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Investment Topics

2010:
International equity and fixed income markets.
Ten fund managers. Ten key questions.

In this edition of *Investment Topics* we ask ten of our Invesco UK managers how they see key issues affecting their markets in 2010. The managers include Bob Yerbury, CIO, who addresses the question of whether the recovery in financial markets seen since March 2009 is sustainable; Paul Read, Co-Head of Fixed Income, who looks at the issue of whether the strong performance of corporate bonds seen in 2009 can be repeated in 2010; Andrew Shard, Fund Manager, US Equities on whether

US companies have lost their competitive edge; and Paul Chesson on whether Japanese equities are still good value.

If there is one common theme it is that, even after the strong recovery we saw in equity markets around the world from March 2009 onwards, aggregate world equity valuations are still attractive and in many markets these are accompanied by good prospects for earnings increases in 2010.

1. Global equities

Bob Yerbury, Chief Investment Officer, Invesco UK.

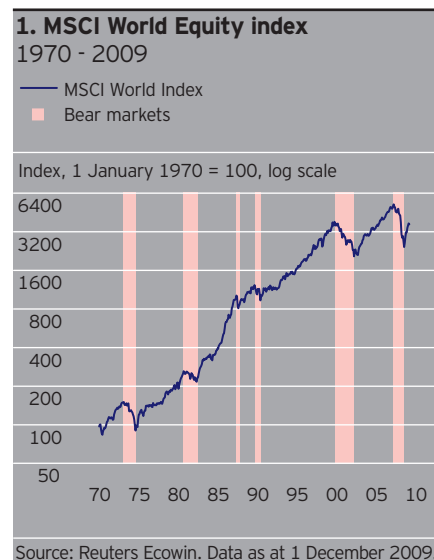
Q: How does the recovery in financial markets we have seen since early March compare with recoveries you have seen before, and what does that lead you to expect for 2010?

A: The recovery in world equity markets saw the MSCI World Equity Index produce a total return of 55% (in US dollar terms) in the nine months from the end of February to the end of November 2009. That was stronger than any of the other nine-month recoveries after bear markets since 1970 (see Figure 1).¹

However, it is fair to say that the severity of the bear market we experienced from late 2007 until early this year, and the accompanying concern about global economic prospects, was also more marked than in any of those previous periods. It was also much more severe than I had expected. So there is a sense in which the stronger rebound can be justified by the severity of the downturn.

Even after the recovery, however, aggregate world equity valuations are still attractive. Over the last decade we have seen a secular de-rating of equities as an asset class. One important reason is that institutional investors, in particular, have shifted from equities to fixed income and alternative assets (such as hedge funds). I think 2010 could well see some rebalancing of portfolios back towards equities.

Within the equity markets, what we saw in 2009 was that as optimism about economic recovery grew, the more cyclically sensitive areas of the equity



market benefited most. In many regions, the type of companies which we prefer to invest in - well managed companies, with strong finances and which are in a position to grow earnings and dividends on a multi-year basis - lagged behind.

However, many of these companies have produced strong results, which often went unrewarded by their share price performance last year. In the UK, companies such as Tesco, BAT, Astra Zeneca and GlaxoSmithKline fell into that category. Such companies can do well, I think, even with the continued challenging economic environment in 2010.

So, in summary I am optimistic about prospects for overall equity markets, but expect better quality companies to fare best in 2010.

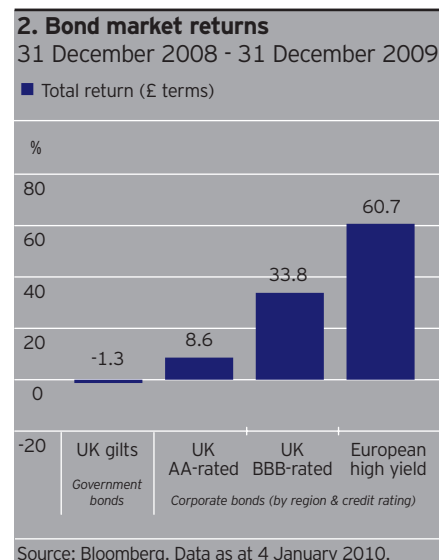
2. Corporate bonds

Paul Read, Co-Head of Fixed Income, Invesco UK.

Q: Can the strong performance of corporate bonds seen in 2009 be repeated in 2010?

A: 2009 was an exceptional year in fixed income markets, with conditions improving markedly from what were highly distressed conditions early in the year. Between the end of 2008 and the end of November 2009, the returns from UK AA-rated corporate bonds in sterling terms amounted to 10% and from European high-yield bonds more than 60% (see Figure 2). Those returns were generated predominantly from capital appreciation as bond prices rose, in addition to coupon payments.

Such a strong performance is unrepeatable in 2010. We think we will now enter a period in which bonds do indeed give 'bond like returns'. That is, as well as coupon income, there will be some, but much more limited, prospect



for capital gain. We do still see value in some sectors - bank debt offers good value. But, certainly, there can be no repeat of the strong gains of 2009.

¹ A bear market in this context is defined as a fall of 20% or more.

3. Asian equities

Stuart Parks, Head of Asian Equities, Invesco UK.

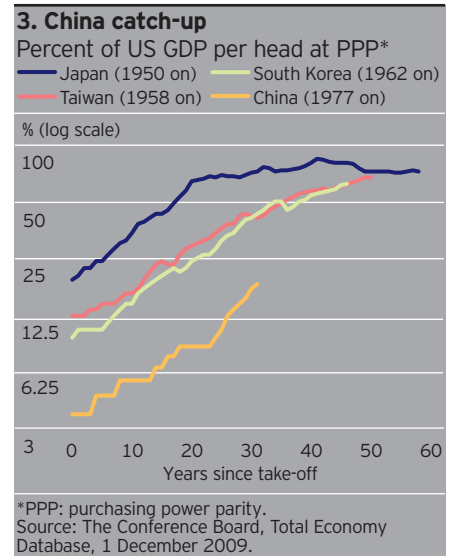
Q: The Asia Pacific (ex Japan) equity market produced strong returns in 2009 and some now see a bubble developing. How do you see the risk and return prospects for Asian markets in 2010?

A: The rise in Asia Pacific (ex-Japan) markets in 2009 reflected a recovery from the oversold position of early 2009, easy global liquidity conditions and a recognition of the structural strengths of the region. Even after that rise, however, valuations are still reasonable: the price to book ratio is around 2.0 and the P/E around 14 on the basis of expected 2010 earnings (which the consensus sees as 25% higher than in 2009). Given that valuation and earnings backdrop, the fundamental basis for continued market appreciation looks intact on a two to three year view; but the progress of equity markets, especially in Asia, is never smooth and there are three principal risks which I see for 2010.

The first is, indeed, that a new bubble develops and some already see signs of one inflating. While we dispute that - valuations are well away from bubble territory - there is a risk of markets rising in an unsustainable manner in 2010.

Second, a stronger dollar (maybe driven by a firmer than expected US economy and an earlier rise in US interest rates) poses a risk for Asia. Generally, Asian markets find it more difficult to make progress in a strong dollar environment.

Third, higher Asian inflation, leading to an earlier move to tighten monetary policy in the region. For many countries, the vulnerability to higher inflation stems from higher food prices: these pressures are already evident in India; and in China, where inflation has just moved into positive territory, food prices pose the



greatest future inflation risk.

However, it is certainly possible that deft policy action can head off these risks. China, for example, has recently taken measures to curb property market speculation; and a resumption of renminbi appreciation against the dollar may help both to ease inflationary pressures and affect the perception of Asian economies still being dollar-linked.

These issues should, of course, be seen in the longer-term context of the growth of China and other Emerging Asian economies. China is still in the process of a multi-decade period of growth which will take its GDP per head up towards the levels of those in the US, emulating the earlier successes of Japan, South Korea and Taiwan (see Figure 3).

Overall, therefore, I think it is still right to be optimistic about the prospects for Asia on a multi-year view; but as always it would be unrealistic to expect a smooth ride.

4. US

Andrew Shard, Fund manager, US Equities, Invesco UK.

Q: We hear much of the rise of emerging economies and the threat they pose to the large, developed economies, notably the US. Do you think that US companies have lost their competitive edge?

A: US companies, and the US economy, are still, in my view, extremely competitive. Indeed, the response of US companies to the downturn in global activity demonstrated to me just how quickly they can respond to changed circumstances - and that is an encouraging sign for the future. US companies, for example, reduced costs, labour and capacity on an unprecedented scale and acted very quickly to reduce capacity in the face of falling demand and did this more quickly and to a

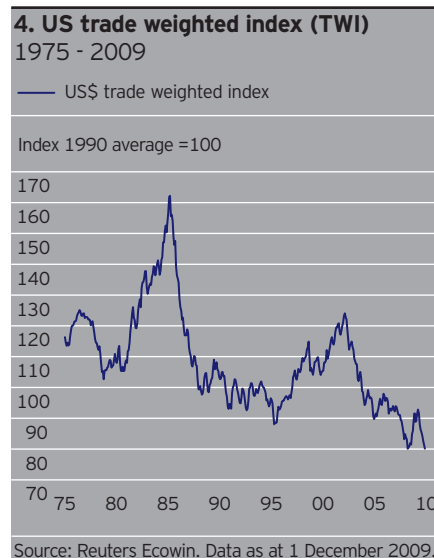
greater degree than other developed economies. Excess inventories were, in many industries, cleared quickly and are now being rebuilt. US corporate practices are still ones which are emulated in many other countries; and of course the notion of a "US" company makes less sense than in the past as so many have global operations.

The banking sector shows just how responsive US companies can be in difficult circumstances. Capital raisings have helped restore balance sheet durability; all the banks which received financial support from the government have either repaid that support or are finalising their plans to do so; some weak banks have gone out of business or have been combined with stronger companies. All this has happened on a time scale which is much shorter than would be

the case in other economies around the world - Japan's banking problems, for example, rumbled on for years and years. To us, this means that the survivors are now in a stronger position and we are very constructive on their prospects in the medium term.

The steady fall in the value of the dollar (see Figure 4) will also help US companies' competitiveness, by making their exports cheaper in world markets, in coming years.

So, I doubt very much that US companies have lost their competitive edge. Indeed, in my view, US companies' strengths have, in many ways, been re-emphasised by the recent crisis.



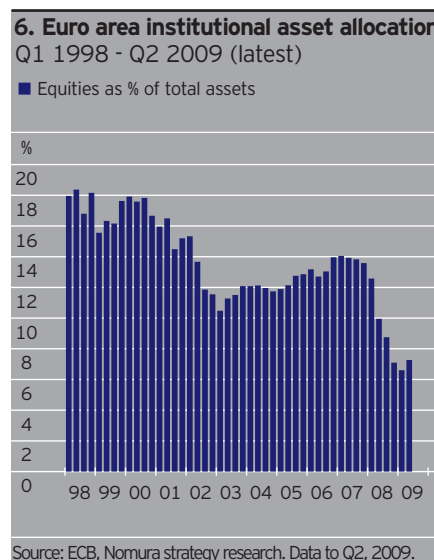
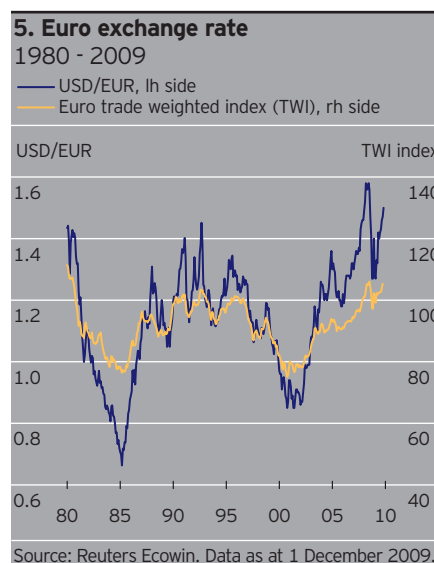
5. European equities

Jeff Taylor, Head of European Equities, Invesco UK.

Q: We have heard much about Greece's debt problems and fears it may even default. Do you think Greece's problems could spill over to other economies and markets in Europe, adversely affecting European equity markets?

A: Greece has been a well-publicised trouble spot but the new prime minister is, finally, taking measures to curb the budget deficit. Although Greece has high government debt levels, overall European levels of government and consumer debt remain relatively low. Partly because of this, Greece's problems have so far been contained, with little evidence of contagion to other European markets. I think this will remain the case in 2010. Greece's problems may have contributed to the euro weakening against the dollar in late 2009 (see Figure 5), and if that continues it could help European companies' competitiveness (although I think the euro exchange rate is much less important for European companies than many claim, as many have very diversified global operations and actively manage their currency risk).

I am positive on the longer term outlook for European equities, particularly so when comparing them to cash and bonds. Weightings of equities held by Euro area institutions (insurance companies and pension funds) are close to their lows (see Figure 6). Assets invested in treasury or money market funds, in both the US and France, remain close to record highs. Therefore, as the appetite for risk improves, especially in the context of current low returns on cash, I think that it is logical to expect money to flow back into equities, longer term. Furthermore, European equities are cheap by historical standards. In aggregate, price/earnings ratios are not stretched. Furthermore, certain sectors and stocks are extremely cheap. In the case of telecoms, for example, the



dividend yield on the equity is typically much higher than the yield on the debt. This is despite our view that telecom dividends are robust and so points to very good relative value for equity.

6. European small caps

Adrian Bignell, Fund manager, European Equities, Invesco UK.

Q: Is there still value in European small companies?

A: Yes there is, but the pattern of valuations across European smaller companies is a diverse one. In some areas, valuations have become stretched; in others there are still attractive valuations available. For example, late in 2009 we reduced exposure to some European healthcare-service providers. That reflected our view that the sector's traditionally defensive qualities had been somewhat overvalued by the market

and there were better opportunities elsewhere. We also reduced exposure to oil service companies, taking advantage of the strength in oil prices. The funds from these sales were redeployed in companies which we estimated to be trading on cheap valuations. These included German mobile-phone wholesaler Drillisch, which we also view as being a possible takeover target, and Neopost, Europe's largest provider of mailing systems and mailing supplies. As well as its cheap valuation, Neopost has an attractive 6.5% dividend yield. Another holding purchased was Voest-Alpine, an Austrian-incorporated steel maker, again on a cheap valuation.

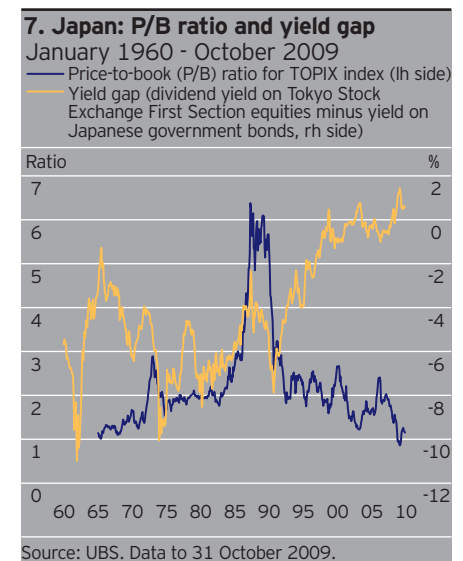
7. Japan

Paul Chesson, Head of Japanese Equities, Invesco UK.

Q: All we hear about Japan seems to be bad news: recession, deflation, demographic problems and political uncertainty. In these circumstances, are Japanese equities still, in your view, good value?

A: It is true that the news flow in relation to the Japanese economy at times seems unrelentingly bad: Japan experienced a steep recession in early 2009; deflation has returned and Japan's poor demographics will constrain its economic growth in coming years. However, many of Japan's leading companies are export-orientated and for those the state of the Japanese domestic economy is not particularly relevant. They are much more affected by the behaviour of the global economy and their earnings are far more geared towards the gradually recovering developed economies and the fast-growing Asian economies. Japan, after all, has the world's major source of economic growth - China - on its doorstep.

Furthermore, in the equity market valuations are still at unusually attractive levels. This is demonstrated by the price to book ratio for the overall market which was only just above 1.0 at the end of 2009, little changed from a year earlier (see Figure 7). That ratio measures the market value of Japanese companies' equity relative to the book value of those companies (that is the value of those companies' assets). Its average level,



even excluding the 'bubble period' of the late 1980s, is close to 2.0. Additionally, book value does not include the non-financial assets - the knowledge base and technological skills - which are so important for the Japanese companies which we favour in our portfolios.

In conclusion, Japanese equities are still very good value. For 2010, the key issue is what the catalyst might be for a recovery in the equity market and a rise in the price/book ratio. One such catalyst may be a rise in US interest rates. For example, in 1994, when the US raised interest rates after the Savings and Loan crisis, Japan's equity market rose even though markets in the rest of Asia fell.

8. Emerging markets

Dean Newman, Head of Emerging Markets, Invesco UK.

Q: We have heard a lot about Brazil recently: it was one of the strongest equity markets in 2009, it is now investment grade and will host the Olympics in 2016. Is this an Emerging Market that really is now making a successful transition to being a rich, advanced economy?

A: Yes, I think it is making such a successful transition and that this will continue on two fronts: international and domestic. In terms of global integration, perhaps just as important as being chosen as the venue for the 2016 Olympics is the fact that many new bilateral trade co-operation agreements are being put in place, most notably with China, but also with other regions. For example, Petrobras has made a significant investment in Saudi Arabia.

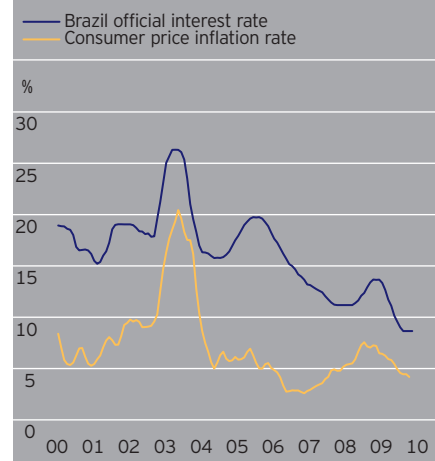
Domestically, one of the most important transitions is from a high inflation and interest rate environment to one where both of these are low and stable (see Figure 8, overleaf).

For consumers, cheaper finance and easier access to it has proceeded alongside sharply increased demand for 'big ticket' consumer items, such as furniture and appliances. Moreover, even as debt levels have risen, debt service costs have been maintained at a relatively low share of incomes as a result of lower interest rates.

For companies, the ability to obtain finance at low long-term interest rates is a completely new development which can drastically transform their financial structure. It allows a better balance between debt and equity finance, for example.

It is fair to say that these changes are still at an early stage. That means we remain convinced of the long-term strength of Brazil's equity markets. In the short-term, however, there are some warning signs. The weakness of the dollar during 2009 has started to put

8. Brazil interest rates and inflation 2000 - 2009



Source: Reuters Ecowin. Data as at 1 December 2009.

pressure on Brazilian exporters; a 2% tax on foreign investment in stocks and bonds has been introduced; and there is some uncertainty surrounding this year's presidential elections (when Lula's second term of office ends). But we would see these as temporary uncertainties in a long-term structural process of change.

9. Emerging Europe

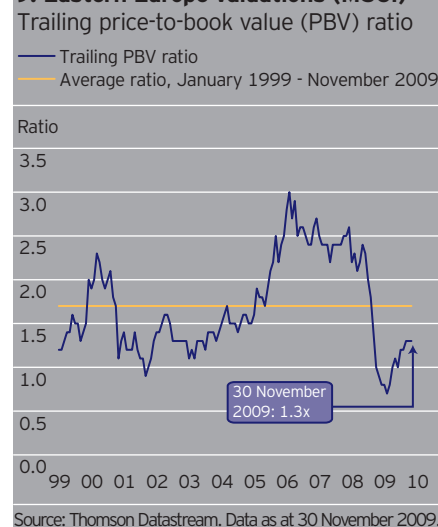
Liesbeth Rubinstein, Fund Manager, Emerging European Equities, Invesco UK.

Q: Equity markets in Emerging Europe often attract less attention than those in Asia and Latin America. How do you see their prospects in 2010?

A: It is true that Emerging European equity markets are less well recognised as a play on global economic recovery, but we think that perception can change in 2010. Russia, of course, is one of the BRIC economies but it differed from the other members of that group in 2009 in that it saw a contraction in overall GDP. However, that was concentrated in the first quarter of 2009, when oil and gas prices were particularly low, and GDP expanded in the third quarter. Russia has already, therefore, emerged from recession. If the world economy continues to recover in 2010, this should underpin oil and commodity prices and Russia stands to benefit from that development, being a substantial oil and gas exporter.

The bigger longer-term issue for Russia, however, is the growth of domestic demand. In that respect, we remain very constructive with regard to the outlook. The government has the ability to continue spending on strategic infrastructure projects, given its very low level of indebtedness; it is likely that Russian interest rates will continue to fall in 2010; and that consumer spending will continue to be underpinned by income growth as well as easier and cheaper access to finance. In that sense, the dynamics behind Russia's longer-term growth are not that different to those of Brazil, also a major commodity exporter,

9. Eastern Europe valuations (MSCI)



Source: Thomson Datastream. Data as at 30 November 2009.

which has received much more attention as a target for Emerging Market equity investment.

Whilst the Baltic countries attracted much attention in 2009, these are not part of the Emerging European equity universe, and it is important not to treat the region as a homogenous bloc. Hungary, Poland and the Czech Republic are well placed to benefit from the recovery in the Eurozone economy that is now underway. Moreover, Emerging European markets are attractively valued in relation both to other Emerging Markets and to developed markets. For example, in late 2009 they traded at a lower price/book value than their historic average (see Figure 9): that was not the case for other Emerging Market regions.

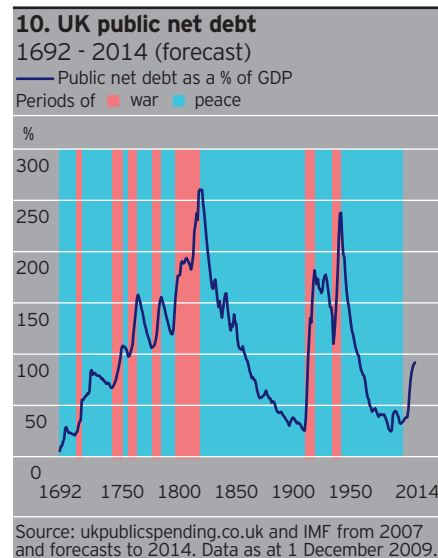
10. Government bonds

Paul Causer, Co Head of Fixed Income, Invesco UK.

Q: With governments around the world running large - in some cases unprecedentedly large budget deficits - are you bearish on the outlook for government bonds?

A: In government markets, future supply remains a key concern. The required funding of large government deficits will mean there will be substantial issuance of new government debt in 2010. The outstanding stock of government debt in many countries will rise sharply: in the UK the expected rise is the debt level has no peacetime parallel (see Figure 10). I do not think it is very likely that aggressive action to cut fiscal deficits will be taken in 2010; but what we will need to see are credible plans for reducing deficits in the future. Government bond markets will be highly sensitive to such announcements. We saw an indication of that in late 2009 when the UK gilt market reacted adversely - prices dropped and yields rose sharply - in response to the pre-Budget report, which was seen as falling short of the required fiscal tightening.

There is also a concern in the US government bond market that, with the average maturity of government debt



outstanding as short as it has been since the early 1980s, there will be increased issuance at the long end of the market. Given that short-term interest rates are likely to be anchored at low levels for some time, the implication is that the yield curve will remain steep.

We still see the best strategy in the government bond markets to be short duration, to protect against the effects of any further rise in long-term bond yields.

Valuations in the UK equity market will be discussed in detail in the forthcoming edition of *Investment Topics* which will be issued in early 2010.

Further information

Contact us

UK, Malta, Isle of Man, Jersey and Guernsey:

Telephone +44 1534 607600

Dubai:

Telephone +971 4425 0950

Ireland:

Telephone +3531 439 8100

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International Development Division
Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire RG9 1HH, UK

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