

## Where are we in the equity cycle?

At a time when investors are increasingly questioning the sustainability of the stock market upswing amid sovereign debt problems and concerns over economic growth, we take a closer look at the equity cycle to find comfort in history. The market action we have seen so far has been straight out of the textbook and the current anxieties are not unusual. Every new bull market needs to climb the wall of the worry and as we now move into the earnings growth phase of the equity cycle, markets should grind higher over the next several months.

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## Where are we in the equity cycle?

At a time when investors are increasingly questioning the sustainability of the stock market upswing amid sovereign debt problems and concerns over economic growth, we take a closer look at the equity cycle to find comfort in history. The market action we have seen so far has been straight out of the textbook and the current anxieties are not unusual. Every new bull market needs to climb the wall of the worry and as we now move into the earnings growth phase of the equity cycle, markets should grind higher over the next several months.

### THE STORY SO FAR

After the rapid rebound from the trough in March 2009, recent market action has been more mixed as volatility has reared up again. Investors have begun to question the sustainability of the upswing in the equity cycle. Recent weeks have seen heightened volatility due to anxiety over US plans to curb risk-taking in the banking sector, sovereign debt concerns in peripheral eurozone economies, and doubts over the outlook for global growth as China has begun to tighten its monetary policy. Do all these factors mean that the equity upswing is breaking down?

### WHY NOT TO PANIC...

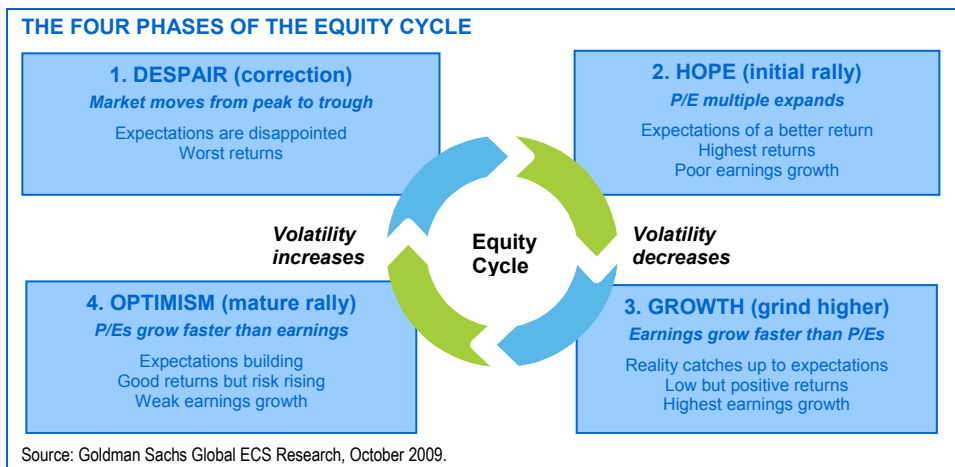
Yes, a major sovereign default would be a shock to the global economy and could stall the market advance. But, the vast swathe of historical evidence suggests the greater likelihood is that what we are experiencing now is just a normal corrective phase within a longer upswing. In every new bull market, investors must climb the wall of the worry, hoping that anticipated economic and corporate improvements are not derailed.

Most investors have short memories, particularly when it comes to recalling how bull markets develop. Because losses hurt more than gains are enjoyed, bear markets stick in the memory much longer. Investors may remember the last phase of the bull market when making money seemed relatively straightforward. They are less likely to recall the nervous way in which that bull market developed, the unlikely conditions from which it sprang and the hurdles that it had to overcome before it could achieve the much-vaunted tag of 'sustainable'; a description that commentators are not yet willing to apply to the current cycle.

### THE TIME-TESTED PATTERN OF THE EQUITY CYCLE

Although the speed and extent of the correction and the rebound were extreme, the market's behaviour throughout the recent crisis has been typical of many previous equity cycles. When we look at history, four distinct phases can be identified within equity cycles. Moving from one peak of the cycle to the next, these phases can be described as: Despair, Hope, Growth, and Optimism.

Researchers from Goldman Sachs used historical data to break down these phases by average price return and whether those returns are driven by valuation or earnings growth. They found that despite the fact that most earnings growth occurs in the third 'growth' phase of the cycle, the best returns are made in the second 'hope' phase when investors anticipate the prospect of earnings growth coming through in the near future.



## MOVING INTO THE GROWTH PHASE?

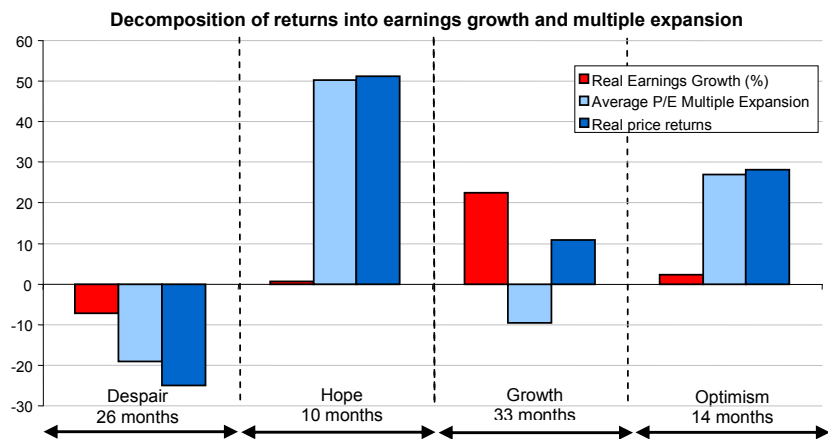
Generally, the 'despair' phase is associated with recession or the prospect of recession and lasts around 26 months, on average. This is when the equity market moves from peak to trough. In the context of the current cycle, equity markets troughed in March 2009 after peaking in mid-2007.

More attractive valuations, combined with the expectation of better conditions ahead, eventually cause a rebound in markets in the 'hope' phase. This short phase is typically when the highest returns are available; we witnessed a sharp rally like this in the months following March 2009.

As you can see from the chart below, the 'hope' phase is when earnings growth is discounted by investors in advance and cheap valuations drive returns. Most earnings growth actually occurs in the subsequent 'growth' phase, when price returns are more moderate. The cumulative effect of sustained economic and earnings growth eventually brings about a last phase full of 'optimism', that is often characterised by high levels of retail investor buying. This is when confidence can run ahead of itself and equity markets peak as valuations become too rich.

The evidence now points to equity markets being in transition from the 'hope' to the 'growth' phase. There are no 'hard and fast' milestones that symbolise such a shift but the balance of historical evidence suggests that PMI surveys typically move back above 50 (which they have) and unemployment shows signs of peaking (which, it could be argued, is the case in the US).

### THE FOUR PHASES DECOMPOSED INTO RETURNS AND DRIVERS OF RETURNS



Source: Worldscope, Haver Analytics, DataStream, Goldman Sachs ECS Research, October 2009.

## THE GROWTH PHASE

An interesting aspect of the 'growth' phase is that it typically begins with a great deal of uncertainty. Strangely enough, although conditions have improved from the trough, investors begin to perceive equities as more risky at this point in the cycle. In their view, they have already been paid for future earnings growth in the 'hope' phase and that growth may or may not materialise. A certain amount of nervousness over the threat of central banks tightening too soon or governments regulating too harshly so that they kill off economic growth is only natural.

However, the corporate earnings outlook is encouraging as profits come off a low base in 2009 and leading indicators of activity suggest an ongoing expansion of global economic growth. Earnings growth is likely to come through, like it has done in previous equity upswings. Markets are likely to grind higher as a result, offering the prospect of moderate, positive returns to investors before a more rewarding gain in the final phase of the cycle.

## CONCLUSION AND INVESTMENT IMPLICATIONS

Earnings growth drives equity markets over the long term, but it is rarely paid for when it occurs. The last decade, in particular, saw some of the strongest earnings growth in modern history, but also some of the worst returns. This was due to the inflated valuation of shares at the start of the decade after a period when investors became over-optimistic.

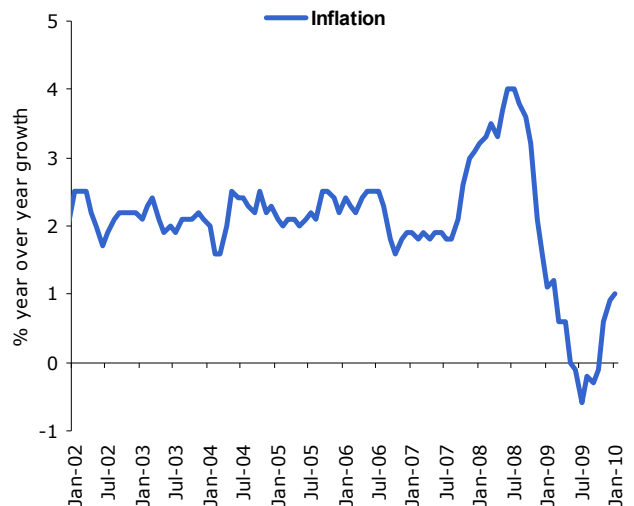
At this point in the cycle, valuations are fair and reasonable given the economic outlook. Equities and particularly commodities and commodity-related equities tend to perform well in the 'growth' phase of the equity cycle. Sector calls are less important in this phase; in fact, Goldman Sachs found that that the 'growth' phase offers the least potential for sector selection. Bottom-up research, insightful stock selection and the ability to identify those companies that can beat earnings expectations become paramount.

## Europe

Economic indicators continued to improve in January. Data released during the month showed that eurozone industrial production climbed 1.0% month-on-month in November, twice as much as expected. The European Commission's economic sentiment indicator rose for a tenth consecutive month in January as reviving global demand helped exports and bolstered earnings across the eurozone. Moreover, German business confidence, published by Ifo, increased to the highest level in 18 months in January sparked by a revival in exports. The European Central Bank (ECB) kept interest rates at a record low, while consumer prices in the eurozone edged up, pushed by a rise in oil prices to a 15-month high. Meanwhile, although the rise in the region's unemployment has slowed in recent months, it still seems poised to trend higher and reached 10.0% of the workforce in December.

### INFLATION RISES

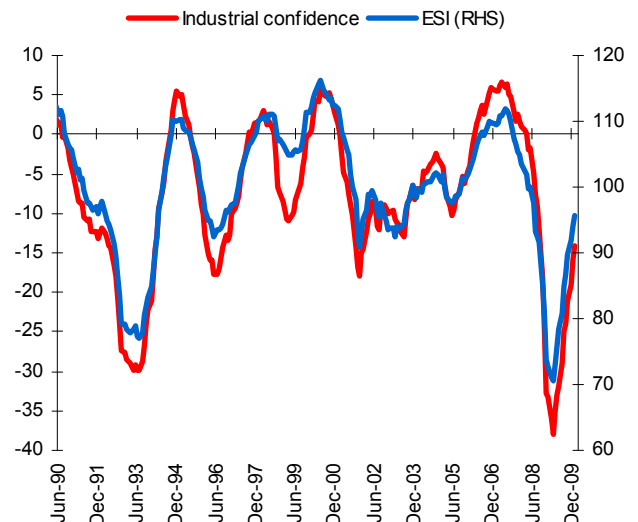
- Annual inflation in the eurozone rose to 1.0% in January from 0.9% in December, according to a first estimate by Eurostat. The rate is the highest since February 2009 as cold weather pushed oil prices to a 15-month high, though tourism and clothing prices were under pressure in January due to seasonal factors. Core inflation, excluding energy and food prices, remained fairly stable at 1.1% in January.
- While overall inflation is somewhat higher in view of the increasing trend in the oil price, it is nevertheless significantly below the ECB's target of below, but close to 2.0%. Eurozone unemployment rate also edged higher in December, which will also dampen the pressure on prices in the near future. Meanwhile, the central bank's latest inflation forecast for the eurozone, released in December, points to a rate of increase of 1.3% in 2010, slightly above its September estimate. In 2011, the ECB expects inflation at 1.4%, still under its target.
- The moderate price climate is offering the ECB sufficient scope and time to implement the reversal of monetary policy both cautiously and gradually, in line with current plans. Analysts do not expect rate hikes to take place before the fourth quarter of the year.



Source: DataStream, January 2010

### CONFIDENCE IN THE ECONOMY GROWS

- The European Commission's Economic Sentiment Indicator (ESI) for the euro region continued to improve, registering the tenth consecutive increase in January since the low in March. The ESI advanced from a revised 94.1 in December to 95.7 in January, the highest since June 2008 due to a general improvement in sentiment. Among the member countries, Italy reported the most significant rise followed by the UK and the Netherlands. The improvements were less marked in Germany, France and Spain.
- At a sector level, details suggest that confidence in the industrial sectors continued to increase in January, driven up by rising orders which increased production expectations. The declining level of stocks, across all the main industrial sectors, confirmed further de-stocking. Confidence among consumers remained unchanged in the euro area. In contrast, the construction sector saw the only drop. Nevertheless, firms reported an increase in their capacity utilisation, which currently stands at 72.4% overall, although this is still below historical averages.
- The eurozone economy returned to positive growth in the third quarter, driven by a rebound in industrial production. However, even as manufacturing has benefitted from a rebound in global trade, deteriorating labour market conditions coupled with fiscal consolidation could weigh on consumption.



Source: Bloomberg, January 2010

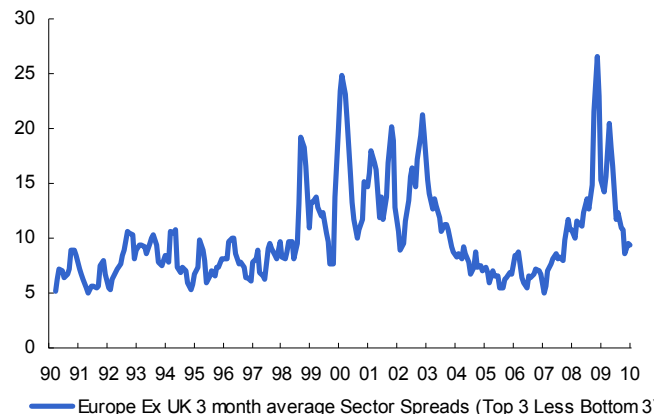
## European markets

European equities ended the month lower as concerns about the economic and financial condition of peripheral eurozone economies weighed upon sentiment. The fiscal health of Greece came under scrutiny as the European Commission questioned the nation's statistical data. Key Irish banking shares retreated as Bank of Ireland's shareholders approved taking part in the country's "bad bank" scheme in order to avoid falling fully into state ownership. Financials were also hit by fears about the possible removal of some stimulus measures and US President Barack Obama's plan to curb risk taking in the financial sector. Elsewhere, energy names declined in response to weaker oil prices and materials firms tracked commodity prices lower amid worries over tightening monetary policy in China. On a positive note, the technology sector was boosted by solid earnings releases from Nokia and SAP. Bid activity also supported markets; Cadbury accepted the revised offer from Kraft Foods and Novartis bought a majority stake in the world's largest eye care company Alcon.

### FOCUS SHIFTING TOWARDS STOCK PICKING

- The chart depicts the three-month Continental European sector alpha, which is the return available to investors from consistently buying the best three and selling the worst three performing sectors. After reaching high levels in November 2008 and April 2009, sector alpha has experienced a falling trend lately.
- Calling sectors was the key in 2008 and 2009; long positions in defensives and a negative stance in financials and economically sensitive stocks worked well in 2008 as worries about the crisis reduced risk appetite. A reverse trade was profitable over the last year, when early-stage economic recovery and liquidity support provided drove the recovery rally.
- Sector rotations may accompany short-term spikes in volatility during 2010. However, reduced liquidity, fewer positive surprises on the macroeconomic front, rising corporate confidence and further narrowing in credit spreads are likely to accompany falling sector alpha with investors choosing stocks within sectors, not between them. It is becoming more important to focus on stock selection and thorough research to pick the best investment ideas.

European Sector alpha - Return from buying best and selling worst-performing sectors

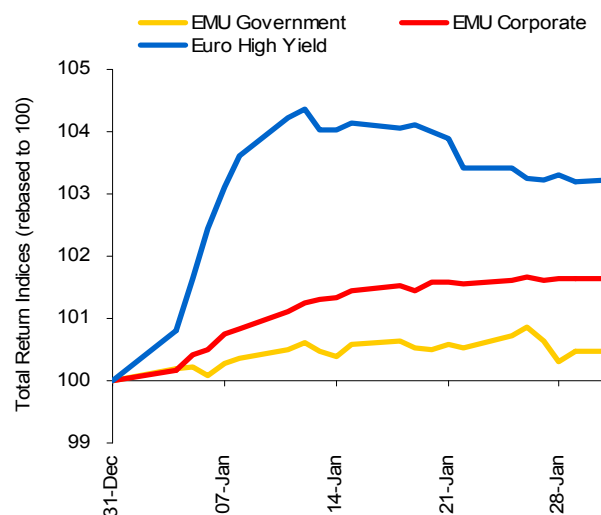


Source: DataStream and Citi Investment Research and Analysis, January 2010

European government bonds ended higher in January, in light of sovereign concerns surrounding euro member countries, particularly Greece and their impact on the region's competitiveness. Investors feared that the country could not implement strict fiscal policies to reduce its large budget deficit. Nonetheless, investment and sub-investment grade bonds witnessed broad based tightening of credit spreads. On 4th February, the European Central Bank (ECB) left the refinancing rate unchanged at 1%.

### HIGH YIELD OUTPERFORMS ONCE AGAIN

- While leaving the interest rate unchanged, the ECB President Jean-Claude Trichet said that the Bank will take further decisions in March regarding the implementation of the gradual phasing-out of non-standard measures. Commenting on the situation in Greece, he said that he is confident that Greece can get its budget deficit under control. Moreover, he called upon governments to decide and implement ambitious fiscal exit and consolidation strategies in a timely fashion.
- Government bonds ended January in positive territory, returning 0.5%. Investment-grade corporate bonds recorded returns of 1.7%, outperforming government debt. Within the investment grade bond market, AAA-rated securities generated 1.1% returns, underperforming BBB-rated bonds which returned 2.0% over the month. Meanwhile, sub-investment grade bonds recorded 3.2% gains and were the best-performing fixed income asset class (see chart).
- Over the month, the European 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 0.21 percentage points to 1.12%, while those on 30-year maturities fell by 0.19 percentage points to 3.93%.



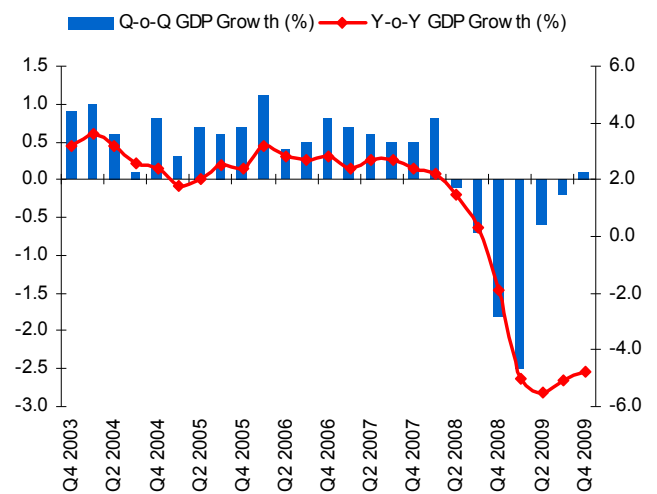
Source: BofA Merrill Lynch, January 2010

## United Kingdom

The latest data from the Office for National Statistics (ONS) showed that unemployment fell by 7,000 to 2.5 million in the three-month period ended November 2009, the first quarterly decline since May 2008. Further positive news came from the housing market; mortgage lender Nationwide said that house prices rose by 1.2% in January from the previous month. Moreover, data from the British Bankers Association showed that mortgage approvals climbed to their highest level since September 2007. However, the annual inflation rate accelerated at a record rate of 2.9% in December. This was more than the 2.0% target set by the Bank of England (BoE) that was last exceeded in May 2009. Against this backdrop, the BoE's policymakers voted unanimously to keep interest rates on hold at a record low of 0.5%.

### UK GDP EMERGES OUT OF RECESSION

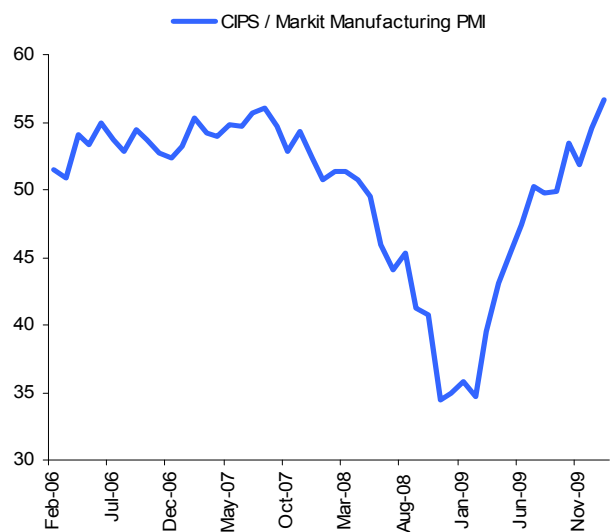
- The UK economy resumed growth by less than economists forecast in the fourth quarter as service industries and manufacturing expanded just enough to pull the UK out of its longest recession on record. GDP grew just 0.1% from the third quarter in the last three months of 2009. The recession, which lasted for six consecutive quarters, has shaved 6% off GDP, the ONS said.
- The ONS figures also showed that GDP fell by a record 4.8% in 2009. The preliminary GDP estimate could be revised down, or up, in the coming months. The UK is the last major economy to exit recession. France and Germany both began growing again between April and June in 2009, while the US and Japan also emerged from recession last year.
- In its latest policy meeting, the BoE's Monetary Policy Committee said it was putting its £200 billion quantitative easing programme on hold, but warned the economy remained sluggish and said it would start buying assets again if need be. Meanwhile, in its latest economic projections, the International Monetary Fund predicted that UK economy will grow by 1.3% in 2010, compared with its October forecast of a 0.9% expansion.



Source: The Office for National Statistics, Q4 2003 to Q4 2009

### OVERSEAS DEMAND BOOSTS MANUFACTURING

- A rise in domestic as well as overseas demand led the UK manufacturing industry to a 15-year high. Data released by the Chartered Institute of Purchasing and Supply/Markit (CIPS/Markit) showed that the manufacturing purchasing managers' index surged from 54.6 in December to 56.7 in January.
- The increase came as new orders rose at their fastest pace in six years, with export orders growing at their fastest since 1996. The improving global economic situation and continuing weakness of the pound also led to a sharp rise in foreign demand for UK manufactured products. The recession had led to many manufacturers being forced to cut jobs but this new demand means some firms are taking on staff for the first time in nearly two years.
- The CBI's monthly industrial trend survey also reiterates a rise in output expectations by manufacturers. Moreover, the labour market suggests a fall in the number of people unemployed.



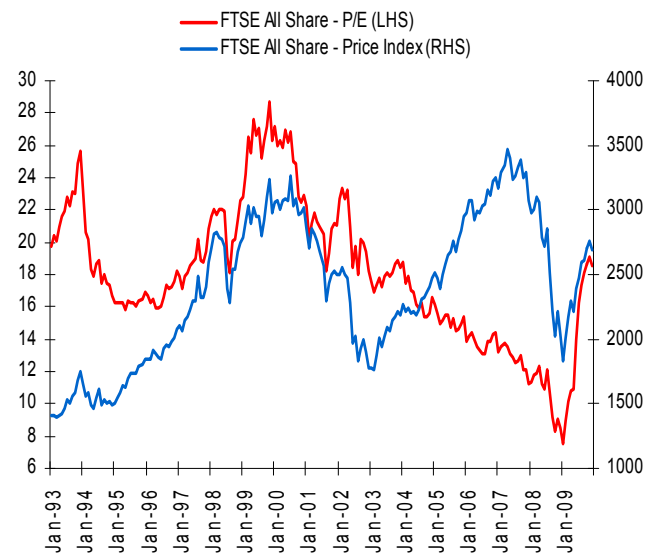
Source: Bloomberg, January 2010

## United Kingdom markets

**UK equities declined in January after two successive months of gains. Equities started 2010 on a strong note, but came under pressure later in the month due to speculation that global governments may step up plans to unwind stimulus measures, while weak economic data, particularly in the US, led to worries about the strength of the recovery. There were also fresh apprehensions about the financial sector following US President Barack Obama's proposals to limit risk-taking at banks, while credit ratings agency Standard & Poor's reiterated its concerns about the UK banking system. The benchmark FTSE All Share Index fell by -3.6% over the review period.**

### STOCK VALUATIONS ON THE RISE

- A strong rally in stock prices starting March 2009 has led to a recovery in equity market valuations, which are now around their historical average. The average trailing price to earnings ratio (P/E) for the FTSE All Share Index is now at 18.5, just above its long-run average of 18, prompting concerns in some quarters that stock prices are no longer as compelling as they were a few months ago.
- The market decline in January has further heightened these worries, while uncertainty over the extent of recovery and the possibility of the BoE ending its quantitative easing programme have also made investors jittery. Nevertheless, analysts have pointed out that earnings at the majority of the UK's blue chip companies come from outside the country, which should enable them to benefit from wider global revival. Moreover, the massive downsizing and cost cutting undertaken by companies at the height of the recession has led to an increase in profit margins, and thus strong cash flows and higher dividends can be expected to form a substantial part of total returns in the years ahead.
- The outlook for earnings is also improving. UBS estimates that on an average, profits at UK companies could rise by 17.9% in 2010 and 23.5% in 2011, against an estimated -19.9% in 2009. Compared to this, the 12-month forward P/E estimate for UK market is only 13.3.

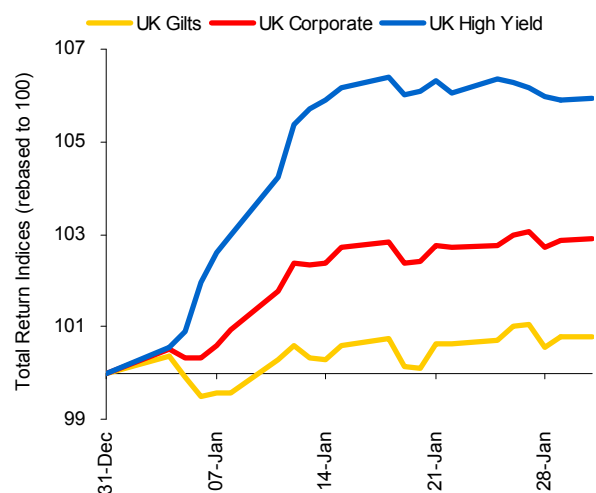


Source: DataStream, Jan 1993 to Feb 2010

**UK government bonds (gilts) ended January in positive territory, buoyed by concerns surrounding Greece and its impact on the eurozone economies. On 5th February, the Bank of England (BoE) halted its £200 billion-pound (\$317 billion) bond purchase plan but left open the option to buy more as officials gauge the health of the UK's recovery. The bank also kept the benchmark interest rate at a record low of 0.5% and the BoE Governor Mervyn King added that the considerable stimulus from the easing in monetary policy, the lower level of sterling and the recovery in UK export markets should together support domestic activity.**

### ANOTHER GOOD MONTH FOR RISKY ASSETS

- Gilts ended January in positive territory, generating returns of 0.8%. Gilts were boosted by a flight to quality in light of fears over the debt burden and the potential loss of the country's AAA rating. Investment-grade corporate bonds bounced back into positive territory and advanced by 2.9%, despite the fact that the BoE started selling some of the corporate bonds it had bought as a part of its quantitative easing program. Leading the pack were the real estate and insurance sectors.
- Within the corporate bond market, AAA-rated securities were the worst performers across the credit spectrum, generating 1.8% returns, while BBB-rated bonds ended higher by 3.7%. Despite risk aversion, sub-investment grade (high yield) paper rose 5.9% and outperformed both corporate bonds and government debt (see chart).
- In terms of the yield curve, yields moved down broadly in parallel in January. Yields on two-year maturities fell by 0.06 percentage points to 1.26%, whereas those on 30-year paper declined by 0.03 percentage points to 4.39%.



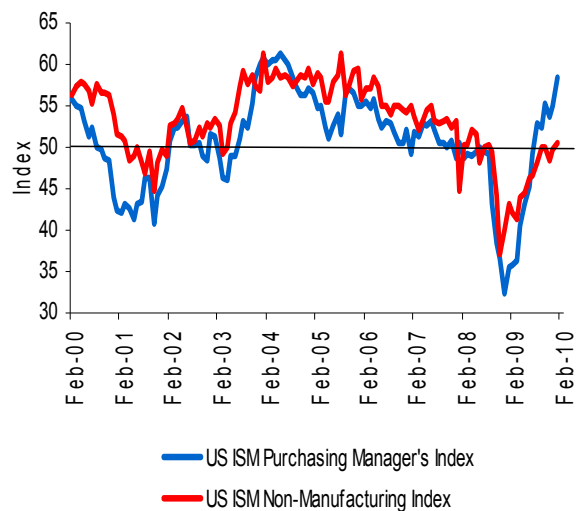
Source: BofA Merrill Lynch, January 2010

## United States

The economic recovery process continued in January, with advance estimates from the Bureau of Economic Analysis showing a better-than-expected 5.7% annual rate of increase in real GDP in the fourth quarter of 2009. Investors also reacted favourably to strength in the manufacturing sector and Department of Commerce data which showed that durable goods orders rose 0.3% over the same month. Meanwhile, the Conference Board's Consumer Confidence Index rose for the third straight month in January, driven by improved economic conditions. However, job losses continued, and the unemployment rate remained high at 10%. On the housing front, existing home sales declined in December although many attributed this to the end of the home buyers' tax credit.

### A MANUFACTURING-LED RECOVERY?

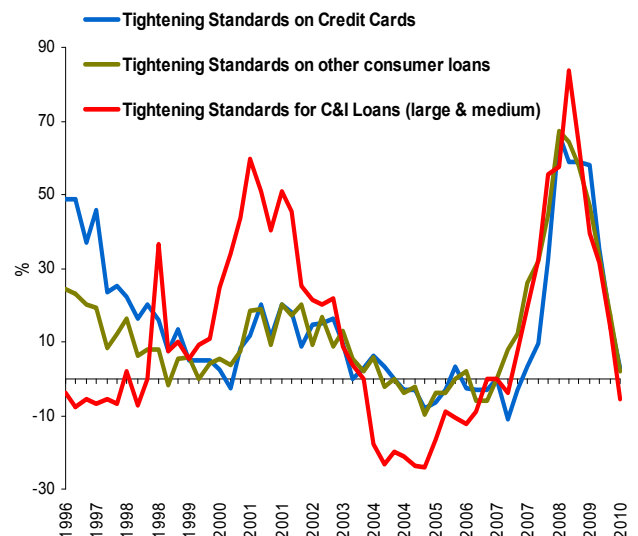
- Recent reports have confirmed the recovery in the manufacturing sector: the ISM Purchasing Manager's Index for January rose for the sixth consecutive month to 58.4% (a reading above 50 indicates expansion over the previous month) its highest reading since August 2004. The key components of the index - production, employment and new orders - all increased, during the month.
- The manufacturing sector has received a boost from the restocking of inventories; excessive draw-downs last year resulted in extremely low inventory levels which are now being rebuilt and should boost production. The fact that the manufacturing sector caters to international demand has provided a further push.
- Nevertheless, continued weakness in the services sector, a much larger component of the economy, continues to weigh on sentiment. January's Non-Manufacturing Index registered some growth but fell short of expectations; the services segment is more sensitive to the domestic consumer who continues to face job losses and stagnant income. For the recovery to be sustainable these issues need to be addressed and Obama's renewed focus on job creation is a step in the right direction.



Source: Datastream, February 2010

### BANK LENDING STANDARDS IMPROVE

- The January Senior Loan Officer Survey showed that fewer banks tightened standards for loans to consumers and companies in the final quarter of 2009. Commercial banks generally ceased tightening standards across loan types but they are yet to unwind the considerable tightening that occurred over the past two years. A net 5.5% of banks reported easing standards for commercial and industrial (C&I) loans to large and middle-market firms.
- However, banks continued to tighten standards for smaller firms with a net 3.7% reporting they had "tightened somewhat." Lending standards for commercial real estate loans were also tightened further. A net 27.3% of banks said they had tightened standards for commercial real estate over the quarter. Meanwhile, loan demand from both businesses and households weakened over the quarter. Banks reported a weaker appetite for business loans while demand for loans from households was more mixed.
- While the lending survey data hints at only sluggish recovery prospects, policy makers are more bullish about the economy and mindful of easy financial conditions outside of the banking sector. The Federal Open Market Committee said in its policy statement that "while bank lending continues to contract, financial market conditions remain supportive of economic growth."



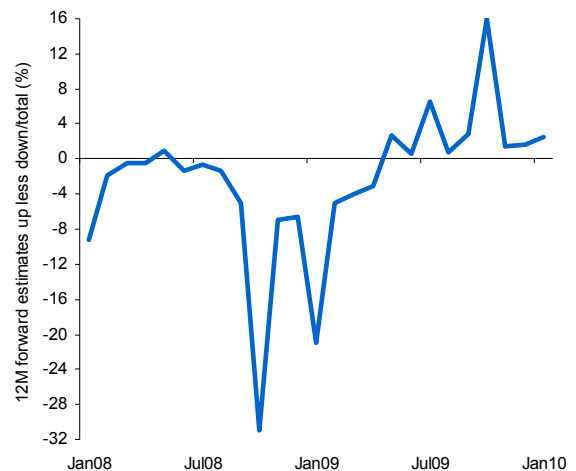
Source: US Federal Reserve, February 2010

## United States markets

Political and regulatory developments dominated investors' minds and pushed US equities lower in January. Financial stocks bore the brunt of President Obama's proposal to curb banks from owning, sponsoring or investing in hedge funds for proprietary profit, an important source of income for some. Uncertainty about the fiscal stability of Greece, Portugal and Spain and mixed earnings announcements in the banking sector also held back gains. Meanwhile, China's efforts to curb overheating in its economy prompted a sell-off in materials shares, while a surprise reduction in the Democrats' power in the Senate threatened to dilute the health care reform process. In contrast, technology shares after outlook announcements at firms such as SanDisk, Motorola, IBM and Qualcomm disappointed.

### EARNINGS SURPRISES CONTINUE

- As of early February, of the 267 S&P 500 companies that had made earnings announcements, 77% had exceeded expectations.\* However, unlike the previous two quarters when earnings surprises helped push stock markets higher, these results have not had the same effect.
- The strong rally in US equities, post the March-2009 lows, has ensured that much of the good news that we are now seeing may already be priced in. Earnings tend to recover at an above-average pace during a recovery and many of the gains that were expected from the extensive cost-cutting activity undertaken in previous months have come through.
- Going forward, there is some uncertainty about whether earnings growth can be sustained in an environment where demand remains constrained. Some analysts are worried that the consensus forecasts for 2010 corporate profits are too high. After all, the recession has set sales of the nation's 500-largest companies back several years. Encouragingly, however, this is where stock-specific fundamentals come into play; for there are many firms that are well placed to grow. Network equipment business Cisco Systems is citing stronger sales in almost every customer segment and region.

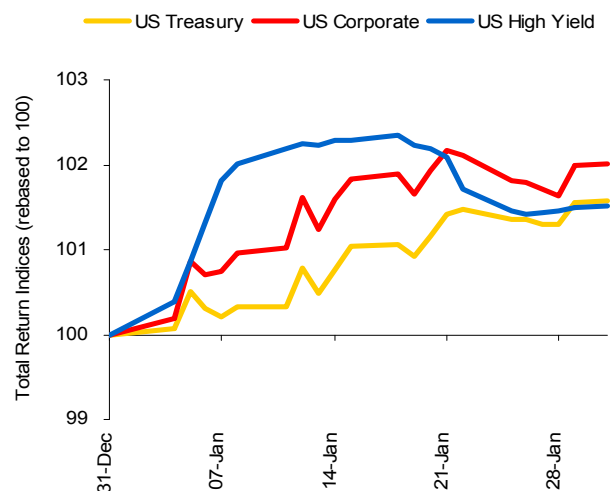


Source: Datastream, January 2010; \*Source: CNBC, Thomson Reuters, Feb 3 2010

US government bonds advanced in January as concerns that Greece may fail to rein in its deficit increased the safe haven appeal of US Treasuries. Meanwhile, in its last meeting, the Federal Reserve (Fed) restated its intention to cease buying mortgage-backed securities in March and maintained its pledge to keep interest rates near zero for an extended period. The Fed also repeated that it will close four facilities supporting money markets and bond dealers in February as well as dollar swap programs with central banks in Europe and Asia.

### CORPORATE BONDS OUTPERFORMED

- US corporate bonds outperformed government and high yield bonds in January. Treasuries generated a return of 1.6% while corporate bonds returned 2%. High-yield securities returned 1.5% over the period.
- In the corporate bond market, lower-rated BBB bonds continued to outperform other asset classes within the credit spectrum, returning 2.4% over the month. Higher quality AA-rated bonds returned 1.4% and were the worst performers. AAA-rated paper returned 1.8%. Elsewhere, Treasury Secretary Timothy Geithner stated that the US was in no danger of losing its Aaa debt rating even though the Obama administration has predicted a \$1.6 trillion budget deficit in 2010. He further added that investors around the world turned to US Treasury securities and dollar-denominated assets whenever worries arose about global stability.
- Over the month, the yield curve steepened as yields on short-term debt declined more than those on longer-dated securities. Two-year bond yields fell by 0.32 percentage points to 0.8% while those on 30-year bonds fell by 0.15 percentage points to 4.5%.



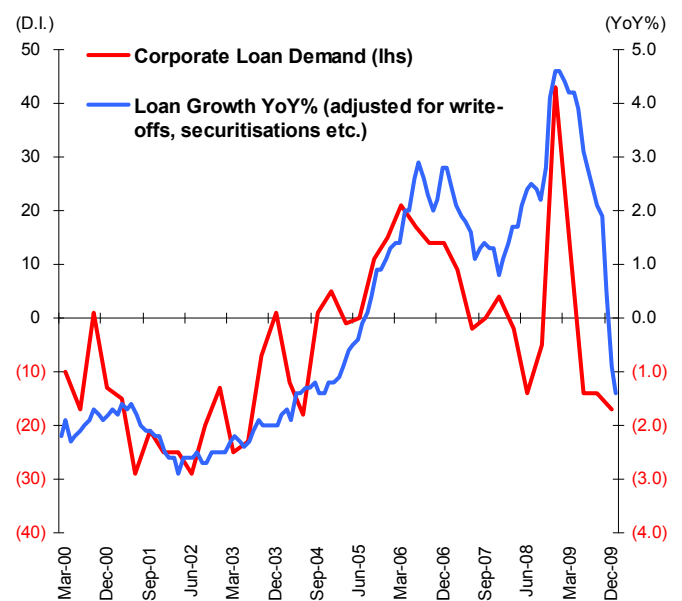
Source: BofA Merrill Lynch, January 2010

## Japan

Macroeconomic indicators pointed towards relatively robust activity, particularly in areas of the economy closely tied to a recovery in external demand. Amid solid growth in the Asia region, the year-on-year rate of change in Japanese exports and industrial production turned positive for the first time since mid-2008. While leading indicators (the new orders PMI for Chinese manufacturers and the US ISM new orders index) suggested that the solid uptrend in exports was set to continue, the transition towards a self-sustaining recovery remained tenuous. Government incentives continued to underpin growth in household spending, primarily in the area of energy-efficient consumer durables, but employment and income conditions remained weak, as evidenced by a record drop in year-end bonus payments.

### BANK LENDING DECLINES FOR A SECOND MONTH

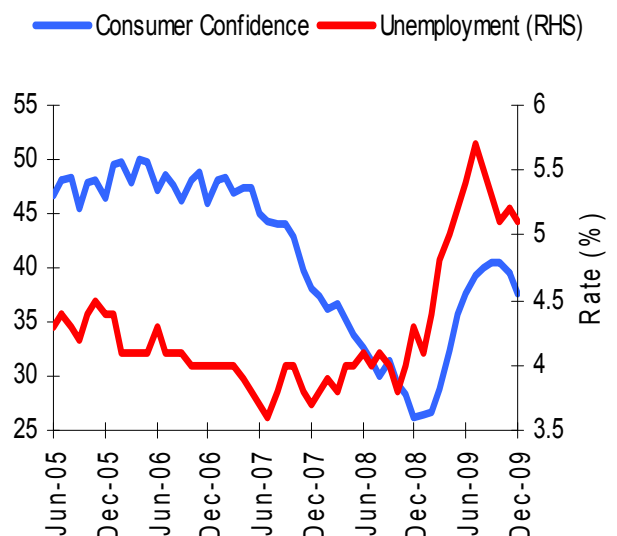
- According to the Bank of Japan's Principal Figures of Financial Institutions report, the daily balance of bank lending (adjusted for special items including securitization of loans, exchange rates and loan write-offs) fell for a second consecutive month in January, with the rate of decline accelerating to -1.4% year-on-year (the sharpest rate of decline in four years) from 0.9% in December.
- The recent reversal is partly a reaction to the surge in demand for bank loans in the wake of the global financial crisis, as well as a subsequent recovery in capital markets (according to data compiled by Bloomberg, bonds issued by Japanese companies rose by 50% year-on-year to ¥795 billion in January).
- However, corporate demand for financing remains fundamentally weak, as evidenced by the central bank's quarterly survey of senior loan officers, which recently fell to its lowest level since mid-2004.
- In particular, demand for funds among smaller companies remains depressed due to the relatively low level of domestic economic activity and many large corporations continue to cut back investment as they struggle with excess capacity. As a result, bank lending appears unlikely to undergo a meaningful rebound in the near term.



Source: Bank of Japan, January 2010

### CONSUMER CONFIDENCE DECLINES

- Japan's household sentiment index fell to a six-month low in December, indicating the need for further measures to stimulate consumer spending and sustain a recovery from recession. December's sentiment was down 1.9 points from 39.5 in November to 37.6.
- Confidence in Japan has been battered by 18 months of falling wages and rising unemployment. A dearth of spending has caused consumer prices to decline for nine months as retailers discount products to attract customers. Latest data shows that the income and employment outlook is still weak as the pressure on companies to rein in labour costs remains strong in face of ongoing deflation.
- Despite gloomy signals from the labour market, government incentives have had a positive impact on consumption. Indeed, Finance Minister Naoto Kan urged lawmakers to pass a proposed ¥7.4 trillion (\$82 billion) extra budget for the current fiscal year, stating that it would contribute 0.3 percentage points to economic growth. Stimulus efforts implemented by the previous administration have begun to fade, signalling it may be too early to see a sustained recovery in consumer spending.



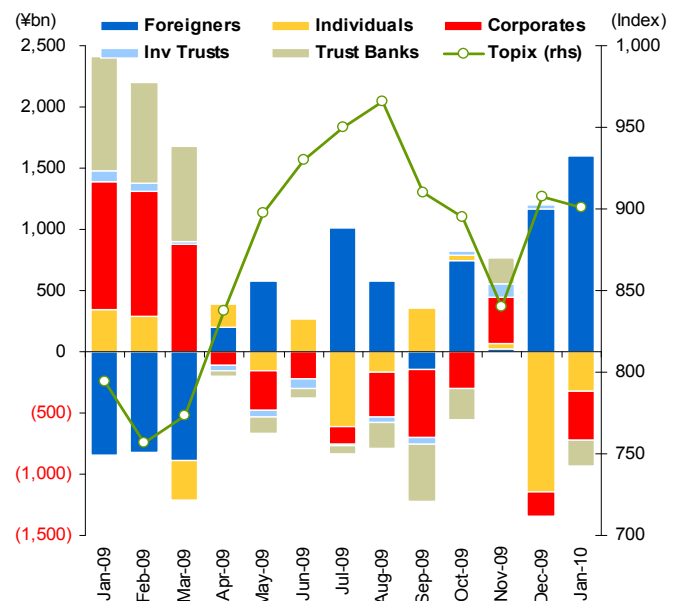
Source: Bloomberg, January 2010

## Japanese markets

The Japanese market got off to a strong start in early 2010, spurred by robust economic indicators, a weakening of the yen to around ¥93 against the US dollar and signs that equity financing had peaked. Although the prospect of monetary tightening in China and tougher financial regulations in the US sent share prices sharply lower in the latter half of January, Japanese stocks outperformed their global peers. Over the month, the broad-based Topix returned -0.7%. In terms of sector performance, a clear reversal trend was evident at the start of the year. Marine transport stocks, which had fared poorly in 2009, rebounded amid robust demand from China and other emerging markets. Laggard financials and defensive names also performed strongly. In contrast, JAL led a decline in airline stocks and Toyota Motor's extensive product recall weighed upon the transport equipment sector.

### NET BUYING BY OVERSEAS INVESTORS HITS A 3-YEAR HIGH

- Although the global financial crisis precipitated a wave of selling by overseas investors that culminated in the first quarter, they returned to the Japanese market from April onwards and in calendar 2009 as a whole were net buyers for the first time in two years. On the other hand, domestic investors, many of whom bought on weakness in the first quarter, were predominantly net sellers during the recovery rally.
- In the summer, growing confidence in an earnings recovery encouraged buying in Japanese stocks. Later in the year, a weaker yen and the implementation of additional monetary easing by the Bank of Japan fuelled strong buying interest from foreign investors and in January 2010 their net purchases exceeded ¥1 trillion for a second consecutive month.
- While the recent strong interest from overseas investors is largely attributable to a reversal of heavily underweight positions rather than a deliberate shift to an overweight strategy, their remains scope for further buying.
- As a rebound in the world economy, a more stable exchange rate and the effects of cost cutting enhance the prospect of Japanese companies achieving strong profit growth in fiscal 2010 we could see foreign investors increase their positions in Japan.

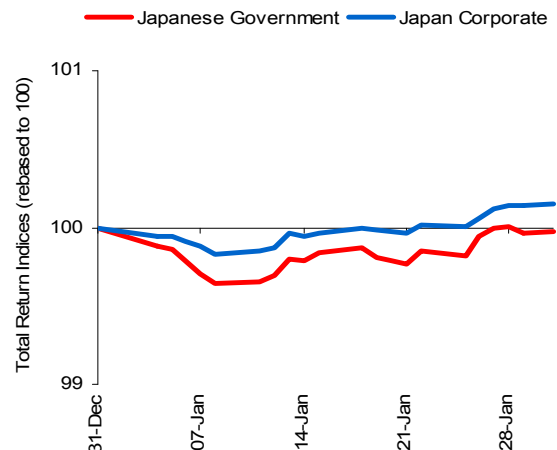


Source: TSE, Bloomberg. February 2010

Japanese government bonds fell in January amid rising bond sales which increased concerns about Japan's growing public debt. Meanwhile, the Bank of Japan held its interest rates near zero and said it remains committed to fighting deflation. The central bank left its assessment unchanged that the economy is "picking up" because of worldwide stimulus efforts while also suggesting "there is not yet sufficient momentum to support a self-sustaining recovery in domestic private demand."

### GOVERNMENT BONDS WEAKEN

- Japanese government bonds returned -0.03%, underperforming investment-grade corporate debt, which gained 0.15%. Lower-rated BBB paper continued to outperform other bonds within the credit spectrum, returning 0.5% over the period. Meanwhile, AAA and A-rated bonds both returned 0.2% over the month.
- Standard & Poor's cut the outlook for Japan's Aa sovereign credit rating, citing Prime Minister Yukio Hatoyama's failure to come up with credible policies to contain finances. The Finance Ministry forecasts public debt may swell to ¥973 trillion by March 2011, exacerbating a debt load that's already the largest in the industrialised world.
- Over the month, the yield curve steepened as yields on short-term debt fell while those on longer-dated securities rose. The yield on two-year government bonds declined by 0.08% to 0.2%, while that on 30-year paper advanced by 0.11 percentage points to 2.3%.



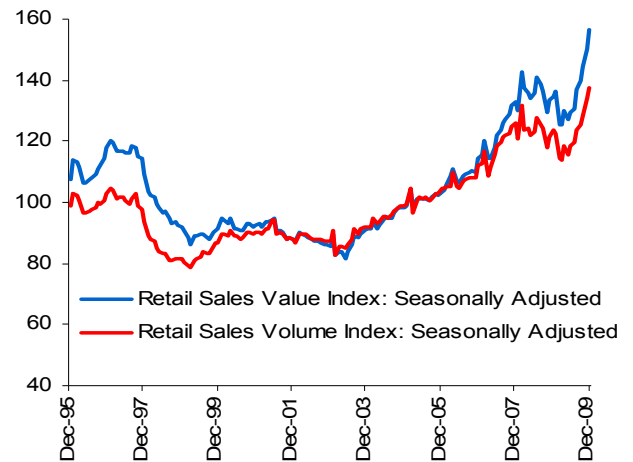
Source: BofA Merrill Lynch, January 2010

## Asia Pacific

Macroeconomic data for December and China's Purchasing Managers' Index for January confirmed that the upbeat momentum in industrial activity is intact, helped by solid investment and retail sales growth, and a notable upturn in the export sector. The Chinese economy expanded by 10.7% from a year ago in the fourth quarter of 2009, while Singapore's GDP contracted. Investors focused on indications that the credit-led stimulus policy is being moderated, as reserve requirements for banks were raised in China and India. Elsewhere, employment improved in Hong Kong, Australia, Taiwan and Singapore, supported by significant expansions in industrial output.

### HONG KONG RETAIL SALES BOUNCE

- Hong Kong's retail sales surged in December, on both an annual and monthly basis. Nominal sales rose by 16% year-on-year and real sales were up 11.3% in December. The increase for 2009 was recorded at 0.6% year-on-year in value and 0.8% contraction in volume terms. During the Asian Financial Crisis, retail sales shrunk by over 8.0% and 1.5% respectively.
- In part, retail sales growth can be explained by a buoyant tourist market. Just as importantly, the sector is an obvious beneficiary of the massive expansion in the monetary base that occurred during 2009. Strong price momentum in residential and commercial markets along with stabilising unemployment and payrolls supported consumer confidence and Hong Kong's emergence out of recession.
- However, inflation is gradually picking up pace and monetary authorities are concerned about the potential risk of asset bubbles for the territory due to continued capital inflows and record low interest rates.

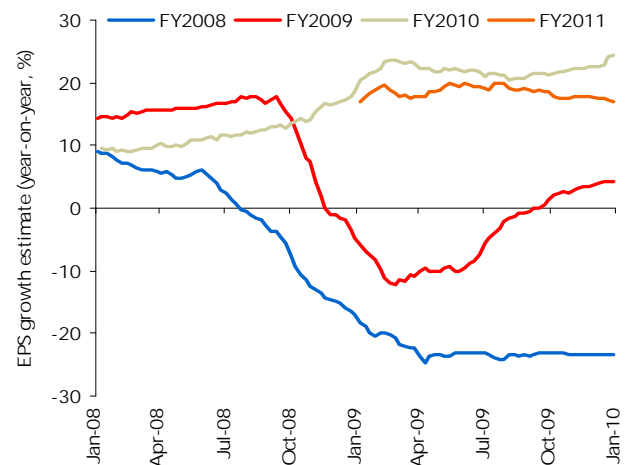


Source: CEIC, February 2010

Stock markets in the Asia Pacific region started the year on a weak note, as share prices came under selling pressure across global markets. Monetary tightening in China, increased risk of European debt default, and fears about curbs on US banks dampened sentiment. Regional stocks lagged their global peers on an average as commodity prices succumbed to deepening concerns about economic recovery. Subsequently, while most sectors ended the month in negative territory, materials stocks were significantly impacted. Foreign institutional investors turned net sellers in India and Thailand, but continued to purchase in Korea, Indonesia and Taiwan.

### EARNINGS GROWTH IS RECOVERING

- Asia Pacific ex Japan continued to see a healthy upward revision in earnings forecasts in January. As earning results pour in, the 2009 and 2010 estimates rose over the month and the market now expects earnings to expand by 4.4% in financial year 2009 and by another 24.5% in 2010.
- All countries and sectors are expected to see growth but the range of forecasts is wide. The information technology sector leads the pack thanks to global recovery in demand for its products and software services. Industrials and materials are also areas which could record a robust increase in profits, supported by private as well as government investment spending.
- With earnings growth likely to outgrow the inflation rate, companies can enhance shareholder value by passing increased costs on to their customer.



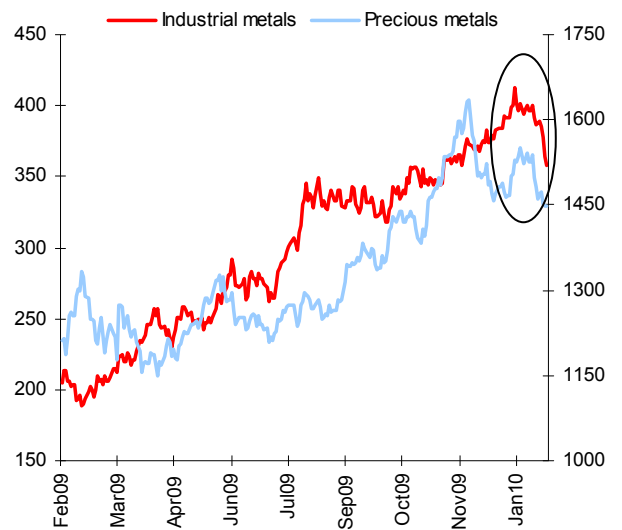
Source: IBES consensus estimates, DataStream, Fidelity Investment, February 2010

## Emerging markets

Remarks made by Chinese policymakers impacted upon all emerging market data releases this month. China modestly raised bank reserve requirements, prompting regulators to instruct some banks to bring a temporary halt to lending amid growing fears of asset bubbles and inflation. Furthermore, China's Premier Wen Jiabao said the country will manage the pace of credit growth. Meanwhile, the Reserve Bank of India also raised its cash reserve ratio by a wider margin than forecast; the central bank increased its economic growth forecast to 7.5% in the year to March 2010, from an earlier estimate of 6%, and increased its inflation forecast to 8.5% from 6.5%.

### CHINA TAKES THE SHINE OFF METALS IN JANUARY

- After a noteworthy rally in the latter half of 2009, metal prices retreated sharply in January amid fears that China, the world's largest user of industrial metals, could rein in stimulus measures. Given China's remarkable pace of economic growth and its role in underpinning global economic activity, this development prompted concerns about a shrinkage in demand and weakened sentiment towards commodities. In particular, copper led a broad decline in industrial metal prices.
- Commodity prices came under further pressure from rising risk aversion, after a sell-off in equities following the US President Barack Obama's proposal to curtail the size and growth of big banks. Sovereign risk fears also gained ground given concerns about the fiscal positions of Greece, Spain and Portugal. The renewed strength in the US dollar also proved detrimental; a stronger dollar makes commodities denominated in the currency more expensive for holders of other currencies.
- Nevertheless, the International Monetary Fund (IMF) forecast that commodities prices are set to remain high by historical standards over the long term as the industrialisation of emerging countries supports continued consumption. The IMF had correctly anticipated last year that the low prices of early 2009 were unsustainable, contrary to the view that the era of high commodities prices was over.

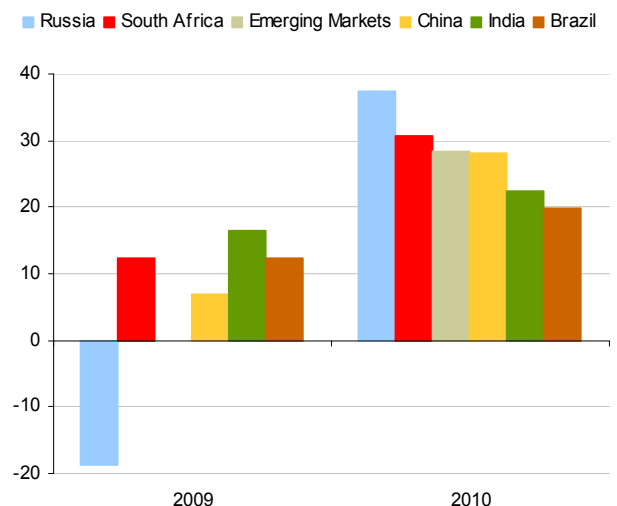


Source: DataStream, January 2010. MSCI S&P Spot Price Indices, US Dollar

After a period of strong performance, emerging market equities ended in negative territory in January. Worldwide events, such as President Obama's proposed regulation to curb risky investment activity in the banking sector, China's proposal to curb domestic lending, and the spectre of sovereign defaults emanating from Greece, Spain and Portugal weakened investor sentiment worldwide. Latin American stocks were the worst performers, followed by Emerging Asian markets, both of which underperformed the broader emerging markets index. At a sector level, consumer discretionary stocks led the decline, followed by materials and energy companies.

### EARNINGS GROWTH EXPECTED TO CONTINUE

- After a particularly strong performance in 2009, valuations of Emerging Market equities have re-rated substantially from the base levels witnessed in 2008. This led to near term concern about an asset bubble building up in emerging markets, and a rise in risk aversion given the fiscal problems in the developed world.
- In spite of the rally, there still is room for gains in emerging markets. Earnings are expected to grow at a healthy pace in 2010 across this asset class, with a very strong recovery seen in Russia, Turkey and South Africa. In recent months, Russian markets have recovered with the uptrend in oil price. It is well known that the country is a repository of natural resources. Additionally, Russia has tremendous growth potential, as penetration levels for most goods and services are well under half of those in Western Europe. Over January, Russian equities delivered a positive performance, even as regional peers Brazil, China and India ended in negative territory. This is in contrast with 2008, when Russian markets were the worst performers in the region.
- Even Brazil, China and India are expecting healthy growth in earnings in 2010, partially aided by strong domestic consumption.



Source: DataStream, IBES, January 2010



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