ECONOMIC AND MARKET COMMENTARY FROM FIDELITY

GLOBALWATCH

JUNE **2009**

Fidelity INTERNATIONAL

EMERGING VERSUS DEVELOPED MARKETS

EDITORIAL

The recent market rally has been welcomed by weary investors, but the nature of it has also brought an uncomfortable sense of déjà vu. A rally in cyclical stocks led by emerging markets - it feels uncannily like we have stepped back a few years to the days of the 'raging bull'.

So what should investors do? And, which markets should they be targeting? Emerging markets have outperformed developed markets since the October lows of last year. Could decoupling be for real this time around?

RECOVERY? YES, BUT FROM A LOW BASE

The market recovery so far has been somewhat narrowly based on bank recapitalisations and an inventory recovery rather than sustainable growth. The better-than-expected trend in economic data is more a function of how bad things got in the fourth quarter of last year.

Companies liquidated inventories sharply in what was a severe economic downturn. However, the pace of liquidation only needed to moderate for it to become a positive contributor to GDP growth. Manufacturers are now responding to an upturn in new orders, from a low base, by resuming production and replenishing stocks. Historically, when monetary and fiscal stimulus is applied, asset prices respond before the economic data does. Just as they do at the onset of every bull market, investors will have to climb a 'wall of worry' with each data release either confirming or reshaping the market's trajectory.

After the most serious financial crisis of modern times, it would be foolish to assume that markets will rise in an uninterrupted trend from here. However, the worst seems to be behind us in terms of systemic financial collapse and, while periods of consolidation are likely, long term investors should be scaling into a market that seems intent on fighting its way higher.

FIRST IN, LAST OUT?

So where should investors be putting their cash to work? Early optimism that the US economy could recover quickly based on the first-mover principle seems to be dissipating, as fears mount over the sheer size of US government debt. Unprecedented stimulus implies unprecedented problems; by many yardsticks, the US economy is in bad shape, running huge government and external trade deficits and the dollar has been in retreat.

Some economists expect the US to see a period of sub-trend growth, as consumers rebuild savings by spending less. Others believe that higher savings may not necessarily restrain the economy because the government stimulus already in place should compensate for any decrease in private sector spending.

Federal Reserve Chairman, Ben Bernanke, admitted the US revival would "only gradually gain momentum". Endorsing government measures as "necessary and appropriate", he conceded that the budget deficit threatened the country's financial stability and warned that the government could not continue to borrow indefinitely at the current rate.

Recent market action in Treasury bonds has reflected these concerns. Yields moved up amid speculation that foreign central banks were using buybacks to exit Treasuries, counteracting the desired impact of quantitative easing. A sustained upward move in Treasury yields combined with a downward trend in the dollar could quickly become big problems for the US. This explains why gold has remained relatively strong despite the rally in risk markets.

THE APPEAL OF HARD ASSETS

Investors are becoming increasingly preoccupied with the potential consequences of recent government actions. With the pendulum swinging towards higher inflation risk, unintended consequences seem likely.

For instance, as the Fed expands the money supply, emerging economies are beginning to call for an alternative to the dollar as a reserve currency. This is because significant inflation in the US would cause great damage to countries that hold dollar assets in their foreign exchange reserves.

Already, rising commodity prices are reflecting not just bouncing demand from a low base, but a preference for hard assets on the part of investors. Indeed, governments may be in the process of inadvertently reigniting the old boom in an effort to delay further economic pain till some future date.

The beneficiaries of these trends seem to be commodities and emerging markets. The banking crisis and western governments' reactions to it may have accelerated the shift of power to the east and to the emerging markets.

A RETURN TO DECOUPLING?

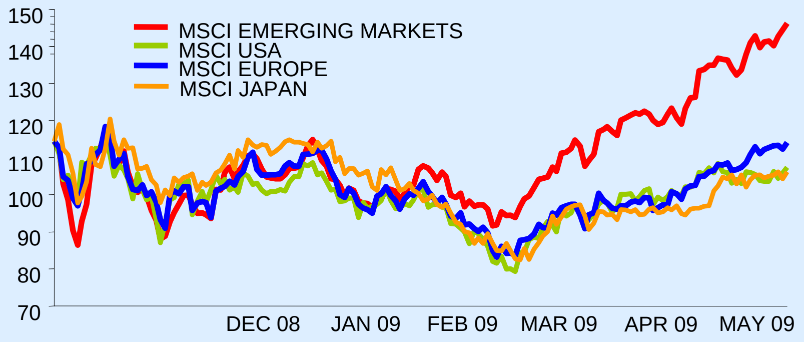
It seems you just can't keep a good investment concept down. Decoupling is back. Based on the premise that emerging markets can generate their own secular growth regardless of events in the developed world, it became fashionable towards the end of the 2002 to 2007 bull market.

However, the decoupling thesis took a battering in 2008 when the western-inspired credit crunch caused emerging markets to fall just as hard as their developed cousins. If emerging markets were a genuine refuge from the problems in the west, they should have outperformed.

In October last year, however, there may have been a genuine disconnect. Emerging markets hit a bottom and started to rally months before other risky assets. The realisation that emerging markets were now a different economic proposition seemed to prompt investors to believe in decoupling again.

Initial fears of contagion caused capital to be repatriated back to developed countries, forcing up the cost of debt and pushing down currencies in emerging markets. However, stronger economic fundamentals than ever before in Asian and Latin American economies enabled them to weather the crisis and restore confidence. Brazilian sovereign debt is now less risky than Ireland's.

EMERGING MARKETS HAVE OUTPERFORMED SINCE THE OCTOBER LOWS



Source: DataStream, as at 12.06.09
Returns quoted in USD

THE POWER OF CHINA

The Chinese government's huge fiscal stimulus program has also played a key role in the emerging market recovery story. In an economy that is still largely state-controlled, this flood of government money seems to have been effective. Banks have been lending aggressively and industrial commodities, particularly metals like copper, have risen strongly in recent months.

Some observers are even taking the view that China has saved the world from depression. Time will tell. Pessimists argue that China is merely creating excess capacity and that the demand for industrial metals may be artificial, as a physical hedge against dollar weakness. Then again, China may just be on track to become a great economic power by building links to its interior and unleashing its buying power.

In recent years, there has been a flood of capital into Chinese banks, which is laying the foundation for a consumer-driven boom. As China increasingly leads world growth, and becomes a hub for capital flows, we could also see a change of leadership in financial markets. Shanghai and Hong Kong will increasingly compete with New York and London. Chinese authorities recently confirmed plans to allow foreign companies to list shares on their stock market. This comes at a time when New York and London have to contend with increased regulation and, at least for the time being, outright government intervention.

CONCLUSION

The asset allocation decision is one of the most important facing any investor, given the large differentials in return that can occur between stock markets. Emerging markets have outperformed their developed counterparts comfortably over the last ten years and much of the evidence points to this trend continuing. But investors should beware of simply extrapolating the past into the future. Developed markets and economies have been battered by the most serious financial crisis of modern times. Emerging markets are still largely dependent on developed markets as a source of demand. We are in uncharted territory and the road towards full recovery could be more protracted and much less linear than many expect.

The size of the government stimulus is unprecedented and its consequences remain uncertain. Investor expectations are driving moves into hard assets as a hedge against inflation that has barely appeared yet. The sensible choice for investors is to diversify between emerging and developed markets.

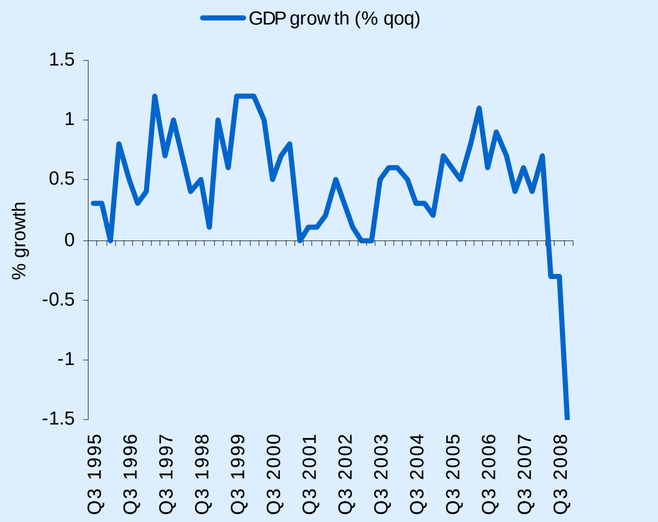
In twenty years time, the balance of power in the world economy is likely to be very different and it is important that investors have exposure to these developing themes. However, it is not always necessary to invest in a region directly to get access to its growth. Indirect investment in developed companies that stand to benefit is a powerful approach, as is investing in global sector funds which target the energy, materials and industrial sectors which are geared to the industrialisation of emerging markets.

EUROPE

ECONOMY

Macroeconomic indicators were mixed, though the data seemed to suggest a slowdown in the pace of decline in economic activity. As per the flash estimate by Eurostat, consumer prices in the eurozone stopped rising in May, with annual inflation at 0.0%, igniting concerns that prices will fall in the months ahead. However, the European Central Bank president Jean-Claude Trichet stressed that short term price volatility is not a factor in the bank's decisions, and with oil prices on the rise again, a deflationary episode is unlikely to last long. Eurozone economies shrank by a record 2.5% in the first three months of the year as recession battered the continent. However, more recent data releases showed that the region's services and manufacturing sectors contracted less than expected in May as the pace of the fall in new orders eased. Both the European Commission's Economic Sentiment Index and the German Ifo Business Confidence Index rose for a second consecutive month.

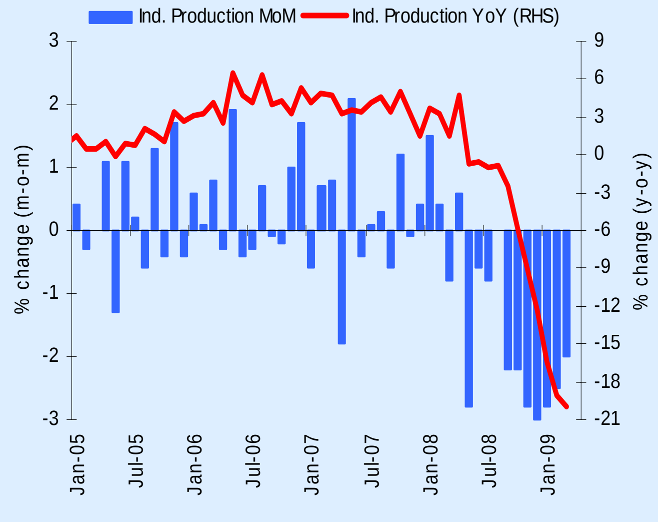
EUROZONE GDP FALLS



Source: Datastream, May 2009

- The eurozone economy contracted at a sharper rate than estimated in the first quarter of 2009. Real GDP fell by 2.5%, marking the fourth consecutive quarterly slump. The decline in GDP was driven in part by a record 3.8% contraction in the region's largest economy, Germany, as demand for its high value goods, such as cars and machinery, collapsed.
- Nevertheless, there are signals that the worst of the recession is probably over, although there is still limited evidence it will end any time soon. Sentiment indicators have turned the corner, signalling that the speed of the decline in economic activity is slowing. The huge impulses from monetary and financial policies are now expected to start taking effect. Furthermore, the outlook for exports should be healthier again in the second half of the year.
- Economists believe that the contraction will be much smaller in the second quarter of 2009 and the eurozone economy should stop shrinking in the second half of the year. The European Commission also maintained its view that stabilisation will take hold, followed by a gradual recovery in 2010, as set out in their spring forecast.

PACE OF CONTRACTION SLOWS



Source: Bloomberg, May 2009

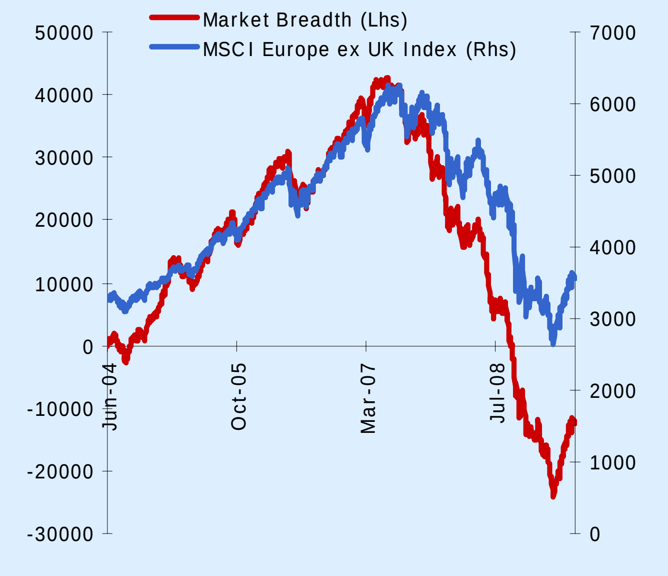
- European industrial production declined for the 11th consecutive month in March as the recession forced manufacturers to cut costs. Output fell 20.2% from a year earlier, the biggest decline since records began. In March, production fell 2.0% from February, and the pace of decline was slower than the previous months. At a country level, output declined by 21.7% from a year ago in Germany and by 15.9% in France.
- The weakness was broad based; output in the most cyclical sectors such as intermediate goods and capital goods fell notably, while non-durable consumer goods output, whose demand is somewhat less cyclical, declined at slower pace. On a positive note, the euro area PMIs posted another strong rise in May. The overall manufacturing index posted its biggest ever one month increase, rising 3.7 points to 40.5.
- Likewise, the industrial confidence indicator from the European Commission reported a similar trend, rising in April from its all-time low in March. Both indices remain very low by historical standards. Nevertheless, these are initial signs of improvement. Meanwhile, although new orders continued to decline, the pace of contraction has clearly abated and with inventories significantly reduced in most sectors, any upturn in demand will feed quickly through to increased production.

EUROPE

EQUITY MARKET

European equities advanced for a third straight month in May due to optimism that stock markets and economies may have been through the worst and are now on a path towards recovery. Energy and materials firms were boosted by higher crude oil and metal prices. Financials were supported by broker upgrades and news that several institutions were seeking to return government funds. Investors continued to rotate out of defensive areas, which prompted the underperformance of healthcare firms. The automobiles segment declined, faced by mixed news on the bankruptcy of General Motors and Fiat's interest in Chrysler. Larger companies lagged their smaller peers.

MARKET BREADTH IMPROVES



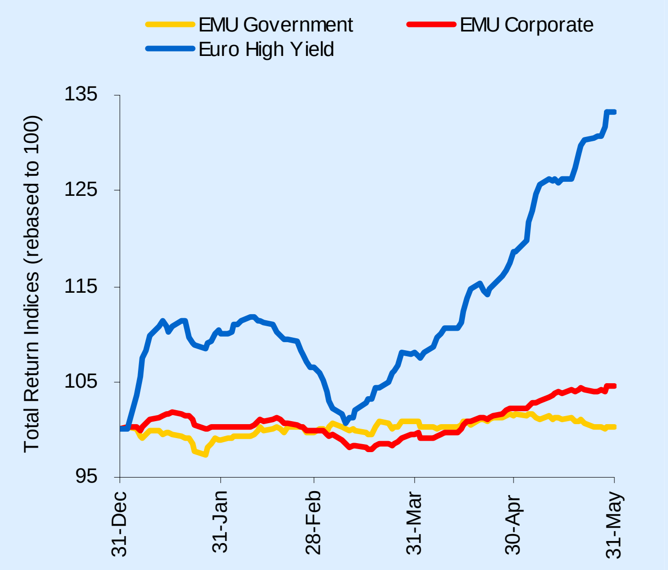
:Source: Datastream, May 2009

- The cumulative "advancers less decliners" (A/D) line for the European equity market has started showing an upward trend since March this year, which indicates better market breadth. Over the last five years, the number of shares that ended in positive territory exceeded those finishing lower, except in 2008, when the direction was reversed. However, since March of this year, each month has witnessed more stocks that moved higher than falling ones. This indicates an improving market breadth, or in other words, an increase in the pool of rising stocks.
- Improving market breath and lower volatility has boosted the confidence of investors, who are coming back to stock markets that now offer some relative stability. Equities in the region have generated double digit returns over the last three months.
- The close correlation of the A/D line with the MSCI Europe ex UK index means that shares have risen irrespective of fundamentals. Bottom-up stock pickers have therefore not been well rewarded in this environment as the weakest companies have often led market gains. However, history shows these trends rarely continue for long and in-depth research of companies combined with the willingness to take non-consensus positions will once again be critical to outperforming the market.

FIXED INCOME MARKET

European government bonds ended lower in May as resurgent risk appetite reduced demand for the relative safety of fixed income and investors speculated that the worst of the recession might be over. On 5 June, the European Central Bank (ECB) left interest rates unchanged at 1% and ECB President Jean-Claude Trichet stated that interest rates are "appropriate". He added that the bank would complete its proposal to buy €60 billion of covered bonds in the primary and secondary markets by June next year.

HIGH YIELD BONDS OUTPERFORM



Source: Merrill Lynch, May 2009

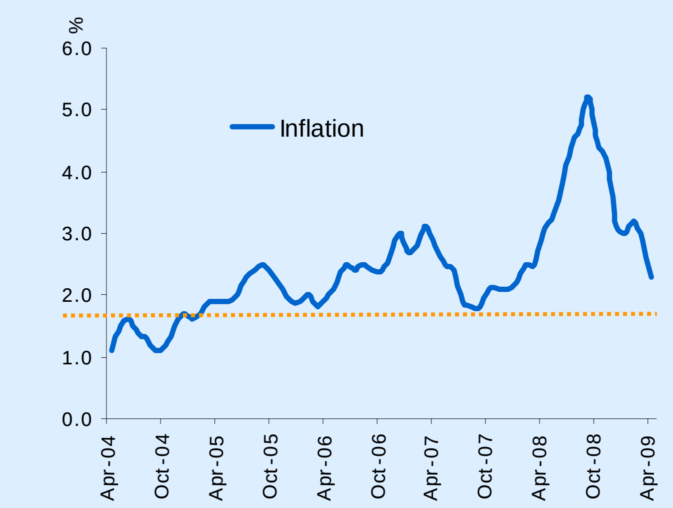
- Towards the end of the month, ECB President Jean-Claude Trichet said that the bank has ensured that rapidly falling inflation rates would not cause a slump in price expectations. However, European consumers expect prices to fall more steeply over the next 12 months adding to evidence that deflationary pressures are building in the region. In its latest survey of economic sentiment, the European Commission said that a gauge of euro-area consumers' price expectations reached a record low of -7 in May, after turning negative in April for the first time.
- Government bonds ended lower in May, posting -1.2% returns. Investment-grade corporate bonds returned 2.3% outperforming government debt. Within investment-grade, AAA- rated securities generated -0.1% returns underperforming BBB-rated bonds which returned 3.9%. Meanwhile, sub-investment-grade bonds returned 12.5% and were the best-performing bond class (see chart).
- Over the month, the European yield curve steepened as yields on long-dated bonds rose more than those on short-dated paper. Yields on two-year government bonds rose by 0.08 percentage points to 1.42%, while those on 30-year maturities rose by 0.46 percentage points to 4.36%.

UNITED KINGDOM

ECONOMY

Economic news continued to be gloomy. Unemployment jumped in the first quarter by the most since 1981 as the recession forced companies to cut workers. The number of jobless rose 244,000 in the three months through March to 2.22 million, the highest level since 1996, the Office for National Statistics (ONS) revealed. Meanwhile, the Confederation of British Industry's (CBI) latest survey of retailers showed that retail sales deteriorated in May. A separate CBI survey noted that demand for goods made in the UK remained weak in May, although manufacturers were more optimistic than at any time since September 2008. Against this backdrop, the Bank of England's (BoE) policymakers voted unanimously to keep interest rates on hold at 0.5% and announced that it will inject an extra £50 billion into the economy. On a positive note, house prices rose 1.2% in May from April, offering evidence of improvement in the housing market, according to figures from the Nationwide building society. UK banks granted more mortgages in April than a month earlier, a sign the market for home loans is stabilising, the British Bankers Association said.

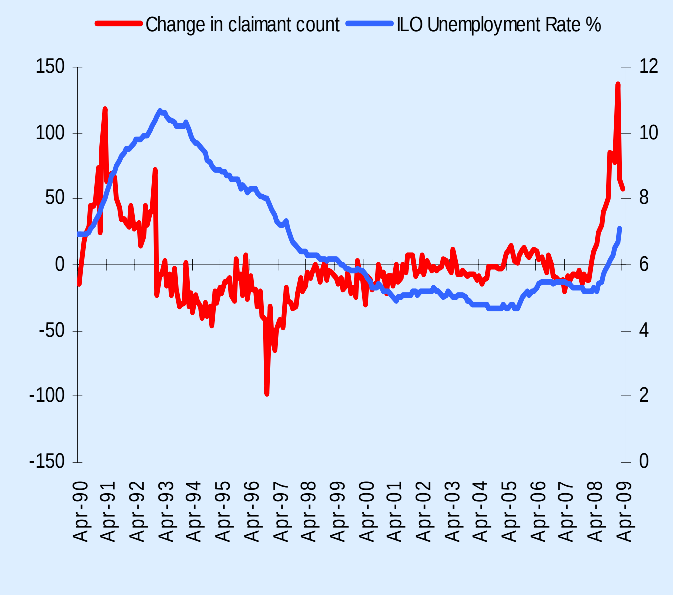
INFLATION DROPS FURTHER



Source: The Office for National Statistics, April 2004 to April 2009

- Annual consumer-price inflation slowed in April, while retail prices also dropped sharply, highlighting the strong deflationary pressures facing the economy. The Consumer Price Index (CPI) was up 2.3% from a year earlier, compared to a 2.9% rise in March, the ONS revealed. The Retail Prices Index (RPI), which is used for workers' wage settlements, fell further to -1.2% from -0.4%. The key difference is that the RPI measure includes mortgage costs, which have dropped significantly as the BoE cut interest rates over the past year.
- The drop in the inflation rate was led by housing costs as electricity and gas bills fell, the ONS said. The official CPI figure is still above the government's target of 2%, and the BoE expects it to drop further during this year. The central bank governor Mervyn King recently said that inflation will slow "sharply" as the recession creates slack in the UK economy.
- However, the risk of deflation, in which consumers put off purchases because they expect prices to drop, further weakening the economy, still looks remote. The BoE's policymakers kept the key rate unchanged in May and increased to £125 billion their plan to buy assets with newly created money to counter the threat of deflation.

IS THE WORST YET TO COME?



Source: Bloomberg, May 2009

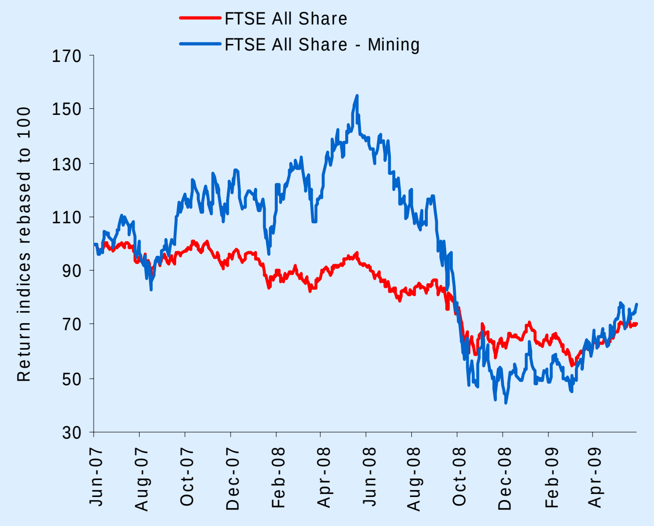
- Labour market conditions continued to deteriorate as sharp falls in industrial output over the last few months led to lower demand for labour. According to the data released by the Office for National Statistics, the number of people claiming jobless benefits rose 244,000 in the three months through March to 2.22 million. On a quarterly basis, the unemployment rate in the first quarter of 2009 increased to 7.1%, compared to 6.3% in the preceding quarter. Claims for jobless benefits rose by 57,100 in April.
- The sector with the largest quarterly fall in jobs was finance and business services, which shed 102,000 positions. The deterioration in the labour market had an impact on earnings too. Average earnings including bonuses fell by 0.4% in the first quarter from a year ago. Lower bonuses in the financial sector contributed to the negative annual growth rate. Average earnings excluding bonuses increased by 3.0% during the same period.
- The situation is expected to worsen over the months ahead. The Bank of England's (BoE) regional agents reported overall employment intentions remained weak and pay deals in excess of 3% were rare, while pay freezes were widespread. In its efforts to revive the economy, the BoE has already lowered interest rates to 0.5% since early October and increased bond purchases by adding £50 billion ($76 billion) to its quantitative easing program as the timing and strength of the economic recovery is "highly uncertain."

UNITED KINGDOM

EQUITY MARKET

UK equities extended their gains for a third consecutive month in May led by a strong performance from resources stocks and banks as positive US economic data suggested the recession may be easing. However, persistent concerns about the UK economic outlook, underlined by a downgrade from rating agency Standard & Poor's, prompted investors to take profits at regular intervals. The benchmark FTSE All Share returned 4.2% over the review period. Sector performance showed a mixed trend over the month. Mining and metals firms enjoyed strong returns supported by higher commodity prices. However, investors largely moved out of consumer-facing stocks as rising unemployment constrained spending.

HOPES OF RECOVERY BUOY MINING STOCKS



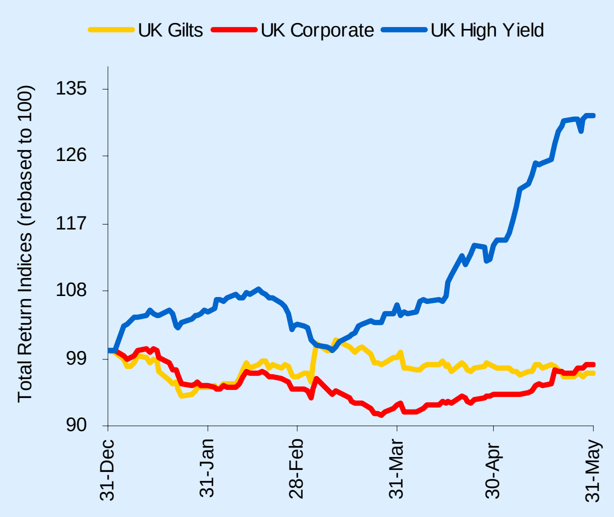
Source: DataStream, June 2007 – May 2009

- After a prolonged downturn, which lasted until mid-March, metal and mining firms are back in demand, fuelling the recent rally in UK stock market. Renewed hopes of a global economic recovery have led to increased risk appetite and higher investor interest in cyclical stocks. The upturn in mining shares reflects this optimism; the FTSE All Share – Mining index has returned 45.2% this year, compared to 4.1% for the overall market. Energy stocks also advanced over the period, with oil prices moving from $36 to $63 by the end of May.
- Trends in prices of metals, notably copper, have also increased as investors hoped that a potential recovery in the world economy, especially in China, could boost demand for metals and push up prices. Companies have been reluctant to add new supply due to the credit crunch, instead focusing on cost-cutting measures and shoring up their balance sheets through rights issues.
- Despite the recent rally, the near-term outlook for the sector remains cautious, with some analysts suggesting the revival has been premature. According to IBES, mining sector earnings will fall by nearly 46% this year, although a potential recovery in the global economy could lift average profits by about 14% next year.

FIXED INCOME MARKET

UK government bonds (gilts) ended May in negative territory for the second consecutive month due to a significant rise in stocks and an increase in risk appetite. Gilts were also subdued after Standard and Poor's changed its UK AAA ratings outlook to 'negative' from 'stable', citing the country's debt could reach 100% as a proportion of GDP. Meanwhile, in its meeting on 4 June, the BoE left its interest rate unchanged at 0.5% and decided to continue with its programme of asset purchases totalling £125 billion.

HIGH-YIELD DEBT SOARS HIGHER



Source: Merrill Lynch, May 2009

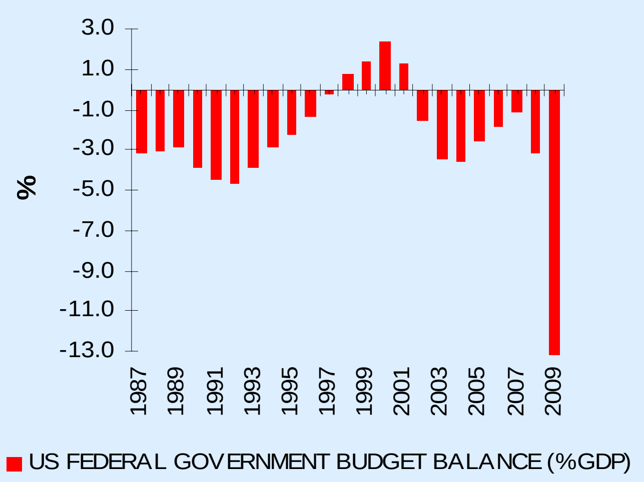
- In its quarterly inflation report released in May, the BoE said that the growth outlook continues to be clouded by exceptional uncertainty and reiterated concerns that it may take longer for bank lending to return to normal. Based on market interest rate expectations and £125 billion of asset purchases, the BoE said inflation is forecast to fall rapidly in coming months and then remain below the 2% target until the end of the forecast horizon.
- Gilts ended May in negative territory, generating returns of -0.9%. Investment-grade corporate bonds performed well, returning 4.3% and outperforming government-issued debt. Within the corporate bond market, AAA-rated securities were the worst performers across the credit spectrum and generated a return of 0.4%, while BBB-rated bonds led the way, returning 6.2%. Sub-investment-grade paper returned 15.2% and outperformed corporate and government debt (see chart).
- In May, the yield curve steepened, as yields on short- dated bonds rose less than those on long-dated paper. Yields on two-year maturities rose by 0.02 percentage points to 1.08%, whereas those on 30-year paper rose by 0.21 percentage points to 4.56%.

UNITED STATES

ECONOMY

On the economic front, revised first quarter GDP figures showed that the economy contracted at an annual rate of 5.7%, slightly less than the initially estimated 6.1%. Encouragingly, employers also cut fewer jobs in April although the unemployment rate rose to 8.9%. Of particular significance was the unexpected rise in consumer confidence in May, which boded well for future consumption activity, even though April registered a decline in retail sales for a second straight month. Meanwhile, housing woes continued, as an unexpected fall in housing starts and permits in April discouraged investors, while house price data for March also showed a decline.

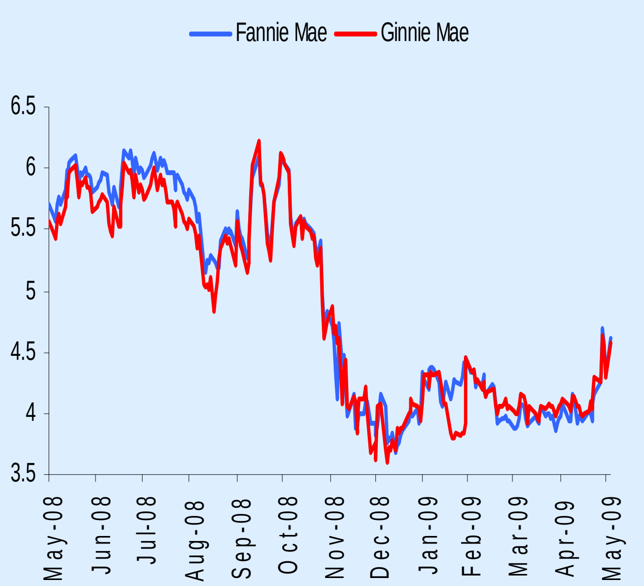
US DEFICIT: ADDED PAIN?



Source: DataStream, May 2009

- Ratings agency Moody's Investors Service has confirmed that the US government's triple-A credit rating is stable, despite a significant deterioration in the nation's debt. While this may come as a relief to investors spooked by a recent cut in Britain's rating outlook, it highlights real concerns: the deficit for the current budget year (ending Sept. 30, 2009) is estimated to be at an all-time high of $1.84 trillion; this is four times the size of last year's $454.8 billion deficit, which in itself was a record, and when considered as a share of the overall economy, the highest since 1945.
- However, these numbers must be put in context, particularly as they stem from efforts to counter acute financial market distress and economic contraction. Despite this, questions are being raised about the creditworthiness of the US and the defensiveness of the dollar. Recent fears that the US could lose its triple-A credit rating caused the dollar to depreciate significantly. It also highlighted other concerns: if foreign investors refrain from investing in US government treasuries, the cost of borrowing, which is linked to bond yields, may increase and oppose efforts to reduce mortgage rates and stimulate housing markets.
- Neverthless, the Obama Administration is mindful of the implications of a large deficit and is intent on halving it by the end of the presidential term. Also, the US remains a diverse and resilient economy, with high per-capita income, and a central position in the global economy.

MORTGAGE RATES RISE



Source: Bloomberg, May 2009

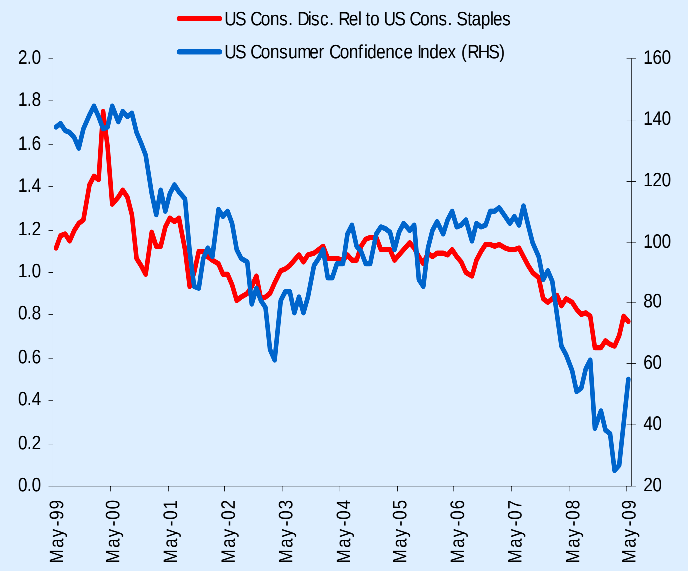
- After increasing last month, yields on Fannie Mae and Freddie Mac mortgage bonds soared further in May, pushing up interest rates on new home loans. The rise in mortgage rates was partly driven by a rise in US Treasury yields, which may temper a recovery in the housing market and challenge the Federal Reserve's (Fed) ability to stimulate the economy. US Treasuries are weakening amid concerns that record bond sales would overwhelm demand as US bailout and stimulus spending adds to the nation's debt burden.
- The Fed stated in March it would increase its planned purchases of agency mortgage bonds guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae by $750 billion, to as much as $1.25 trillion, and start buying government notes. Subsequently, equities markets gained amid optimism the global recession might be easing and banks stabilised while prices of bonds aside from Treasuries soared.
- According to analysts, the Fed's plan to buy as much as $1.25 trillion of mortgage securities has so far this year helped about two million more homeowners to refinance than otherwise would have been to the case. However, the rise in loan rates last month, may have undone about one-third of the increase in the affordability of homes to buyers.

UNITED STATES

EQUITY MARKET

Financial stocks led US equities higher in May, as 'stress test' results provided some clarity on the capital positions of major financial institutions. Encouraging economic data improved sentiment, prompting a run-up in oil prices, which boosted energy shares. Material stocks also gained ground after the US dollar weakened on fears that the triple-A rating of the US may be threatened by the mounting budget deficit and weak economy. Nevertheless, investors took comfort from the fact first quarter corporate profits increased 1.1% - the first increase in a year and a turnaround from a 10.7% drop in the fourth quarter. General Motors, however, readied itself for bankruptcy.

CONSUMER STOCKS: HAPPIER TIMES?



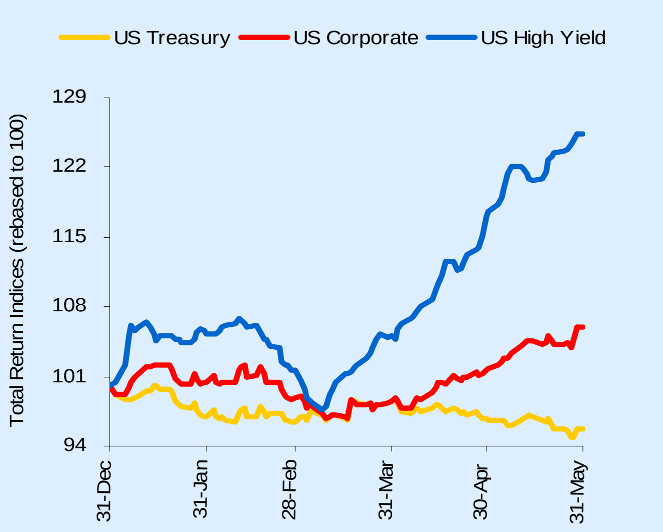
Source: DataStream, May 2009

- Consumer discretionary stocks have outperformed consumer staples by over 10% in the last five months. Signs of stabilisation in credit markets and the appearance of economic green shoots have prompted a rally in these early cyclicals that were beaten down to very compelling valuations.
- An unexpectedly sharp rise in consumer confidence in May has left investors more upbeat, particularly as the Conference Board Consumer Confidence Index, has posted its biggest jump in six years, and reached the highest level since September 2008.
- While this surge in confidence bodes well for consumer stocks, the low level of the overall index reflects the caution consumers continue to feel at a time when jobs are being lost and house prices remain weak. A closer examination of the data also reveals that most of the improvement is a result of a rise in the Expectations Index (which rose to 72.3 from 51.0 in April). The situation on the ground is improving more slowly, as borne out by the much smaller increase in the Present Situation Index.
- Despite this, the improvement in confidence is encouraging. What remains to be seen is whether consumers decide to increase spending as a result or to reduce their debt levels instead.

FIXED INCOME MARKET

US government debt continued to weaken due to concerns over record issuance and the viability of the nation's credit rating. The fear that the US's top-credit rating may be under threat had risen since Standard & Poor's cut Britain's outlook to "negative" from "stable", citing the nation's soaring debt burden. Elsewhere, following the US regulators' stress tests on 19 US lenders, 10 firms that were found to have a total capital shortfall of $75 billion have now raised, or announced plans to boost, common equity by $48 billion.

HIGH YIELD BONDS CONTINUE TO OUTPERFORM



Source: Merrill Lynch May 2009

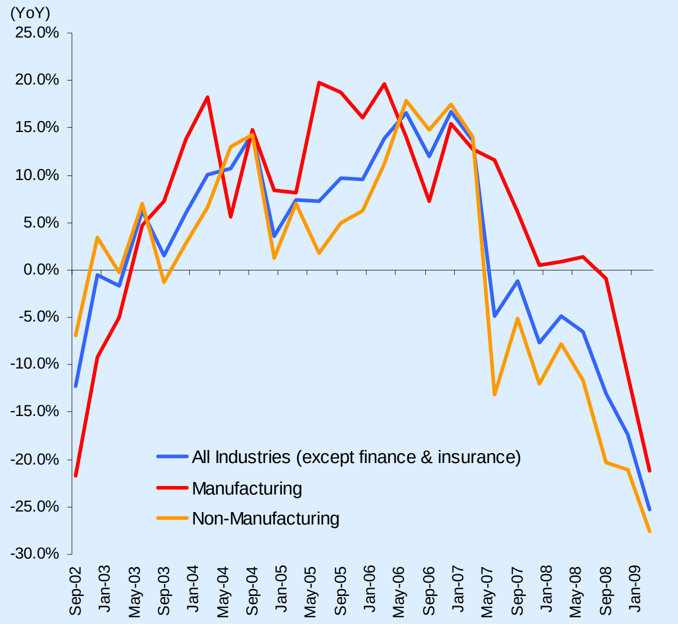
- In May, US government bonds posted negative returns, underperforming investment-grade corporate debt as well as high-yield securities. Treasuries generated a return of -1.0%, while corporate bonds returned 4.3%. High-yield securities were the best performing asset class once again, returning 7.1% over the month. Meanwhile, Federal Reserve Chairman Ben S. Bernanke stated that large US budget deficits threaten financial stability and the government cannot continue to borrow indefinitely at the current rate to finance the shortfall. Bernanke's comments signal that the central bank sees risks of a relapse into financial turmoil even as credit markets show signs of stability.
- In the corporate bond market, lower-rated BBB bonds continued to outperform other asset classes within the credit spectrum, returning 5.5% over the month. Higher quality AAA-rated bonds were the worst performers and returned 0.9%, while A-rated securities returned 4.1% over the period.
- The yield curve steepened, as yields on shorter-dated bonds rose less than those on long-term securities. Two-year government bond yields rose by 0.02 percentage points to 0.92 %, while ten-year bond yields rose by 0.34 percentage points to 3.46%.

JAPAN

ECONOMY

The government's announcement that first-quarter real GDP had contracted at an annualised rate of 15.2%, the steepest decline in post-war history, was within expectations and had little if any impact on the market. Export and industrial production data continued to improve, with output showing the sharpest month-on-month increase in 56 years. On the other hand, employment and income conditions continued to worsen. Meanwhile, the Bank of Japan (BoJ) upgraded its assessment of the domestic economy for the first time in almost three years. Amid signs that the first three months of 2009 represented the bottom of the recent downturn, the central bank acknowledged that exports and production had started to level out against a backdrop of progress in inventory adjustments. The BoJ believe gross domestic product should display a significant improvement in the April–June quarter and the pace of deterioration is likely to moderate gradually, although they remain alert to potential risk factors, such as weakness in corporate and consumer spending.

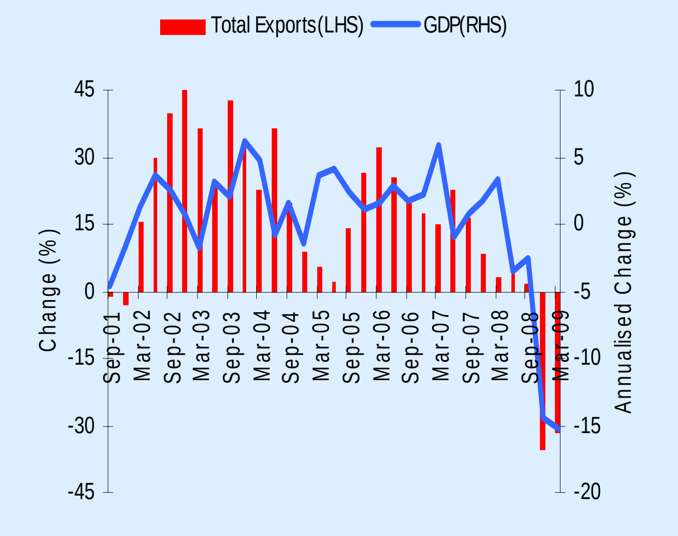
RECORD DECLINE IN CAPITAL INVESTMENT



Source: MoF, June 2009

- In early June, the Ministry of Finance (MoF) released its quarterly Financial Statements Statistics of Corporations by Industry report. The survey was consistent with other major indicators in confirming the accelerated decline in the Japanese economy during the first three months of the year.
- According to the MoF's report, corporate capital investment, which accounts for around 15% of GDP, fell by 25.3% year on year in the first quarter. Although the data came in marginally ahead of consensus expectations (a Bloomberg survey pointed towards a 30% drop), it marked a record quarterly contraction. A combination of rapidly declining external demand and plunging profits led companies to shelve or suspend capex plans. In manufacturing industries, commodity-related and electronics firms made the most significant cuts to spending, while services and real estate companies led declines among non-manufacturers.
- While exports and production have started to pick-up, corporations remain concerned about overcapacity, which suggests that capex is unlikely to make a significant contribution to GDP growth for some time. In fact, a recent survey conducted by the Nikkei revealed that Japanese firms plan to curtail capital investment by 16% in the current financial year. If accurate, the forecast would represent a second consecutive annual decline and the sharpest on record.

ECONOMIC GROWTH CONTINUES TO DECLINE



Source: Bloomberg, May 2009

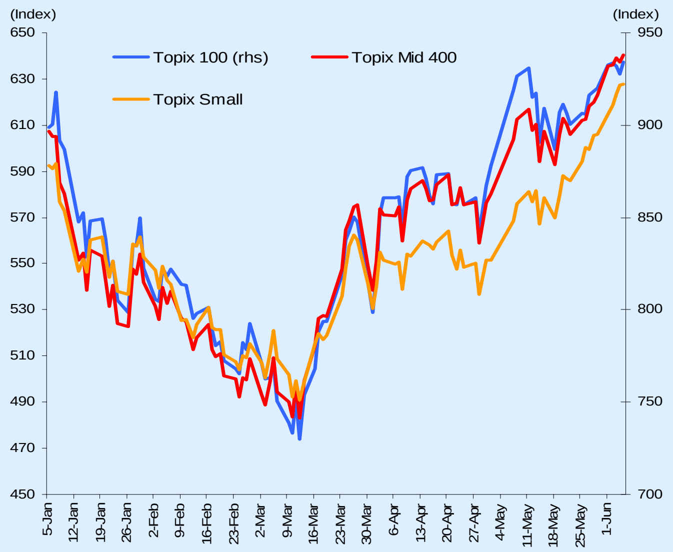
- Japan's economy shrank at a record 15.2% annual pace in the first quarter as exports collapsed and consumers and businesses cut spending. The contraction followed a revised fourth-quarter drop of 14.4%.
- The nosedive in exports was deeper than the previous quarter; they plunged an unprecedented 26%. This forced companies from Toyota Motor to Hitachi to cut production, workers and wages. The export falls were mirrored by drastic declines in production, corporate profits and consumer spending.
- However, reports in the past month suggest that the economy may grow for the first time in a year this quarter, albeit from a low point, as exports stabilise and Prime Minister Taro Aso's ¥15.4 trillion stimulus plan, announced in April, takes effect. On a customs clearance basis, exports were down by 39.1% year-on-year (YoY), while imports decreased by 35.8% in April. This implies international trade continued to shrink YoY in April but the pace of the decline moderated. The pace of job losses is also likely to be slowing.

JAPAN

EQUITY MARKET

In May, the broad-based Topix index returned 7.2%, appreciating for a third consecutive month. Improvements in a number of economic indicators encouraged the view that the worst of the global recession had passed. In addition, the results of the US bank stress tests were in line with expectations and served to ease concerns about capital financing. Over the month, commodity-related sectors such as mining, shipping, non-ferrous metals and wholesales mirrored gains in resource prices. Meanwhile, non-bank financials also performed well. In contrast, defensive sectors remained relative laggards and the spread of the swine flu virus continued to weigh on transport stocks.

SMALLER COMPANIES GAIN MOMENTUM



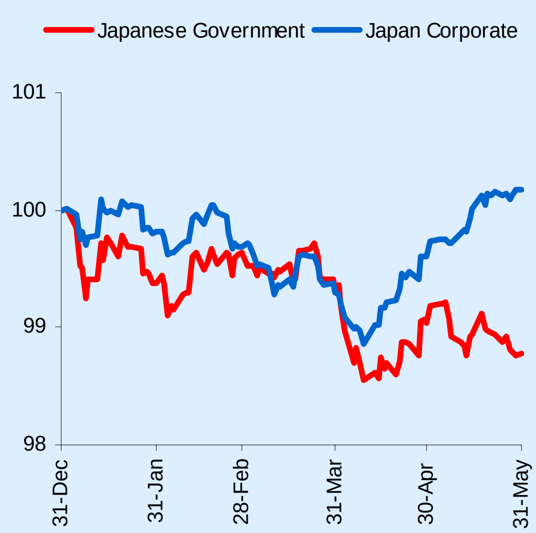
Source: Bloomberg. June 2009

- In recent weeks, smaller companies have started to outperform their larger counterparts. As the chart shows, large-cap stocks rose sharply at the start of the month, led by exporters and banks, but retreated abruptly between 11 and 18 May. From this point onwards, smaller companies gained an edge and rose beyond their year-to-date highs.
- In the wake of the financial crisis, mid- and small-cap stocks, which are typically domestic oriented, held-up relatively well. They were less exposed to the sharp downturn in the external environment and due to their low foreign-ownership ratios were relatively insulated from a surge in net selling by overseas investors. As signs emerged that the global downturn had started to moderate, however, investors focused on beaten-down large caps, including many cyclical stocks and exporters.
- More recently, market momentum has shifted once again largely because the valuations of many large-cap exporters expanded in tandem with the rebound in their share prices. Investors have turned to smaller companies, many of which appear attractively priced. A pick-up in trading activity by individual investors, who benefited from the recent market rally, was also supportive and contributed to further outperformance in early June.

FIXED INCOME MARKET

Japan's government bonds completed a third month of losses, the longest stretch since April 2006, on signs that the recession in the world's second-largest economy may be easing. Demand for debt also waned amid concerns that investors might struggle to absorb increases in supply as the government seeks to fund stimulus spending. The Ministry of Finance last month said it will boost bond issuance by 15% to ¥130.2 trillion ($1.4 trillion) in the current fiscal year.

CORPORATE BONDS OUTPERFORM GOVERNMENTS



Source: Merrill Lynch May 2009

- Japanese government bonds returned -0.3% in May, underperforming investment-grade corporate debt, which returned 0.6%. A-rated bonds outperformed other bonds within the credit spectrum, returning 1.6% over the period. Higher quality AAA-rated bonds were the worst performers, returning 0.1%, while the lower-quality BBB paper generated a return of 0.8%.
- Prime Minister Taro Aso won parliamentary approval for an extra budget of ¥13.9 trillion ($144 billion) to help pay for a stimulus package aimed at pulling the nation out of a recession. Elsewhere, the Bank of Japan raised its view of the economy for the first time in almost three years amid signs that a record contraction in the first quarter represented the worst of the recession.
- Over the month, the yield curve steepened. The yield on two-year government bonds fell by 0.03 percentage points to 0.36%, while that on 30-year paper advanced by 0.12 percentage points to 2.26%.

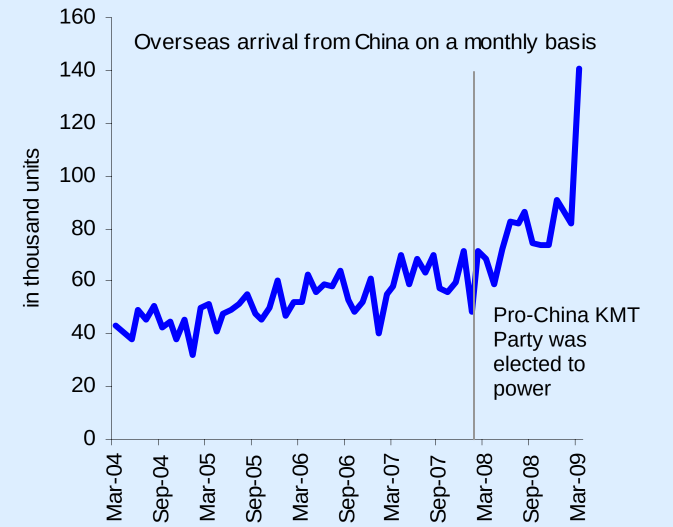
Fidelity INTERNATIONAL

ASIA PACIFIC

ECONOMY

Economic data in the Asia Pacific ex Japan region was mixed, although signs of improvement could be seen on a month-on-month basis. Industrial production recovered in April in Korea, Singapore and Thailand. In China, the Purchasing Managers' Index rose above the expansionary threshold of 50 for a third consecutive month in May. Inflation continued its downtrend and most countries, except Indonesia and Philippines, kept interest rates unchanged. Meanwhile, first quarter GDP growth in Malaysia, Taiwan, Singapore and Philippines indicated a sharp contraction, prompting downward revisions of 2009 GDP forecasts.

CLOSER CROSS-STRAIT TIES BODE WELL FOR TAIWAN



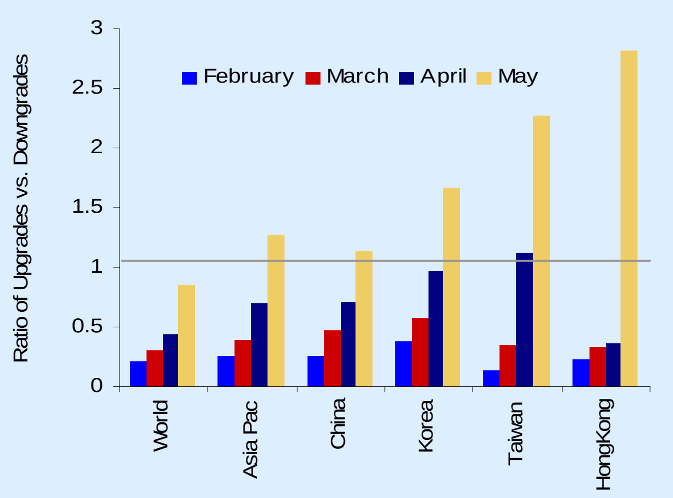
Source: Bloomberg, May 2009

- The third round of negotiation between Taiwan and China to improve cross-Strait relations concluded successfully, marking the one year anniversary of President Ma's pro-business KMT Party government. The liberalisation of Chinese investments in Taiwan is expected to create more business opportunities and more direct and portfolio investment from China. This will in turn, increase Taiwan's potential GDP in coming years.
- One of the most evident and immediate economic benefits of the warming political relationship has been a massive influx of mainland tourists. The opening of the Taiwanese tourism market and direct flights to China has received unexpected enthusiasm from the mainland. Consumption in Taiwan is likely to receive a boost from the increase in tourists.
- Taiwan is capitalising on Chinese growth in many ways. Taiwanese and mainland banks may get permission as early as next month to set up operations in each other's territory. Authorities on both sides are also mulling a Comprehensive Economic Cooperation Agreement, which would further reduce trade barriers and promote the freer flow of goods, capital, technology and labour. The new policy would offer Taiwanese companies access to the massive Chinese market.

EQUITY MARKET

Asia Pacific equities continued to deliver robust performance in May. The region responded positively to the economic recovery in China, an improvement in credit markets and inflationary global economic policies. The MSCI AC Asia Pacific ex Japan index returned 14.4% in US dollar terms. All sectors ended in positive territory, but cyclical stocks led the market. The energy sector benefitted from higher oil prices, while hopes of healthy loan growth due to reduced borrowing costs buoyed shares in financials. On the other hand, defensive sectors such as healthcare and consumer staples lagged.

UPBEAT EARNINGS FORECASTS



*MSCI Indices

Source: DataStream, May 2009

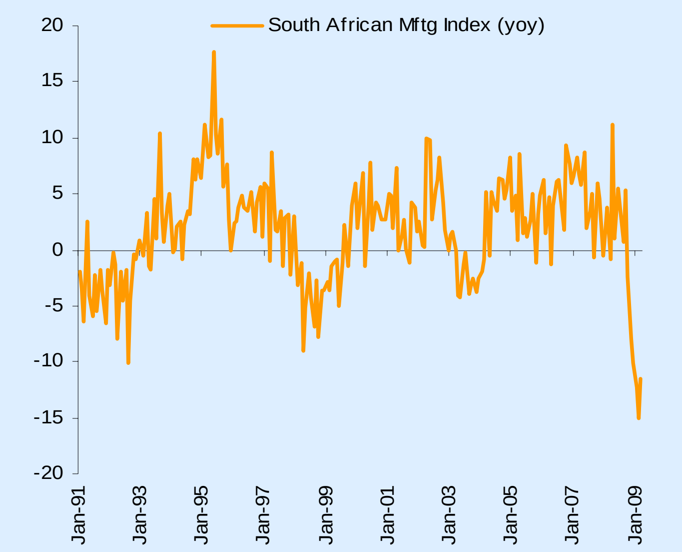
- Analysts have become increasingly positive about the growth potential of corporate Asia. Recent data releases suggest that the downturn in the regional economy might have reached its nadir during the first quarter of the year. A turnaround is expected in the Chinese economy, partly aided by Beijing's massive fiscal stimulus package. The upward adjustment to earnings is also, in part, because analysts had previously lowered their estimates aggressively in light of slower end-market demand.
- Consumer-related companies have seen a distinct improvement in outlook for the next 12 months given better-than-expected employment data and low interest rates. The growth in manufacturing output exceeded expectations in China, Singapore and Taiwan in April. Not surprisingly, industrial and material companies also saw more upgrades than downgrades in May. Analysts expect growth momentum to pick up in the second half of 2009.
- In Hong Kong, the prospects for real estate firms improved, as the sector is highly leveraged to the recovering economic outlook. Analysts were upbeat about these companies in light of strong residential property sales and low borrowing costs.

EMERGING MARKETS

ECONOMY

The majority of the data released from developing countries over the month confirmed the view that economic activity remains lacklustre. Chinese exports fell steeply in April for the sixth month in succession, suggesting the worst might not be over for the world's third largest economy. Elsewhere, a slump in industrial production hurt Russian GDP growth, despite the government's stimulus spending. Nonetheless, Indian economic activity surpassed forecasts due to the strength of its service sector, while improving expectations of a recovery in the US underpinned the increase in commodity and oil prices.

SOUTH AFRICAN RECESSION



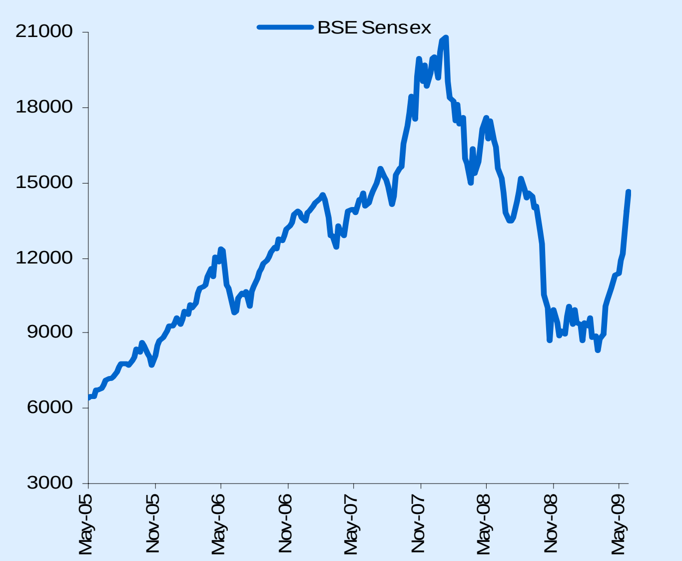
Source: DataStream, May 2009

- South Africa's GDP contracted in the first quarter of 2009 and led Africa's biggest economy into recession for the first time in 17 years. According to Statistics South Africa, the pace of economic activity shrunk by an annualised rate of 6.4% in the three months to March 2009, after declining 1.8 % in the final quarter of 2008. Over the first quarter, manufacturing and mining activity contracted substantially, but the former has seen some recovery recently. Retail activity also continued to trend lower for the fourth consecutive quarter, but the construction industry expanded.
- The newly installed President Jacob Zuma will face high levels of joblessness, as manufacturing and mining firms fired workers and unemployment reached 23.5% in the first quarter. The Director-General of the National Treasury Lesetja Kganyago remarked recently that the government will probably not meet its target to cut the unemployment rate to 14% by 2014.
- Nonetheless, Moody's Investors Service has forecast that South Africa's recession is likely to be "brief," and expects the economy to return to growth in the third quarter, as increased fiscal expenditure and lower interest rates spur consumer spending. The ratings agency expects a more robust recovery in economic activity, which is expected only sometime in 2010.

EQUITY MARKET

Emerging Market equities gained substantial ground, driven by compelling valuations and a growing appetite for riskier assets. Latin American markets outperformed, led by Brazil, where real estate developers, retailers and banking shares found favour against a backdrop of low interest rates. Meanwhile, a resurgence in oil prices increased the attractiveness of Russian stocks, while the prospect of a stable government boosted Indian equities. Investor confidence in South Korea weakened after nuclear tests by North Korea.

INVESTORS APPLAUD A STABLE GOVERNMENT IN INDIA



Source: DataStream, May 2009

- Indian equities rallied sharply in May after the ruling Congress party won a big majority in the parliamentary elections. Investors speculated that the incumbent Prime Minister Manmohan Singh would now not require the support of the smaller communist party that had frustrated his government's plans to entice foreign investment and divest state-owned companies in his first five-year term. After the results were declared, the BSE Sensitive Index (Sensex) jumped 17%, the biggest one-day increase in 17 years.
- At the end of the month, Indian stocks received another fillip, as better-than-expected economic growth figures supported the existing momentum in the market. India's GDP expanded by 5.8% in the three months to March 2009 vs. a forecast 5.2% growth rate. The breakdown of GDP data showed manufacturing continued to suffer, while services, which now account for 57.3% of the Indian economy, expanded; farm output rebounded after declining in the previous quarter.
- Consequently, the stock market has nearly recovered to levels seen a year ago, before the financial market crisis in the US and Europe took hold. The upbeat news-flow coupled with recovering appetite for relatively risky assets has encouraged investors to take a positive view of Indian businesses.