

August 2008: Markets go hesitant to the year end

Good news and bad news

During the summer, market sentiment shifted somewhat – in a positive direction in the USA and in a negative one in Europe. The shift came out as a weak relative performance of the European equity markets and the strengthening of the U.S. dollar. The brighter forecasts stem from the price of crude oil and raw materials starting to fall and stronger-than-expected U.S. economic growth. The price of crude oil has fallen by 35 dollars from the July highs despite the crisis in Georgia and other production disturbances. U.S. economic growth, on the other hand, accelerated to a rate of 3.3 percent as a result of strong exports and a tax breaks.

The more negative expectations were fuelled by the still-bleak outlooks of the U.S. housing market, fears about banks and high inflation. The European Central Bank has justified raising its refinancing rate and exercising tight monetary policy with runaway inflation. However, the interest rate rise in July was the last straw, that crushed business outlooks in the euro zone. The Ifo Index, which describes the business outlook expectations of German manufacturing companies, and the INSEE Index in France fell to their lowest levels since 2005. Industry has not been so pessimistic in Italy since the year 2001.

Emerging market equities in decline

The crisis in Georgia thoroughly unnerved western investors in Russia. Moreover, declining raw material prices, a fear of companies falling foul of the authorities (e.g. the dispute over the management of British Petroleum's subsidiary TNK-BP and the tax ambiguities of steel company Mechel) and high inflation caused extreme market movements and capital outflow from Russia. The economic impact of the conflict between Georgia and Russia is expected to remain slight, as the economic fundamentals are strong: consumption demand is on the rise and, despite the recent decline, the high price of oil still supports the Russian economy. We believe that the Russian financial and currency markets may continue to be hampered by nervousness in the coming months, but we are hopeful with respect to the Russian corporate bond market outlook, in particular.

Russian equity prices have dropped by nearly 30 percent since the end of June. In Latin America, the decline in raw material prices has caused prices to slide

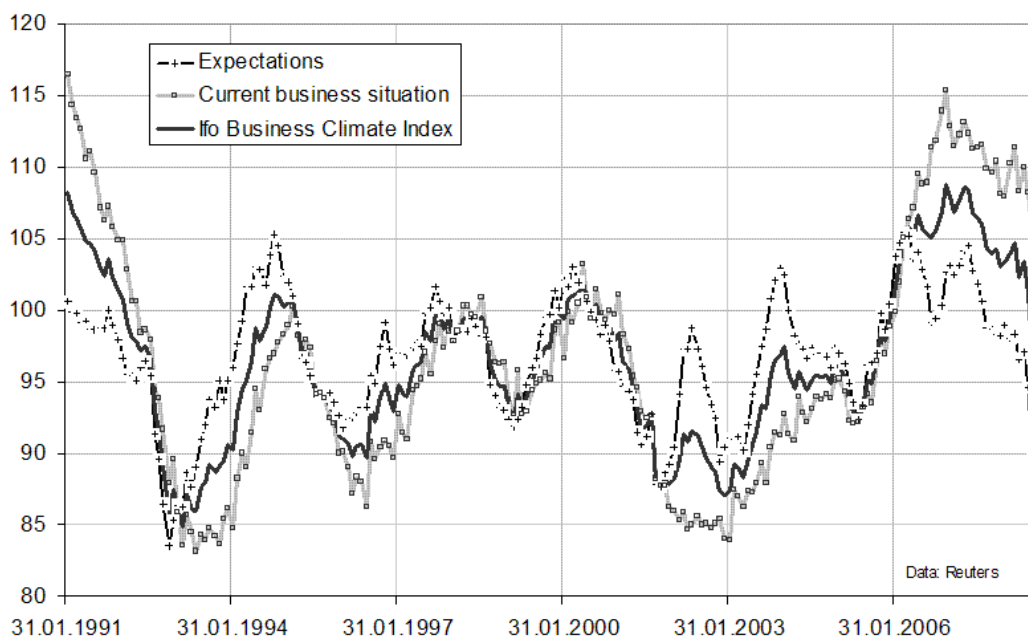
by over 15 percent. Asian equity prices have also fallen by over 10 percent on average measured by MSCI's regional indexes. Weakening economic growth and a poor economic outlook in China have been partly to blame for the decline in Asian equity prices. In China, second quarter GDP growth slowed to 10.1 percent, compared with 11.9 percent in 2007. The slight decrease in growth carries a positive effect by easing inflationary pressures.

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A tentative attempt to rally was seen in August amid falling crude oil prices. A lasting decline in oil prices would further refresh the equity markets and ease inflationary pressures. Equity market profit outlooks for 2009 are still high in relation to the economic growth outlook. We expect a decrease in profit outlooks to be likely, although the deteriorated operating environment has been largely factored into market prices. Conditions that would allow a more sustainable rise in equity prices will remain elusive until the weakening profit trend eventually reaches a turning point.

In the euro zone, the fixed income outlook is overshadowed by the hard line of the European Central Bank. Recent comments by its board members have still been concerned about a possible increase in wage demands. The tightening of liquidity, which traditionally takes place at the year-end, and the relentless distrust in the interbank markets, which is reflected in high Euribor rates, add to the unpredictability in the money markets. On the corporate bond markets, spreads in both the Investment Grade and High Yield classes offer good compensation for default risks, but investors' appetite to purchase is low.

Figure: German manufacturing companies' business outlook expectations have deteriorated rapidly



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