Illumination: Equity strategy and market outlook

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Equity market overview

In summary, we expect stock picking to come back to the fore in 2010 and against this background favour high-quality growth stocks on modest valuations, especially those with diversified global exposure. From a sectoral perspective, we advocate moving to more overweight positions in defensive sectors such as telecoms and utilities, particularly given early cyclicals appear to have run their course and risks will likely rise as the year progresses. We believe it is still defensible to retain an overweight position in basic materials given global growth prospects. On the negative side, we have structural and valuation concerns over the financials and consumer (goods and services) sectors.

Distinction through differentiation

There are many reasons to feel bullish at the start of 2010, but uncertainties clearly remain. While 2009 was the best year for the FTSE (and a number of other global indices) since 1997, with the market recording a 22% gain, lack of consensus over future direction is evidenced by the broad range of estimates for where the FTSE may end 2010. The UK market closed 2009 at 5,412 and, according to a recent Reuters, stock market watchers vary in their opinion for the next 12 months, positing a range of 4,700 to 6,250.

Our perspective is not to get involved in making predictions (especially given that many doing so have found themselves mostly wrong-footed in the last two years by the Lehman debacle and the subsequent equity market rally). However, we believe it is very fair to assert that while global equity markets have moved with remarkable synchronicity on both the way down and the way up in the last two years, this will not be the case in 2010. Assuming a broadly stable outlook for the global economy, we expect stock-picking to come back to the fore and believe investors can most likely gain distinction through differentiation.

The >50% rally experienced by the UK equity market since March suggests that a sustainable recovery has become increasingly priced in, even if the British economy remains the only one among the G20 still to be technically in recession. Moreover, it is now more a matter of when, rather than if, the interest rate raising cycle will need to begin. While Australia, Israel and Norway have already begun the process of rate tightening, consensus seems happy to assume that rates in the UK (and the US) are unlikely to rise before Q3. With these scenarios effectively discounted and UK equities trading at no better than slightly cheap valuation levels (16.6x forward P/E versus a 10-year average of 18x), the case for stock selection is reinforced.

Our Illuminator product provides a fundamental framework for stock picking, but in broad terms we favour high quality growth stocks on modest valuations, and especially those with diversified global exposure. From a sectoral perspective, we advocate moving to more overweight positions in defensive sectors such as telecoms and utilities, particularly as early cyclicals appear to have run their course. We believe it is still defensible to retain an overweight position in basic materials given global growth prospects. On the negative side, we continue to have structural and valuation concerns over the financials and consumer sectors.

Looking back

Market performance: Onwards and upwards

3 March marked the turning point for UK equities, with a 54% gain recorded from this date through to the year-end. December did not disappoint, as the FTSE rallied into the close of the year, peaking on 29 December and posting a 3.3% gain for the month. The UK market's absolute gain of 22% in 2009 was its best since 1997 and most developed economies similarly turned in stock market performances of 20-25% relative to the previous year.

The robustness of the domestic equity market comes in spite of the fact that the UK economy remains in recession. This was confirmed by the Office for National Statistics on 22 December when it published its revised analysis for Q3 GDP, showing a 0.2% contraction (vs previous estimates for a 0.3% decline). The UK recession has now endured for six quarters, making it the longest on record and according the economy the dubious status of being the only among the G20 still to be in recession.

Equity investors, however, appear to be looking beyond this, focusing on two factors: the health of the rest of the world (at least 30% of the FTSE comprises 'global proxy' stocks within the basic materials and oil sectors) and the improving circumstances of the domestic economy. According to the latest survey from CIPS, UK manufacturing grew at its fastest pace in two years in December. This performance was echoed elsewhere in the world, with December's ISM data in the US showing a fifth consecutive month of expansion, while purchasing managers in China are at their most optimistic in five years.

Economies globally have been helped by low interest rates, with the Bank of England voting unanimously in December to keep rates on hold. Against this background, consumers have continued to spend, with retail bellwether John Lewis reporting its best-ever Christmas, recording like-for-like sales growth of 12.7% in the five weeks to 2 January. ASDA, JD Sports, Majestic Wine, Next and Sainsbury (among others) all also posted better-than-expected revenues. Some of this spend should, however, be put down to seasonal purchasing augmented by consumers mindful of January's VAT increase. Indeed, one potential concern going forward is that despite strong retail spend patterns, consumer confidence in December dropped by five percentage points (according to the Nationwide), its biggest fall since November 2008.

Corporate news has been light on the ground recently although the Q4 reporting season is set to begin in earnest in the coming weeks. M&A, however, continues to act as a source of investor intention. Kraft's quest for Cadbury continues and shareholders in the UK company have until 2 February to decide whether or not to accept the Kraft offer (the cash component of which was recently sweetened). Elsewhere, investors in Shanks were rewarded with a bid from Carlyle in late December. Only nine IPOs took place in 2009, raising less than £1bn in new equity. However, assuming equities markets are able to maintain their ascent, further transactions could be forthcoming in 2010. Potential names in the frame include New Look and Ocado, among others.

Exhibit 1: Performance over 2009 of major UK indices (in percentage points)

	Full-year	Last six months	Last quarter	Last month	Since trough
FTSE 100	21.6	29.8	10.3	3.3	54.3
FTSE 250	43.5	28.9	6.9	3.4	64.8
FTSE 350	22.9	29.7	9.8	3.4	56.3
FTSE Small Cap	48.7	26.2	(0.9)	1.8	73.2
FTSE All-Share	23.4	29.7	9.6	3.3	56.7
Relative UK performance					
FTSE 100 vs FTSE 250	(21.9)	0.9	3.4	(0.1)	(10.5)
FTSE 250 vs FTSE All-Share	20.1	(0.8)	(2.7)	0.1	8.1
FTSE Small Cap vs FTSE All-Share	25.3	(3.5)	(10.5)	(1.5)	16.5

Source: Datastream, Edison Investment Research

Sector performance

Despite a move of more than 50% in UK equities since their March trough, outperformance has been far from universal. Notwithstanding stock-specific events (such as deal-making, for example), the disparity between sector leaders and laggards is noticeable. Every sector is in positive territory from its position at the start of March, but a gain of just over 17.7% for the utility sector stands in stark contrast to returns of more than 100%

for both the financials and basic materials sectors. Over the course of 2009, the utility sector (admittedly down just 0.6%) was the only to finish in negative territory, although telecoms and healthcare posted gains of less than 10%. Meanwhile, technology and basic materials are both up by more than 70%.

Over every time period analysed for 2009, basic materials was the best performing sector, partly reflecting hopes of an improving global economic outlook. Technology and financials have also proved robust. It is notable, however, that in the last quarter both technology and financials underperformed, while utilities – the laggard sector over the year – turned in almost the third strongest gain (after basic materials and oil & gas), adding just over 10% between October and December. Although utilities have begun to move up the rankings, the performance of neither the telecoms nor the healthcare sectors has meaningfully improved – yet.

Exhibit 2: Best and worst performing sectors in FTSE All-Share Index over 2009

Note: * 3 March 2009.

	Top three				
	Full year	Last six months	Last quarter	Last month	Since trough*
Best	Basic Materials	Basic materials	Basic materials	Basic materials	Basic materials
	Technology	Technology	Oil & gas	Utilities	Financials
	Consumer services	Industrials	Utilities	Oil & gas	Technology
	Bottom three				
	Full year	Last six months	Last quarter	Last month	Since trough*
	Healthcare	Oil & gas	Consumer services	Consumer services	Oil & gas
	Telecoms	Healthcare	Telecoms	Telecoms	Telecoms
Worst	Utilities	Utilities	Financials	Financials	Utilities

Source: Datastream, Edison Investment Research

European footnote

As mentioned previously, one of the key stories of 2009 was synchronicity, and the performance of Europe's major bourses closely mirrors that of the FTSE. This is the case for every time period analysed with the exception of performance since March's trough, when the UK market has underperformed its peers in France, Germany, Italy and Spain. Many similar factors have been at work across all of Europe, namely lower interest rates and stimulus efforts from national governments leading to improved production and consumption trends, but continental Europe has recovered markedly more quickly than the UK. Figures released by Eurostat on 8 January show that the EU recorded 0.4% GDP growth in Q3, in contrast to the UK's figure of -0.2%.

Exhibit 3: Performance over 2009 of major European indices (in percentage points)

	Full-year	Last six months	Last quarter	Last month	Since trough
DJ EURO STOXX	21.3	26.5	8.0	3.2	65.1
DJ EURO STOXX 50	19.0	27.0	9.3	3.7	66.7
France CAC40	19.8	28.7	10.0	4.4	59.3
Germany DAX30	21.6	28.5	10.6	4.0	63.8
Spain IBEX35	28.0	25.1	7.2	0.9	78.2
Italy MIBTEL30	18.0	24.3	3.9	2.7	86.6
FTSE 100	21.6	29.8	10.3	3.3	54.3
FTSE All-Share	23.4	29.7	9.6	3.3	56.7
UK relative to Europe					
FTSE 100 vs EURO SROXX 50	2.6	2.8	1.0	(0.4)	(12.4)
FTSE All-Share vs EURO STOXX	2.1	3.2	1.6	0.1	(8.4)

Source: Datastream, Edison Investment Research

Our strategy

After a 50%+ rally since the trough in equities, it is harder to argue for similar levels of returns in 2010. Nonetheless, we believe a constructive case for being overweight equities can still be made and we would highlight the following positive factors. Many of the features that were in place at the start of the last bull run in 2003 also appear present today. Most noteworthy is the (steep) shape of the yield curve and the fact that equities are trading on just 1.5x book value, a level last seen after the bubble had burst at the end of the dotcom era. Operating leverage (rising revenues on low cost bases) could also help boost earnings momentum. Moreover, some 55% of investors expect a better global outlook in 2010 according to a survey by Barclays Capital of more than 700 institutions from around the world, and confidence should be boosted not only by further evidence of fund inflows, but also by a likely increase in M&A activity.

Notwithstanding such an optimistic world view, two crucial questions remain for investors: first, should investors favour equities over other asset classes? And, within equities, how will the UK market perform? It is worth noting that the real stars of 2009 were emerging markets and alternative asset classes such as commodities. The Shanghai stock market gained 80% in the year, while crude reported its biggest climb in over 10 years, up 75% in 2009. As long as the generic global recovery thesis remains intact (and no major geopolitical dislocations occur), there would seem little that should disrupt the strength of these asset classes.

Gold too will likely remain robust after having continually touched new highs in 2009. Gold's strength was helped by the weakness of the US dollar, but in the absence of imminent interest rate rises (which we do not expect), it is hard to see what could lead to a notable strengthening in the dollar. Furthermore, for many investors gold will remain a perceived safe haven, an asset class that can continue to appreciate (our analysts assume that a level of $1,800/oz will be reached by 2013) while also acting as a hedge against inflation.

2010 may well be a difficult year for UK equities, evidenced by the wide range of forecasts (4,700 to 6,250) for where the FTSE may end December. The situation is not helped by the similarly broad views on GDP growth. *The Economist* is most cautious on prospects for the UK, assuming only 0.6% growth for 2010, but it is worth noting that the Bank of England is almost twice as bullish as the Treasury in its expectations for the economy (see Exhibit 4). This is despite the fact that the Bank notes that "many banks still have high levels of leverage and unbalanced funding structures" (Financial Stability Report, 18 December). On its own estimates, British banks will need to refinance over £1,000bn in wholesale funding in 2010, which could result in potential volatility in both the debt and equity markets.

Other UK-specific uncertainties may also prevail, most prominent among them being the impending general election (which must be held by 3 June). Irrespective of which party wins, some potentially significant decisions will need to be taken on taxation and expenditure, which will have a meaningful effect on consumer and business sentiment. The not-inconceivable scenario of a hung parliament could engender further uncertainty.

Exhibit 4: GDP forecasts: a wide range for the next two years

Source	2010	2011
Bank of England	2.2	4.1
Treasury	1.0-1.5	3.5
CBI	1.2	2.5
The Economist	0.6	N/A
Simple Average	1.3	3.4

Source: Bank of England, CBI, *The Economist*, UK Treasury, Edison Investment Research

Against this background, we reiterate our core thesis, namely that **stock-picking will increasingly matter in 2010**. In broad terms we favour high quality growth stocks on modest valuations. Since we are confident in prospects for global GDP growth in 2010, we continue to favour those stocks most exposed to the global economy, primarily within the basic resources sector. Importantly, these companies tend to be high quality growth stocks on still modest valuations, something investors should look for in their stock-picking. Elsewhere, we advocate moving to more overweight positions in defensive sectors such as telecoms and utilities, particularly as early cyclicals appear to have run their course. On the negative side, we continue to have structural and valuation concerns over the financials and consumer (goods and services) sectors.

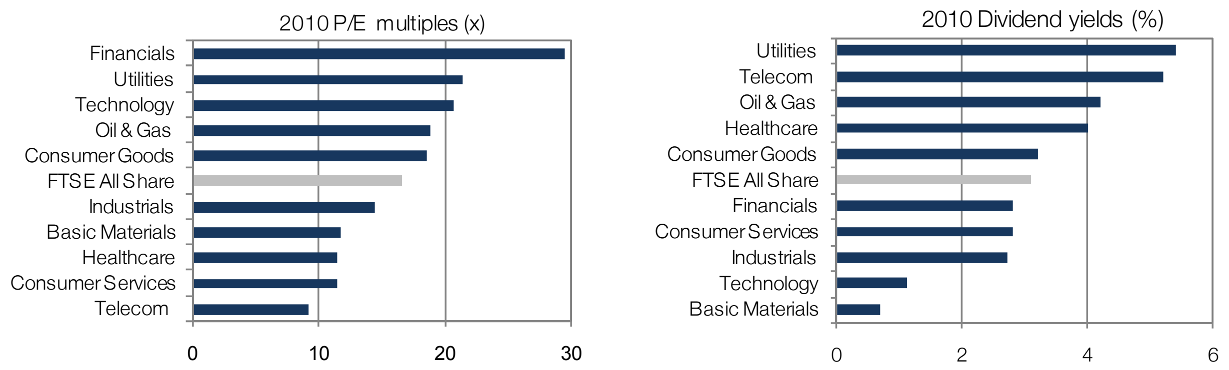
Exhibit 5: Towards a sector weighting

Note: * Edison View; ** All Share benchmark weight.

Position	Weight*	Sector	Weight**	P/E	Yield	One month	Three months	Six months	12 months	YTD	Since trough
Best	OW	Basic materials	12.4%	11.8	0.7%	13.6%	24.5%	78.9%	113.9%	6.7%	142.2%
	OW	Telecoms	5.5%	9.2	5.2%	(1.6%)	5.0%	24.8%	1.9%	(2.4%)	27.3%
	OW	Healthcare	7.7%	11.4	4.0%	1.6%	5.9%	18.4%	5.6%	(0.5%)	31.9%
	N	Utilities	3.4%	21.3	5.4%	4.2%	8.9%	17.3%	(0.8%)	(0.5%)	17.0%
	N	Industrials	6.8%	14.5	2.7%	5.8%	6.1%	33.8%	27.1%	3.0%	53.4%
	N	Technology	1.5%	20.6	1.1%	9.2%	6.7%	39.0%	79.1%	6.2%	79.0%
	N	Oil & gas	18.6%	18.8	4.2%	9.3%	11.1%	34.3%	20.0%	4.8%	36.7%
	UW	Consumer services	9.5%	11.4	2.8%	1.7%	4.8%	25.3%	26.7%	0.9%	45.8%
	UW	Consumer goods	11.5%	18.6	3.2%	2.0%	5.4%	26.8%	21.3%	(1.1%)	40.2%
Worst	UW	Financials	23.1%	29.5	2.8%	5.4%	(2.4%)	35.7%	28.1%	3.8%	111.1%
Total			100.0%	16.6	3.1%						

Source: Datastream, Edison Investment Research

Exhibit 6: 2010 P/E multiples and dividend yields



Source: Datastream, Edison Investment Research

Value and yield

We believe that value and yield will take increasing precedence in 2010, displacing the momentum-style investing that has characterised much of the last year. At some stage, rising interest rate and inflation concerns will likely weigh on equities. The impact is likely to be felt most heavily in the financials sector, which trades on 29.5x 2010 P/E (notwithstanding clear valuation disparities within the quoted group), and offers a below-average dividend yield (2.8% vs 3.1% for the market). We feel that the case often advocated by bulls of the financial services sector – namely, that the government will not enter a rate-rising cycle until the UK's banks have been restored to health – is also well discounted and reflected in valuation levels at present.

In contrast to the market premium commanded by financials, the basic materials sector trades on just 11.8x forecast P/E despite its gain of over 90% in 2009. In addition to likely ongoing strong end-market demand, the sector may also benefit from potential M&A interest. Other sectors that look attractive on a valuation basis include those with a more defensive bias, in particular telecoms (on 9.2x), and also healthcare (on 11.4x).

These two sectors also screen well on dividend yield, offering average 2010 yields of 5.2% and 4.0%, respectively. Utilities currently offer investors the highest dividend potential, yielding 5.4% for 2010, but some of this is offset by the sector's forward earnings multiple of 21.3x. This disparity supports our preference for telecoms and healthcare over utilities – see Exhibit 5.

Key themes for 2010

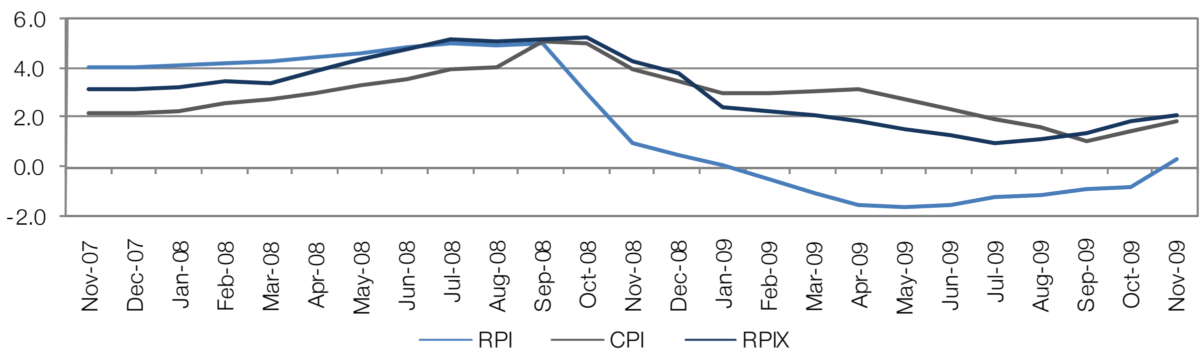
We present below four key thematic drivers that will likely influence the direction of equity markets over the next year. The themes we highlight are of global relevance but are approached from a UK perspective. Our list is non-exhaustive and non-exclusive, but we feel it important to provide investors with a conceptual framework in which to form their stance on equities. Moreover, our considerations help inform our sector and stock preferences. In summary, we favour high-quality stories preferably with either exposure to global growth trends or attractive valuation, cashflow and yield prospects.

Interest rates and inflation – what will the Bank of England do next?

Equities have been helped by a benign environment of stable interest rates and government support in the form of quantitative easing. However, the outlook seems considerably more uncertain. This is echoed particularly by comments from the Bank of England. In its last report, it states "the medium-term prospects for output and inflation continue to be driven by the balance of two opposing sets of forces" and adds that inflation is likely to be "volatile" in the near term.

The key challenge for the Bank – and as a consequence, for the strategies adopted by investors – relates to when may be the appropriate time to start raising interest rates. On the one hand, there is a considerable stimulus still working through the economy from the substantial easing in monetary and fiscal policy (and note, the addition of £25bn committed to quantitative easing in November), while on the other hand, banks are continuing with their process of balance sheet repair. This is likely to limit the availability of credit, while high levels of debt will also likely weigh on consumer spending, which could have an impact on the level of recovery in economic activity. The current programme of quantitative easing is due to end in February, although some commentators have not ruled out the possibility of it being further extended. The Bank itself stated on 7 January that "the scale of the programme [of QE] will be kept under review."

Exhibit 7: UK inflation trends since November 2007, % change year-on-year



Source: Office for National Statistics, Edison Investment Research

Evidence supporting both perspectives on quantitative easing is unhelpfully contradictory, suggesting that the Bank will need to adopt a delicate balancing act. CPI Inflation in the UK rose 1.9% year-on-year in November, a noticeable pick up on October's rate (1.5%), while RPI inflation turned positive for the first time since January 2009. Inflation appears to be driven by the impact of the 2008 petrol price falls dropping out, while consumers have been benefiting from lower VAT. Such trends are also being witnessed in the US and a number of other

European countries and could continue for some months, although UK VAT has reversed as of the start of this January (discussed in more detail below).

Global developments further confuse the issue. The European Central Bank and the Federal Reserve appear committed to low interest rates, but some countries have already begun the process of rate tightening. Admittedly, economic prospects for Australia (which has now implemented three rate rises in the current cycle) are somewhat different (ie more positive) than for much of the rest of the developed world, but within the OECD, Norway and Israel have also joined Australia on a rate-raising cycle. In contrast, it is also worth bearing in mind that Japan – the world's second largest economy for now – is experiencing the opposite problem with deflation returning to the Japanese economy in September (consumer prices down 2.2% year-on-year) for the first time since 2006.

UK bond yields and the price of gold support the thesis that the Bank of England will likely keep rates on hold for now, irrespective of trends elsewhere. Nonetheless, it remains the case that central banks cannot support money markets indefinitely, and it seems unlikely to us that quantitative easing will be further extended in 2010 unless GDP growth takes another turn for the worse. All other things being equal, rates in the UK may not rise until at least Q3 this year.

If rates are set to remain low, then this could support further positive sentiment towards equities. The question, however, is how much of a benign interest rate environment is already discounted. Historical evidence suggests that equities tend to peak at least one quarter ahead of first rate hikes and then fall in the quarter following rate rises. In other words, there is still scope to enjoy the rally while it lasts, but investors will need to become increasingly selective.

Furthermore, there remains the longer-term argument that governments everywhere (and particularly in the UK post the nationalisation of much of the banking sector) will need to refinance. This potentially heralds a world of ongoing deleveraging, higher taxation and lower growth. Such a prognosis again argues for a more defensive equity portfolio bias, reflected in our preference for telecoms, healthcare and utilities and our negative stance on financials. Our favoured sectors also offer dividend yields substantially ahead of that provided by 10-year UK government bonds (3.6%).

The UK consumer: in good or poor health?

One key driver of the Bank's decision-making process is likely to be how the UK consumer behaves. From a stock-market perspective, this clearly matters too, since the consumer goods and services sectors combined constitute just over 20% of the London market. While many indicators regarding the health of the consumer seem broadly encouraging, we have concerns going forward and these issues also support our relative underweight stance on the related sectors.

Retail sales have been rising recently, with October's 3.8% increase the fastest witnessed since May 2008 according to the British Retail Consortium. Similarly, retail bellwethers have sounded increased notes of optimism as evidenced by recent comments from John Lewis and Next among others. The housing market also appears more robust, up 0.4% in December, marking eight consecutive months of rises according to Nationwide (although Halifax makes it only six months of rises). Moreover, mortgage lending is up 5% year-on-year based on data from the Council of Mortgage Lenders, which sees "some reasons to be cheerful about the UK economy."

There are, however, risks ahead. First, current data-points, while encouraging, are flattered by easy year-on-year comparisons, especially given the post-Lehman nadir in confidence. Second, while consumers are spending at present, this may be curtailed given the increase in VAT back to 17.5% (from a previous 15.0%

level) on 1 January. December's drop in consumer confidence (the largest since November 2008, according to Nationwide) is a potentially worrying sign. Moreover, despite showing good year-on-year improvements at their recent results, both Marks & Spencer and Next did sound notes of considerable caution over consumer prospects for 2010. Furthermore, several other large UK companies including Kingfisher, Luminar, Marstons, Mitchell & Butler and Sainsbury have noted that higher VAT may have a negative impact on expenditure.

It should also not be forgotten that while the rate of unemployment is slowing, the actual number of people unemployed continues to rise, up by 21,000 in November to 2.49m. Companies including BAE Systems, Borders, British Airways, Corus and First Quench have all recently reduced headcount, and more worryingly, according to a recent survey in the *Financial Times*, over 50% of UK employers say that even if redundancies are at an end, wages will likely be frozen in 2010. Given pay freezes, average earnings could be falling for the first time in a generation.

The risk remains that higher taxation combined with wage freezes slows economic expansion, irrespective of the outlook for interest rates. At the least, we see a strong case to be made for caution towards the consumer goods and services sectors, especially as early cyclicals appear to have run their course (evidenced in performance terms) and valuation is not specifically supportive (see Exhibit 5). While some consumer sub-sectors such as pubs & restaurants, sportswear retailers, bookmakers and advertising agencies may benefit from a football World Cup-related affect in 2010, we do not expect this to be a panacea for the broader industry.

Government policy and the economy: change on the way?

The UK must elect a new government by 3 June at the latest. Its decision and whether a new, Conservative administration is installed (as voting intentions currently suggest) or Labour retains power could have ramifications both for economic policy and the stock market. A hung parliament is also not an inconceivable scenario, and such an outcome would almost certainly be negative since it would create a period of uncertainty and likely policy stasis.

Despite currently broadly favourable UK economic indicators on growth, consumption and production, the impending election is likely to be fought more on future intentions than historic indicators. Labour's pre-budget report, released 9 December, provided few clues on policy direction, although notably only 32% of UK consumers felt upbeat about the economy after the budget, relative to 46% before the event, according to a recent poll by Mori.

While election results tend only to have a limited direct impact on equities, there are some important considerations to bear in mind. First, irrespective of the Bank of England's independence, a strong case can be made for interest rates remaining on hold at least until June 2010, with all stakeholders in the UK likely to be keen to preserve current economic fragility. Second, with UK debt levels high and still rising, taxation and spending policies may come under pressure. Any decisions on further VAT increases will likely be deferred until after the election, but some commentators have suggested that the rate of value-added tax could rise to 20%. It is also worth noting that Spain recently raised rates on VAT from 16% to 18%. Other taxes could also rise, and Labour's current policy is to increase the top rate of taxation from 40% to 50%. With regard to spending, it has become an increasingly consensus view that there will likely be cut backs in a number of public services, with healthcare and infrastructure likely to be particularly singled out.

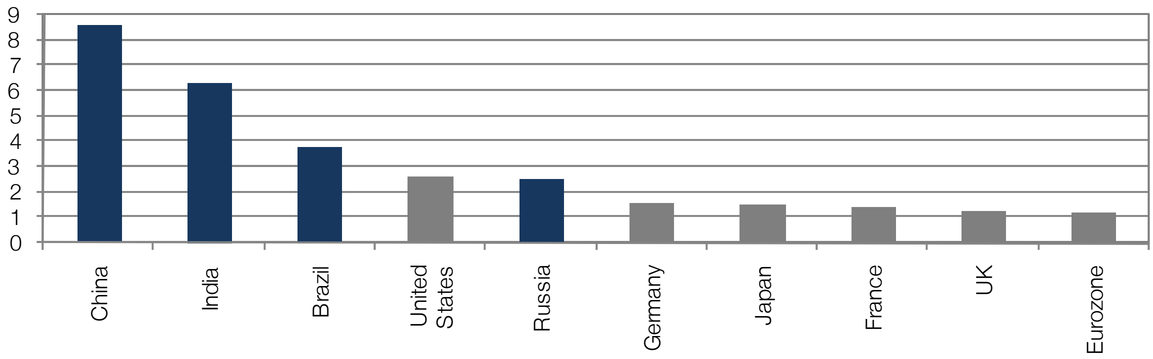
Uncertainty over the future direction of government policy further reinforces our view regarding the adoption of a somewhat defensive portfolio bias with an emphasis on individual stock-selection. Moreover, despite the Bank of England's optimism over the GDP outlook for the UK economy (as mentioned above, the Bank is now forecasting 2.1% growth for 2010 and 4.0% for 2011), we see more attractive growth prospects elsewhere, particularly in the BRIC economies. This also supports our preference for high-quality, globally diversified growth businesses.

Can the BRIC economies continue to grow at their current rate?

Growth may be improving in the UK, but the outlook appears sclerotic in the context of the outlook for the BRIC economies. While the emerging importance of Brazil, China, India and Russia is relatively well discounted, it should not be forgotten that UK-listed companies can benefit from this increasingly entrenched secular trend. Moreover, results from the most recent reporting season show that those companies meeting or exceeding expectations are doing so through growth in emerging markets, which is compensating for declines in developed countries.

Recent macro data support the thesis. China's industrial production growth, for example, rose 19.2% year-on-year in November – at the fastest pace since June 2007 and ahead of consensus expectations – while Russia reported that its economy had expanded by 13.9% in Q3. GDP estimates for 2010 assume that the Chinese economy will grow by 8.6% with India close behind (6.3%). While current forecasts are not so attractive for Brazil and Russia, both these countries continue comfortably to outpace their Western peers. The reasons for this growth relate to increasing industrialisation and urbanisation, drivers that are likely to remain intact over the medium term.

Exhibit 8: 2010 GDP estimates, % change year-on-year (BRIC economies shaded in blue)



Source: The Economist, Edison Investment Research

UK-listed basic materials and oil & gas stocks (responsible together for some 30% of the 100-Index's overall weighting) constitute effective plays on the global economy rather than the UK specifically. These companies should benefit from the increased confidence being shown by the BRIC nations particularly, while the currently weak pound should also help further rebalance the UK economy in favour of exports. While the debate remains open over whether emerging market demand can offset declining western (particularly US) consumption patterns, this represents a more medium-term issue in our view. For 2010, we continue to favour an overweight stance on the basic materials sector in particular, especially given its forward P/E multiple of just 11.8x.

Conclusions

In summary, we favour high-quality growth stocks on modest valuations, but from a sectoral perspective, we advocate moving to more overweight positions in defensive sectors such as telecoms and utilities, particularly if early cyclicals have run their course as recovery scenarios become increasingly priced in. We believe it is still defensible to retain an overweight position in basic materials given global growth prospects. On the negative side, we continue to have structural and valuation concerns over the financials and consumer (goods and services) sectors.

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