

26 July 2007

WEEKLY RESEARCH NOTES

All that glisters

In Book V of Edmund Spenser's *The Faerie Queene* the Elizabethan poet describes a Golden Age. "For during Saturnes ancient raigne it's sayd, That all the world with goodnesse did abound: All loued vertue, no man was affrayd Of force, ne fraud in wight was to be found: No warre was knowne, no dreadfull trompets sound, Peace vniuersall rayn'd mongst men and beasts, And all things freely grew out of the ground: Iustice sate high ador'd with solemne feasts, And to all people did diuide her dred behests."

Markets have enjoyed a golden age of their own in more recent times. Since the post-TMT bubble nadir in March 2003, the MSCI Eafe Index has risen 162 percent and MSCI Emerging Market Index by a thumping 322 percent. Those of a bearish disposition will find little solace in recent history. The outperformance of emerging markets has soared to vertiginous levels (see Chart 1). Further, State Street Global Markets' measures of equity flows into developed are at an all time record over the last six months.

Is the gilt coming off? In equity markets prices have been zig-zagging of late and volatility as measured by the Vix Index in the US remains at elevated levels. Since the short-lived "made in China" swoon in late February the Vix has stubbornly stuck above 14 and currently stands at 18. However, this is still a golden scenario compared to the horror show unfolding in the credit world with CDS indices gapping, LBO financing faltering and hedge funds imploding.

A three-legged stool has supported risk appetite and prices. First, historically low interest rates created a "money for nothing" culture. Fortune has favoured the feckless – from the private equity buccaneers buying companies for six times Ebitda, to buy-to-let investors in property and punters in fiendishly complex structured credit products who have taken the plunge for 200 basis points above the risk-free rate and no questions asked. Rates have risen and latterly spreads have followed suit. The "money for nothing" era is over.

The second leg of the stool has been reserve accumulation by Asian central banks and commodity producing countries. This particular support for markets looks as sturdy as ever. Reserve accumulation amounted to \$850 billion in 2006 and is not slowing down. China alone has piled up \$400 billion in the last twelve months. Oil is near historic highs which keeps the flow of petrodollars (worth perhaps \$500 billion in 2006) on full bore. The bid of the sovereign wealth funds has never been more important to markets.

The final leg is the yen carry trade. Estimates vary, but the process of borrowing cheap yen to capture a yield spread is estimated to have pumped \$200 billion of liquidity into markets over the last year. This prop is beginning to have pressure applied. Japanese inflation will doubtless fall today. But that will not necessarily stop the Bank of Japan raising interest rates at its August 22nd meeting.

Our Research

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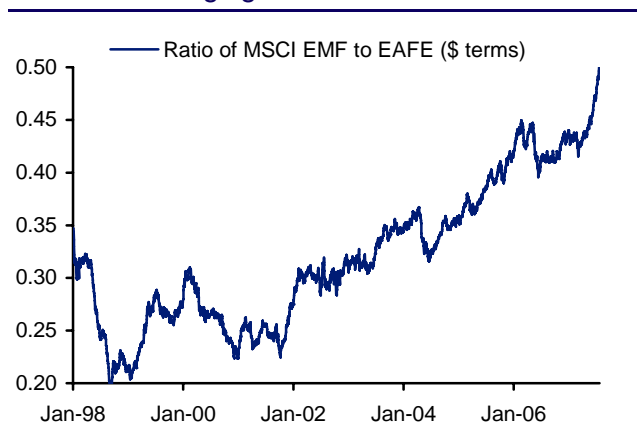


Short yen is still the consensus trade to end all consensus trades. Looking at six-month flows into the yen (our positioning proxy) for the Foreign Exchange Flow Indicator, the yen short is now 291 days old and counting. This is a record for the persistence of any short currency position dating back to 1995. A weak yen (and positive carry) have been a fixture of markets. But, even this trade is looking too well bid. In the past two weeks institutional investors have been tentatively buying back their short yen position.

A two-legged stool is just about viable. But if one of those legs wobbles the whole structure will become unstable. The progress of the yen and Japanese rates are well worth watching. Already, there are signs of investor nerves. State Street's Investor Confidence Index fell sharply this month. Flows into some of Asia's more flighty markets are also beginning to wane (see Chart 2).

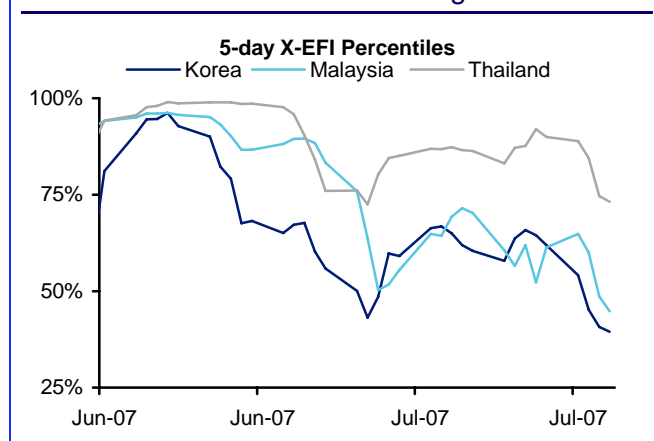
Spenser's famous work is an allegory on the reign of Elizabeth I, regarded at the time and by history as a golden age. But even poets have to live in the real world. *The Faerie Queene* is said to have been written under an oak tree by the river Blackwater on the poet's estate in Ireland. He had to flee those lands and his castle in 1598 during a bloody rebellion that claimed one of his children. All that glisters isn't golden.

Chart 1: Emerging markets take-off ...



Source: State Street Global Markets

Chart 2: ... but flows are softening



Source: State Street Global Markets

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