

# Investments

# Monthly Review



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June 2009

## Highlights

- Equity markets enjoy another positive month.
- Commodities surge ahead.
- Investors shun government bonds.

## UK

UK equities enjoyed a third consecutive month of positive performance. The FTSE All-Share index finished 4.2% higher, bringing it back to the level at which it started the year. Although economic data remains poor, investors chose to focus on a slowdown in the rate of deterioration, fuelling hopes that the global economic downturn may turn out to be less severe than originally anticipated. As a result, the miners and the oil & gas producers outperformed the broader market. The banking sector also continued its strong recovery during a month that produced a mixed set of first-quarter results for the major UK institutions.

Though economic prospects in the UK remain challenging, greater concerns about economies elsewhere were reflected on the currency markets, where sterling reached its highest level this year against both the dollar and a basket of currencies. UK interest rates were kept at 0.5% in June. Many traders believe the worst of the financial crisis has now passed. Yet, notes of caution from other quarters tempered such encouraging developments. Mervyn King, the Governor of the Bank of England, warned that conditions underpinning the outlook for the British economy had worsened since February. The bank also announced an additional £50 billion worth of quantitative easing, which is to be completed by August. While this was warmly welcomed by the markets, it also heightened concerns about the implications of soaring levels of government debt - and prompted the ratings agency Standard & Poor's to lower its outlook on UK government debt from "stable" to "negative".

Much of the corporate news was similarly bleak. BT announced a pre-tax loss of £1.3 billion and cut its dividend. It was one of several companies to announce job losses; Wolseley, citing further weakening in its markets, was another. Capital raisings continued apace, with 3i Group, Taylor Wimpey, Lonmin and Travis Perkins amongst those coming to the market.

## Summary

- Equity markets rise for the third straight month.
- The banking sector continues to rebound.
- Concerns grow over the level of government debt.

## US

May brought further gains for US equity markets. The S&P 500 index rose by an ample 5.6% over the month in dollar terms. The results of the US government's stress tests, which examined the financial health of 19 of the country's largest banks under a variety of predicted economic conditions, were released in the early days of the month.

# Investments

# Monthly Review



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Market sentiment prior to the release of the results was wary, as investors contemplated the amount of funds needed to ensure stability for the banks. However, the news that ten of the banks needed a combined \$74.6 billion (£46 billion) to improve their cash reserves and pass muster was surprisingly well received. Bank of America, which is responsible for nearly half of the total shortfall, said it planned to sell assets and issue \$17 billion (£11 billion) in common stock to help raise the \$33.9 billion (£21 billion) it needs.

Investors' "it could have been worse" reaction to the news meant that the financial sector of the S&P 500 posted the strongest gains of the month, returning 13.1%. The energy sector was close behind with a gain of 10.2%, bolstered by a rise in crude oil prices. Consumer discretionary and telecoms were the only losers in May, declining 1.1% and 1.3% respectively.

The month's economic data were mixed. The US Commerce Department reported a 0.4% drop in April retail sales, following a 1.3% fall in March. Sentiment was also knocked by figures showing the number of households facing repossession jumped 32% in April, according to a report from RealtyTrac Inc. Later in the month, the Federal Reserve predicted higher unemployment and a steeper drop in economic activity than it had previously forecast. This surprised some analysts, who had hoped for a more upbeat assessment from the central bank.

In contrast, an unexpected jump in consumer confidence led to a rally in equities in the final days of May. A report from the Conference Board showed that the consumer confidence index had risen to 54.9 from a revised 40.8 in April - beating analysts' predictions of an increase to 42.3. The surge continued, despite the looming fate of General Motors, which eventually filed for chapter 11-bankruptcy protection in early June.

## Summary

- Financials rally on market response to stress tests.
- The Fed predicts higher unemployment and a fall in economic activity.
- General Motors fails and seek protection from creditors.

## Europe

European equities delivered their third successive month of gains in May - although the ride was far from smooth. Overall, the FTSE Europe ex-UK index was up by around 3.4% in local currency terms. The main impetus for the market has been a growing confidence among investors that the global economy is on the road to recovery. The results of the closely watched stress tests on the US banking system - which threw up no negative surprises - were also a source of relief.

As expected, the European Central Bank cut interest rates by 0.25 percentage points to 1% on 7 May (and maintained them at 1% in June) - the lowest level on record. However, the bank surprised observers by launching a programme to buy €60 billion (£55 billion) of covered bonds (an important source of funding for mortgage lending). Financial conditions also showed signs of improving, with interbank lending rates dropping to their lowest level since the credit crisis started. There were also tentative signs that some credit funding was starting to flow once more.

# Investments

# Monthly Review



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Elsewhere, rights issues by companies continued apace as firms look to slash acquisition-related debt accrued in the boom years. This month, France's Danone, Italy's Enel and Tiscali all came to the market - to the tune of just over €11 billion (£10 billion). As economic conditions stabilise and companies look to consolidate, it is unlikely this will be the last round of capital raising by European firms.

As the month ended, recovery prospects for the eurozone economy gained momentum after the European Commission's index for economic sentiment rose for the second consecutive month. This is an important report as it is regarded as a guide to future trends in activity. But the survey was not without its worrying elements, with concerns about unemployment in the 16-nation region continuing to loom large.

## Summary

- European equity markets record further gains.
- Interest rates reach a record low.
- The economic picture shows tentative signs of improving.

## Japan

Japanese equities ploughed ahead during May. Optimism about global economic recovery and some better-than-expected economic data helped the Topix index to rise 7.2% in yen terms. Strong returns in early May were driven by progress in the financial sector as Japanese banks rose in tandem with their US equivalents.

Exporters also initially surged, but the strengthening yen soon began to take its toll. Carmakers were particularly badly hit, after Toyota revealed a \$6.9 billion (£4.3 billion) loss and announced that it was cutting its dividend by 30%. Elsewhere, Sony injected some cheer into the market issuing a mostly upbeat outlook for this year. The electronics giant said, "we expect operating losses to contract significantly." This sentiment echoed predictions by fellow electronics companies Olympus, Casio and Hitachi that sales would make a recovery in the second half of the year.

Economic data were also given a positive interpretation. Official figures showed that Japanese first quarter GDP fell by a record 4% as exports plunged, which is equivalent to a 15.2% decline on an annualised basis. Nevertheless, the result beat analysts' predictions of a 4.2% decline (16.1% annualised).

The optimistic theme was continued by the Bank of Japan, which upgraded its assessment of the country's economy for the first time since 2006. The accompanying statement said that the economy was still deteriorating, but exports and production are beginning to level out. The bank's eight-member policy board voted unanimously to leave Japanese interest rates at 0.1%.

## Summary

- Some exporters predict a recovery in sales later this year.
- The Bank of Japan upgrades its assessment of the country's economy.

# Investments

# Monthly Review



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## Emerging Markets

For the third month in a row, emerging market equities produced double-digit gains. The rise in commodity and oil prices, which underpin the asset class, and signs of a slowing in the global economic downturn contributed to the strong performance. In local currency terms, the MSCI Emerging Markets index rose 12.5% during May; year-to-date it is ahead nearly 32%.

India's market put in a particularly strong showing, with investors reacting euphorically to the United Progressive Alliance's landslide election victory. The MSCI India index rose nearly 29%, much of the increase coming the day after results were announced.

China also enjoyed another month of double-digit gains as investors took encouragement from the latest industrial production data and hopeful consumer news from the US. The government also announced it would put aside \$38.4 billion (£24 billion) into a foreign exchange reserve pool to help Asian nations fight the financial crisis.

In Russia, the central bank cut interest rates by half a percentage point (to 12%), which proved good news for financial stocks. The Russian market is up by around two-thirds since the start of the year. Several other countries also cut interest rates during the month, including Brazil and Mexico.

On the corporate front, Bharti Airtel, one of India's largest telecoms companies, said it had revived merger talks with South Africa's MTN Group. Because MTN has a strong presence in the Middle East, a merger - likely to be worth about \$60 billion - could create an industry giant in two of the sector's most attractive markets.

## Summary

- Emerging market equities produce another strong showing.
- Election results send the Indian market sharply higher.
- Bharti Airtel revives merger talks with MTN.

## Bonds

Government bond markets were hit by a variety of factors during May, with the result that yields rose to six-month highs in many of the major global markets.

Investors were in a confident mood, shunning government bonds and moving instead into equities and corporate bonds. Commodities were also back in favour. The price of US crude oil rose nearly 30% in May, topping \$66 per barrel. Investors were also spooked by forecasts made by Opec's secretary-general that the price could now reach \$70-\$75 by year-end.

The effect of an imminent rise in supply of bonds further fuelled the sell-off. In the US, the Treasury auctioned more than \$100 billion (£63 billion) of new bonds - part of an anticipated \$2,000 billion (£1250 billion) of new issuance to help plug the US budget deficit.

In the UK, the perilous state of the nation's finances led ratings agency Standard & Poor's to warn that it has lowered its outlook on UK government debt - from "stable" to "negative". It

# Investments

# Monthly Review



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maintained its AAA rating on gilts, but cautioned that with government debt approaching 100% of national income, the rating would not be sustainable in the medium term. This is the first time the credit rating agency has lowered its outlook since it started analysing the country's finances in 1978.

With investors seeking riskier assets, corporate bonds were in favour. Gains in corporate bond markets mirrored those in equity markets over the month, with the high yield market putting in a robust performance.

Nevertheless, despite investors' apparent rise in confidence, economic data did little to point to an imminent recovery. In the UK, the CBI's distributive survey showed retail sales dropping back in May, while April inflation data came in a little below expectations. CPI inflation dropped to 2.3% (from 2.9%) and RPI inflation (which includes housing costs) fell to -1.2%. Elsewhere, data on US housing and labour markets offered little for investors to cheer, while Germany's much-watched Ifo survey of business sentiment showed some signs of an improvement in business conditions, but pointed to further falls in production.

## Property

Some green shoots of recovery - albeit tentative ones - are becoming more apparent in the UK commercial property market. A total return of -1.6% in April continues to indicate that the rate of decline is stabilising as April's fall was the smallest monthly decline since August 2008. Investors, indicating that the market could reach its trough in the second half of 2009, have taken this trend positively.

While sentiment towards commercial property may be improving, declining rents are still pulling values down - the reason why further price declines are expected this year. Rents fell 3.2% over the three months to the end of April - the biggest drop in 16 years - as recessionary pressures continue to weaken demand and increase defaults in the occupier markets.

Nevertheless, with initial yields (rent divided by value) from commercial property at a 12-year high of 7.8%, buyers are unable to resist dipping tentative toes back into the market. Cash-rich institutions are beginning to find value in parts of the market - such as large lot sizes - which are out of the reach of debt-backed investors. The focus, though, is on prime, site-specific properties with secure tenants and long leases. Foreign investors are also beginning to look at the UK market again, given the sharp pricing correction relative to other property markets. Sterling weakness has also made UK property prices more attractive to non-sterling denominated investors.

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