

Big value in Japan

Investor apathy towards Japan has not only been well-founded but more often than not well-rewarded in recent years. Past frustrations have led to Japanese equities falling off the radar for many investors. At a time when pessimism towards Japan seems to have become standard practice, we find that there are, in fact, reasons to be cautiously optimistic towards a market which seems to be under-owned and undervalued.

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Big value in Japan

AT A GLANCE

- Japanese equities are under-owned and offer excellent value on a number of valuation measures
- The Japanese corporate sector has a disproportionate number of world class companies.
- The new government seems more committed to stimulating the domestic economy
- Concerns over Japan's demographics are often overplayed
- Investors should consider an allocation to a market that has more capacity than most to surprise positively.

Investor apathy towards Japan has not only been well-founded but more often than not well-rewarded in recent years. Past frustrations have led to Japanese equities falling off the radar for many investors. At a time when pessimism towards Japan seems to have become standard practice, we find that there are, in fact, reasons to be cautiously optimistic towards a market which seems to be under-owned and undervalued.

Japanese equities look relatively cheap compared to history, particularly given the fact the corporate sector is in rude health after companies aggressively cut costs to protect their margins. More recently, Japan has started to perform well relative to other markets. As emerging markets have begun to wilt, an interesting contrarian case can be made for Japan, which has more capacity than other markets to surprise investors positively.

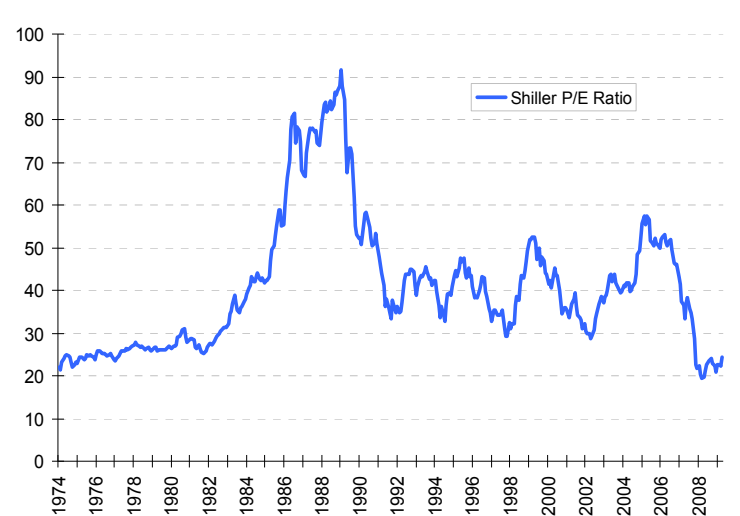
WHY SHOULD WE EXPECT SOMETHING DIFFERENT FROM JAPAN?

Since the credit crunch, Japanese equities have lagged the global market recovery, despite the economy being a highly sensitive beneficiary of recovering global and Asian growth. There were some technical reasons why Japan failed to participate as fully in the rebound, including the strength of the yen and an overhang of secondary issuance. In fact, the latter part of 2009 saw a significant increase in equity issuance, particularly among Japanese banks, which had a dampening effect on the stock market. However, the market has performed relatively better since investors took the view that the bulk of capital-raising was complete when Sumitomo Mitsui Financial Group announced its rights issue in December 2009.

This firmer tone has been supported by economic data. Unemployment has fallen back from its post-crisis peak and Japan produced encouraging economic growth numbers in the first quarter of 2010, indicating the economy grew at an annualised rate of 5%. However, the composition of the growth was still biased towards the export economy, underlining the fact that Japan remains dependent on world economic growth.

Despite the fact that leading indicators of global activity have begun to peak out, indicating a moderation in the pace of growth, we remain at the start of what is likely to be a multi-year recovery in economies and stock markets. While the best gains in markets may be behind us, history shows that equity markets can still perform well even after leading indicators have peaked. As long as economic and corporate earnings growth remains positive, Japanese equities should make progress. This was the case in 1983, which could be a useful route-map since it was not a jobless recovery. Given unemployment is now falling back in the US, Japan, the UK, Australia and even Spain, we may see further upside in equities of the kind we had in 1983.

JAPANESE VALUATIONS ARE HISTORICALLY CHEAP



Source: Morgan Stanley Data as of 31.03.2010. Shiller PE based on 10-year average earnings.

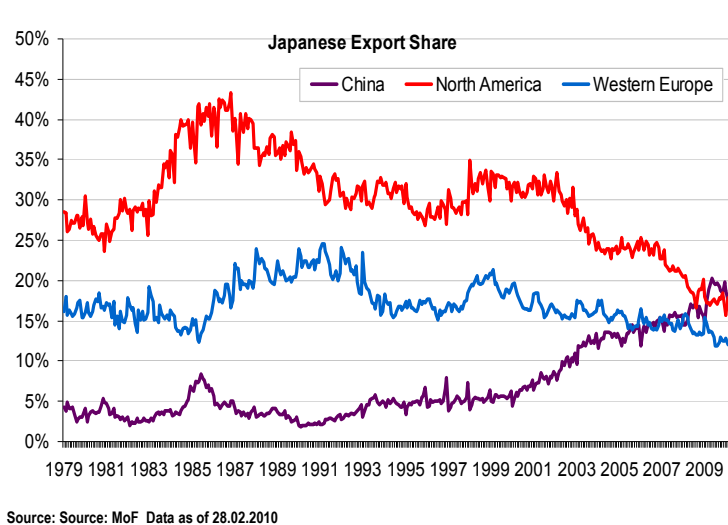
JAPAN CURRENTLY OFFERS HISTORIC VALUE

Japanese shares are attractively valued on a number of long-term valuation measures. This is partly because, as we have mentioned, Japanese equities have not yet participated as fully as other markets in the global stock market recovery.

Prices have tended to lead earnings in most equity markets during the recovery – this is perfectly normal as investors discount better earnings coming through. However, Japanese equities have been an exception to this general trend and prices still have to catch up to reflect the turnaround in the corporate sector.

We can see this from the cyclically adjusted 'Shiller' PE valuation ratio shown in the chart. Since the real estate bubble in Japan in the late 1980s, Japanese shares have de-rated to the point where now, even excluding the bubble, they are historically cheap. On this valuation measure, Japanese equities are trading well below average, and compare very favourably to other developed markets. Japanese equities also look attractive when you consider they offer a free cash flow yield of 7% - versus the 6% offered by the US market and a negative cash flow yield in China.

CHINA IS NOW LEADING DEMAND FOR JAPANESE EXPORTS



JAPAN EDGING CLOSER TO CHINA AND AWAY FROM THE US?

We have discussed how Japan remains sensitive to foreign buying and global economic growth, but the nature of this dependence is changing. Japan has traditionally been heavily dependent on the US consumer. However, over the last decade the importance of the US as a trading partner has been steadily eroded, while China has assumed a greater importance in Japan's growth.

China is now Japan's largest trading partner, representing around 20% of its exports. Most observers are agreed that this is a positive long-term driver for Japanese equities. Japan, by virtue of its excellent location, will be a significant beneficiary of Asian regional growth, and rising incomes in China and India. However, in the short term, it might be a possible downside risk if the Chinese authorities were to tighten policy much more aggressively than expected.

On the other hand, the US nevertheless remains a significant trading partner and their economy is recovering strongly; the US yield curve remains steeply positive, which is a positive for Japanese firms that are exposed to the US market.

CONCERNS OVER DEMOGRAPHICS ARE OVERDONE

Another important factor in company margins has been demographics. Japan's ageing population is often cited as a negative macro risk in terms of the dependency ratio and the impact on pension provision.

Analysts at Morgan Stanley believe that investor alarm over Japan's demographics is overdone and has only become popular as a way of explaining the long bear market in Japanese stocks. Showing that Japan's total fertility rate has already bottomed out, they argue, counter to mainstream thinking, that the country's ageing population could actually be supportive for equity valuations. They base their argument on evidence from the US that shows how equity multiples move in tandem with the ratio of middle aged to young people.

Moreover, even on a superficial reading of Japan's ageing population, at the corporate level it can be viewed as a positive. This is because Japan is a seniority-based society and, as baby boomers retire, they are being replaced by younger workers at a fraction of the salary cost. Corporate wage bills are falling, which is having a further positive effect on profit margins.

THE JAPANESE CORPORATE SECTOR HAS A LOT OF INTELLECTUAL PROPERTY

The credit crisis prompted Japanese companies to cut costs aggressively in order to protect their profit margins from an anticipated reduction in demand. This pre-emptive action has put many companies into a strong position in their sectors, relative to their western counterparts.

In an environment where growth is at a premium, the Japanese market has a number of growth-oriented companies. In fact, automation companies, such as Tsugame, have been taking record orders from China, where labour shortages have encouraged many factory owners to take invest more heavily in capital machinery.

Japan produces a lot of high-end, high-priced goods, specialising particularly in the sophisticated machine goods space. After the credit crunch, demand for these goods was hit hardest of all - another reason that Japan lagged during the initial recovery. Going forward, as emerging markets produce and demand more, and also attempt to move up the value chain, demand for these goods can be expected to grow strongly.

CONCLUSION

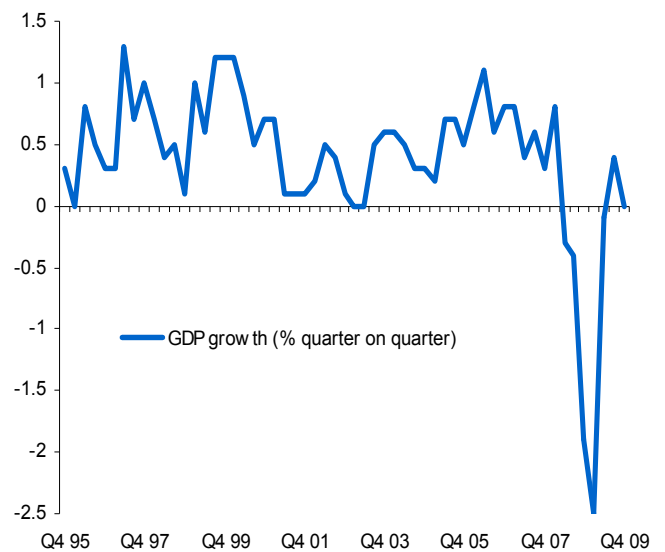
The firmer trend in foreign buying of Japanese stocks since the turn of the year suggests that a handful of savvy investors have already begun to increase allocations to Japanese stocks. They have been drawn to the attractive valuations, and an expected reversal in the headwinds holding back the market: yen strength can be expected to wane given prime minister Kan's support of a weaker currency, while the balance of equity supply and demand is expected to improve from both sides now that capital raisings are out the way. Interest is steadily picking up in an asset class that looks increasingly dangerous to ignore.

Europe

Economic indicators released in May remained mixed. Data revealed that Europe's economy expanded at a faster pace than economists anticipated in the first quarter as a global recovery boosted exports. However, sentiment in the region was adversely affected by the debt crisis in the peripheral regions. German business confidence also slipped marginally. The purchasing managers' index for the eurozone was mixed; manufacturing was weaker than expected and the services sector index was encouraging. The annual inflation in the region was estimated at 1.6% in May, a marginal rise from 1.5% in the previous month. However, a fall in core inflation – which strips out the most volatile components – showed inflation pressures were low. The euro declined sharply during the month against the US dollar and the yen.

EUROZONE ECONOMY RESUMES GROWTH

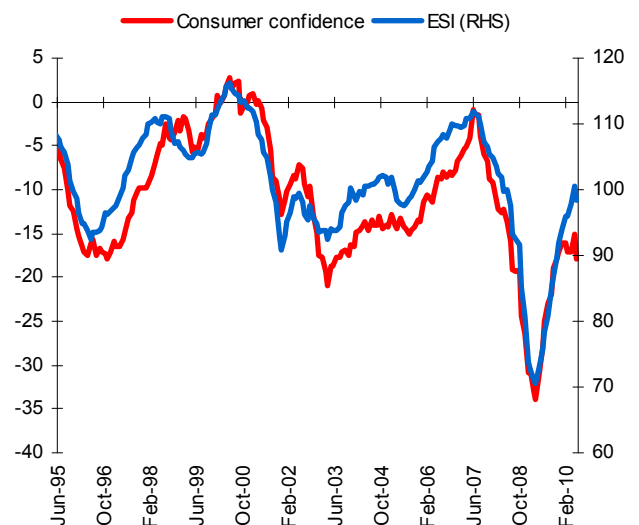
- The eurozone economy expanded slightly faster than expected in the first quarter of 2010, as GDP growth recovered to 0.2% after stagnating in the last three months of 2009. Economic activity is still benefiting from loose monetary policies, and improved global activity and trade are lifting exports. Industrial production expanded strongly in the period, although muted consumer spending held back growth.
- The divergence of trends among the large economies was somewhat less pronounced than in the last quarter. Economic expansion in Germany and Italy exceeded expectations, while France's growth remained below expectations. Spain finally emerged from recession with a 0.1% upturn, the first gain in seven quarters.
- In its May forecast, the European Commission noted that Europe's economic prospects are improving slightly, despite worries about government debts and persistently high unemployment. The commission also raised its 2010 growth forecasts for eurozone to 0.9% from 0.7% estimated in February. The speed of recovery is expected to increasingly vary across countries, reflecting the extent of the housing-market correction needed, the size of the financial services sector and the degree of internal and external imbalances.



Source: Datastream, May 2010

CONFIDENCE IN THE REGION DECLINES

- The European Commission's Economic Sentiment Indicator (ESI) for the euro region fell in May after a sustained rise since March last year. The ESI declined from 100.6 in April to 98.4 in May as ongoing tensions in the financial markets impacted sentiment. Among the member countries, Germany, the UK and the Netherlands reported a rise whereas France, Spain and Italy witnessed a fall in confidence.
- At a sector level, confidence declined across the board, with the exception of the industrial sector. Confidence fell notably among consumers who remained concerned about the general economic outlook and the recent volatility seen in the financial markets. The construction and retail trade sectors also witnessed a decline. In contrast, the industrial sector benefitted from a rise in new overseas orders.
- The fiscal austerity measures in the eurozone economies coupled with higher unemployment could restrain consumer spending and domestic demand. Furthermore, although the euro's decline against the sterling and the US dollar helped bolster exports in export-oriented economies like Germany, it is also pushing up import costs.



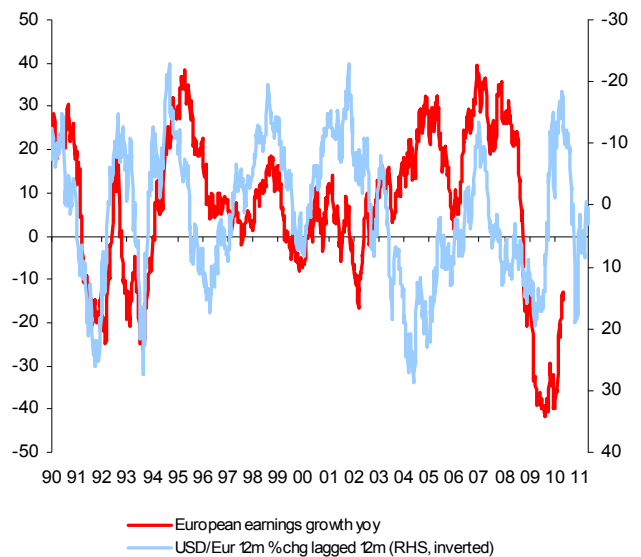
Source: Bloomberg, May 2010

European markets

European equities fell in May as fears of a contagion from Greece's debt crisis undermined investor confidence. Moreover, there were growing concerns that the tough austerity measures across Europe would dampen growth in the region. Germany's move to ban naked short sales of a range of financial assets in a bid to curb speculative trading also detracted from risk appetite. Financials stocks were the biggest decliners over the month. Resources firms were hurt by a proposed tax on mining companies' profits by the Australian government. However, the larger-than-expected emergency loan package of around \$ 1 trillion for European countries quelled fears that the debt crisis would spread to the rest of the peripheral Europe. Defensives, including consumer staples and health care, were among the best-performing sectors. Markets started rebounding towards the end as investors speculated that recent declines might have been overdone.

EURO DECLINE LIKELY TO BENEFIT INTERNATIONAL EARNINGS

- There are many European companies which generate sales from outside Europe and are likely to see better business as their products become cheaper in foreign currency terms with the decline in the euro. The translational effect of US dollar earnings in the euro will also have a positive impact.
- According to ASR, the main sector beneficiaries are those with the biggest sales outside of Europe. These not only comprise the cyclically-orientated areas, most notably technology, basic resources and automobiles, but also include health care, which derives a high proportion of earnings from overseas. Other notable gainers are areas in which companies sell products normally denominated in US dollar, such as aerospace & defence, oil & mining. Sectors with the least foreign sales exposure include real estate and defensives such as utilities and telecommunications.
- The weakening currency and the likelihood that monetary policy will now stay looser for longer will provide much needed support to the region's economy and will serve to partially offset the additional austerity measures introduced by some countries. An orderly decline in the euro, as seen so far, is expected to be beneficial to companies via an improvement in the earnings outlook.

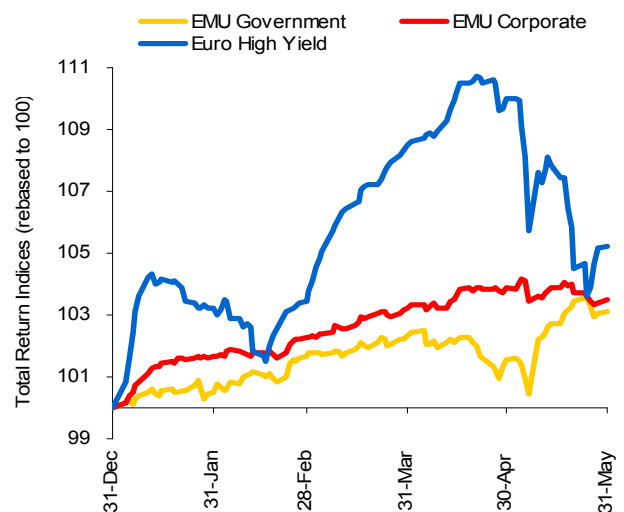


Source: Absolute Strategy Research, May 2010

European government bonds ended higher in May, as concerns that the sovereign crisis in Europe may derail economic recovery and increase financial losses prompted investors to move to the relative safety of government bonds. In credit markets, spreads widened across the board, led by subordinated financials. On 6 May, the European Central Bank (ECB) kept its key interest rate at a record low of 1%.

HIGH YIELD UNDERPERFORMS

- To bring stability to the financial markets, the European Union (EU) and the International Monetary Fund (IMF) brought out a comprehensive financial assistance package of €860 billion (this includes €110 billion in IMF support to Greece, a €60 billion EU Stabilization Fund, €440 billion in country loan guarantees and up to €250 billion in IMF funds). The Fed reinstated reciprocal currency arrangements with the central banks globally to address the temporary dysfunctions in short-term dollar funding markets.
- Government bonds ended May in positive territory, advancing by 1.5%. Investment-grade corporate bonds declined by 0.3%, and underperformed government debt. Within the investment grade bond market, AAA- rated securities generated 1.0%, outperforming BBB-rated bonds which fell by 1.1% over the month. Meanwhile, sub-investment grade bonds declined by 4.3% in light of a flight to quality and were the worst-performing fixed income asset class (see chart).
- Over the month, the European yield curve shifted downwards, with yields falling across the board. Yields on two-year government bonds fell by 0.26% to 0.51%, while those on 30-year maturities declined by 0.33 percentage points to 3.36%.



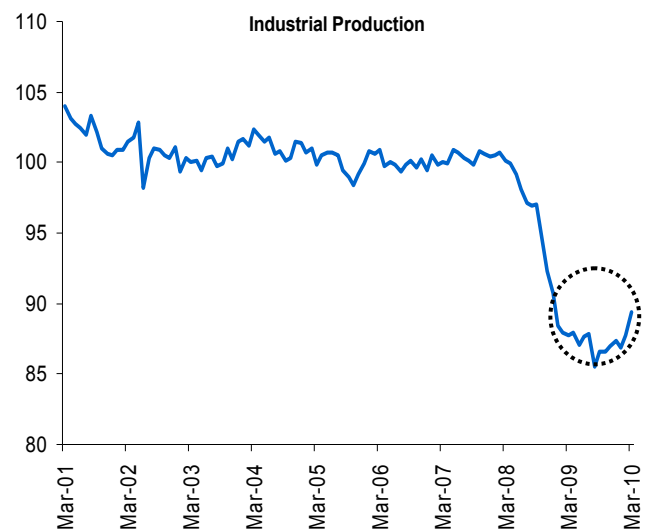
Source: BofA Merrill Lynch, May 2010

UK

News on the economic front was mixed. Revised data from the Office for National Statistics (ONS) showed that GDP grew by 0.3% in the first three months of 2010, compared to an earlier estimate of 0.2%. The increase in the growth rate was due to an upward revision to output from the production industries. However, the annual rate of inflation rose to 3.7% in April from 3.4% in March, mainly driven by higher transport costs. The latest data from the ONS showed that the number of people claiming unemployment benefit fell more than expected in April. Meanwhile, the Bank of England's policymakers voted unanimously to keep interest rates on hold at a record low of 0.5% and not to extend its quantitative easing programme.

STRONG GROWTH IN INDUSTRIAL PRODUCTION

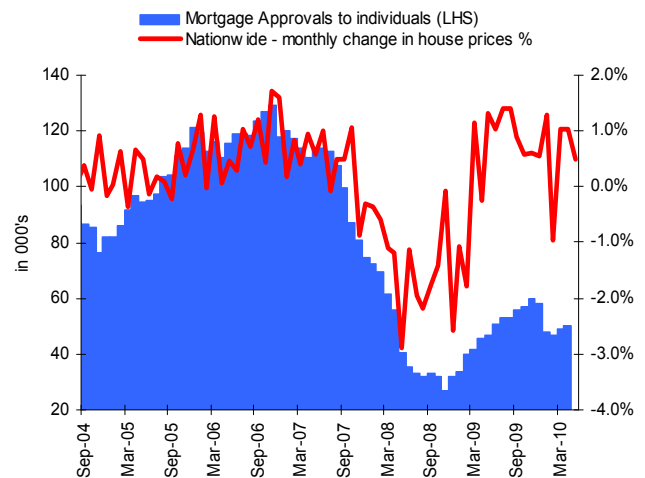
- UK industrial output saw its strongest monthly expansion in almost eight years in March, according to the latest figures from the ONS. Year on year, production output in March 2010 was 2.0% higher than in March 2009. Encouraging export demand, mainly due to weakness of the pound, contributed to the robust performance by manufacturers. Overall, industrial production accounts for 17% of the UK economy.
- The latest industrial trends survey by the Confederation of British Industry (CBI) supported the ONS data. The CBI survey revealed that UK factory orders surged in May, especially from abroad, as demand strengthened. The CBI survey showed that export order books were above par for the first time in over two years. 27% of manufacturers said that export orders were above normal, while 24% said they were below. The resulting balance of +3% shows that export orders are no longer sub-par, having improved considerably on April (-16%).
- According to the CBI, the weak pound has made UK exports more attractive and manufacturers are benefiting from the pick-up in world trade. This is helping the recovery in manufacturing, and a slightly stronger rise in production is predicted in the coming months.



Source: DataStream, March 2001 to March 2010

HOUSE PRICE GAINS LEVELLING OFF

- The latest housing market data released by Nationwide Building Society showed that house prices in the UK rose to the highest in almost two years in May and may keep climbing because of a lack of properties for sale. The average cost of a home increased 0.5% from April to £169,162, the highest level since July 2008.
- Similarly, mortgage approvals data released by the BoE rose to a four-month high in April as warmer weather and the ending of a transaction tax on house purchases helped boost demand. Former UK Chancellor of the Exchequer Alistair Darling scrapped a transaction tax on house purchases for first-time buyers spending £250,000 or less from 25 March this year. Nevertheless, the number of mortgage approvals are still about half the total that were granted at the peak of the UK's housing boom in 2007.
- Since reaching a trough in February 2009, house prices have risen by 12.2% and are now just 9.5% below the October 2007 peak. The Government's plan to introduce a higher rate of capital gains tax on non-business assets, which could include second homes, may prompt those owners sitting on hefty gains to sell before the higher tax rate comes into effect. This may help ease upward pressure on house prices in the short term.



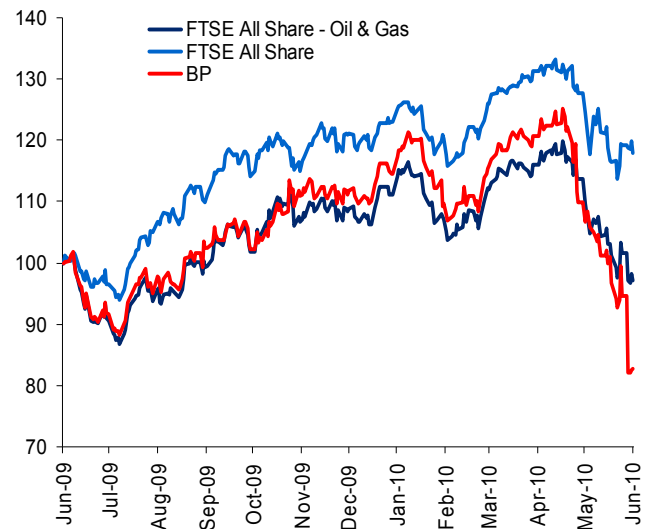
Source: Bloomberg, May 2010

UK markets

UK equities declined in May as concerns mounted that Europe's debt crisis will hamper economic growth. A \$1 trillion eurozone rescue package, designed to stop potential debt defaults in the region, only partially helped to ease these worries. Investors were also apprehensive about the newly proposed Australian tax on resources companies' profits. Meanwhile, following an unclear election verdict, a Conservatives-Liberal Democrats coalition government headed by David Cameron took office during the month and immediately announced plans to cut the nation's budget deficit.

BP IN FOCUS AS THE ENERGY SECTOR LEADS THE FALL

- After touching a 2010 high on 15th April, the FTSE All Share Index fell more than 14% by 25th May, to its lowest level for the year. But the benchmark index recovered nearly 5% by the end of May to limit the losses for the month. All sectors within the FTSE All Share Index ended the month in negative territory with oil & gas producers making the largest negative contribution to overall market.
- The weak performance of the energy sector was mainly due to the sharp fall in index heavyweight BP as it struggled to contain the oil spill from one of its wells in the Gulf of Mexico. Speculation about the company's future mounted as the share rout - taking the stock to its lowest level in more than a year - was compounded by BP's estimate that related costs are approaching \$1 billion. Since the explosion on the Deepwater Horizon drilling platform on 20th April, shares in BP have declined by more than 33%. During the same period, the FTSE All Share Index has dropped 9.4% and the FTSE All Share Oil & Gas Index has fallen by nearly 19%. The problems were exacerbated by concerns about weakening demand as the European debt crisis intensified, triggering a 15% drop in the price of crude oil in May.
- The IBES estimates a 12-month forward earnings growth rate of 33% for the sector. However, it remains to be seen how the latest crisis impacts profits projections going forward.

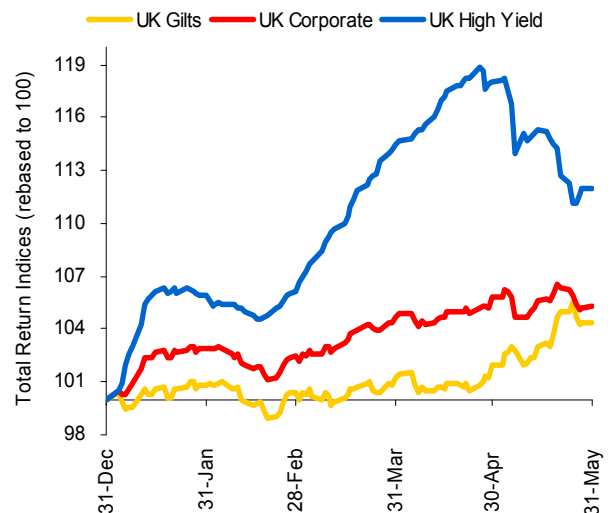


Source: DataStream, June 2009 to June 2010

UK government bonds (gilts) ended May in positive territory, benefiting from a flight to safety due to fears over the European sovereign debt crisis. The sterling fell against the US dollar over the month amid concerns over the country's fiscal deficit situation. On 8 April, the Bank of England (BoE) kept its bond purchase program on hold for the third month and left the interest rate unchanged at a record low of 0.5%.

FLIGHT TO QUALITY HURTS HIGH YIELD BONDS

- The 6 May general elections resulted in a coalition government of the Conservatives and the Liberal Democrats. The new UK government announced its first steps to tackle the country's fiscal deficit. The Chancellor of the Exchequer George Osborne announced a plan to cut government spending by £6.2 billion in 2010-11 in order to tackle the UK's 2009 budget deficit of £156 billion. More details on public spending cuts are revealed in the post-election budget on 22 June.
- Gilts ended May in positive territory, rising by 2.4%. Investment-grade corporate bonds fell 0.5%, underperforming government bonds. Within the corporate bond market, AA-rated securities were the best performers across the credit spectrum, generating 1.6% returns, while BBB-rated bonds declined by 0.9%. Sub-investment grade (high yield) paper fell by 5.1% and underperformed both corporate bonds and government debt (see chart).
- In May, the yield curve shifted downwards, and yields on short-dated bonds fell more than those on long-dated paper. Yields on two-year maturities declined by 0.25 percentage points to 0.88%, whereas those on 30-year paper fell by 0.20 percentage points to 4.28%.



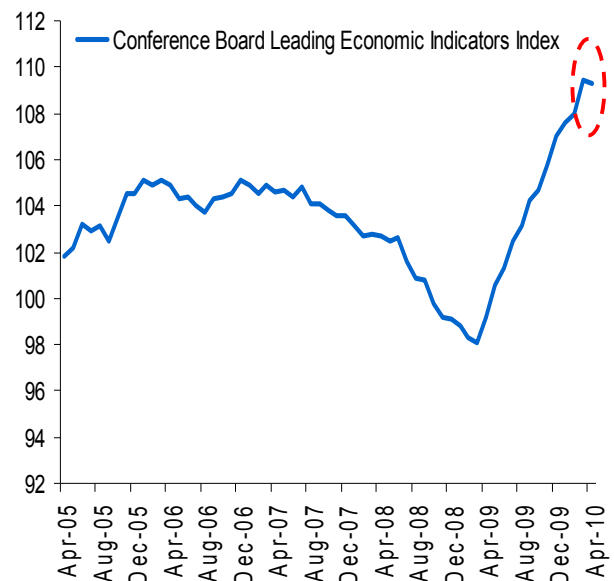
Source: BofA Merrill Lynch, May 2010

US

Economic data releases remained mixed. The US economy added 290,000 jobs in April, the largest monthly increase in nearly four years. Perceived signs of labour market recovery helped fuel an improvement in consumer confidence in May. While consumer spending remained flat in the previous month, the gain in real disposable income provided hope that things would improve. Supportive news also emanated from the housing sector where April new and existing home sales rose, as buyers rushed to purchase houses before a federal home buyer tax credit expired. However, S&P/Case-Shiller data revealed that the National Home Price Index fell 1.3% (seasonally adjusted) in the first quarter of 2010. The revised GDP data pointed to weaker-than-forecast growth at an annual rate of 3.0%. Within that, the pace of growth in the services sector remained unchanged in April, while the manufacturing sector grew at its fastest pace in almost six years.

LEADING INDICATORS: POINTING TO A SLOWDOWN?

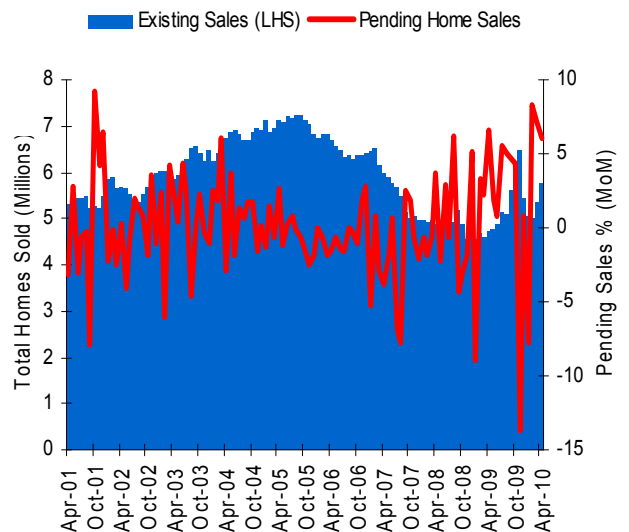
- The Conference Board leading economic indicators index declined unexpectedly by 0.1% in April after 12 consecutive month-on-month increases, signalling that the second half of 2010 may witness a slowdown in economic activity. The majority of the ten index constituents that are considered a gauge of future economic activity ended lower.
- A closer look at the numbers suggests that much of the weakness in April stemmed from an 11% decline in building permits which was linked to the end of tax incentives for the sector. Excluding this metric, the index rose 0.2% in April. Nevertheless, investors are keeping a close eye on economic data releases to gauge how things will pan out in the second half of the year when the effect of the fiscal stimulus fades.
- While it is true that the pace of economic recovery may well slow down, it is likely that the lower growth rate will be more self-sustaining. This is because the virtuous cycle of job creation has started, albeit slowly, and it should encourage consumer spending, which in turn will further employment generation. Also, interest rates are likely to remain low and supportive because inflation is not yet a problem and central banks are worried that the eurozone debt crisis could halt the fragile global recovery process.



Source: Datastream, May 2010

EXPIRY OF TAX CREDIT BOOST HOME SALES

- The number of contracts to buy previously owned homes climbed in April as Americans took advantage of the last month of a tax credit (30 April was the deadline to sign contracts and obtain as much as \$8,000 in government assistance). The index of pending home re-sales rose 6% in April, following a revised 7.1% gain in March. Compared with April 2009, pending sales were up 25%. Sales of existing homes, which account for about 90% of the housing market, also rose 7.6% to a 5.77 million annual rate in April.
- However, the number of homes on the market increased by the most in a decade and average home prices were down 31% in March from their July 2006 peaks, according to the S&P/Case Shiller. Increasing supply, combined with mounting foreclosures and the probability that sales may retrench after the expiry of federal credit, may bring an end to the improvement in home values.
- As indicated by figures from Freddie Mac, 30-year mortgage rates fell towards the end of April amid concerns that the European debt crisis may slow global growth. This may help prevent the housing market from slipping.



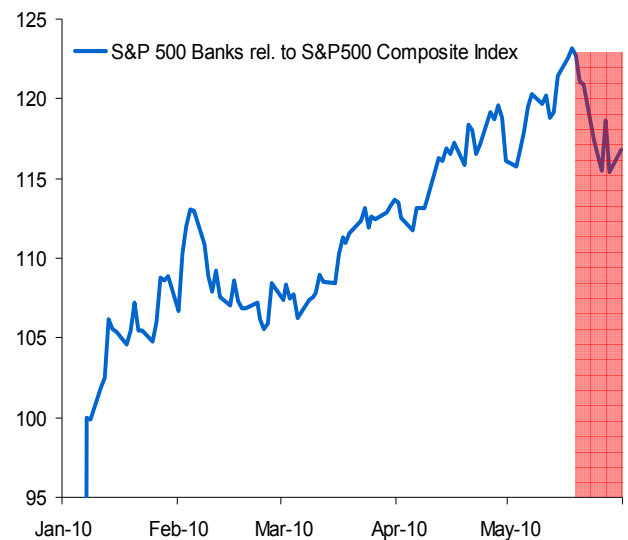
Source: Bloomberg, May 2010

US markets

US equities witnessed a broad-based sell off in May, as concerns about the fiscal health of peripheral eurozone countries dominated sentiment. Investors feared that sovereign debt problems in Europe could escalate and that austerity measures enacted in the afflicted countries may impact the global recovery. The prospects of an uncertain demand environment weighed upon energy and materials stocks. Shares in industrial firms, which generate a large part of their sales internationally, also came under pressure. Elsewhere, financial stocks ended lower after the US Senate approved regulatory reforms that could potentially hurt profits in the sector. In company-specific developments, Costco Wholesale and Tiffany reported quarterly profits that beat expectations. Dell also posted stronger-than-anticipated results but management remained concerned about currency volatility and components shortages going forward.

BANKING STOCKS: CONTINUED UNCERTAINTY?

- The uncertainty over proposed financial regulatory reform has been weighing down banking stocks recently. Although final legislation is still some months away, analysts believe that proposals to cap fees for checking accounts and credit cards; to restrict proprietary trading and curb derivatives usage will impact earnings if they go through.
- However, it is interesting to note that despite this, many influential investors including Warren Buffett and John Paulson continue to hold large positions in banks. In fact, rating agency Fitch has also revised its overall outlook for the US banking sector to 'stable' from 'negative', because earnings, liquidity and capital positions are improving and non-performing assets seem to be stabilising. Analysts believe that the impact of regulation is now becoming more quantifiable, while the credit environment continues to improve. The Federal Deposit Insurance Corporation is also seeing more tangible signs in the form of higher bids in failed bank asset auctions.
- Despite these indications, US bank earnings remain much lower than they were before the crisis and small institutions continue to feel the strains of tough credit conditions. Encouragingly, many of the regulatory and eurozone-related risks are better understood by the market now. Still, investors will be watching developments closely.

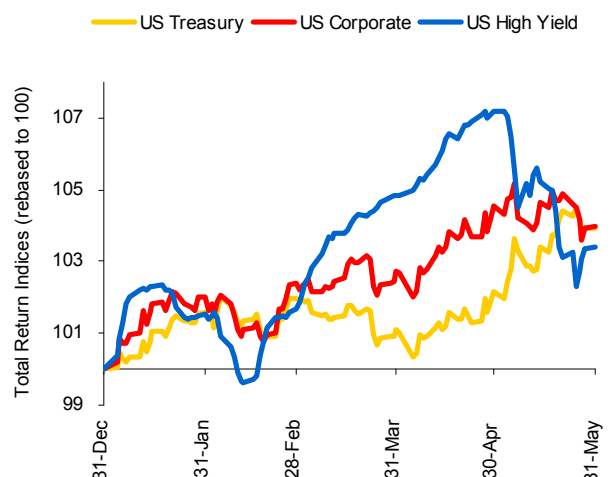


Source: Datastream, May 2010

US Treasuries climbed in May amid speculation that efforts to contain Europe's debt crisis may slow the global economic recovery. The gap between yields on 2 and 10-year notes narrowed as equities dropped and stagnant US consumer prices shifted the focus from inflation to deflation. Elsewhere, the Federal Reserve (Fed) restated its intention to keep the benchmark interest rate near zero.

GOVERNMENT BONDS OUTPERFORM

- US government bonds advanced in May and outperformed both investment grade corporate and high yield debt. Treasuries returned 1.7% while investment grade securities returned -0.6%. High-yield securities were the worst performing bond class, returning -3.5% over the period.
- In the corporate bond market, lower-rated BBB bonds underperformed other asset classes within the credit spectrum, returning -1.0% over the month. Higher quality AAA-rated bonds returned 0.9% and were the best performers. Meanwhile AA and A-rated paper both returned -0.3%. On a year-to-date basis, investment grade corporate bonds returned 4.0%; Treasuries returned 3.9% and high-yield bonds recorded 3.4% returns.
- Over the month, the yield curve flattened as yields on short-term debt fell less than those on longer dated securities. Two-year yields declined by 0.19 percentage points to 0.77% while those on ten-year bonds fell by 0.37 percentage points to 3.29%.



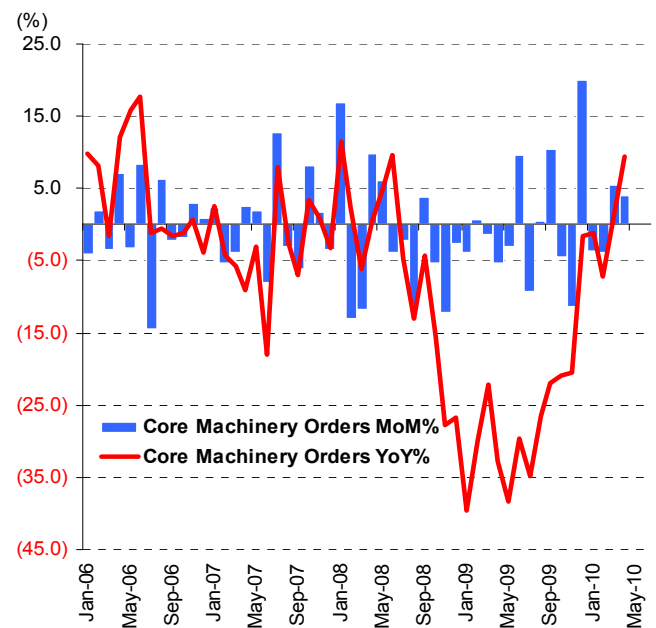
Source: BofA Merrill Lynch, May 2010

Japan

According to revised data released by the Cabinet Office, Japan's real GDP expanded at an annualised rate of 5.0% in the January-March quarter, exceeding consensus forecasts of a 4.2% gain. It marked a fourth consecutive quarter of economic growth. While exports continued to lead the upturn, personal consumption and housing investment surprised on the upside amid signs of a broadening recovery. Corporate capital investment was also firmer than expected. The data supported the view of the Bank of Japan, which upgraded its assessment of the economy, stating that signs of a self-sustaining recovery had started to emerge. Although the pace of growth is expected to slow in the coming quarters as export demand moderates and the effects of government stimulus start to fade, the economy should continue to expand beyond its potential growth rate as domestic demand gradually improves.

MACHINERY ORDERS SHOW CLEAR RECOVERY TREND

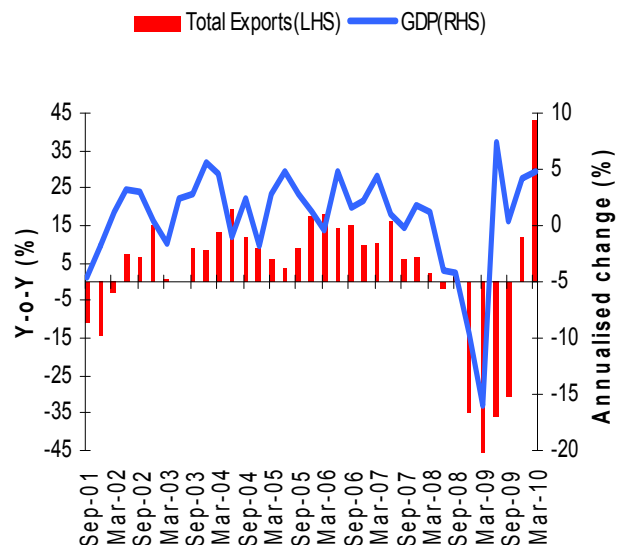
- Private sector core machinery orders (excluding shipping and electric power) expanded by 4.0% in April, boosted by growth in non-manufacturing sectors. The data surpassed consensus forecasts of a 1.7% increase and marked a second consecutive month of growth. Compared with the same period a year ago, machinery orders rose by 9.4%.
- After bottoming in the first half of 2009, machinery orders, a leading indicator of capital spending, have recovered steadily amid a rebound in global economic activity and corporate earnings.
- Although manufacturing orders fell for the first time in five months, largely a reaction to strong growth in March, non-manufacturers showed a clear improvement. The data suggests that a recovery in corporate capital investment, which accounts for around 15% of GDP, has started to spread through the economy to a broader range of industries.
- While a steady recovery in capital investment is underway and corporate sentiment remains firm, the sovereign debt crisis in Europe and the effects of a weaker euro on the competitiveness of Japanese exports are potential risk factors. However, a sustainable recovery in the global economy, led by Asian nations, and a pickup in replacement demand in non-manufacturing sectors should enable capex to remain on a gradual uptrend.



Source: Cabinet Office, May 2010

EXPORTS CONTINUE TO DRIVE GDP GROWTH

- Japan's economy grew at an annualised 4.9% in the January-March quarter for the fourth consecutive quarter of expansion. The main driver of growth was exports. Shipments abroad advanced 43.5% in March from a year earlier. Robust global demand, particularly in Asia, is feeding a turnaround in Japan's economy, offsetting weak domestic demand and falling prices. Japan's exports to China climbed 41.4% in April from a year earlier to ¥1.15 trillion. Shipments to the US advanced 34.5%, accelerating from 29.5% in the previous month. However, sales to Europe increased 19.8%, slowing from 26.7% in March.
- Finance Minister Naoto Kan said he expects the Bank of Japan (BoJ) to support an economy with "flexible and appropriate" policy and that officials must be "cautious" about calling the recovery self-sustaining. Meanwhile, keeping its key interest rate unchanged at 0.1%, the BoJ stated that "the economy is likely to be on a recovery trend," as a result of the country's rising exports, driven particularly by emerging Asia. It also announced details of a scheme to encourage commercial banks to lend to companies in growth industries as the country battles deflation and weak domestic demand.
- However, fears grew for Japan's exporters after heightened anxiety over European debt and doubts over the strength of the US economy sent investors piling into the safe-haven yen, prompting it to rise.



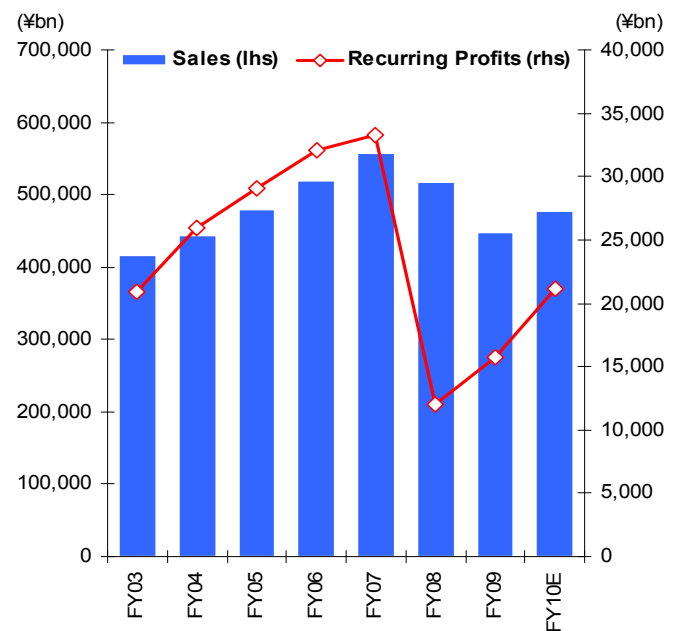
Source: Bloomberg, May 2010

Japanese markets

In line with global equity markets, Japanese equities trended sharply lower in recent weeks, relinquishing gains accumulated since the start of the year. Mounting concerns about sovereign credit risk in Europe, stricter financial regulations and steep currency fluctuations contributed to a renewed upswing in volatility. Certain Japanese stocks were notably weaker against this backdrop and the broad-based Topix fell by 10.8% in May. Over the month, non-bank financials, exporters and resource stocks suffered the steepest declines, whereas defensive sectors held up relatively well. Meanwhile, beneficiaries of weaker oil prices, most notably paper companies and tyre manufacturers, suffered only mild declines.

FY09 PROFIT GROWTH EXCEEDS EXPECTATIONS

- In the six years between fiscal 2002 and 2007, Japanese companies recorded an unprecedented period of unbroken profit growth. While the onset of the global financial crisis brought this run to a halt in 2008, they returned to growth in fiscal 2009.
- Business conditions remained severe due to the lingering effects of the global downturn and sales declined by around 13% year on year. However, Japanese companies recorded a near 30% increase in recurring profits, supported by aggressive cost-cutting measures and improvements in productivity.
- Furthermore, a combination of strong growth in operating cash flow and the postponement of investment plans resulted in a significant rebound in free cash flow. Even after reducing interest-bearing debt, companies still have surplus funds that can be used to revive capex, pay bonuses or raise shareholder returns.
- Looking ahead to 2010/11, Japanese firms are forecasting a further 30% rise in recurring profits, fuelled by a return to top-line growth and the effects of operational gearing. However, management forecasts appear conservative (many are based on worst-case forex scenarios) and consensus estimates point towards profit growth of closer to 50%.
- While a weakened euro may cloud the earnings outlook for some Japanese exporters, global economic indicators remain robust and as long as the debt crisis does not spread globally, aggregate earnings should continue to recover.

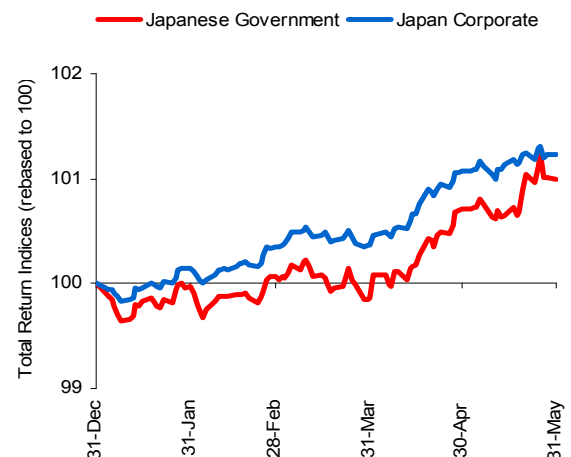


Source: Toyo Keizai (TSE1-listed companies excl financials), May 2010

Japanese government bonds gained in May as concerns that Europe's credit crisis could worsen boosted demand for the relative safety of government debt. Meanwhile, former finance minister Naoto Kan was voted in as Prime Minister, replacing Yukio Hatoyama who resigned after his own popularity declined.

GOVERNMENT BONDS OUTPERFORMED IN MAY

- Japanese government bonds rose by 0.3% in May, outperforming investment-grade corporate debt, which gained 0.2%. Higher-quality AAA and AA bonds rose 0.2% over the month and were the best performers within the credit spectrum. A-rated paper returned 0.1% over the month as did the lower-rated BBB bonds.
- On 1 June, the BoJ added ¥1 trillion (\$11.1 billion) into the financial system to boost liquidity after stock markets declined worldwide and pushed the yen to an eight-year high versus the euro. This credit program will offer one-year loans to banks at the key overnight rate, as long as they lend the money to companies for projects that could foster economic growth.
- Over the month, the yield curve flattened. The yield on two-year government bonds remained unchanged from last month at 0.17%, while that on 30-year paper declined by 0.4 percentage points to 2.09%.



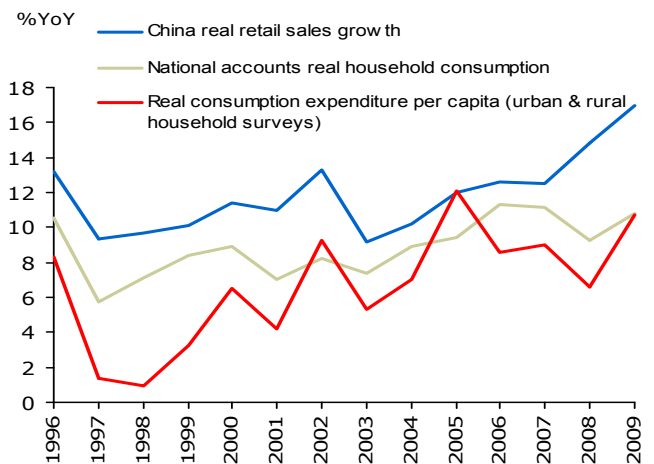
Source: BofA Merrill Lynch, May 2010

Asia Pacific

Asia Pacific ex Japan continued with its steady pace of economic expansion. Hong Kong's GDP growth for the first quarter came in stronger than expected, up 8.2% from a year ago. The export sector contributed strongly, driven by strong trade flows among Asian countries as well as a moderate recovery towards the US market. The Indian economy expanded by 8.6% over the first quarter largely led by growth in industrial output. In Malaysia, real GDP rose by 10.1%, the fastest pace in a decade, driven by domestic demand and improved exports. The robust increase prompted Bank Negara to raise the overnight policy rate by 0.25 percentage points to 2.5%. Taiwan, Singapore and Philippines also recorded solid economic expansion.

GROWING SUPPORT FROM CONSUMPTION

- Retail sales proved a bright spot in April, pointing to an improvement in China's growth structure. Chinese consumers picked up more slack from industry in April, with retail sales growth accelerating to 18.5% from 17.9% in the first quarter of 2010. Real retail growth was 15.5%, up two tenths from March.
- China Consumer Confidence hit its highest level since 2007 according to Nielsen and the Chinese Statistics Bureau's Economic Monitoring and Analysis Center's "Q1 2010 China Consumer Confidence Survey Report" released in May. Confidence jumped as people expect wages to rise and see an improved outlook for jobs.
- Most of Beijing's stimulus policies have continued in 2010. The "old-for-new" subsidy program had generated sales worth RMB39.1 billion from the sale of 10 million new household appliances as of 20 April 2010. China's "appliances to the countryside" program, which offers rural consumers subsidies on select products, generated revenue of RMB42 billion on the sale of 4.8 million household appliances in the first four months of 2010.

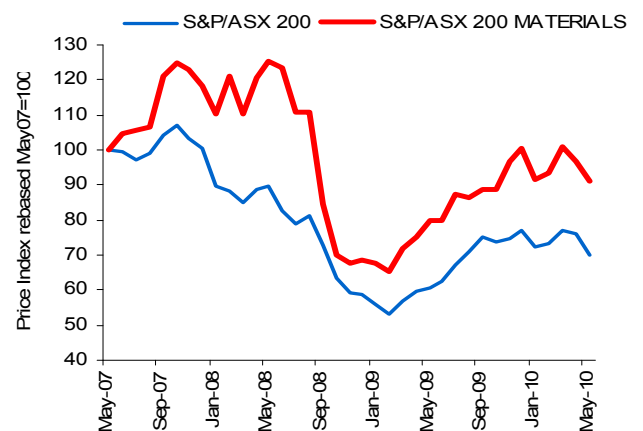


Source: CLSA Asia Pacific Markets, May 2010

Problems in Greece continued to hurt Asian equities, which fell in tandem with global markets in May. Investors feared that sovereign debt issues in Europe could escalate and that austerity measures enacted across afflicted countries may impact the global recovery. Concerns over slower growth in China and increased tension in the Korean peninsula also took a toll on sentiment. Commodity prices fell weighing down mining companies, while financials and industrials came under pressure in view of rising risk aversion. Although all sectors lost ground, utilities and consumer staples were relatively resilient.

AUSTRALIAN MINING FIRMS FACE INCREASED TAX

- The Henry Tax Review, although extensive in its scope, held key interest for investors due to its impact on the overall economy and on the mining sector in particular. The main thrust was the introduction of a 40% Resource Super Profits Tax – a tax on mining profits after allowing for extraction costs, capital investment and providing shareholders with a normal return on their investment.
- The main reasoning for the resources tax is that taxes from the mining sector have more than halved as a proportion of profits over the last decade, while profits have increased significantly.
- On a positive note, the government will provide a resource exploration rebate. Moreover, the additional money raised by this measure – A\$12bn in the first two years of the tax – will be channelled into three areas: lower business taxation; increased superannuation concessions and increased infrastructure spending, benefiting the overall economy.



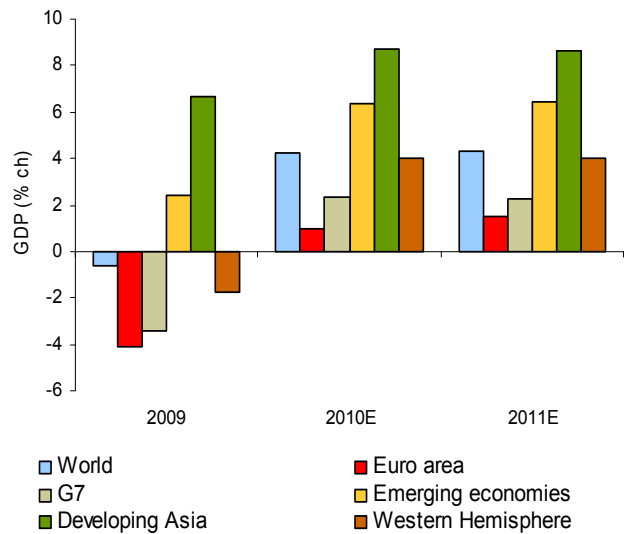
Source: DataStream May 2010

Emerging markets

At the start of May, the People's Bank of China increased bank reserve ratios by half-a-percentage point for the third time in order to curb speculative property investments. Meanwhile, in Brazil, retail sales data for March showed a substantial increase from a year ago; these signs of robust economic activity prompted the Brazilian Finance Minister to forecast a GDP growth rate of 5.5% to 6% in 2010. Elsewhere, manufacturing activity in India continued to expand in April, while the Indian economy grew by 8.6% in the three months to March from a year ago.

EMERGING MARKETS DRIVE GLOBAL GROWTH

- Emerging market economies are likely to grow at an annual rate exceeding 6% in 2010-2012 after expanding by 2.4% in 2009, according to the International Monetary Fund's (IMF) latest projections. In contrast, the advanced economies of G7 are expected to expand by over 2% during the same period, following a contraction of 3.4% in 2009.
- The IMF also forecasts that the Asian economies, which suffered less during the downturn, will lead the recovery in terms of both smaller output gaps and higher growth rates. This robust pace of growth has re-attracted capital flows to emerging markets. Consequently, emerging markets are facing the challenge of absorbing these inflows without triggering inflationary pressures or creating asset bubbles.
- Domestic demand will support economic expansion in many emerging markets. In China and Brazil, stronger private consumption and investment is expected to play a leading role, going forward. In India, growth is projected to be supported by rising private demand. In Russia, growth is expected to stage a modest recovery, but underlying private domestic demand is likely to be subdued. The Chilean economy is projected to grow amid highly accommodative policies and reconstruction efforts.

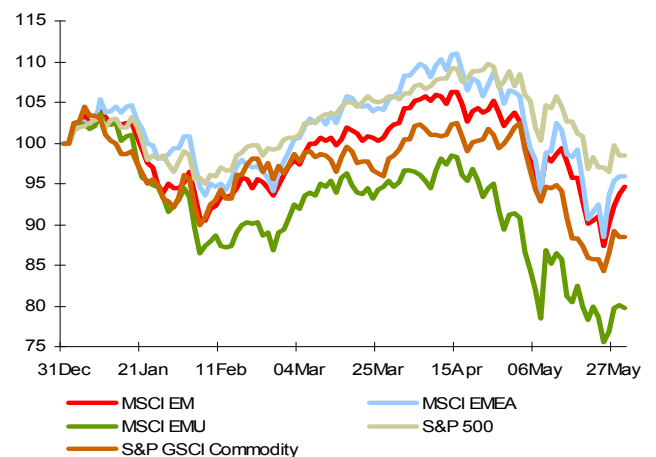


Source: IMF World Economic Outlook, April 2010, GDP at constant prices

Emerging market stocks ended substantially lower in May amid a worldwide sell off in equities. Concerns about the impact of the European debt crisis on the ongoing global economic recovery unnerved investors, amid speculation about the extent of reductions in future government expenditure in the eurozone. Sentiment was also subdued by China's measures to curb speculation in its real-estate sector, which included a half-a-percentage point increase in the reserve requirement ratio for banks. Geopolitical issues involving North Korea and South Korea also hurt confidence. At the sector level, export-dependent and commodity-related stocks suffered steep declines. These included shares in industrials, materials and information technology firms.

EMERGING MARKETS: HOLDING THEIR GROUND

- Fears about a sustainable global economic recovery have unnerved investors, as the sovereign debt crisis came to the fore in peripheral Europe at the start of 2010. Commodity prices also receded amid prospects of lower demand due to the European crisis, alongside China's steps to manage its economic growth. In this environment, emerging market equities have held relatively steady on a year-to-date basis compared to developed markets in Europe. While the MSCI EMU Index, which includes 11 developed European countries, fell by 20% over this period, the MSCI Eastern Europe, Middle East and Africa (EMEA) Index fell by 4%, and the MSCI EM Eastern Europe Index declined by 7.3%.
- Many of the emerging markets offer lower debt to GDP ratios; have more robust financial systems and higher foreign currency reserves compared to developed markets. Brazil and India also enjoy strong domestic consumption trends that underpin economic growth. The recent sell-off has shaved off some of the valuation premium from emerging market stocks.



Source: DataStream, May 2010; Daily Total Returns Indices % in US\$, Rebased to 100



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