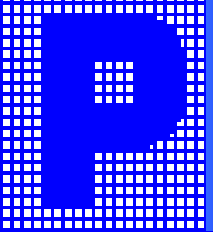


Content

- i. Gold Investment – Stick with Gold, slow growth environment could put Mortgage Backed Securities in an attractive light
- ii. Fixed Income Recommendation – Mortgage Backed Securities



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23 October 2009

Stick with Gold, slow growth environment could put Mortgage Backed Securities in an attractive light

Equities – The trend for equities is still higher, but the price action could be sluggish. We are expecting a flat return for the next month

Commodities – Commodities have been trending higher on a weak dollar and not due to fundamental demand. We expect a correction for most commodities but gold is still preferred.

Fixed income – The outlook for fixed income is rather mixed at the moment but we are sticking with safer bonds rather than risky bonds

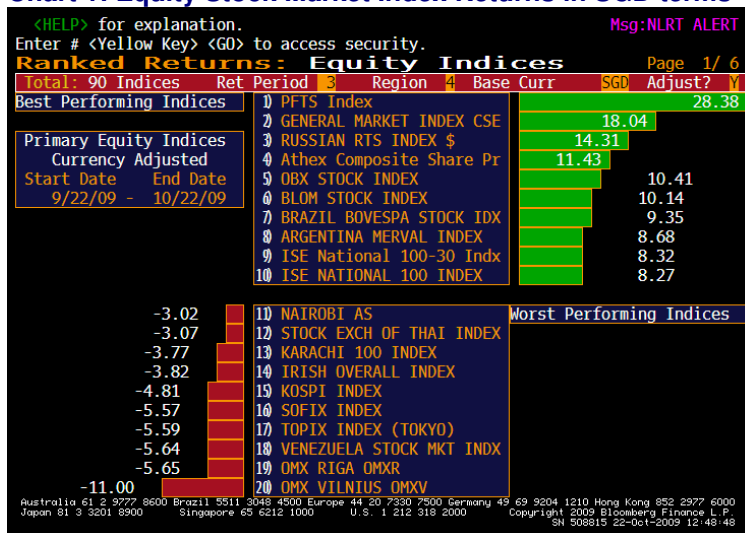
Equities – Slow, volatile recovery

The theme for equities has not changed. Equities ended the past month modestly higher, with most of the top gainers coming from Latin American markets. Brazil had recently won the bid for the 2016 Olympic Games and this was a boost for the region. Sentiment ran high in the country which boosted the stock market. Elsewhere, the surge in oil prices gave Russian stocks a lift as the country, with its large amounts of oil reserves is set to benefit from the high oil prices. Russia also recently signed an agreement to supply natural gas to China which is tagged to the price of crude oil prices.

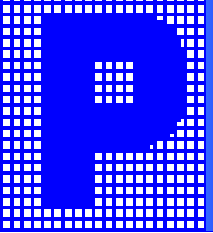
Report Highlights

Oil prices boosted the Russian stock market while the winning Olympic bid gave the Brazilian stock market a lift

Chart 1: Equity Stock Market Index Returns in SGD terms



Source: Bloomberg, from 22 Sep 08 to 22 October 09



Our projection for the S&P 500 to touch 950 did not materialize last month. The index instead created a support level at the 1000 level and headed higher. We still maintain our ultimate target for the S&P 500 at 1120 but it seemed that the market is rather buoyant on better than expected earnings results and could break through this critical barrier. Nevertheless, we are still expecting a bumpy ride toward higher levels and would not be surprised to see equities consolidate first before heading higher.

Our examination of the recent earnings results show that the market have great expectations for the Asian markets prior to the earnings result. However, most Asian companies have not preformed up to estimates and sales and earnings have in fact been downgraded for 2010 and beyond. This is a stark contrast to what analyst were expecting prior to the earnings season. On the other hand, earnings in the UK and the US have surprised to the upside and even topped most analyst estimates. Now the market expects earnings in the UK and the US to relatively do better than Asian companies on a relative basis.

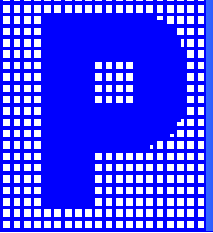
The chart below shows the Chicago Board Options Exchange implied volatility index. The index has been trending lower on a rally in equities. It was apparent that traders do not expect much volatility in the stock market. From another perspective, volatility is trading at very low levels and it is very cheap to purchase options. The 20 support level is critical support for the VIX and unless we break this level, we would be cautious on the stock market at its current level.

Chart 2: The CBOE VIX Index



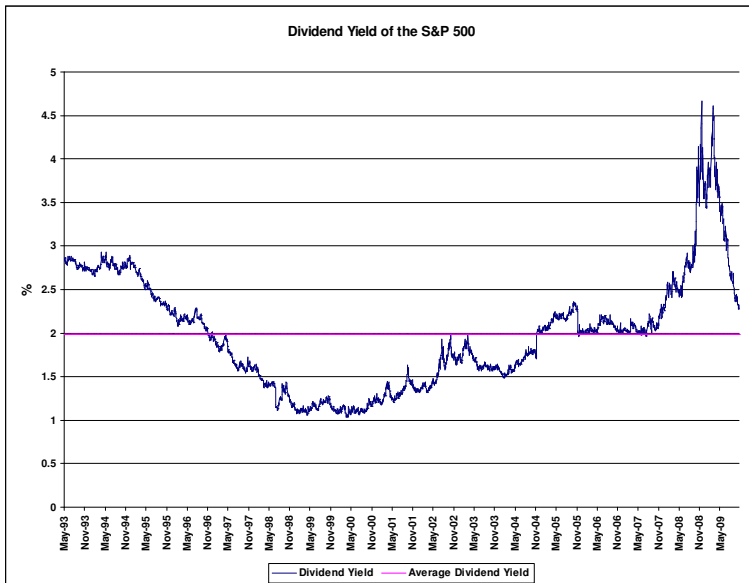
Source: Bloomberg

We expect the VIX to bounce off 20 and head higher on stock market short term weakness



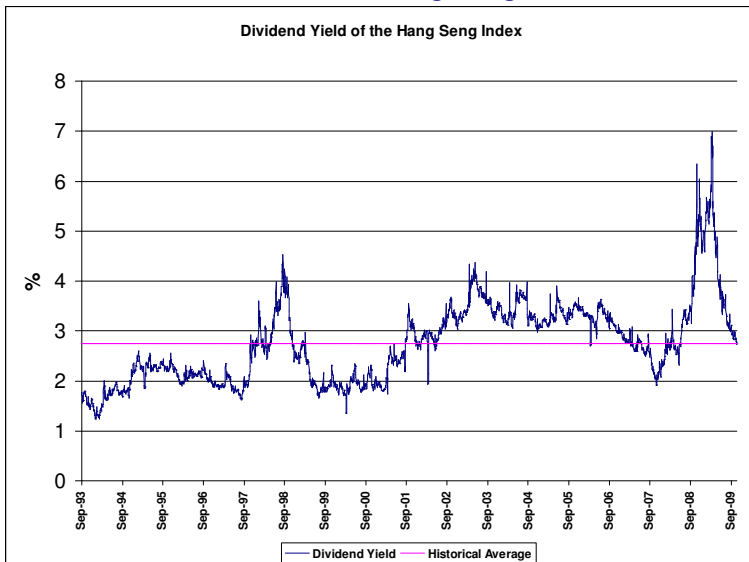
While we expect some weakness in equities for the short term, but if we look at the S&P 500 and its dividend yield (see Chart 3), we find that the index is actually not expensive and now close to its historical average. This could mean that the S&P 500 could still trade higher ground. Head east and we see that the Hang Seng is actually trading quite close to fair value as it has reached its historical average. (See Chart 4)

Chart 3: Dividend Yield of the S&P 500 Index



Source: Bloomberg, as of 21 October 2009

Chart 4: Dividend Yield of the Hang Seng Index



Source: Bloomberg, as of 21 October 2009

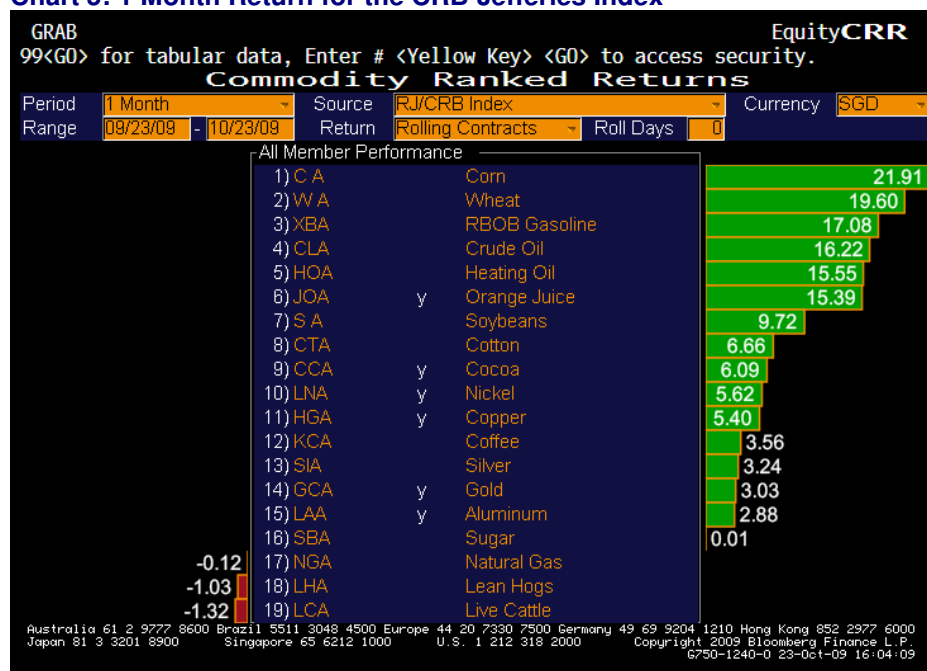
The S&P 500 is not expensive enough.

The Hang Seng on the other hand is reaching the historical dividend yield average

Commodities – Weaker in the short term

Commodities ended the previous month higher, which was beyond our expectations. Most of the contracts in the commodity index closed higher on US dollar weakness. The best performing contracts were the soft commodities, namely Wheat, Corn and Gasoline. The drought in India seems to be keeping wheat prices supported. Crude Oil, supposedly the leading commodity contract was also one of the top performers. Only natural gas and sugar closed the month flat.

Chart 5: 1 Month Return for the CRB Jefferies Index



Most contracts were in the green which highlighted the bullishness in commodities.

Moving forward, we expect commodities to be volatile, and could end the next month lower eventually. Inventory levels in our opinion are high and demand is not as robust as in prior years. This could put some pressure on commodities as weak fundamentals put pressure on prices. We suspect the rise in commodities is primarily driven by the weak US dollar and nothing else. Chart 6 shows that inventory levels this year is higher than levels in 2008 and 2007, which shows that the consumption in commodities is still not compelling. Chart 7 shows that forward curve for Crude Oil as of 22 October 2009. The front end of the curve trades about \$74 / barrel while the spot was about \$81 / barrel on the same day. This backwardation process shows that crude prices could correct in the short term, which is why we are less bullish on commodities for the time being.

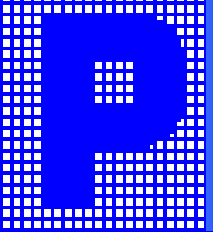


Chart 6: Department of Energy WTI Crude Oil Inventory



Source: Bloomberg

There is plenty of oil still available this year

Chart 7: Forecast and Forward for WTI Crude Oil as of 22 October 2009

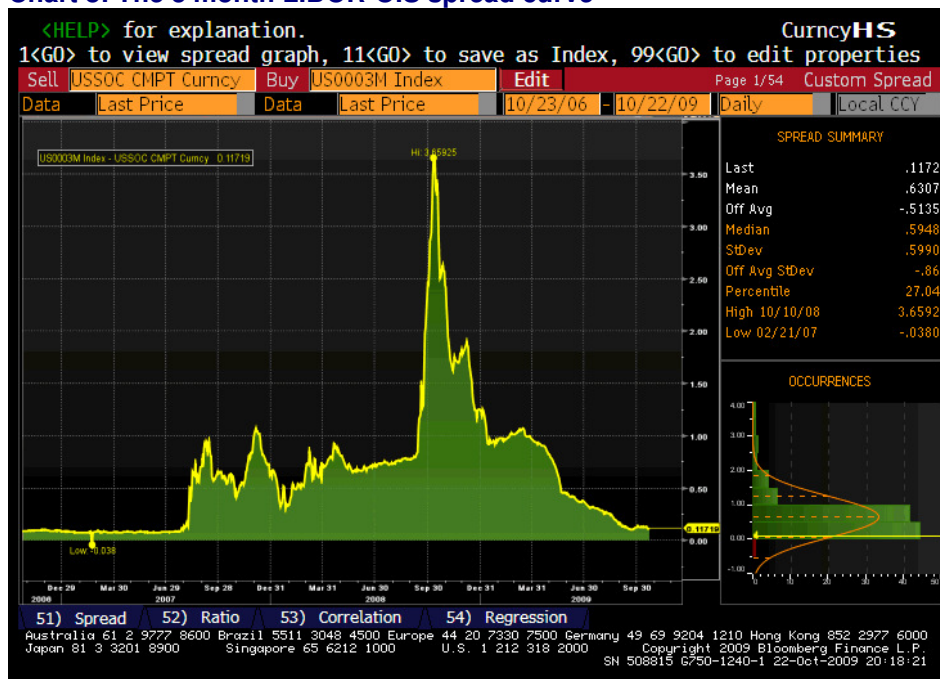


Source: Bloomberg

Fixed Income – Mortgage Backed Securities tactically positioned

We expected safer bonds to outperform higher yields but the latter merely outperformed by a slight margin. The Legg Mason Global Bond Trust closed the month 0.24% lower while the Schroder Global High Yield Bond Fund closed the month 0.12% higher. The Fed Fund effective rate continued to trade below the Fed Target and implied probabilities derived from Fed Fund options show a mixed picture for the upcoming FOMC meeting. In a speech on 19 October 2009, the Fed Chairman said that the US must increase its savings rate and he said that the most effective way to accomplish this goal was to establish a sustainable fiscal trajectory, anchored by a clear commitment to substantially reduce the federal deficits over time. Bernanke also called on China and other countries to reform their economic practices.

Chart 8: The 3 month LIBOR-OIS spread curve



The 3 month LIBOR-OIS rate has recovered to pre crisis levels

Source: Bloomberg

Moving forward, we are less positive on high yields as the spread between the LIBOR and OIS rate has reached pre crisis levels (Chart 8) so we think that opportunities in the high yield space should be limited. Our investment case for mortgage backed securities stem from the fact that the central bank's intentions to reduce the fiscal deficit and to get people to save more over time. Therefore there is greater assurance to the mortgage investor as risky assets start to taper off their gains in recent months. Also, the long end of the curve has moved considerably higher on weaker US dollar concerns pushing commodities and triggering inflation fears once again. Read the Focus of the Month for November 2009 for more details

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24 October 2009

Mortgage Backed Securities

It would seem that our recommendation for global bonds last month would turn out very wrong given that equities continued to stay buoyant on robust earnings and better than expected economic data, but we are still keeping our call on safer rather than risky assets. This month, we are recommending investors look at US mortgage backed securities, which are essentially a sub structure of the array of securities issued by the US government.

U – shape more likely than V-shape recovery

We probably sound like a broken recorder but make no mistake – the recent rally in the equity market was due to government stimulus and spending. This has led to a sharp increase in exports from most economies boosting production and GDP growth. However, the job market which has been a lagging indicator continues to be weak. We suspect that the US unemployment rate, which was at 9.8% (see Figure 1) could hit 10% or more. This could put a dampener on Asian exports and could hit jobless recovery of the economy. As a result, we still think that the jobless recession in Asia is not over, unlike the consensus.

Large downside risks are unlikely

Nevertheless, we do not see large downside risks and would envisage a bumpy recovery for the global economy. This volatile ride higher for risky assets is likely to continue until we have reached “an equilibrium stage” where by the Chinese government feels comfortable with un-pegging their currency to the US dollar. This, as Bill Gross of PIMCO pointed out could signal the beginning of a new era for Asian economies. Figure 2 shows that companies in the non financial sector have more cash now and they are better prepared for an economic slowdown. This provides a cushion for negative company equity.

Worth taking a look at MBS

Given our scenario for a slow recovery, we feel that mortgage backed securities are relatively attractive.

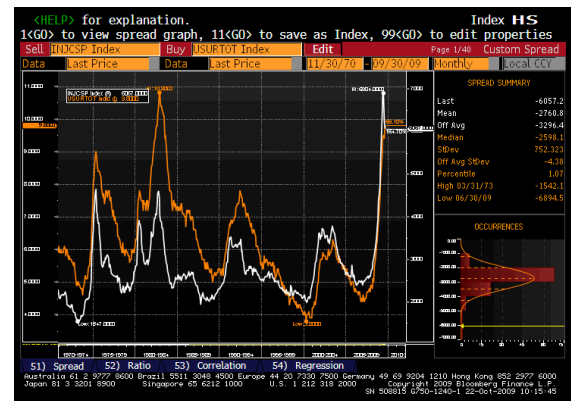


Figure 1: US unemployment rate and continuing claims
 Source: Bloomberg

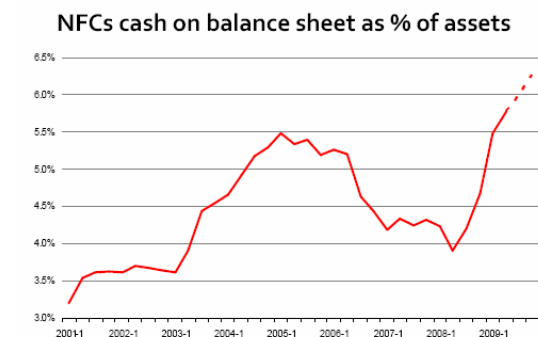


Figure 2: Cash as a percentage of assets on non financial companies
 Source: SG Global Economic Research, BLS, as of 21 October 2009

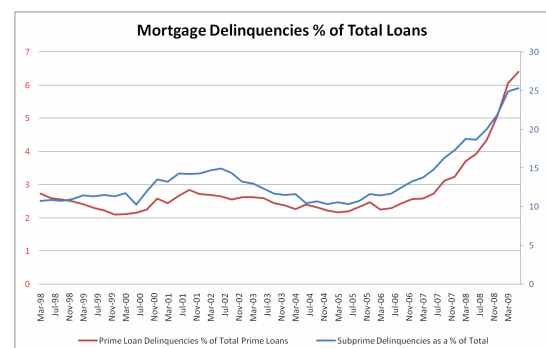


Figure 3: Mortgage Delinquencies
 Source: Bloomberg

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Unit Trust Focus of the Month

The amount of delinquents in MBS are high

Figure 3 shows the mortgage delinquencies in the sub prime and prime loans in the US, which have continued to hit new highs in recent quarters. This has prompted the US government to step into the market by taking over Freddie and Fannie Mae and even created incentives for banks to modify mortgage loans with home owners. Given the amount of distress in the sector, we feel that this could be an opportunistic time to look at MBS.

But people must and can afford their mortgage payment

Whilst the distress in the mortgage market continues to be high, the affordability of the US home owner did not drop as much. Figure 4 shows that Americans can still afford homes, meaning that people can still afford to pay their mortgages. Realize this – if there is anything that consumer is going to spend, it would be on their mortgages because the US government wants the people to save and people are not going to spend as their pre crisis. If we observe the personal income levels for the US consumer (see figure 5), the net income is decreasing meaning that the consumer is still facing headwinds.

Figure 6 shows the prepayment rates for a typical 30 year mortgage issued by Fannie Mae. As the diagram shows, the spread between the prepayment rates for the mortgages have widened should we see a drop of 300 basis points on the mortgage rate. This shows that the dealers have seen an improvement in the payment ability on mortgage backed securities.

Recommended Fund

We like the Franklin Templeton US Government Bond Fund, which invests in US mortgage backed securities. The fund is mainly for conservative investors who want to participate in the US mortgage market.

Franklin Templeton US Government Bond Fund Performance (as of 22 October 2009)

	1 mth	3 mth	YTD	1 Year	3 Year	5 Year
Absolute Return	0.49	1.48	4.02	5.82	N.A	N.A
Maximum Drawdown				-2.62		
Volatility				3.60		
Semi variance				3.47		
Sortino Ratio				2.09		



Figure 4: US Home Affordability Index
Source: Bloomberg

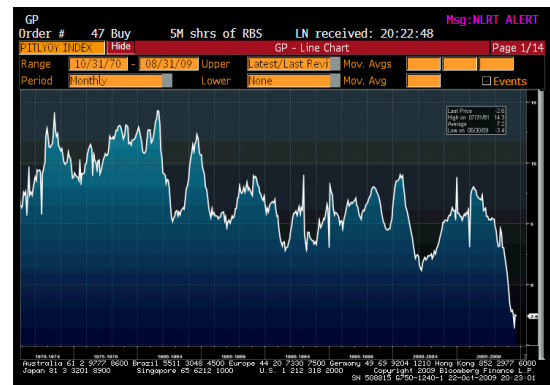


Figure 5: US Personal Income Year on year Growth
Source: Bloomberg



Figure 6: US Dealers forecast on a typical 30 year Fannie Mortgage Loan
Source: Bloomberg



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Asset Class Update

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