



**“Further falls in the price of oil helped the majority of equity markets make gains this month, although Asian markets finished in negative territory. The weaker outlook for Eurozone growth helped allay fears of further interest-rate hikes in the near term.”**

**William Killeen, Head of Balanced Product**

### Majority of stock markets edge higher...

- Most equity markets ended the month in positive territory although Germany bucked the trend in Europe with a modest decline of 0.9%. Asian markets appeared to suffer more than most, as fears of lower global growth continued, while the ISEQ rebounded well from July's 16% decline.
- Equities were buoyed by further declines in crude oil prices at the beginning of the month, although heightened geopolitical tensions supported crude somewhat in the latter half of August. Equity markets were also buoyed by US economic data releases — which proved to be surprisingly positive in nature — and by some better than expected earnings results.

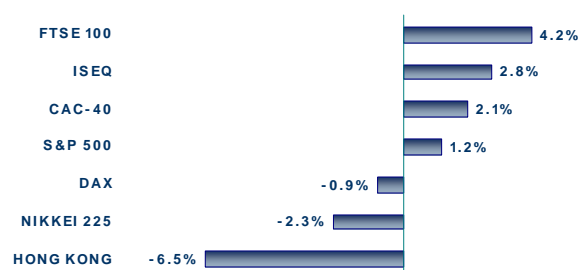
### Eurozone economic slowdown gathers pace...

The Eurozone economy contracted in the second quarter by 0.2% — confirming the slowdown in economic activity that was apparent in data releases over the past few months. This was the first contraction in the economy since the introduction of the euro, with the year-on-year growth rate slowing to 1.5%. The French economy contracted 0.3%, while the German economy shrank 0.5%. The gloomy outlook for the Eurozone region's biggest economy weighed on the DAX this month. Meanwhile, surprisingly robust US manufacturing data, and a much higher than anticipated second quarter GDP growth rate of 3.3%, helped the S&P 500 gain 1.2%.

Consumer and healthcare stocks were among the strongest performers, as stocks with 'defensive' qualities were favoured. Meanwhile, the performance of the financials sector was mixed. Banks were boosted by the hope that interest rates would not be raised in the near term, due to the outlook for lower inflation and slowing growth. The credit crisis remained very much in focus however, as some US financial institutions warned of further losses. Energy and materials stocks lagged, although these sectors pared losses at the end of the month as commodity prices rebounded. Fears of a disruption to supplies, following the outbreak of violence in South Ossetia, stemmed the recent oil price declines.

Notwithstanding further deterioration in the domestic economic backdrop, the ISEQ enjoyed its first monthly gain since April. Financials set the pace as the sector delivered its best monthly performance since April 2003.

### Equity market returns – August 2008



Source: Bloomberg. Capital returns in local currency.

### Euro falls sharply against the US dollar...



Source: Bloomberg.

### US economy rebounds strongly in Q2...



Source: Bloomberg.

## Bonds continue recent strong rally...

Bond markets continued where they left off in July with another month of gains. Fixed-interest assets grew in appeal after news that the Eurozone economy contracted in the second quarter, while a drop in the inflation rate helped ease concerns that the European Central Bank (ECB) would be forced to raise rates anytime soon. Inflation eased to 3.8% this month, from 4% in July, as oil continued to fall. As widely anticipated, the ECB left interest rates unchanged at 4.25%. Jean-Claude Trichet acknowledged that growth will be “particularly weak” through the third quarter, and markets interpreted this as meaning rates could be reduced before the end of the year. The euro fell some 6% against the dollar to end the month at US\$1.4670.

The UK economy stagnated unexpectedly in the second quarter, ending a run of 63 consecutive quarters of growth. UK gilts made strong gains, while the British pound fell sharply. Japanese bonds also gained as the world’s second-largest economy contracted at an annualised rate of 2.4% in the second quarter.

## 10-year bond yields

	31-Dec-07	31-Jul-08	31-Aug-08
<b>US</b>	4.03	3.95	3.81
<b>UK</b>	4.51	4.81	4.48
<b>Germany</b>	4.31	4.36	4.18
<b>Japan</b>	1.51	1.54	1.42

Source: Bloomberg.



## BIAM Outlook

- Despite ‘celebrating’ its first anniversary this month, the credit crunch shows few signs of ending. The dearth of liquidity in international money markets that has marked the current financial crisis remains in evidence, with persistently elevated inter-bank lending rates confirming that banks continue to hoard cash. The elevated cost of credit continues to hamper global merger and acquisition activity — only US\$145 billion of deals were announced in August, the lowest since September 2004. Despite some better than expected earnings results in the second quarter, banks and securities firms continue to report losses and writedowns that have now reached over US\$500 billion since the start of 2007.
- The outlook for the US economy remains weak, notwithstanding the impressive GDP growth rate recorded in the second quarter. It must be noted that exports accounted for the bulk of the expansion, and with the rest of the world now showing signs of slowing growth, the fear is that demand for US exports will diminish over the coming quarters. The effects of the fiscal stimulus package enacted in February has broadly washed through the system and the worry is that consumer spending will now slow in the near term. On a more positive note: housing — the epicentre of the US financial crisis — has shown some tentative signs that the pace of house price declines may be easing a little.
- We retain a modest underweight stance in relation to equities, due to the degree of uncertainty prevalent in markets at present. The continued decline in oil prices should help lower inflation and give central banks, such as the ECB and Bank of England, more leeway to enact interest-rate cuts. We continue to keep risk at a minimum in relation to sectoral bets, being slightly underweight in more economically-sensitive sectors, while modestly overweight in European financials — whose valuations remain attractive.