

Weekly Market Commentary (17 to 24 July 2009)

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US: Earnings continue to fuel market gains

- ◆ Wall Street stocks enjoyed another strong week as the second-quarter earnings season continued to bring positive surprises. The Dow Jones returned 4.0%, while the broader S&P 500 rose 4.1% and the tech-biased NASDAQ rose 4.2%.
- ◆ Of the 200 companies in the S&P 500 to have reported so far, 75% have beaten expectations, compared to only 62% this time last year. The VIX index, a measure of volatility, fell below 24 for the first time since the collapse of Lehman Brothers last September as cost cutting helped companies from Caterpillar to Merck to surpass analysts' estimates.
- ◆ Ford Motor Co, the only one of the big three US automakers to avoid a government rescue, reported a surprise USD 2 billion profit for the second quarter, helped by debt restructuring and an increase in domestic market share. Government scrappage schemes also boosted overseas demand for some of Ford's models.
- ◆ The financial sector saw some disappointments following the prior week's record earnings from Goldman Sachs. Morgan Stanley reported a USD 159m loss for the quarter after a USD 700m writedown on its commercial property portfolio, while Wells Fargo announced mounting bad loans.
- ◆ However, sentiment around the sector was helped by hopes that CIT Group, the lender to small and medium-sized businesses, may avoid bankruptcy, after it succeeded in agreeing a USD 3 billion rescue package with a group of private bondholders.
- ◆ Investors also responded positively to comments from the Federal Reserve chairman, Ben Bernanke, in his biannual testimony to Congress. Outlining the central bank's "exit strategy" from its current accommodative policy stance, Mr Bernanke said the economic outlook appears to be improving, but stressed that the Fed intends to keep rates low for an "extended period," saying high unemployment will prevent a sharp recovery.
- ◆ Economic data releases in the week were largely encouraging. Existing home sales rose for a third consecutive month in June, increasing by 3.6% as lower borrowing costs and foreclosure-driven price falls attracted buyers. The Federal Housing Finance Agency said single-family home prices rose 0.9% in May.
- ◆ The Conference Board's index of leading economic indicators – a gauge of the economic outlook for the next three-to-six months – also showed a third successive monthly improvement in June, reinforcing hopes the worst may be over. Initial jobless claims rose from a six-month low in the week to 18 July; however, analysts attributed this to distortions caused by the timing of shutdowns in the auto industry.

EUROPE: Positive run continues despite mixed data

- ◆ Speculation that profits will improve as the global economic slump eases helped push the MSCI Europe Index higher by 4.1%.
- ◆ Among the major markets, Germany's DAX posted a strong 5.0% gain while both Italy's S&P MIB and the French CAC 40 were up by 4.6%. The UK's FTSE 100 rose 4.3% and Spain's IBEX was ahead by 4.0%. The Swiss SPI was up 2.8%.
- ◆ Positive earnings across the continent boosted sentiment. Vodafone surged as first-quarter sales rose 9.3% to GBP 10.7 billion, while Zinc producer Boliden announced a 66% year on year rise in second-quarter net income and pharmaceutical giant Roche raised its earnings forecast for the year.
- ◆ Markets were also boosted by further signs of the return of merger and acquisition activity. Volkswagen's board agreed to merge with Porsche after the departure of the sports-car maker's chief executive officer cleared the way for the two German car manufacturers to combine. Meanwhile, Sanofi-Aventis, France's biggest drugmaker, agreed to take control of Shantha Biotechnics in an acquisition that values the Indian vaccine maker at EUR 550m (USD 784m).
- ◆ Economic data was mixed. The Ifo German business confidence index rose for a fourth month in July, suggesting Europe's largest economy is shaking off its worst recession since the Second World War. Eurozone manufacturing and service industries also contracted at the slowest pace in ten months in June.

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- ◆ Despite these signs of economic revival, lagging economic indicators remained weak. Spain's unemployment rate hit 17.9% during the second quarter, the highest level since the last three months of 1998. The number of unemployed rose by 126,700 to 4.14m taking the Spanish jobless rate to more than twice the average level for the European Union.
- ◆ Meanwhile, a preliminary estimate of UK gross domestic product (GDP) released at the end of last week showed that the UK economy contracted 0.8% in the second quarter compared to the previous quarter.
- ◆ Although the UK economy's decline has eased from the 2.4% quarter on quarter contraction recorded in the first three months of 2009, the data represents the fifth successive quarter of negative growth in the UK and takes the annual rate of decline to 5.6%, the biggest fall since records began in 1955.
- ◆ Given this contraction in activity, core inflation remains worryingly sticky. As a result the Bank of England looks likely to continue to assess the inflation outlook before deciding whether to exit or possibly extend its programme of bond purchases, otherwise known as quantitative easing.

JAPAN: Monthly economic data improves marginally

- ◆ The TOPIX was 4.8% higher as an improvement in export data sparked hopes that the Japanese economy was stabilising after its recent slump. Although still much lower than a year ago, exports in June fell at their slowest pace this year and were higher than a month earlier as global demand picked up.
- ◆ The BoJ's real export index continued to rise solidly in June (+5.7% mom) and took 2Q to +59.2% qoq, a clear rebound from the plunges in the previous two quarters (-74.4% in 1Q'09 and -46.8% in 4Q'08). However, the 2Q average of the index was still 31.8% below its 3Q'08 average despite the impressive gain.
- ◆ Nationwide department store sales for June were stronger than expected, rising a solid 3.2% mom after -2.3% in May. In yoy terms, the sales posted -9.5%, the smallest decline in five months after -12.5% in May and -11.5% in April.
- ◆ The BoJ bank loan officers survey revealed that corporate loan demand has reduced substantially in 2Q. The corporate loan demand DI marked -14 after 13 in 1Q'09 and 43 in 4Q'08. Improving financial market stress and weak sales by SMEs are the key reasons for the decline.
- ◆ Japan Tobacco, the world's third largest tobacco company by sales volume, said it will acquire two unlisted Brazilian leaf tobacco suppliers – Kannenberg & Cia and Kannenberg, Braker, Hail & Cotton Tobacos - in a move to better cope with steep price gains and unstable supplies of the raw material outside Japan.
- ◆ Toyota Motor, the world's biggest car maker by sales volume, said it will make hybrid vehicles in Europe for the first time next year. Toyota, which holds only 5% of market share in the European market, aims to gather momentum in the region by enticing cost-conscious customers with the hybrids.
- ◆ Prime Minister Taro Aso dissolved Japan's lower house of parliament last Tuesday and confirmed the national elections to be held on 30 August. This will pit the ruling party LDP in search of a platform against the ascendant opposition DPJ with ambitions to boost social spending and shrink the government.

ASIA: Korean economy accelerates in 2Q

- ◆ The MSCI AC Asia Pacific ex-Japan Index rose 4.7% in USD and 3.9% in local currency terms.
- ◆ Hong Kong's Hang Seng surged 6.3% higher as investors continued to favour stocks linked to resurgent Chinese economic growth. Property developers also rose on expectations for stronger demand for new developments and rising property prices.
- ◆ In South Korea, the KOSPI rose 4.3%, lifted by strong corporate earnings and economic reports. The headlines were taken by the very strong performance of the Korean economy over the second quarter, which grew at its fastest pace for nearly six years.
- ◆ Korea's growth was boosted by rising exports and by strong household spending, which was lifted by low interest rates and a large government stimulus package. The results of these twin drivers of growth were seen in reports of strong quarterly earnings from Samsung and LG, which saw strong external demand for flat panel televisions, and from Lotte Shopping Co, a department store operator that benefited from strong domestic demand.
- ◆ Australia's All Ordinaries climbed 2.6% as rising commodity prices continued to support the country's large mining sector. The Reserve Bank of Australia said the economy is better than it forecast a few months ago, helped by exports to China, the lowest borrowing costs in half a century and government spending.

- ◆ Singapore's Straits Times was up 4.2% while Taiwan's TWSI rose 1.8%. The MSCI China Index rose 6.1%. The International Monetary Fund said China has scope for further stimulus measures to counter rising unemployment, citing the country's low public debt.

EMERGING MARKETS: Russia soars on oil strength

- ◆ Emerging market stocks produced another week of gains as commodity prices rose and strong earnings in developed markets boosted risk appetite. The MSCI Emerging Markets Index returned 4.1%.
- ◆ Russia's resource-rich RTS led the way, rising 9.5% as oil climbed almost 6% to USD 67 per barrel (West Texas Intermediate) on hopes the global economy is beginning to recover.
- ◆ Commodity price strength also boosted Latin American stocks. Brazil's BOVESPA rose 4.6% to a six-week high, helped by an unexpected drop in unemployment to a six-month low in June and by a 0.5% interest rate cut from the central bank, taking rates to a record low of 8.75%. Mexico's BOLSA returned 3.5%.
- ◆ Emerging European stocks benefited as western European companies reported strong second-quarter earnings, contributing to hopes of a recovery in demand from the region's main trading partner. Poland's WGI ended the week 7.8% higher, while Hungary's BUX rose 4.2% and the Czech PX rose 3.8%.
- ◆ South Africa was a notable laggard, with the JSE All Share rising 1.7%. South Africa's finance minister said low savings rates among consumers and businesses are limiting the potential for economic growth and increasing the country's reliance on foreign capital.

BONDS & CURRENCY: The Fed is likely to stay with current policy for the near future

- ◆ Global bonds declined last week, with the 10-year US Treasury yield rising 2bps to end the week at 3.66%; the 10-year Japan JGB yield up 6bps to finish at 1.38%; while the 10-year Europe ECB yield climbing 8bps to close at 3.48%. In Fx-land, the US dollar was down against the euro (-0.7%) and sterling (-0.6%) while up against the Japanese yen (+0.6%).
- ◆ Fed Chairman Ben Bernanke went to Capitol Hill last week to give his semi-annual testimony to the Committee on Banking, Housing, and Urban Affairs in the Senate. He was clear in pointing out that easy policy was likely to be needed for some time yet.
- ◆ The Fed chairman's two major concerns about US growth related to the labour market and consumption. He indicated that recovery would only be gradual until 2011, while inflation would remain subdued over this period. He also mentioned that any change of policy would occur once banks start to lend more aggressively and when credit growth recovers.
- ◆ Bernanke pointed out that any exit strategy would be an exercise in management of the Fed's balance sheet and, in particular, how to reduce the stock of reserve balances held by US banks at the central bank. He listed four methods by which the Fed's balance sheet would be shrunk.
- ◆ These included increasing interest paid on reserves held at the Fed as well as the nuclear option of selling its long-term Treasury holdings in the open market. All of the four policies would be aimed at reducing broad money growth and placing upward pressure on interest rates.
- ◆ The reasons for Bernanke to talk about the exit strategy is that he is keen to provide a route map in good time to manage investors' expectations and to avoid undue volatility in the bond market. In particular, it seems clear to us that when the time comes, the Fed would choose to tighten liquidity to place upward pressure on short-term interest rates.
- ◆ This might be preferred to measures that could impact the long end of the yield curve, potentially damaging a housing market which is likely to remain fragile for some time yet.
- ◆ For all the throat clearing about exit strategies, the real issue is whether the Fed is currently running too tight a policy. Broad money growth has slowed sharply on a six-month annualised basis, while real interest rates have risen as headline inflation has fallen – contributing to a marginal tightening of overall monetary conditions.
- ◆ While these are concerns, our sense is that the Fed is going to stay with its current policy for the foreseeable future. With mounting evidence of stabilisation in the housing market and economy, it would be easy for the bond market to be jittery. But the clear message from Bernanke's testimony is that bond investors should relax.