



# MONTHLY REPORT

DECEMBER 2009

## ASIA PACIFIC

Asian stocks were up across the board on signs that global economic growth will accelerate. The MSCI AC Pacific Asia ex-Japan Index rose 2.6% in USD and 1.3% in local currency terms.

The MSCI China Index rose 2.4%. The Chinese manufacturing purchasing managers' index rose the most in five years in December to a seasonally adjusted 56.1 (a level above 50 represents expansion). Sentiment in Hong Kong was also boosted by strong Chinese economic data. The Hang Seng gained 1.9%.

China's robust economic growth has led to persistent fears that the Chinese economy may overheat. But China's banking regulator stressed during the week that China's banks have more than enough capital and advocated an extension of credit to smaller companies and consumers.

Taiwan's exports climbed the most in 14 years in December, up 46.9% from a year earlier. Although exports rose from a low base, they are being fuelled by a global recovery that is boosting demand for computers, mobile phones and television screens. The TWSI added 1.1%.

Australia's All Ordinaries rose 1.2% amid mixed economic data. On the positive side, retail sales increased 1.4% in November, the most in eight months, while home building approvals leapt 59% over the same period. On the negative side, reports showed that Australian manufacturing activity had contracted in December for the first time in five months and that activity in the services sector had also stalled.

Korea's KOSPI was 0.7% higher, while Singapore's Straits Times edged ahead by 0.9% despite a larger than expected 6.8% annualised contraction in fourth-quarter GDP.

## JAPAN

The country's Finance Minister resigned due to ill health and was replaced by Deputy Prime Minister Naoto Kan – Japan's sixth Finance Minister in just 18 months. Kan immediately faces the task of trying to tackle renewed deflation and prevent Japan from dipping back into recession.

The TOPIX ended the week 3.7% higher. Japanese exporters received a welcome boost as the yen hit its lowest level against the US dollar since August. There were also positive signs from the auto sector, as Japanese car sales rose for the fifth straight month in December.

Despite the year-end rally, the performance of the Japanese stock market in 2009 could be considered disappointing given the market's historic relationship with global economic activity. Sustained yen strength, a sharp rise in unemployment and political indecisiveness were the most marked differences from previous economic rebounds, and each contributed negatively to investor sentiment as attention shifted to more rapid recoveries in the emerging economies around the Asian region.

We believe these factors are set to reverse during 2010. The yen strength has largely been a consequence of more drastic quantitative easing elsewhere and will reverse when overseas central banks look to exit these abnormal policies.

Japan has, however, slipped once again into deep deflation; hence the Bank of Japan is unlikely to alter its policy in a comparable time frame. These policy disparities will result in a weakening of the yen, more consistent with the longer-term concerns about the fiscal deficit.

The high expectations for the newly appointed DPJ Government have been unfulfilled so far due to the severity of the economic downturn and the need to pacify junior coalition parties in the Upper House. The immediate focus for the Prime Minister, Mr Hatoyama, is to secure a majority in the Upper House election in July 2010, which will allow the DPJ to proceed more smoothly with the promises of its election manifesto.

## UNITED STATES

---

Wall Street made a bright start to 2010, with the S&P 500 rising 2.7% to end the week at a 15-month high. The Dow Jones was up 1.8%, while technology stocks joined in the rally as NASDAQ climbed 2.1%.

Equities were helped by a further drop in volatility. The Chicago Board Options Exchange Volatility Index (Vix) fell to its lowest level since before the collapse of Lehman Brothers in September 2008 – suggesting that investor confidence has recovered from last year's financial crisis.

Mining and oil-related stocks paced the stock market rally as hopes for a strong global economic recovery boosted commodity prices. Oil prices rose back above USD 80 per barrel to end the week at their highest level since October 2008.

Corporate activity also helped boost sentiment. In the energy sector Chesapeake Energy rose after agreeing to sell a quarter of its Texas shale gas business to French oil group Total to form a joint venture worth as much as USD 2.25 billion.

Swiss drug maker Novartis struck a deal to buy out minority shareholders in US eye care group Alcon for USD 11.2 billion in equity. Meanwhile, Kraft Foods sold its frozen pizza business to Nestlé for USD 3.7 billion, using the proceeds to sweeten its offer for UK confectioner Cadbury.

Economic data, meanwhile, was mixed. The latest surveys from the Institute of Supply Management showed that the US services sector had returned to growth in December after contracting in November, while manufacturing activity increased last month at its fastest pace since April 2005.

Factory orders also rose more than expected, up 1.1% month on month in November. However, optimism over the strength of the recovery was tempered by employment data released at the end of the week, which showed non-farm payrolls had fallen by another 85,000 in December compared to expectations from many investors for a small rise in hiring.

Housing market data was also disappointing, with pending sales of existing homes down by a record 16% in November over the previous month as a government tax break expired.

Despite the mixed economic data investors appear to remain upbeat. Clearly the economic outlook is brightening, but the uneven nature of the recovery should help keep interest rates low for an extended period and ensure that the authorities don't remove stimulus programmes too early. In the minutes from the last Federal Open Market Committee meeting the Federal Reserve reassured the market that it would continue its bond purchase programme beyond its March deadline should the economy weaken.

## EUROPE

---

European equities got off to a positive start in 2010, with the MSCI Europe Index ending the week 2.2% higher at its best level since October 2008.

Among the major markets, the French CAC 40 led the way with a 2.8% increase, followed by a 2.4% rise for Italy's S&P/MIB and a 2.2% gain for the UK's FTSE 100. Switzerland's SPI was up 1.5%, while Germany's DAX ended the week 1.3% higher.

Positive Chinese economic data boosted mining stocks as metal prices pushed ahead, while oil prices surged to a 15-month high on the back of cold winter weather in Europe and North America, helping provide good support to energy companies.

Takeover news provided a boost to sentiment as Novartis bought Nestlé's stake in US eye care company Alcon. Nestlé said it would use the cash to finance a SFR 10 billion share buyback programme.

Economic news was broadly positive – particularly in the UK where the latest manufacturing purchasing managers' index hit a 25 month high in December,

while mortgage approval surged to their highest level since March 2008.

German industrial production was also up in November, although the 0.7% month on month rise was a little less than expected. Eurozone inflation for December was in line with expectations, rising 0.9% year on year, reinforcing hopes that the European Central Bank would keep Eurozone interest rates on hold in the near term and help ensure that the regional economic recovery takes root.

## GLOBAL EMERGING MARKETS

The MSCI Emerging Markets Index strengthened by 1.7%. Most markets were up on a wave of New Year optimism.

In Emerging Europe the Czech Republic's PX posted a strong 3.6% gain. Exports have been boosted by revived demand from Western Europe, helping the country record a trade surplus for the 11 months to November 2009.

Hungary's industrial output declined less than forecast in November, dropping 9.3% from a year earlier. The BUX surged 4.6%. Meanwhile, Poland's WGI rose 2.3%.

In Latin America, Brazil's factory output surprisingly fell in November for the first time in nearly a year. However, investors still expect Brazil's economic growth to strengthen this year. The BOVESPA recorded a 2.4% increase over the week.

Mexico's IPC also delivered a 2.4% rise, with investors hopeful that a broad-based recovery in the US economy this year would boost US demand for Mexican exports.

## BONDS & CURRENCY

A record USD 17.5 billion plunge in consumer credit, a 16% decline in pending home sales and a net 85,000 jobs shed in the US economy alongside a 1.2% contraction in Eurozone retail sales and an unexpected fall in UK consumer confidence were not exactly what investors had hoped or expected to see in their first week back after the holiday period.

But last week's data disappointments were, in our view, symbolic of the choppy and at times nerve-wracking nature that this recovery is likely to have, rather than necessarily causes for doubt over whether or not it can be sustained.

However, it could even be argued that these developments were good news: slow growth will keep monetary policy supportive, subdued hiring will buoy corporate profits and debt paydowns will help to repair household balance sheets.

The Icelandic government called a referendum on a bill that would see the country repay some USD 5.5 billion to the governments of the UK and the Netherlands to cover losses suffered on deposits made with internet bank Icesave. Given the stern public opposition to the bill and rising probability of default, Iceland had its long-term foreign currency issuer default rating lowered to junk status by rating agency Fitch, while Standard & Poor's said it could cut the country's rating by one or two notches in the next month.

Rates on Icelandic credit default swaps surged by close to 100 bps. While in itself a potential default by the tiny island nation may not have major repercussions for global markets, the lack of fallout from the downgrade was reassuring, especially given the growing concerns around the more indebted Eurozone countries.

The spread between 10-year government bond yields in the so-called PIIGS (Portugal, Ireland, Italy, Greece and Spain) of the Eurozone and Germany even managed to end the week some 8 bps tighter, while yields in other large deficit countries such as the US and UK were also unaffected.



Markets were also able to shrug off a small rise in Chinese three-month bill yields, the first in over four months, which increased from 1.33% to 1.37%. Although the Chinese authorities may be unwilling to see interest rates and the value of the currency increase materially in the near term for fear of damaging trade competitiveness, the larger-than-expected 17.7% yoy surge in exports for December, which saw China overtake Germany to become the world's largest exporter, may make revaluation marginally more probable.

Indeed the forward market priced a 0.8% increase in the expected degree of RMB appreciation over the next twelve months. Chinese currency revaluation (and corresponding weaker demand for US Treasuries) remains one of the potential event risks of 2010, but a gradual adjustment may ultimately be less disruptive to markets than a sharp one.

#### GENERAL ADVICE WARNING

*so far as the law allows, the author disclaims any warranty or representations to the accuracy or reliability of the information and statements in this document. the author expressly advise that it shall not be liable in any way whatsoever (whether negligence or otherwise) for any loss or damage which may be suffered by any person relying upon such information or conclusions contained in this document or otherwise arising in connection with the contents of or any omission from this document except where a liability is made non-excludable by legislation. this document does not purport to contain all relevant information and any statement as to any future matter is a present prediction of possible future outcome the accuracy of which cannot be guaranteed. the author has not knowledge of the readers specific investment requirements and therefore recipients should not rely upon the contents of this document but should make their own assessment and evaluation, undertake an investigation and enquires and seek advice to enable them to make any decision concerning their own risk.*