lowering 2003 from 2.5% to 2%.

• We are also reducing our interest rate forecasts - we now expect one 25 basis point cut by the ECB in the fourth quarter with the potential for a further 50 basis points of easing in 2003 if growth disappoints further in the eurozone.

• Our pro-cyclical stance has been reduced due to the softening global economy and euro strength. We are now underweight consumer cyclicals and neutral in basic industries.

Large caps see relative bounce after becoming oversold



Source: Datastream and Aberdeen Asset Management

Japan

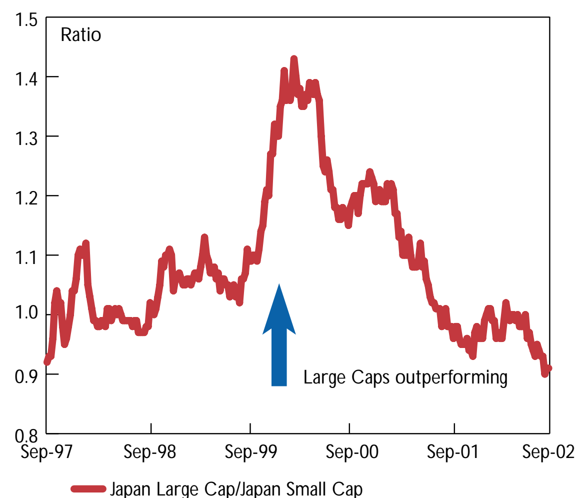
• Japanese growth has surprised on the upside leading us to revise up our forecasts this year. This has been driven by the upturn in traded exports and industrial production.

• Given the dependence of Japanese growth on export performance, a sharp loss of export competitiveness would be unhelpful at present, as would a sharp deceleration in global demand.

• This would normally provoke a lowering of interest rates to offset the shock. However, given current interest rates levels, the Bank of Japan has been aggressively boosting liquidity growth in the economy.

• Identifying stock opportunities has become easier following the recent market falls, but we are not at the stage where we have more buy ideas than cash available.

Large caps have not bounced against 2nd tier stocks as in other markets



Source: Datastream and Aberdeen Asset Management

Equities

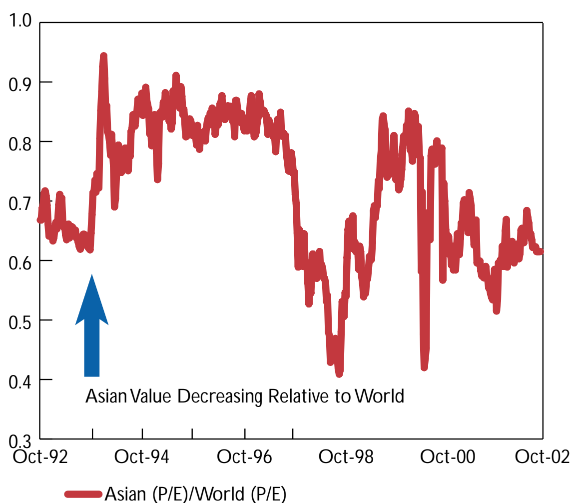
Asia Pacific

• Asian markets have generally held up relatively well in the current global economic environment with a combination of domestic growth dynamics, structural reform and lower market valuations supporting relative performance.

• Although the sharp drop in US equity markets has impacted Asian equities, the magnitude of the decline has been less severe, reflecting the resilience of the region. The past month has, however, seen a relative underperformance by Asian markets as double dip concerns magnify. We believe this represents a good buying opportunity.

• China's economy has continued to steam ahead, expanding by 8% year-on-year in the second quarter. Other bright spots include Korea and Thailand. Singapore is also showing improvement.

Asian stocks still attractively valued compared to developed regions



Source: Datastream and Aberdeen Asset Management

Emerging Markets

• EMEA economies and markets have done relatively well in the current environment, with outperformance of the main markets in local and currency adjusted terms.

• Given the increasing risk backdrop, EMEA has done relatively well over the past quarter, however, the past month has seen underperformance of major markets.

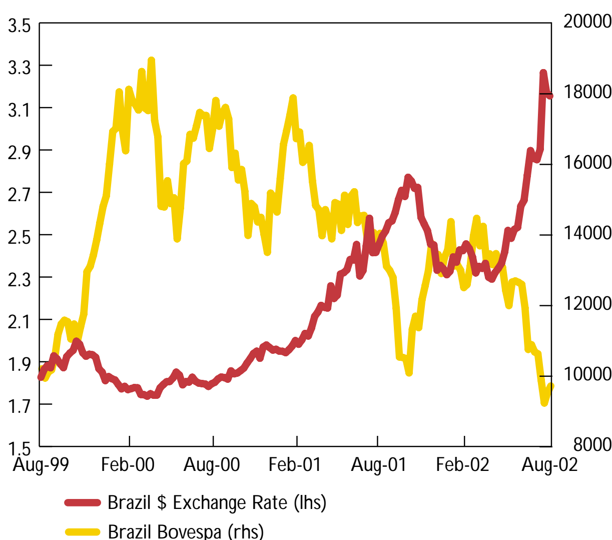
• Capital flows in general remain positive although some markets have suffered from the generalised increase in risk premia.

• Latin America has represented a major problem with systemic risk concerns associated with Brazil and Venezuela following on from Argentina's default of last year. The announcement of a $30bn IMF package for Brazil has done little to improve the market's mood in the short term. Investors remain fearful of a potential change of president in the October elections. This uncertainty is likely to remain in place until a new president is able to clarify their policy agenda.

• Mexico remains the main counter to this with its economy largely coupled to the fortunes of the US economy. Its market has been relatively defensive within Latin America.

• Many economies within the EMEA region are still gaining from closer ties to European markets and the convergence expected from EU enlargement in 2004. Russia has also benefited from higher oil prices and improving legitimacy, with strong year to date performance, although again the last month has seen a setback in global risk aversion trades. The Czech Republic has been one of the best performing EMEA markets in the past month.

Brazil currency and asset markets under pressure



Source: Datastream and Aberdeen Asset Management

• UK property has continued to offer diversification benefits, particularly as a relatively safe haven against the turbulence of global equity markets. With most investors looking to hold or increase their property exposure, strong investment demand and a supply shortage are fuelling renewed capital growth, despite generally weak letting conditions. A number of ex-property funds are looking to re-enter the market, often through indirect investment.

• In the second quarter of 2002, returns increased to an annualised rate of 12.1%, the strongest three month performance since May 2000. Property now has a track record ahead of UK equities and gilts over one, three, five and 10 years.

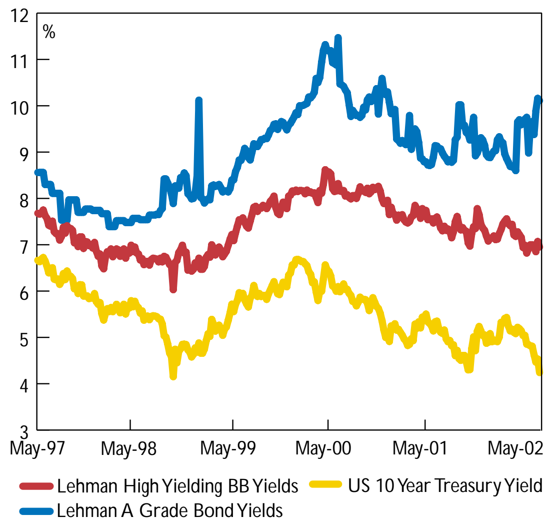
• We expect the market to lose some of its momentum during the remainder of 2002 as asset allocation requirements are satisfied, with the IPD Annual index expected to show a total return of around 10% for the year as a whole.

• Retail property remains on target to be the top performing market sector this year, for the first time since 1997, with rental values continuing to edge upwards, particularly for out-of-town retail parks.

• The impact of the recent financial market turmoil is already affecting demand for offices, with tenants unwilling to make new lease commitments until the outlook becomes clearer. In this environment rental values in central London and the main South Eastern markets have further to fall and these markets look overpriced at current yields.

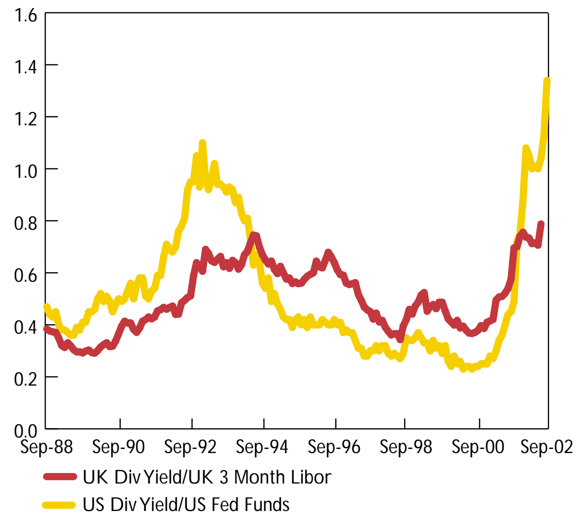
Charts of the Month

Treasuries rallying but credit failing to follow yield lower



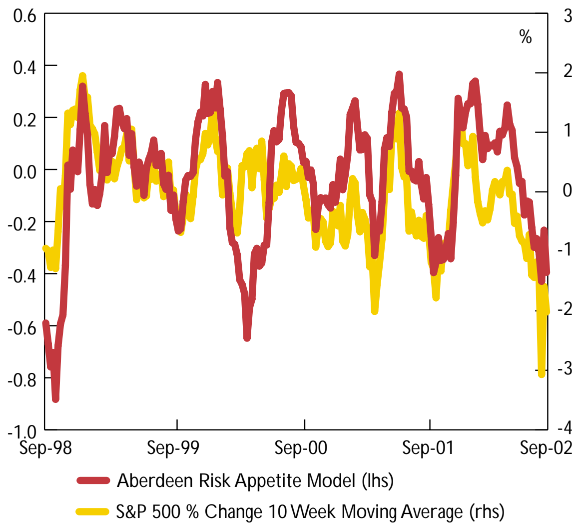
Source: Datastream and Aberdeen Asset Management

Rising dividend yield makes equities more attractive versus cash!



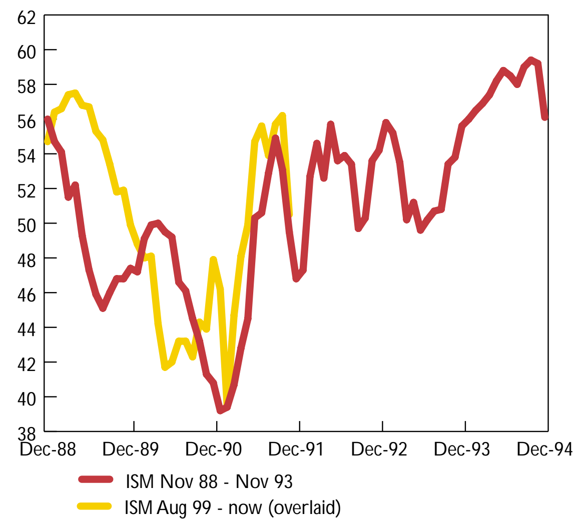
Source: Datastream and Aberdeen Asset Management

Aberdeen Risk Appetite Model (ARAM) suggests equities have been oversold



Source: Datastream and Aberdeen Asset Management

ISM volatility similar to early 1990s



Source: Datastream and Aberdeen Asset Management

Alternative Economic and Market Scenarios

By Steven Kaye, Global Investment Strategist, Aberdeen Asset Managers

A more uncertain economic and market environment is leading us to believe that two relatively negative scenarios - **Alternative Scenario A- Equity market Spiral and Alternative Scenario B- Equity Market Churn have been increasing risks.**

Among the factors contributing to this increased uncertainty are that equity markets have weakened further since our last monthly update, with the S&P 500 touching 780 before rallying back to the current 900 level. This has in turn caused a dip in key economic lead indicators that have raised concerns about the risk of an economic double dip. Ongoing uncertainty over corporate earnings quality also remains a drag.

As a result, we have raised the probability for both scenarios A and B to 20% from 15% last month and the probability for our core view that there will be a moderate cyclical recovery in risk assets in 2002 has been moved down to 55% from 65%. The scenario that we believe is least likely is **Alternative Scenario C - Strong Synchronised Global Recovery, which we are giving only a 5% probability**

AAM Central Asset Sector Forecasts 12 mths

Equities	+10
Fixed Income	+4
Property	+8
Cash	+4

Local markets actual % return unless otherwise stated

Alternative Scenario A, is seen as a major risk.

This scenario assumes that imbalances from the 1990s stockmarket bubble are yet to be fully unwound and this combines with a global economic recovery that remains vulnerable to shocks. Retrenchment on either front (macro or micro) could lead to a further downward spiral, with the recent equity bounce unsustainable. The scenario foresees a further sustained fall in both consumption and profits, which results in underperformance of risk assets and a potential deflationary backdrop.

Equities would be expected to fall further, with investors seeking shelter in safe haven assets such as bonds and cash. Yield curves would be expected to flatten, with negative real interest rates needed for some time to restore economic momentum.

Further support for this scenario lies in the fact that recent consumer spending in both the US and UK has been financed by borrowing and a strong property market. Therefore, consumers have little scope for increased expenditure and any change in the ability to finance debt, either through increased costs or higher unemployment could act as a catalyst for reversal. Deterioration in current employment levels could, ironically, be driven by layoffs as corporates attempt to restore profitability.

Scenario A - Equity Market Spiral

	12 mth forecast
Equities	-20-25
Fixed Income	+7
Property	+3
Cash	+2

Local markets actual % return unless otherwise stated

Alternative Scenario B, is a halfway house between a moderate cyclical recovery and a further downward spiral.

Financial markets still have significant post-bubble stresses to work through and economic recovery does not guarantee an immediate market response. A review of market history suggests that it takes a number of years for equities to make significant progress in a post-bubble environment, which allows for a significant dichotomy between the macro and micro environment.

Under this scenario, economic growth is maintained at modest levels. This subdued macro environment would prevent both unemployment levels falling and a corporate earnings recovery. Scenario B favours yield products such as higher quality credit and higher yield equities. High yield credit would be under pressure from high levels of corporate default as lesser quality companies struggle to deleverage. Corporate equity requiring strong revenue growth to drive profitablity would continue to underperform.

Property would be likely to perform well - equities would be expected to underperform overall.

Alternative Scenarios A and B are effectively two sides of the same coin and before lowering the probability of Scenario A markedly in future we would look for indications that the present equity bear market is at an end. In past market cycles, factors encompassing valuation, asset allocation, corporate financing/restructuring and sentiment have been indicative of this.

Scenario B - Equity Market Churn

	12 mnth forecast
Equities	0
Government Bonds	+2
Corporate Credit	+7
Property	+6
Cash	+2

Local markets actual % return unless otherwise stated

Signs for an end to the bear market?

Equity market valuation as an indicator

One of the most basic indicators for the end of a bear market is that valuations have become unequivocally attractive on all measures. Although equity valuation is mixed, equity/bond ratios are as favourable as they have been at any time in the last 20 years.

Another valuation indicator is that growth stocks become very cheap - these are still trading on a premium to market valuations although we would look for this to unwind.

In terms of dividend yield, though we have been able to identify individual attractive stocks this is not yet on a market-wide basis but we are now seeing equity dividend yields in the US and UK above short term interest rates for the first time in 30 years.

Asset allocation as an indicator

An analysis of asset allocation shows that equities remain relatively over-owned compared to previous cycles - some further decline of equity exposure as a percentage of pension fund assets is likely therefore.

Another indicator would be that cash has become a favoured asset - US money market funds are around 22% of the Wilshire 5000 which is on a par with the early 1980s. The peak seen in the early 1990s was 17%. Also, mutual fund flows would turn positive and volumes normalise - these flows have been negative and volumes have recently been high.

Corporate restructuring indicators

These would include an observation that high credit market interest rates and tight credit conditions begin to ease - official interest rates are currently at emergency low levels but any liquidity generated has gone into the consumer sector at the expense of corporate liquidity. Implied default rates remain very high.

Another indicator is balance sheet restructuring, which is clearly a priority for most companies, particularly those with high debt levels. One signal of this working through would be an upsurge in recapitalising rights issues.

Aggressive cost reduction and rising corporate bankruptcies are other signals of positive restructuring- there are increasing signs of the former but there have been only isolated cases of the latter so far.

Sentiment indicators

In terms of sentiment indicators for the end of the bear market, signs to look for would be more discrimination amid sell-offs of stocks and markets. This means more selective market price movements rather than the general weakness seen in the past few months.

Also, consensus sentiment should be bearish - at present the consensus is still for an equity rebound, although indicators such as option volatility suggest high market caution. Other signs would be stock prices failing to fall on bad news and insider buying at historically high levels, paticularly from corporate directors - Vickers stock research in the US still highlights heavy insider selling.

Watch key indicators in coming months

Overall, recent falls in equities undoubtedly left them oversold on a technical short-term basis. The rally in August has not been surprising therefore.

Other factors that we are keeping a close eye on are consumer spending and job market stability as these are prerequisites for the core scenario.

Leading economic indicators such as the US's Conference board, ISM (also UK CIPS and German Ifo), the shape of the yield curve, capital goods orders, initial jobless claims, housing market indicators and the relative performance of cyclical stocks are all areas to monitor. Further deterioration in these factors over the coming months would be indicative of a seriously deteriorating backdrop and would reduce the likelihood of our core view materialising.

UK Property Market Outlook

By Andrew Smith, head of strategy, Aberdeen Property Investors

While the continued surge in house prices is the subject of daily press coverage, commercial property's continuing outperformance of equities and bonds has re-kindled professional investor interest.

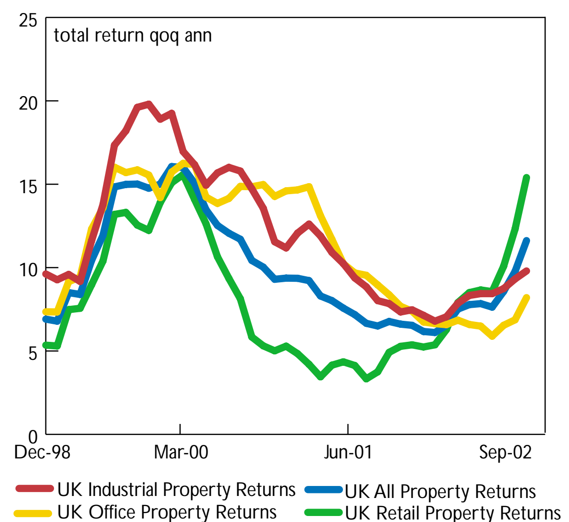
Until recently, the impetus came from the debt-financed segment of the market, which has been boosted by successive interest rate cuts. This helped to fill the gap left by institutions, which found themselves overweight in property in response to the prolonged underperformance of the equity market. Over the last few months, however, UK and overseas institutions have become more active. Some funds that moved out of property in the 1990s are returning to the market, and many multi-asset investors now seem content to allow property weightings to remain above the levels considered acceptable in recent years. Those who have done so feel vindicated in the light of the latest fall in equity markets.

This reassessment has fuelled an upsurge in demand for property. Yields have started to edge lower in response to the increasing investor appetite and a shortage of available stock and have been supported by parallel falls in bond market yields against which the property risk premium is assessed.

UK property saw a return of 6.7% in 2001, based on the Investment Property Databank (IPD) Annual Index - the weakest result for six years, but comparing very favourably with gilts (3.9%) and the FTSE All Share return (-13.3%). By comparison, in the second quarter of 2002, property returns increased to an annualised rate of 12.1%, the strongest three month performance since May 2000 (IPD Monthly Index). Property now has a performance track record ahead of UK equities and gilts over one, three, five and 10 years, and the advantage of much lower volatility.

The gradual divergence in performance of the three main market sectors has become more pronounced in recent months. Retail property is now the runaway winner, pushing industrial returns to a below average three month position for the first time since January 1998. After a two year run of strong performance the office sector now trails in a poor third place.

Property sector returns diverging



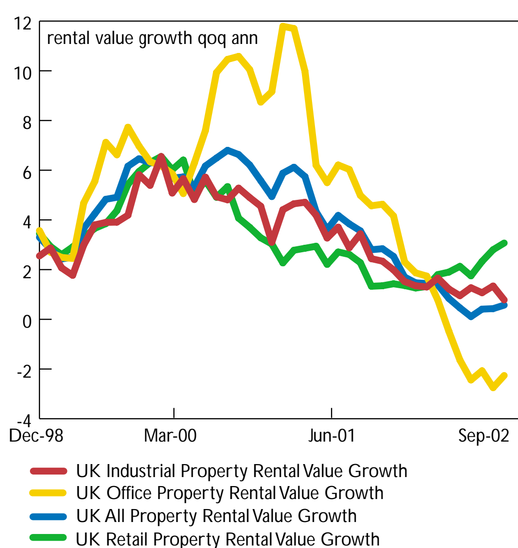
Source: IPD Monthly Index, Aberdeen Property Investors

While the UK property market remains on course to deliver returns approaching 10% in 2002, the sustainability of this performance is questionable. Overall, the market is essentially ex-growth. Pockets of rental growth in the retail sector (focused on the major regional shopping destinations and strong out-of-town retail parks) are offset by still falling rental values in the main office markets of London and the South East, where the current uncertainties have undermined tenant demand and vacancy rates have risen sharply. Dwindling business confidence has brought a slowdown in tenant demand for office and industrial space, as companies have reviewed their property requirements. The recent financial market volatility has meant that occupiers have been reluctant to make new lease commitments until the outlook becomes clearer.

UK Property Market Outlook

With the consumer spending boom expected to slow and margins under pressure from goods price deflation, retail rental growth is likely to see some loss of momentum and cannot be counted on to offset the sluggish performance of other market segments.

Rental growth may come under pressure if economic growth slows



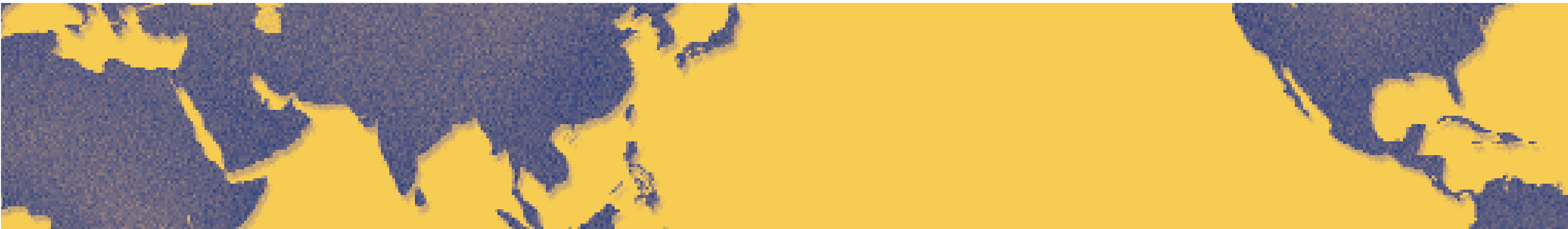
Source: IPD Monthly Index, Aberdeen Property Investors

The key issue at this stage in the cycle is whether investment demand will push capital values above levels that are sustainable given the supply and demand fundamentals which drive the letting market. Central London offices (and the City sub-market in particular) are most at risk. Should this happen, along with weakening investment demand as asset allocation requirements are satisfied, there is a risk that yields may weaken until rental growth becomes more firmly embedded. On the basis of our current economic forecasts we do not expect much improvement until the second half of 2003.

Nevertheless, the market has avoided the speculative building excesses of the late 1980s and the over-exuberant investment market conditions seen in 1993, when yields were bid down sharply in response to the post-ERM bond yield re-rating, despite a lack of fundamental support from rental growth. Following healthy rental growth in recent years, most portfolios are set for continuing income growth as rent reviews (which generally take place five yearly) are settled.

As such, although UK property returns are likely to dip again in 2003, assuming the economy escapes a second round slowdown, the market is priced to deliver five year real returns of about 7%-8%, well above the long term average of just over 4%. In the event of a second round weakening in economic growth, higher yielding industrial and provincial office investments offer defensive qualities and rental values for out-of-town retail investments should prove relatively resilient.

Coupled with diversification benefits and the opportunity to add value through the active management of assets after purchase, the increase in institutional asset allocations to property seems justified. There is a likelihood, however, that those who are only now re-entering the market have already missed the best bit of the party.



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