



## Update by Chris Wozniak, Director of Global Bonds and Currencies

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### *Global Economics*

#### *US*

The US Federal Reserve (Fed) left interest rates unchanged as expected in September, citing “reduced impetus from energy prices” as the reason that inflationary pressures will probably ease. In fact, August CPI seemed to confirm this observation, with the monthly rise of 0.2% only half the increase seen in July. Meanwhile, evidence of a slowdown in the housing market continued to mount, with August housing starting down at 6% (although new home sales still rose). That said, the Fed’s Poole noted that the emphasis on housing is somewhat overdone, but that the economy is slowing and inflation is under control. This has led some market players to look for a rate reduction in the first half of next year. Durable goods orders were also weaker than expected, falling 0.5% overall on the month in August. Finally, the July trade deficit set another record, widening by 5% to \$68 billion, although July was also the month that saw the peak in oil prices and this undoubtedly added to export values. The IMF however warned that a disorderly fall in the dollar is the biggest risk to investors, and financial markets are not taking this properly into account. US 10-year bond yields headed lower over the course of the month, ending at 4.63% compared to starting levels at 4.72%.

#### *Europe*

The European Central Bank (ECB) continued to respond hawkishly to new data releases, noting that “strong vigilance” on inflation pressures is still necessary since they could persist into 2007. Markets see a further rate increase in October. September eurozone consumer confidence increased to its highest level in more than 5 years, while inflation fell to below 2% for the first time since January 2005. That was probably thanks in large part to the decline in oil prices during the month of August, but the central bank nevertheless will remain attuned to the fact that lower energy prices and stronger confidence will amount to a boost to spending. That said, the Ifo Institute warned that the ECB should not raise rates beyond the “neutral” level.

#### *UK*

The picture in the UK remained quite different, with housing market variables holding their value in spite of the August interest rate increase from the Bank of England. That said, the MPC were unanimous in their decision to keep rates on hold in September, with the expectation that inflation will probably slow next year, particularly in the wake of the decline in recent oil prices. The Nationwide house price survey rose 8.2% on the year in September, the fastest pace of growth since February of last year, while UK mortgage approvals held close to a five-month high in August. Second quarter GDP was however revised down to 0.7% on the quarter, though unchanged from the first quarter. The continued strength of key economic variables has bolstered the case for a rate increase in November, although further increases beyond that level appear questionable given the outlook for a slowdown in the economy next year.



### *Japan*

In Japan, Shinzo Abe was elected to the post of prime minister. Bank of Japan Governor Fukui noted that consumer prices will keep rising, and last month's revision to consumer prices has not affected the central bank's outlook. He also noted that strong growth in the corporate sector is expected to spread to the consumer sector and contribute to a persistent growth trend. After falling in July, retail sales recovered in August, rising a greater-than-expected 2% on the month. In addition, Japanese factory output rose to a record in August, while core consumer prices increased to a 0.3% annual rate from 0.2% in August.

### *Market Outlook and Portfolio Strategy*

#### *Currencies*

The dollar strengthened against world currencies on a trade-weighted basis in September, ending the month at 1.26 versus the euro compared to starting levels at 1.28, while rising to 118.18 versus the yen compared to starting levels at 117.09. Against sterling, the dollar also strengthened, rising to 1.86 from 1.90. The yen continued to weaken in September on a trade-weighted basis, while the euro and sterling remained largely flat. A soft-landing scenario for the US economy is undoubtedly a short-term dollar positive, but in the longer term we feel that the US currency is still likely to be undermined by persistently large external deficits.

#### *Government bonds*

US 10-year bond yields headed lower over the course of the month, ending at 4.63% compared to starting levels at 4.72%. UK yields were broadly unchanged over the month, prevented from following US yields lower by the stronger economic backdrop. Yields in the eurozone fell marginally in September from 3.76% to 3.70%. Ten-year yields were unchanged on the month, ending at 1.66%.

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