Review of **global markets**

Week ending Friday 15 August 2008

EUROZONE MOVES CLOSER TO RECESSION

The eurozone moved closer to recession on Thursday after it emerged that the economy contracted in the second quarter for the first time since the launch of the euro. The economy shrank by 0.2 % in the three months to June, as inflation driven by commodity prices wiped out growth. German GDP fell by 0.5. A bigger shock was the 0.3% contraction in France's GDP. In the eurozone, inflation was a record 4% in July, according to Eurostat, the European Union's statistical office, although that was lower than its original estimate of 4.1%. Adding to the alarm, forecasters expectations for inflation in the longer term were the gloomiest since the euro was introduced in 1999, the European Central Bank reported on Thursday. Eurozone politicians and economists said the eurozone's deterioration reflected largely external shocks and a correction from a strong first quarter, when GDP rose by 0.7%, boosted by a strong German performance. The European Central Bank will fail to achieve its goal of keeping inflation below 2% for an 11th consecutive year in 2010, according to a quarterly survey of forecasters published by the ECB. The forecasters predict inflation will average 3.6% this year, 2.6% in 2009 and 2.1% in 2010, raising their expectations from May. The expectation for inflation in the longer term, defined as through 2013, rose to 2.03%, the highest since the survey started in 1999 and up from 1.95% three months ago.

BOE PROJECTS INFLATION TO PEAK AT 5%

The Bank of England projected that inflation will peak at about 5% in the next few months, before falling slightly below 2% in the medium term. But the fourth consecutive nasty surprise on prices pushed UK inflation to 4.4% in July, its highest since the early 1990s and more than double the government's target. Disappointing price cuts in the summer sales, rises in food and fuel inflation, and a broad-based rise in prices of other goods and services caused the latest jump. Britain's economy faces a year of stagnation and the downturn could be acute enough to send inflation below target in two years' time, Bank of England the signalled in its latest quarterly forecasts. According to data from the Bank of England, the net withdrawal of mortgage lending by building societies is unprecedented; not even in the darkest days of the last property recession did net lending become negative. The labour figures are the weakest since the economic slowdown began. Investors interpreted the BOE's quarterly report as dovish and economists said they now expected earlier rate cuts. The Royal Institution of Chartered Surveyors monthly survey, released on Tuesday, showed the ratio of completed sales to stocks of unsold property fell, again, from 18.2% in May to 17% in June, the lowest level since 1995. Surveyors also reported a further drop in new instructions, new buyer numbers and dwindling numbers of completed sales. With price indices by the main lenders showing double-digit year-on-year declines, few in the industry hold out hope for any rapid improvement. Rics said a net balance of 83.9% of surveyors thought prices had fallen in the past three months, while a balance of 68% expected further declines.

SUSTAINED US INFLATIONARY PRESSURE

Consumer prices rose by 0.8% in July, twice as fast as expected, damping hopes that falling crude oil prices and the slowing consumer demand would rapidly ease inflationary pressures. The surprise jump in the consumer price index on a monthly basis was accompanied by an annual increase of 5.6%, which was more than forecast and the largest jump since 1991. Meanwhile, core prices rose by 0.3%, higher than expected, amid sharp increases in the prices of apparel, tobacco and public transportation. The US trade deficit narrowed unexpectedly in June by 4.1% to $56.8bn, as exports grew more than twice as fast as imports in spite of surging oil prices. Supported by the weakness of the dollar, US exports jumped in June by 4%, the most since February 2004, to a record level of $164.4bn (110.2bn, £86.4bn). Imports rose by a record 1.8% to $221.2bn, driven entirely by a surge in purchases of foreign oil. Demand for other international goods and services declined by 1.4% in a sign of retrenching US consumer spending. Monday's Federal Reserves survey of senior loan officers, conducted every three months, highlighted that domestic banks had tightened standards in all major loan categories since the last survey in April, with consumer loans in particular becoming tougher to secure. The survey also pointed to a bleak outlook, with large net fractions of foreign and US banks expecting lending standards to tighten further in the remaining part of this year and smaller, though substantial, net fractions expected the stricter terms to continue next year. Retail sales in the US fell by 0.1% in July, recording their first drop in five months as the effect of the government's $100bn round of economic stimulus cheques to consumers began to wear off inflation is likely to remain the main source of concern for the Fed.

JAPAN WORST QUARTER IN SEVEN YEARS

Japan's economy contracted 0.6% in the second quarter, an annualized 2.4%. It was Japan's worst quarterly performance for seven years. Bank of Japan figures stunned markets on Tuesday when it announced wholesale inflation was at a 27-year high of 7.1% in July, putting pressure on corporate profits and triggering bankruptcies among small and medium-sized companies in particular. It was the largest rise since 1981 after the second oil shock, and the 10th consecutive month in which increases in corporate goods prices exceeded consensus forecasts. The government on Monday announced outlines of an economic stimulus package aimed at helping small businesses affected by the sharp rise in energy costs. Bankruptcies caused by surging costs have been on the rise, according to Teikoku Data Bank. Japan's current-account surplus narrowed by a record in June as exports fell and higher oil prices pushed up the import bill. The surplus shrank 67.4% to 493.9 billion yen ($4.5 billion) from 1.52 trillion yen a year earlier. Exports fell 1.5% in June from a year earlier, the first decline since November 2003. Imports climbed 17.8% to a record 6.59 trillion yen. Japan imports virtually all of its oil, which surged to a record $147.27 a barrel on July 11.

SINGAPORE CONTINUES SLOWDOWN

Weaker demand in the major economies, coupled with the need to contain inflationary pressures, is expected dampen growth in the fast growing Asia economies. Singapore's economic growth slowed in the second quarter to 2.1% from a year ago, providing fresh evidence that the US slowdown is beginning to affect Asian economies. The Singapore Government is predicting full-year growth of 4-5% following 7.7% growth in 2007. Exports are predicted to drop between 2% and 4% - the first fall since 2001. Much of the slowdown is attributed to manufacturing, which contracted by 5.2% in the second quarter from a year ago. Pivate banking and new tourism initiatives are expectd to offset the weakening manufacturing sector which is centred on electronics. But there are concerns tourism could suffer as consumers in the region reduce leisure spending. Services growth slowed slightly from the government's initial estimate of 7.7% for the quarter. A continued fall in the oil prices might provide the government with more room to pursue pro-growth policies if inflation falls from its 26-year high of 7.5%. Singapore uses its exchange rate as its prime monetary policy tool and appreciated the currency in April to curb imported inflation from fuel and food. The Singapore dollar has already fallen 3.2% against the US dollar this month. And an easing of oil prices could allow the depreciation of the Singapore dollar that would make exports more competitive.

INDIA MAINTAINS TIGHT MONETARY STANCE

India's economic growth is expected slow to 7.7% this fiscal year from 9% in 2007 as high oil and food prices and tightening credit markets take their toll. In its outlook for the year through to March 2009, the Economic Advisory Council to Prime Minister Manmohan Singh said inflation would slow to 8 to 9%, but said that the central bank would have to maintain a tight monetary stance to tame rising prices. While India's growth spurt of recent years has been fuelled by private investment and domestic consumption, but the council expects both to slow this year. The Reserve Bank of India's benchmark interest rate is at a seven-year-high as it battles inflation at a 13-year high of 12%. India's agricultural output will also grow just 2%, down from a 4.5% expansion last year. This is due in part to an erratic monsoon, highlighting the challenge India faces in boosting agricultural productivity and meeting rising demand for food grains. Elsewhere in Asia, South Korea said it will sell or merge 41 of the nation's 319 state-owned companies as part of President Lee Myung Bak's pledge to make government-run firms more competitive. The plans include selling a 49% stake in Incheon International Airport Corp. and part of Industrial Bank of Korea and its affiliates. The government also said it would merge Korea National Housing Corp. and Korea Land Corp.

MAJOR CORPORATE NEWS

Revelations of further fallout from the sub-prime meltdown underscores news-flow from major corporations last week. UBS AG, Switzerland's biggest bank, plans to separate its investment banking and wealth management units after mounting subprime writedowns prompted rich clients to withdraw funds for the first time in almost eight years. UBS fell 56 centimes, or 2.4%, to 22.62 francs in Swiss trading. The bank reported a second-quarter net loss of 358 million Swiss francs ($329 million), compared with a 5.55 billion-franc profit a year before. About 3.8 billion francs in tax credits cushioned the loss. UBS said it doesn't expect the adverse economic and financial trends" that led to the quarterly loss will improve in the second half. Meantime, ING reported a 25% drop in quarterly net profit on Wednesday as returns from investments fell, but the writedown on subprime and related investments was smaller than expected. The Dutch financial services group warned, however, that market conditions would remain challenging in 2009. Its second-quarter results included a $44m writedown on the most problematic asset classes, such as investments linked to US subprime and Alt-A mortgages. It also cut shareholders' equity by $260m to reflect changes in market values. Quarterly net profit fell to $1.92bn from 2.56bn a year earlier while earnings per share dropped to $0.94 from 1.18. JPMorgan Chase & Co. had its biggest decline in six years after reporting a $1.5 billion loss on mortgage-backed assets in less than two months. JPMorgan dropped $3.97, or 9.5%, to $37.92. It was the steepest one-day decline since July 23, 2002, when the bank was accused of hiding Enron Corp. debt. JPMorgan Chief Executive Officer Jamie Dimon oversaw more than $14 billion of writedowns, losses and credit provisions on mortgage-tainted assets through the second quarter, less than the $55 billion reported by Citigroup Inc, its bigger rival. Meanwhile, Wal-Mart, the world's largest retailer, said on Thursday it was seeing evidence of the slowdown in US consumer demand spreading to developing markets as customers in its international markets deal with growing food and energy costs. The retailer also highlighted concerns over inflation in China, where inflation was running at approximately 8% during the second quarter. However, Wal-Mart, which operates international stores in Latin America, the UK, Japan and China, said it had increased market share in many of its international markets during its second quarter, while its low-price focus again helped it outperform its retail competitors in the US.

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Version 01/2007

Complied: 18 March 2008