Friday, February 25th 2011

Where to start? Everything is happening everywhere! A friend said to us that things are happening so fast that listening to the news is like trying to read Playboy magazine with your wife turning the pages… We can understand. Lifetime fixtures are falling all around us. Blink and the landscape has changed. It feels like the rapid collapse of the Soviet Union some years back, this time on fast forward. Was Ben Ali "Miss January" to be forgotten come Mubarak as "Miss February" already obliterated by an early glimpse at Miss March, Qaddafi?

It all is scary, oil prices are spiking, Iranian warships passed the Suez Canal, global equities are dropping, or are they? Actually, not much has happened as far as market reactions. Yes, spot oil, especially that of the Brent persuasion, has spiked but the forward curves imply that this is only a temporary supply problem- Saudi Arabia will cover the shortfall easily in the very near future. Treasury yields have held more or less steady- The 10 year T. Note yields today 3.47% much like it did before all this. No one talks of Ireland, Greece or of other PIIGS anymore.

We would like to think that the markets are telling us that the basics of the world's economies are doing fine and getting better. We would venture that in looking beyond the immediate smoke-covered CNN screen we may see great opportunities! Much like the global growth triggered by the rebuilding of Eastern Europe, true democracy for over 150 million North African Arabs and Egyptians may bring peace and prosperity way beyond their own borders! Perhaps Iranian leadership will understand the truth of the protests around them? Maybe we are not en-route to apocalyptic times but rather to times of great, global prosperity?

Stock markets seem to be discarding the disaster scenarios, bond markets seem to be supportive of this view too. Investors have not flocked into Gold as one may expect, the US$, albeit a safe-haven when dangers arise, has held in a narrow band. The Swiss Franc has been the exception as it is rallying more and further every day. We can't understand what is driving the CHF and find that at these levels 0.925 to the US$ and 1.28 for the Euro it is very lofty.

We do remain long-term bullish on oil though. Interim disruptions and resulting spikes aside, we note that the world oil use is now running at over 88 million barrels per day. In 2005 this figure was 80 million. A 10% increase as fuel economy has improved on car fleets, the latest aircrafts consume 20% less than yesteryear's models, windmills proliferate beyond the low lands of Holland and every government subsidizes solar energy whilst we are just seeing the light at the end of a huge recession. We stay with energy. We stay with our equities and we remain light on our bonds (the risks we see in bonds are credit related rather than inflation-risk affected).

Will some imaginative Hedge Fund managers now invest in Israel, as a leveraged play on the normalization of the Arab world? Maybe, maybe not, but we like the idea that they *can* take such views and positions and sometimes may be right, big-time, so we remain with our relatively large Hedge Fund exposures.

We leave you to follow your CNN with Doris Day's words "What will be will be…" with a backdrop of Bogey & Becall leaving Casablanca…

Currencies

- The US Dollar fell this week as growing turmoil and violence in the Middle East made investors opt for the safety of the Japanese Yen and Swiss Franc. The Yen has risen 1.5 percent this week against the Dollar, the biggest gain this year. The Franc has advanced 2.1 percent against the Dollar since Feb 18. The Franc climbed to a record 92.28 centimes today before trading at 92.80
- The British Pound also weakened this week against most major currencies, in line with the declines of the US Dollar. It is currently at 1.165 versus the Euro, having begun the week at 1.187
- Still, we remain of the view that the Swiss Franc should weaken from these much extended levels, barring any major geopolitical event and/or renewed Debt issues within the EU.
- Meanwhile, the Euro advanced versus the US Dollar this week amid rising speculation that European Central Bank officials will signal that they are contemplating raising interest rates (we do not expect any action though) to combat inflationary pressures. The Euro has risen to a high of 1.384 this week versus the US Dollar from 1.369 at the beginning of the week. It is currently trading at around 1.38.
- We think the Euro could well rise to test the $1.40 mark but long term we do expect the common currency ultimately to come back under pressure from sovereign debt issues.
- Commodity related currencies such as the Australian and Canadian Dollars were higher this week versus the US Dollar on higher commodity prices but were weaker against the Euro, as many market participants anticipate interest rate differentials will lower.

Fixed Income

- Government bonds gained this week as investors sought the safest government securities amid violence in Libya and the threat of contagion in the region.
- Yields on 10 yr US Treasuries dropped by 12 basis points this week to 3.462% currently and by 14 basis points for 30 yr US treasuries to 4.545%. Yields on shorter term US government securities were stable.
- Long term European government bonds followed the same path as their US counterparts, but not for shorter term securities as speculation grows that the ECB will become more hawkish due to inflationary pressures. The yield on 2yr German Bunds rose by 15 basis points this week to 1.542%.
- Investment grade corporate bonds were robust this week but high yield securities' prices dropped on lower appetite for risk.
- We remain keen on higher yielding bonds, and stay away from government and emerging markets sovereign bond. We find that High Yield bonds of all kinds compensate for their implicit credit risks and will be less sensitive to inflationary perceptions.

Equities

- Global stock markets dropped sharply this week as investors continued to fret over turmoil in Libya and how the resulting surge in oil prices might impact the global economic recovery. The MSCI World index is down -2.6% for the week as of yesterday's close.
- The major loss came in the first part of the week, and have tempered slightly following reassurances from Saudi Arabia and the International Energy Agency that global oil production won't be significantly affected by the turmoil in Libya. Asian and European equity markets are actually up for the day as we write this.
- Cyclical sectors underperformed this week on the back of the sharp decline in appetite for risk, with the industrials, consumer discretionary, financials and technology sectors seeing the sharpest losses.
- Conversely, more defensive sectors such as consumer staples, health care and utilities outperformed, although these are still down by roughly 1% for the week.
- The best performer was the energy sector, which is only slightly negative for the week, as oil prices reached levels last seen 2.5 years ago.
- Volatility spiked this week, with the VIX index rising by nearly 30% for the week to 21.32 currently. We expect the VIX index to remain elevated as long as we do not see some sort of resolution to the Libya debacle and the turmoil in the Middle East region.
- Our view on equities remain constructive in general for the year given improving economic growth, attractive valuations and strong corporate health combined with the relative unattractiveness of fixed income securities.
- However, we do anticipate continued pressure in the short term given the significant run-up in asset prices and the Middle East situation, inflation concerns and Europe's debt crisis which is far from resolved.

Emerging Markets

- Emerging Market equities did even worse than their developed counterparts this week, with the MSCI EM index down by 3.1% as of yesterday's close. This brings the losses for the year to 5.6%...
- Losses this week were driven by the turmoil in Libya and the broader region, compounding the inflationary pressures on many EM countries through higher oil prices. However, with yesterday's retreat in oil prices, most EM markets are up today.
- Middle Eastern stock markets were the most affected. Turkey also was a big loser this week, with its major index the ISE 100 down 7% for the week. Turkey is negatively affected as the higher oil prices negatively impact its current account deficit.
- Chinese and Brazilian stocks outperformed this week (at last), with the Shanghai SE composite index flat for the week and the Ibovespa down by 1%.
- Separately, Russia's central bank unexpectedly lifted the refinancing rate from a record low this week, the first increase since December 2008, and boosted reserve requirements for a second month to curb inflation.
- Meanwhile, Asian currencies are set for a weekly decline, led by the Taiwan Dollar and South Korea's Won, as the turmoil in Libya pushed up oil prices and sapped demand for emerging-market assets.

Commodities

- Commodities rose again his week, led by massive gains in energy. Agriculture and industrial metals were down for the week, while precious metals were up.
- With the turmoil in Libya and in the broader region, crude oil prices jumped by 14% this week, reaching a high of $103.41 per barrel, a level last seen over 2 and a half year ago! Oil prices have declined however following assurances from OPEC in general and from Saudi Arabia in particular that they would be able to increase supply to cover for any shortfalls from Libya. Crude oil prices are now at $97.84 a barrel.
- Precious metals gained this week, with gold and silver both up around 1% on the week, but price action was choppy. Gold is currently at $1402.5 per ounce, having reached a high for the week of $1418.2
- Industrial metals were slightly negative for the week with the decline in appetite for risk while agriculture was down by roughly 4.5%, as measured by the S&P GSCI agriculture index.
- We believe that the current environment will continue to be supportive for commodities as supply and demand fundamentals continue to be in focus.