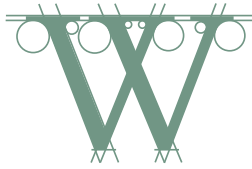


Challenges ahead as economic growth nears peak

July 2010



While the precise economic impact of the current sovereign crisis will take some time to become clear, the weight of the evidence now suggests that we are close to a peak of the rebound in economic growth. On a global basis we see significant challenges ahead, with many governments embarking on fiscal tightening.

The recent meeting of the G20 marked a turning point, and fiscal austerity now appears to be the policy of choice. This brings with it risks to growth, although official interest rate policy is likely to be kept loose in an attempt to ensure that fiscal adjustment does not cause too damaging a slowdown. In addition to fiscal tightening, household and financial sector deleveraging will reduce the average growth rate of the G4 economies over the next few years. The world is therefore increasingly reliant on emerging market economies as the future drivers of global economic activity.

With regards to inflation, we expect the global environment for inflation to remain subdued throughout 2010 as output gaps remain large and high levels of unemployment are limiting wage growth. This is reflected in the market for global inflation-linked securities, where inflation expectations, as reflected in short-dated bonds, have all but disappeared. We do not expect a sustained pickup of the market's inflationary expectations, and in fact deflation could become a real concern. The UK is the exception, where consumer prices have exceeded the Bank of England's forecast for some

time now. The VAT hike in January 2011 is likely to add approximately 1% to inflation over the short term.

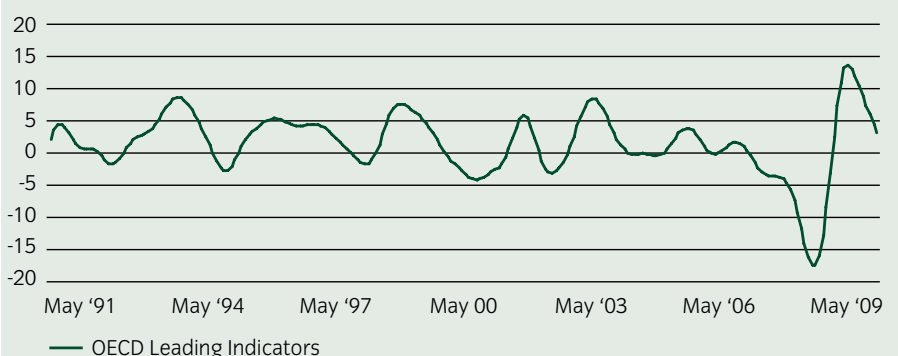
Growth to slow

We expect to see growth in the US slow from current levels, although on balance we believe that a double dip will be avoided. The housing market is struggling once more. In addition, the stimulus to growth from the rebound in activity from a very low base is going to fade. Car sales leapt 80% last year and clearly this impetus cannot be sustained, particularly when the consumer is also going to feel the pinch from upcoming fiscal tightening.

We expect the Federal Reserve to maintain rates at current levels during the remainder of 2010 and thus it is likely that the treasury market will remain well supported.

In Continental Europe, the high debt levels of the Southern European economies have been a focal point for many months now. In response, unprecedented support measures have been put in place. However, it still remains to be seen whether these measures will dispel the fundamental doubts about the creditworthiness of these countries. Overall, given the difficult conditions in the eurozone, where growth is at best anaemic (we have recently reduced our

Chart 1: OECD G7 leading economic indicators (6m % change)



Source: Insight and OECD.

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European growth forecasts), we do not expect the ECB to make any changes to interest rates, which are currently at 1%. Yields of the core European countries, led by Germany, are likely to continue to remain low, while yields on peripheral European bonds will remain volatile.

Future UK rate rises likely

In the UK, with the emergency budget out of the way, the gilt market is now free to go back to trading on economic fundamentals rather than politics. The Conservative-Liberal coalition, while still in its infancy, appears to be working effectively to formulate UK policies. Bond investors were expecting fiscal tightening in the emergency budget towards the end of June, and there was little disappointment. We believe that the measures outlined in this budget will, for now, address rating agencies' concerns for the safety of the AAA rating. Fears of prolonged high levels of gilt issuance have also been assuaged. We are forecasting growth of 1.0% in 2010 and 2.0% in 2011. Certainly, while interest rates are not likely to change for the rest of the year, we believe that the market will start to price in an interest rate rise next year, potentially for early 2011. While we are forecasting slightly higher gilt yields across the curve 12 months from now, the risk in the short-term is that gilts

continue to rally as they continue to serve as a safe haven and benefit from the improved sentiment around reduced issuance levels. Therefore in terms of duration and curve positioning, we will continue to position ourselves tactically over or underweight as and when opportunities present themselves.

Volatility in risk assets

The second quarter of 2010 was a tough quarter for risk assets. However, while market conditions seem to be improving, the risks remain elevated. Nevertheless, we believe that there is value to be had in investment grade corporate bonds at these levels (chart 2). Our favoured sectors include financials (primarily lower tier 2 bank paper and insurance), basic industrials, consumer non cyclicals and media. In terms of underweights, these include consumer cyclicals, utilities, highly subordinated financials, pharma and tobacco. Once the market stabilises, we will look to increase exposure to credit risk.

Emerging market debt is likely to remain dominated by global trends in the near term. Risk asset markets remain under threat from fears of a double dip recession, with tightening fiscal policy coupled with the potential for trade barriers being erected, posing a real, if unlikely, threat to risk assets.

In high yield and loans, market conditions have deteriorated more than in investment grade, as would be expected in a risk-averse environment. In high yield, fears of outflows, together with the changeable economic background and poor liquidity over the summer, means that we are unlikely to see any significant rally before the new issue market reopens in September.

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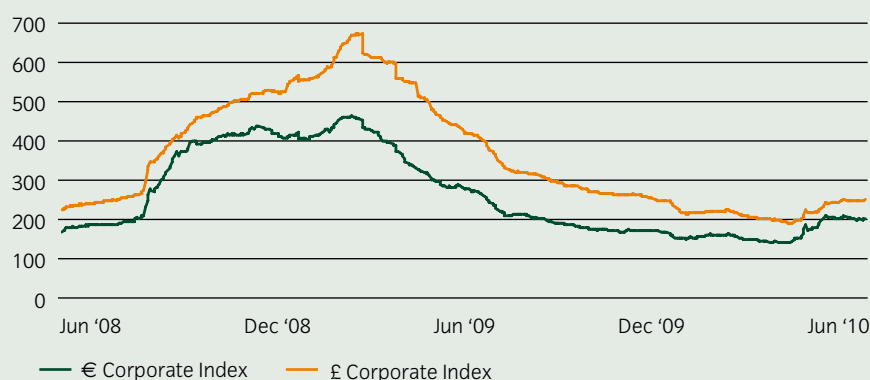
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Chart 2: Euro and Sterling corporate bond spreads (bps)



Source: Insight, Merrill Lynch.

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