WARWICK FINANCE SOCIETIES

Market Wrap-Up

Week ending January 20, 2013

Warwick Investment Club

This week's content:

Macro Strategy

Cautious Optimism for 2013

By Swasti Gupta, Analyst, 2nd-year BSc Economics

The S&P 500 closed on a 5-year high at 1,485.98 on Friday, after increasing for a third consecutive week since the New Year. The rally comes in response to strong fourth quarter earnings results, announced by banks and industrials earlier this week. Meanwhile Wall's Street's fear gauge, as measured by the VIX volatility index[1], closed the week at its lowest level since 2007 amidst speculation of a "great rotation"[2].

The CBOE VIX index is a measure of volatility perceived by investors. A forward looking measure, it is based on the pricing of options which investors use to protect their portfolios against losses in the S&P 500. In essence, greater investor confidence implies a low VIX - and this is exactly what we have seen with the VIX falling 31% since the start of the month to 12.46 (compared to a VIX of 79.13 at the height of the financial crisis implying very high volatility).

Fiscal Cliff Compromise It appears that the fiscal cliff may have been sufficiently averted as far as investors are concerned with sequestration delayed for another two months. However, the debate over the debt ceiling is still ongoing with a vote to be held next week about raising the short term ceiling from its current level of $16.4 trillion which the US economic is expected to reach in early February. However, Investors remain cautious that the US debt ceiling is going to have to be reduced in the long run. This, most accept, won't be done by tax hikes alone. America will, at some point, have to cut its spending which may have an impact on the global economy.

Earnings Season Amongst the winners of earnings season so far have been banks such as Morgan Stanley and Goldman Sachs both of which set a 52 week high during Friday's trading session at $22.46 and $144.81, respectively. Morgan Stanley returned to profit in the fourth quarter of 2012 with a net income of $481 million, beating analyst forecasts of 10 cents earnings per share. However, return on equity was modest at 3.2% compared to that for Goldman Sachs at 11%.

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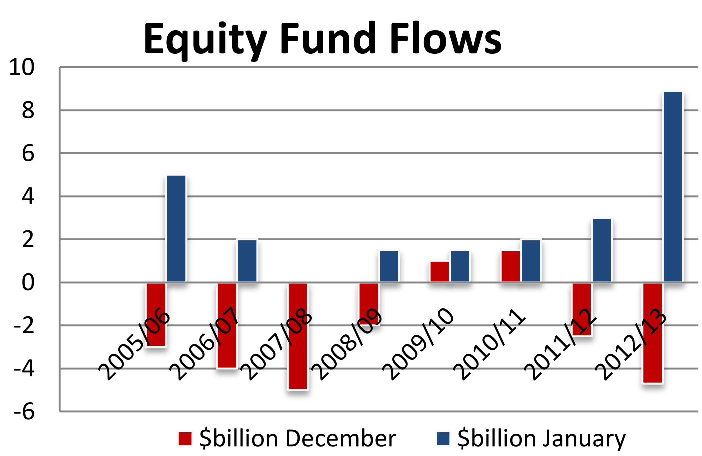
[1] The Volatility Conundrum, *M Stainton- WIC Wrap Up 14th October*

[2] The Great Rotation, *W Caffrey- WIC Wrap Up 30th December*

The banking industry fared better than most, aided by a more relaxed revision of liquidity coverage ratios (LCR) under Basel III earlier this month. Initially drafted in 2010, the liquidity coverage requirements (to withstand a 30 day net outflow of funds during a crisis) only accepted government debt and top rated corporate bonds. However under new global requirements, BBB rated corporate bonds and equities as well as top quality mortgage-backed securities can account for up to 15% of the reserve requirements. In effect, being able to count more high yielding assets in their reserve requirements has boosted profits.

Expectations of stronger fundamentals and equity valuations during earnings season have also fuelled investor optimism, setting the stage for the return of M&A activity in 2013 funded by "cheap money", as central banks maintain low interest rates. By guaranteeing bonds for bailout countries, the ECB in particular has reduced the risk of a full euro-zone breakup, extending stability into commodities, currencies and derivatives with global currencies' implied volatility hitting a 5 year low this month.

The funds research firm EFPR reported record inflows of investment into actively managed equity funds of $22.2 billion in January. Are we witnessing a great rotation, or this is just a well-dressed January effect? Like the December effect[3] the January effect is a seasonal anomaly, whereby investors buy back assets they sold off in December to offset capital gains tax (withdrawals shown in the graph below in red).



Source: JP Morgan Market

However, looking at historical data since 2005, we can see some evidence for the December and January effects, but equity fund flow data for 2013 is unprecedented as shown below, and cannot be wholly attributed to seasonal variation.

[3] Merry Christmas, J Ong- *WIC Wrap Up 30th December*

As 2013 looks to be another year of the 'central bank put' with low interest rates and subsequently low yields on fixed income products, investors should tread with caution in any attempt to distil seasonal effects from this January rally. With earnings season well under way, a potential January effect alongside such financial coercion may force investors to abandon fundamentals in search of illusive returns.

Eurozone

The EU: In or Out?

By Christopher Viggor, MSc Economics

Much debate in the political sphere of late has been centred on the EU; chiefly whether the UK should keep the status quo and remain part of the EU as it is, repatriate powers to the UK court whilst remaining part of the EU, or leave the EU altogether.

The pro-EU campaign seems to have made a better fist of laying out their position thus far. A group of big-business leaders have written a letter published in the Financial Times voicing their concern that in David Cameron's determination to renegotiate Britain's relationship with Europe getting us kicked out altogether. They believe dire consequences will follow for the British economy. Quite revealing however is that those who signed the letter published in the FT all belong to basically the same group who also warned that it would have been a disaster if Britain left the European Exchange Rate Mechanism and later that Britain would fall behind economically if it didn't join the single currency.

It is possible to see that there may be some vested interests driving their stance. The senior partner of Clifford Chance, for example, has signed the letter. Rules and regulations coming out of Europe have though helped commercial law become one of the biggest growth industries of the modern age. A survey of business people by the British Chambers of Commerce reveals that only 26% are in favour of the position outlined in the FT letter i.e. the status quo. It would seem then that they are not the voice of business.

Nick Clegg, the Liberal Democrat leader, has also waded into the debate saying that even discussing a referendum will hurt the economy and that it is putting 3 million jobs at risk. I find it very unnerving that a politician as high as Nick Clegg is in government is unwilling to debate a political structure that will be fundamental to Britain's social and economic progress. This inflexibility and obstinacy from a man in such a powerful position I believe is far more threatening to the UK's economy than the government's willingness to have a reasoned and informed debate can ever be.

The position that is trotted out most frequently by the pro-EU corner is that the EU offers our exporters access to the single market and our nation influence in the world. I believe that there is no reason why Britain could not survive and indeed flourish outside the EU whilst maintaining access to the single market and even increasing its influence on the world stage as a result of its prosperity.

It may come as a surprise that many other countries in the world have managed it without being a member of the EU. Switzerland, for example, with a population smaller than the English Midlands, exports almost as much to Germany from outside the EU as Britain does from within it. With regards to influence it is economic success that brings power in the world - not being a member of a debilitating political structure. The most politically powerful countries in the world are also, surprisingly, the most economically successful. Looking at the BCC's survey of business people again more than a third of respondents (35%) said that the disadvantages of the single market's increasingly mountainous rules and regulations now outweigh the benefits.

The British government should do whatever it takes to make Britain as economically successful as it can be. It may well be that that is more out than in.

Eurozone

Italy – is politics enough?

By Andrei Damaschin, Co-Editor, 3rd-year BSc Accounting and Finance

One month from the vote, Italy's election campaign is running at full speed. The leaders of the main political parties blame each other for the country's state of disarray. However, none of them is proposing measures that will solve Italy's real problems. There has been a collective failure by politicians, academics, journalists, and the public at large to understand the origins of Italy's crisis. Only when under pressure from financial markets or international institutions has Italy tackled causes rather than symptoms.

The steps taken by Italy's leaders to address its crisis have focused on reducing its budget deficit and its public debt, mainly by raising revenues. Spending cuts and structural reforms were postponed until a "second phase", the so-called "growth phase". But by that time, the pressure of the markets had vanished, and the required urgency had evaporated. As a result, since the start of the Eurozone crisis, Italy's economy has suffered more than any other, save for Greece. Gross domestic product has fallen 7% since 2008, more than Portugal (5.5%), Ireland (5%) and Spain (4%). Per capita income has fallen back to levels last seen in the mid-1990s. The election debate continues to focus on fiscal measures: property taxation and ways to boost aggregate demand. State intervention is seen as the only way to increase employment, and to protect ailing companies.

The missing word is ***competitiveness***. Italy's economy has lost competitiveness over the past decade or so. Internal labour costs have grown at a faster pace than productivity, and faster than in most of the rest of the world. Since the creation of the euro, Italy's unit labour costs have risen by about 30% more than the currency area average. Other indicators of international competitiveness, such as tax rates, costs of starting a business, market flexibility, layers of bureaucracy, research and development investment, and transparency, show Italy as a laggard. The result? Stagnant productivity.

This explains why Italy's current account has moved from surplus at the start of monetary union to a deficit of about 4% of GDP in 2010. Italy's external competitiveness has not even improved since the start of the crisis, unlike in Spain, Ireland and even Greece, where “internal devaluation” has occurred. The current account adjustment has taken place largely through a reduction of imports of goods and services (by 7% in 2012), while exports have recovered (increasing by 1%), but at a slower pace than the Eurozone average.

Weak competitiveness has depressed growth, which in turn has worsened the public finances. The measures to tackle the latter have further reduced competitiveness and growth, creating a vicious circle. The only way to escape is to adopt measures to improve competitiveness and increase Italy’s growth potential. However, these measures require the determination to fight the opposition of multiple interest groups, which protect privileges and so-called “acquired rights”.

In this respect, the main obstacle resides in a traditional tendency in the Italian political system to avoid confrontation and to decide by consensus. Since the mid-1970s, governments have become used to taking decisions in concert with all sorts of unions and interest groups, representing labour, employers, commerce and banks, with the aim of achieving social cohesion.

During the 1970s and 1980s, the cost of inflexibility was shifted on to the public budget and on to the value of the currency, which was devalued several times. The debt burden doubled in a decade, from 60% of GDP in 1980 to 120% in 1992. The Italian lira went from 250 to the Deutschemark in the mid-1970s to 990 before joining the euro.

Since the start of monetary union, no room was left for inflation or the state budget to pick up the bill. As a result, Italy stopped growing. In these conditions social cohesion is unlikely to last. The new government will be confronted with tough decisions. Unless it wants to try to revert to the policies of the 1970s and 1980s, which cannot be done within the Eurozone, it will have to start taking decisions without waiting for all social partners to sign up. (France’s recent decision to press ahead with labour market reform might be a good model.) This action might be politically costly, but will be unavoidable.

Election campaigns are surely not the right time to send tough messages to the public. But each of the candidates for prime minister should at least show that they are aware of the challenges and that they are willing to change how the country is governed. They have one month left to do so. There is no time to waste.

World Markets

Currency Wars

Is it me or is it getting hot in here?

By Eliott Anderson, Co-Editor, 3rd-year BSc Management

How do you stimulate demand for your goods, both abroad and at home? Artificially lower the value of your money.

Known as **devaluation**, the lowering exchange rate for one's currency can be achieved through a mix of monetary policies, including direct government intervention (i.e. capital controls or by buying foreign currencies/selling their own) or indirectly (i.

e. quantities easing). The result of the latter decreases the real price of exports and raises the price of imports, boosting demand for domestic industries from both at home and abroad.

Currency Wars occur when countries compete against each other to achieve a relatively low exchange rate for their own currency. Such practices are considered hostile, for they push unemployment overseas, and can spiral out of control if trading partners retaliate with their own devaluation, leading to a worldwide decline in international trade (not a good thing).

Which currency will come out on top?

From Russia with Love

The front page has renewed talks of a worldwide currency war that was first brought to our attention by the Brazilian Mister for Finance in 2010. The most recent rhetoric from the Russian Central Bank chairman Alexei Ulyukayev as he fires warning over the currency war, at a time when Japan's newly elected center-right government is pressured to weaken the yen.

In an age of global trade and economic downturn, governments are taking the issue seriously. The last important currency war took place during the 1930's great depression, (when countries abandoned the Gold Standard), a situation they would like to avoid at all cost. Unilateral currency interventions and covert manipulation for competitive advantage are threatening to raise political tensions. It's therefor important to understand whether it's all talk or if this war is already underway.

The Advanced Elders vs the Emerging Youth

The plot emerged as the US told China off for manipulating its currency to sustain growth. US lawmakers have already proposed legislation targeting China that would punish countries for manipulating their currencies, a move that Chinese officials have strenuously opposed. However, China argued that the US was indirectly devaluing the dollar via the successive rounds of quantitative easing. Low returns across US and EU bonds and equities led investors looking for higher returns took their cheap dollars to emerging markets, purchasing and driving up exchange rates for their currency. The dispute is likely to intensify following the Federal Reserve's new commitment to keep interest rates close to zero until US unemployment falls below 6.5% (It's currently at 7.8%).

Back in Japan, a desire for a weaker yen has united Japanese politicians and business leaders since the currency began to appreciate with the onset of the global financial crisis more than five years ago. Mr Abe, now prime minister, this month announced Y10.3tn ($116bn) of debt-financed stimulus spending and is pressuring the Bank of Japan to loosen monetary policy to support the economy and combat persistent price declines. But it is emerging markets that are feeling the heat from policies enacted in advanced economies.

120-day exchange rate history for JPY to USD, http://themoneyconverter.com

The rouble has been strengthening against the US dollar since May last year and the central bank has intervened frequently – buying or selling roubles. The central bank sold $400 million worth of roubles this week whilst buying $504 million of foreign currency. Why? GDP growth was 4.9% in the first quarter of last year but slowed to 2.9% by the third.

As the FT reports:

> "The intervention has worked," says Ivan Tchakarov of Renaissance Capital in Moscow. "They were selling roubles and buying dollars to stop the rouble from strengthening." Job done? Probably not. "If you asked the central bank to explain itself in writing, it would present this as smoothing out volatility," says Tchakarov. "But they are worried. They would like a weaker currency."

120-day exchange rate history for RUB to USD, http://themoneyconverter.com

So are BRICs gearing up for all-out currency warfare? With the main policy rate at 12.25%, evidence suggesting Brazil was overheating; the increase in foreign capital inflows should have been welcomed with the inflation it brought. Brazil's actions to limit currency appreciation highlight the dilemma faced by many fast-growing economies since allowing currency appreciation limits domestic **overheating**, when price levels rise as production doesn't grow as fast as demand. But it also undermines the competitiveness of domestic industry.

South Korea wants a meeting of G20 finance ministers and central bank governors in Moscow next month to focus on the adverse effects of easy money in the US, EU and Japan. Columbia has been at the receiving end of a record level of foreign investment, with inflows expected to hit $16bn in 2012. This in turn has pushed the peso up almost 9% last year – something that is proving to be a drag on the country's manufacturing sector.

It takes two to go to war

We were in a cold 'currency' war to start off with, as the US and EU indirectly (thou not unintentionally) devalued their currency through monetary easing policies. However, the war is quickly heating up. As governments and central banks around the world, especially from emerging markets, retaliate by increasing their competitive to sustain their high growth. As a result, international trade will weaken and recovery will slow down. Political tension will rise as direct intervention become common, and social unrest will appear as unemployment rises and imported goods come to be expensive.

But we may not be in too deep yet. As officials voice their concerns, talks will begin on how to avoid the spiral down. If the EU and the US are able to start a modest recovery without hurting emerging economies, there may be hope. As the FT reports,

> After the European Central Bank signaled a more positive outlook on the Eurozone last week, the Swiss franc fell to its weakest level in 20 months as traders took advantage of the improved sentiment in Europe to dump what has been one of the most popular havens for investors during the Eurozone crisis. The move sent the franc to its lowest level since the Swiss National Bank intervened in the currency markets in September 2011 in an effort to protect its exporters from heavy inflows into Switzerland by overseas investors.

China

Take-off instead of hard landing?

By Wodzik Kicinski, 2nd-year BSc Economics

If any Western economy grew by 7.8% last year it would be considered as an amazing economic performance. But for China its 2012 GDP rise is the lowest result since 1999. Its spectacular growth performance with an average annual GDP growth of 9.9% in the past 10 years has created huge expectations, which resulted in problems to adjust to the growth slowdown.

After a year dominated by bleak economic indicators, a 4th quarter GDP figure of 7.9%, published on Friday January 18th, finally broke a 7 quarter-long growth slowdown and restored positive attitude of the market resulting in a 1.4% daily rise of Shanghai Composite Index.

Chinese economy grew thanks to a central government $158 billion infrastructure stimulus, adopted in September, and loosening of monetary policy through two mid-year interest rate cuts. The third contributor was export, driven by increased demand from the United States and Europe. Chinese exports rose 14.1% in December compared to only 2.9% in November and overall Chinese trade surplus amounted to $213 billion (50% more than in 2011).

However these positive results should be regarded more prudently as an economic stabilisation is unsustainable as long as China does not transform its imbalanced growth model.

Over reliance on investment as an engine of the economic growth in China is best shown by the property sector. For the past two years policy makers tried to prevent a real estate bubble from bursting through tighter credit regulations and even though a year-on-year housing prices are slowing a sequential growth rate is still a source of concern. An eventual contraction could have disastrous effect for the dragon economy as the real estate together with industries linked to it accounts to over 10% of the GDP.

What is more Chinese problems are interlinked. Real estate bubble directly corresponds to local governments indebtedness. As land revenues fall, the local governments are deprived of their most lucrative source of revenue and will struggle to pay their interest rate obligations. In order to gain liquidity some of the governments restored to services of shadow banking institutions, some of which defaulted last year, exposing a need for the policy makers to rein a yet unregulated sector.

Luckily Chinese policy makers recognise the need for an adjustment. China's growth so far relied on opening up and this should continue. "*Reform is exciting, but it is also full of difficulties and challenges*" said Xi Jinping, Secretary General of the Communist Party of China (CPC) and future president. Opening up, that is planned for example in the telecom sector, would mean that Chinese state owned enterprises (SOEs) will have to accept private sector competition.

Another serious problem for China is a decrease in its working population, which begun in 2012. As a result of one-child policy Chinese "demographic dividend" comes to an end. With a decreased pool of workers the growth focus has to shift from a labour-intensive production to more automation and better paid workforce, which produces better-quality products.

A figure that really summarizes the development and challenges facing Chinese economy is a less accentuated 3.7% fall of Foreign Direct Investment (FDI) in 2012, a first decrease since FDI slump due to the global crisis in 2009. Compared with 63% FDI increase in Thailand this signifies that China gradually loses its competitiveness as a low-cost manufacturing base. A break-down of this statistic provides an even better illustration of a transition beckoning in China. Manufacturing FDI fell by 6.2%, whereas FDI in service sector (excluding property market) grew by 4.8%. Chinese restructuring from an investment led growth to one based on a strengthened domestic consumption is thus inevitable.

Positive 4th quarter GDP data should be therefore regarded as a sign of stabilization of Chinese growth. The answer for the question posed in the title of the article is: neither. Remembering equal (and small) odds of a hard landing as well as a growth take-off we should just get used to moderate growth figures of 7 to 8% and closely watch reforms undertaken by new Chinese leaders.

Japan

Challenges Facing Japan

By Melson Chun, 2nd-Year Law

Following the recently published article on Japan, I will carry to discuss briefly some of the pressing challenges facing the Japanese government. The Financial Times recently said that Japan is emerging from an era of irrelevance and this came at the back of several decisive actions taken by the Liberal Democratic Party since its electoral victory in 2012. Frequently quipped as “Abenomics”, the government aims to adopt a three pronged approach towards fighting deflation to put the country back on a sustainable course of growth.

First, the government wants to pursue a flexible fiscal policy. Through an expansionary fiscal policy, the government hopes that the huge amount of money, mainly spent on public works and infrastructure improvements, will replace the role of the non-existent consumers within the domestic economy. Recent reports revealed that the cabinet has approved requests for an additional 13.1 trillion yen to be included in the 2013’s main draft budget. This means that the budget for the year could exceed 93 trillion yen, making it one of the largest budgets ever seen since the budget started increasing 7 years ago.

While this could spell good news for construction industry, which will be seen as the chief beneficiary of the budget, scepticism has it that the effect of such a budget might leave much to be desired for. Previous budgets have seen little or no impact in the real economy, with the economy barely budging before retreating back into recession.

Secondly, the government also hopes to pursue unlimited monetary easing to (i) weaken the persistently strong yen to boost export competitiveness, and (ii) ease credit conditions even further such that even in an age of deflation, savings would attract a negative interest rate. Interestingly, the dollar-yen rate has risen tremendously since its lows with the government or central bank barely spending a single cent in the open market.

Inarguably, the upcoming central bank meeting scheduled to take place between 21-22 January will be one of the most watched policy meeting ever. There are huge expectations on the central bank to pursue a more radical monetary policy on both the political front and the market. Shinzo Abe threatens to re-write the central bank legislation should it not adopt a higher inflation target of 2%. The open markets have built such huge expectations for the central bank to act that should it even marginally miss expectations, there will likely be a huge knee-jerk reversal in the currency market.

Lastly, the government also hopes to pursue a growth strategy to attract greater investment, talent and foreign companies to set up their bases after the underlying conditions in the economy have improved. This could be in the form of real inflation, a weaker yen and shift of attitudes of Japanese companies towards employing foreigners into their companies. Arguably, this can be one of the most challenging strategies to pursue. Japanese companies are known to be extremely conservative and averse to hiring. The youth population are frequently known as "the lost generation" due their lack of quality work experiences. This arose from the reluctance of the senior managers to step down from their positions, hence restricting the mobility within each company and reducing the opportunities for the young.

Also, the demographics of the Japanese population shows that the economy is one of the fasting shrinking economies around and this is because the young married couples are simply not reproducing fast enough. It is expected that the currently population of 127 million will drop to 100 million by 2050 and it is no brainer that such a huge reduction in population will cause profound changes within the economy.

It will incredibly interesting to watch how the events play out eventually, both from an academic point of view and an investor's point of view.

Note from the Team

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The Warwick Investment Club Research Team