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Newsflash

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Risk assets stumbled somewhat in October. Although the returns in nominal terms were negative from equities, for example, the monthly returns hide a strong start to the month, followed by weakness. Market participants almost seem to have paused for a period of introspection following the near euphoria since March this year. This pause is a positive in a way as it provides the wider investing public a moment to stop and reconsider what has driven these recent rises in equity prices. One likely source of this buy side pressure is the wall of money flowing into investment assets from the Quantitative Easing (QE) programmes globally. Every purchase made of debt using the QE funding, must have provided a seller of the debt with capital. As a result, the QE funds are disseminating throughout the investible universe. The recipient of sale proceeds from QE may not wish to reinvest the proceeds at prevailing interest rates. This, coupled with a generally improving sentiment may make the equity market attractive. From a fundamental point of view, the economic data remains mixed and in many instances is only improving insofar as it is not getting any worse. The end of de-stocking has provided something of a fillip to growth and purchasing managers' surveys, which reflects gentle to moderate improvements in business conditions. It is clear, however, that the recent equity market weakness has increased uncertainty somewhat and this is clearly reflected in the VIX index which has returned to the levels of September 2008 and June 2009. Volatility has declined in recent months, but it is still well above the pre-crunch levels that are just visible on the left hand side of the chart on the next page.

Fixed income in general performed reasonably well in October, benefitting from this increased investor uncertainty, with credit and high yield proving resilient to the softness in equity markets towards the month's close. US High Yield, for example added 1.8% in the month to bring its year to date return to 52.2% in US Dollar terms and European High Yield performed similarly in October to bring the year to date returns to 72.6% in euro terms. According to Moody's, the default rate for global speculative grade debt hit 12.4% in October, which is the highest level since the great depression. However, the pace of corporate defaults is decelerating and Moody's claims that its trailing rate is near a cyclical peak. As BCA assert, there are factors such as the rebound in equity markets, general improvement in the environment for risky assets, and strong gains in corporate credit quality which support the case for a gradual decline in the default rate. The government debt markets were less active, with the broad global government index, the JP Morgan GBI returning 0.0% in the month. Investment grade credit securities provided returns that bisect high yield and government debt of 0.7% in the US, 0.6% in the UK and 0.9% in Europe. The credit markets may have been protected, but they were not immune from the equity markets as the persistent narrowing in investment grade spreads abated in the last week of the month.

Equity markets rallied for the first few weeks of October, continuing the momentum of the markets since the trough in March. Valuations of equities globally are not especially cheap on a backward looking basis, and this is perhaps understandable in light of earnings compression, especially post Lehman's bankruptcy in 2008. However, strong gains in corporate earnings projected for next year bring forward PERs to more reasonable levels. Bloomberg's composite has a forward PE of 16 times at present index levels and this appears reasonably attractive, for the MSCI World. Despite this, equities were down for the month, with the MSCI World returning -1.8% in US Dollar terms. Equities are significantly up 22.7% year to date, however, and this is despite poor returns in both January and February before the developed markets turned in March.

Emerging markets equities have led the developed markets since turning in 2008 and October saw a continuation of this trend. In fact, despite softening towards month end from a mid month peak of nearly +7%, GEM ended just in positive territory, posting a return of 0.1% in US Dollar terms. Viewpoint continues to believe that the headwinds faced in the emerging markets are more cyclical than structural and therefore these economies should continue to provide relatively superior returns when compared to developed markets. That process is likely to be a gradual one, however, and does not preclude the increased volatility that has traditionally accompanied an investment in emerging markets equities.

Within the currency markets, the recent dollar weakness continued amongst most major currencies. This was even the case for Sterling, which gained 3.1% against the greenback, despite having a torrid year against most majors. The Australian Dollar also rallied against the US Dollar helped by a positive interest rate environment. Australia has embarked upon an interest rate hiking process much before many other economies internationally and this, coupled with the economy's close alignment to the commodities markets may provide some strength for the Aussie Dollar for the medium term. The yen weakened against all majors, losing -1.1% against USD at a time when the dollar was itself falling. Viewpoint is not positive on the developed market currencies in the short-to-medium term, with the structural problems apparent in these heavily indebted public and private balance sheets awaiting adjustment. Overall the emerging markets currencies are more

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. October 2009.

attractive as there are many macro economic factors that argue for their strengthening versus the major developed market currencies in the medium term.

Listed property markets displayed equity-like returns in October, suggesting that the technical attractiveness that was present earlier in the year may have now dissipated. Globally, REITs returned -4.7% in US Dollar terms to underperform the MSCI World. Whilst property securities are priced in part on the basis of the market's expectation for underlying property returns, direct property investments are valued in arrears, and are potentially attractive, having only just bottomed out in many countries. Property securities have massively outperformed underlying property values this year, and have moved from being relatively undervalued to potentially overvalued as they are now discounting a big recovery in property values. Commercial property itself is now offering the prospect of reasonable returns. Selected property deals can now be funded (where financing is available) at a level which is below present rental yields. This is providing an opportunity for managers with liquid assets to embark on a more 'traditional' form of property investment, dominated by yield and investment return rather than highly leveraged development and speculative returns, with the potential of moderate capital gains as a kicker to performance over time. There remain uncertainties regarding the occupier market as well as the difficulty in extracting funding from banks whilst the economic picture remains cloudy, but buildings with high quality tenants and long leases are a relatively strong proposition.

The commodity markets were extremely strong in October, perhaps on the back of an improving macro picture in the emerging markets. Oil added 17.3% in the month, to bring the year to date returns to 93.8%. Broader commodities added 5.8% in the month, bringing their year to date returns to a comparatively modest 20.2%. Agricultural commodities are flat year to date despite a strong return of 6.1% in October.

Asset Class Performances

Asset Class/Region	Index	Currency	Oct 2009	YTD 2009
Equities				
United States	S&P 500 NR	USD	-1.9	16.3
United Kingdom	FTSE All Share TR	GBP	-1.8	21.1
Continental Europe	MSCI Europe ex UK NR	EUR	-3.2	20.2
Japan	Topix TR	JPY	-1.7	6.1
Global	MSCI World NR	USD	-1.8	22.7
Global Emerging Markets	MSCI World Emerging Markets TR	USD	0.1	64.7
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	0.0	-2.5
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	1.2	9.9
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	0.7	17.9
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	1.8	52.2
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-0.3	0.8
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	0.6	11.3
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.1	4.4
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.9	14.7
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	2.0	72.6
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	-0.5	0.0
Global Government Bonds	JP Morgan Global GBI	USD	0.0	3.9
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.5	7.4
Global Convertible Bonds	UBS Global Convertible Bond	USD	-0.4	35.0

Asset Class/Region	Index	Currency	Oct 2009	YTD 2009
Property				
US Property securities	MSCI US REIT TR	USD	-4.7	10.7
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	0.5	11.1
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	-1.8	35.0
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	0.6	42.5
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	-1.3	25.7
Currencies				
Euro		USD	0.9	6.1
Sterling		USD	3.1	14.6
Yen		USD	-1.1	0.1
Australian Dollar		USD	2.4	29.6
Rand		USD	-3.2	18.1
Commodities				
Commodities	RICI TR	USD	5.8	20.2
Agricultural Commodities	RICI Agriculture TR	USD	6.1	0.0
Oil	Brent Crude Index (ICE) CR	USD	17.3	93.8
Gold	Gold index	USD	4.6	20.9
Interest rates	**Last meeting**		**Current rate**	**Last change**
United States	23 September 2009	USD	0.25%	0.00%
United Kingdom	8 October 2009	GBP	0.50%	0.00%
Eurozone	8 October 2009	EUR	1.00%	0.00%
Japan	14 October 2009	JPY	0.10%	0.00%
Australia	8 October 2009	AUD	3.50%	0.25%
South Africa	22 September 2009	ZAR	7.00%	0.00%

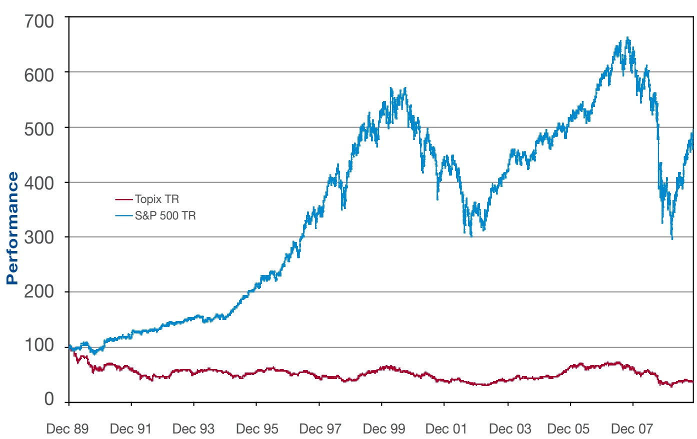
Source: Lipper Hindsight, November 2009.

FOCUS: Japan

Over the course of this year, Japan has been the subject of many column inches dedicated to its huge asset bubble in the 1980s and subsequent deflation in the following decade. Policy makers globally, and particularly in the US, whose Fed chairman, Ben Bernanke, was a notable student of Japan's economic woes, are using the world's second largest economy as a case study for what not to do following the bursting of an asset bubble. Japan experienced similar problems to what other developed countries are now going through, but mistakes were made along the way and policy makers are keen to avoid repeating them.

Since the peak of Japan's asset bubble twenty years ago this December, the economy has broadly speaking marked time in terms of nominal GDP. Added to this, the country's current debt burden stands at almost 200% of GDP and demographic trends are unfavourable due to an aging population. Although many investors have continued to muse over Japan in recent years, sighting extreme levels of undervaluation in the equity market for example, it is a country that is often ignored by investors when making asset allocation decisions. It is evident from the current popularity of emerging market equities that strong economic growth and healthy investment returns are often enough to bring particular markets to the forefront of investors' minds. Japan clearly shares neither of these characteristics having endured deflation and a bear market since markets peaked in 1989.

Chart 1: Topix vs. S&P 500 Cumulative Total Return



Japan's remarkable growth trajectory through the 1980s had put it on course to overtake the US as the world's largest economy, especially given that the US was mired in stagflation and suffering from high unemployment at the time. Indeed during the 1980s there was a point when the world's top ten banks (measured by deposits) were all Japanese. However, Japan's growth had largely been driven by overinvestment and financial leverage, and this led to bubbles in the financial and real estate sectors. Since the 1989 peak, Japanese equities have massively underperformed other developed markets as the country has since gone through an extended period of deleveraging. Some believe that Japan's excesses are only just reaching the end of the unwinding process due to insipid regulation that has failed to clean up the banking system until long after the crash. The trends towards lower asset turnover and deleveraging over this period have subsequently led to both lower returns on equity and share prices leaving them at their depressed current levels.

Despite investors repeatedly being disappointed by Japan throughout this lengthy bear market, there have been periods when the market has rallied extremely sharply. Historically, these rallies have been led by recovery in OECD Leading Indicators which usually result in strong returns for equities in general, and particularly for Japanese equities. Chart 2 (overleaf) shows this trend using six monthly rates of change for each of the indices. This shows why Japan is often viewed as high-beta play on global equities, perhaps due to its heavy reliance on exports. It is also evident from this chart that the relationship looks to have broken down more recently. Interestingly though, if one considers the performance of Japan relative to global equities instead (see chart 3 overleaf), then it looks as if the relationship actually broke down around 2008 before the global recession kicked in. The recent underperformance of Japan could therefore be payback for this period of resilience. The point is that the market could have been misbehaving compared to "normal" behaviour for longer than it seemed.

Chart 2: Topix vs. OECD Leading Indicators

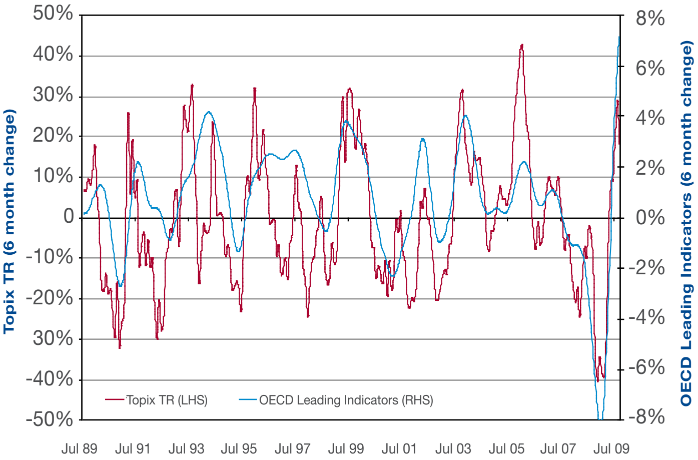
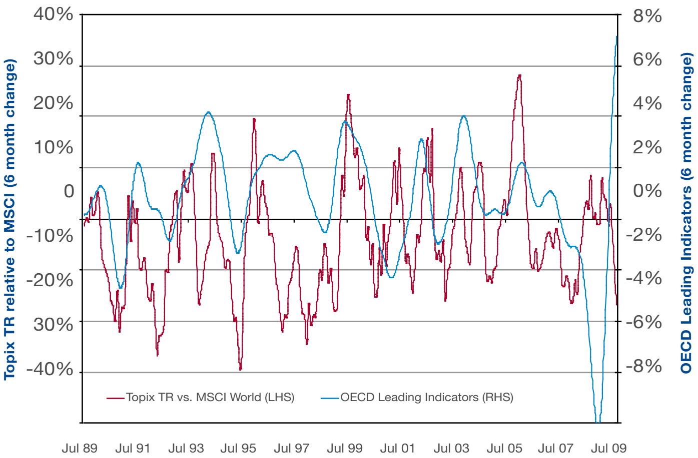


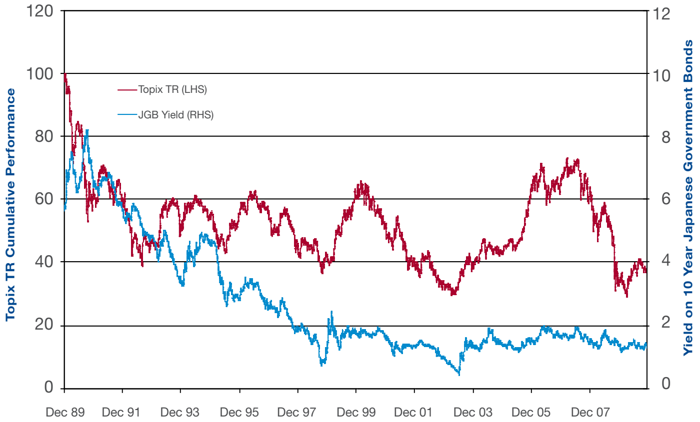
Chart 3: Topix relative to MSCI World vs. Leading Indicators



Either way, the extent of the very recent underperformance of Japan is certainly eye-catching. Below are a handful of observations that may help inform a decision on whether Japan should be more readily considered as a good long term investment.:

- One of the most compelling arguments in favour of Japan is that this long bear market and period of deleveraging has left corporate balance sheets in rude health. There is now significant scope for improving ROEs by increasing leverage or asset turnover. In Japanese households, high domestic savings rates have also created a huge deposit base in Japan which is now in fact over twice the size of its total stock market capitalisation. This is not the case in other large economies such as the US and China where the opposite is true by a similar scale. The economy has required endless stimuli over the past years and yet has never really shown the prospect of recovering properly, and this can partly be blamed on aversion by consumers and banks to spend and lend respectively. If inflation were to pick up in Japan then these conservatively managed assets would need to be switched with those that require a greater risk tolerance. This is very much an opposite position to be in compared to the Western world.

Chart 4: Topix TR vs. JGB Yield



- Investors have persistently underweighted Japanese equities in their portfolios. In the case of domestic investors; their equity holdings in general are significantly lower than average levels seen in other developed economies, and this has typically been countered by large holdings of Japanese Government Bonds (JGBs). This has fuelled a two decade long bull market in JGBs which has left yields at today's low levels. An extreme example is the Japanese Post Office, one of the largest financial institutions in the world, which owns no equities at all. This point, together with the first point above, indicates that potential exists for a significant reallocation to equities which could bolster buy-side forces.
- The trend of investing in JGBs has not changed of late, as domestic investors and institutions have continued to absorb the significant amounts of issuance. There is concern however, from investors outside of Japan in particular, that the flood of issuance that is expected over the coming years may not dissipate so readily. It has also been suggested that some large global macro hedge funds are now selling the JGB market short. The overall size of Japan's debt burden should not be forgotten, at almost 200% of GDP. Given this, any continuation of the recent rise in yields as a result of excess supply could spell problems given the significant resultant increase in debt-servicing costs.

- Japan's trade surplus and high export ratio mean that the economy is more cyclically exposed than other countries, and further economic contraction would not bode well for investors. Nonetheless, the latest GDP release for Q3 showed annualised growth of 4.8% that was well ahead of consensus. With approximately a quarter of Japan's exports going to China at present, continued growth in China should be a positive for Japan. Indeed, the last decade has seen Japan's share of total exports to BRIC (Brazil, Russia, India, China) countries increase at a far greater pace than for the US or Europe - over 20% of BRIC imports are now sourced from Japan.
- Another key point to consider is the recent political change that has taken place. With the Democratic Party of Japan (DPJ) winning a resounding victory in the Lower House elections, the near uninterrupted 54 year rule of the Liberal Democrat party was brought to an end. Although change will not occur overnight, this has the potential to usher in a new climate with the DPJ focusing on improving demographics and boosting domestic consumption. This was seen as a vote against the economic malaise of the past 20 years, and the prospect of a stable government alone is positive compared to the various coalition led governments that were previously in place.
- Demographics in Japan are often cited as a reason not to invest there. While the aging population is clearly a problem, it is not unique to Japan. Russia, Italy, and other parts of Europe also suffer from similar poor demographic trends. One of the focuses of the newly elected DPJ will be to improve productivity which will counter these problems to some extent, and Japan already spends a very significant amount of over 3% of GDP on R&D.
- Equity valuations appear to be very attractive, particularly in the small cap area, and many value-based equity managers continue to find a significant number of opportunities in this market. A general lack of interest in Japan has led to lower coverage by sell side analysts and also to lower liquidity in some areas. There are still high quality, large cap companies that have net cash on their balance sheet, and many small caps are trading at or below book value. This apparent breadth of undervaluation is unique to Japan at the moment, and although it has been the case for some time, that alone is not a good reason to prevent eventual readjustment.

In conclusion, one cannot argue that the Japanese economy does not face some significant headwinds. However, this can also be said of most other developed markets at this juncture, and so underweighting Japan is not necessarily the obvious trade that it once was. At some point investors may just begin to start taking notice of valuation opportunities; finding them adequately compelling to return to Japanese markets. If one lesson has been learnt from the Japanese experience over the last twenty years by comparing investors' views from then and now, it is that nothing is inevitable.

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