

Transcript – Recorded 17 October 2008

Topic : Contrasts the current fiscal and economic environment with that of 1982 to 2000 and discusses potential challenges for tomorrow.

Speaker: Russ Koesterich, Barclays Global Investors' Chief Investment Strategist

Introduction

Thank you for joining us for a conference call with Russ Koesterich, chief investment strategist of Barclays Global Investors. Russ will be contrasting the current fiscal and economic environment with that of 1982 to 2000 and will highlight the potential changes for tomorrow, finishing with a discussion of appropriate solutions for investors. I must also advise that this conference is being recorded today Friday 17th October 2008. I would now like to hand the conference over to your speaker today Russ Koesterich. Please go ahead sir.

Russ Koesterich:

Good morning and thank you all for joining me today to discuss the macro economic and the fiscal outlook. I'd like to start off by really outlining the topic of today's call and then go into some examples about what we're really seeing out in the global perspective. Obviously we're in the middle of an extraordinary period. Over the last couple of months we've seen the dissolution of an investment bank Lehman Brothers, that went back to it's found in 1853. We have seen the worst week in financial markets at least in the United States on record. And we've also had the most aggressive coordinated government intervention into financial markets since the 1930s.

But even before this week we've had a period arguably going back to the peak of the last bull market in 2000 which has been very different than the environment that we all grew up in during the 80s and the 90s when equity markets were generally strong, inflation was generally decelerating; you had a much more favourable environment for most asset classes. So I'm going to touch on the recent past; I'd like to put it in the context of the broader challenges we've been facing over the past seven or eight years and to the extent to which in my opinion many of those challenges are likely to continue going forward over the next three to five years. And in that vein I'd like to focus on five main topics, the prospects for a continued lower global equity market returns, higher inflation, slower economic growth, particularly in the developed markets, lower fixed income returns after inflation and finally the increasing correlation between equity markets.

And after spending some time going through these I'd like to try to offer some potential solutions. The main point of the call is going to be going through what's different today, how it's different from the 80s and the 90s, the extent it's likely to continue and then what are the responses you can do for yourself, for your clients given these different circumstances. So let me start with the first issue, which is the prospects for lower global equity returns. Now back in 1999 a number of academics did a survey in the United States and they asked individuals that had discount brokerage accounts what they thought would be the average return for equity markets over the next ten years. And the response was over 20%. So where at the end bull market investors in the

United States believed that over the next ten years equity markets would return about 20% on average over this period.

Now obviously that was wildly optimistic and very off the mark. For those of you who have a copy of the presentation I'm working off of, you can see on page four that the current period, the period up through 2008 has been the worst period at least for US equities since the 1930s. There's been a lot of discussion over the past couple of months, are we headed towards another depression; at least from the prospects of the equity market over the last seven years we haven't seen these low returns this low since the depression. Even before the recent sell off, even if you go back to last fall when most equity markets were making highs, markets in the United States, in much of Europe had basically been flat in inflation adjusted terms for the last eight years. And that was obviously before the recent sell off.

So moving forward, let's contrast how different the returns have been recently to what they were like during the 80s and the 90s. So again using the United States as a proxy, if you go back to 1926 which is in the inception for the S&P 500, you find that on average stocks produced returns without dividends of about 7% to 8% per year. Now during the period between 1982 and 2000 large cap equities in the United States actually produced returns which were double that. During that 18 year period the average return to the S&P 500 was about 15%. Now if you were fortunate enough to invest in the period between 1995 and 2000 at the peak of the last bull market, your annualised return was in excess of 25%. So all those people and it's very easy to go back and think it was foolish, were expecting returns of 20% or more at the end of 1999, they were simply looking at what they had experienced over the last five years and extrapolating forward.

Now if you look at the recent period, the last seven or eight years, we've had an environment that with the exception of emerging markets and US small caps, most world developed markets have produced negative returns over the past seven or eight years. We've not seen a period when global markets have been this stagnant for this long since the 1970s. You really have to go back to the last secular bear market which occurred between 1968 and 1982 for a period where global equities have been this weak for this long. Now when people think about what the environment is likely to be going forward it's worth realising that we are in a secular bear market. And then in the past we've seen three secular bear markets this century. There was one between 1906 and 1921, there was another between 1929 and 1954 and there was a third secular bear market as I mentioned between 1968 and 1982. So you can see that in general the secular bear markets have lasted anywhere between 15 and 25 years. It doesn't necessarily mean that this one will go this long, but it helps put the current sell off in perspective, it also suggests that even if the market is able to find a cyclical bottom in the near term, which I think it very well may do, we are still likely to be in an environment over the next three to five years when equity market returns are below their long term average.

Now if we move forward and we look at some of the other challenges facing the environment right now, one of which is that we've been in an environment, particularly over the past three or four years, where inflation has been accelerating after several decades when the general direction of inflation was down. Now if you think given the likelihood of a global recession, that we're going to see a cyclical downturn in inflation over the next six to 18 months, but over the longer term I would expect that inflation is going to remain elevated. Even with the pull back in the global

economy, US CPI remains over 5%, US producer prices remain close to 9%, these are only slightly off their levels, which were the highest we've seen in 17 to 20 years. If you look at other countries, particularly in emerging markets we still see very elevated inflation levels, compared to what we had just five years ago.

Now the argument for why that may continue at least over the next three to five years, it's despite the fact that we're looking at a cyclical downturn, there are several secular factors that argue for higher inflation. One of which is we're seeing wages go up in many of the emerging markets, particularly China, which has been a source of global deflation over the past several years. I think we're also likely to see a period when global commodities, after a cyclical downturn start to re-emerge. For many commodities, particularly energy the supply curve has shifted higher and as a result we're likely to continue to see energy prices elevated compared to the level in the 80s or the 90s. And the third reason I think we're going to see a period where inflation remains elevated compared to the last 10 or 15 years is that the US dollar is likely to remain weak, due to certain secular imbalances which are going to take a long time to rectify.

Specifically given the size of the US current account deficit, I would expect that the long term direction of the dollar continues to point down and that tends to be inflationary. So with the near term I would fully expect inflation to continue to decelerate, particularly in the United States, which is likely to experience a prolonged deleveraging, but over the longer term I'll define that as the next five to seven years, I think we're going to have a period where inflation remains elevated compared to the levels we got used to back in the 1990s.

The third topic I'd like to highlight is the issue for global growth and of all the things we're going to talk about today I think this is the one I have most conviction in, which is that after four or five consecutive years where global GDP was at or around 5% which represented the best period of growth since the 1970s, I think we're looking at a prolonged period, probably the next 18 to 24 months where we are experiencing a global recession. And I think the recession is likely to be the worst in the United States, which has been the epicentre of the global imbalances. So for those of you that have the slide deck I would ask you to turn to page 11. There's been a lot of discussion over the last few months about the causes of the slowdown, the causes of the bursting of the bubble.

To my mind the principle issue that we're facing is the fact that the entire global economy, but particularly the US economy has become over geared or over leveraged. If you look at page 11 you can see that typically the amount of debt to GDP, gross domestic product in the United States has normally been about 140% to 150%. So debt has typically been about 50% larger than gross domestic product. Recently total debt to GDP has grown to about 230%, so we're about 75% above that long term average. Now what's been particularly troubling is that this debt has been used primarily in the mortgage market. Had the debt been used through corporate expenses, given the fact that corporations potentially could have been expanding their research and development spending, their capital spending, infrastructure spending, then arguably that debt would have been used for more productive means. And as a result you would have expected economic growth to be accelerating, given the fact that we were deepening our capital pool.

Instead what's happened is that really all of this additional debt has gone into consumption. Between 2000 and 2008 total mortgage debt in the United States doubled. If you look at the chart on page 12 you can see that mortgage debt to real estate value is now 50%, so what that means is that in the United States right now total mortgage debt is equal to 50% of the total value of all real estate. Now this is very interesting, because what's happened also over the last seven or eight years is that home prices in the United States have doubled. So one would expect given that home prices have doubled, that mortgage debt should be going down as a percentage of home prices. Instead we've seen the opposite, despite the fact that home prices are much more expensive than they were ten years ago, mortgage debt represents a greater portion of the value of the home than it's ever had. The reason this has occurred is that individuals in the United States have been taking out equity on their home at an accelerated rate over the last four or five years. So the level of debt has doubled and it's now reached a level that I think is unsustainable.

The cost of servicing that debt to the US consumer is now 14.5% of total disposable income. So put another way, 14 cents of every dollar that US consumers make will have to go to debt repayment, that is a record, we've never seen it close to that level and I think this is one of the reasons that we're starting to see US consumers pay down their debt. Now this is very evident if you look at the numbers produced by the treasury. So in the second quarter of 2008 the annual growth in household debt was 1.4%. That's the lowest level we've seen in 50 years. In contrast as recently as about three years ago, US households were accumulating debt at about 10% a year, now they're barely growing their debt at all. I think before the cycle has ended we will see negative numbers for debt growth in the United States.

So effectively over the next year or two US consumers will go from accumulating debt, which has been accelerating the economic cycle, to paying off their debt. And as they begin the process of delevering, I think the most important consequence is we're looking at a prolonged slow down of the US economy. Even if the US economy recovers from a recession over the next year, I think that the recovery is likely to prove very anaemic. That over the next three to four years the US economy is probably going to grow below par or below its long term expected growth rate and that's going to lead to slower overall global growth.

So the fourth topic that I wanted to go through is the position of interest rates, particularly right now in the United States. Now given the fact that we're seeing this deleveraging and given the fact we're in an environment where growth is likely to be slow for a period of time, you would expect that you'd at least have some positive pay off from the bond market. But if you look right now at the US treasury, the yield on the US ten year treasury is about 3.9%. Inflation as I mentioned is still over 5% in the United States. So effectively you're getting a negative real return, a negative inflation adjusted return of about 1.5%. Now this contrasts to the long term average; typically US treasuries yield about 250 basis points to 300 basis points over the rate of inflation. Even if inflation decelerates very sharply over the next year, let's say inflation goes from 5.5% down to 2.7%, they would still represent a very low yield on US treasuries.

Given the fact that bond yields may even go lower given the deleveraging in the United States, given the economic slowdown, I think we're likely to see a period over the next one to two years where the real inflation adjusted yield on US treasuries continues to be negative. So not only are

we getting very low if not negative returns from the stock market, at least as it applies to the United States, we're likely to get low to negative yields for US treasuries as well.

The final challenge I wanted to talk about is the notion of diversification and why it's become more difficult to find diversification. So on page 14 of the presentation we have a slide that looks at the rolling three year correlation between various markets. Between the MSCI Emerging Markets Index and the S&P 500, between the MSCI EAFE and the S&P 500 and between the MSCI EAFE and the MSCI Emerging Markets Index. And what you find is that over the last six or seven years as global economies have become more synchronised, correlations between global equity markets have converged. Now this has made it much more difficult to get diversification simply through geographic diversification. One example is that over the last seven or eight years the correlation between the US market and the Japanese stock market has gone up by 50%.

So where was the case ten years ago that you could achieve a reasonable amount of diversification simply by having equity exposure in different markets, that's no longer the case. Today to find diversification you need to go much further afield, you need to look at emerging markets, you need to look at frontier markets, you need to look at other asset classes such as commodities, other strategies, such as a carry trade or buy rights strategies using options, to get the type of diversification that you could obtain simply by geographically diversifying your portfolio ten years ago.

So just to conclude in terms of the challenges, we're in a very different environment than the bull market we enjoyed during the 80s or 90s, it's obviously gotten much more typical over the last couple of months, but even before that the entire period of this decade has been much more challenging than the previous few decades. And I think many of those challenges are likely to continue. In particular I'd expect that global equity returns are likely to remain lower for the next three to five years; we may see a cyclical rebound in the market in the near term, but I think that would be a relatively muted rebound. I don't think we're going to go back and test the highs any time soon. I think we'd expect higher inflation, although we might see inflation tick lower over the next six to 12 months. If I look at five to seven years given the prospects for higher commodity prices, a weak dollar and slower productivity, I expect inflation to be elevated compared to the 90s.

Again I'm very convinced we're in a period of slow economic growth, particularly for developed markets and most particularly for the United States, which is going to go through a period of a very painful delevering. I would expect low real yields from the US treasury market over the next three to five years and I would also expect that again as the economy has become more synchronised we're likely to find that global equity markets experience higher correlations than they did during the 80s or the 90s. So the key message is simply that what worked in the past is unlikely to work going forward.

Now having outlined the challenges I would like to spend a few minutes providing at least a few potential solutions to the challenges I just discussed. So in some way the advantage we have right now, the advantage you have as it relates to your clients is that we do have a broader array of instruments than we ever had in the form of ETFs. The advantage of ETF as you all know, they offer greater transparency, they offer the opportunity to invest in a number of markets which were very difficult to access in the past. And they do so in a very transparent and cost efficient manner.

So what I'd like to do is go through those challenges one at a time and then give a couple of suggestions for how certain ETFs may help address those challenges.

So starting on page 19 let me begin by the prospects for higher inflation. Now again I should just qualify that I do expect inflation to decelerate over the next six to 12 months, but if you're looking further out I do think inflation is likely to be an issue. So the things that you can do to help protect your portfolio, the first thing obviously is to have a higher allocation to commodities. Even if you believe that we're in a cyclical downturn in commodities, it still makes sense to have some portion of your portfolio, arguably between 5% and 10% allocated to real assets. And the reason for that is that commodities behave very differently than equities and fixed income instruments. They tend to do the best in periods of higher inflation and as a result they tend to have negative correlations to both stocks and bonds.

If you can't go out and purchase commodities directly, you can increase your allocation to those markets that are levered to commodities. Examples of that would be Australia, Brazil and Canada, these are markets that tend to do well when commodity prices are rising, given that many of their exports are commodity driven. The areas that I would avoid, specifically financials, which again tend to struggle with higher inflation environments and also consumer discretionary stocks, particularly in the United States. And by consumer discretionary I mean specifically retailers, hotels, restaurants. The reason I think these would do poorly in a higher inflation environment is I don't think that hourly wages in the United States will keep up with inflation. And as a result hourly workers will find that their after inflation pay cheques continue to go down and they have less disposable income to spend and therefore these stocks are likely to suffer.

The second challenge that I'd like to discuss is slower growth. So some of the things we can do to insulate your portfolio, one idea is actually to raise your allocation to growth as opposed to value. If you go back and you look at the performance of different styles depending upon the economic cycle, what you find is that generally growth outperforms value in periods when the economy is growing slowly. Now this is a bit counterintuitive; you would think that growth would do worse in these environments, but what tends to happen is that first of all many of the growth stocks tend to be in defensive sectors such as healthcare and staples. Second of all growth also tends to do better, because investors put a higher premium on companies that can grow their earnings in a slow economic environment. So a tilt towards growth as opposed to value is likely to pay off better and indeed it has been working better since the summer of 2007 when the global economy started to decelerate.

Again the other thing you can do is increase your allocation to defensive sectors, specifically global health care and consumer staples, both of which have been performing better on a relative basis during the recent bear market. And the obvious thing to avoid are global cyclicals; in other words those companies whose prospects are very levered to economic growth. Specifically that would mean controlling your exposure to basic materials and industrials. The third challenge I wanted to talk about are prospects for lower equity and lower fixed income returns. So to address that I think there are a couple of things you can do, one of which would be to increase your allocation to emerging markets as opposed to developed markets. Now emerging markets typically had a higher beta and have also suffered the worst during down turns and they've certainly been hit very hard over the last few months.

I think these actually do represent a good value. One we've seen valuations come down substantially; many of these markets are very cheap, where a year ago they were quite expensive. Second of all, unlike previous downturns in the global economy such as 1994 and 1997, emerging markets are not the source of problems this time around. Most of them are running fiscal surpluses; they have current account surpluses, very high foreign currency reserves. In contrast as I mentioned, the centre of the problem this time is the US consumer, not emerging markets. So I think the markets look more stable from a macro perspective and that they're also likely to enjoy higher growth rates over the next five to seven years. Again because they don't have the same imbalances of economies in the United States and Japan. I think we're going to see higher economic growth rates and as a result, higher earnings growth in these markets.

The second thing I'd be looking to do would be to increase my allocation to so called alternative beta. Part of that would be commodities, but also would be thinking of ETFs and other instruments that use strategies that are very uncorrelated with global equity markets. So for example ETF that use a process of writing covered calls against the portfolio to generate extra income. ETFs then employ a carry trade where you invest in fixed income instruments and high yielding countries and finance that by borrowing from low yielding countries. And yet the advantage of these is that the correlation tends to be fairly low with global with global equity markets, so in an environment where fixed income instruments and equities are producing below average returns, one these offer the prospects for higher returns, but also they help to lower the correlation with these asset classes.

And then finally I'd like to talk about this notion of higher correlations. So in a world where markets have become increasingly correlated, what can you do to achieve diversification? Well again what I would try to do is lower my allocation to developed markets, which increasingly are moving in tandem and to increase my allocation to those markets, which again tend to be a little less correlated with the rest of the world. Specifically one place to look are the so called frontier markets. So these would be those countries that have not yet graduated into the MSCI Emerging Markets Index. They include places like Columbia in Latin America, they include many of the countries in the Middle East, the United Arab Emirates. They would include in Asia places like Vietnam. And with interest in many of these countries is that they have companies that tend to be uncorrelated or unrelated to the global economy. Many of the largest companies in these countries are very focused on domestic demand and as a result you find that the frontier markets are actually much less correlated with global markets or even emerging markets than anything else. So the extent that you can access these countries, not only do they provide the opportunity for higher secular returns, they are also uncorrelated and help improve your diversification.

So just to conclude and I think it's obvious to everybody that we're in a very different environment that we were in during the 80s or 90s. We've seen accelerated inflation, we've seen equity returns that are substantially negative, actually the worst we've had since the 1930s as opposed to the bull market between 1982 and 2000. In this environment it makes sense to be much more aggressive in your asset allocation, in your tactical allocation that you needed to be in the 90s. Back in the 1990s it was enough to simply buy large cap equities and hold them, now you need to be much more tactical and in doing so you really need to pay attention to transaction costs and find ways to access alternative beta, differentiated beta in a way that's very transparent and efficient. So I

would encourage everybody to think creatively about their portfolios and to look for these opportunities, given the fact that many of the things that worked previously have just proven very ineffective over the last five or eight years and have been particularly ineffective over the last few months.

So I'm going to conclude my formal comments there and then we did want to open it up for any questions that anyone might have.

Question 1

Clearly market valuations are factoring in a severe recession coming through which will be multiple quarters. I think some of the concern out there around market valuations and the chances of assets getting cheaper from here is the concern that we might move into a depression period. What are your thoughts around that in terms of where the market is placed and indeed how the macro economy is placed with respect to a risk of depression:

Answered by Russ Koesterich:

Yeah I think that's really the crux of whether or not this represents a buying opportunity or not, so let's see if we can put things in context. At the low last week the MSCI world index was trading at about ten times earnings. This is the lowest we've seen since 1982. For many developed markets, particularly in Europe we were seeing whole countries trading at seven or eight times earnings. So there's no doubt the market is cheap and by many measures we were really back to the levels we last saw in 1982. So effectively over the last year we've wiped out a generation of multiple expansion. Now I think we're already discounting a fairly severe economic slowdown, not just in the US but globally. So in order to say that the market is really not cheap right now, I think you need to view the outlook for the next six to 12 months more in line with a global depression than a global recession.

Now my own opinion is things are not that bad yet and I don't think they're likely to get that bad. First of all just to put things in context, back in the depression the unemployment rate in the United States was 25%. Currently it's 6.1% and while I do think it's likely to go higher, I think it's unlikely to go above the 7% to 8% mark, which would be one third of the levels we saw in the depression. We also have a much more evolved safety net in terms of fiscal stimulus than we had back in the 1930s. Central banks also have a much greater understanding of how to implement counter cyclical measures than we did 70 years ago. So unless you believe that the effects of the global credit crisis are going to get much much worse and that the various things we've seen from the central banks, from the major developed countries are going to be completely ineffective, I think the likelihood of a global depression is fairly low. We're probably going to see global GDP decelerate from about 5% to about 3% to 3.5%, but that's not going to be a depression.

And given the fact I think we're not likely to be in a depression, then you can make the argument that the valuation levels we're now seeing probably represent a decent buying opportunity 12 to 18 months out.

Questions 2

Just one question on the US inflation expectation you have. I would like to have a clarification of whether you expect the US inflation actually to stay quite high, even under the low growth and also the deliberating going on in the financial sector?

Answered by Russ Koesterich:

Yeah I would expect, I should divide my comments into the intermediate term, which I'll define as the next six to 18 months and the longer term which I'll define as the next five to seven years. Over the intermediate term I do expect US inflation to decelerate. So we're already seeing that somewhat. Yesterday we had to produce the price numbers which were at 9.7% at their peak a few months ago, they're currently decelerated to 8.7%. As the price of oil remains low it's very natural to assume that US consumer inflation will probably go from about 5.4% down to between 2% and 3%. Now that said I don't expect to go back to the deflationary environment or the near deflationary environment we had back in 2002 where core inflation was as low as 1%. I think what's instead likely to happen is that given the amount of fiscal stimulus that we've seeing and the amount of treasuries that are going to have to be floated in the US market, I think what you'll see is a period of the dollar being weak and we're also going to see a period when productivity growth is relatively slow.

So as a result, once inflation decelerates due to the cyclical factors, I think we'll start to reaccelerate again probably back in 2010. So if I look out five years I think inflation is likely to remain in this 4% to 5% range, rather than the 1% to 2% range we had during the 90s. But in the intermediate term I do think we'll see a deceleration in US inflation.

Question 3:

And one other question on this inflation, the US dollar weakness may cause some deflation, further deflation pressure outside the US do you think?

Answered by Russ Koesterich:

That's very possible, which is probably not a bad thing. I think outside the US it's likely to be a little bit of a different story. But there are some factors that I think are going to create upward pressure and inflation globally in the long term even besides the dollar. So I do expect commodity prices to rebound after the cyclical downturn and I also think that some of the benefits that the global economy had during the 90s were tied to a huge number of labour, a huge global labour pool coming on line in many of the emerging markets, particularly China. To the extent that a lot of that pool has already come online, we're no longer likely to see the deflationary impact of Chinese labour lowering global wages.

So I think the removal of that factor will also lead to higher global inflation three to five years out.

Question 4

Russ just interested in some elaboration on the commodity prices from an Australian perspective. We've seen our market hit fairly hard and particularly our commodities companies, with commodity prices coming off the peak. What do you see as the likely timeline for changes in the commodity prices and the impact that might have on the Australian market? And secondly I guess further in terms of your currency, the US currency to the Australian dollar we've seen a 30% fall,

which restricts us in terms of looking at international investments, if we're going to see that turn around?

Answered by Russ Koesterich:

Let me start off with the question about the commodities and the outlook and obviously Australia as I mentioned before, markets are very geared to commodity prices, particularly on the industrial metal side. Again my short term view is that commodity prices will continue to trade lower with the global economy. That said I think for some of the commodities, copper being one, energy being probably the best example, you're probably somewhat close to a floor. I think in the case of energy, which again will have a little less of an impact on the Australian market, we probably won't see oil trade much lower than \$55 a barrel and we're not far from that now. I think we went over \$70 today. And the reason for that is the global supply curve for energy is shifted dramatically higher. It used to be the case ten years ago that the marginal producer for oil was OPEC, now if you look at OPEC they only have about 6% spare capacity.

And a lot of what they do have is heavy sour crude rather than light sweet crude, which is not really what the global refineries can take. So as a result most of the marginal crude on the market is coming from places like Siberia, the deep water Gulf of Mexico and these are places that are very expensive to produce oil. So as a result I think that oil prices, once you get past the cyclical downturn will head up again and that the prospect for commodities is probably brighter once you get through this period of deleveraging and a global slow down.

Now in terms of the dollar I think one of the reasons you've seen the dollar strengthen or the main reason, arguably the only reason the dollar strengthened over the past several months is on risk aversion. We've seen this trade in the global markets where effectively the world is divided into two asset classes, there are US treasuries and everything else. And everything else is viewed as risky and US treasuries are viewed as safe and as a result we've seen the dollar strengthen particularly against the euro and the pound. And to my mind this is really just a risk aversion trade; eventually the market will stabilise and when it does, the structural reasons why you want to be short the dollar is still in place. We're still running a current account deficit close to 5%, you'd expect us to have low interest rates for a prolonged period, as we go through this delevering. So I think that as you get past the early part of 2009 and financial markets stabilise, I would expect the downward trend in the dollar to reassert itself.

Question 5

I want to understand a bit more about your view on US treasuries, because you do say in the short term that real yields will stay negative, yet you have a view that the US dollar is likely to weaken. With all the US treasuries that are going to be swamping the world, why would we see a much steeper yield curve and in fact treasuries be a bad place to be?

Answered by Russ Koesterich:

Well I think they are a bad place to be and again I need to separate out the near term from the longer term. In the near term I think the treasuries are likely to continue to get a bid simply on the risk aversion trade. And I would expect the yields to remain low in the US, because you are likely to see this deleveraging. But I think you're totally right and I agree with you, I think right now except for central banks that have non economic reasons to purchase treasuries, this is arguably

the worst trade in the world right now. You've got the ten year, again it's 3.9%, you've got headline inflation in over 5% resulting in a negative yield. Typically treasuries have yielded 270 basis points over the rate of inflation. And as you point out quite correctly we're going to see a flood of treasuries coming to the market over the next few years.

Even before the recent turn down the US budget deficit was forecasted for 2009 at \$440 billion. That does not include the price of the war in Afghanistan, it does not include the price of the war in Iraq, the real number is probably closer to \$600 billion. In addition we know we've got a fiscal package which is likely to come online of another \$150 billion. When you add to that the cost of the TARP, the treasury's plan for dealing with the banks, it's not inconceivable that the US deficit could start to approach \$800 or \$900 billion as you get into 2010, particularly as the US economy slows and tax receipts start to drop. So I think we will see a flood of treasuries into the market, I think to the extent that inflation does remain somewhat elevated over the next five years, these are a terrible trade. And I would expect that once you get to the point where investors are no longer fleeing into treasuries due to risk aversion we will see a back up in yields.

Question 6

Hi Russ, I take it that you believe developing economies will be largely unaffected by any slow down within the developed economy, is that about right?

Answered by Russ Koesterich:

I don't think they're going to be unaffected, this goes back to the discussion about the decoupling thesis, which a lot of economists were arguing about in the beginning of the year. And I think it's been demonstrated that the strict version of that theory that the emerging markets would simply decouple from the developed markets has not been the case. We have seen export growth slow very dramatically in Asia, we've seen Brazil be hit by the pull back in commodities. That said I do think many of the emerging markets, particularly in Asia and Latin America are better positioned from a structural perspective to withstand the global slow down than they are in the United States and Europe. Many of these countries are running structural surpluses, they have current account surpluses, they have reserves. So they have the wherewithal to enact a number of counter cyclical measures. Now I still think we'll see growth decelerate, it's already happened, we've seen Chinese GDP go from 11% to 12% down to 9% to 10%, it's not inconceivable it can go as low as 7% to 8%.

But I do think that the slow down in these markets will be less pronounced than in many of the developed markets, particularly the United States. And again the reason I say that is I believe the biggest global imbalance is centred in the US, so it's likely to bear the brunt of this recession.

Question 7

Thank you very much for your representations. Regarding page 19 you mentioned that real asset is one of the solutions for higher inflation. Is there any particular real assets you recommend, say gold or...?

Answered by Russ Koesterich:

Yes this is an interesting question. In general my thought is that and this is very consistent with the Barclays investors philosophy, unless you have an insight into a particular commodity you're better off having the advantage of breadth, purchasing an ETF or another instrument that gives

you access to a broad array of commodities. There are two commodities in general that I do think you want some exposure to and those are crude oil and gold. The argument for gold is again I do think the dollar will be weak over the next five years and gold is a very good hedge against the weak dollar. The argument for crude is based on two factors. First of all I think that we're likely to see strong demand out of emerging markets for crude for prolonged periods once we get past the cyclical downturn. And second of all as I mentioned before, the supply curve for crude oil has shifted dramatically higher. We don't have a lot of spare supply of light sweet crude and much of the crude we're likely to bring online over the next few years in places like Canada is very expensive to produce.

So as a result I think we'll see the cost of supply in the world with crude gradually creeping higher and once the global economy starts to recover, I think we'll see a rebound in energy prices and crude move back up to probably at least the \$90 range.

Question 8

Hi Russ thanks for the presentation. Since you mentioned emerging markets and frontier markets offer value and better growth story, to invest in those markets how are they going to be funded? From which part of the client's portfolio would you recommend?

Answered by Russ Koesterich:

Yes this actually has come in quite a bit with our institutional clients. And generally what they're doing which I agree with is they're funding that allocation from developed equities, particularly the United States. Now some of that represents the home country bias, so as a general rule I would fund it from the developed markets, but more specifically I would look to the extent of your own portfolios or the portfolios of your client have a strong home country bias and I would use that home country bias to fund these allocations to both emerging markets and to frontier markets.

Question 9

Can you just elaborate on your view on commodities, given a world in which you're seeing very slow growth?

Answered by Russ Koesterich:

I think in the near term commodity prices are likely to continue to struggle, so I would not expect much of a rebound in commodities, particularly those that are more industrially driven, such as copper or nickel until we see a bottom in the global economy and that could be anywhere between 12 and 15 months away. My views on why you want an allocation to commodities are twofold. First of all I do think that once we get past the cyclical down turn there are secular reasons both on the demand side and the supply side which I mentioned, which argue why commodities are likely to do better over the next five to ten years.

The second argument for doing it is more of a risk trade, which is the fact that what's unique about commodities is that in opposition to equities and fixed income this is the only asset class that really does well when inflation is higher. And to the extent that what you want to find when you diversify are asset classes that respond differently to different economic circumstances. I think having some exposure to commodities, even if you do believe that this cyclical bull market is over is advantageous. And the reason it's advantageous is it helps diversify the portfolio and in doing



so helps move you further out on the efficient frontier, in other words you can produce higher returns for a given level of risk.

So just to summarise that, longer term I think for secular reasons for being in commodities are increased global demand from the emerging markets, higher supply curves for many commodities, particularly energy and the second reason has to do with the diversification benefit.

First I want to thank everyone for joining us this morning, we really appreciate it. I know that this is a very difficult time to be away from your desk and away from your computer. So thank you for joining us and I'd just like to wish everyone good luck in what I know is a very difficult period, thank you.