

INTERIM REPORT June 2011

I predicted in our 2nd Quarter 2011 review that sufficient unresolved events existed which until "played out" would keep markets generally within a tight trading range on low volumes. The then outstanding geopolitical and economic concerns have been further exacerbated by:-

- The repercussions of Japan's recent difficulties impacting global part supplies
- General price inflation
- Greek debt reschedule...by another name
- IMF chairman's resignation
- Ending of QE2 and other stimulus programmes and the possibilities of a QE3 in the USA
- No substantial relief in drought affected areas and appalling weather and floods in the southern US states.
- Sufficient downward revisions by corporations as to their overall 2011 performances
- Still unresolved conflicts in Libya and Yemen with the expectation of further unrest in neighboring undemocratic states. The first successful conviction of a "Wall Street" titan and the likelihood that a plethora of new prosecutions will finally be issued to big financial entities considered



the instigators of the financial melt-down

I shall wait until next month's 3rd Quarterly Review to address most of the above in detail and instead attempt here, to summarise the majority and highlight a few. I view it as likely that we shall see markets fall back in the short term as risk aversion increases and then create a low from which an extended "bull market" will be formed into the mid-long term.

The most important business and economical factors weighing on markets and general sentiment are QE2, price inflation and disrupted manufacturing performances. The latter is not surprising as the events in Japan have severely disrupted the manufacturing processes of important parts and components needed within every conceivable durable good made throughout the world. Supply lines have been restarted but expected electricity supply disruptions throughout their hot summer months will delay their opportunity of meeting outstanding or current demand. An additional boost to the USA manufacturing sectors recent boom was...in no small part... because of a specific stimulus package which is now effectively ended. The programme allowed buyers of major components to "depreciate"...for tax purposes their full cost within one year; rather than over the normal 8-12 years depending on the item. The unknown impact of the end of this programme...as much as important component supply disruptions... is the reason for the recent less bullish "full year" earning pro-



jections by Manufacturers.

When we add in the current price inflation of basic materials and energy with the mid term impact that a possible QE3 programme could be implemented; then the level of performance/ productivity uncertainty within the sector and general nervousness is understandable. Therefore the events of the past two months have not done much to clarify the overall situation nor aid future predictions.

The ending of of the USA's QE2 stimulus programme later this month has already been priced into the market. As yet no accurate assessment is possible as to whether other private and sovereign buyers of US debt, will be purchased at current levels and interest once the FED withdraws from their QE2 buying programme. The programme requires that the FED begins to sell their QE2 accumulated "T" bills into the marketplace at the same times as the normal "new issues" required by the US government to meet ongoing requirements will double supply at a time of skeptical demand. It is for this reason that some believe that a new... QE3 stimulus... is likely. If this is the case then markets will experience a short lived rally and then a severe correction.



The simple economical/mathematic reality is that an extra stimulus will dilute the US dollar's value further, requiring more USD to buy commodities, stocks and anything else priced in USD. The initial boost to markets will quickly dissipate as an understanding of the inevitable consequences of a new stimulus. The postponement of the sale of treasuries bought through QE2 coupled to the prospect that sometime in the future... when the then current "treasury issuance" to meet US government's normal needs... compete with the selling of the QE2 and a QE3 bought treasuries could have serious consequences.

However as with many other circumstances we are currently focused; it has an opposite/positive upside. Commodities will rise, multinational with diverse currency income will benefit as will exporters with now cheaper goods. It isn't that realistic opportunities don't exist within our current circumstances. It could be a minefield but with a little care and commonsense they can be successfully crossed. The elephant in the room is the level of increasing debt which if not addressed could cause a "systemic risk". No matter how skillfully you transverse the minefield if you are within range of a low yield atomic bomb your skill is negated; as indeed your life. It makes the profession of analysis and prediction fraught with consequences; especially within a two tiered process. Traders of options, FX and hedges change day to day results while the second tier seek mid to long term possibilities. This has not been a good time for traders as "range

bound" markets do not afford sufficient spread to hedge their options. In addition their buying/selling decisions are predicated on actual daily/trend movements and rarely on the underlying reasons behind the movement. For this reason the mine field we wish to cross is not that difficult. It's whether there is a/large bomb/s present.

We discussed in our last review whether China would have relief from the drought which was impacting one of their main growing regions. Sadly they didn't. This will have the affect of higher wheat and ancillary foodstuff prices; which will raise agriculture investment values.

Normally this would be a signal to buy those investments. It could also mean that oil prices would then fall as the increase spending on basic food would reduce available discretionary spending levels on unnecessary travel etc. This would suggest a good time for some profit taking for those already invested and an opportunity to buy the dip for those interested in entering/reentering this sector at a lower level. Ancillary effects would be that supermarkets would see lower sales as price margins narrow and less frequent trips impact "impulse buying" volumes etc. Never the less, if the dollar weakens then even oil would see a considerable jump and could reward the risk of holding the investment with a considerable upside gain.

Those are a few of the sample contradictory influences we con-

stantly face. The bomb or arsenals of bombs which can make the analysis irrelevant are many and varied. They certainly exist they have Greece especially, Piigs generally, Sovereign debt haircuts for banks, overall debt generally, withdrawal/ending of stimulus programmes etc., painted on each of them.

Since the meltdown, banks throughout the world have had unprecedented assistance to restore their balance sheets. In effect they have been and are still being protected. Greek debt is the equivalent of a bank manager giving an individual... fully maxed out on their creditcard with no real desire/possibility to change their spending habits... an increase to their credit limit. This decision has little to do with Greece but a default with a haircut will have an enormous, domino impact on banks (the largest holders of Greece and other Piigs countries debt) capital ratios. Even to or above the level of the sub prime debacle volume.

The Euro's strength (in a world of unloved currencies), in light of the proposed reschedule and a fixed date when "haircut protection" is withdrawn, remain. surprising. Once again it is the "trading" perception rather than a longer term logical one that prevails. If it allow us to pass through the minefield and offers us sufficient time to clear any and all bomb impact area, then although it will have a general impact we could use the event to our advantage. It is the timing that is critical and for those of a longer logical viewpoint much

harder to control. We have no real influence in any of the myriad possibilities/events which could be the catalyst for the deployment of bombs.

The prevailing recent viewpoint has been to sell the rallies and buy the dips. Tomorrow's USA unemployed figures is considered to be the catalyst of future sentiment. If private job creation figures are low then I expected markets to correct further. If the S&P500...now 1312...slips back much further then eventually 1300 will be tested and if breached then I can envision 1270 being reached before a base to rebuild the rally is seriously attempted. Today Moody down rated three major US banks and threatened to do the same to the USA, if the logjam in its government cannot resolve credit ceilings limits.

All of the above cause concern and uncertainty and if the complaisant confidence of those that believe central banks and governments will continue to pursue the philosophy of creating and supporting the policies of best asset value strategies; is undermined then we may see an extended correction across markets. This will be emotional rather than pragmatic but if we believe the "bear" viewpoint; is quite feasible.

The "bull" philosophy is also quite persuasive. Major corporations are awash in cash, improving productivity, reducing costs and the recent reduction in 2nd half profit forecasts they believe is caused more by Japan, weather and other temporary events/setbacks which will begin to clear by late summer. Underlying fundamentals would tend to support much of the "bulls" contention.

Therefore there is some compelling reasons on both side of the argument to consider and balance.

I believe tomorrow's non farm payroll figures will disappoint...if not this month then certainly next...as government could massage these with ancillary data. But short term general trends are likely to weaken further. The debate will be centered on the amount. Without a systemic event nothing much should change. Markets will probably trend lower by circa 3%. This would be a likely level to expect an attempt to rebuild the "bull" rally. It is at this time that consensus becomes vulnerable to any event which supports either side.

Logic would suppose... as there are more "probabilities" out there on the downside which could go wrong... that the likelihood would be that the "bears" will prevail. Current sentiment certainly supports that expectation.

There is little expectations that a few magic bullets will be created and applied to quickly resolve many of the outstanding issues which remain stubbornly difficult to rectify. The "log jam" in Washington is unlikely to ease anytime soon. The republican party... with their eyes on next year's US president election... will be reticent to gift President Obama any agreements which will improve his reelection chances. Never the less, I believe that the impact and uncertainty of many of the issues listed at the beginning of this report influenced corporate decisions to delay new hiring for a few months. I would expect them to continue their steady recruitment expansion once Japan or new sourced components allow full production.

The current uncertainty has seen a flight to bonds and this could greatly help the FED to sell their QE2 accumulated hoard. If there is no QE3 and governments and their Central Banks can improve their communication skills and better target the inevitable new stimulus programmes, to achieve or perceived to achieve tangible results then we may see the current

situation move more into a “soft summer correction”. Greece will get its “bail out” money. Some agreement on the USA’s “debt ceiling increase” will be made and some outstanding issues resolved. All these could further help support markets.

The nervousness however is tangible, risk adversed and emotionally based which could indicate considerable volatility to either side of the ‘bull-bear” divide. We shall monitor and advise accordingly.

Regards

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