Monthly market review **September 2009**

Markets overview

September was another strong month in equity markets, as shares made gains across the US, Europe and Asia. Japan was the main laggard, as momentum weakened. Bond markets performed less well this month, with little change over the period. Meanwhile, UK commercial property continued its slow-yet-steady rehabilitation, with monthly total returns edging further above zero.

Global themes

Sterling plunged this month following comments from the Bank of England that the UK economy was set for a protracted period of weak growth. Later in the month, the Bank tried to stem the flow after the Monetary Policy Committee voted unanimously to keep policy unchanged in September, but Governor Mervyn King and David Miles still felt a future expansion of bond buying might be desirable.

UK equities

UK equities delivered positive returns in September, driven higher by mining stocks and the takeover attempt for Cadbury.

In the UK, economic news was generally positive. Manufacturing output rose by 0.8% in July, following an 0.6% advance in June, with auto production (cash for clunkers) an important factor. There were also some tentative signs that some parts of the labour market may be loosening up, as the August KPMG survey of recruitment consultants reported that permanent placements had moved above 50 for the first time since quarter one of last year. And in the housing market, more agents reported prices up than down, for the fist time since July 2007. On the downside, retail sales volumes were flat in August, while the CBI Industrial Trends survey reported a very weak export orders. Lastly, inflation dropped by less than expected in August, with consumer prices up 0.4% on the month and 1.6% higher than a year ago.

In the market, the best performing stock was Cadbury, up nearly 40% after a £10.2 billion takeover bid from Kraft Foods. The shares soared as investors believed the offer would trigger rival offers from Nestle and Hershey, forcing Kraft to raise its bid.

Other leading stocks over the month included precious metals miners Fresnillo (Mexico, silver) and Randgold (South Africa, gold) as prices continued to rise. Other commodity producers rallied too, though to a lesser extent. Hedge fund manager Man Group also enjoyed a better month after reporting that redemptions from its funds had slowed recently.

On the downside, Home Retail Group suffered from concerns about pricing policies at its Argos division. Other losers included RBS and Lloyds Banking Group, as the banks signalled their intentions to raise capital from the equity market to start paying back the government. And property companies Liberty International and British Land faced profit taking after a strong period of performance in recent months.

European equities

European stock markets performed well again in September. Most of the major markets enjoyed decent mid-single-digit gains, though Switzerland and Sweden were among the laggards that struggled to deliver a meaningful rise.

In Europe, the German Ifo business climate index rose to 91.3 from 90.5 in August, the highest reading since September 2008. And although German industrial production fell by 0.9% in July, the figures were downwardly distorted by a holiday effect. Also, the German government's efforts to maintain jobs have curbed the increase in unemployment, while German investor confidence (as reported by the ZEW survey) rose to the highest level in more than three years in

September. Elsewhere, Europe also posted a fourth monthly trade surplus in July as exports picked up.

Angela Merkel, Germany's chancellor, enjoyed an election victory that strengthened her centre-right domination of the political landscape. Analysts expect Ms Merkel to put a distinctive German stamp on European policies, from fiscal discipline and climate change to the institutional changes that would be introduced if the EU's Lisbon treaty came into effect next year.

In the financial sector, BNP Paribas, France's largest bank, said it would seek 4.3 billion euros in a capital increase to help repay the government. BNP Paribas and Societe Generale, the country's second-largest bank by market value, received a total 8.5 billion euros from the state to boost capital and sustain lending.

Europe's biggest telephone company, Deutsche Telekom, and France Telecom, this week agreed to merge their UK units (T-Mobile and Orange) to form the country's largest mobile-phone operator. Meanwhile, Vivendi announced plans to buy Brazilian telecommunications provider GVT for about $3 billion.

HeidelbergCement, which carried out Germany's biggest share sale in five years (2.25 billion euros), is poised to start bond sales to tackle about 5 billion euros in refinancing needs that can't be covered by disposals and cash flow. In other rights-issue news, Deutsche Wohnen, Germany's second-largest publicly traded residential landlord, plans to raise a net 237 million euros in a share sale to cut debt.

US equities
The US market rose in September as economic news continued to give positive momentum to equity investors.

In economic news, it was reported this month that the S&P/Case-Shiller home-price index fell 13.3 percent in July from a year earlier, the smallest drop in 17 months. The decline was less than forecast, a sign the housing slump that led to the worst recession in seven decades is abating. Meanwhile, confidence among US consumers unexpectedly fell in September as a rising unemployment rate weighed on households. Meanwhile, a good example of the consumers' present focus is the pace at which consumer credit is being paid back. In July, a record $21.6 billion was repaid. Meanwhile, industrial production rose by more than expected, while retail sales were stronger-than-expected in August.

The retail sector reflected these developments. Kroger shares fell after the largest US supermarket chain reported second-quarter profit that fell more than analysts' estimates and cut its earnings forecast for the year. And Best Buy, the world's largest electronics retailer, disappointed with second-quarter profits that decreased more than expected on lower sales of digital cameras, video games and DVDs.

There was some significant M&A activity this month. Walt Disney, the world's biggest media company, outflanked Hollywood competitors while enhancing its film lineup with the $4 billion acquisition of comic-book pioneer Marvel Entertainment (Spiderman, The Hulk and Captain Marvel).

Abbott Laboratories' purchase of Solvay's pharmaceutical unit for 4.8 billion euros will give it full control of the TriCor cholesterol drug and a bigger presence in emerging markets. The purchase will also lower Abbott's dependence on the arthritis drug Humira.

Meanwhile, Xerox's plan to buy Affiliated Computer Services for $6 billion was believed to point to more acquisitions of consulting companies as hardware companies try to revive slumping sales. Xerox's acquisition will help triple the amount of revenue it gets from services.

Japanese equities

The Japanese stock market performed poorly in September and underperformed other world markets, having outperformed in recent months.

The key development during the month was the election, which delivered a spectacular blow to the incumbent LDP. The upstart DPJ Party surged to power for the first time in more than 50 years, led in an ironic twist by the grandson of the man who founded the LDP in 1955 and became its first prime minister. The DPJ has promised to revive the economy emerging from its deepest recession since World War II by boosting child-care spending, cutting taxes and curtailing bureaucracy.

In economic news, a revision to second quarter growth reported a 0.6% quarterly advance instead of the provisional 0.9% growth. Meanwhile, consumer confidence rose for an eighth month in August, but the momentum of improvement is slowing. Meanwhile, machinery orders reversed much of the previous month's gains, in July, falling 9.3% after the 9.7% gain in June. A steep drop in manufacturing orders points to a broader weakness.

Suntory Holdings, Japan's third-largest brewer, made a offer to buy soft-drink maker Orangina Schweppes from Blackstone Group and Lion Capital Holdings, in a search for faster growth in Europe. In other takeover news, Dainippon Sumitomo Pharma agreed to buy Sepracor for $2.6 billion to gain a US sales force and experimental treatments in the world's largest drug market.

Tokyo Electric Power and Electric Power Development were reported to be planning improvements to their hydroelectric power plants. The companies expect the new Japanese government will call for the reduction of carbon dioxide emissions.

Lastly, Aiful, Japan's second- largest consumer lender by assets, announced plans to cut as much as 44% of its workforce and forecast a full-year loss, sending the shares to a six-month low. Aiful plans to cut as many as 2,000 jobs through early retirement, after a government crackdown on interest charges that ran as high as 29%.

Asia equities

Asian equity markets performed well in September, with high single-digit returns in many markets. Greater Chinese indices delivered strong gains across the board, with Taiwan performing the best.

China's manufacturing sector expanded for the sixth straight month in August to a 16-month high, according to the purchasing managers' index, an indication that the economy continued to see a strong recovery. This is in spite of fears that a slowdown in bank lending could stall the recovery. Such concerns have led to high volatility in the market.

Also in China, policymakers plan to raise the limit on foreign currency quotas for investors under the Qualified Foreign Institutional Investors program to $1 billion from $800 million. It will also shorten the lock-up period for some medium- and long-term QFII funds such as pension funds and insurance funds from one year to three months.

The Singapore government cut its stake in Citigroup to less than 5%, realising a $1.6 billion profit as its investment companies reduce holdings in European and US banks. This month, the Government of Singapore Investment Corp. reported a loss of around US$41.6 billion in the last fiscal year, one of the worst years for the sovereign wealth fund. Meanwhile, China Investment

Corp., China's sovereign wealth fund, bought a 15% stake in Noble Group, a Hong Kong-based commodity supplier linked to Chinese demand for coal, iron ore and soybeans.

In other economic news, Vietnamese economic growth accelerated to 5.8% this quarter, buoyed by domestic demand and government stimulus spending that has revived bank lending. Meanwhile, Malaysia's Prime Minister announced that its government will be more "prudent" in its spending as it seeks to trim the budget deficit amid a strengthening economic recovery.

In M&A activity, SK Telecom said it would sell its 3.8% stake in China Unicom back to that company for about $1.26 billion. Alibaba.com agreed to buy an 85% stake in Chinese internet services provider China Civilink, while Chinese web portal Sina said it would scrap its $1.66 billion purchase of the advertising assets of Focus Media amid a drawn-out regulatory approval process.

In other corporate activity, Myer Group, the Australian department store chain owned by a consortium led by US private equity firm TPG, said it plans to raise up to $2 billion in an IPO.

Government bonds

It was a mixed month in government bond markets. Two-year bonds performed relatively poorly, with yields rising and prices falling, as central bankers made more positive comments about the health of the world economy and hinted at an end to the extraordinary measures that have been in place for much of this year. Medium-dated bonds fared better, while long-dated bonds performed the best. This picture was replicated across the major government bond markets.

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Investment grade corporate bonds

Corporate bonds performed well again in September. Spreads over government bonds continued to narrow from the extremely high levels at the start of the year. Meanwhile, the Markit iTraxx Europe, the continent's main credit default swap index, which tracks the 125 most liquid names in the investment-grade class, also continued to fall in September.

During the month, Lloyds Banking Group, the UK's biggest mortgage lender, and the financial unit of Volkswagen announced issuance plans that may help resuscitate Europe's 2.2 trillion-euro asset-backed securities market. The organisations announced the first public sales of securitised debt in more than a year. Asset-backed bonds are one of the last parts of the credit market to recover from the economic slump.

High yield bonds

High yield bonds performed well again in September. Spreads over government bonds continued to narrow from the extremely high levels at the start of the year. Meanwhile, the Markit iTraxx Crossover index, the main credit default swap index for high yield bonds, also continued to fall in September.

Investors have started to believe that the European high-yield bond market will take a more central role in the funding of below-investment-grade-rated companies, moving it closer to its larger, more mature US counterpart for the first time. Capital constraints on banks, which have forced them to curb new lending to the corporate sector, already have led to a surge of more than €8 billion worth of new junk-bond issuance in the past five months, reawakening a market that had effectively been closed since the summer of 2007. Bankers and investors expect issuance to keep rising as European companies use capital markets instead of traditional bank financing.

This month, Alcatel-Lucent plans to raise at least 750 million euros in a sale of convertible bonds to refinance debt. The world's largest supplier of fixed-line phone networks is rated B1, four levels below investment grade, at Moody's and an equivalent B+ at Standard & Poor's.

Index linked gilts

Index-linked gilts were little changed in September, with returns broadly in line with those from conventional government bonds. Returns were consistent across short-, medium- and long-dated index-linked bonds. UK index-linked gilts performed broadly in line with their overseas equivalents, where shorter-dated issues generally fared better than longer bonds. In inflation terms, consumer price inflation (CPI) fell to 1.6% in August from 1.8% in July. The CPI measure fell below the Bank's 2% target rate for the first time in nearly two years in June. Meanwhile, retail price inflation (RPI) was -1.3% in August, compared with -1.4% in July.

Property

The latest report on the UK commercial property market was released in mid-September and covered August. The decline in commercial property that began in mid 2007 turned the corner in July and the positive trend continued in August, with a positive total return on UK commercial property of 0.9%, according to independent property performance analysts IPD. Among sectors, there was no difference in returns between retail, and industrial assets. Industrials remained the strongest performing sector over 6-month and 12-month periods. Meanwhile, the office sector is still the weakest sector over the past three months, as unemployment continues to tick up. Compared with other asset classes, commercial property underperformed equities and especially property equities, which continued to revel in the more positive economic environment.