thesis
asset management

Thesis Market Commentary

March 2011

"The oil can is mightier than the sword" Everett Dirksen (US politician, 1964)

As the express train of revolutionary democracy grinds to an unwelcome halt at Libya junction, and Western governments, in particular, ponder the repercussions of direct intervention, all eyes are now focusing on the oil price. Predictions of $150 and above have, however, had to be rapidly revised following the tragic news from Japan.

First the bad news

Unless tensions in the Middle East subside rapidly, then prices seem set to remain relatively high, particularly if the major producers such as Saudi Arabia and Iran have production disrupted for an extended period.

Other at risk countries now are Iraq, Algeria, Oman, Yemen, Bahrain and not forgetting Nigeria (an oppressive regime with elections due next month).

History shows that social revolutions and wars in oil rich nations, since Gaddafi's takeover of Libya in 1969, have -with the notable exception of Kuwait post the Gulf war - all led to supplies falling by around one half in subsequent years and never fully recovering and were followed by global recessions. An extended period of prices above $115 would impact on the global economic recovery.

Having lost a significant amount of refining capacity Japan will need to import more oil (as well as LNG,etc) to replace power generation lost by the nuclear reactors.

A more positive slant on the situation

Loss of half Libya's production equates to c750k bpd (barrels per day), but OPEC has c5m bpd spare capacity and the OECD has a near record three months of inventories.
States such as the UAE and Qatar should be relatively immune to protest as both the countries themselves, as well as most of the population, are immensely wealthy.

Saudi Arabia could well jump the gun on OPEC and, with significant excess capacity, increase production imminently. On the political front the ruling monarchy is much better placed to endure protest and has the resources to pacify with enhanced social conditions. With the winter season (almost) behind us then the seasonal drop in demand will ease pricing pressures.

Although Japan is a net importer of oil, and therefore the longer term implications for energy prices generally are, as mentioned earlier, negative, in the short term the severe disruption to manufacturing capacity, and fears over the severity of the radiation fallout, imply a temporary fall off in demand – hence the 15% drop in prices since the weekend.

Comparing the current situation with previous conflicts

Oil prices rose by 240% in just a few weeks in 1973/74, by 150% in 6 months in 1978/79, also by 150% in 3 months in 1990 and 100% over 12 months in 2007/08. This time prices have risen 14% in one month and 36% in the last 8 months. Only the 1970s recession can be clearly attributed to the oil price rises.

Increased global demand over the last couple of years means the price would have risen anyway, probably to within the $70-$90 preferred OPEC range. The oil price spike to $150 a barrel in 2008 would have had little impact on GDP had it not been for the financial crisis which, contrary to some media reports, was the main cause of the subsequent recession.

The prospects for fiscal tightening are now receding, particularly in the US. The Fed held rates when unemployment stood at nearly 6% (9% currently) and inflation was 5.5% (3% now) – so unlikely to see a change of policy. With the UK and Japan the most vulnerable G7 economies to higher oil prices then, as we have cautioned before, talk of imminent rate hikes may be premature. My only reservation is that the casting vote on the Monetary Policy Committee may be in the hands of a Mr Bean (aka the Deputy Governor of course!).

As most of the oil price rises happened last year then economic forecasts have already factored in all bar the last 10%-20%, effectively, if held, knocking only 0.3% off GDP and adding 0.5% to inflation.

Scare stories of the vulnerability of Emerging economies to higher oil prices are overstated. Given their vastly superior growth rates the impact is in fact less than on Developed countries. According to Capital Economics, for example, although a $10 price per barrel rise in oil prices adds up to 1% to Chinese GDP; this still leaves the rate net of this at 7%-9%. This compares with the US where although the impact is only a quarter of that on China (typically around 0.3%) GDP afterwards is at a paltry 1.7%-2.7%!

No doubt forecasts will have to be tweaked as the situation develops. For now the speculators and oil producers will determine shorter term movements. In the meantime, having sold our MENA (Middle Eastern and North African) fund last November, I note that some aficionados of the Del Trotter school of investment theory ("Who dares wins") are already proposing buying into the region's equity markets (assuming they remain open long enough!). That requires nerves (not to mention other essential parts) of steel.

Michael Lally
Chief Investment Officer

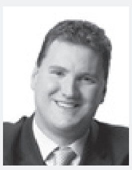
Email Michael with any feedback:
michael.lally@thesis-plc.com

Market News

European equities in catch up mode

European equities have sharply outperformed the FTSE 100 year to date. Indeed the UK market has also underperformed the US and Japan in 2011, but over the 12 months there is really not much difference between the major markets, except in respect of the US, which has been standout. So what can one read into these movements? Well in respect of the US, its GDP growth has been much improved compared to Europe and the further rise in the US ISM manufacturing index in February suggests that the economy has a lot of near-term momentum, which has helped.

Comparatively, European growth has lagged behind and issues over the fate of the Euro have bubbled away for some nine months now, but these fears look to be receding at long last. Buoyed by the financial strength of the German economy, European markets now appear to have moved into catch up mode - which in turn begs the question of why the UK should currently be lagging behind? As with any movement in stockmarkets it is impossible to pin down one single factor (much as the media likes to try and do so). However, the Middle East situation has clearly impacted the big oil stocks and the general retail sector has taken a pounding following Primark's poor results. Going forward, the FTSE 100 could potentially have a catch up period of its own, if conditions remain favourable for stockmarkets in the shorter term. In the longer term, UK share valuations look attractive and equities are a good place to be in this inflationary environment - in addition they are ably supported by plenty of corporate activity and takeovers.



Giles Marriage
Investment Manager

Email Giles with any feedback:
giles.marriage@thesis-plc.com

BP is the process of both selling and buying assets. After shedding its stakes in natural gas fields in the North Sea and in an onshore oil field in Dorset (Wytch Farm), BP is spending $7.2 billion to buy into India's fast-growing oil and natural gas business. BP will take a 30% stake in 23 oil and natural gas fields operated by **Reliance Industries**, India's largest private company. The two companies said they would also create a 50-50 joint venture to buy, transport and market natural gas, which is increasingly in demand in India as the country's economy grows at nearly 9% a year.

Elsewhere in the sector **Regal Petroleum**, the AIM-quoted oil and gas company, has been taken over by one of Ukraine's largest business conglomerates, **Energees Investments**. **General Electric** has also agreed to buy the **John Wood Group's** well-support business for about $2.8 billion. G.E. has already struck several deals, including the takeover of **Wellstream Holdings** two months ago.

Advisory and accountancy firm Ernst & Young has highlighted in a report that merger and acquisitions (M&A) activity in the global mining sector is expected to accelerate in 2011, fuelled by strong commodity prices and repaired balance sheets. Early signs that bank lending may recover this year could also give a further boost to the level of deals. The total M&A deal value surged 89% to $113.7 billion in 2010, with a jump in cross-border deals in emerging markets, even with limited access to debt funding.

On this theme - **Glencore**, the privately owned mining conglomerate, has recently opened talks with Sovereign wealth funds from China and Qatar to bring in a cornerstone investor for its blockbuster $60 billion London float.

Rio Tinto is refusing to give up on its acquisition of **Riversdale** and has extended its bid of 3.9 billion Australian dollars by 14 days. In addition, **Imerys** had made a binding $340 million offer to buy Rio's talc division.

Anglo American and **Lafarge** are in the process of forming a $2.8 billion UK joint venture - The deal will join Anglo American's Tarmac U.K. with Lafarge Cement U.K. in a company owned equally by Anglo and Lafarge. Together, the companies employ about 7,300 people in Britain, making cement, lime, aggregates, ready-mix concrete and asphalt.

Elsewhere, **Centrica**, the owner of **British Gas**, has unveiled a £2 billion gas deal with Qatar and Li Ka-shing, the octogenarian billionaire and one of Britain's biggest foreign investors, is close to clinching the acquisition of a £3.7 billion power distribution business in a deal that would give him control of half of Britain's electricity network.

Turning to shipping, shipyard owner **A&P Group** has been bought by **Atlantic & Peninsula Marine Services**. A&P's work includes repairs, conversion and fabrication work at two yards in north-east England - at Hebburn on the Tyne and in Middlesbrough on the Tees. This will hopefully be good news for jobs in the region.

Homebuilder **Persimmon** has reported a sharp rise in full-year profits after cutting costs and selling more houses. Pre-tax profits for 2010 came in at £153.9m, almost double the £77.9m the company made in 2009. It added that the average house sale price rose by 4% to

CONTINUED ON P3

Comparative Index performance

Indices	Value as at 28/02/11	% Change on Month	% Change 2011 year to date	% Change on 12 Months
FTSE 100 Share	5994.01	2.24%	1.59%	11.94%
FTSE All Share	3106.58	2.05%	1.43%	13.51%
Dow Jones	12226.34	2.81%	5.60%	18.41%
Euro Stoxx 50 EUR	3013.09	2.01%	7.89%	10.43%
Nikkei 225	10624.09	3.77%	3.86%	4.92%
FTSE A British Government All Stocks	152.60	-0.48%	-2.42%	1.15%
Sterling/US$	1.6257	1.52%	4.13%	6.69%
Sterling/Euro	1.1775	0.69%	0.95%	5.37%

Market News

£172,475. Rival **Taylor Wimpey**, has entered into final-stage talks over the sale of its North American business in a deal expected to fetch the UK housebuilder up to $1 billion.

Interserve are reportedly in advanced talks with **Mouchel** over a tie-up that would create one of Britain's biggest public sector outsourcing companies, where further details are expected soon.

News Corp, Rupert Murdoch's media group, is now close to an agreement with UK regulators in respect of a remedy for the apprehension about its £13.2 billion bid for **British Sky Broadcasting**.

Diageo has agreed to buy **Mey Icki**, a Turkish liquor company, in a deal that will expand the firm's global reach. The move is the first multibillion-dollar deal by Diageo in more than a decade, and is also its latest step to expand its developing markets presence in search of new areas for growth

Shares in **HMV Group** have fallen 20% after the struggling music and book retailer said full-year pre-tax profits would miss market expectations of £45m. The company also said it expected to breach its banking covenants when they are tested after its full-year results. It said it had started talks with its lenders with a view to changing its loan facilities.

International Airlines Group, formed by the merger of **British Airways** and **Iberia**, will look to buy out smaller European carriers before pursuing major deals further afield. IAG boss, Willie Walsh, said BA and Iberia had drawn up a shortlist of 12 targets to pursue after their $9 billion merger was completed late last year. The group wants to lead global consolidation of the airline industry by folding Asian and Latin American carriers into its network, but Europe is likely to be its first port of call.

About 20 bidders are finalising offers for all or parts of Astra Tech, the dental and medical devices unit that **AstraZeneca** hopes could fetch $2 billion. Astra Tech, which had revenues last year of $535 million, is the world's third-biggest dental implant maker.

CSR, a British chip maker, is to buy the **Zoran Corporation**, a maker of technology for digital photography and video. The deal is an effort by CSR to keep pace in the burgeoning market for smartphones with advanced cameras that can upload photos and video to various social media.

"The recent wave of Stock Exchange mergers marks an era of consolidation that will leave no more than four global trading firms in five years' time," Xavier Rolet, the chief executive of the **London Stock Exchange** (LSE) has said recently. This statement came following the LSE's purchase plans of Canadian peer **TMX Group** and **Deutsche Boerse's** deal with **NYSE Euronext**.

Banks – The Good, the Bad and the Ugly...

HSBC, Europe's biggest bank, has reported pre-tax profits of £11.8bn for 2010, more than double the figure for 2009. Losses from bad debts fell significantly. However, analysts said the results had still fallen slightly short of expectations.

Barclays reported pre-tax profits of £6.1bn for 2010, up nearly a third on 2009. This figure was better than the City's forecasts! Performance-related pay has fallen 7% to £3.4 billion compared to 2009, and has fallen by 12% in its Barclays Capital investment banking arm. Barclays Capital paid out £2.6 billion in bonuses, while its profits almost doubled to £4.8 billion. Barclays has also agreed a deal to buy Egg's more than one million UK credit card accounts from US bank Citigroup.

Royal Bank of Scotland is to push ahead with the sale of £1.6 billion of unwanted legacy loans from the boom years in commercial real estate, whilst Northern Rock is poised to launch a range of mortgages offering up to 90% of a property's value – will some banks never learn?!

Lloyds Banking Group's profits rose, but the shares fell on the day of the results, as chief Eric Daniels also departed. Even though the £2.2bn profit for 2010 was a vast improvement on last year's loss of £6.3bn, the bank has had to make £13.1bn of bad debt provisions. Ian Gordon, an analyst at Exane BNP Paribas, described the figures as a "horror show"!

Anglo Irish Bank, the lender whose huge bets on development have come to epitomise the reckless excess of Ireland's real estate bubble, said that it lost 17.6 billion euros in 2010.
This amount is a rather sad record for an Irish company.

Sources: Reuters, Citywire, BBC News & Dealbook.com