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WEEKLY RESEARCH NOTES

The summer of content

JG Ballard, author of *Empire of the Sun*, once said that: "I would sum up my fear about the future in one word: boring. And that's my one fear: that everything has happened; nothing exciting or new or interesting is ever going to happen again. The future is just going to be a vast, conforming suburb of the soul." The comforting thing about markets is that, whether up or down, they are rarely dull. They can be capricious and in spite of the teachings of modern portfolio theory, are rarely fully coherent or conforming.

However, it may be that the stage is set for a period of quiescence. When a wise old bird like the Bank of England declares the worst of the credit crunch is past it behoves the young and shrill to take note. Institutional investors too have called time on the immediate crisis and are looking beyond the fierce urgency of now. Investor behaviour over the last few weeks has been remarkably consistent. Opportunistic risk seeking is the order of the day rather than the timidity that characterized the final quarter of 2007.

The signs are clear. Flows into developed country stock markets as tracked by State Street Global Markets' Cross-border Equity Flow Indicator (X-EFI) have recorded their highest monthly reading since August last year when the credit crunch started. In the past month flows into these markets were 72nd percentile (only higher on 28 percent of occasions in the eleven-year history of the X-EFI). One month ago developed market equity flows were pallid (30th percentile) and at the start of the year they were wretched (8th percentile, therefore higher on 92 percent of monthly readings). Japan has seen flows at close to record levels in the last fortnight.

Flows at the sector level also reflect the revival in risk appetite. Institutional investors are buying sectors such as Financials and Consumer Discretionary. Even IT and Energy flows have picked up markedly in recent weeks. Defensive sectors such as Consumer Staples and Health Care are being sold globally.

Prices tell a similar story. Since Bear Stearns Sunday (March 16th) the S&P500 is up 7.53 percent, the FTSE100 12.43 percent and the Nikkei 225 17.49 percent. World equity markets are enjoying their best month for more than a year. Wherever you chose to look there are signs of equanimity breaking out. The iTraxx Europe index of investment grade CDS, a good barometer of credit market sentiment, has seen spreads fall from 160 basis points on March 13 (Bear Stearns Sunday minus three days) to 71 basis points, a fall of 55 percent in seven weeks.

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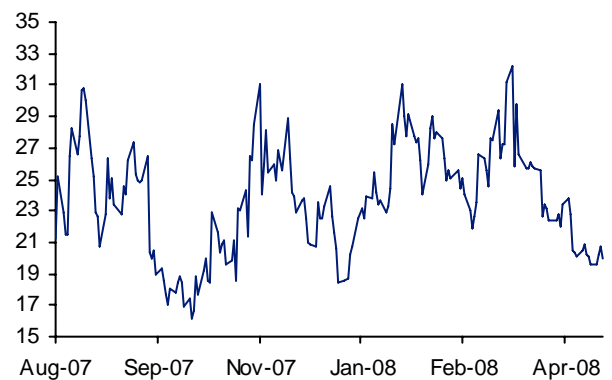


In mid-March the Vix index of expected US stock market volatility hit 32, it has been trading around 20 this week. But perhaps the most telling evidence of returning risk appetite is rising global bond yields. The safe-haven bid has disappeared from markets and with it the sense that this is a crisis that is out of control. The modest rally in the dollar in the wake of this week's Fed rate cut is further evidence that markets now believe that the emergency measures undertaken since March are working and policy can be normalized. The rescue of Bear Stearns and the opening of the discount window to broker dealers put a line under fears of systemic financial risk. The credit crisis has further to run, but markets are close to a period of stasis.

There is still an argument between bulls who believe equity markets are cheap because of historically low price earnings ratios and those of a more glass half-full mind-set that think the "e" in this p/e calculation is unsustainable. The economy will dictate the outcome. Any sustained slowdown will inevitably put pressure on what look like peak earnings. But, economic data is not deteriorating as fast as many had expected. The tug-of-war between conflicting views may result in a stalemate for the next few months.

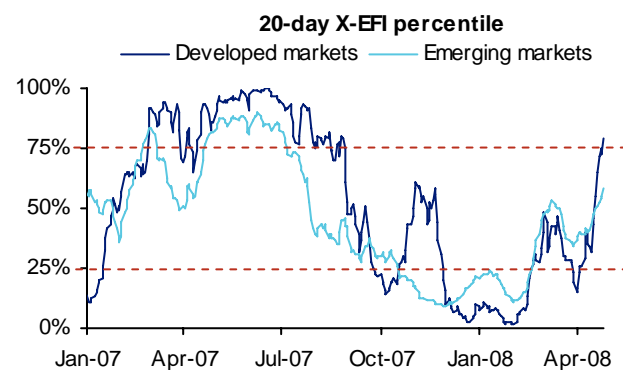
Unfortunately for JG Ballard and adrenaline junkies, markets may well stay dull and a little bit boring. As the Old Lady of Threadneedle Street puts it in the *Financial Stability Report*: "The most likely path ahead is that confidence and risk appetite turn gradually as market participants recognise that some assets look cheap on a fundamentals basis." Apart from the odd use of the plural, there is nothing in that assessment to disagree with. Welcome to the summer of content. It is a much needed period of respite.

Chart 1: As the VIX index falls ...



Source: State Street Global Markets

Chart 2: ... equity flows recover



Source: State Street Global Markets

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