

INVESTMENT NOTE

June 2011

Risk On, Risk Off

Directionless markets focus on short term news.

A glance at the chart of any of the major global equity markets reveals that equities have barely moved a step since the beginning of February, around the time when events in Egypt began to escalate. Since then geopolitical events and natural disasters have seen equity markets develop into a saw-edged pattern reflecting very short term “risk on, risk off” trading with no real direction. The financial media attempt to ascribe a wholly discreet reason for every twitch and turn in daily movements, but it remains a frustrating market for those trying to understand whether we are entering the final chapter of the global financial crisis or simply caught in a short term ‘value trap’ which will see equities enter into a new late-bull stage.



In the absence of any new bad news, the equity market appears perfectly capable of rallying 5% or more flushed as it is with cheap cash and a generally healthy picture emerging from corporate earnings which have been consistently beating analyst forecasts for the last three quarters and raising earnings estimates in a challenging environment. In the fleeting periods of confidence, money has flowed quickly into commodities, Emerging Market, equities and the Euro. However, as we have seen with the most recent US and UK growth scares, combined with a re-emergence of worries over the unending drama of Greek debt, the market quickly switches back to “risk off” favouring the US dollar, Government bonds and gold.

In the UK, this can be most clearly seen in the emergence of polarised views on the Gilt market. The bullish view on bonds has been driven by fears over the fragility of the UK economic recovery and the prospect of interest rates remaining lower for longer. This is compounded by an expectation that austerity measures have yet to bite when the economy is already sluggish. Furthermore, there is now speculation that the disappointing recovery may lead to a second round of quantitative easing, putting downward pressure on yields.

The countering bearish view is driven by the perception of the Bank of England holding on to a rising balloon of inflation (currently at 4.5%) commodity price inflation embedding itself as a permanent rise in prices and rating agency Moody’s, among others - now placing the UK’s triple AAA debt rating under scrutiny. All of these factors have combined to put some downward pressure on Sterling although with the obvious problems afflicting the Euro, US dollar and Japanese Yen, it is not always apparent. **However, at IOAM, we do take this latter view as being likely to prevail in the longer term.** We are aware of the significant foreign support for Gilts which may take flight in the event of an incremental downgrade to UK growth, something which, ironically, forms part of the bull case for Gilts and lower yields.

We currently see some parallels with the Gilt market rally in the third quarter of 2010, all be it with far less of an oversold position in equities, after which the Gilt market quickly declined by nearly 7%. We are currently in a ‘quiet patch’ in terms of corporate earnings news flow and expect macro and geo-political events to hold sway in the short term. **However, then, as now we reiterate our positive view on risk assets and expect equities to return to favour at the expense of fixed interest securities, particularly Gilts as the summer months unfold.**

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