Market Review: July 2010

Risk makes a strong comeback as Micro and Macro factors turn supportive

- ✓ Market positioning had turned rather bearish by the end of June. All contemporary risk-aversion indicators were pointing towards that when we wrote our June review – weak equity momentum in developed markets, investor outflows from risk asset classes, strong Yen/$, strong Gold/$, lower Govt treasury yields, weak industrial commodities and crashing global freight indices and higher credit spreads. Against that backdrop, July experienced a surprisingly rapid turnaround in sentiment and outcomes. Three key market concerns that plagued markets in June surprised positively. First, the European situation started flipping as positive leaks led the actual publication of stress test results on the 91 European banks. Ignoring the divergence in views on the degree of real stress built into the tests, the actual results showed the banks to be in much better health than feared by many, helping rally European shares strongly; particularly banks/financials. Euro/USD caught a sustained bid on short covering (it was the most shorted currency pair coming into July), strengthening above 1.30. Relaxations in proposed capital adequacy norms by the Basel 3 committee played a helping hand along side. Second, economic data confirmed a sequential growth slowdown in China as its 2Q10 GDP grew 10.3%yoy vs 11.9% yoy in 1Q10. PMI that had dropped to 52.1 in June dropped further to 51.2 in July, indicating expansion at a lower pace. June CPI grew at a softer pace of 2.9% yoy. That set expectations that the Chinese would not tighten any further even if few expect them to loosen policy immediately. Chinese equity markets, the biggest in the region and with the weakest momentum, reacted favorably to such shrinking tightening expectations, rising 10% in Shanghai and 13.8% in Shenzhen (bear in mind, they're still down 22% each for 2010). That had a positive effect on the HK-listed universe and the region in general. Finally, from a bottom-up perspective, the 2Q10 earnings season got underway in US/Europe with a reasonably strong set of numbers. Profit growth was ahead of expectations, revenue beat too was strong and a majority of companies guided positively for the remainder of 2010, except for some disappointments in the investment banking sector. In Asia, however, earnings upgrade momentum faded as the upgrade/downgrade ratio turned to parity after 5-6 quarters in the upper half.

- ✓ The **obvious beneficiaries** of the risk reversion trade were equities, credits and commodities but underperforming Government bonds didn't suffer much, mainly due to a decline in yields at the short-medium end of the curve. ML's US Treasury Master returned +0.69% (+6.2% YTD'10). Credit spreads compressed impressively for both high grades and high yields, causing strong returns in corporate bonds. ML's US Investment Grade Corporate Master returned an impressive +2% after its 2% gain last month and is now +8.2% YTD'10. The High Yield Master II returned +3.4% (+8.3% YTD'10). Reuters/Jeffries CRB commodities index gained 6.1%, driven by higher oil, base metals and agricultural commodities to compensate for weakness in bullion.

- ✓ **EU's stress tests** showed the health of the 91 banks tested to be better than market expectations, with only 7 banks (5 Spanish, 1 Greek and 1 German) requiring just EUR 3.5bn capital to reach the target Tier 1 capital mark of 6%. Many have expressed concerns that no haircuts were used for banks' investment books of sovereign debt or that the economic scenarios weren't stressful enough. On the positive side, large European listed banks came out well above the watermarks. While solvency fears have been put to rest temporarily, new capital issuance by the European financial sector is likely to be far more than the stress test number. **Basel 3,** close on the heels of the European bank stress tests, announced relaxations in banks' liquid funding requirements, treatment of deferred tax assets and banks' non-consolidated minority investments for capital adequacy purposes and pushed out implementation of liquidity ratios to 2018 at a lower rate of 3% vs 4%. Measures will reduce banks' capital requirements relative to previously announced norms.

- ✓ **<u>Flows turned positive towards EM equities</u>** in July. According to ML (source EPFR Global), July had net inflows of $8.4bn in EM equities ($5bn in Global EM funds and $3bn in Asia funds) and an outflow of $5.6bn from US equity funds. YTD, EM funds have had inflows of $25bn ($18bn in global EM funds and $7bn in Asia funds) while US (-$17bn), Europe (-$12bn) have seen big outflows. On the fixed income side, Lipper estimates money market funds to have had outflows of $411bn this year with bond funds seeing inflows of $110bn.

- ✓ **<u>UK's ratings</u>** of AAA/A1+ were affirmed by S&P though it retained a –ve outlook. Moody's downgraded Portugal to A1 (Stable) and moved Ireland to Aa2 (Stable). In a thumbs-up sign for Asia, Moody's said that speculative-grade default rate for non-financial companies in the Asia-Pacific ex Japan region will plunge to 3.5% in 2010 from 17% in 2009. Meanwhile, China's home grown rating agency, Dagong Global Credit Rating Co. issued its maiden set of sovereign ratings that challenged conventional rating wisdom. It rated China at AA+ (Stable) for L/C and AAA for F/C debt while putting US at AA (-ve) and UK at AA-(-ve) for both L/C & F/C debts. Denmark, Norway, Switzerland, Singapore and Luxembourg were the only ones to get AAA for both L/C & F/C debts. Are we seeing a new era in credit ratings? Not quite yet but if US/UK/Japan keep accumulating debt, noises about their top ratings will only increase!

- ✓ **<u>On the economic front</u>**, US 2Q10 real GDP growth missed consensus, at +2.4% qoq annualized vs expectations of +2.6%. Q110 was, however, revised 1% higher to +3.7%. Looking at the Q2 report, personal consumption was weaker than expected +1.6%. Both residential and non-residential investments were very strong. The big miss came from trade, as imports had a very strong quarter and net exports took nearly -2.8% off the headline print. US June Non Farm Payrolls declined 125k including a 225k decline in Census workers. Private sector added fewer jobs (+83k vs +110k expected). The employment rate dipped to 9.5% from 9.7% as estimated size of the labor force shrank 0.4%, pushing the participation rate lower to 64.7% from 65%. <u>Euro Area 1Q'10 GDP</u> rose 0.6% yoy, led by higher exports (+2.1% qoq), state spending (+0.2%) and inventory accumulation. German exports rose sharply, keeping manufacturing growth strong. <u>UK's 2Q10</u> GDP grew 1.1% qoq (+1.6% yoy), its fastest expansion for four years as rebounding services, manufacturing and construction ignited the recovery. <u>In Asia</u>, China slowed down as its 2Q2010 GDP growth was 10.3% yoy vs 11.9% yoy in 1Q2010. Industrial Production growth dropped to 13.7% yoy in June (is +17.6% yoy YTD). PMI dropped to 51.2 from 52.1 on softer new orders and exports. Trade surplus for May was US$ 20bn, helped by exports that rose 43.9% yoy to $131bn. Home price growth slowed to 11.4% yoy as prices dropped 0.1% mom in June (first sequential drop since Feb 2009). India's May Industrial Production sobered to +11.5% yoy from the torrid pace of growth the past few months. Singapore reported 2Q10 GDP growth of 26% annualized and revised its 2010 target higher to 13-15% from 7-9% earlier.

- ✓ The **<u>US earnings season</u>** showed strong numbers yet again. Numbers were very strong in Western Europe as well though Emerging Asia wasn't as strong as companies reported softer EPS numbers as compared to consensus expectations. The EPS surprise breadth too fell to 1 which could lead analysts into revising their estimates lower in coming weeks. A summary from Bloomberg (as of 2nd Aug) shows-

Region	EPS Growth (yoy) Surprise	Revenue Growth (yoy) Surprise	Cos with +ve/-ve EPS surprise	Cos with +ve/-ve Revenue surprise
United States	+8.9%	-0.2%	940/455	878/450
Western Europe	+15%	+4.2%	207/168	316/140
Emerging Asia-Pac	-10.4%	+6.9%	148/142	125/100

✓ **Volatility indicators turned benign.** Equity volatility indicators eased in all regions, led by VIX that closed -11 points lower at 23.5 (was up 17 points in 2Q10). Money market stress indicators were down as confidence in the system got a boost from the European Stress test results. 3m LIBOR-OIS spread softened 7bps to 26bps. JPM's EM Bond Index spread narrowed 45bps. Investment grade, high yield CDS and cash bond spreads narrowed as well.

I. Equities

			Change	Change	Change	Change	Change	Change	Change
EQUITIES	**Currency**	**31-Jul-10**	**(Month)**	**(Q2'10)**	**(Q1'10)**	**(YTD'10)**	**(Last1yr)**	**(2009)**	**(2008)**
HK/China									
Hang Seng	HK$	21,030	4.5%	-5.2%	-2.9%	-3.9%	2%	52%	-48%
H-Shares	HK$	11,905	3.8%	-7.5%	-3.1%	-6.9%	-2%	62%	-51%
Shanghai Comp	CNY	2,638	10.0%	-22.9%	-5.1%	-19.5%	-23%	80%	-65%
Shenzhen Comp	CNY	1,075	13.8%	-22.0%	0.8%	-10.5%	-4%	117%	-62%
MSCI China	USD	352	4.4%	-4.6%	-1.6%	-2.0%	4%	62%	-51%
Developed									
S&P500-US	USD	1,102	6.9%	-11.9%	4.9%	-1.2%	12%	23%	-38%
Dow Jones-US	USD	10,466	7.1%	-10.0%	4.1%	0.4%	14%	19%	-34%
Russell 2000-US	USD	651	6.8%	-10.2%	8.5%	4.1%	17%	25%	-35%
DAX-Germany	EUR	6,148	3.1%	-3.1%	3.3%	3.2%	15%	24%	-40%
FTSE100-UK	GBP	5,258	6.9%	-13.4%	4.9%	-2.9%	14%	22%	-31%
CAC 40-France	EUR	3,643	5.8%	-13.4%	1.0%	-7.4%	6%	22%	-43%
ASX 200-Australia	AUD	4,494	4.5%	-11.8%	0.1%	-7.7%	6%	31%	-41%
Nikkei 225-Japan	JPY	9,537	1.6%	-15.4%	5.2%	-9.6%	-8%	19%	-42%
VIX Index	%	23.5	(11.0)	17.0	(4.1)	1.8	(2)	(18)	18
Asia & Other EM									
India-Sensex	INR	17,868	0.9%	1.0%	0.4%	2.3%	14%	81%	-52%
Thai-SET Index	THB	856	7.3%	1.2%	7.3%	16.5%	37%	63%	-48%
Singapore-STI	SGD	2,988	5.4%	-1.8%	-0.4%	3.1%	12%	64%	-49%
Korea-KOSPI	KRW	1,759	3.6%	0.3%	0.6%	4.5%	13%	50%	-41%
Taiwan-TWSI	TWD	7,761	5.9%	-7.5%	-3.3%	-5.2%	10%	78%	-46%
Malaysia-KLCI	MYR	1,361	3.6%	-0.5%	3.8%	6.9%	16%	45%	-39%
Brazil-BOVESPA	BRL	67,515	10.8%	-13.4%	2.6%	-1.6%	23%	83%	-41%
Russia-RTSI$	USD	1,480	10.5%	-14.8%	8.9%	2.4%	45%	129%	-72%
Select MSCI Indices									
MSCI Far East xJpn	USD	278	6.5%	-5.3%	0.8%	1.7%	13%	69%	-51%
MSCI Asia-Pac xJpn	USD	811	7.5%	-8.9%	2.1%	0.0%	16%	74%	-52%
MSCI Europe	USD	4,032	11.6%	-15.2%	-1.8%	-7.0%	7%	36%	-46%
MSCI AC World	USD	119	8.1%	-12.1%	3.1%	-2.0%	11%	35%	-42%
MSCI EM	USD	374	8.3%	-8.4%	2.4%	1.6%	20%	79%	-53%
MSCI BRIC	USD	464	7.6%	-9.3%	1.0%	-1.5%	17%	93%	-59%

Source:Bloomberg/Internal

- **Equities** ended the month with universal gains. All major markets tracked by us closed in positive territory. Developed markets staged a strong comeback, led by MSCI Europe, that gained 11.6% in USD terms, helped significantly by strong Euro/$ (+6.2%) and GBP/$ (+4.7%). Within Europe, Value outperformed Growth by a wide margin and Financials (led by Banks) outperformed other sectors, especially IT & Health Care. In USA, Large Caps trailed Mid/Small caps marginally. Sectorally, Industrials and Real Estate stocks outperformed while Health Care posted the lowest returns. Leading names like Caterpillar, UPS, Fedex, GE (it upped its quarterly dividend by 20%), Intel, Microsoft, Apple etc. were among those that cheered the markets with a strong set of numbers. In Asia-Pacific x Japan, Australia was particularly strong, helped by a strong currency (USD weakened 7% against AUD) while India trailed other countries after a strong performance last month. Sectors that did well in the region included Industrials, Materials, Financials and Consumer Discretionary where as Health Care (-ve returns), Energy, Utilities and Telecom Services underperformed. China-listed markets led the rally in Asia as Shanghai/Shenzhen surged 10% and 13.8% respectively (both markets are still down 22% compared to the close of last year).

- Regionally, returns from MSCI AC World (+8.1%) were similar to those from MSCI EM (+8.3%) while the Asian block (+6.5% on MSCI FE x Jpn and +7.5% on MSCI Asia-Pacific x Jpn) lagged a tad after a strong showing last month. The more diversified MSCI EM (+8.3%) outperformed MSCI BRIC (+7.6%) due to stronger performance by the EMEA region.

II. Fixed Income & Credits

			Change	Change	Change	Change	Change	Change	Change
Key Policy Rates (%)		31-Jul-10	(Month)	(Q2'10)	(Q1'10)	(YTD'10)	(Last1yr)	(2009)	(2008)
US-Fed Funds	USD	0.25	0.00	0.00	0.00	0.00	0.00	0.00	-4.00
UK Bank Rate	GBP	0.50	0.00	0.00	0.00	0.00	0.00	-1.50	-3.50
ECB Ref Rate	EUR	1.00	0.00	0.00	0.00	0.00	0.00	-1.50	-1.50
Australia Cash Rate	AUD	4.50	0.00	0.50	0.25	0.75	1.50	-0.50	-2.50
China 1y Dep Rate	CNY	2.25	0.00	0.00	0.00	0.00	0.00	0.00	-1.89
China 1y Lend Rate	CNY	5.31	0.00	0.00	0.00	0.00	0.00	0.00	-2.16
Treasuries (%)									
USA-10y	USD	2.91	-0.03	-0.89	-0.01	-0.93	-0.57	1.6	-1.8
UK-10y	GBP	3.33	-0.03	-0.58	-0.08	-0.69	-0.48	1.0	-1.5
GER-10y	EUR	2.67	0.09	-0.52	-0.30	-0.72	-0.63	0.4	-1.4
Australia-10Y	AUD	5.20	0.11	-0.69	0.14	-0.44	-0.41	1.7	-2.3
Japan-10y	JPY	1.07	-0.02	-0.31	0.11	-0.22	-0.35	0.1	-0.3
Hong Kong-10 EFN	HKD	2.23	-0.06	-0.50	0.21	-0.35	-0.10	1.4	-2.3
China-10y	CNY	3.29	-0.02	-0.16	-0.17	-0.35	-0.19	0.9	-1.7
Singapore-10y	SGD	1.95	-0.42	-0.46	0.17	-0.71	-0.46	0.6	-0.6
Korea-10y	KRW	4.84	-0.11	0.00	-0.44	-0.55	-0.49	1.2	-1.5
Credits (bps)									
3m USD LIBOR-OIS Spread	USD	26	-7	24	1	18	-2	-112	54
N. America CDX 5y IG CDS	USD	104	-19	35	3	18	-7	-120	127
Europe 5y IG CDS	USD	105	-24	50	3	29	17	-102	127
Asia 5y IG CDS	USD	118	-26	47	-5	16	-9	-266	301
Asia 5y High Yield CDS	USD	453	-30	128	-54	45	-164	-826	900

JPM EMBI Index	USD	313	-45	97	-33	18	-85	-430	470

Source: Bloomberg/Internal

- In the developed world, **policy rates were hiked** by Canada (+25bps to 0.75%, it lowered GDP growth forecasts for 2010 & 2011 slightly), New Zealand (+25bps to 3%, it confirmed that it will continue to withdraw monetary stimulus, albeit at a slower pace) and Sweden's Riksbank (+25bps to 0.50% but doesn't expect many more rate hikes in the longer term). **In Asia**, India stole headlines as RBI finally got into action, raising Repo rate 50bps to 5.75% & Reverse Repo rate 75bps to 4.50% in light of high inflation, strong industrial production, high credit growth and a rising current account deficit. It raised its growth and inflation forecasts while shifting its policy stance decisively to contain inflation and anchor inflationary expectations. Others that hiked included Malaysia (+25bps to 2.75%, its second hike in the last 3 months that took the policy rate to what it called an "appropriate" level), Korea (+25bps to 2.25% in an unexpected move after 16 months at 2% and more hikes are in the offing) and Thailand (+25bps to 1.50% to normalize monetary policy as export gains remained strong, private investments rose and inflation expectations that, though modest, edged up). Philippines and Indonesia haven't yet moved in this cycle but we suspect they'd have to move sooner than later as a recent uptick in commodity prices will test their current inflation assumptions. Outside Asia, Brazil (+50bps to 10.75%, 25bps less than consensus as inflation and growth readings showed signs of easing), Chile (+50bps to 1.5%, its second hike this quarter as it normalizes monetary policy in face of a strong economic activity indicator that rose 7.1% yoy in May) and Israel (+25bps unexpectedly to 1.75% as house prices rose and inflation expectations remained high) led in hiking policy rates. No major Central Bank cut rates last month while among those that stayed unchanged were RBA (level appropriate), BoE, ECB, BoJ, Bank of Mexico (an eleventh straight time on deflation concerns), Turkish Central Bank and South African Central Bank.

- Government Bond Yields ended mixed after a strong rally last month. Benchmark 10-yr yields moved the most in Germany (+9bps, move away from "safety"), Australia (+11bps), India (+27bps, policy rate hikes and higher inflation), Thailand (+29bps), Philippines (-33bps, a surprisingly dovish Central Bank), Indonesia (-30bps, dovish Central bank and better fiscal numbers) & Singapore (-42bps, strong GDP growth led to a stronger currency appreciation bias). In Brazil, the 3-yr Treasury yield declined 28bps as the magnitude of the rate hike was smaller than expected while weak inflation in Mexico helped its benchmark yields lower by 29bps. Spain, Portugal, Ireland & Italy were big beneficiaries of the stress test results in Europe as yields declined appreciably. 2-yr treasury yields were down 103bps, 71bps, 53bps & 35bps respectively. Greek yields declined as well but on a relatively modest scale, highlighting market concerns of a likely restructuring in Greek debt sometime in the future.

- Credit spreads all came in appreciably as fund flows into bonds were strong and European stress test results were greeted positively by markets. US Investment Grade credit spreads closed -20bps tight at 189bps on the ML Corporate Master while High Yield spreads (ML HY Master II) tightened 54bps to 659bps. JPM's EMBI bond spread closed 45bps tighter. CDSs closed well inside their June levels and High Yields outperformed High Grades, as in cash bonds. US Financials (the average of 5 big bank 5-yr senior CDSs) narrowed 31bps.

III. Currencies

CURRENCIES (USD vs. Others)	31-Jul-10	Change (Month)	Change (Q2'10)	Change (Q1'10)	Change (YTD'10)	Change (Last1yr)	Change (2009)	Change (2008)
DXY (Dev Mkts $ Index)	81.54	-5.2%	6.1%	4.1%	4.7%	4%	-4%	6%

Bberg JPM Asia Dollar Index	112.00	-1.3%	1.4%	-1.2%	-1.2%	-3%	-3%	6%
Bberg JPM Latin America Index	111.12	-2.5%	2.6%	-1.1%	-1.0%	-4%	-13%	24%
USD/EURO	1.3052	-6.2%	10.4%	6.0%	9.7%	9%	-2%	4%
USD/GBP	1.5689	-4.7%	1.6%	6.5%	3.1%	7%	-10%	36%
USD/AUD	0.9042	-7.0%	9.1%	-2.1%	-0.7%	-8%	-22%	25%
Yen/USD	86.47	-2.2%	-5.4%	0.5%	-7.0%	-9%	3%	-19%
HKD/USD	7.7668	-0.3%	0.3%	0.1%	0.2%	0%	0%	-1%
CNY/USD	6.7745	-0.1%	-0.6%	0.0%	-0.8%	-1%	0%	-7%
HKD/USD 12M Fwd	-0.25%	0.0%	0.0%	0.0%	0.0%	0%	0%	1%
CNY/USD 12M Fwd	-1.27%	0.2%	0.9%	0.0%	1.1%	0%	-5%	10%

Source: Bloomberg/Internal

- In Currencies, it was all about **$ weakness and strength in Euro, GBP, AUD and Emerging Market currencies**, especially Eastern Europe. In the risk aversion trade the previous two months, Euro/USD had become the most shorted currency pair and it rallied strongly through the month on short covering. European data surprised on the upside, led by strong industrial growth. The stress tests and capital relaxations announced by Basel 3 too played a hand in turning sentiment around. Finally, signs of weaker growth in US led to a reduced appetite for USD as a safe haven currency. Consequently, USD dropped 6.2% against EUR, 4.7% against GBP, 7% against AUD, 5.7% against NZD 3.4% against CHF and 3.2% against CAD. In Asia, USD was weaker by 1.8% against PHP, 1.4% against IDR, 2.8% against SGD, 3.2% against KRW, 1.7% against MYR and 0.5% against TWD. It was almost unchanged against INR. In Latin America, USD lost 2.8% against BRL, 2.3% against MXN and 4.5% against Chilean Peso (CLP). Action was thick in the EEMEA space, as USD reversed part of its massive gains against East European currencies. It was down 4.5% against ZAR, 3.2% against RUB, 9.6% against Czech Krona, 9.4% against Polish Zloty, 6.6% against (Hungarian Forint) and 4.8% against Turkish Lira.

IV. Commodities

Commodities		31-Jul-10	Change (Month)	Change (Q2'10)	Change (Q1'10)	Change (YTD'10)	Change (Last1yr)	Change (2009)	Change (2008)
Reuters/Jefferies CRB Index	USD	274.4	6.1%	-5.4%	-3.5%	-3.2%	7%	23%	-36%
Baltic Dry Index	USD	1,967.0	-18.2%	-19.7%	-0.2%	-34.5%	-41%	288%	-92%
Nymex Crude	USD/bl	79.0	4.4%	-9.7%	5.5%	-0.5%	14%	78%	-54%
Brent Crude	USD/bl	78.2	4.2%	-9.3%	6.1%	0.3%	9%	71%	-51%
Gold	USD/toz	1,181.7	-5.2%	11.9%	1.6%	7.8%	24%	24%	6%
Silver	USD/toz	18.0	-3.6%	6.5%	4.2%	7.0%	29%	49%	-24%
Copper	USD/T	7,290.0	12.1%	-16.4%	5.7%	-1.0%	27%	141%	-54%
Aluminum	USD/T	2,163.3	9.8%	-14.7%	4.3%	-2.3%	15%	45%	-36%
Corn	USc/bu	392.8	10.9%	2.7%	-16.8%	-5.2%	16%	2%	-11%
Soybean	USc/bu	1,052.5	11.0%	0.8%	-9.5%	1.2%	-7%	7%	-19%
Wheat	USc/bu	661.5	42.3%	3.2%	-16.8%	22.2%	25%	-11%	-31%
Sugar	USc/lb	19.6	8.5%	8.7%	-38.4%	-27.4%	5%	128%	9%

Source: Bloomberg/Internal

- **The Commodity complex saw a strong reflationary trend after 2-3 months of softness.** Gold and US$, the two safe haven plays were hammered as investor positioning shifted to long base metals, long agricultural products and long crude oil. Gold ETFs, that have seen sizeable inflows this year, experienced outflows, reducing investment demand for the yellow metal. Simultaneously, improving tactical conditions in crude oil (strong demand conditions as China's oil imports reached an all-time high; continued deep-sea drilling ban in the Gulf of Mexico will delay potential supplies in US), base metals (end of policy tightness in China is likely to prompt trader restocking; net long positions in copper jumped to a 2-month high based on CFTC data) and agricultural commodities (poor weather conditions that seriously hurt output prospects in wheat and corn) presented them as better bets from an investor perspective. Maintenance shutdowns and extremely low inventory levels with Chinese steel mills helped the steel sector as steel prices rebounded about 5% from mid-month lows. Wheat production was dealt a blow by drought conditions in Russia & Kazakhastan and rains in Ukraine (EU, Turkey and the former Soviet Union states account for 45% of global wheat exports). Russia cut its wheat production estimate for the season by -5mt to 85mt (markets expect further cuts) as it declared emergencies in 17 regions. France too cut its forecast output even as US production estimate was raised by USDA. A USDA report that estimates wheat stockpiles to reach 187mt by end of the season in 2011, about 63mt higher than in 2008 and equal to 3 years of US production was hardly a dampener for wheat bulls who took the grain higher by 42% higher during the month. Also lending a helping hand to Wheat was USDA's cut in corn production forecast (hot weather in the corn growing parts of USA) that pushed corn prices sharply higher, in the hope that corn feed will be substituted by wheat feed by animal farmers. Sugar was helped by strong Asian demand (Thailand recently entered markets to buy back sugar that it had exported recently) and transportation problems in Brazil even as output forecasts are being revised higher in India, one of the biggest sugar consumers in the world.

Looking Ahead…

✓ Market sentiment changed dramatically between June and July. Risk, which was sold off aggressively in June, returned with a bang as investor positioning shifted decisively in favor of risky assets like equities, credits and commodities (gold being a shining exception!). Robust fund flows into EM equities and Corporate bonds (especially high yield funds) played a hand in pushing portfolio managers to deploy cash that had accumulated the past two months (ML's strategy survey showed cash in EM Portfolios to have edged above average levels by the end of June). On the macro side, the clear positives came from the European stress test results that were better than the street expectations. While concerns that no haircuts were used for banks' investment books of sovereign debt (Greek 10s still trade at a yield of about 10% yield while Greek 2s are just below 10%, indicating serious probability of a debt restructuring) or that the scenarios weren't stressful enough are valid, the exercise did bring greater transparency to European banking books, clearing the way for analysts to assess capital requirements with tighter assumptions. Bottom-up factors remained supportive for markets as 1Q10 corporate results were again ahead of expectations on both revenue and EPS. Asian earnings, though, disappointed a tad on EPS even as Revenue growth remained strong. Recent data shows that the Asia earnings revision breadth has turned flat for Asia, after staying in the upgrade territory for 5-6 quarters.

✓ Overall valuations are still supportive, in the range of 12-15x for 2010 and 10-14x for 2011. With monetary policy staying benign in developed markets, China probably having already run its tightness course for this year (it seems to have turned "neutral" after recent data pointed to a slowdown in growth) and other Asian Central banks well and truly in the accommodative zone despite recent rate hikes, such valuations aren't entirely worrisome unless analysts start revising earnings downwards; and we do not seem to be in that downward earnings revision zone, at least in the immediate term. The concerns on market performance in August mainly stem from tactical indicators as historically, a surge in fund flows of the type we saw in July has tended to lead to weak market performance in subsequent weeks. We'll see if that plays out in August or building momentum continues to take markets higher.

- ✓ US Fed's June minutes showed that it revised its economic outlooks for 2010/11 lower to 3-3.5% (3.2-3.7% previous) & 3.4-4.2% (3.5-4.5% previous). In his testimony to the Congress on 21 July, Bernanke confirmed Fed's readiness to support markets with more measures should the economic recovery falter. He also stated that Fed's intensions to normalize monetary policy were subject to fulfillment of conditions relating to employment and inflation. On the other hand, the surprising strength in Eurozone economic conditions (strong PMIs in manufacturing and services, robust retail sales and strong business/consumer confidence) prompted Mr Trichet, the ECB President to call for a global move towards tightening, primarily through fiscal cuts. His arguments that well coordinated fiscal adjustments don't necessarily drag long-term growth down and the need to create buffers for future interventions by improving Govt balance sheets have some merit. It's unlikely that Bernanke will allow himself to be influenced by his European counterpart's thoughts yet, given his concerns about the US economy. In other words, easy monetary conditions will continue at least for the rest of this quarter, which should support markets. Even the Japanese talk of greater fiscal discipline may have to be put on hold due to recent electoral reverses for the ruling party in the upper house.

- ✓ Finally, a word on environmental issues facing the world. Emission control talks may have been put on the backburner in recent months but recent events amply demonstrate the dangers posed to the environment. Even as BP finally found success in containing the oil leak at the Macondo spill in the Gulf of Mexico, China faced its own "Gulf of Mexico" as oil spilled out along the coast of Dalian from a pipeline blast in one of Petrochina's fields. While it successfully stopped the leak, the spill grew to cover an area of more than 430 sq km. In another environmental incident in China, its top Gold producer, Zijin Mining's copper smelting plant leaked waste water containing acidic copper into the Ting river in Fujian, damaging thousands of tons of fish. Global warming is well and truly in as July temperatures soared in several parts of US and Europe. Disruptions in weather patterns bode ill for stability in agricultural outputs, causing large swings in prices and posing serious challenges to the billions of people in populous countries like China, India, Brazil. Several countries used protectionist policies in 2008 to tackle food inflation by either banning exports or capping prices or both. If prices continue to run up further (the positive rollover effect that we talked about last month isn't much in sight now, given the July price action: global wheat prices are up 25% over the last 12m, Corn's up 16% and some base metals up even more), it will pose policy challenges, especially in the import dependant Asia. That could lead to intervention in free-market principles, besides damping the great consumption story that Asia is likely to embark upon, in the next leg of its economic resurgence. Hopefully, we will not have to revisit 2008 this time but what's not visible yet is a long term plan to boost agricultural productivity in regions like China and India aimed at greater self reliance.

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