GlobalWatch:

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All that glitters...

Gold has surged to new highs, creating heightened investor interest in the precious metal. Its exponents argue it is a good store of value and a useful hedge at a time when western economies face rising debts, depreciating currencies and the likelihood of higher inflation. Critics argue gold is merely an uncertainty trade and is overvalued. So, what does its price say about the prospects for investment and what should we be investing in as a result? PAGE 2

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Fidelity INTERNATIONAL

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THE GOLD BUG VIEW

Investors do not have to look far to find someone ardently espousing the reasons for owning gold. The view that 'gold is a good inflation hedge' has been prominent in the national press. And according to the doom-mongers, the world is looking more like the 1970s by the day; a time when inflation was of the 'jack-in-the-box' variety.

Huge monetary and fiscal stimulus may have avoided financial collapse and depression, but it has come at a cost. Western economies now have to finance surging deficits by issuing new bonds, at the same time as central banks are buying bonds via quantitative easing strategies. The problem is that this method of financing higher government spending increases the money supply and stimulates inflation as governments monetise their debts.

Gold investors fear that if the US and other western economies follow this path, it will begin to undermine the value of paper cash and, ultimately, destabilise the entire fiat money system (with the US dollar as reserve currency) that underpins our society. In such a crisis, where the greenback is no longer a safe haven, gold would be the investment of choice.

The theory has been given fuel recently when the Central Bank of India pushed the gold price to new highs with its deal to buy 200 tonnes of gold from the IMF. This is where a compelling thread of the story comes in. Increasingly strong emerging market nations, such as India and China, have high foreign currency reserves (mostly in dollars) but very low reserves of gold compared to western developed nations. Imagine if China and other nations were to start using dollars to build up reserves of gold?

THE GOLD CYNIC VIEW

The gold cynics are not convinced. For starters, they point to the fact that gold has a rather mixed record as an inflation hedge. We can see from the chart overleaf, that as inflation was brought under control in the 1980s and interest rates fell back to more moderate levels, the gold price also fell back, before virtually stagnating for the next 20 years. This was despite the fact that cumulative inflation was still positive during this period. Certainly, buying in 1980 would not have made much sense on either hedging or investment grounds for many years. Timing is everything with this particular hedge.

In practice, gold tends to protect against large, episodic rises in inflation, as opposed to the cumulative effect of inflation over a period of time. The truth is that smart investors buy gold to make profits on their investment, not necessarily to hedge against inflation. The issue tends to be obfuscated by fact that the 'right' time to invest in gold can often, but not always, be associated with concerns over higher inflation.

This brings us to the more historically robust reason behind a surge in the gold price. That is uncertainty. Gold is fundamentally an uncertainty trade or a "crisis hedge". Back in 1980, the real reason gold prices were rising was the international crisis arising from the Soviet invasion of Afghanistan and the Islamic Revolution in Iran. For the last few years, it has been down to fear over the financial system and western currency regimes, particularly the dollar.

A CROWDED TRADE?

Money has been pouring into physical gold funds and, in many countries, you can now buy gold at the bank, the airport or even at a department store. There are even gold adverts on television, advising people to sell their unwanted jewellery. Such measures of widespread interest fulfil many of the necessary conditions for a crowded trade. When a finite investment like gold becomes as crowded as this, sentiment begins to outweigh the fundamentals and the asset becomes intrinsically overvalued. The fact that a lot of people seem to be buying gold encourages others to buy, due to the underlying psychological urge to conform.

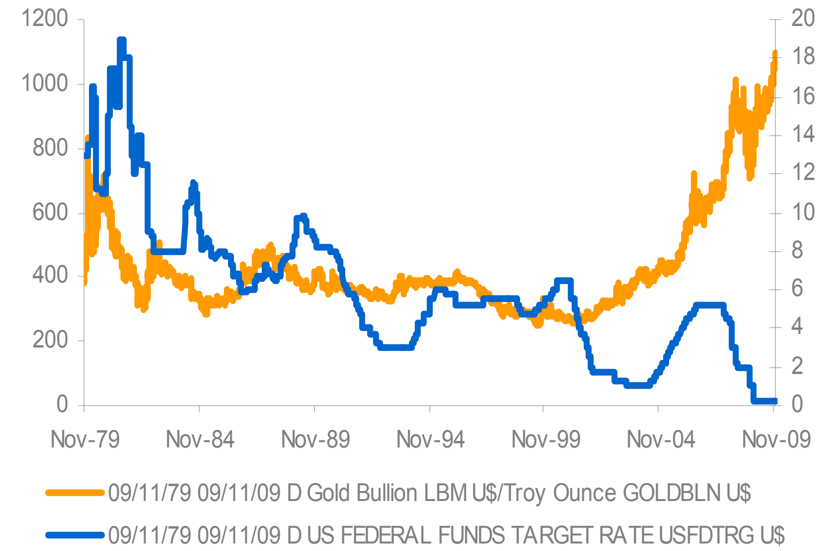
GOLD, FOR:

- *Insurance against debt monetisation and sovereign debt crises.*
- *Protects against episodic, extreme loss of purchasing power in fiat currencies.*
- *Central banks, such as India, have been buying stocks.*

AND AGAINST:

- *Mixed record as a hedge, particularly over longer time periods.*
- *Opaque market where it is unclear what is driving the price.*
- *Gold is a crisis hedge and is likely to lose its lustre if sovereign debt and currency crises can be averted.*
- *Currently at record highs, gold has the hallmarks of a crowded trade.*

GOLD HAS SURGED IN RECENT YEARS AS INTEREST RATES HAVE FALLEN



Source: Thomson DataStream, as at 10.11.09.

This 'herding' phenomenon is invariably associated with new investment views, which explain why the rally "is different this time".

Unfortunately for those converted late to the herd, history shows, time and again, that these crowded trades are only fleetingly lucrative and almost always painful. In the 1980s, it was Japanese stocks; in the late 1990s, it was dot.coms; and in 2005 to 2007, it was commodities. Each had many ardent subscribers just before the bubble burst.

The conditions seem to be in place for a bubble in gold. It is at a record high (in US dollar terms) and there are compelling views as to why it could go higher. It may indeed go higher but the likelihood is that, as with all bubbles, this one will end and gold will begin to revert back towards its fundamental value, which is principally determined by its primary use in the manufacture of jewellery.

REASONS NOT TO INVEST IN GOLD

What if we avoid the extreme loss of confidence in the fiat money system that the gold bugs seem to be banking on? Western governments may find a way to muddle through, without the kind of crisis that tends to reward gold investors.

Between 1946 and 1974, the US government debt to GDP ratio fell from 121% to 36% on the back of economic growth and fiscal tightening policies, such as tax rises and spending cuts. The real price of gold halved between 1946 and 1972[1].

True, the extent of fiscal cuts required now is likely to be less politically acceptable, but it still does not mean we are bound to see an extreme event. While China has encouraged its people to buy gold, it has not started to accumulate gold in any meaningful way and it retains it long-held strategy of investing in dollar-denominated treasuries, while picking up hard assets in oilfields and mining companies via sovereign wealth funds and state-owned companies.

Assuming the death of the dollar and the fall from influence of the US economy seems premature. While we are seeing a rebalancing of power to emerging markets, this is a secular process that will take years to complete. As western economies stabilise under positive economic growth conditions, gold will almost certainly go back into hibernation at some point. This may take some time of course, but investing in gold now certainly entails a lot more downside risk than it did only a year ago.

HOW TO PLAY THE GOLD STORY WITHOUT BUYING HIGH-PRICED GOLD

If you are persuaded by the gold bug story, but would rather not buy gold at record highs, there are more attractively valued alternatives which may also be better long-term investment opportunities. If the gold price is accurately predicting the risk of acute debt monetisation by western economies, then inflation-protected bonds would be an attractive investment and a better inflation hedge.

A good way to get leveraged exposure to the gold price is by buying gold mining stocks. Platinum is another precious metal that has not surged as much as gold but has more attractive long-term prospects because of its greater industrial use. A key input into autocatalytic converters, its use in the auto industry is predicted to grow strongly due to emissions regulations and the strong demand from emerging markets for cars. Investing in platinum mining stocks or funds that favour these stocks among other miners could be a more attractive long-term option for value-orientated investors.

CONCLUSION

The smart money got into gold back into 2006 and in 2003-4; these shrewd investors bought in at lower prices when everyone else was buying into stock markets headed for a top. Now with gold at record highs, investors are likely be better-served by putting their money back to work in conventional investments. Investors may still profit from the gold story through inflation-linked bonds, mining and platinum stocks.

1. Source: Credit Suisse. Global Equity Strategy, 19.10.09

Europe

Economic indicators were mainly positive in October. The eurozone's Economic Sentiment Index and German business climate indicator, published by Ifo, continued to rise in October. Adding to the signs of economic recovery, eurozone's Purchasing Manager Index showed that manufacturing expanded for the first time since May last year. Data also revealed that the region's industrial new orders index rose by 2.0% in August. Meanwhile, annual inflation remained in negative territory in October as consumer prices fell 0.1%, following a 0.3% annual decline in September, according to the flash estimate by the Eurostat. While unemployment in the region continued to rise, there was some positive news from Germany, where the unemployment rate reached its lowest level this year. In its early November meeting, the European Central Bank (ECB) kept its interest rates at a record low of 1.0%. ECB governor Jean-Claude Trichet said there will be a bumpy road ahead and any exit from extraordinary measures will be gradual.

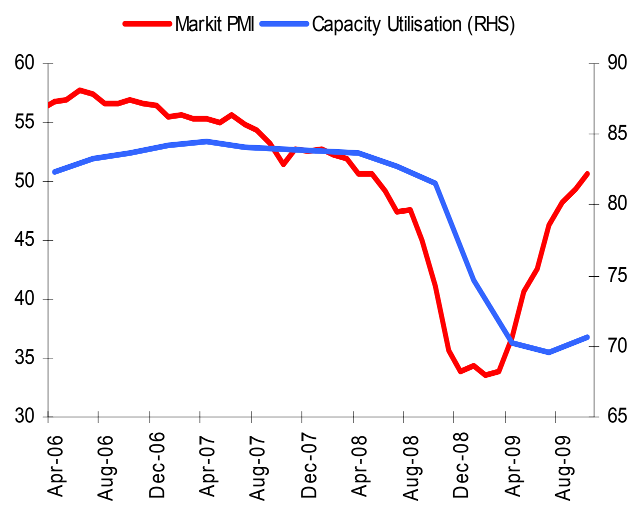
UNEMPLOYMENT LEVEL CONTINUES TO RISE

- The eurozone economy seems to be emerging from recession, but the benefits of recovery are yet to filter through to labour markets. Unemployment levels across the region rose to 9.7% in September, the highest rate since January 1999. This brought the number of people unemployed across the eurozone to 15.3 million.
- The largest unemployment rates were recorded in Latvia (19.7%) and Spain (19.3%). Spain's jobless levels rose for the third consecutive month in October as stimulus spending for the year began to run out. The Spanish economy has been hit by a severe slump within the construction industry, which has led to a significant amount of employment losses. On a positive note, Germany and the Netherlands have held down job losses with government incentives. The lowest unemployment rates were recorded in the Netherlands (3.6%) and Austria (4.8 %).
- Unemployment levels are traditionally believed to lag growth and it will take some time for the optimism about the economic recovery to feed through into employment markets. In its early November meeting, the European Commission forecast that unemployment would rise to 10.7% in 2010 and hit 10.9% in 2011.

Source: DataStream, October 2009

NEW ORDERS BOOST MANUFACTURING

- Manufacturing in the euro area expanded for the first time since May 2008, supporting the view that the region is pulling out of recession. According to Markit, the Purchasing Managers Index (PMI) increased to 50.7 from 49.3 in September. At a country level, the manufacturing PMI stood above 50 for the third consecutive month in France. In Germany, the index increased above the 50-mark for the first time since August 2008. Meanwhile, in countries like Italy and Spain, although the index rose, the indices remain below the expansion limit.
- Factories in Europe increased capacity usage on assembly lines in the three months to October as confidence in the economic outlook rose to the highest since Lehman Brothers collapsed. According to the European Commission, capacity utilisation rose from its record low of 69.6% in July to 70.7% in October, the first gain since April 2007. Germany and France registered the largest increase in monthly new orders.
- The expansion in Germany and France has been largely driven by the governments' car scrappage schemes. However, even as the output outlook has improved, employment continues to contract in the region and capacity utilisation still remains below its historical trend. Furthermore, demand could be limited by the appreciation of the euro against the US dollar.



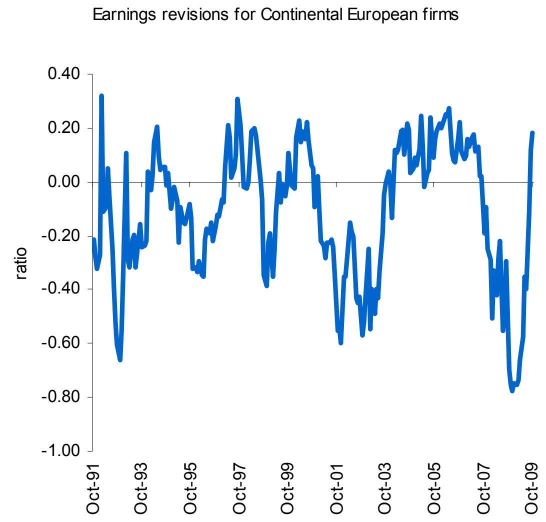
Source: Bloomberg, October 2009

European markets

Following three months of significant advances, European equities retreated in October as mixed news prompted investors to question the sustainability of pick-up in economic growth and company profits. Discouraging results held back shares in the IT sector, notably SAP and Ericsson, and a weak demand environment for power and gas weighed upon utilities. Investors worried that the strength in business for financials may not last for long, dragging down shares in the sector. Given the uncertain environment, defensive areas, such as consumer staples, telecoms and health care, outperformed. Health care names were also supported by positive news regarding drug approvals. Moreover, oil prices advanced with economies starting to come out of recession. Accordingly, energy stocks performed well compared to other sectors, although they declined marginally in absolute terms. Overall, larger companies outperformed their smaller counterparts.

IMPROVING TREND FOR EARNINGS REVISIONS

- The chart highlights the recent positive trend of earnings upgrades for Continental European firms. It shows the ratio of net upgrades (number of companies that have been upgraded less those that have been downgraded) as a proportion of total estimates for the MSCI Europe Index. Over the last two months, more companies saw their profit forecasts increased than reduced by analysts. This is in contrast to the discouraging trend witnessed over almost the last two years.
- Among the key names that have reported earnings so far, banks such as Credit Suisse beat forecasts, although technology names including Nokia disappointed investors. According to the latest update from Citigroup Research, of the companies that have posted results by October, 78.3% exceeded or met analysts' estimates, mostly due to cost-cutting. Going forward, there should be a shift in focus to genuine organic growth and any upturn in profits is more likely to be driven by a combination of higher sales and better operating profit margins.
- There are signs that the worst might be behind us in terms of economic and market performance. There is a very real possibility that rising sales and falling costs could help European firms produce impressive profits in 2010. Indeed, I/B/E/S estimates are already predicting income growth of 27.2% for the region next year.

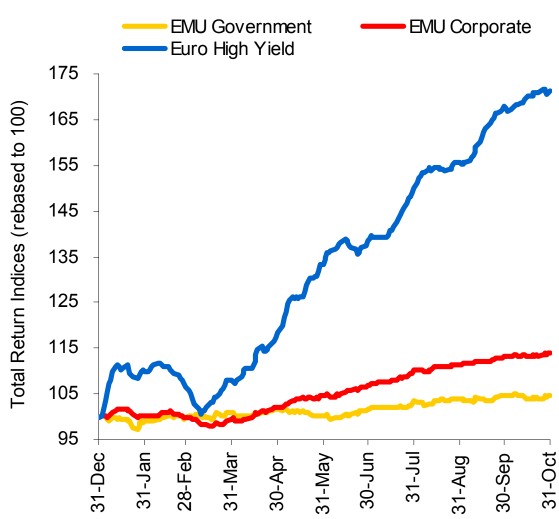


Source: DataStream, October 2009

European government bonds ended little changed in October, alternating between stronger than expected economic data and a flight to safety on the part of equity investors. In its semi-annual forecasts, the European Commission said that the euro region will return to growth and expand by 0.7% in 2010 and 1.5% in 2011. The region's average deficit will widen to 6.9% of economic output next year and unemployment will reach 10.9% in 2011. Meanwhile, in early November, the European Central Bank (ECB) left base interest rates unchanged at 1% and Bank President Jean-Claude Trichet said they would withdraw some liquidity measures as the economy improves.

HIGH YIELD CONTINUES TO OUTPERFORM

- ECB president, Jean-Claude Trichet urged banks to lend after data showed loans to households and companies posted their first annual decline on record in September. Loans to the private sector fell 0.3% from a year earlier in September after increasing an annual 0.1% in August. Nevertheless, banks tightened credit standards for households less aggressively in the third quarter and the ECB expects that trend to continue in the fourth quarter.
- Government bonds ended flat in October and generated 0.1% returns. Investment-grade corporate bonds rose 0.8% over the month. Year to date, investment grade bonds have yielded a return of 16.5%, strongly outperforming government bonds which generated 4.6% returns. Within the investment-grade bond market, AAA- rated securities generated 0.3% returns, underperforming BBB-rated bonds which returned 1.4%. Sub-investment-grade bonds were the best performing fixed income class once again and registered 2.0% returns (see chart).
- Over the month, the European yield curve was little changed and yields on short- and long-dated bonds rose slightly. Yields on two-year government bonds rose by 0.02 percentage points to 1.29%, while those on 30-year maturities rose by 0.03 percentage points to 3.98%.



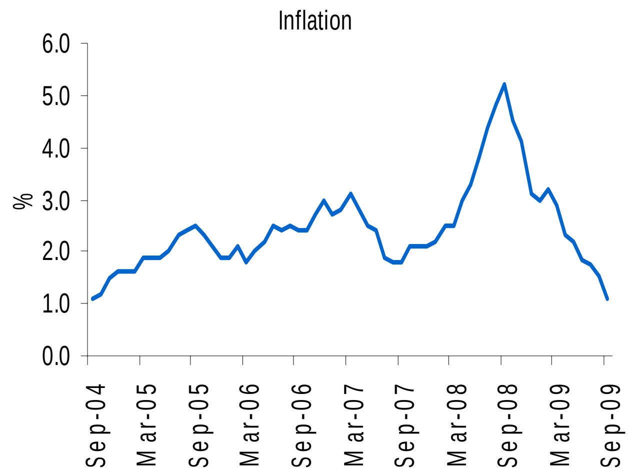
Source: BofA Merrill Lynch, October 2009

United Kingdom

The Office for National Statistics (ONS) revealed that GDP contracted by 0.4% in the third quarter. The unexpected drop, contrary to expectations of a small rise, was mainly due to weakness in services, manufacturing and construction segments. The economy has now shrunk over six quarters. In other data, Nationwide Building Society said that its consumer confidence index rose further in September, to the highest level since April 2008. Further positive news came from the housing market; the latest survey by Nationwide revealed that home prices posted their first annual gain in 19 months in October as low interest rates and improved confidence encouraged buyers. Moreover, data from the Bank of England (BoE) showed that mortgage approvals climbed to their best level for 18 months in September, adding to signs of a recovery in the housing market. Meanwhile, figures released by the ONS revealed that unemployment in the three months through August rose further, although the rate of increase slowed. Against this backdrop, the BoE's policymakers kept interest rates on hold at a record low of 0.5% and expanded its asset purchase programme by another £25 billion to £200 billion in November.

SHARP FALL IN INFLATION RATE

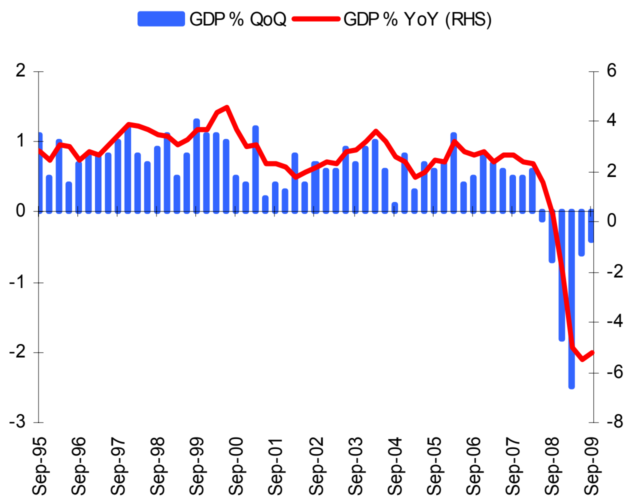
- The ONS reported that the Consumer Price Index (CPI) fell to 1.1% in September on a year-on-year basis, down from 1.6% the previous month. This is its lowest point since September 2004, and below the BoE's 2.0% target. Many firms are cutting prices to survive, which is slowing inflation.
- The main cause of the drop last month was cheaper electricity and gas costs, which are 7.3% lower than a year ago. Meanwhile, the Retail Price Index inflation measure, which includes mortgage interest payments and housing costs, and is used for many pay negotiations, slipped to -1.4% from -1.3%. The slide in inflation was greater than had been expected, but was largely attributed to high energy prices a year ago, compared to September this year, when they were much lower.
- However, analysts have suggested that CPI may be poised to rise as petrol prices make a major upward contribution over the coming months, given the crude price has risen from a low of $35 a barrel late last year. In the minutes of its September policy-setting meeting, the BoE left the key interest rate at a record low of 0.5% and said it will spend the remainder of its planned bond purchases to improve liquidity. Policymakers also noted that inflation will increase, going forward.



Source: The Office for National Statistics, October 2009

SIXTH QUARTER OF CONTRACTION

- Contrary to the widespread expectation of a small positive reading, the UK economy contracted for the sixth consecutive quarter. The first estimate released by the Office for National Statistics showed that the economy contracted by 0.4% in the third quarter after a decline of 0.6% in the second quarter. On an annual basis, the economy shrank by 5.2%, marginally better than the second quarter figure of -5.5%.
- At a sector level, industrial production fell by 0.7% (-0.5% in Q2), construction declined by 1.1% (0.8%) and services by 0.2% (-0.6%). Mining and quarrying made the largest contribution to the decline falling by 3.5%, compared with a fall of 0.6% in the previous quarter. Likewise, distribution, hotels and restaurants fell by 1.0%, compared with a decrease of 0.4% in the previous quarter.
- The Bank of England (BoE) had predicted that growth would return to positive in the second half of the year. Consequently, the data turned out to be disappointing. Nevertheless, the latest manufacturing and services surveys point to a gradual recovery in both the sectors. Furthermore, the housing market continues to stabilise in light of a rise in house prices and an increase in number of mortgage approvals.



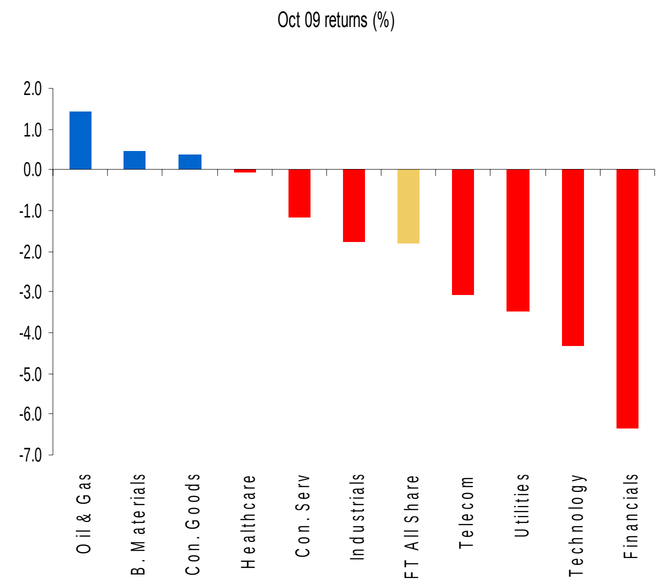
Source: Bloomberg, October 2009

United Kingdom markets

Following three months of gains, UK equities declined in October as concerns emerged that the rally may have outpaced the prospects for economic growth. Nevertheless, third-quarter earnings were largely positive, and an expansion in third-quarter US GDP, for the first time in a year, added to signs that the global economy is recovering. The benchmark FTSE All Share Index returned -1.8% over the month. Large-sized companies, returned -1.7%, outperforming their mid- and small-sized peers, which recorded returns of -2.7% and -3.2%, respectively.

FINANCIALS DRAG MARKETS LOWER

- Financial stocks were the biggest drag on the FTSE All Share Index in October, as news about banks' impending asset sales and capital raising plans undermined investor sentiment towards the sector. Banks, insurers and financial services firms underperformed the broader market. The FTSE All Share – Banks Index posted a return of -8.1% over the month, compared to -1.8% for the FTSE All Share. Among the constituents of the FTSE 100 Index, Royal Bank of Scotland (RBS) declined the most, followed closely by Lloyds Banking Group and Barclays.
- Recent news has led to concerns about the strength of recovery in the financial sector and weighed upon stock prices. Following Dutch financial services group ING's announcement that it will split the business into two parts as part of a plan to pay back government bailout funds, the focus turned to part-nationalised UK lenders RBS and Lloyds, which have also been under the scrutiny of the European Commission, investigating the impact on competition of the billions of pounds received in state aid.
- After much speculation, in early November, Lloyds announced a record £13.5 billion rights issue and along with RBS agreed to sell off some businesses to limit their reliance on government support. Lloyds is now set to escape the cost of participating in the government's Asset Protection Scheme altogether, while RBS will participate in the scheme on revised terms, although it will bring state ownership in the bank to 84.4% from the current 70%.

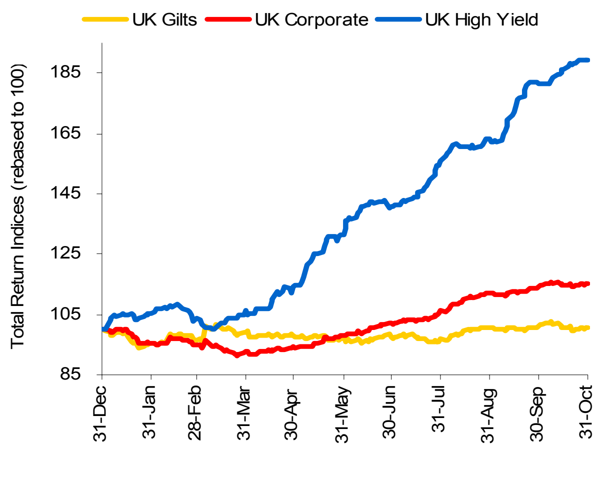


Source: DataStream, 30 October 2009

UK government bonds (gilts) ended October in negative territory, after data releases showed that contrary to expectations, the economy contracted yet again in the third quarter. Gilts were also impacted by concerns over quantitative easing programme and better than expected corporate earnings results from the financial sector. In the credit markets, investment grade bonds were little changed and spreads were relatively flat over the month. In its meeting in early November, the Bank of England increased its asset purchase program by £25 billion to £200 billion and kept the base rate at a record low of 0.5%.

HIGH YIELD OUTPERFORMS ONCE AGAIN

- As investors speculate about the strength of the economic recovery, the UK government will inject more capital into two of the country's biggest banks, Royal Bank of Scotland and Lloyds Group. The government will inject £25.5 billion of capital into RBS and the bank will place £282 billion of high-risk debts into the government's toxic asset scheme. Lloyds, meanwhile, will raise at least £21 billion of new funds.
- Gilts ended October in negative territory, generating returns of -0.3%. Investment-grade corporate bonds outperformed government-issued debt, advancing by 0.9%. Within the corporate bond market, AA-rated securities were the worst performers, rising 0.2%, while BBB-rated bonds returned 1.5%, outperforming other investment grade bonds. Sub-investment-grade paper rose 4.3% and outperformed both investment grade corporate bonds and government debt (see chart).
- In October, the yield curve steepened, as yields on short- dated bonds fell, while those on long-dated paper rose. Yields on two-year maturities fell by 0.03 percentage points to 0.86%, whereas those on 30-year paper rose by 0.04 percentage points to 4.13%.



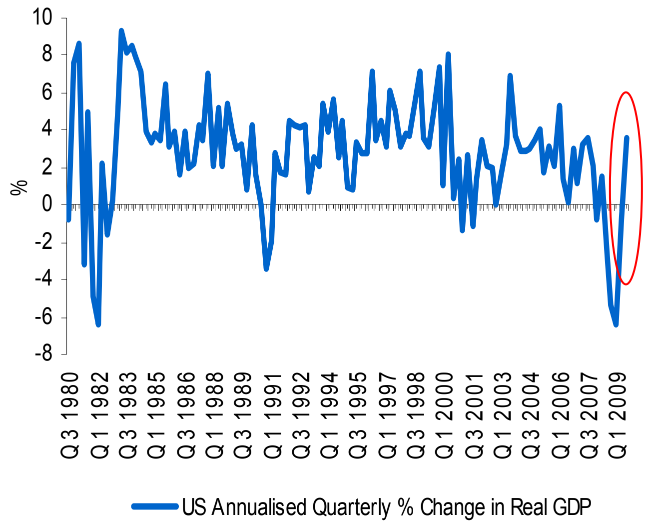
Source: BofA Merrill Lynch, October 2009

United States

On the economic front, mixed data releases showed that although the recovery process was underway, key concerns remain. Investors took heart from initial GDP estimates that showed the economy expanded at an annual rate of 3.5% in the third quarter. Meanwhile, the Institute for Supply Management's index for the services sector also demonstrated growth for the first time since August 2008. However the consumer remained subdued. The Conference Board's Consumer Confidence index declined for a second month in a row, to a lower-than-expected reading of 47.7 in October, as worries about the state of the job market remained. Consumer spending fell by 0.5% in September, marking the first decline in five months, and the biggest drop since December 2008. Elsewhere, on the housing front, sales of newly built single-family homes unexpectedly declined 3.6% while new construction rose less than forecast in the same month.

A RETURN TO GROWTH?

- The US economy has returned to growth in the third quarter of 2009 after contracting for four quarters. The most recent figures, which are the highest in two years, have been welcomed by investors as another sign of the recovery process taking hold. Nevertheless, it is worthwhile looking at the underlying data when drawing conclusions about the future economic outlook.
- While the quarter-on-quarter pace of increase in GDP is encouraging, it stems from a very low base of economic activity in the previous three-month period. Additionally, the main contributors to this growth have been increases in consumption and residential real estate investment; both segments have received a considerable but temporary boost from government stimulus measures including the cash-for-clunkers program and the first-time homebuyer's tax credit.
- This has raised questions about the sustainability of such growth. Many are hoping that consumer confidence will be lifted by a rebound in economic activity, although so far this has not happened because the job market remains weak. Encouragingly, businesses are running down their inventories more slowly now, which means they are closer to realigning their stocks to current demand. This suggests that firms may soon have to rely on production to satisfy any increase in demand. Also, a cheaper US dollar is helping boost exports to international markets where demand is more robust.



Source: DataStream, October 2009

BORROWING RATE DECLINES

- Data shows that the US financial system has markedly improved. Credit markets have continued to stabilise, issuance of new debt, particularly by corporates, has expanded dramatically and the cost of new borrowing has declined precipitously from record high levels one year ago. The Libor-OIS spread, the difference between the three-month dollar rate and the overnight indexed swap rate, which peaked in October 2008, is now down to its pre-crisis level.
- The TED spread, the difference between what banks and the US Treasury pay to borrow for three months, also dropped implying that the overall stress in US financial markets is back to late-2007 levels. Large banks such as JP Morgan and Citibank have returned to profitability, posting significant third-quarter profits.
- Meanwhile, the Federal Reserve's (Fed) commitment to keeping interest rates zero and its use of other extraordinary monetary policies continues to remain supportive for the financial system. However, despite these efforts, consumer credit fell for the seventh straight month in August. A primary reason for this is delinquencies and defaults on many loans are still rising, forcing banks to tighten lending standards while focusing more on preserving their capital. This implies that still more needs to be done to attain a fully functional credit market that is completely supportive of economic recovery.

Source: Bloomberg, October 2009

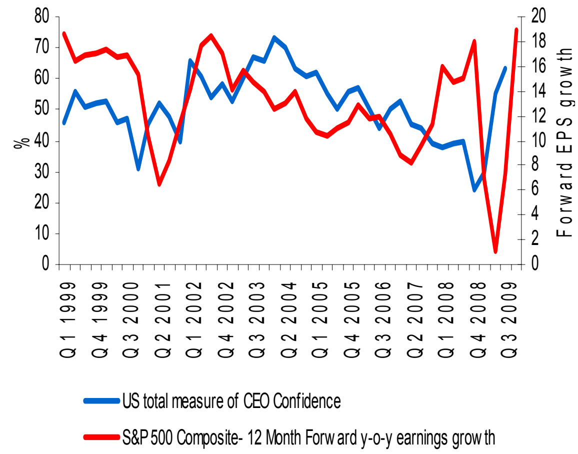
GlobalWatch:

United States markets

After posting seven consecutive months of gains, the S&P 500 Composite Index retreated in October. Investors watched for signs that the turnaround in corporate activity and the economy was sustainable, especially given the rise in valuations over recent months. Financial shares, which had seen some of the sharpest gains, lost ground, as investors took profits. However, with the exception of Bank of America which posted a loss, many financial bellwethers exceeded earnings expectations. Several regional banks saw the pace of deterioration in assets slow and some stabilisation in loan books. There was some uncertainty about the future of the government's home buyer tax credit and this led to volatility in home-related stocks. A range of companies including 3M, AT&T, McDonald's, Apple and Amazon.com reported solid results. Aircraft manufacturer Boeing and biotechnology company Genzyme posted lower-than-anticipated earnings.

WILL INCREASED CONFIDENCE GROW EARNINGS?

- Expectations of a continued improvement in the economy have pushed the Conference Board's measure of CEO Confidence to the highest level in five years. This result, based on a survey of 100 CEOs, many of whom have the power to make large investment decisions, seeks to gauge the economic outlook of corporate America while also gauging their business-related concerns.
- As per data released in October, the majority of CEOs feel that the economy had improved from six months ago and would continue to do so in the coming period. This evidence points to a possible round of re-hiring activity and to a rebuilding of inventories in coming months which should help sustain the recovery process, particularly at a time when consumer spending has been slow to rebound. It also hints at a continued recovery in earnings and subsequent upgrades.
- In fact, S&P 500 earnings growth could actually outpace GDP growth as many US companies are increasingly catering to international markets, which are seeing more robust demand. Over 40% of the S&P EPS is being driven by such demand, particularly in sectors such as energy, technology, materials and industrials.

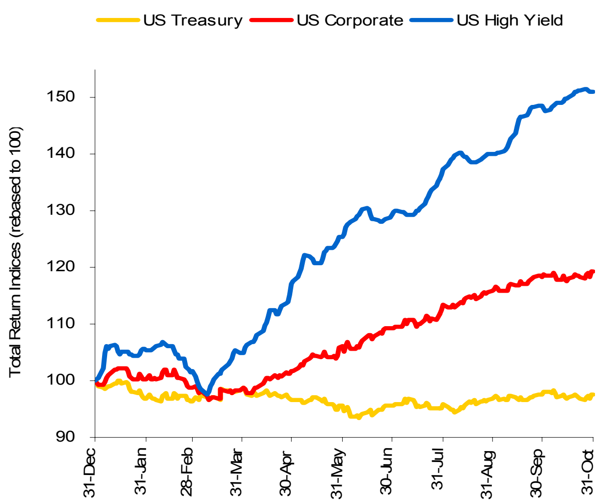


Source: DataStream, October 2009. *Figures on EPS growth have been sourced from Bank of America/Merrill Lynch, 05 October 2009

US government debt declined in October amid increasing government debt sales and speculation that the economy would recover from the recession. Elsewhere, the Fed completed its $300 billion Treasury purchase program in October amid signs that the seven-month buying spree helped stabilise the housing market and limit increases in borrowing costs. The purchases were part of the Fed's extraordinary debt buying programs which attempted to unlock credit markets.

HIGH YIELD BONDS OUTPERFORM

- US government bonds continued to underperform corporate and high yield debt in October. Treasuries generated a return of -0.1% while corporate bonds returned 0.8%. High-yield securities returned 1.8% in October and were the best performing asset class once again.
- In the corporate bond market, lower-rated BBB bonds continued to outperform other asset classes within the credit spectrum, returning 0.9% over the month. Higher quality AA and A-rated bonds both returned 0.8%. Meanwhile, AAA-rated securities returned -0.1% over the period and were the worst performers. On a year-to-date basis, investment grade corporate debt has risen 19.3% against a loss of 2.5% by government debt.
- Over the month, the yield curve steepened as yields on short-term debt declined while those on longer dated securities rose. Two-year bond yields fell by 0.06 percentage points to 0.9% while those on 30-year securities advanced by 0.18 percentage points to 4.2%



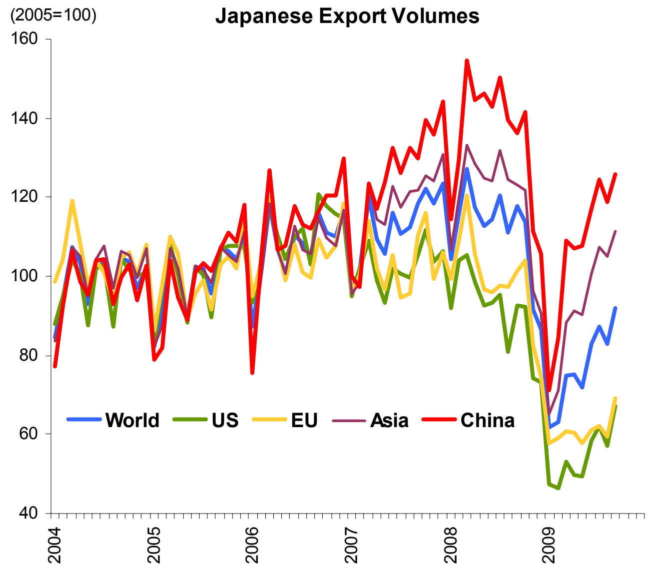
Source: BofA Merrill Lynch, October 2009

Japan

Towards the end of October, the Bank of Japan (BoJ) released its semi-annual Outlook for Economic Activity & Prices report. Although the central bank remained cautious, it did appear to suggest that the balance between upside and downside risks has become more neutral. It raised its real GDP growth forecasts for fiscal 2009 and 2010 to -3.2% and +1.2%, respectively. At the same time, the BoJ released its first ever estimate of economic growth for fiscal 2011, predicting real GDP of +2.1%. The forecast is well above both the market consensus (the average estimate stands at around +1.3%) and the central bank's revised potential growth rate of around 0.5%, reflecting its optimistic view that improvements in the corporate sector will spill over to the household sector. However, the BoJ predicted that core consumer prices would decline for a third straight year in 2011 (the core CPI is expected to fall by -1.5% in fiscal 2009, -0.8% in 2010 and -0.4% in 2011), suggesting that a highly accommodative monetary stance will remain in place for the foreseeable future.

ASIA DRIVING RECOVERY IN EXTERNAL DEMAND

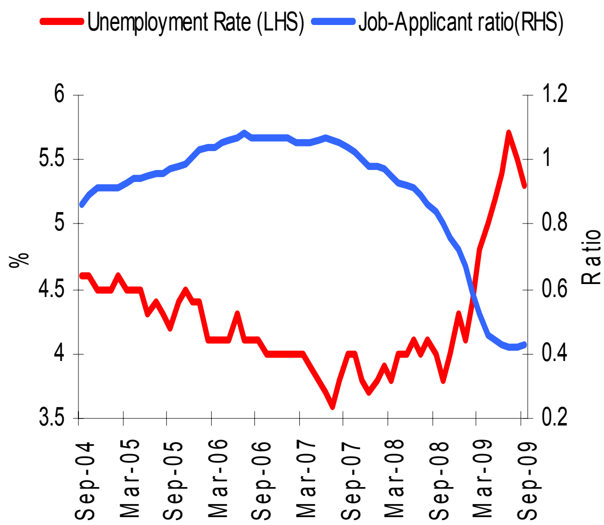
- Following the financial crisis, a synchronized global downturn and sharp appreciation in the yen dealt a severe blow to Japan's export-dependent economy. Although export volumes continue to decline in year-on-year terms, the rate of contraction has eased from around -40% at the start of the year to around -20%. Moreover, since the economy bottomed in the first quarter exports have increased in six out of the eight subsequent months.
- As the chart shows, Asia has led the turnaround in external demand, as a rapid economic rebound in countries such as China has fuelled demand for Japanese exports. Shipments to the US and Europe are also showing a recovery trend, albeit one far more muted in comparison.
- Leading indicators of Japanese exports, such as the US ISM manufacturing and new orders indices, the OECD leading economic indicators and the manufacturing PMI for China, suggest that a V-shaped recovery is likely to continue through the fourth quarter.
- Thereafter, export volumes should remain on an upward trend, but a combination of adverse foreign exchange effects and an end to government incentives could slow the pace of recovery.



Source: MoF, October 2009

EMPLOYMENT IMPROVES

- Japan's unemployment rate unexpectedly fell to 5.3% in September from 5.5% in August. Furthermore, the job-to-applicant ratio also improved for the first time in more than two years. The ratio rose to 0.43 in September from a record low of 0.42 in August, implying there are 43 jobs for 100 job seekers. Even though the labour market shows signs of improvement, the situation remains rather fragile. A government program providing wage subsidies is supporting the job market. Industries have applied for aid on behalf of about 2 million workers.
- Meanwhile, Japan's wages continued to decline in September. Monthly wages including overtime and bonuses slipped 1.6% from a year earlier. This indicates that consumer spending may not be able to support growth even after the improvement in the unemployment rate. Companies that have enjoyed renewed demand are still under pressure to keep wages low because the yen's advance is eroding profits. However, despite the decline in wages, overtime hours among manufacturers rose 4.1% from a month earlier as factories boosted output amid a rebound in trade. Industrial production also rose in September.
- As a result of improving economic conditions, the Bank of Japan (BoJ) decided to let its programme of outright purchases of commercial paper and corporate bonds expire as scheduled by the end of 2009. BoJ Governor Masaaki Shirakawa also said they would only extend a program providing unlimited collateral-backed loans to banks one last time through 31 March.



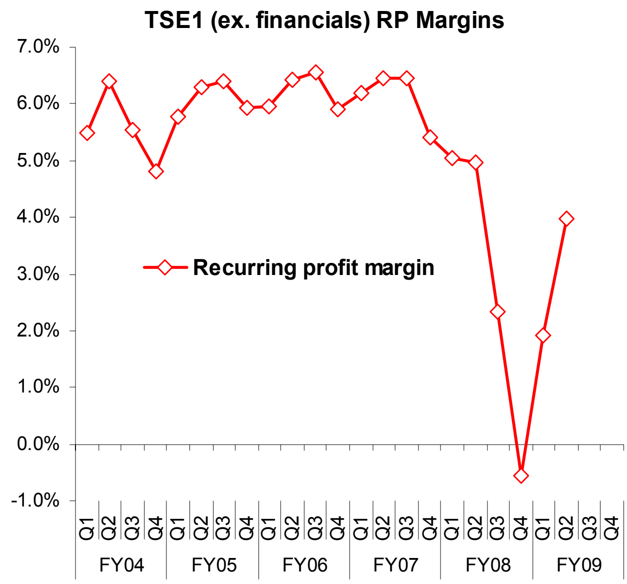
Source: Bloomberg, October 2009

Japanese markets

In October, the broad-based Topix returned -1.7%, declining for a second consecutive month, albeit in step with other global markets. At the start of the month, Japanese stocks mirrored declines in their US and European peers, with a surge in the yen to ¥88 against the US dollar weighing heavily upon exporters. Although interim earnings results produced positive news flow, share prices remained under pressure because of uncertainty surrounding the policies of the new government and concerns about the country's fiscal deficit. Smaller companies underperformed in October, reflecting a rotation towards large-cap growth stocks. At a sector level, insurance, metals products and oil & coal suffered the steepest declines. Defensive industries struggled, while non-bank financials rebounded from a sharp drop in September.

SIGNS OF RECOVERY IN CORPORATE PROFITABILITY

- Towards the end of the month, the interim results season got under way in Japan. Aggregate second quarter earnings for TSE1-listed companies (excluding financials) have so far revealed a 24% year-on-year decline in sales and a 45% drop in recurring profits. Despite the double-digit contraction at both the top line and the recurring-profit level, companies' results showed a clear recovery trend compared to previous quarters.
- Moreover, a key feature of the current results season is a clear improvement in corporate profitability. According to preliminary data, the aggregate recurring profit margin for Japanese companies (TSE1-listed firms, excluding financials) recovered from -0.6% in the first three months of the year to 4.0% in the July–September period.
- Unlike in the previous quarter, when Japanese companies turned profitable solely as a result of their restructuring efforts, the latest results reveal that a resumption in sales growth is complimenting the effects of cost cutting.
- As the chart shows, recurring profit margins have almost returned to the pre-Lehman level. However, the fact that they remain below the average rate of around 6% that prevailed from fiscal 2004 through 2007, suggests that companies are likely to maintain their efforts to restructure and enhance efficiency.

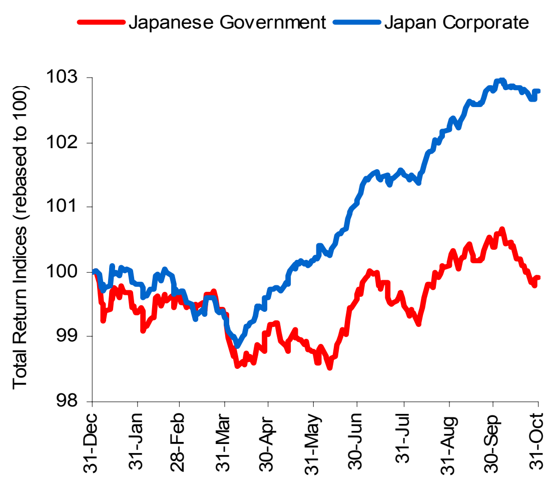


Source: Toyo Keizai. November 2009

Japanese government bonds ended the month in negative territory for the first time since July as stock markets improved, reducing demand for government debt. Meanwhile, in its semi-annual outlook, the BoJ stated that Japan's economy has started to pick up, and in the second half of fiscal 2009 it is likely to improve gradually on the back of improvements in overseas economies as well as the effects of economic policy measures.

GOVERNMENT BONDS DECLINE

- Japanese government bonds returned -0.5% in October, underperforming investment-grade corporate debt, which returned -0.01%. Higher-rated AAA paper outperformed other bonds within the credit spectrum, returning 0.7% over the period. Lower-rated BBB bonds returned 0.6% over the month while AA-rated bonds continued to be the worst performers, returning -0.2%.
- The BoJ governor Shirakawa further said that the central bank would keep interest rates low even as the economy picks up. He further added that it would take a little while before Japan's economy can achieve a full-fledged recovery and that the bank was committed to prolonging the current extremely accommodative financial environment.
- Over the month, the yield curve steepened as yields on short-term debt rose less that those on longer dated securities. The yield on two-year government bonds rose by 0.01% to 0.3%, while that on ten year paper advanced by 0.11 percentage points to 1.4%.



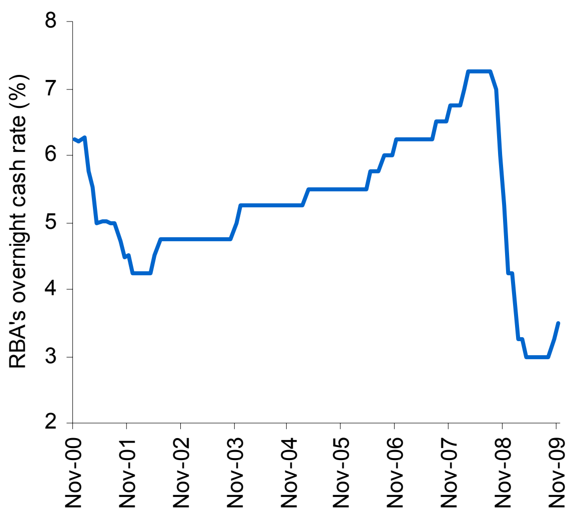
Source: BofA Merrill lynch, October 2009

Asia Pacific

Concerns regarding the sustainability of economic recovery in the Asia Pacific ex Japan region abated, as economic expansion in China, Korea and Singapore in the third quarter exceeded expectations. Real GDP in China grew by 8.9% on year-on-year basis, supported by fixed asset investment and higher private investment notably in the property sector, which more than made up for weak exports. Manufacturing continued to be strong in Korea, while Taiwan and Australia benefited from demand from China. The Reserve Bank of Australia raised key interest rates in October and early November by a quarter of a percentage point each time to 3.5%.

AUSTRALIA RAISES INTEREST RATES

- The Reserve Bank of Australia (RBA) reiterated its strong economic outlook in its quarterly Statement on Monetary Policy (SMP) released in early November. Policymakers have substantially upgraded their forecasts for growth from what they expected three months ago. Real GDP is now predicted to grow by 1.75% this year and 3.25% in 2010 from previous estimates of 0.5% and 2.25%, respectively. And while underlying inflation is now significantly above expectations, it is still expected to ease to within the target band, with the RBA maintaining that the removal of monetary policy stimulus will be a gradual process.
- Given labour market resilience, improving consumer confidence and historically low interest rates, it is unlikely that consumer spending will fall in a heap over the remainder of the year. At the same time, with businesses more optimistic, firms are much more likely to hire additional staff and dust off those investment plans that they put on ice when the financial crisis hit.
- Looking ahead, the central bank clarified that it will monitor developments closely and set monetary policy so as to promote sustainable growth, gradually lessening monetary stimulus over time if the economy evolves broadly as expected.

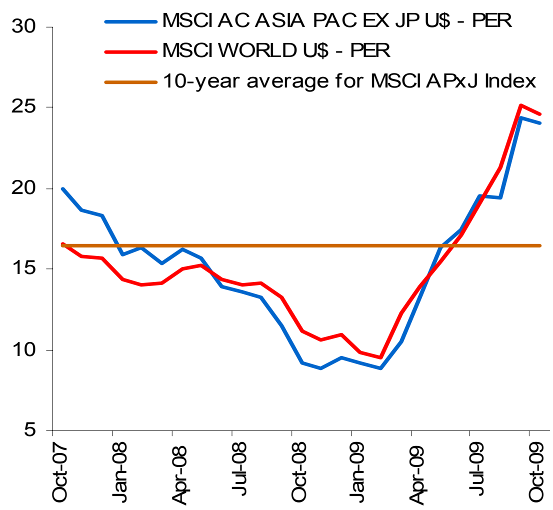


Source: Bloomberg, November 2009

Most stock markets in the Asia Pacific region were subdued, except for China. Doubts over the sustainability of the recovery in share prices countered optimism about better-than-expected earnings. While economic data continued to be encouraging, uncertainty over the possible withdrawal of recent fiscal and monetary stimulus measures hurt sentiment. All sectors, with the exception of consumer staples, declined. Foreign fund inflows slowed in Korea, while they turned negative in Taiwan. Bucking the trend, an impressive rebound in shares in Chinese companies boosted Hong Kong shares as well.

VALUATIONS MOVE HIGHER

- Given the strong rally since mid-March, stock price valuations have moved higher even as actual earnings improved. Stocks in Asia Pacific ex Japan region are currently trading above the long term average, although slightly lower than their global peers. Using a Price to Earnings ratio based on forward earnings, however, points to a valuation level closer to that of its long term average, as companies are expected to enjoy the earnings growth benefits of economic recovery.
- From a sector perspective, there are some sectors including the automobile industry which, unlike their Western counterparts, have withstood the difficulties of a global recession and continue to record strong growth. Positive investor sentiment towards sectors such as home appliances and property has made these stocks popular with market participants, hence pushing their valuations to above market average levels. Among countries, Indonesia and Singapore equities appear relatively cheaper than their regional peers.
- As a result, investors need to be cautious regarding valuation and employ a disciplined approach to investing. In this environment, it becomes more critical to look for good quality firms which have room for further upgrades and positive earnings surprises.



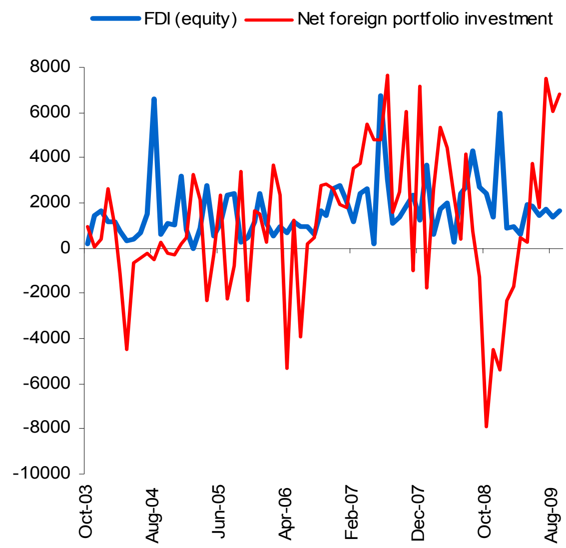
Source: DataStream, November 2009

Emerging markets

The International Monetary Fund (IMF) raised its forecast for global growth in 2010 and revealed that emerging Asia, particularly China and India would lead the world economy out of recession. China's GDP expanded at an annual pace of 8.9% in the third quarter, real estate investment continued to grow, and in September, external trade improved as both imports and exports declined at a smaller pace. The Reserve Bank of India kept key policy rates unchanged, but withdrew several unconventional easing measures, indicating policy tightening could be on cards. The Russian central bank lowered its benchmark refinancing rate yet again.

BRAZIL INTERVENES TO CURB APPRECIATION OF THE REAL

- Brazil initiated a currency intervention measure by launching a 2% tax on capital inflows into domestic equities and fixed income instruments. Direct investment in the productive economy will not be affected by this move. The government finally gave in to pressure to counter the appreciation in the Brazilian real. The currency has already risen by over 30% in value against the US dollar since the start of this year, which has been particularly detrimental for exporters.
- Portfolio inflows have been especially strong since Brazil emerged from a brief recession in the second quarter, apparently shrugging off the impact of the global crisis. Such investments can be quite volatile compared to foreign direct investments (FDI) that are made for a longer duration and less influenced by short term news flow. Any substantial portfolio investment or withdrawal can lead to rapid currency fluctuations.
- However, some believe that the capital tax will only have a short-term impact on the real and Brazil's robust economic fundamentals will continue to bolster the currency in the long run. For the government, the measure will give a much-needed fillip to tax receipts, though the country's Finance Minister Guido Mantega has insisted the objective is to prevent a bubble from forming in Brazil's financial markets.

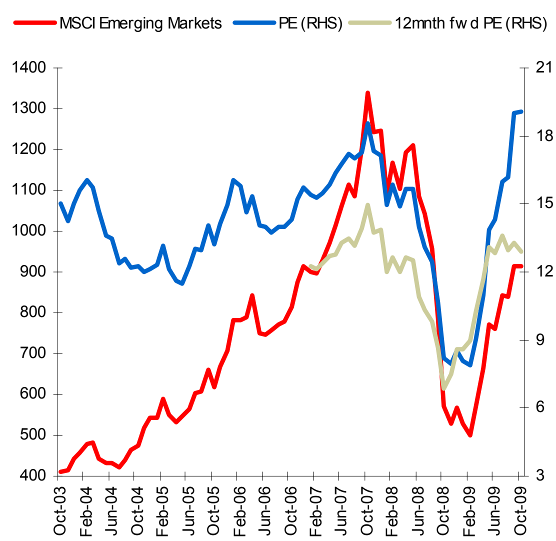


Source: DataStream, October 2009; US$ million

Emerging Market equities ended the month only marginally higher, amid concerns about the sustainability of an economic recovery in the US coupled with speculation about withdrawal of central banks' stimulus support measures. Asian equities were the leading detractors due to weakness in India, Taiwan and South Korea, which undermined the positive performance of Chinese equities. Conversely, Brazilian stocks continued to drive positive returns from Latin America, despite the imposition of a 2% tax on foreign portfolio investments in domestic equities. At a sector level, consumer staples were the best performers, while technology stocks fell after a period of strong performance.

EMERGING MARKETS RALLY GENERATES SOME UNEASE

- The MSCI Emerging Markets Index has risen by 61% YTD in 2009. The rally has been supported by a recovery in risk appetite thanks to government stimulus and inventory rebuilding. In comparison, the S&P 500 Composite has risen a mere 14.7% from the start of 2009. On a valuation basis, the Emerging Markets Index is now valued over 19 times its historical earnings, while it trades at almost 13 times its 12-month forward earnings.
- Lately, investors have become a little wary of a potential bubble developing in emerging market stocks, as the sustained uptrend has prompted valuation concerns and has made these equities susceptible to bouts of consolidation in the short term. This was apparent in India during October, as investors responded poorly to the central bank's suggestion that interest rates could rise soon and some corporate
- While some short-term market valuations look relatively expensive, the long-term rationale for investing in emerging markets remains very clear. While demand from the developed world continues to make a contribution, the economic growth of emerging markets is also supported by the internal dynamics of rising consumption. Other compelling factors include government investment in infrastructure, urbanisation and rising regional trade among emerging markets.



Source: DataStream, October 2009; MSCI Emerging Markets Price Index in US$

GlobalWatch: