

15 May 2008

WEEKLY RESEARCH NOTES

Material witness

London, E13, is not a postcode that is on the itinerary of most tourists. The home of West Ham United Football Club is a long way from the glitzy streets of Mayfair and Chelsea. Though arguably the least glamorous of the big London sides, it can boast a proud heritage. Its distinguished alma mater includes three of the team that won the World Cup for England for the first and only time in 1966. However, probably the one thing everyone knows about West Ham is its club anthem "I'm Forever Blowing Bubbles".

Sometimes it seems as though markets have adopted this song as their own. In recent years we have endured the TMT bubble and bust. We are in the midst of a credit market implosion following years of excess when risk was systematically mispriced. Now, if you enter the words "commodities" and "bubble" into any news search engine you will generate thousands of articles. Alan Greenspan believed that it is only possible to spot bubbles in retrospect after a nasty correction. It seems as if the world's commentators disagree wholeheartedly when it comes to commodities.

The view of institutional investors offers a different perspective on this debate. The picture is a mixed one. In January, the first sign of rising risk appetite was a sharp spike in flows into commodity producing nations in Latin America. One-month flows across developed equity markets languished in the 2nd percentile (flows higher on 98 percent of one-month periods in the 11-year history of the Cross-border Equity Flow Indicator). However, selling had just turned to buying in commodity-exporting Latin America, with one month flows in the 51st percentile.

It seemed as if markets heavy with commodity plays were being sought out as safe havens. That proved a good trade. Commodities were one of the few asset classes (along with government bonds) that did well in the first quarter, with the S&P GSCI index rising 13.29 percent. But Latin American equities also fared reasonably well, declining 1.92 percent compared to a 9.53 percent fall in the MSCI World Index.

Now risk appetite has broadened markedly. Flows into developed markets over the last month now stand in the 94th percentile and momentum is strengthening. Flows into Latin America have not strengthened as much. Over one month flows currently stand in the 76th percentile. This, of course, is a relative judgment. But flows do reveal a shift in preferences. At the global sector level institutions are also tentatively selling Materials over the past month (see Chart 1).

The key to this behaviour may be the US dollar. The DXY index currency basket against the dollar is now up 3.7 percent from the lows it hit in mid-March. With recent testimony from officials suggesting interest rates in the US have fallen far enough for the time being, the Federal Reserve seems to have put a floor under the currency. The implications for commodities are clear. Commodities are priced in dollars, so some of their strength has reflected dollar weakness as producers aim to maintain margins or hedge by selling dollars.

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Contact Information

State Street Media Relations

> **Carolyn Cichon** +1 617 664 8672
ccichon@statestreet.com

> **Mary Bailey** +44 20 7864 7075
m Bailey@statestreet.com

Editor

> **Andrew Capon** +44 20-7864 7876
amcapon@statestreet.com

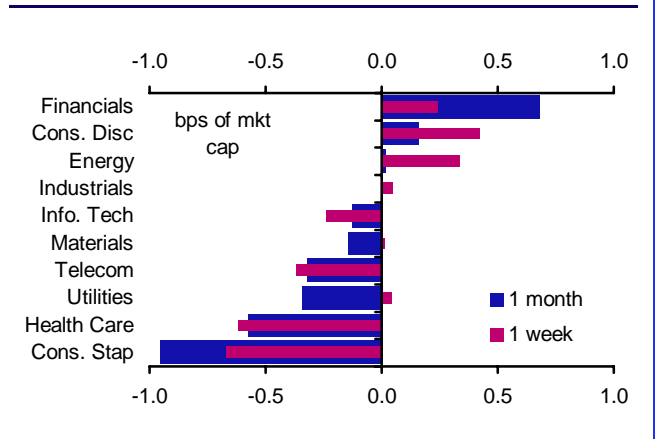


A stable or rising dollar could signal trouble ahead. The weak dollar and high commodity prices have been part of the reflation mechanism that has kept the world economy surprisingly strong through the credit crunch. Countries who export to the US, such as China, are forced to intervene and buy dollars to keep her manufacturing sector becoming uncompetitive as her currency rises. China accumulated reserves at a staggering rate of \$154 billion in the first quarter. Fed custody holdings, a good proxy for global reserve growth also grew at a record pace (see Chart 2). Commodity producing countries face a similar influx of capital as their exports command premium prices. No wonder that Brazil has joined the ranks of countries with sovereign wealth funds this week.

Dollar strength stops both sources of liquidity creation. That does not necessarily mean that commodity prices will fall, but the macro strategy team at State Street Global Markets is taking no chances. It has cut both its long position in the Australian dollar and South African rand. If equity flows into Materials, Energy and commodity countries turned sharply negative that would be a clear signal that investors think a bubble may have started to deflate. That could be bad news for markets (Energy is now the biggest sector in the S&P500 at 17.6 percent and Oil and Gas and Basic Materials the second and third largest in the FTSE100, at 20 percent and 17 percent, respectively).

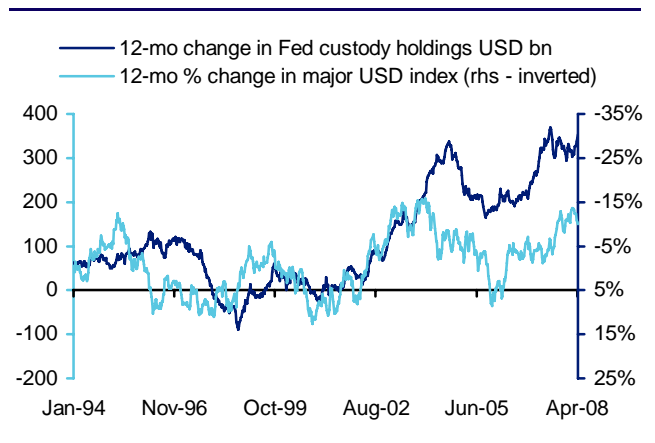
Watch this space. In the meantime those speculating in oil (up nearly 84 percent in a year) or wheat (up 93 percent) might do well to heed the words sung each home game by the faithful at Upton Park: "I'm forever blowing bubbles,/ Pretty bubbles in the air./ They fly so high,/ Nearly reach the sky,/ Then like my dreams,/ They fade and die."

Chart 1: Flows into commodity sectors soften



Source: State Street Global Markets

Chart 2: Stronger dollar likely to constrain reserve accumulation



Source: State Street Global Markets

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