

Thesis Market Update

October 2011

"A strong and stable euro is as likely as deep-fried ice-cream"

Gisela Stuart MP

This is perhaps a very timely quote, from the Labour MP for Birmingham Edgbaston, given the remarkable resilience of the currency (until very recently) this year, a time when all other euro assets have been tumbling amid increasing concern as to the solvency of large parts of the European financial system. The fact that the Honorable Member happens to be German, a country not noted for its sense of humour, is also refreshingly pleasing.

So now we wait until next month to decide Greece's fate. Despite 70% of Germans apparently against the bailout, the Bundestag last week voted 6:1 in favour. Perhaps the politicians made the decision after lunch, ie. they were 'only following hors d'oeuvres' (sic). Bearing in mind these are defined as an appetiser before the main meal then there's probably more truth in this than you may think.

Let's not forget that German GDP only grew by a sluggish 0.1% in the second quarter - below the 0.2% Eurozone average - while the German Institute for Economic Research has revised down its estimates for next year's growth to 1.8%. And guess which previously insolvent state has just announced predicted 2.8% growth next year - Iceland.

This brings us back to the currency. Clearly the Euro has been artificially supported, with the Chinese a most influential, but low profile, angel. Taking the football analogy, we see the most likely outcome as being one of two scenarios, ie.

- Greece et al will face the ignominy of being cast into the Stygian darkness of non-league status, but - free of the euro shackles - use devaluation as a tool to eventually engineer a reasonable recovery. Better a Phoenix than a Dodo.
- The Euro league splits into two, ie. Premiership and the rest. A strong incentive to re-join the big boys - if they can afford it.

The question is whether the politicians decide or the markets. For now we can expect more fudges but with investors likely to take a haircut on Greek bonds worthy of Sweeney

Todd (ie. think 60% instead of the widely publicised 20%), then their patience is wearing thin. The EFSF (European Financial Stability Fund) won't be big enough to recapitalise all the weaker banks which are already finding access to capital markets increasingly difficult.

As I have mentioned before, the dollar is by far the most liquid and heavily traded currency, with the euro in second place but at around half the levels. Failing a collapse in talks then the trigger for a concerted attack may be the expected interest rate cut by the ECB either next month or in December. With daily turnover in the trillions (and an estimated 95% of this being speculative as opposed to commercial) one should never underestimate the power of markets to determine policies.

I name this ship QE2

The timing of the Bank of England's decision to inject a bigger than expected £75 billion of Quantitative Easing into the economy (aka QE2) caught many by surprise - hence the "shock and awe" media headlines - and not least the gilt market where prices in the medium to long end, ie. 8-15yrs (where the buy backs will be focused) rallied sharply. Coming ahead of the November inflation report this reflects the Bank's concern as to the deterioration in the immediate economic outlook and a likely undershooting of its 2% inflation target 'in the medium term'. Also, in light of the likely significant recapitalisation of European banks then expect further impetus, ie. a QE3, early next year.

Despite the preponderance of gilt Bears this year (at least until fairly recently) we have maintained our positions in clients' portfolios (focused at the medium/longer end of the curve). Whilst prices could edge higher, we are now more concerned with possible political U-turns (which could again raise the spectre of a possible sovereign downgrade) and are therefore closely monitoring yields with a view to implementing our strategy of reducing weightings and switching to the high grade corporate sector.

This Month

- Eurozone woes
- QE2 sets sail
- Bank downgrades
- Market News

Bank downgrades

In market terms, this wasn't a big issue; indeed many of the standalone ratings of the banks have actually been upgraded. What Moody's is doing is taking a view that there if there is less Government support for troubled banks in the future, and with the ring fencing of the traditional banking side, then there is consequently a greater probability of losses for senior bondholders. This was a fine-tuning of investment grades, not a wholesale downgrade, something markets had already largely discounted over the last few months.

Having hardly covered themselves in glory in 2008, ratings agencies are now conspicuously more proactive, so expect more big names to feature (in and out of the financials sector) over the next few months.

I've noticed that recently market commentators particularly favour the use of 'risk-on' or 'risk-off' to describe market movements and sentiment. Rather like traffic lights this should warn investors whether or not it is safe to proceed. Unfortunately, just when you decide to venture forth, there is always a good chance of being knocked sideways by a rogue driver jumping the lights.



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Fact - Greece has been in sovereign default for 105 of the last 200 years - it's what they do...

Despite the market volatility during the summer, private investors were net equity buyers throughout the period, adding £1.3 billion into the asset class between the start of June and 22 September. According to research from Capita Registrars, this represents the fifth consecutive period where private investors were net equity buyers, with £3.5 billion added since mid-May 2010, the longest sustained period of net buying since the research started six years ago. However, conversely, net retail fund sales fell to their lowest level since October 2008 in July, while equity funds saw net outflows for the first time in over two years, according to the Investment Management Association. Given the above conflicting stories - investors are clearly fickle beasts at present!

Along similar lines, a new study conducted by a Swiss university has reported that "Traders behave more recklessly and are more manipulative than psychopaths". "Naturally one can't characterise the traders as deranged", a prison official told Der Spiegel magazine. "But for example, they behaved more egotistically and were more willing to take risks than a group of psychopaths who took the same test". The Swiss clearly know about such matters, given UBS' reported £1.5 billion loss generated by rogue trader Kwaku Adoboli in September. This subsequently cost UBS' CEO Oswald Gruebel, his job. "I'm responsible for everything that happens at the bank," Mr Gruebel told a Swiss Sunday newspaper, "but if you ask me whether I feel guilty, then I would say no." What hope without leadership?

Comparative Index performance ▼

Indices	Value as at 30/09/11	% Change on Month	% Change 2011 year to date	% Change on 12 Months
FTSE 100 Share	5128.48	-4.93%	-13.08%	-7.57%
FTSE All Share	2654.38	-5.22%	-13.34%	-7.43%
Dow Jones	10913.38	-6.03%	-5.74%	1.16%
Euro Stoxx 50 EUR	2179.66	-5.32%	-21.95%	-20.68%
Nikkei 225	8700.29	-2.85%	-14.94%	-7.14%
FTSE A British Government All Stocks	166.46	3.30%	6.45%	3.33%
Sterling/US\$	1.5584	-4.10%	-0.18%	-0.84%
Sterling/Euro	1.1640	2.92%	-0.21%	1.01%

Market News

Financials

Santander UK is likely to acquire more than 300 branches from the state-backed **Royal Bank of Scotland** for more than £100 million less than the price agreed by the two banks last year, due to the current poor state of the economy.

Barclays has received the highest number of bank complaints during the first six months of the year, according to new data published by the Financial Services Authority. The FSA's figures showed that Barclays received 251,563 complaints, compared with 181,907 at **Lloyds TSB**, 168,888 for **Santander** and 147,109 against **NatWest**.

Man Group, the world's largest listed hedge fund manager, said clients withdrew money over the summer months (\$2.6 billion) at the fastest pace since early 2009 amid 'relentless volatility' in world markets, knocking its fragile recovery. The shares fell 21% on the day of the announcement.

Goldman Sachs is bracing itself for what could be one of its worst quarters since it went public 12 years ago and is preparing to expand its cost-cutting initiative by hundreds of millions of dollars, a move that could lead to 1,000 additional job losses.

Elsewhere, some of **Berkshire Hathaway's** \$43 billion cash hoard, usually intended for acquisitions, is to be used in a buy-back to bolster the flagging shares of Warren E. Buffett's company.

Consumer

Marks & Spencer has been fined £1 million for failing to protect customers, staff and workers from potential exposure to asbestos.

Warren Buffet has bought another 34 million shares in **Tesco** for £120 million, taking his stake to 3.6%.

Australia's competition watchdog has given the go-ahead to **SABMiller's** \$10 billion friendly acquisition of brewer **Fosters Group** as expected, saying the bid would not lessen competition.

Resources

Global miner **Rio Tinto** has not received any requests from Chinese buyers to delay iron ore shipments, a senior executive recently reported.

BP is planning a pipeline stretching 1,300km across three countries to bring gas from Azerbaijan to Europe.

Tech

According to reports **Facebook** has delayed its \$66.5 billion IPO until late 2012 in order to keep employees focused on their jobs rather than a pay-out.

Apple's iPad has captured 80% of the tablet computer market in the US and Canada in April to July whilst staff mourn the sad passing of inspirational leader Steve Jobs.

Yahoo has confirmed it has heard from potential buyers in an internal letter to employees and is exploring its strategic options.

Misys, the British banking software firm courted by a U.S. rival in the summer, posted a 4% rise in first-quarter revenue, helped by customer wins in Asia and the Middle East.

Eastman Kodak shares lost a quarter of their value after the loss-making digital imaging company revealed it was tapping \$160 million of a \$400 million credit facility.

Other news

U.S. pumps and valves manufacturer **Colfax**, 41% owned by billionaire brothers Steven and Mitchell Rales, has made an agreed £1.53 billion offer for **Charter International**, worth £9.10 a share, trumping **Melrose's** £1.43 billion conditional bid.

Albemarle & Bond reported a higher full-year pretax profit, bolstered by its pawnbroking business and strong contributions from gold buying, and said it expected record gold prices to aid growth in the new financial year.

Defence giant **BAE Systems** finally confirmed that it is cutting almost 3,000 jobs at sites across the country, mainly in its military aircraft division.

EasyJet has sent shockwaves through the aviation world after Europe's second-largest low-cost carrier said Sir Stelios Haji-Ioannou, its founder and largest shareholder, was planning to set up a new airline.

Finally, US regulators are considering action against **Standard & Poor's** for giving top ratings to mortgage-backed investments shortly before they imploded in the financial crisis. Surely not sour grapes over a debt downgrade?!



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Sources: Dealbook, Yahoo Finance, Mineweb, BBC News, Reuters, Citywire and Investment Week.

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