

Royal Preferred Banking



September 2009

# MarketWatch

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# Market Review

## US Equities

US equities surged in August as reports from consumer confidence to home sales beat economists' forecasts. Dow Jones rose 3.5% while S&P 500 gained 3.4%. The better-than-expected economic data and corporate earnings boost investors' confidence on the coming recovery. Consumer confidence jumped to 54.1 in August from a revised 47.4 in July. Durable goods order rose 4.9% in July, better than economists' expectation. New home sales leapt 9.6% to a seasonally adjusted annual rate of 433,000 in July. House prices index is improving from 15.5% drop from last year in June compared with a drop of 17% in May. Housing market is firming up slowly.

## Europe Equities

Equity markets in Euro zone continued its rally in August as economic data pointed to an improving outlook in the region. France and Germany surprised the market as reported an economic growth in the second-quarter. Germany's DAX Index gained 3.5% while the UK's FTSE 100 index bounced 6.5%. Germany, Europe's

largest economy, grew at an annualized pace of 1.3% in the second-quarter. Germany's IFO Business Climate index surged to 90.5 in August. Germany's ZEW index, reflects investors' and analysts' expectations, surged from 39.5 to 56.1 in July, the highest level since April 2006. The overall economic growth of euro zone fell at an annualized rate of 0.4% in the second-quarter while it contracted at a pace of 9.7% in the first-quarter.

## Japan Equities

In Japan, Nikkei gained 1.3% in August as improving economic data and the victory of Democratic Party of Japan (DPJ) help boost investors' confidence on the economy may be pulling out of recession. Japan's economy expanded at an annualized pace of 3.7% in the second-quarter. Industrial output rose 1.9% in July, beating economists' expectation. Japan's PMI rose to 53.6 in August, the highest since November 2006, reflecting that manufacturing industrial is expanding. However, jobless rate rose to 5.7% in July, spurring concern on consumers spending.

## 0.1

### Performance of Major Asset Classes

Equity Index	End of August 2009 Level	Monthly Performance (August 2009)
<b>Developed Markets</b>		
Dow Jones	9,496	3.5%
Nikkei 225	10,493	1.3%
FTSE 100	4,909	6.5%
DAX Xetra	5,465	2.5%
<b>Asian Markets</b>		
Hang Seng	19,724	-4.1%
KOSPI	1,592	2.2%
Straits Times	2,593	-2.5%
Taiwan Weighted	6,826	-3.6%
<b>Emerging Markets</b>		
Brazil Bovespa	56,489	3.1%
Russia RTSI	1,067	4.8%
India Sensex	15,667	-0.02%
China SH Composite Index	2,668	-21.8%

## Far East ex Japan Equities

Equities in Far East Asia (ex Japan) have consolidated in August mainly due to the July new loan growth in China dropped drastically compared to June and economists predicted the new loan amount may diminish further in August. Investors worried the Chinese government might further tighten its credit policies and triggered the profit taking on the equity market. China's Shanghai A shares plummeted 21.8% in August and was one of the biggest months decline since the financial crisis broke out a year ago. The greater China region also fell with Hong Kong's Hang Seng Index retreated 4.1% while Taiwan lost 3.6%. Singapore Straits Times was down 2.5%. However, KOSPI rose 2.2%.

## Emerging Market Equities

Emerging markets ended mixed in August. Russia RTSI rallied 4.8% and Brazil Bovespa rose 3.1%, on speculation that the global economic recession is ending, spurred the demand for commodities. India Sensex ended flat and closed at 15,667, as concern about the monsoon rainfall may erode the farm output which narrowed the growth from the better-than-expected corporate earnings outlook.

## Bonds

The U.S. 10-year treasury yields dropped 8.2BP in August as China's equity markets slid, spurring demand for risk-free assets.

## Hedge Funds

Performance of hedge fund was up in August 2009 with CS Tremont Hedge Fund Index jumped 2.54%. The convertible arbitrage gained 5.8% as convertible valuations continued to improve with the support of a stabilizing credit market, although the pace of appreciation slowed. The emerging markets sector climbed 3.83%. The equity long/short sector rose 2.99% while the global macro sector rose 1.78%.

# 0.2

## Bond

	End of August 2009 Yield Level	Monthly Performance (August 2009) (Basis Points)
US Treasury 10-Yr	3.398	-8.2
Japan Govt Bond 10-Yr	1.310	-10.9
UK Govt Bond 10-Yr	3.556	-24.5
Germany Govt Bond 10-Yr	3.257	-4.3

Source: ABN AMRO Bloomberg, EcoWin & AWSJ

## Commodities

Commodities continued to move sideways in August. After breaking US\$74 per barrel, WTI crude oil prices consolidated and end up gaining 0.7% in August. However, gold prices lost 0.3% as the equity markets rallied, eroding demand for gold as an alternative investment.

## Currencies

The dollar weakened against most major currencies in August, as developed markets' equity pick-up spurred investors' risk appetite, curbing demand for safe-haven currencies. The Australian dollar rose against the dollar by 1.1% while the euro also rose against the dollar by 0.6% in August.



# 0.3

## Commodity

	End of August 2009 Level	Monthly Performance (August 2009)
Crude Oil	69.96	0.7%
Gold (Comex)	951.3	-0.3%

Source ABN AMRO Bloomberg, EcoWin & AWSJ

# 0.4

## Currency

	End of August 2009 Level	Monthly Performance (August 2009)
Yen (vs USD)	93.12	1.7%
Euro (vs USD)	1.433	0.5%

Source ABN AMRO Bloomberg, EcoWin & AWSJ

# Asset Allocation

## Overall Strategy

- Market's appetite for risk keeps increasing in August, and equities and commodities continue to outperform the fixed income asset classes. In the months ahead, the market's balance of risks around the recovery may shift from the downside to the upside. This would help driving up the equity prices between now and the end of the year. Even if the data is patchy enough to give equity markets pause for thought and result in some pullbacks, it should not lead to new lows.
- Far East ex Japan and emerging markets are two regions that we currently overweight under the equity asset class. We believe the current measures to fine tune the macro policy in China should sustain the long-term trend of growth. Rest of neighbouring Asian countries will benefit from the long lasting growth in China.
- On bonds front, we are cautious on the government bonds, as ballooning US budget deficit is a long term negative. Meanwhile, we remain overweight on investment grade corporate bonds as credit spreads continue to narrow which signals an improving credit condition.
- The weighting of commodities as a whole remains overweight. In the short term, Chinese recently measures to avoid the asset prices inflation may give commodity price a pause. However, we think the move should lead to a more sustainable trend of growth in the long term, and is positive to the long-term commodity demands.



Asset Classes	Tactics*	Remarks (for Long-term View)
<b>Equities</b>	<b>Overweight</b>	
US	Underweight	
Europe	Neutral	
Japan	Neutral	
Far East ex Japan	Overweight	Recent correction in Chinese equity performance will be a short-term one, as its fine-tuning macro policy will lead to a more sustainable trend of growth in long term.
Emerging Markets	Overweight	Valuation of emerging markets looks attractive when taking its higher earning growth into account
<b>Bonds</b>	<b>Underweight</b>	
Government (Developed)	Underweight	Ballooning US budget deficits is a long term negative to the US government bonds.
Corporate (Developed)	Overweight	Corporate credit spreads continue to narrow, reflecting the continued improvement of credit conditions.
Emerging Markets	Neutral	
<b>Alternative Investments &amp; Mixed Assets<sup>+</sup></b>	<b>Neutral</b>	
Hedge Funds	Neutral	
Commodities	Overweight	Chinese recent measures to avoid asset bubbles are positive to the long term commodities demands.
Others	Neutral	
<b>Cash</b>	<b>Neutral</b>	

+Note: This category includes investment instruments other than plain-vanilla bonds and equities.

\*Investment horizon = 12 to 18 months



## Traditional Asset Classes

Market's appetite for risk continues to rise in August, as more economic data have suggested the global recession is closed to over, and growth is expected to resume in the near future. However, as the nature of recession is associated with both the failure of financial sectors and global synchronization, we foresee a slower and weaker recovery. Therefore, the likelihood for a V-shape economic recovery is low. With better-shaped banking sectors and stronger consumer spending, the economic growths in emerging economies are anticipated to rebound faster than counterparts in US and Europe.

### US Equities: Underweight

Even though more signs have suggested that the worst of the US recession is over and a modest recovery should commence from the third quarter of this year, indicators on domestic demands are still very subdued. Weak labour market activity and moderate expectation on future income improvement will constrain the consumer spending. Considering the consumer spending accounts for more than 60% of US GDP, weak economic growths remain within our expectation. Therefore we continue to underweight US equities.

### Europe Equities: Neutral

Although German IFO index of business confidence has risen for the fourth month in a row, and the ECB's monetary policy is likely to remain expansionary, the euro zone lending numbers were weaker than expected. Without a sustainable pick-up in lending growth, economic recovery will be below long-term average growth. We remain neutral to the Europe equities.

### Japan Equities: Neutral

The Democratic Party of Japan (DPJ) has won a majority of seats in the Lower House, which ended the ruling party's leadership for more than half a century. The victory from DPJ could be a short-term positive for Japanese equities, but face deep skepticism from voters' uncertainty about its future structural reform. Therefore it will take time for DPJ to win the market's confidence. We remain neutral to Japan equities.

### Far East ex Japan Equities: Overweight

Far East ex Japan economies are likely to regain growth momentum during the second half of 2009. Comparing to the rest of economy zones, in our opinion, the economy of emerging Asia have been gaining stronger momentum, as China's macro-economic stimulus should keep fuelling the region. We believe that the recent correction in Chinese equity performance will be a short-term one, as its fine-tuning macro policy will lead to a more sustainable trend of growth in long term. Therefore, we remain overweight to Far East ex Japan equities.

### Emerging Market Equities: Overweight

In our forecast, the medium-term earning growths for emerging and developed markets are with medians of 16% and 12% respectively. Considering both markets is currently trading on similar forward PEs, the valuation of emerging markets looks more attractive when taking its higher earning growth into account. Therefore, we remain overweight to Emerging Market equities.

### Bonds: Underweight

As evidences continue to mount that the global economy recovery is on the way, we retain the underweight rating for the government bonds, but overweight investment grade corporate bonds and high yield bonds. Corporate credit spreads continue to narrow down in the last week of August (Moody's Baa over 10yr Treasuries trade below 300bp), which reflecting the continued improvement of credit conditions.



## Alternative Investments

### Hedge Funds: Neutral

Our weighting for hedge funds is unchanged at neutral. Convertible Arbitrage led the index in monthly performance with a 5.8% return, its seventh straight positive month, while Managed Futures continue to struggle during a challenging July. In general, as most equity markets posted a double-digit rally in July, hedge funds enjoyed a very good month.

(% chg)	Jul 09	Jun 09
CS Tremont	2.54	0.43
Convertible Arbitrage	5.80	4.05
Emerging Markets	3.83	0.69
Equity Neutral	1.79	-0.21
Event Driven	2.33	1.02
Fixed Income Arbitrage	3.65	1.83
Global Macro	1.78	-0.85
Equity Long Short	2.99	-0.04
Managed Futures	-0.43	-2.32

Source: CS

### Commodities: Neutral

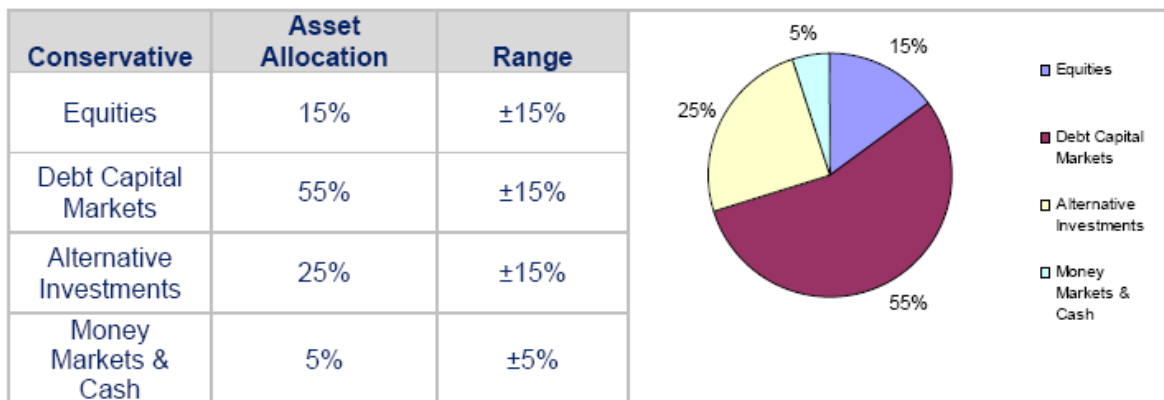
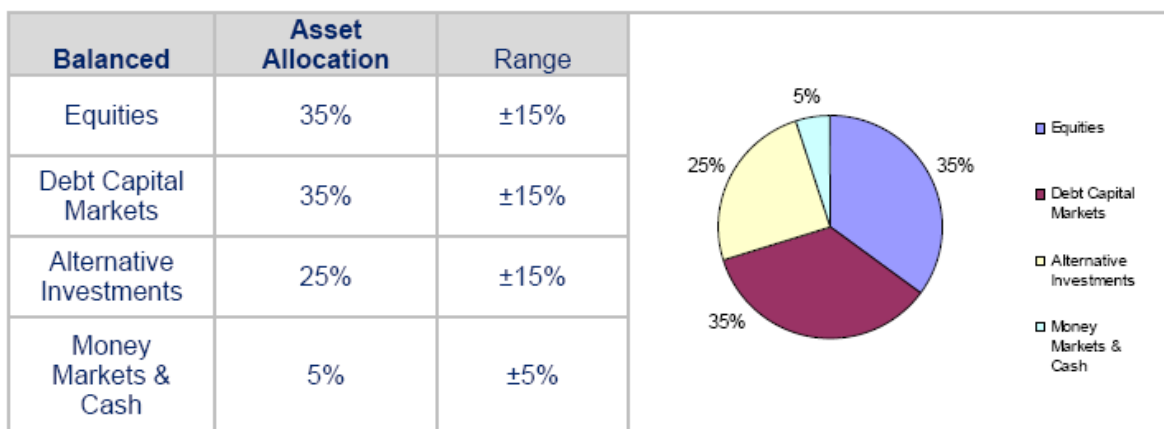
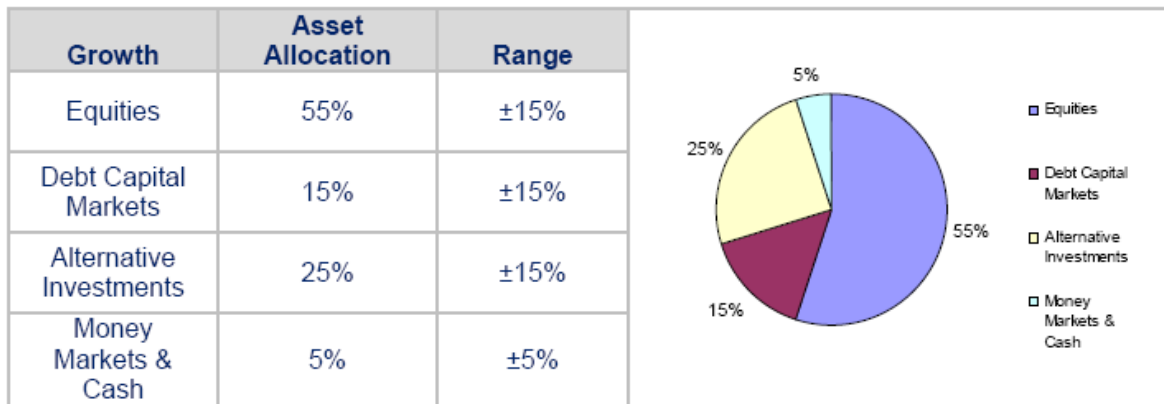
Chinese government recent intention to curb the bank lending and limit the overcapacity in some manufacturing sectors is to avoid popping up the asset bubbles. The measure should lead to a more sustainable trend of growth in the long term, and is positive to the long-term commodity demands.

(in % chg)	Aug 09	Jul 09
Corn	-3.9	-2.4
Gold	-0.2	2.9
Copper	12.9	12.6
Oil	0.7	-0.6

Source: EcoWin



# Benchmark Portfolios



## FX & Interest Rate Monthly

<p><b>The dollar is oversold and poised to rally on any better news.</b></p>	<p><b>When sentiment is very negative, currencies can rally even if the news, on the face of it, is poor.</b> We believe that the current weight of negative expectations is likely to constrain any further weakness of the US dollar. We remain cautious on the outlook for the US economy, which faces problems left over from the liquidity crisis. Yet we calculate that the US dollar is clearly undervalued and so will rally as the economic recovery is confirmed, however weak and hampered by US consumers' woes that recovery proves to be.</p>
<p><b>Global re-balancing means the reversal of some fundamental trends.</b></p>	<p><b>Global rebalancing has finally arrived in the aftermath of the crisis.</b> The US trade deficit has halved over the past year, falling to under \$44 billion from a peak of \$94 billion in July 2008. This has had a corresponding impact on its trade counterparties, cutting exports around the world. As a consequence, an increasing proportion of the huge federal deficit will be financed by domestic savings, relieving some of the downward pressures on the dollar.</p>
<p><b>Sterling appears overvalued.</b></p>	<p><b>Sterling has rallied during the market recovery.</b> A return of economic growth would reduce the stress on the fiscal deficit and remove any need for further quantitative easing (QE), while sterling assets appear cheap, with the pound still 20% below its ten-year average. However, the Bank of England has extended QE, and the government's fiscal policy is unlikely to be clear until after the next general election. We therefore forecast that sterling will give up some of its gains, though overseas asset purchases will be supportive, especially if capital markets are strong.</p>
<p><b>The unwinding of QE has already started.</b></p>	<p><b>Both the nature and the scale of the measures adopted to address the liquidity crisis were unprecedented.</b> That has prompted concerns over their impact and the likely difficulty of unwinding these measures. Yet the process has already started as participation in certain schemes has fallen, with total credit extended to banks down to less than \$600 billion from \$1.5 trillion at the start of the year, as the cost and access to the market has become more attractive. The current strategy seems to be to focus on the withdrawal of QE before increasing interest rates – underpinning our forecasts that interest rates will remain at current 'rock-bottom' levels into next year and, in some cases, the year beyond.</p>

Currencies	Spot 8/17/2009	RBS Forecast (as of 12 August)				Past Performance (in %)					
		Dec-09	Mar-10	Jun-10	Sep-10	-1W	-1M	-3M	-6M	-12M	YTD
Euro vs Dollar	1.41	1.32	1.32	1.32	1.35	-0.6	-0.3	3.5	11.9	-4.2	1.2
Yen vs Dollar	94	95	89	90	93	3.0	-0.4	1.0	-2.2	14.5	-4.2
Sterling vs Dollar	1.63	1.55	1.50	1.54	1.65	-1.4	-0.1	6.9	14.4	-12.5	13.4
Swiss Franc vs Dollar	1.08	1.16	1.15	1.15	1.14	0.4	-0.1	2.3	8.3	1.5	-1.4
Swiss Franc vs Euro	1.52	1.53	1.51	1.52	1.54	1.0	0.1	-1.2	-2.7	5.7	-2.7
Australian Dollar vs Dollar	0.82	0.78	0.75	0.73	0.74	-2.1	2.4	8.5	28.5	-5.1	17.7
Euro vs Sterling	0.86	0.85	0.88	0.86	0.82	0.7	-0.2	-3.3	-2.2	8.6	-12.1
Renminbi vs Dollar	6.84	6.80	6.70	6.60	6.50	0.0	-0.1	-0.1	0.0	0.5	-0.2

	Growth (GDP)			Inflation (CPI)			Interest Rates					Decision Next Date
	2008	2009(C)	2010(C)	2008	2009(C)	2010(C)	Current	Dec'09 (F)	Mar'10 (F)	Jun'10 (F)	Sep'10 (F)	
US	1.1	-2.6	2.1	3.8	-0.6	1.8	0.25	0.25	0.25	1.00	2.00	23-Sep-09
UK	0.7	-4.0	0.8	3.6	1.8	1.8	0.50	0.50	0.50	0.50	1.00	10-Sep-09
Eurozone	0.6	-4.4	0.4	3.3	0.4	1.2	1.00	1.00	1.00	1.00	1.00	3-Sep-09
Japan	-0.7	-6.2	1.4	1.4	-1.2	-0.6	0.10	0.10	0.10	0.10	0.10	17-Sep-09

(C) Consensus Forecast

(F) RBS Forecast

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