



“The month began with the election of Barack Obama as the next President of the United States, but even this high-profile event only temporarily knocked the economic downturn from the headlines. Equity markets generated negative returns as policy-makers grappled with the accelerating nature of this slowdown.”

Brian Routledge — Head of US Equities

Financial markets stay volatile...

- For the second month in a row, a strong final-week rally helped partially reverse losses incurred by equity markets. Focus shifted away from the travails of the banking crisis to the difficulties unfolding in the real economy amid a notable deterioration in the economic landscape.
- Central banks continued to cut interest rates aggressively and governments began to focus on providing a fiscal response to the problems facing the global economy. The ongoing uncertainty and mixed reaction to various initiatives resulted in significant financial market movements, with bonds continuing to outperform equities in this environment.

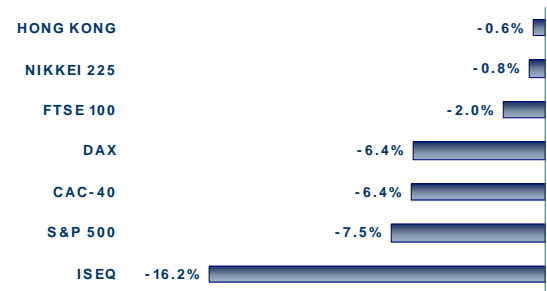
Equities decline as sentiment weakens...

The Irish stock market experienced further weakness as banks continued to occupy investor thoughts. The financial component of the ISEQ Index fell by 42.8% in November amid concerns about recapitalisation prospects. The reluctance of the government to provide the required capital spurred private equity interest, with rumours circling Bank of Ireland in particular. The Irish Association of Investment Managers also expressed an interest. In the first 11 months of 2008, the financial index has lost 85%.

Bank weakness was not unique to Ireland with investors unnerved by the US decision not to use the Troubled Assets Relief Program (TARP) fund to purchase ‘troubled assets’, instead opting to use it to provide capital for banks. This was mitigated by a subsequent plan that provides a facility to buy US\$500 billion of mortgage-backed assets. Other poor performers were the economically-sensitive technology, materials and industrials sectors. The steady income-generating telecommunications and utilities sectors outperformed, while energy stocks attracted interest amid suggestions the oil price may be bottoming out below US\$50 per barrel.

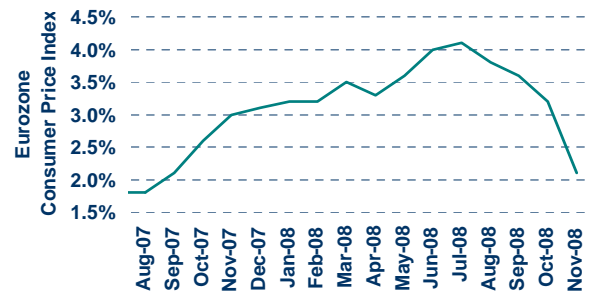
Consumers are following the banks in de-leveraging and Irish retail sales fell 6.2% in September from a year earlier. The stalled construction industry has resulted in rising jobless numbers in all major markets as associated areas, from mortgage providers to furniture retailers, cut costs. The numbers being laid off have accelerated recently. In Ireland, the unemployment rate hit 7.8%, with the live register rising to 277,200 in November, a 63% increase from last year. The US non-farm payroll shrank by 533,000 in November, the worst since December 1974. There were also upward revisions to the numbers of jobs lost in the previous two months, meaning nearly 1.3 million jobs were lost in the last three months.

Equity market returns – November 2008



Source: Bloomberg. Capital returns in local currency.

Eurozone inflation drops sharply...



Source: Bloomberg.

Rate of US job losses accelerate...



Source: Bloomberg.

Bond markets gain as central banks cut rates...

In the month of November, the Eurozone and Japan announced that their respective economies were in recession and this was followed by confirmation that the US has been in recession since December 2007. This is the first time since the 1940s that all three have been in recession at the same time.

Against this grim backdrop, central banks accelerated the pace of interest rate cuts. The Bank of England stunned markets with a 150 basis point cut in its base rate to 3%. The European Central Bank lowered its rate to 3.25%, with its second 50 basis point cut in a month.

With the inflation threat receding and equity markets remaining intensely volatile, bond yields continued to decline. After the sharp steepening of the yield curve recently, longer-dated bonds outperformed in November amid suggestions that the US government might begin purchasing such bonds to drive down long-term market rates and help prevent deflation. The yield gap between 2-year and 10-year German bunds narrowed from 135 basis points at the end of October to 107 basis points at the end of November.



10-year bond yields

	31-Dec-07	31-Oct-08	30-Nov-08
US	4.03	3.97	2.92
UK	4.51	4.52	3.77
Germany	4.31	3.90	3.26
Japan	1.51	1.48	1.40

Source: Bloomberg.

BIAM Outlook

- The sustained nature of the financial sector distress and emerging macro data points to a more prolonged economic downturn than previously envisaged. The scale of interest rate cuts in November were necessary responses to the economic deterioration and have been followed up with further deep cuts in early December – UK rates were cut to 2% and Eurozone rates to 2.5%. As large as the cuts to date have been, we anticipate further action as well as the use of other tools to stimulate growth. The Federal Reserve (Fed) has also strongly hinted that it may follow a policy of ‘quantitative easing’, as stimulus via lower interest rates – already at 1% – is limited from here. It has started to purchase mortgage-backed securities and Ben Bernanke suggested the Fed may buy long-term government treasuries as a way to reduce longer-term market interest rates.
- Lower interest rates should provide some relief for consumers who have been reining in spending. That retrenchment has presented major retailers with difficulties. In the UK, both Woolworths and MFI were placed in administration in November, while a sizeable Irish pub chain and the clothing retailer Sasha have also sought protection from creditors in recent weeks.
- Business sentiment continues to fall very sharply to multi-year – if not multi-decade – lows on both sides of the Atlantic. Housing activity remains weak in most English-speaking countries and leading indicators have weakened again. Equity market valuations acknowledge this recessionary environment. The consensus view of market participants is that stocks are cheap, but it is possible equity valuations could re-test lows given the pending weakness in corporate earnings. We are guided by cheap valuations from both a bottom-up and top-down perspective and therefore we maintain our bias towards cheaper stocks. We also continue to have a slight bias in favour of ‘defensive’ stocks at this time.