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Barclays Wealth examines: the next bubble, U.S. debt, the Euro, Asian growth and using discipline to increase risk

- **The next bubble may be forming in developed sovereign debt**
- **The U.S. debt picture is better than depicted**
- **The Euro will survive, but the process won't be pretty**
- **Asian growth in upcoming decades will resemble the past three; China, India and Indonesia equities are particularly attractive**
- **Use discipline to increase risk when everyone's worried and trim back when everything looks fine**

The October 2011 edition of Barclays Wealth *Compass*, entitled "Perspectives on Markets: Yesterday, Today and Tomorrow," reflects upon the past two decades of market volatility with an eye toward understanding and positioning for the future. The firm's chief investment officer and heads of regional Investment Strategy, Behavioral Finance and Quantitative Analytics answer five key questions in the special edition.

Lessons of the Past Suggest a Bubble in Sovereign Debt

In his answer to "How did we get here?" **Head of Americas Investment Strategy Hans Olsen, CFA,** looks at the financial crises of the past 15 years, describing a clear pattern in which a "New Idea," promising economic or financial transformation, and low — even negative — real interest rates lead to a mispricing of money and massive overvaluation of the idea.

Mr. Olsen says: "With that pattern as a guide, it appears the next bubble could be forming in the sovereign debt of developed economies." He continues: "As the bull market in uncertainty prevails, it is easy to see why money has flocked to sovereign debt markets around the globe. Real yields are negative by some measures across the yield curve for U.S. treasury script, but the prices being paid for the income are hard to understand."

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U.S. Debt Picture Is Better Than Commonly Depicted

In “Is there life after debt?” **Kevin Gardiner, Head of Europe, Middle East and Africa Investment Strategy** shows the picture commonly painted of the aggregate U.S. economy being tightly shackled by “too much debt” is overly simplistic. He provides many examples including the following facts:

- The U.S. household sector‘s gross financial assets amount to roughly $50 trillion, vastly more than its total gross liabilities of $14 trillion. Add in tangible assets, and U.S. consumers’ net worth is hugely positive, equivalent to 3.9 times GDP. Although it has fallen by a fifth since its 2007 high, it is actually 9% above its 50-year average.
- While U.S. consumers’ gross debt levels may remain historically high, the cost of servicing that debt isn’t.

Most Likely Outcomes for the Euro Area

Chief Investment Officer Aaron Gurwitz explores whether the Euro will survive. By taking a view that the euro area sovereign debt situation is unlikely to end any time soon in either a financial catastrophe or a final resolution, he outlines the probability of four scenarios and their implications. “The most likely scenario, with a 45% chance, is that Europe will ‘muddle through badly,’” said **Mr. Gurwitz**. In that scenario the following happens:

- Political, legal resistance to the current plan continues;
- There is a renegotiated deal;
- There are larger bond-holder losses;
- There is Prolonged economic weakness in periphery; and
- Italy and Spain remain at risk.

If that, then – all else being equal – there will be small but negative impact on the euro area. Risk asset prices will decline. German interest rates will remain low, and we will see peripheral spreads grind wider with occasional spikes.

“The second most likely scenario, with a 40% probability, is that the euro area will “muddle through well,” continued **Mr. Gurwitz**. In this scenario, things develop more quickly with the Euro area parliaments approving and implementing the EFSF, the IMF and the ECB providing occasional favorable liquidity infusions and the renegotiated bailouts being more generous. In this case, the result will likely be:

- Gradual appreciation of the Euro;
- Steady ECB tightening; and
- Risk assets producing normal returns.

However, the fundamental problem remains unresolved and the risk of eventual default by euro area sovereign borrowers will continue to unsettle markets. (For the other two scenarios, see page 21 of *Compass*)

Consider Buying Chinese, Indian and Indonesian Equities as Asian Growth Likely Continues Apace

In the essay, “Is Asia the answer or another question?” **Head of Asia Research, Economics & Investment Strategy Benjamin Yeo** analyzes whether the region can continue its breakneck rate of economic growth over the coming years and tests if these prospects are reflected in stock market valuations across Asia. He concludes that:

- Asia’s growth in the next two decades will likely be similar to that of the past 30 years – regardless of any slowdown in the developed word, if several structural elements are managed well.
- Driving Asian growth are two regional trends: Surging intra-Asian trade and increasing domestic consumption.
- The most attractive equities markets for the medium term appear to be China, India and Indonesia.

“On both traditional valuation parameters such as price-to-earnings (PE) ratios or price-to-book (PB) value ratios, and on an alternative approach to valuations — one that compares the market capitalization of the country’s stock market to its gross domestic product— China and India are attractively valued, said **Mr. Yeo**. “While Indonesian equities may not seem compelling based on traditional valuation metrics, they

definitely are on a Market Cap/GDP ratio. Combined with the outlook for growth, we believe these equities markets are worth considering."

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Managing Portfolios Through Volatility: Steps for Improving Performance

Head of Behavioral and Quantitative Finance Greg Davies answers the question "What do we do now?" by leveraging insights derived from behavioral finance and historical returns to show how investors can use three rules to reduce risk and get through short-term uncertainty, thus improving portfolio performance.

He begins with the principle that although the future becomes murkier the further ahead we look, investing sensibly in risky assets is a lot less uncertain in the long run than in the short run. Over any 12-year period in the last 40 years, there have been no negative returns in the MSCI World Index. The problem, he explains, is that investors live perpetually in the short-term so they're always buffeted, financially and emotionally, by the short-term's extreme uncertainty.

Rules of Thumb:

- Ensure financial liquidity is sufficient to meet needs. That's to avoid selling at the wrong time, which is the biggest driver of underperformance.
- After that, it's about psychological liquidity, having the mental resilience to stick with your portfolio. Some simple, yet practical, steps can help to reduce the stress of the investment journey:
  - Diversify across assets classes. A comparison of MSCI World Index returns to those of a diversified portfolio over the past 20 years shows muted declines in the diversified portfolio and better overall performance.
  - Rebalance regularly to your baseline asset allocation to respond effectively to events as they transpire.
  - Supplement these sensible backward looking responses to events with educated forward tactical positioning, to take advantage of times when it might be good to tactically overweight certain asset classes and underweight others over a three-to eighteen-month timeframe.

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To read the full Barclays Wealth *Compass* Report October 2011 click here

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About Barclays Wealth

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Barclays is a major global financial services provider engaged in retail banking, credit cards, corporate and investment banking and wealth management with an extensive international presence in Europe, the Americas, Africa and Asia. With over 300 years of history and expertise in banking, Barclays operates in over 50 countries and employs over 145,000 people. Barclays moves, lends and invests money for customers and clients worldwide

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