

# GLOBAL WATCH

JANUARY 2009

## EDITORIAL

### THEN AND NOW: LOOKING BACK AND FORWARD TO THE THEMES DRIVING MARKETS

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2008 was a year that will live in the memory of investors for some time. Financial markets staged a historic sell-off amid levels of price volatility not seen since the Great Depression. The surprisingly deep extent of the credit crisis radically changed the financial landscape. Policymakers responded with an unprecedented level of stimulus as it became clear the world stood on the brink of depression and deflation only a few months after surging commodity prices had made inflation the main threat to the world economy.

Here, we look at the themes driving investment markets then and now, as inflation has given way to deflation, passive government to interventionism, and risk appetite to risk management.

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## THEN AND NOW LOOKING BACK AND FORWARD TO THE THEMES DRIVING MARKETS

EDITORIAL

**2008 was a year that will live in the memory of investors for some time. Financial markets staged a historic sell-off amid levels of price volatility not seen since the Great Depression. The surprisingly deep extent of the credit crisis radically changed the financial landscape. Policymakers responded with an unprecedented level of stimulus as it became clear the world stood on the brink of depression and deflation only a few months after surging commodity prices had made inflation the main threat to the world economy.**

**Here, we look at the themes driving investment markets then and now, as inflation has given way to deflation, passive government to interventionism, and risk appetite to risk management.**

### FROM INFLATION TO DEFLATION: OUT OF THE FRYING PAN AND INTO THE FIRE?

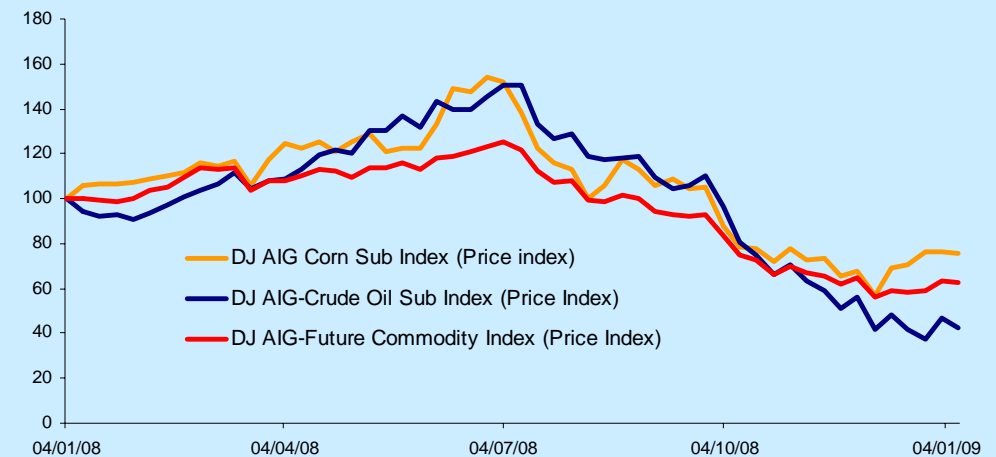
It seems a distant memory now, but in the early part of the 2008, inflation was rampant, driven by sharply rising energy and food prices. Central bank inflation targets became swamped and there were serious concerns over increases in the price of various commodities, notably crude oil and staple foods.

At the same time, the real impact of the credit crisis on the financial sector was causing investors to re-evaluate their view of an already slowing world economy. As economists revised down growth estimates, it became clear the world stood on the brink of a very deep recession that would hit both developed and emerging economies. Commodity prices fell even more sharply than they had risen as the financial system went into meltdown and stock markets corrected with gut-wrenching severity. Banks effectively stopped lending as credit markets ground to a halt, causing the prospect of prolonged deflation to become a real threat.

2009 will see the battle between these deflationary forces and the incremental impact of the reflationary measures already taken, or being taken by governments, played out in full. Investors should make no mistake that deflation will be difficult to overcome given the prolonged nature of the asset price bubble that preceded it and the fact that this was exacerbated by high levels of leverage. Although governments are seeking to encourage consumption even as unemployment rises, consumers may be unwilling to spend, particularly on credit, while banks are equally unwilling to lend.

### THE RISE AND FALL OF COMMODITY PRICES

Source: DataStream, 12/01/09. Data is rebased to 100.



### FROM PASSIVE TO INTERVENTIONIST GOVERNMENT POLICIES...

The credit crisis and the spectre of deflation have forced governments off the fence. A 'laissez faire' approach to financial markets was fine for as long as they functioned effectively. Now, we have governments taking stakes in banks, zero interest rate policies and massive fiscal programs.

### ... BUT SHOULD GOVERNMENTS (AND US) BE SAVING OR SPENDING?

If the cause of today's problems were partly due to years of credit-driven spending, surely 2009 should be one of saving? Observers are, however, split over the appropriate policy response to deflation as the incumbent monetarists run out of weapons and the discredited Keynesians return to the fore. The prolific expansion in credit combined with western consumers' willingness to spend rather than save were key factors that sustained the asset price boom. Government policy is now largely focused on taking on more



debt and encouraging consumers to spend the economy out of a deflationary spiral. Counter-intuitive to many people and morally questionable to even more, governments seem to be doing their utmost to bail out indebted consumers while punishing conservative savers.

Encouraging people to save seems more sensible, at least at individual level, but, at a national level, this behaviour might not be beneficial for the economy. This is John Maynard Keynes' 'Paradox of Thrift'. When everyone saves during a synchronised global downturn, consumption and investment and the economy at large shrink to the detriment of all. Plus, with little evidence in the short term of Asian consumers filling the gap in western consumption if savings rates do rise, perhaps spending is the only thing governments can do to militate against Japanese-style deflation? 2009 should provide much of the evidence as to who is right. Beyond that, what most experts are agreed on is that these policies store up problems for the future and inflation is very much forecast to return within the next few years. Indeed, the US government's prolific spending plans, coming on top of an already sizable debt burden, have been compared to a giant 'Ponzi' scheme that borrows from future generations to solve the problems of today.

#### **RISK APPETITE REPLACED WITH A FOCUS ON RISK MANAGEMENT**

One feature of the extended bull market was the heightened investor interest in more complex products and investment strategies which used leverage and derivative instruments, such as hedge funds. While there remains a place for these strategies for investors cognisant of and comfortable with the risks, the wider investor base is increasingly demanding more straightforward and transparent investment solutions. To that end, we have already witnessed substantial redemptions from hedge funds.

More than ever, investors want to understand fully what they are buying and what they are exposed to - a fact that was underlined by those investors indirectly caught up in the Madoff fraud. Within this theme, we are also likely to see a natural shift back to the fundamentals of investing and the concept of selecting experienced asset managers to manage only the assets they excel at managing. Many investors seem to have lost patience with the quantitative models and 'black boxes' so prevalent in the hedge fund landscape. These models were based on past relationships that gave certain scenarios huge and highly unlikely statistical odds of ever coming to pass. Unfortunately, in many cases they did come to pass, as past relationships suddenly broke down in what was a highly unusual year.

Transparency will become paramount. For many investors, particularly those burned by their experience in unregulated hedge funds, this is likely to mean a UCITS III investment fund, where assets remain under the control of the assigned manager and benefit from greater protection.

#### **FROM GLOBAL TO LOCAL, EMERGING TO DEVELOPED WORLD FOCUS**

The world has become increasingly integrated over recent years as economies and stock markets have moved up in synchronised fashion. However, closer integration brings with it a higher inherent vulnerability to shocks having a global impact. Markets have quickly lurched from synchronised growth to synchronised recession.

We can expect financial markets to de-correlate and become more local again. With investors exercising more caution over their investments, they are likelier to feel safer investing in their own domestic markets. With most investment coming from the developed world, this trend is likely to favour developed markets.

Add to that the fact that the US is likely to lead the recovery not just because of its size and resilience but also because it benefits from the first mover principle - as the first economy in crisis, it should also be the first out. Europe and Asia are more likely to lag due to their dependence on a recovery in global exports; this may not be forthcoming if investment rather than consumption is the catalyst for recovery.

Emerging markets are suffering not just from lower commodity prices but also from lower final demand. China's economy may prove to be highly cyclical given the extent it is geared toward manufacturing industries. India's economy has a lower dependence on exports but it is not yet a sufficient source of regional demand to carry other Asian or emerging economies in its wake.

The type of theme betting that was prevalent at the start of 2008 is likely to be replaced by a focus on fundamentals once again and a preference for bottom-up stock analysis. In the first quarter of last year, investors bought commodity ETFs and energy funds because these themes were winning bets at the time and entire sectors and sub-sectors were moving in unison.

Now, there will be a much more significant microeconomic focus with balance sheets, cashflows, profit margins and management teams coming back to the fore; all of these will be used to separate stocks within a sector. It follows that there will be sharp differentiation between winners and losers that will benefit the most experienced and effective fundamental asset managers.

#### **CONCLUSION**

Last year, we saw a lot of change within financial markets and, frighteningly for investors, much of that change seemed to take place at breakneck speed. Investors need to remain alert to the battle between deflationary and reflationary forces as this will have a critical bearing in terms of preferred asset classes.

One positive is that governments are taking historically commensurate action for historically big problems. Bear in mind that while individuals should save this year, paradoxically countries probably should not! Investors will increasingly come back to markets, but they will focus on transparent products, developed and domestic markets, and the need to differentiate at the stock level.

## EUROPE

### ECONOMY

Economic indicators were mixed during the month. The eurozone composite Purchasing Managers Index fell marginally in December, indicating a further slowdown in economic activity. Nevertheless, the figure was better than the consensus forecast. On a more positive note, the ZEW survey of economic sentiment improved for the eurozone's largest economy, Germany. The improvement in the sentiment indicator signals limited concerns about a deepening recession in mid 2009. However, the IFO business sentiment index plunged for its seventh straight month with the fall in export orders continuing to pose a significant obstacle for the export-led German economy. Meanwhile, unemployment in the eurozone rose as the number of persons employed decreased by 0.1% in the third quarter of 2008 compared with the previous quarter.

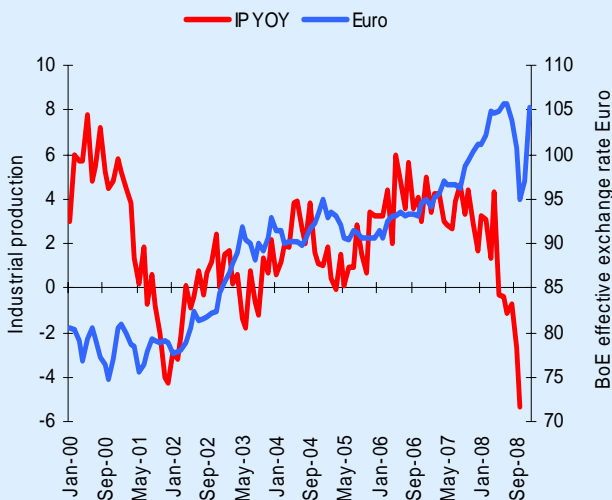
#### STIMULUS PACKAGES FOR 2009

Selected Countries	Tax Cuts & Extra Expenditures		Extra Credit & Similar Measures	
	€	% of GDP	€	% of GDP
Germany	14.81	0.58	21.80	0.85
Greece	0.00	0.00	8.00	3.10
Spain	12.31	1.10	48.28	4.32
France	14.30	0.72	52.70	2.64
Italy	-0.26	-0.02	0.00	0.00
Netherlands	1.30	0.21	0.00	0.00
Austria	0.08	0.03	0.60	0.21

Source: Citigroup and Bruegel, 12 December 2008

- The heads of the 27 European Union (EU) member states approved a coordinated fiscal stimulus package worth around €200bn, equivalent to 1.5% of the EU 27 GDP. According to the plan, each member state will set up a national package (on average around 1.2% of its own GDP) and the EU Commission will provide the additional easing.
- According to the a study by Bruegel, an international economics institute funded partly by EU member states, Spain is the only country in the eurozone that is currently planning classic measures of fiscal easing, such as tax reductions or expenditure gains, larger than 1% of GDP. However, taking into account extra measures to provide credit or capital injections to non-financial companies (like the €20bn strategic fund in France), a range of countries offer a stimulus larger than the requested 1.2% of GDP (as on 12/12/2008).
- While the European Central Bank has started to ease monetary policy, rate cuts so far have not been aggressive, given the sharp fall in activity and inflation data. Furthermore, the banking crisis has reduced the effectiveness through which monetary easing can be translated to the private sector. Hence, fiscal easing seems to be necessary to avoid a deep depression. In that respect, the decision by the EU to implement a "timely, temporary, targeted, and coordinated" stimulus seems appropriate.

#### INDUSTRIAL PRODUCTION DECLINES NOTABLY



Source: Bloomberg, December 2008

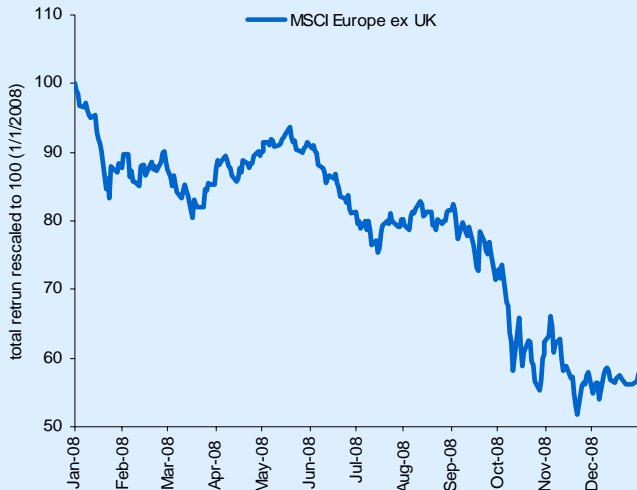
- European industrial production declined 5.3% (year on year) in October, the biggest decline in 15 years as orders weakened and the region's biggest companies cut investment. From the previous month, production fell 1.2%. The fall in October was entirely driven by the manufacturing sector, down 1.3% after declining a revised 1.9% in September. At a country level, output declined by 2.7% over the month in France and by 2% in Germany.
- At a sector level, production fell in all sectors except for non-durable consumer goods, which recorded a marginal 0.3% increase over the month. Output was also affected by the strong downward correction in the automobile sector, after several temporary factory closures planned by the major European carmakers, started to take effect.
- Given the lower levels of domestic and overseas demand, firms are adjusting their production and capacity expectations are at the lowest levels. This has been reiterated by Eurostat which showed that industrial orders in the region fell by 15.1% from a year ago in October and 4.7% on the month. These numbers coupled with the various business surveys (German IFO, Belgian BNB and French INSEE) point to a severe industrial recession in the whole region.

## EUROPE

### EQUITY MARKET

European shares ended marginally lower in December despite steep rate cuts by central banks in the region. Although investors felt that government stimulus measures might limit the damage from the ongoing credit crisis, discouraging economic data led to speculation that that even more sweeping moves could be needed to halt the slowdown. Moreover, profit warnings and analyst downgrades across a wide range of sectors impacted equities. Energy stocks declined, reflecting a drop in oil prices. Banks were also weighed down by their exposure to Bernard Madoff's fraudulent investment advisory firm. On a positive note, industrial and utility stocks bucked the trend and ended higher. Overall, small companies outperformed large and medium-sized firms.

#### EUROPEAN EQUITIES ENDED THE YEAR IN NEGATIVE TERRITORY



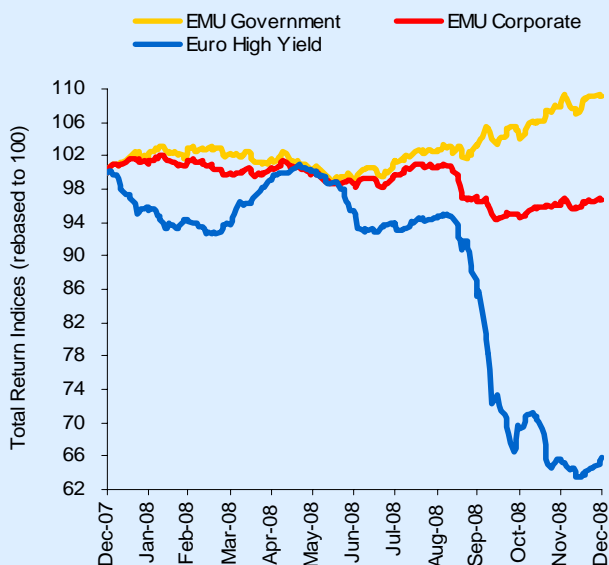
Source: Datastream, December 2008

- European equities generated negative returns in 2008. Markets fell significantly amid intensifying credit market turmoil. Financials were hit badly following the failure of several large investment banks in the US and the need for government in several European banks. The economic environment in the eurozone also weakened, as the region's GDP contracted in both the second and third-quarters of 2008. However, aggressive interest rate cuts by the European Central Bank towards the end of the year provided some encouragement for investors.
- Over the year, there have been downward revisions to earnings estimates. However, following the credit-related market sell-off, equity valuations in Europe have come down to attractive levels. The forward price-to-earnings (P/E) ratio for Continental European equities has fallen to 8.5 times, a 47% discount to the 15-year average.
- Going forward, another factor that could work to Europe's advantage has been the abrupt halt to the dollar's depreciation against the euro. Over the past six months, the euro has fallen by nearly 12% relative to the dollar and this should start to have an impact on the competitiveness of Europe's exports. These arguments make a strong case for stocks in this region, creating opportunities for genuine long-term investors.

### FIXED INCOME MARKET

European government bonds ended higher over the month on the prospect of further interest rate cuts as economic data continued to disappoint. Bolstered by the actions of the various governments, credit markets and high yield bonds ended in positive territory. Meanwhile on 4 December, the ECB lowered its interest rates by 0.75 percentage points to 2.5% in view of deteriorating economic conditions and receding inflationary pressures. Even though investors expect the ECB to lower rates further, president Jean-Claude Trichet has said that there is a limit to how far the bank can cut interest rates and may pause in January.

#### HIGH YIELD MOVES INTO POSITIVE TERRITORY



Source: Merrill Lynch, December 2008

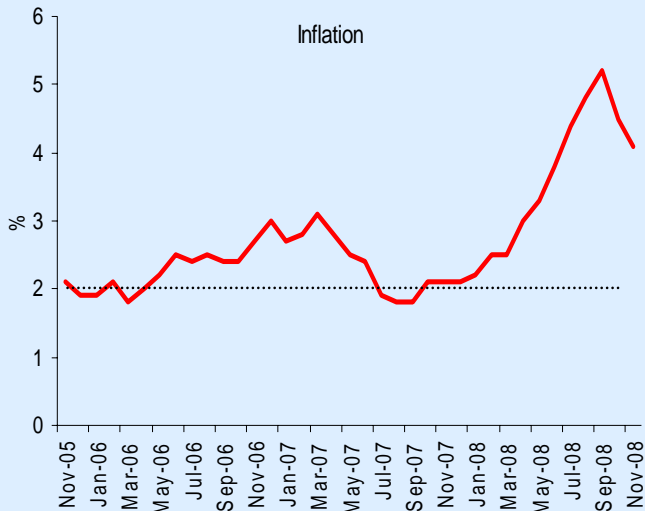
- Credit spreads widened in December, albeit at a slower pace following a series of encouraging government actions in the US. The Fed's decision to lend money to Chrysler and General Motors lifted sentiment in the credit markets particularly, the automobile industry, which saw a tightening of spreads. Likewise, energy and telecommunications also witnessed some narrowing of spreads.
- Government bonds strengthened over the month, generating 1.1% returns on increasingly weak macroeconomic data. Investment-grade corporate bonds returned 0.7% over the month, but underperformed government debt. Within the investment-grade bond market, AA-rated securities generated 1.0% returns while BBB-rated bonds returned 0.8%, matching returns of AAA-rated bonds. Sub-investment-grade bonds generated slightly positive returns of 0.1%.
- Over the month, the yield curve steepened, as yields on short-dated bonds fell more than those on long-dated paper. Yields on two-year government bonds fell by 0.43 percentage points to 1.76%, while those on 30-year maturities fell by 0.18 percentage points to 3.54%.

## UNITED KINGDOM

### ECONOMY

Key economic indicators continued to trend downwards. According to a survey by the Confederation of British Industry (CBI), manufacturers' order books contracted further, despite a fall in the value of sterling. Meanwhile, a separate CBI survey revealed that retail sales declined sharply in December as demand weakened across the board. Conditions in the housing market remained gloomy. There was some respite on the inflation front, as commodity prices fell owing to a weak outlook for demand. Against this backdrop and continuing weakness in the labour market, the Bank of England (BoE) voted unanimously to cut interest rates by one percentage point to 2.0% in December and followed it up with a half-percentage reduction in January. The move brought the rates down to 1.5%, the lowest level in the central bank's 315-year history.

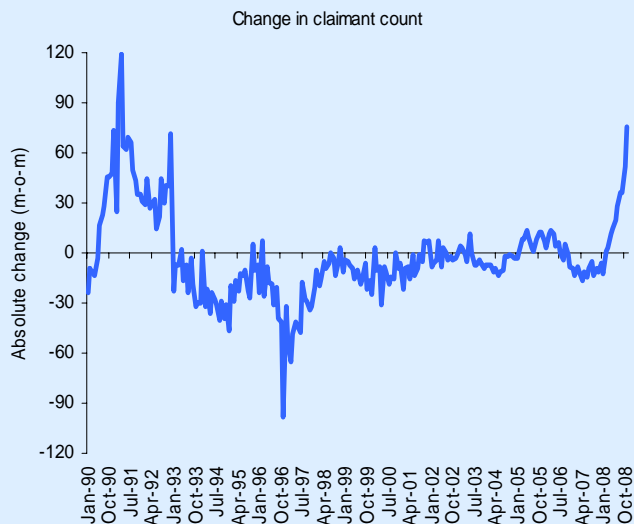
#### FALL IN INFLATION PROMPTS RATE CUTS



Source: DataStream, November 2005 to November 2008. The dotted line represents the Bank of England's target inflation level (2%)

- UK inflation declined in November, raising concerns about the threat of deflation. The Consumer Price Index (CPI) rate fell to 4.1% in November from 4.5% in October, although it remains well above the government's 2% target. The largest downward pressure on the CPI annual rate came from transport costs, as the price of fuels and lubricants fell this year while metal prices have also declined, thus reducing inflationary pressures. Retail Price Index inflation slowed to 3.0%, down from 4.2% in October.
- Most economists expect inflation to fall still further in the New Year, and there are concerns that not only will it go below the target, but that deflation could be possible. Deflation encourages consumers to delay purchases in the expectation that prices will drop further, worsening any economic downturn.
- Recently, Mervyn King, the Governor of the BoE, had warned about the threat of deflation in 2009 as a weakening economy, lower commodity prices and the recent cut in VAT combined to limit price increases. In view of the twin pressures of a slowing economy and deflation, the BoE cut interest rates further in January. However, the reduction limits the central bank's scope to keep fighting the recession with its main policy tool.

#### UNEMPLOYMENT SURPASSES ONE MILLION MARK



Source: Bloomberg, December 2008

- The UK labour market continued to deteriorate at a rapid pace in light of a sharp slowdown in economic growth. Jobless claims have been rising since February this year, and the economy is going through its worst stretch since the early 1990's. The number of people claiming jobless benefits rose by 75,700 in November to 1.072 million and up 257,500 from a year ago. This is also the first time since 2001 that the rate has edged past the one million mark, adding to evidence that redundancies have been increasing.
- Since the start of this year, the number of vacancies has fallen to 520,000, the lowest level in at least seven years. Most of the decline this year came from the services sector, chiefly financial services, retail, and hotels & restaurants. Since its peak in April 2008, employment has dropped 180,000, a fall that has lowered the employment rate by 0.7%, to 74.2%, an almost 10-year low.
- Weaker labour market data was one of the reasons given by the Bank of England to justify the cut in interest rates in December and January. Businesses, which are starved of cash and face a severe retrenchment in demand, are likely to step up the pace of redundancies in coming months which will drive the economy even lower. As unemployment surges further, household expenditure is likely to decline as people increase their savings.

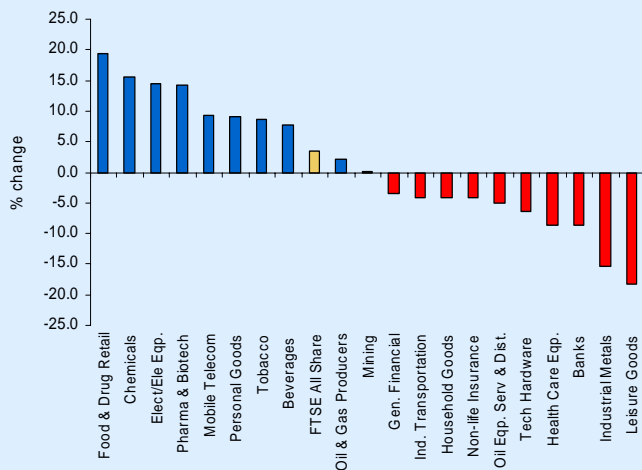
## UNITED KINGDOM

### EQUITY MARKET

UK equities rebounded in December, as investors welcomed further cuts in interest rates by central banks and stimulus packages by governments, which raised hopes of a recovery in economic activity. The benchmark FTSE All Share Index returned 3.7% over the month. Medium-sized companies, with a monthly return of 4.8%, fared better than their small- and large-sized peers, which recorded returns of 4.3% and 3.5%, respectively. Among the constituents of the FTSE 100 Index, Johnson Matthey posted the largest gains; this platinum refiner recorded an encouraging rise in first-half profit and forecast full-year earnings in line with market expectations. 3i Group, a private equity firm, declined the most owing to concerns about its debt burden.

#### DEFENSIVES IN DEMAND

FTSE All Share - sector performance - December 08



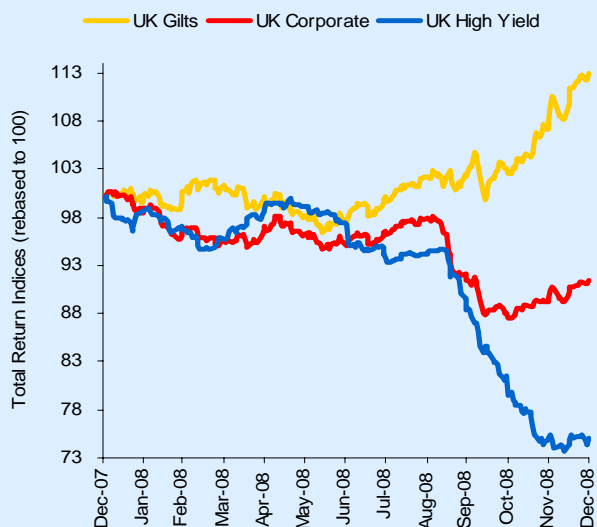
Source: Bloomberg, 31, December 2008

- Equity markets closed a disappointing year on an upbeat note, with the majority of sectors ending December in positive territory. Defensive sectors were preferred, with food retailers, pharmaceuticals, tobacco and beverages firms among the leading gainers. Conversely, consumer-oriented stocks such as leisure goods were out of favour. A weak outlook for demand capped returns from mining shares and oil & gas producers, while financial and real estate companies remained under pressure.
- In view of the continuing uncertainty in the markets, investors favoured large companies with strong balance sheets and the ability to increase or maintain dividends. Mobile telecoms major Vodafone is a good example. Investors welcomed the company's plans to cut costs while it also raised full-year cash-flow projections and increased the dividend. Leading retailer Tesco was another notable stock to advance. Tesco's third-quarter underlying UK sales were slightly better than expected as its new discount range helped to boost sales volumes and customer numbers. Pharmaceutical shares also gained as the strengthening dollar improved the prospects for their US sales.
- As we move into 2009, the preference for large companies with stable earnings potential is likely to continue, as investors continue to fear the effect of the downturn on smaller firms.

### FIXED INCOME MARKET

UK government bonds (gilts) ended the month higher on speculation that the UK would follow the US in lowering interest rates. Bonds were buoyed by worryingly weak economic data which highlighted that the economy is in severe recession. After lowering its interest rates by one percentage point in December, the BoE further lowered rates by 0.50 percentage point to 1.5% on 8 January. The Bank cited rapid contraction in economic activity and restricted availability of credit to households and businesses as the primary reason. Meanwhile, several banks have promised to cut tracker and standard variable rate mortgages in line with the Bank's decision.

#### IS HIGH YIELD TURNING THE CORNER?



Source: Merrill Lynch, December 2008

- The Bank of England's quarterly Credit Conditions survey showed that lenders had reduced the availability of secured credit to households in the three months to mid-December 2008, on concerns about house prices and the economic outlook. The government has pumped £37 billion of taxpayers' money into some of the UK's biggest banks and offered sweeping guarantees to encourage them to lend.
- Gilts ended December in positive territory, generating returns of 5.4%. Investment-grade corporate bonds too ended in the positive territory for a second consecutive month and returned 2.5%. However, they underperformed government-issued debt. Within the corporate bond market, AAA-rated securities were the best performers across the credit spectrum and generated a return of 4.0%, while BBB-rated bonds returned 2.1%. Sub-investment-grade paper returned 0.2%.
- In December, the yield curve steepened, as yields on short-dated bonds fell more than those on long-dated paper. Yields on two-year maturities declined by 1.16 percentage points to 1.05%, whereas those on 30-year paper fell by 0.42 percentage points to 3.70%.

## UNITED STATES

### ECONOMY

The Federal Reserve cut interest rates from 1% to a range of 0-0.25% in December, a development that was welcomed by market participants, but one that also marked the point where an important monetary policy tool was exhausted. President-elect Barack Obama's proposal of a new stimulus package, targeted at generating employment through infrastructure investment, also indicated the use of fiscal measures to support economic growth. The economic situation remained challenging, with the National Bureau of Economic Research officially confirming a recession and data indicating that the unemployment rate in November rose to 6.7% (the highest since 1993). There was also evidence that consumers cut expenditure for a fifth straight month despite a significant decline in prices.

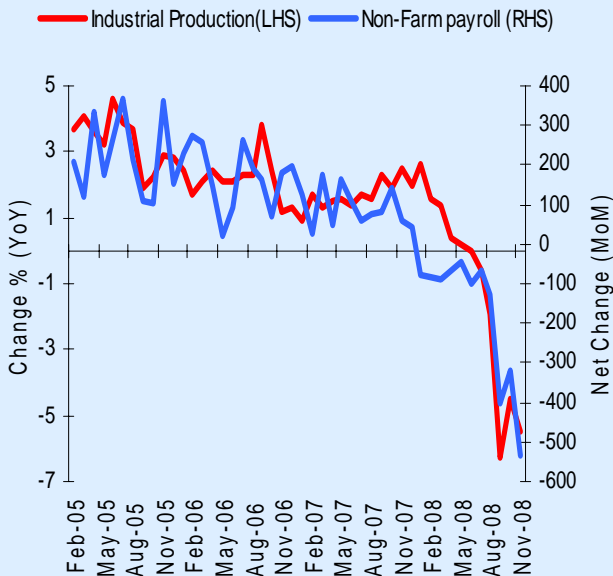
#### US HOUSING: APPROACHING A BOTTOM?



Source: DataStream, December 2008

- The downtrend in the housing market continued, with the Department of Commerce revealing an 18.9% decline in new housing starts in November and a 15.6% fall in permit issuance (an indicator of future construction activity).
- These dramatic reductions were in line with the unfavourable sales conditions facing builders in most markets: prices of single-family homes, for example, retreated (y-o-y) by 18% in October. Nonetheless, inventories are being reduced, which is a step in the right direction for a market that has suffered from over supply for some time.
- How soon the bottom is reached could well be affected by another important factor: home foreclosures. This has become a new channel for supply coming into the market and policy action could stem the tide. Fannie Mae and Freddie Mac have already announced moratoriums on foreclosures. While this will provide temporary relief, other measures are also required.
- The recent reduction in interest rates is a positive factor influencing the demand side. Although the immediate impact may be a spate of refinancings rather than purchases, it is again a step in the right direction.

#### INDUSTRIAL PRODUCTION FALTERS



Source: Bloomberg 31/12/2008

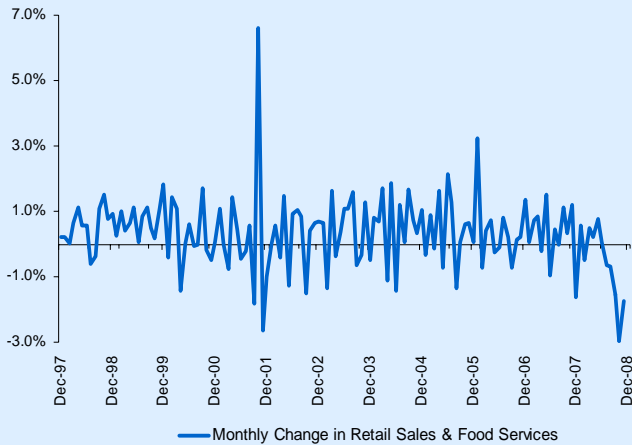
- Industrial production declined 0.6% (month-on-month) in November as exports tumbled and automakers slashed their assembly rate to the lowest level in more than 18 years. The November report was actually weaker than implied by the change in overall production, as according to the Federal Reserve, two technical factors added a percentage point to output. The first factor was a continued rebound in oil and natural gas production, which had been disrupted in September by Hurricane Ike. The second factor was a rebound in aircraft production following the conclusion of a Boeing strike at the start of November. Hurricane Ike and the Boeing strike had both caused significant distortions in production in September and October.
- Manufacturing is poised to keep contracting into 2009 as companies cut back on investment, capital, inventories and production. General Motors is cutting 250,000 units of production from its plan for 2009's first quarter, a 30% reduction. Cummins, a producer of heavy-duty truck engines, said it would eliminate at least 500 jobs by the end of the year.
- A sharp deterioration in the nonfarm payroll employment and a further rise in the unemployment rate re-enforces the weakness in economic activity, which is expected to worsen appreciably over the next few months. Consumption growth and consumer confidence have already slowed sharply since 3Q08 reflecting the increased risk that spending may tumble further next year and prolong the recession.

## UNITED STATES

### EQUITY MARKET

US equities ended the month higher, wrapping up a dismal year on a positive note. The financial and consumer discretionary stocks led gains; the former were buoyed by a larger-than-expected cut in interest rates, while the latter benefited from continuing oil price declines which reduced the pressure on disposable incomes. The automobile sector remained in focus, as investors worried about the ability of the cash-strapped majors to weather the downturn. Although the government did provide a lifeline under conditions which ensured key beneficiaries would need to prove their viability, market participants worried that shareholder value would be eroded nonetheless.

#### RETAILERS: TOUGH TIMES AHEAD?



Source: DataStream, December 2008

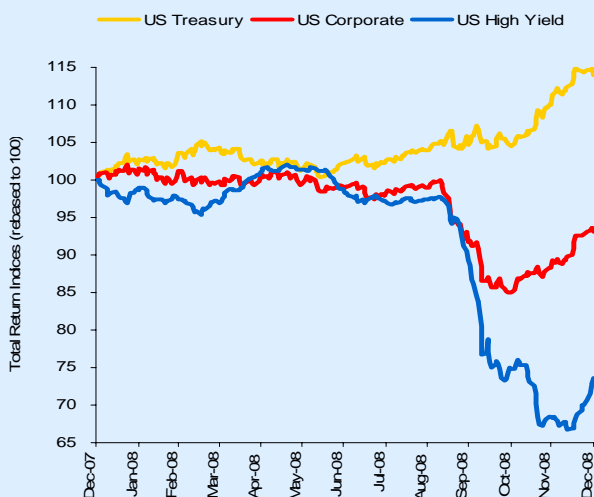
\*MasterCard (Spending Pulse) Survey

- The holiday season, a make-or-break period for many retailers operating in a struggling economy, ended. Initial survey results\* indicate that despite significant price discounting, consumers have curtailed their spending activity. Data from the International Council of Shopping Centers indicated that November saw the worst monthly decline in same-store sales for almost 40 years.
- Retailers are bearing the brunt of considerable stress being felt by the consumer brought on by falling home equity values, curtailed credit availability, rising joblessness and stock market losses. Even in cases where they have been able to attract customers, businesses have faced a dent in their margins because sales have been made at discounted prices.
- These developments have already resulted in high-profile bankruptcies such as of Circuit City and KB Toys. Some experts predict that as many as 3,000 malls and shopping centres in the US could declare bankruptcy by July.
- However, despite the overall negative sentiment, not all retail segments are faring badly. For one, cash-strapped customers are favouring discount retailers such as Wal Mart, which has seen an increase in sales in recent months. E-commerce firms have also fared well this holiday season, with Amazon.com announcing its best season ever.

### FIXED INCOME MARKET

US Treasuries underperformed corporate and high-yield bonds in December as investors rediscovered some of their appetite for risk. The Federal Reserve cut its main interest rate stating that it would target a federal funds rate of between zero and 0.25%. The central bank shifted its focus to the amount and type of debt it buys, seeking to revive credit and end the longest slump in quarter of a century. Furthermore, the US Treasury committed \$6 billion to support GMAC, the financing arm of General Motors, widening the government's effort to keep the largest US automaker out of bankruptcy.

#### TREASURIES UNDERPERFORMED IN DECEMBER



Source: Merrill Lynch December 2008

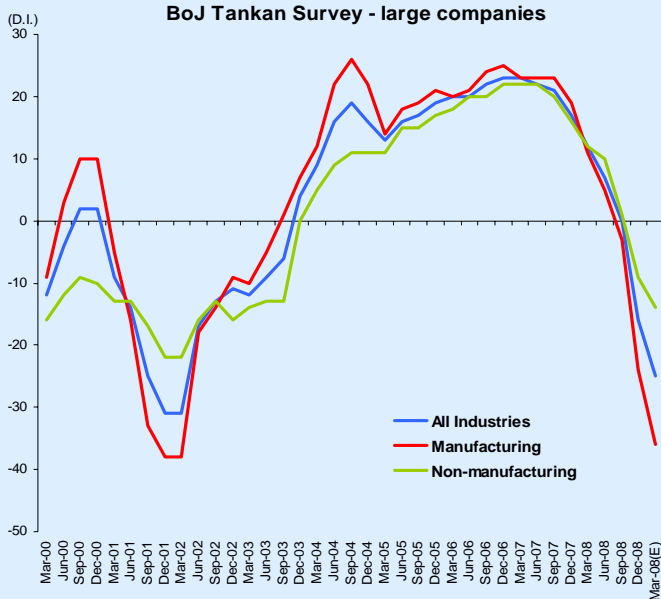
- In December, US government bonds underperformed both investment-grade corporate debt and high-yield securities. Treasuries generated a return of 3.5%, while corporate bonds returned 5.6%. High-yield securities were the best performing asset class, returning 7.5% over the month. Meanwhile S&P reduced ratings on 11 banks including Goldman Sachs, UBS and Morgan Stanley by as many as two levels, saying they faced more operational risk amid a worsening financial meltdown. The agency stated it "wouldn't rule out" cutting the lenders' ratings further if the global credit crisis and economic outlook worsen.
- In the corporate bond market, higher-rated A bonds outperformed other asset classes within the credit spectrum, returning 6.8% over the month. BBB-rated bonds were the worst performers and returned 3.9%, while AAA-rated securities returned 6.4% over the period.
- Over the month, the yield curve flattened, as yields on longer-dated bonds fell more than those on short-term securities. 30-year government bond yields fell by 0.76 percentage points to 2.68%, while two-year bond yields declined by 0.22 percentage points to 0.77%.

# JAPAN

## ECONOMY

Towards the end of December, a number of economic data releases highlighted the increasingly severe impact of the global downturn on the Japanese economy. Exports declined at a record-breaking pace and industrial production posted its worst drop since the government started compiling data in the 1950s. Meanwhile, a series of corporate sentiment surveys underscored the increasingly difficult conditions facing manufacturers. Indicators of employment and consumption also deteriorated, suggesting that weakness in Japan's key growth drivers – large manufacturers – is affecting the broader economy. In a bid to support the domestic economy, the Bank of Japan cut its target rate by 0.2 percentage points to 0.1%. It also expanded its Japanese government bonds (JGB) operations and said that it would purchase commercial paper directly to help cash-strapped firms.

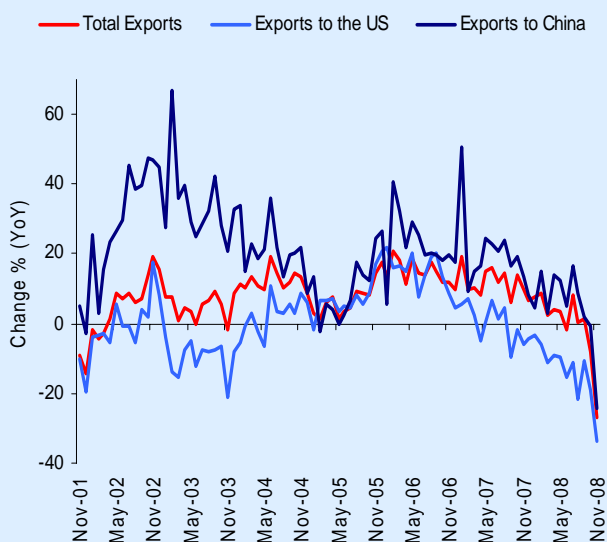
### TANKAN REVEALS SHARP DROP IN COMPANY SENTIMENT



Source: Bank of Japan, December 2008

- In December, the Bank of Japan released its fourth-quarter Tankan survey. It highlighted a rapid deterioration in corporate sentiment, as the effects of the financial crisis on the global economy became increasingly apparent. Confidence among manufacturing and processing industries was hardest hit.
- Since September 2008, sentiment among large manufacturers has deteriorated at the fastest pace in more than three decades, reflecting a sharp drop in exports and the negative effects of a stronger yen. The confidence index for large manufacturers fell by 21 points to -24, the lowest level since March 2002, a time when the economy was suffering the after-effects of the collapse of the IT bubble. Meanwhile, the index of non-manufacturers' confidence fell by 10 points to -9, the first negative reading since late 2003.
- The Tankan survey underscored the growing pressure on firms to adjust inventory, employment and capacity, as well as the increasingly difficult financing conditions faced by SMEs.
- Looking forward, companies expect conditions to deteriorate further in the coming months. The confidence index for large manufacturers is expected to fall by an additional 12 points to -36. Meanwhile, the index for non-manufacturers is forecasted to fall by a further five points to -14.

### EXPORTS NOSEDIVE



Source: Bloomberg, December 2008

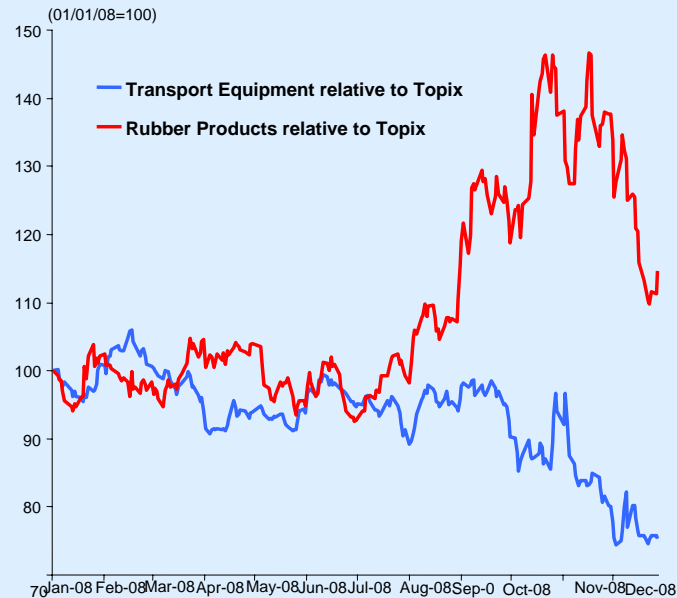
- Japan's exports declined 26.7% in November from a year earlier as global demand for cars and electronics collapsed, signalling that more factory shutdowns and job cuts are likely as the recession deepens. Toyota, Honda Motor and Sony are among the companies that are shedding thousands of workers and closing production lines as profits dwindle.
- The weakening in overseas demand for Japanese goods was broad-based. Shipments to the US slid an unprecedented 34% in November and exports to Europe slid 31%. A government report also showed that the global recession is spreading to the emerging markets that initially propped up exports as demand from the US and Europe evaporated. Exports to Asia fell 27% while shipments to China, Japan's largest trading partner, tumbled 25% over the same period. Additionally, the yen's surge to a 13-year high is exacerbating the woes of exporters.
- Domestic sales are unlikely to make up for the collapse in demand from abroad. Households, whose confidence is at a record low, reduced spending in each month from March this year as wage growth stagnated and job prospects worsened. The government lowered its outlook of economy, stating that it's "worsening" for the first time since 2002. GDP shrank in the past two quarters, sending Japan into its first recession since 2001.

## JAPAN

### EQUITY MARKET

In December, the broad-based Topix Index returned 3.0%, registering its first monthly gain since May. Although domestic and overseas economic conditions continued to worsen, global monetary easing and rising expectations for expansionary fiscal stimulus supported share prices. Falling raw materials costs spurred gains in paper stocks and speculation of a three-way merger buoyed the insurance sector. Meanwhile, an upturn in the price of crude oil lent support to resource-related industries. In contrast, export-oriented stocks fell sharply, as slumping demand and a stronger yen exacerbated concerns about the outlook for their earnings.

#### AUTO-RELATED INDUSTRIES WERE CONSPICUOUS LAGGARDS



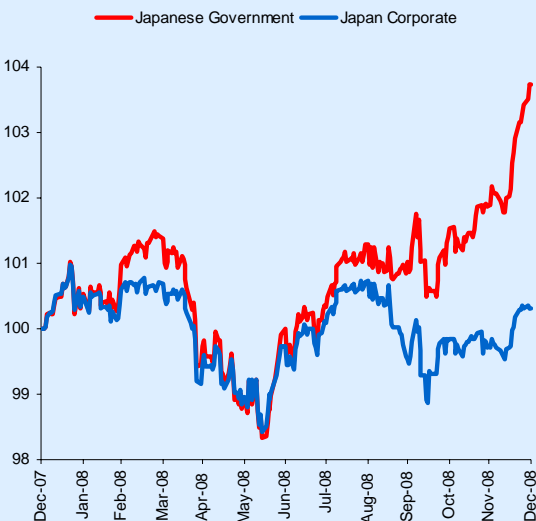
Source: Bloomberg, December 2008

- In the closing stages of 2008, the rapid downturn in the global economy, attendant contraction in external demand and sharp appreciation in the yen took its toll on export-dependent sectors. In particular, the share prices of car manufactures, tyre producers and other auto-parts makers fell sharply. In December, the transport equipment and rubber parts sectors slipped to year-to-date lows, cementing their position as the month's worst two performers.
- Since the start of the year, the market capitalisation of the transport equipment sector has shrunk from 10% of Topix to around 7%. That of rubber products has remained little changed at around 0.5%-0.6%, a trend that owes much to its strong performance through the autumn and early winter when the prices of crude oil and other raw materials underwent major corrections.
- In December, industry leaders Toyota Motor and Bridgestone both announced significant downgrades to their fiscal 2008 earnings forecasts, with the former predicting an operating loss for the first time in its history.
- Although companies such as Toyota and Bridgestone appear undervalued in terms of price-to-book ratios, concerns about the severity of the economic environment and the outlook for the yen are likely to remain significant headwinds for the time being.

### FIXED INCOME MARKET

Government bonds in Japan continued to outperform corporate bonds after the central bank reduced its benchmark interest rate to 0.1% from 0.3% to help the ailing economy. Bond prices are expected to increase more amid concerns that the global recession may deepen further. Meanwhile, the Japanese economy shrank at an annual 1.8% pace in the third quarter, after contracting 3.7% in the prior three months.

#### GOVERNMENT BONDS CONTINUE TO OUTPERFORM



Source: Merrill Lynch December 2008

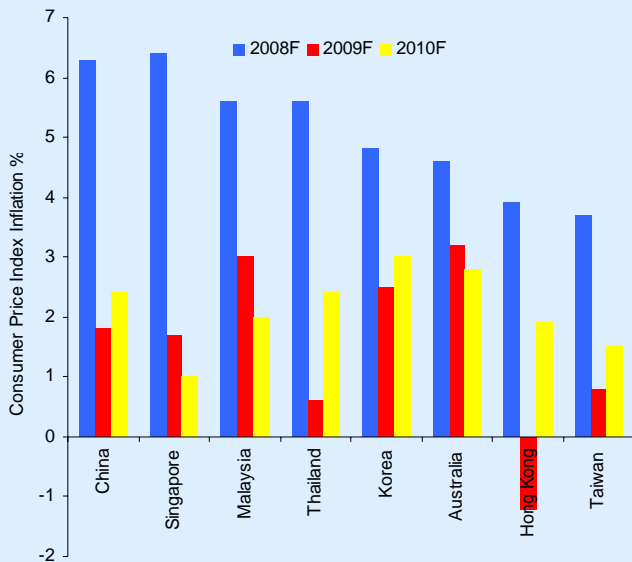
- Japanese government bonds returned 1.8% in December, outperforming investment-grade corporate debt again, which returned 0.6%. AA-rated bonds continued to outperform other bonds within the credit spectrum, returning 0.9% over the period. Lower-rated BBB bonds were the worst performers, returning -0.7%, while the higher-quality AAA paper generated a return of 0.3%.
- The Bank of Japan (BoJ) may consider "extraordinary steps" to counter financial-market turmoil and a deepening recession, according to a policy board member. In addition to reducing interest rates, the BoJ decided to buy corporate debt for the first time in order to pump money into the markets. The central bank has adopted a policy of steep rate reductions with quantitative easing.
- Over the month, the yield curve flattened, as long-term bond yields fell more than those on the shorter-dated securities. The yield on 30-year government bonds declined by 0.45 percentage points to 1.74%, while that on two-year paper fell by 0.22 percentage points to 0.38%.

## ASIA PACIFIC

### ECONOMY

Poor economic data and central bank interest rate cuts were a principal feature during December as deflationary pressures grew and investment activity slowed. Overseas demand continued to weaken as Chinese export growth slumped to -2.2% year-on-year in November, compared to 19.2% in the previous month. Exports also contracted significantly in Korea, Singapore, Thailand and Taiwan. The monetary authorities in Thailand, Australia, New Zealand, China, Korea, Indonesia and Taiwan also lowered key rates in December; however credit conditions remained challenging.

#### DEFLATIONARY EXPECTATIONS REPLACE INFLATION FEARS



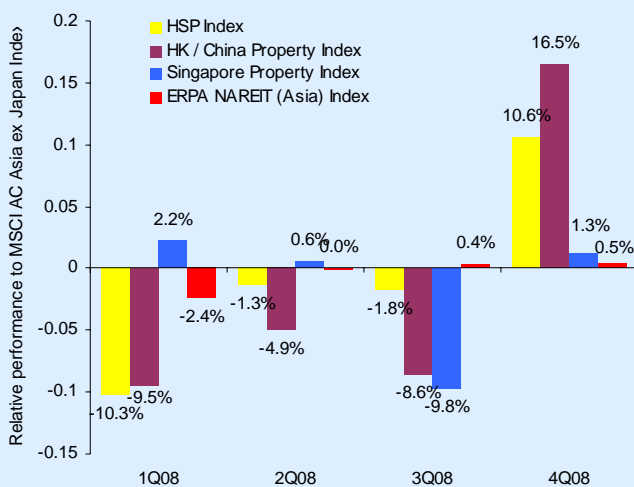
Source: Merrill Lynch, December 2008

- Strong inflationary pressures prominent in the early part of 2008 are easing significantly across the region. This is primarily due to the combination of retreating commodity prices (particularly oil) and the weaker economic outlook. Falling broad money growth is reinforcing the downward trend. As a result, price forecasts have seen a marked downgrade in all countries in the region. According to a Merrill Lynch report, Asian inflation will fall off a cliff from 7.1% in 2008 to 2.6% in 2009.
- In terms of the implications for investment, this means that policy rates have more room to fall; earnings growth in nominal terms will get eroded, and the real cost of debt will increase. From the standpoint of banks, default rates may rise as the values of collateral assets decline.
- The brush with deflation is likely to be short-lived, as excluding food and energy, the price changes are lesser in magnitude and less widespread across the region. Moreover, the world economy is receiving large stimulus packages and economies are prepared for 'deep' cuts in interest rates. Consequently, as shown in the chart on the left, 2010 forecast show inflation becoming more stabilised in a few countries.

### EQUITY MARKET

Asian equities rebounded in the last month of the year, boosted by government efforts to support domestic economies. All sectors of the MSCI AC Asia Pacific ex Japan index advanced, except for healthcare. Industrial stocks were boosted by the anticipated impact on demand that proposed fiscal spending would bring. The People's Bank of China cut its benchmark lending and deposit rates by 0.27 percentage points and lowered the reserve requirement rate. The less-than-expected cut is likely to reflect the authorities' confidence in the fiscal and monetary policies in place, and their willingness to allow more time for these measures to take effect on the economy.

#### THIRD QUARTER EARNINGS SO FAR



Source: Bloomberg, December 2008

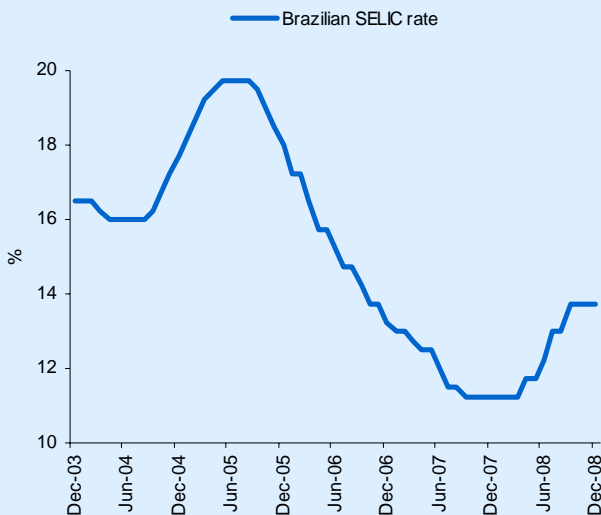
- Governments across the world have introduced several fiscal measures to inject capital into regional economies and avoid a deeper recession. In Asia, most of these plans are geared to meet development goals and establish better infrastructure. As a result, the stimulus packages have boosted stocks in capital goods and infrastructure construction firms. Although its effect on the real economy will be gradual, construction firms and property developers stand to benefit from these measures.
- Property indices in China, Hong Kong and Singapore advanced in the last quarter of 2008. In China, investors expect fundamentals to remain weak in the short term, but regulatory change is proving a powerful share price driver. For instance, shares in Hong Kong listed developers were buoyed in December by a tax cut on home sales in China. Australian listed property trusts (LPTs) lagged as capitalisation rates have softened, indicating that more capital raisings are likely.
- Stocks of property developers and owners should show a sustainable recovery well before physical markets. However, it still appears a little early for this to occur as economic news continues to get worse and policy responses now are likely to have a less significant impact.

## EMERGING MARKETS

### ECONOMY

Governments in key Emerging Markets continued to announce fiscal and monetary policies designed to alleviate a sharp slowdown in economic activity, as data releases confirmed a deceleration in growth. Disappointing news flow included a year-on-year drop in Chinese and South Korean exports in November - the first in seven years for both countries - and a decline in India's industrial output. Meanwhile, the Asian Development Bank lowered its expected growth rate for Asia (excluding Japan) from 7.2% to 5.8% in 2009, the lowest level since 2001.

#### A PAUSE IN BRAZIL'S POLICY TIGHTENING



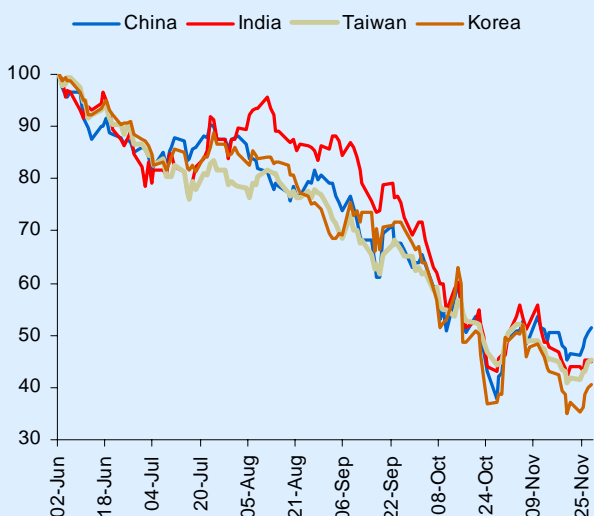
Source: DataStream, December 2008  
SELIC rate =Banco Central do Brasil's overnight lending rate.

- Moderating economic growth has prompted governments in Emerging Markets to use monetary and fiscal measures to maintain growth momentum. Reduced inflationary pressures allowed the Banco Central do Brasil to leave its benchmark interest rate unchanged at 13.75%, in view of the 'severe uncertainty surrounding the macroeconomic environment.' This marks a shift in policy stance for the bank, which had been raising borrowing costs as recently as September 2008. Brazilian President Lula da Silva also urged consumers to step up spending to help the economy overcome the global credit crisis.
- Elsewhere, China resorted to reducing interest rates for the fifth time in three months, as the recession in the developed world hurt demand for its exports and curtailed domestic manufacturing. The People's Bank of China reduced the one-year lending rate by 0.27 percentage points to 5.31% and lowered the deposit rate by the same amount to 2.25%. The central bank also reduced the reserve ratio for banks by half-a-percentage-point. Central banks in South Korea, South Africa and Taiwan also reduced interest rates in December.
- The Indian government announced a second stimulus programme at the turn of the year, following the \$4 billion package put forth in December. The new package includes steps to ease liquidity and provide relief measures for export and housing sectors.

### EQUITY MARKET

Emerging Market equities recovered some ground in December, reversing the negative trend seen over preceding months. Unprecedented monetary easing in the US lifted investor sentiment, as it signalled that the largest consumer economy in the world intended to use all the tools at its disposal to revive growth. Stimulus packages from emerging market governments also provided support and some investors took advantage of attractive valuations given the long-term growth potential of these economies. Industrial and consumer discretionary businesses were the notable gainers at the sector level.

#### STIMULUS PACKAGE BOLSTERS CHINESE STOCKS



Source: DataStream, November 2008; Price Index in US Dollar terms, Rebased to 100

- In 2008, investors increasingly took flight to perceived safe-havens, ultimately avoiding anything remotely risky, as the credit crisis in the US spilled into widespread financial market distress. This trend accelerated after Lehman Brothers' collapse in September and returns from Emerging Market equities dipped sharply by 53.2% over the year. In comparison, the S&P 500 index returns fell by 37% and the MSCI Europe by 46%.
- Amid mounting evidence that the US was slipping deeper into recession and the implications of that for China, commodity prices fell sharply owing to concerns about a drop in demand. This further discouraged investment in Emerging Market equities, heavily weighted in commodity stocks. The energy and materials sectors were worst affected. Industrial stocks detracted sharply; shares in firms that catered to commodity businesses, including mining & heavy equipment manufacturers, shipping companies and related firms also lost considerable ground.
- Elsewhere, financial shares were impacted by negative investor sentiment towards the sector as a whole. The indiscriminate sell-off in financials in Emerging Markets did not reflect the positive fundamentals of financial institutions in these markets compared to western developed markets.

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