

Economic concerns gripped markets in February as industrial production data revealed significant retrenchment by manufacturers amid a sharp drop in demand. The US economy proved to be weaker than previously estimated, contracting by 6.2% in the final quarter of 2008, leading the US stock market to a 12-year low.

Financial markets remain on edge...

- Confidence was in short supply during February as investors, businesses, consumers and governments all endured a volatile ride through the month. Equity markets invariably bore the brunt of nervous activity as cheap valuations failed to be a strong enough lure for investors.
- The backdrop deteriorated across the globe as unemployment levels rose and economic forecasts were revised lower. Collapsing industrial production has become a significant feature amid considerable retrenchment and de-leveraging among both consumers and corporations.

Bank stocks retain centre stage...

Developed country stock markets recorded losses ranging from about 5% in Japan to nearly 12% in the Netherlands. In the emerging market arena, China's Shanghai Composite Index rose 4.6% led by optimism that the government's massive stimulus plan may keep its downturn relatively shallow. In contrast to lending droughts elsewhere, it was reported that Chinese banks provided US\$240 billion of new loans in January alone - a one-month record.

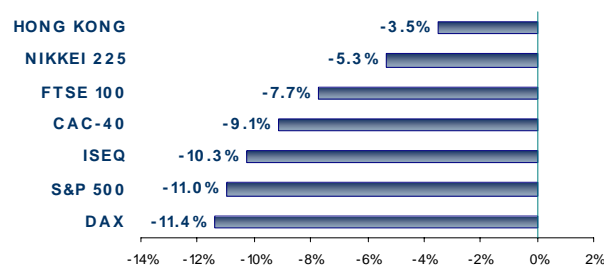
The month ended with the US government increasing its stake in Citigroup to 36%. Federal Reserve Chairman Ben Bernanke's assertion that nationalisation was not being considered failed to calm investors who were increasingly worried about the banking sector's mounting bad debts. In the UK, the government agreed to insure £325 billion of Royal Bank of Scotland's assets in a deal which could ultimately see it increase its stake in the lender to 95%.

In Ireland, the decline in the ISEQ Index was led by banks, with the 'big' three financials experiencing share price drops of up to 70%.

The government announced a €7 billion recapitalisation of Allied Irish Banks and Bank of Ireland, with market sentiment towards the sector remaining weak led by investigations into Anglo Irish Bank. The financial sector accounted for just 3.5% of the ISEQ Index at the end of February, down from about 40% at the start of 2008.

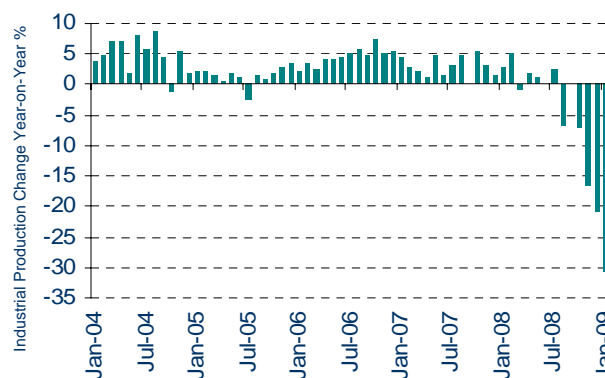
Across global markets, investors gravitated towards 'defensive' sectors such as telecommunications and consumer staples, favouring companies with relatively stable demand and earnings. Normally considered a 'safe haven' in volatile markets, healthcare stocks weakened with concerns that President Obama's health policy proposals could lead to more competition and lower margins.

Equity market returns - February 2009



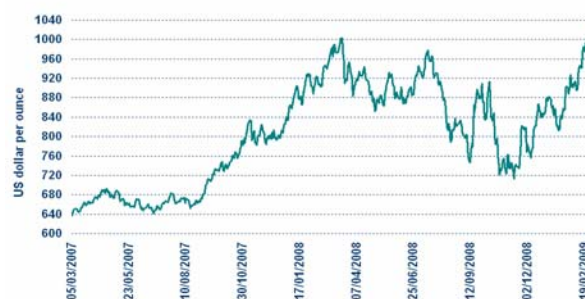
Source: Bloomberg. Capital returns in local currency.

Industrial production collapses in Japan



Source: Bloomberg.

Gold price rises back towards US\$1,000



Source: Bloomberg.

Continued overleaf

European bonds have mixed month...

Bond markets were something of a mixed bag in February, with most European and Japanese markets grinding out positive returns. However, the higher bond yields among non-core Eurozone sovereign issuers (such as Ireland, Greece) were sustained amid concerns about rising budget deficits and banking bad debts. In practical terms, this means that buyers of non-core bonds require a hefty premium to hold Irish government bonds instead of German bonds. At the end of February, that premium was nearly 240 basis points on equivalent 10-year bonds; 5.51% versus 3.11%.

Although the European Central Bank did not make any change to interest rates in February, bond markets priced in a half-percentage point rate cut for early March, contributing to out-performance of short-dated bonds.

The macro environment supports such a move as it emerged the German economy contracted by 2.1% in the fourth quarter amid falling exports. The Eurozone unemployment rate rose to 8.2%, with significant increases being noted in Ireland and Spain.

10-year bond yields

| | 31-Dec-08 | 31-Jan-09 | 28-Feb-09 |
|---------|-----------|-----------|-----------|
| US | 2.22 | 2.84 | 3.02 |
| UK | 3.02 | 3.70 | 3.62 |
| Germany | 2.95 | 3.30 | 3.11 |
| Japan | 1.17 | 1.30 | 1.28 |

Source: Bloomberg.



BIAM Outlook

- While there has been a rebound in some isolated economic indicators, the overall picture remains distinctly negative with several indicators hitting, or remaining at, multi-year lows. Consensus forecasts for 2009 indicate a contraction in output of the order of 2% in the US, UK and Eurozone, while Japan's output is expected to contract by as much as 4%. The setback in Japan has been most marked, with Toyota Motor revealing a 43% drop in global production in January on a year-on-year basis.
- Also of note since the start of 2009 is the spread of the economic malaise from debtor nations, where the crisis began, to creditor nations such as Japan and Germany. There has been a remarkable improvement in the current account position of the US and UK, which stands in stark contrast to a sharp deterioration in the Eurozone and Japanese positions.
- With many stock markets testing significant index levels, equities are cheap by their own history. Based on trailing 10-year earnings, US equities are trading on a price/earnings multiple of about 13 times, which compares favourably with an average P/E of about 16 times over the last 130 years. The issue has essentially become a valuation debate: is all the bad news reflected in market prices today, given what is already known about falling earnings and unfolding economic conditions?
- We cannot rule out the possibility of lower valuations but remain firm in our belief that current conditions are not likely to be as bad as those prevailing during the World Wars, the Great Depression or the stagflation days of the 1970s. As Warren Buffett noted at the end of February - "When investing, pessimism is your friend, euphoria the enemy". With confidence levels joining stock markets at multi-year lows, pessimism is certainly in plentiful supply. Defensive stocks have become relatively expensive, and while no-one can accurately pinpoint the bottom of the current bear market (without the benefit of hindsight), we believe it is worth considering adding to quality, beaten-up cyclical stocks, given the level of pessimism priced into share values.