

Global Investment Outlook



Economic and Market Outlook

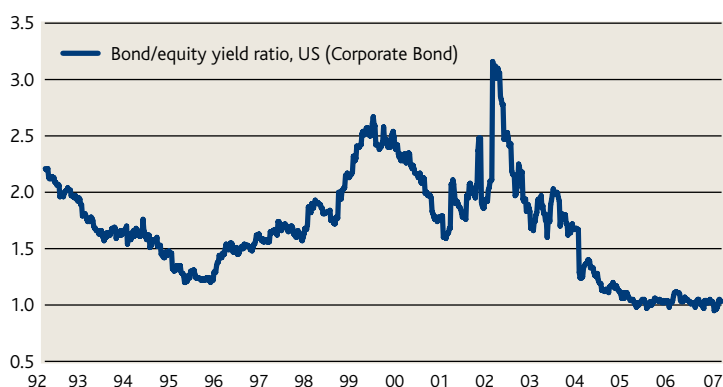
- Global industrial production growth continues to weaken, although the rate of deceleration may decrease as we progress through the year. Most of the recent data supports the notion that the relatively orderly slowdown in the US is making room for above trend growth in Europe and a continued rapid expansion in Asia and emerging economies.
- In the US, much of the immediate concern surrounding the sharp rise in defaults of sub-prime borrowers has dissipated, but the full impact of adjustments to variable rate mortgages is still to be felt on residential investment and possibly consumption. However tax receipts remain strong indicating underlying activity is robust, even though capital gains receipts could be the major cause. A shrinking deficit will limit the contribution to GDP growth from the public sector. We expect growth to remain below trend, possibly dipping below 2.0% year over year.
- The outlook for Europe is the brightest it has been for a while. For example the election of Mr. Sarkozy as French president bodes well for deregulation of their labour market. In the near term, job creation continues in Germany and elsewhere, and whilst business confidence is strong, this should lead to above trend growth in 2007.
- In the UK the year over year growth rate is 2.8% above its sustainable trend. Although the labour market has deteriorated, the growth in incomes including bonuses has remained elevated. This in turn has been a catalyst for persistent house price inflation of circa 10%, leading to sustained consumption growth. Service and manufacturing sector indices remain upbeat. Growth in 2007 should remain at trend.
- There is anecdotal evidence that waning US growth is impinging upon the Japanese recovery. Car production for export has been curtailed, and this is reflected in the most recent government Diffusion Indices of production activity. However the data also suggests that the non-manufacturing sector is displacing the export manufacturing part of the economy as the engine of growth. Whilst we expect growth to continue, a key focus will be investment and jobs which must stay strong.

- Other Asian economies have not been immune to slower external demand. Export growth in S. Korea, Singapore, Taiwan and Malaysia has slowed in February and March with weakness in electronics demand most evident. Meanwhile the exponential growth in activity of the last few years continues to benefit retail consumption as workers benefit from higher incomes. Credit growth in China and India although waning, remains at lofty levels pointing to further economic strength ahead.
- A few of the metals markets look like moving into contango, necessitating further price rises in the spot market for investors to make money. Usually this signals a downturn in prices as speculators become reluctant to participate. We believe base metal prices will subside. Oil remains in its range of \$50 - \$70pb but refined product prices are sturdier as refineries shut in the US for annual maintenance.

Bond Yields, Currencies and Monetary Policy

- We continue to expect competing factors of growth and inflation to persuade the Federal Reserve from shifting monetary policy in the near term. Over 12 months though, moderating core inflation should make easing possible, but this depends on the trajectory of growth at the time, relative to potential, and any output gap.
- UK base rates are set to rise further as the economy grows above its non-inflationary potential. The Bank of England believes there is no spare capacity in the economy and until some appears, policy will be biased to tighten further. Our impression is that further tightening moves along with external factors will slow growth sufficiently to warrant a pause before the year end.
- The ECB's President Trichet continues to describe policy as 'moderate' and on the 'accommodative side' pointing to further hikes in the 'repo' rate possibly in June. We would not be surprised to see rates peaking at 4.25% or above if the Euro-zone economy does not slow to towards 2.0%.
- Japanese monetary policy makers seem content to wait more before pushing policy rates higher. A downturn in petroleum product prices and a persistently negative core rate of inflation suggest further gradualism in removing excessively accommodative policy. Short rates may not reach 1.0% until next year.

The cheapness of debt capital suggests balance sheet restructuring will continue in the US



Source: Factset

Declining unemployment in Europe suggests a tightening bias from the ECB



Source: Factset

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- Tightening of credit conditions is still prevalent in China and we expect this to continue, although here also 'measured' moves consisting of administrative measures amongst others should prevail. Indian policy tightening however is beginning to have some impact on credit growth and we may be nearing a pause in the cycle.
- Government bond yields have changed little over the last month. The degree of correlation between equity prices and developed market yields is currently extremely high. We would not expect any material fall in government yields unless the outlook for equities and concurrent volatility deteriorates. This seems unlikely to occur in any sustained fashion near term.
- The corollary to this of course is the tight level of credit risk premiums in the corporate bond market. Spread widening in recent years has mainly been associated with a fall in government yields as opposed to an outright rise in corporate bond yields. We don't expect this to change soon and with little new issuance scheduled, we believe risk premiums will be range bound over the summer. The same applies to emerging market debt. With regard to stock specific issues we expect corporate activity to remain at elevated levels, and prefer to hold the majority of our riskier positions in bonds with very strong covenants.

Equity

- Until February of this year, global equity markets enjoyed a remarkable run lasting some seven months. In fact this was the longest rise in the S&P 500 for instance, without a correction of 2% or more, for 50 years.
- The S&P itself is increasingly seen as the barometer of global risk appetite and most risky asset returns have become highly correlated to the S&P. What lies behind this remarkable run apart from the fundamental backdrop, is the level of the free float on the US stock market. During the final quarter of 2006 there was a net reduction in the float of US equity of some \$400bn, or 2% of total market capitalisation.
- A lack of IPO issuance due to burdensome regulation (Sarbanes-Oxley) and extraordinarily large share buy back programmes has created this environment. With regard to the latter the relative cheapness of debt capital compared with equity is encouraging companies to gear their balance sheets. This phenomenon is not confined to the US, but is occurring in other developed markets where M&A activity from Private Equity investors is prevalent.
- More efficient balance sheet construction (via enhanced gearing) is often a sign of excess in the stock market. We have not changed our core view on stocks, but are mindful that these shifts in structure can lead to problems when interest rates rise. We still favour stocks over bonds but maintain a keen focus on developments in the micro-economy.

US

- The US equity market is threatening to break up through the highs attained at the peak of the bull market in 2000. Indeed the Dow Jones 30 index has exceeded it. Companies included in this index are currently reaping the benefits of a weaker US dollar, as almost half of the constituents' profits are sourced from overseas.

Key forecasts

	US	Japan	Euro zone	UK	China	Global
GDP rolling 12m forecast	2.5	2.4	2.1	2.6	9.7	2.8
Consensus	2.5	2.4	2.1	2.6	9.7	2.8
CPI rolling 12m forecast ¹	2.3	0.58	2.0	2.0	2.6	1.9
Consensus	2.3	0.3	2.0	2.0	2.6	1.9
Current Base Rates	5.25	0.50	3.75	5.25	6.39*	–
Monetary Policy (3m)	5.25	0.50	4.00	5.50	6.39*	–
Monetary Policy (12m)	4.75	1.00	4.25	5.25	6.39*	–
10 Yr bond Yields (12m)	4.65	2.10	4.20	4.80	n/a	–

¹core rate *PBOC 1 year Yuan Lending Rate

Source: Aberdeen Asset Managers Ltd

Asset allocation

	Deviation (%)
Equities	0.0
- UK	(3.0)
- US	(3.0)
- Japan	1.0
- Europe	1.0
- Asia	2.0
- Emerging Markets	2.0
Fixed Income	(2.5)
- UK	0.0
- Non-UK	(0.5)
- Index Linked	(2.0)
Property	1.5
Cash	1.0

Source: Aberdeen Asset Managers Ltd

- The S&P 500 which is a more representative index of the progress of US stocks may well stall at the 2000 highs of 1527. However we feel that this is unlikely to be a permanent barrier as companies are in substantially better shape, valuations are much lower and liquidity is more supportive.
- Whilst earnings momentum is declining in the US due to a weaker economy the potential for US stocks to underperform other markets still exists but this is becoming more marginal. We remain underweight in global portfolios but are looking for opportunities to increase our weight.

Europe including UK

- In the UK market Private Equity funds continue to play predator. A continuation of this trend reinforces our arguments discussed above, specifically with regard to the reduction in the supply of equity. Until the cost of credit rises, the access to capital markets diminishes or valuations make deals uneconomical, this trend is likely to push the market higher.
- European stocks remain underpinned by the improving macro-economic backdrop. We feel comfortable that consensus profits forecasts will be met, and therefore that valuations are the least demanding here of all the developed regions. We remain overweight.

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Japan

- Corporate activity in Japan is less prevalent than in western markets, perhaps accounting for some of the divergence in performance. Although there have been some instances of late in the form of Pentax (camera manufacturers) and real estate company Da Vinci Advisors, Japanese management on the whole are still opting to protect themselves by introducing anti-takeover measures such as poison pill strategies, rather than focusing on raising value.
- Without the wave of Private Equity bid speculation nudging prices ahead, stock selection is of utmost importance here. Against other Asian companies, the market offers limited value, although on a global basis we feel the relative case is more compelling due to better earnings momentum and we hold a slightly higher weight than the benchmark.

Global Emerging Markets

- If our view surrounding moderate progress in global equity markets is correct then global emerging markets should continue to perform albeit in a less dramatic fashion than in 2006.

Asia

- Whilst developed markets are being starved of equity float, this is not the case in the developing markets. Amongst those listing recently was the China CITIC Bank, the seventh largest commercial lender on the mainland. In India various companies are set to extract further funds from the market to support development and/or investment.
- Local Chinese indices however are clearly over heating, to the extent that government officials see the need to comment as such. Within Asia we are underweight to China, with exposure to the country via Hong Kong listings. Indian stocks have posted generally positive results in April, and whilst the domestic economic environment is slightly more uncertain, we believe that this will not thwart further progress.
- The same is true of Australia, Indonesia, Malaysia and Korea which all made new highs in the month. We continue to focus on stocks which meet our quality criteria, in an effort to mitigate any impact from unforeseen macro-economic events.

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