2013 Outlook

Opportunities on the bumpy road to recovery

For investment professionals only

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3 December 2012

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What did we say a year ago? – Mark Burgess

Opportunities and threats for investors

Positives

- Eurozone crisis focusing the authorities' minds!
- Deficit reduction plans being put in place
- Equity markets are inexpensive even in a low growth environment
- Growth remains resilient in the emerging markets

Negatives

- Survival of the euro requires fiscal and political integration, difficult to achieve and unpalatable for many
- Europe in recession in 2012, the US at stall speed at best, the invisible force of deleveraging
- Corporate profit margins at all-time highs
- Developed world core inflation stubbornly high, as are commodity prices

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How were we positioned?

	Equities Overweight	Bonds Underweight	Other
Overweight	Asia Pacific ex-Japan Latin America US UK Japan	Emerging markets High yield Investment grade corporate	Commodities
Neutral	Europe		UK Property
Underweight		Government	Cash

Source: Threadneedle as at 31 October 2011

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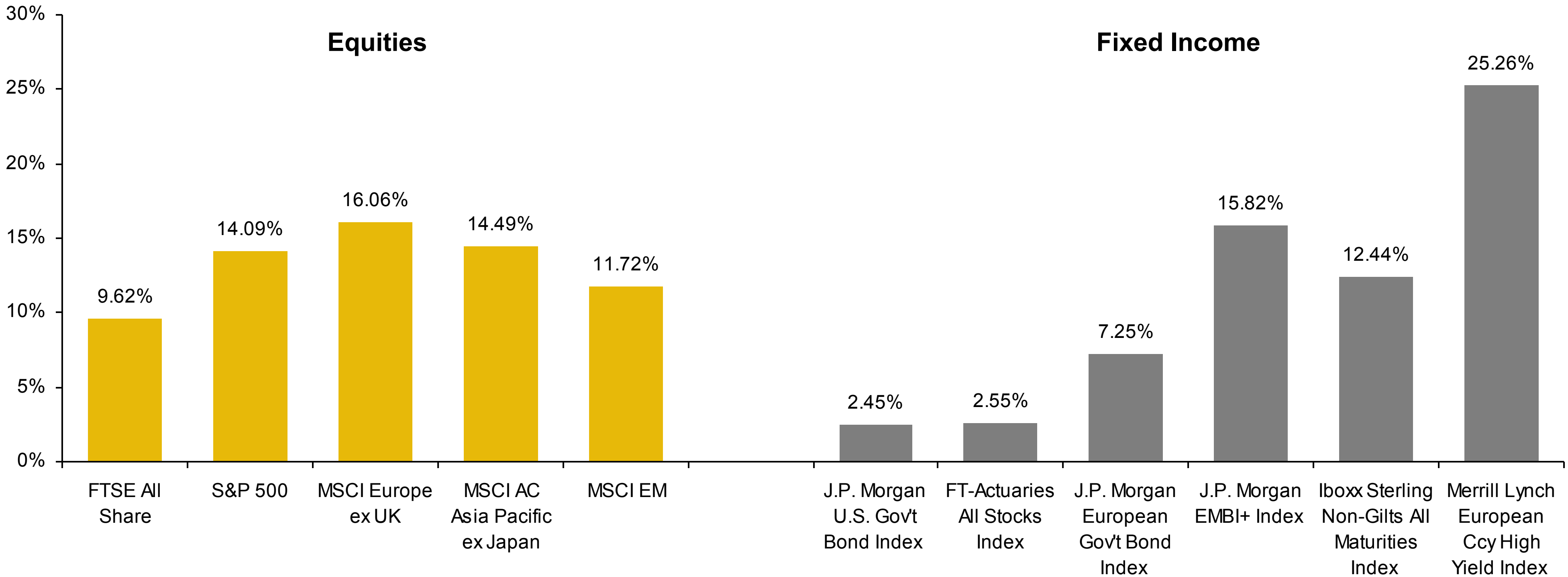
How did it play out? Year to date equity and bond returns[1]



Search for income has driven stellar returns from EM debt and high yield

Source: FactSet and Datastream.
1 Data to close of business on 26 November 2012. All returns in local currency terms.

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2013 Overview – Mark Burgess

Overview

- Macro economic background is very challenged and there are considerable downside risks
- Interest rates will remain low indefinitely
- Yielding assets remain attractive against this backdrop

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Heightened uncertainty presents economic headwind

- Euro crisis continues, but break-up risks to abate
- US fiscal cliff approaches
- China heading for a soft or hard landing?
- Deleveraging process continues to undermine growth

Threadneedle's economic forecasts

Still more cautious than consensus for 2012

	Threadneedle GDP forecasts		
	2011 (%)	2012 (%)	2013 (%)
US	1.7	2.0 (2.2)	1.5 (1.9)
Euro area	1.5	-0.5 (-0.5)	-0.5 (0.0)
UK	0.7	-0.5 (-0.1)	1.0 (1.3)
Japan	-0.7	2.0 (1.8)	1.0 (0.8)
China	9.1	7.6 (7.7)	7.6 (8.1)
Brazil	2.7	1.5 (1.5)	3.5 (3.8)
India	6.5	5.6 (5.6)	6.6 (6.6)

Source: Threadneedle as at 30 November 2012
Figures in brackets represent consensus view

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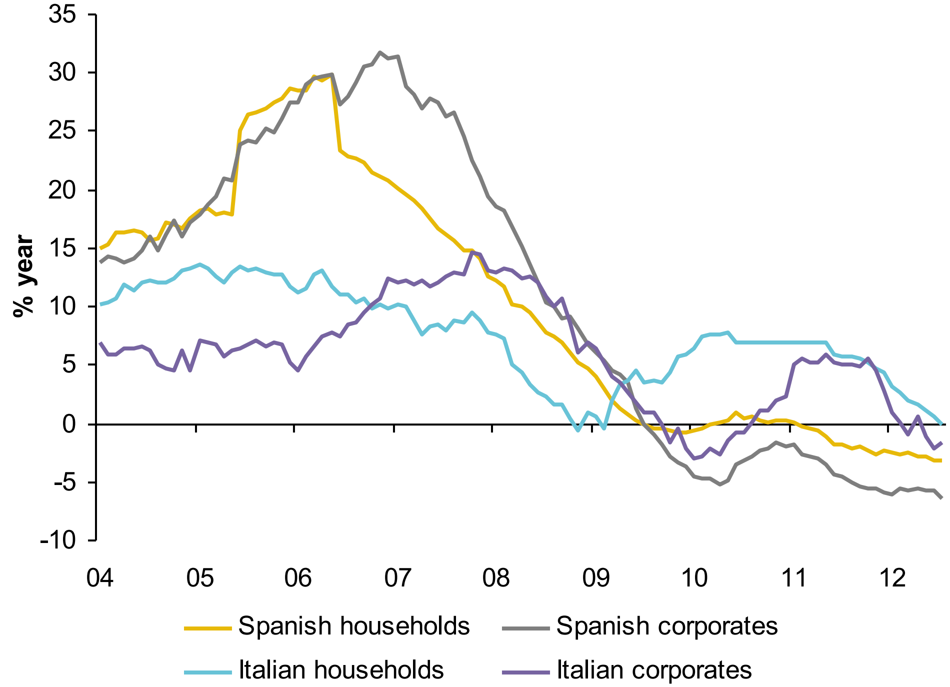
Euro area: fiscal policy tightening in all regions

Fiscal tightening, % GDP

% GDP	2012	2013
Austria	0.0	-0.9
Belgium	-1.7	-0.8
France	-1.1	-1.7
Finland	-0.4	-0.5
Germany	-0.1	-0.2
Greece	-3.6	-2.5
Ireland	-4.4	-0.4
Italy	-2.9	-1.7
Netherlands	-1.1	-1.9
Slovenia	-3.7	-1.3
Portugal	-1.2	-1.6
Spain	-4.1	-2.8

- Fiscal multiplier in normal times assumed at 0.5
- But Greek experience suggests downside risk
- Austerity will continue to drag into 2013

Lending growth, % year



- Deposit outflows exacerbate this trend
- Greek/Irish experiences worsened from here

Source: Threadneedle, ECB, OECD, May 2012.

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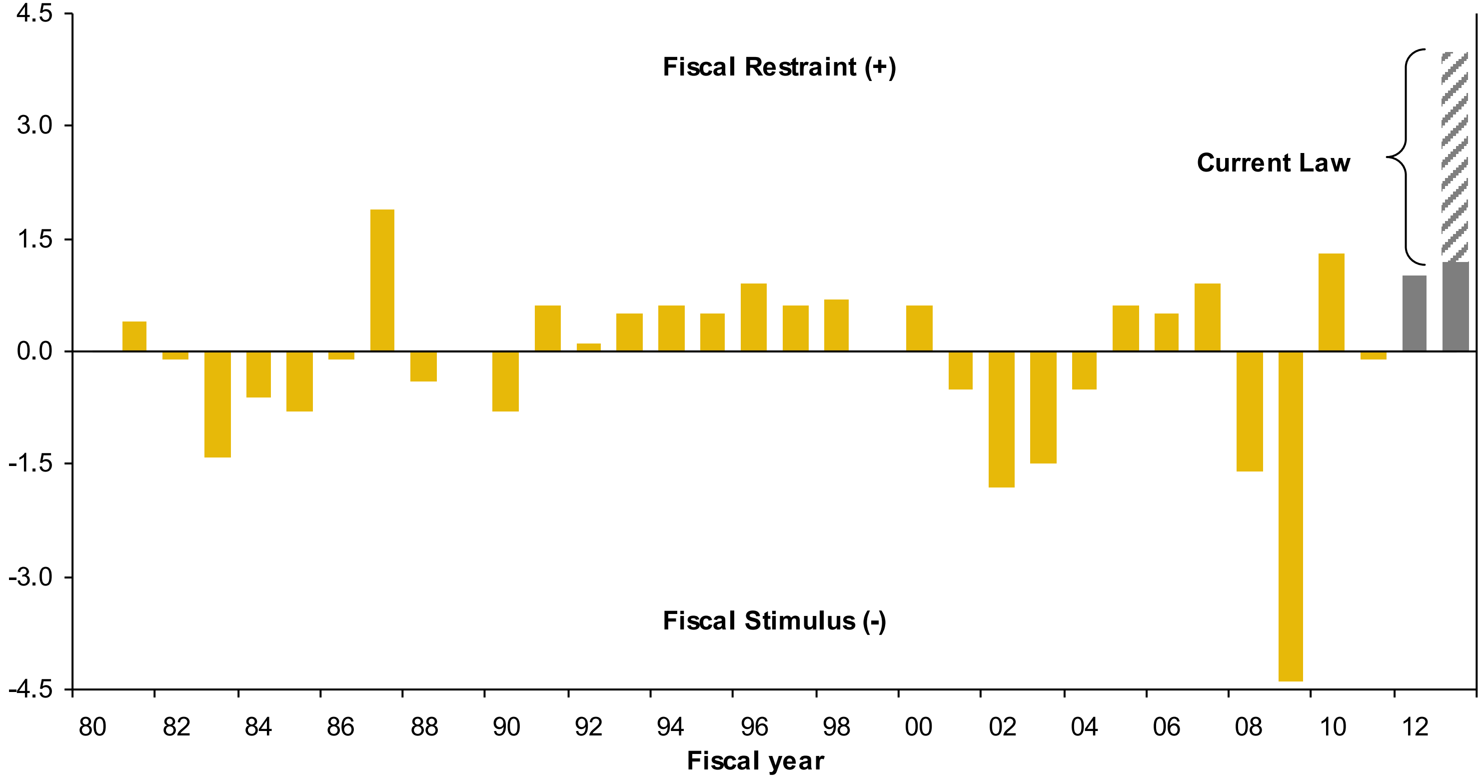
The US fiscal cliff in 2013
We expect a resolution representing a 1-2% headwind in 2013

Percentage points of potential GDP



2013 Fiscal Cliff (% of GDP)	
Expiration of unemployment benefits	-0.2%
Automatic spending cuts (sequestration)	-0.8%
Expiration of payroll tax cuts	-0.8%
Expiration of Bush tax cuts	-0.8%
	c.-3.0%

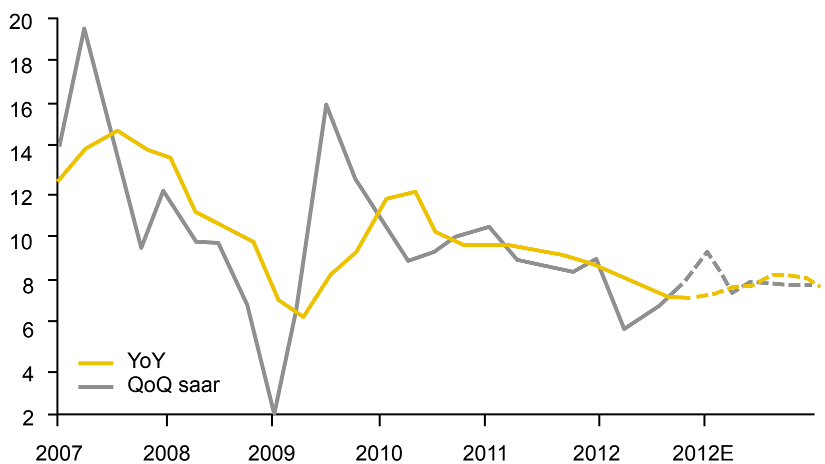
An uncertain environment

Source: Morgan Stanley, April 2012.

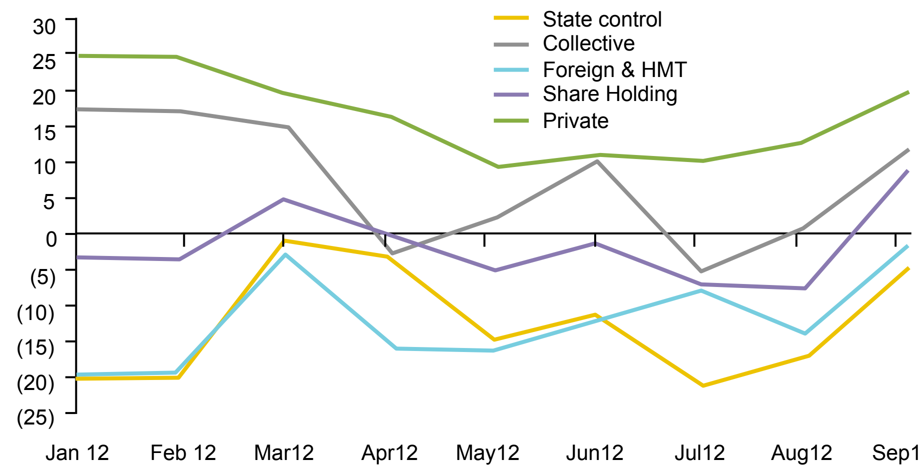
China – Slower growth

- Q3 2012 was the seventh consecutive quarter of decelerating growth and a post-crisis low
- The economy appears to be close to a cyclical bottom
- Industrial profits have been very weak but have started to rebound in recent months
- Leadership transition is almost complete, current policies likely to continue
- However, external risks remain a concern

Real GDP growth (%)



Profits of larger industrial firms by ownership (YoY %)



Source: Threadneedle

Revisiting the key themes driving markets
Key themes remain supportive for higher yielding assets

Themes	Key winning strategies
The search for yield	▪ High yield & corporate bonds ▪ Emerging markets ▪ High dividend equity
Reflationary policies / liquidity	▪ Commodities ▪ Emerging market equities ▪ Emerging market currencies
Slow growth / high volatility	▪ Income-oriented equities ▪ High/medium quality corporate bonds ▪ Emerging market bonds ▪ Absolute return products

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Equities – Leigh Harrison

What does it all mean for equities in 2013?

- Deleveraging will cause sustained low economic growth in the developed world
- Markets likely to continue to lurch from optimism to despair
- Equities are attractively valued
- Stock picking will drive returns

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Threadneedle equity themes

Themes	Thesis	Investment conclusions
Yield and income growth	▪ Deflationary environment will keep yields low ▪ Risk aversion will keep focus on sustainability of yield	▪ Not just high but growing yields, stable earnings and cash flows ▪ Dividend initiators and companies returning cash to shareholders
M&A activity	▪ Corporates in good financial health ▪ Equity cheaply valued ▪ Value added opportunities to supplement growth	▪ Beneficiaries of consolidation ▪ Improved operational and financial management ▪ Opportunities to increase capacity ▪ Low valuation of weak companies
Strong get stronger	▪ Challenging macro environment favours strong business models ▪ Low return environment undervalues ability to re-invest cash at attractive rates	▪ Companies with high return on investment and strong cash flows ▪ Well financed companies with strong management
Growth opportunities	▪ Even in a low growth world there are growth areas	▪ Innovation creates growth opportunities ▪ Outsourcing growth to continue ▪ Health and well-being a growing issue
US economic recovery	▪ Clear signs of recovery in US ▪ Financial system healing	▪ US companies ▪ Exposure to US markets ▪ Risks from 'fiscal cliff'

Source: Threadneedle as at 30 November 2012

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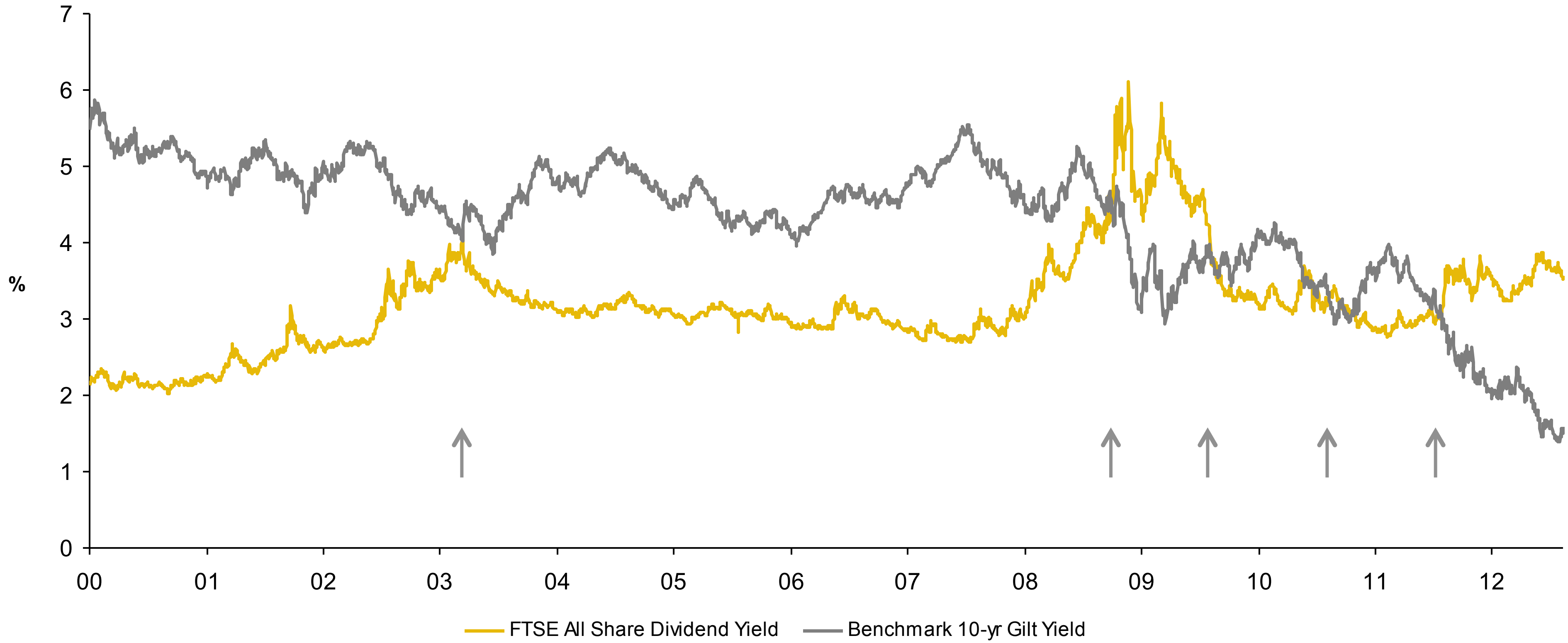
Equities are attractively valued compared to bonds

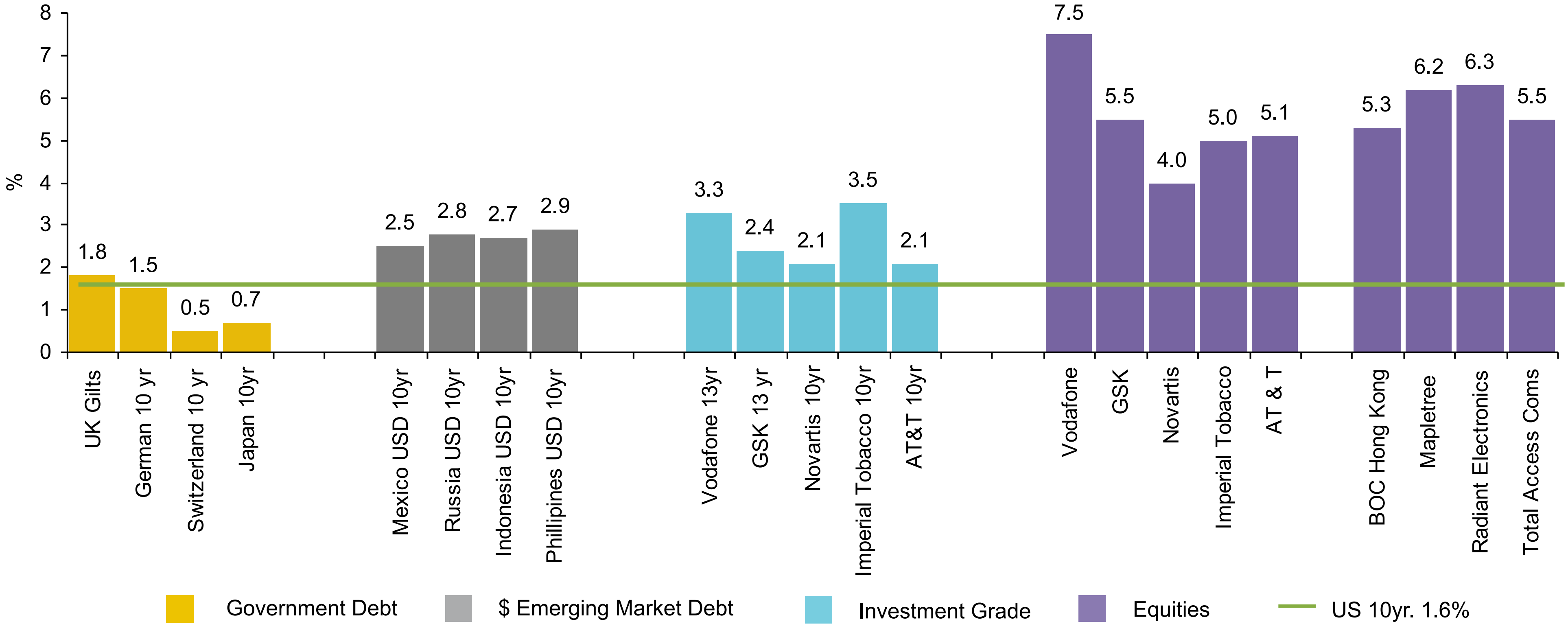
Yield cross over again



Source: Bloomberg, Morgan Stanley Research as at October 2012.

It's not just bonds that can provide income
Equity markets now compete with corporate bonds

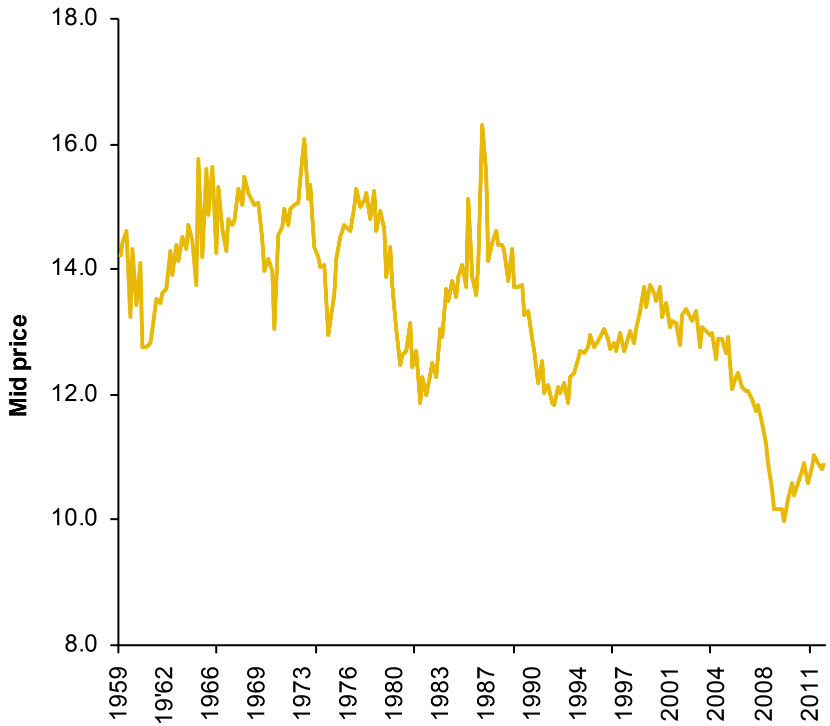
Yield choices



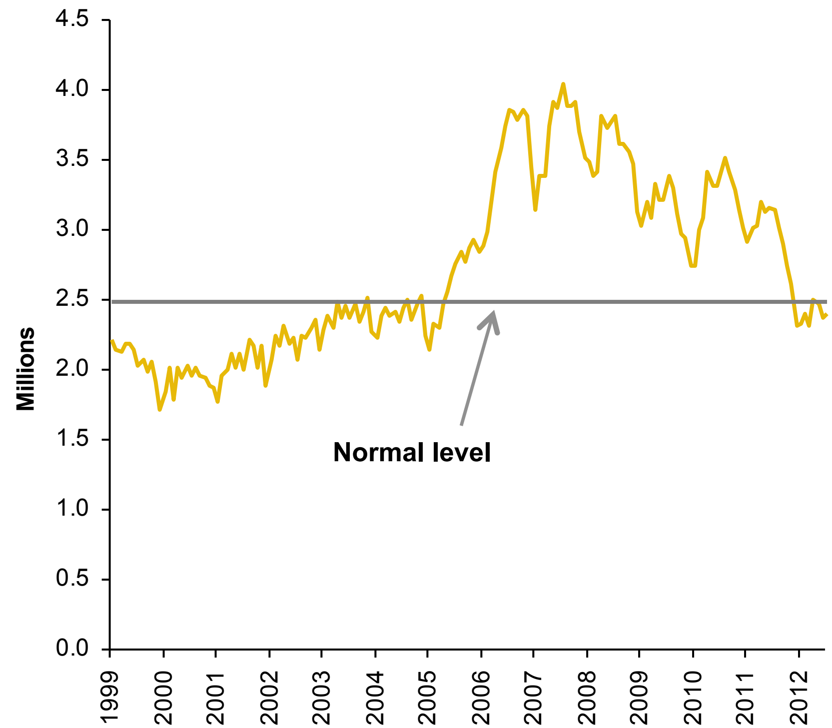
Source: Bloomberg as at 16 October 2012, equity yields are estimated 2013 yields. The mention of stocks is not a recommendation to deal.

The US housing market is healing

Durable goods spending
% of disposable personal income[1]



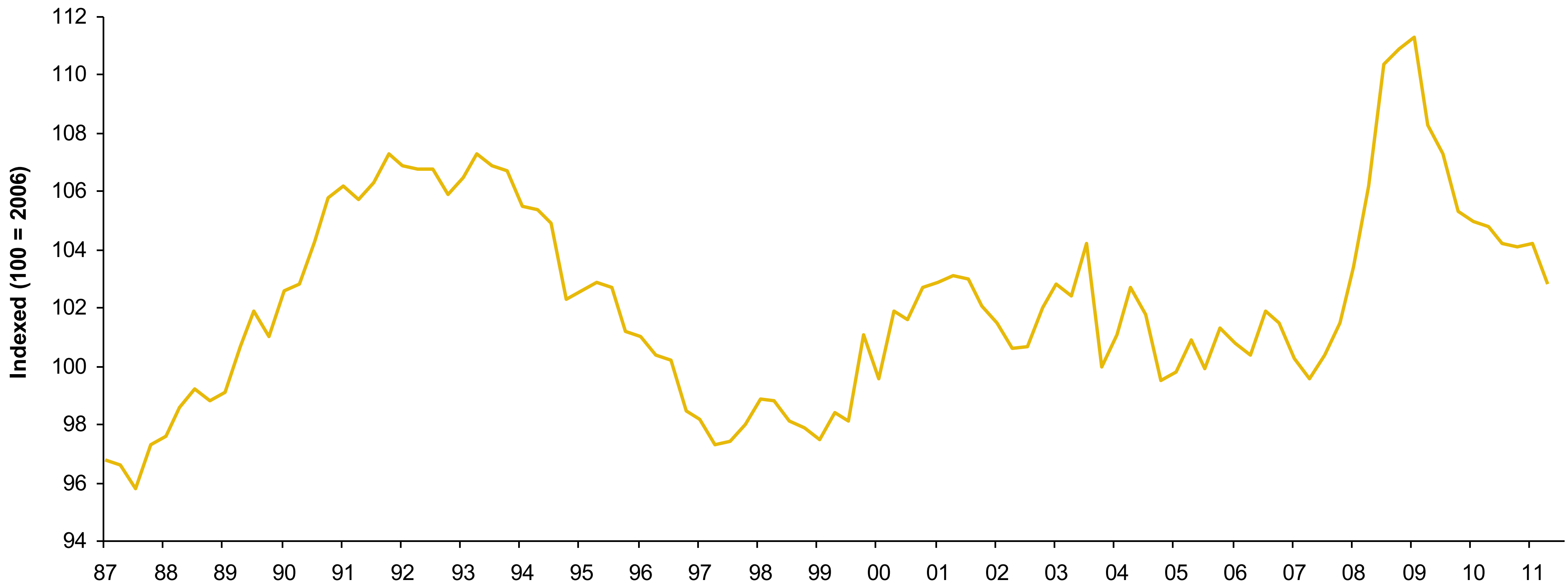
Existing home inventories[2]



1 Source: (left hand chart) Bloomberg, Federal Reserve, as at 31 July 2012.
2 Source (right hand chart):Source: National Association of Realtors (Latest Revision), House Tracker 1999 through July 2012.

An industrial renaissance is underway

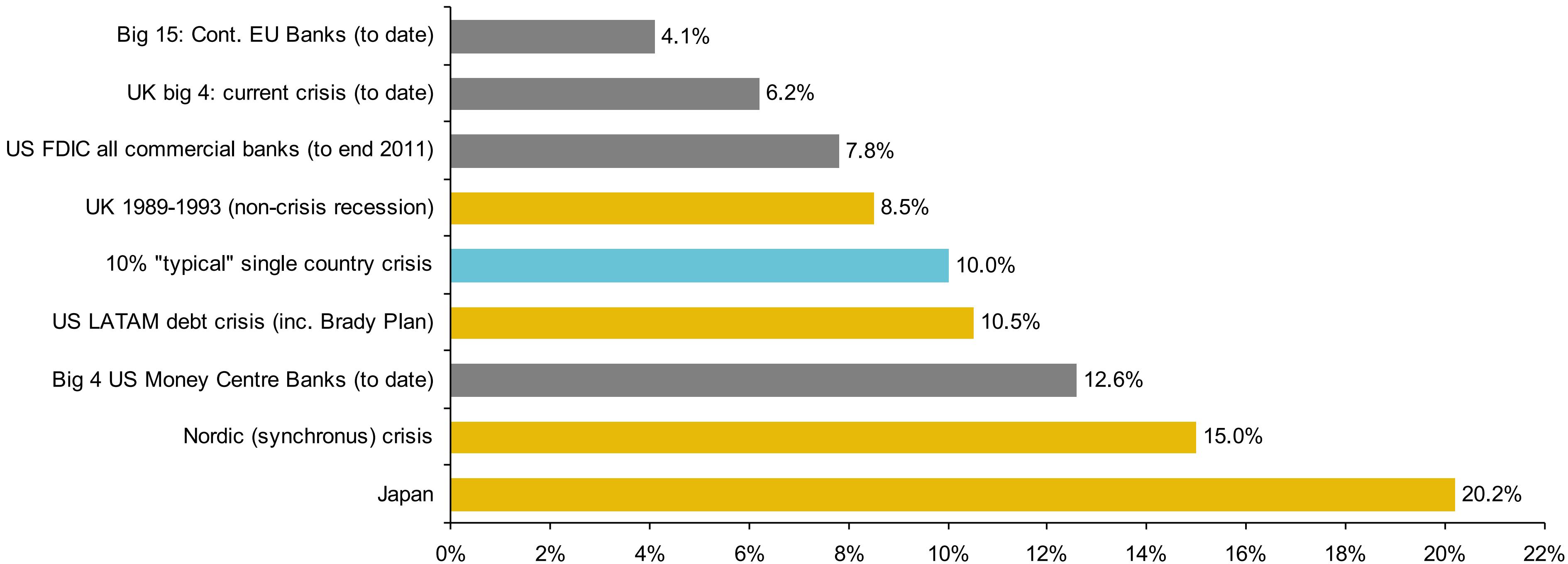
US Manufacturing unit labour costs



Source: Bloomberg, May 2012.

US banks starting to function normally, but still long way to go for eurozone banks

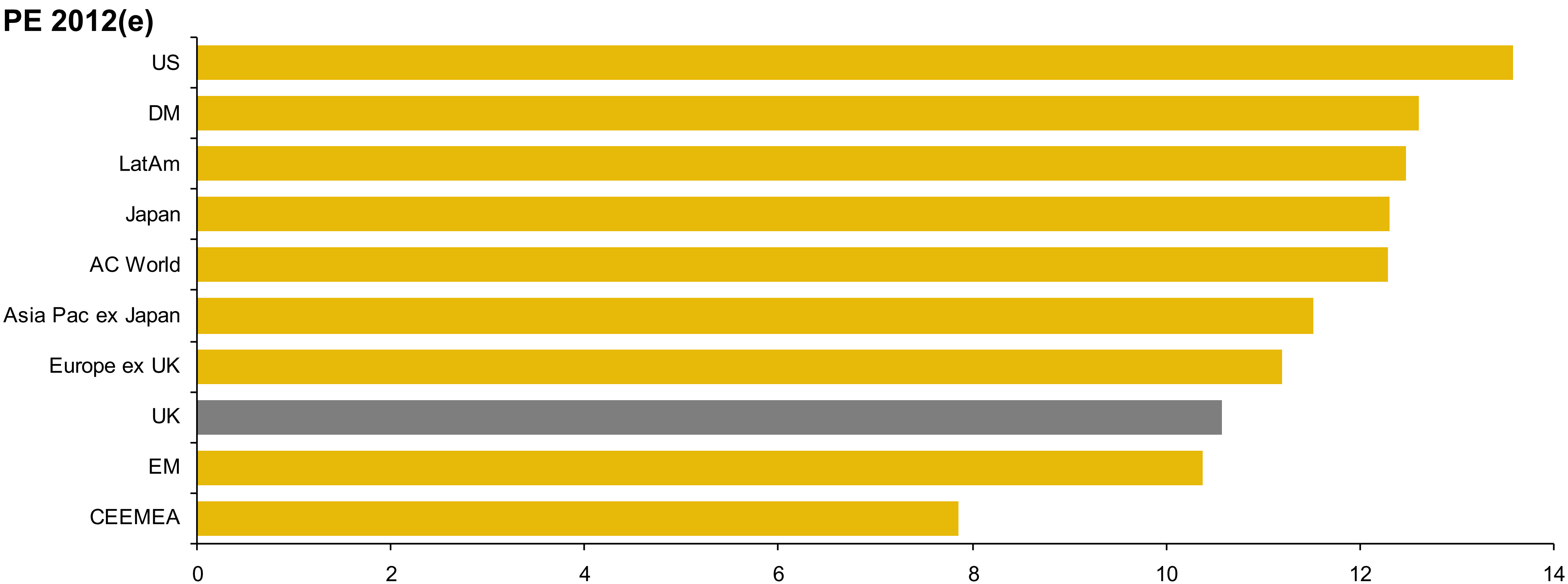
Cumulative loan loss provisions as a % of peak loan assets



- Typical cumulative crisis loan loss rates tend to average around 10%; Japan topped 20%

Source: Companies data, Westhouse Securities, August 2012.

Equity markets are not expensive



Source: Citigroup, as at 27 July 2012.

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Fixed Income – Jim Cielinski

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Key themes for fixed income in 2013

- **Investors:** Give me income; a search for yield becomes a scramble for yield
- **Asset Managers:** A focus on alpha will supplant a fixation on beta
- **Economics:** The struggle for sustainable growth reveals yet again that this is not a traditional corporate recession
- **Markets:** The crisis carousel: the ride is not over yet

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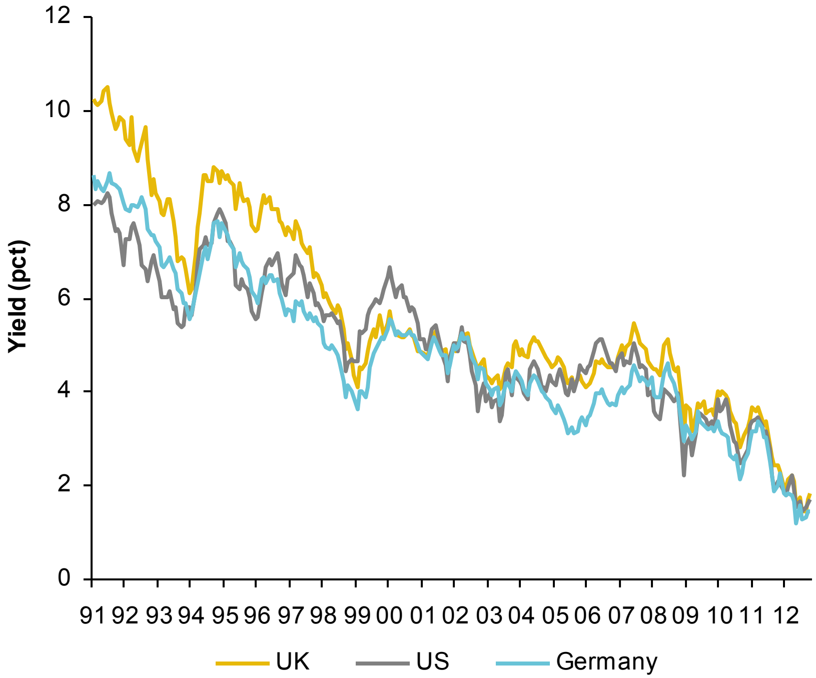
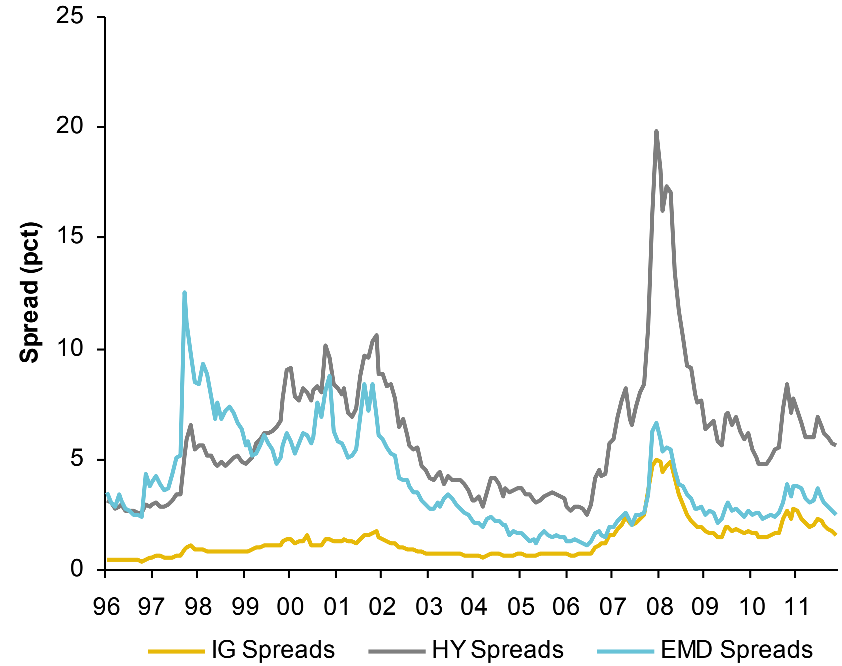
Bond yields and credit spreads
Spreads are attractive; core bond yields are not

Government Bond Yields (UK, US and German 10 year bond yields)



Credit Spreads (investment grade, high yield & emerging market bonds relative to government yields)



Source: Bloomberg, October 2012

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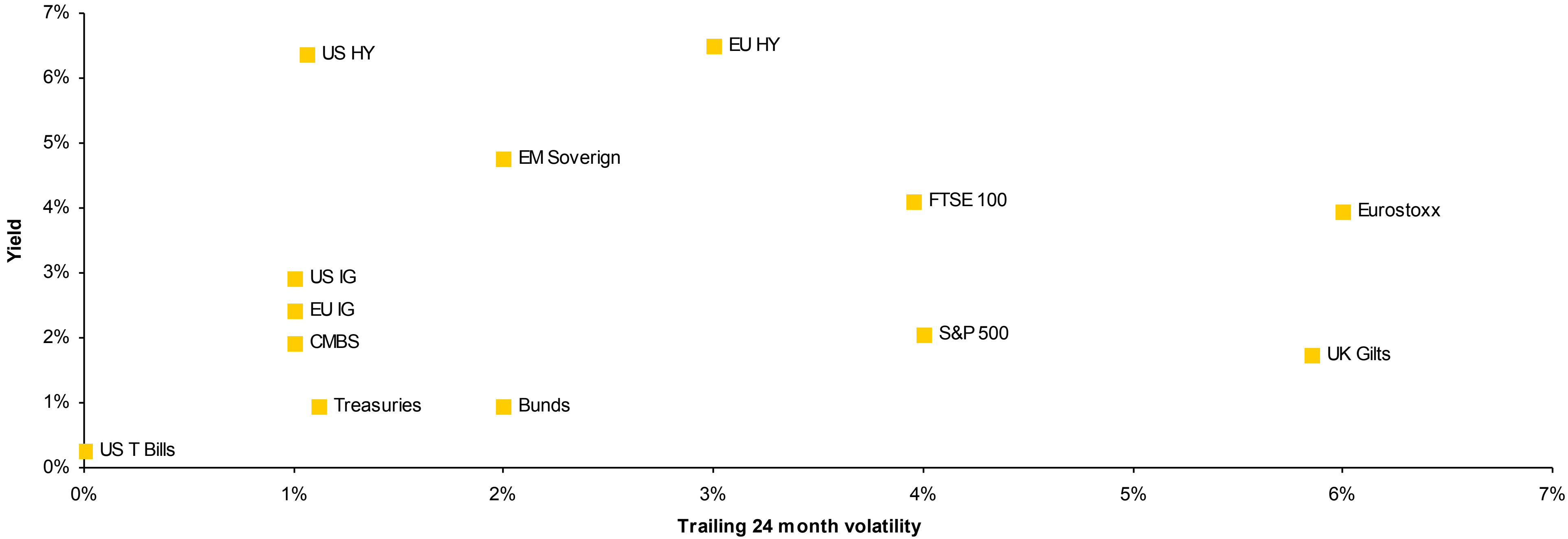
Where to find yield today
Investors of all types are demanding income with relative safety

Current asset class yields (%) vs. volatility



Low yields and higher volatility requires
an evolving investment framework

Source: Merrill Lynch September 2012

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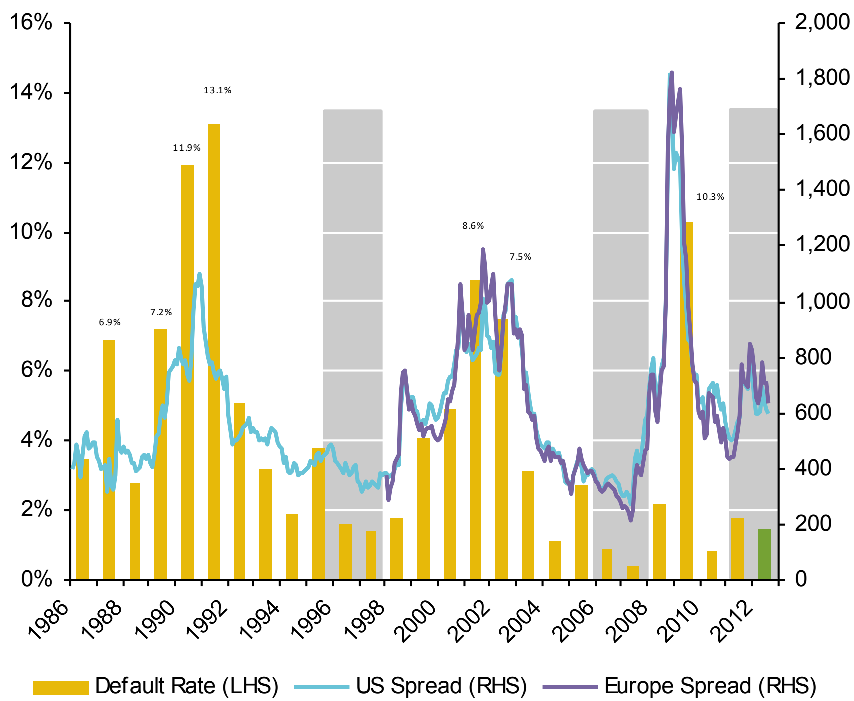
Where are the opportunities in bond markets?
Corporate credit is still attractive despite a powerful rally

High Yield spreads are wide relative to defaults



Global High Yield YTM		**6.4%**
Default Assumptions	Defaults (2013e)	2.3%
	Loss Given Default	60%
Total Expected Default Losses		**1.3%**
Excess Premium Over Default Losses		**5.1%**

Corporate credit quality is still improving relative to sovereign quality

Source (left hand chart) Merrill Lynch, JPMorgan as at September 2012. European Spread used is the HPS2 Index. US Spread is H0A0 Index; (right hand table): Merrill Lynch and Threadneedle as at October 2012.

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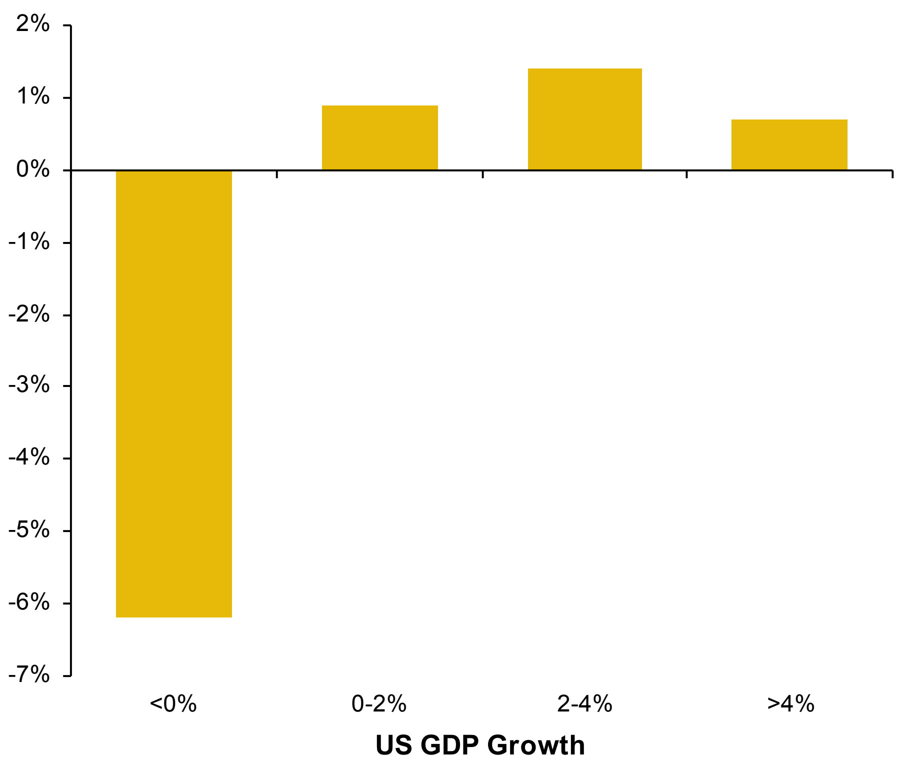
Corporate credit
An asset class designed for slow growth

Average excess returns of Global High Yield over Government bonds in different growth environments



Credit offers attractive yields with moderate risk

Asset Class	Yield	Trailing 2 year volatility
US Treasury Index	0.91%	3.9%
German Federal Gov Index	0.90%	5.4%
$ IG	2.8%	4.0%
€ IG	2.3%	4.4%
$ HY	6.7%	7.5%
€ HY	6.0%	9.8%

- Positive growth, even if sluggish, is sufficient to preclude defaults

Source: Morgan Stanley, Threadneedle, Merrill Lynch as at November 2012.

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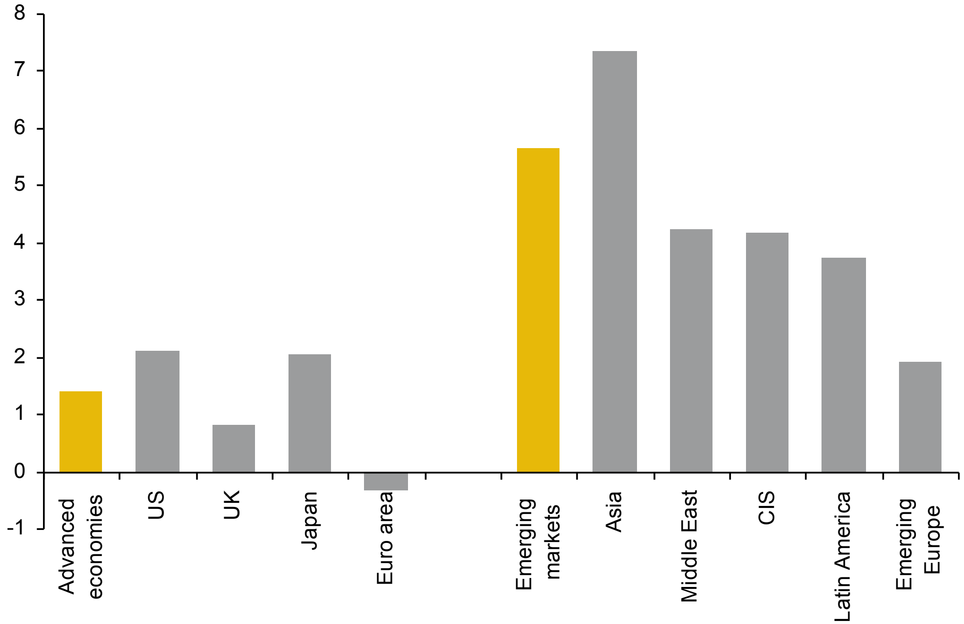
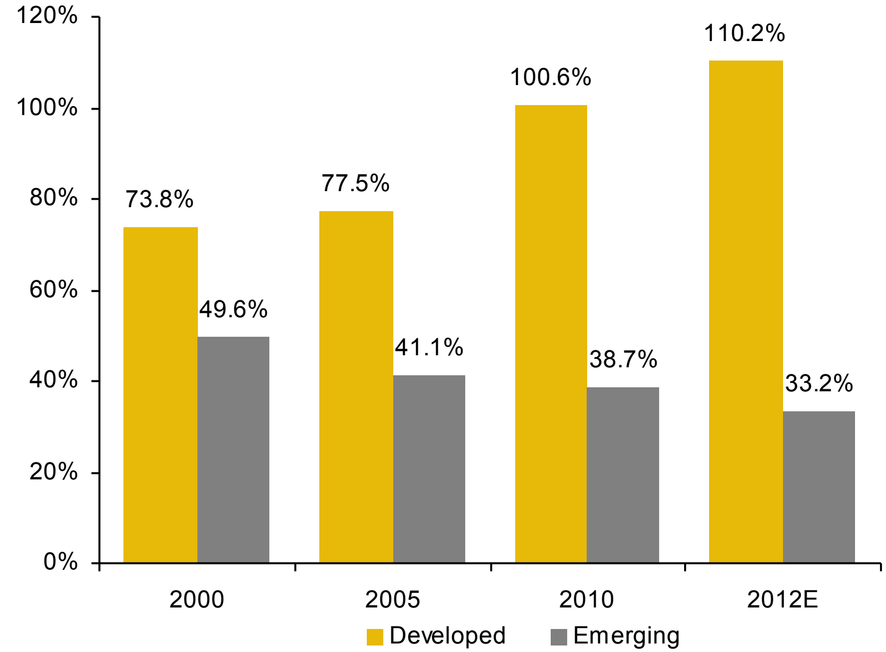
Emerging market growth has become more sustainable
Slow growth should not dent emerging market debt outperformance

2012 growth estimates



Gross debt as % of GDP – spot the pattern



- Better growth, better fundamentals in emerging market bonds

A play on the structural shift in the global economy

Source: IMF, September 2012

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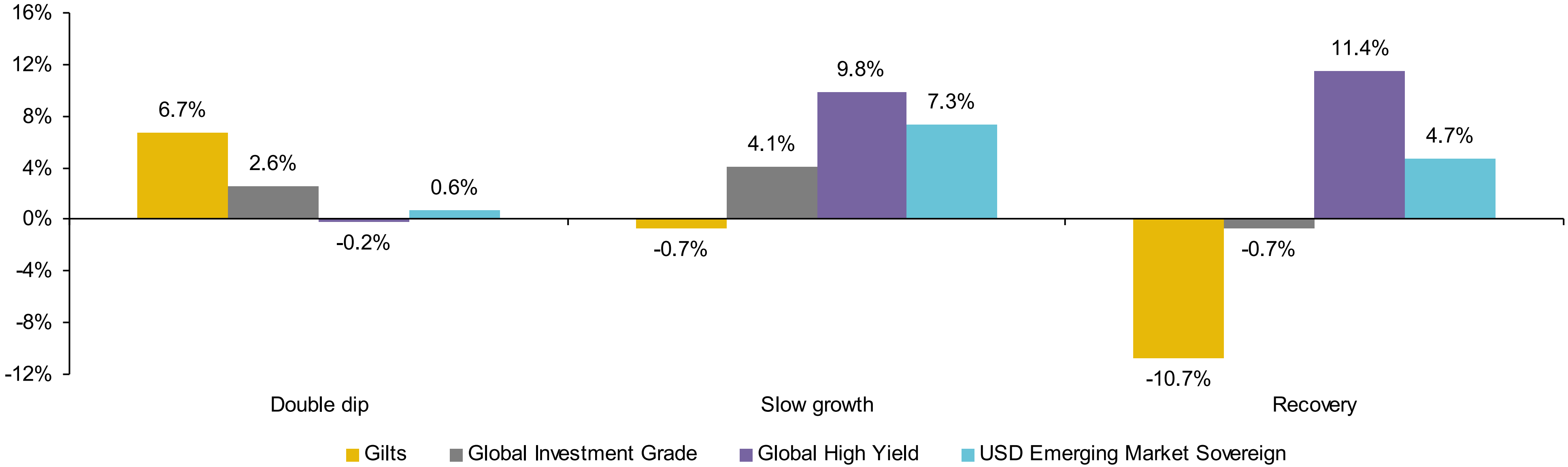
Can bonds deliver respectable total returns?
It's not as bad as you might think

Total return projections for various market environments (12-month horizon)



- **Recession –** Gilts -40bps, IG spread +50bps, HY spread +175bps*, EM spread +100bps
- **Slow growth** – Gilts +35bps, IG spread -50bps, HY spread -110bps**, EM spread -65bps
- **Recovery –** Gilts +125bps, IG spread -70bps, HY spread -225bps***, EM spread -130bps

Source: Bloomberg, Threadneedle as at 30 October 2012.
* 4% defaults with a 40% assumed recovery rate
** 2% defaults with a 40% assumed recovery rate
*** 1% defaults with a 40% assumed recovery rate

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Fixed income – the path forward in 2013

- The search for yield is not yet over, as policy rates will remain lower than inflation
- Valuations in corporate and emerging market bonds are not stretched and these sectors are poised to outperform
- Core government bonds represent poor value but a spike in yields is not imminent
- The tug-of-war between reflationary policy and sluggish growth will continue to produce bouts of volatility throughout the year
- In the eurozone, receding default and break-up risk are the key drivers – expect a better year on that front but with lower returns
- There will be pockets of good return in fixed income, but adjust your sights lower!

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Conclusion

- Macro economic background is very challenged and there are considerable downside risks
- Interest rates will stay low for a very long time
- Yielding assets remain attractive against this backdrop
- Equity valuations continue to be undemanding
- Our asset allocation stance reflects a more positive view on equities as tail risks begin to abate

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Current asset allocation model

	Strongly Dislike	Dislike	Neutral	Favour	Strongly Favour
Asset Allocation	Government Bonds	Index Linked Property	Commodities Cash	Equities Credit	
Global Equity Region		Europe ex UK US	Japan	UK EM Pacific ex-Japan	
Global Equity Sector		Energy Staples Utilities Telecoms Financials	Materials Industrials	Consumer Cyclicals Healthcare	Technology
Bond - FX Hdgd		Japan	Germany US UK	Nordic Australia EM Local	
Credit			Sterling Investment Grade	EM Debt European High Yield	
Commodity		Base Metals Softs	Grains Livestock Precious Metals		Energy
FX	JPY AUD	Euro	GBP Nordic		USD
Portfolio Risk			X		

Source: Threadneedle, November 2012.

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