



Market Wrap-Up

Week ending December 30, 2012

Warwick Investment Club



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Investment Strategy

The Great Rotation

By William Caffrey, Analyst, MSc Finance with Behavioural Economics

For a few months now there has been speculation over the possibility of a “Great Rotation” out of bonds and into equities. For some 30 years now the markets have been majorly bullish on bonds because of falling interest rates and inflation coupled with lousy returns on equities in comparison. In particular, equities have experienced much volatility over the same period; the dotcom and housing bubbles are some examples.

However, in the last three years or so, equities have begun to outperform bonds as interest rates approached zero. In particular, the efforts of central bankers pumping liquidity into the markets have artificially raised asset prices. A Bank of America Merrill Lynch report has said the current level of liquidity in the markets increases the likelihood of an asset price bubble. This of course provides excellent opportunities for fund managers to increase returns in their never-ending “hunt for yield”. But we know that bubbles can have major negative effects when they eventually burst – just look at 2007/08 for an example.

When?

Therefore, key to individual investors and fund managers alike is when the “Great Rotation” will start. According to Thomson Reuters, an early bird catches the worm strategy is fraught with danger. Consider Japan, which has had many false dawns in its day. Many investors have invested in the hope of Japan coming out of its on-going economic woes only to see their returns turn negative when day fails to follow the dawn. On the other hand, reallocate to equities too late and the opportunity may be missed.

When, then, is the right time to switch wholeheartedly into equities? The Bank of America Merrill Lynch report mentioned earlier provides some insight. According to the report, key catalysts are needed to kick-start the rotation. First is a solid solution to the problems in the Eurozone. In particular, the report’s writers see Spain formally asking for help from the Troika as being a significant event in shoring up the crisis and reducing uncertainty. With a more stable Europe, investors are likely to take on more risky investments in the form of equities.

Secondly, the issue of the fiscal cliff is important. The possibility of the world’s biggest economy plunging back into recession in the New Year cannot have a positive effect on equity prices. Even if the US does go off the fiscal cliff in January however, many see the US economy returning to growth later in the year, which may trigger the rotation. In that light, central banks can affect the timing of the Great Rotation. An increase in the interest rates will negatively affect bond prices, triggering a flight to equities. For this to happen however, economies need to

experience growth and inflation, which allows central banks to hike interest rates. At present, this scenario does not look realistic.

What Equities?

Another key question to be answered regarding the “Great Rotation” is which stocks will outperform? A well-known rule of thumb in finance says that when growth is scarce, the market prices growth like diamonds. Therefore, equities that have strong levels of consistent growth can be a decent starting point.

According to the BofA report, those stocks that are likely to outperform are banking stocks and those tied to a recovery in the US housing market. The latter is particularly interesting considering a minor resurgence in housing equities in October, the gains of which have since been given back due to fiscal cliff worries.

The “Great Rotation” provides an excellent investment opportunity for investors in the near future. Timing the start however, can separate the good investor from the great investor.

United Kingdom

UK Employment Forecast

By Eleanor Gaffney, Analyst, 2nd year Economics

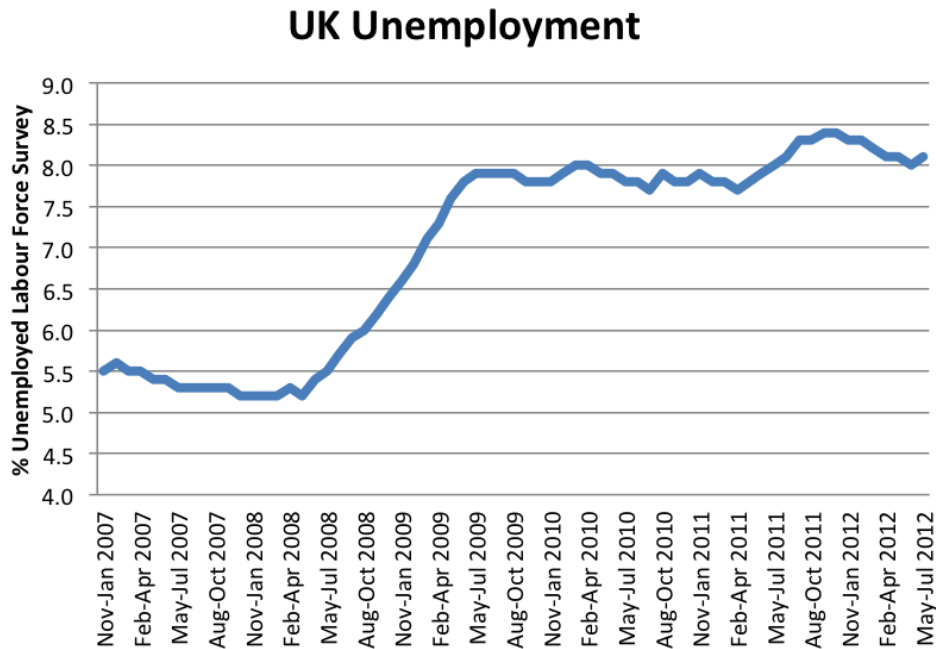
With 2012 drawing to a close, the Job Economist, a leading consultancy firm has forecast that 2013 looks set to bring bad news for the UK labour market, with a modest rise in unemployment, longer working hours and a continued squeeze on wages, as wages continue to not rise in line with prices. This is despite the fact that GDP is forecast to grow somewhat faster in 2013. The unemployment rate is forecast to rise to 8.1 percent at the end of 2013 from 7.8 percent in 2012, and the number of unemployed is seen rising by 120,000 to around 2.63 million.

The Jobs Outlook Report forecasts that private sector employment would increase by around 200,000 next year, more than offsetting a fall of 120,000 in public sector employment. The forecast net increase in total employment of 80,000 is less than a fifth of the net increase in 2012.

Yet this report should be treated with an air of caution after all, as John Philpott, a leading labour economist, reported 'economists were as bad at forecasting the UK jobs market in 2012 as Mayan calendar doomsters were at predicting the end of the world.' This is a reference to the infamous 'productivity puzzle' whereby employment grew by 500,000 and the unemployment rate fell to 7.8%, despite stagnant output data. The ONS concluded that there were several factors at play here. Falling real wages priced workers into jobs and enabled them to stay in employment. This was coupled with the fact that firms built up excess capacity as employers actively sought to hang on to talent and skills they needed to compete in the future. This means that when economic growth begins to pick up, a rise in employment may not be seen as firms already have sufficient employees needed to cope with the rise in demand.

A separate report from the Chartered Institute of Personnel and Development forecasted that the UK's flexible labour market would see employment growing further in 2013, with employment being forecasted to meet the historic milestone of 30 million before the next election. But this job growth would be slower than 2012 as firms draw on their employment reserves.

Figure 1: UK Unemployment



Source: ONS

The Recruitment and Employment Confederation surveyed 600 employers and found a trend suggesting continued job growth to be likely; with 99 per cent expecting to increase or maintain their permanent staff in 2013 and the figure for temporary staff almost as high. The association said confidence was growing fastest in the industrial sector. The biggest skill shortages were in the technical and engineering, professional and managerial, and computing and information technology categories.

While it is true that economic forecasts must be treated with caution, these forecasts do in fact provide a strong bench mark with which to measure what actually happens, and should not be dismissed as completely unreliable. It remains to be seen whether the employment puzzle of strong growth of employment in the private sector in the absence of sustained economic growth will continue on into 2013, yet recent data suggests that it is unlikely that employment figures overall will rise significantly over the course of 2013.

Asia

The Yuan and the American Economy

By Vassil Kirtchev, Co-Editor, 3rd year Economics, Politics and International Studies

As the world's economies are moving out of recession, apart from the regulatory framework, the issue of currencies (and therefore trade) is likely to become the main concern for the coming year. To facilitate trade, there is always the incentive to depreciate a currency (or to keep it undervalued), as goods from the exporting country will be cheaper in relative terms, which is what economic theory tells us. China has consistently been labeled a 'currency manipulator' and has faced criticism, particularly from America for its 'peg' against the dollar, whereby its undervalued currency allows it to have a trade advantage, and hence trade surplus (and it is argued that it may be a cause of some industrial unemployment in the US and EU).¹

On June 19, 2010, however, the currency peg against the US dollar was repealed, "but the increase was so marginal as to be meaningless."² For all practical purposes the yuan is pegged to the dollar. There have been periods when technically it was unpegged as China allowed some gradual appreciation, but it does not freely float against the dollar and the central bank actively manages the yuan-dollar exchange rate. A Chinese commerce ministry spokesman defended China's previous currency policy, and making it clear that China is not to blame for the US "own domestic problems."³ What will be the effects of an appreciating yuan? The implications of this are yet to be felt, so looking at economic theory may aid the analysis. China is a major exporter of consumer goods to the United States. An undervalued yuan would help keep prices low; the US may consume goods at a lower cost, and the Chinese are able to produce and export. If the yuan appreciates, the price of consumer goods produced in China (a sizeable amount) would increase, as the dollar has become relatively weaker. In a somewhat fragile American economy, though technically out of recession, rising consumer prices may have negative effects on growth. However, unemployment is an important aspect to consider. A 'jobless recovery' is not a viable concept for the future, and American productivity must increase for growth to be sustained. In this light, more expensive Chinese imports may spur domestic production and help improve the jobless rate. In addition, this will decrease US dependency on China. To peg the yuan to the dollar required China to buy US Treasury securities and other debt instruments denoted in dollars, and if this decreases at a fast rate

¹ Philip Coggan. "Markets in a muddle." *The Economist*, November 22, 2010.

http://www.economist.com/node/17493462?story_id=17493462&CFID=151596167&CFTOKEN=94124568 (accessed December 18, 2010).

² Ibid.

³ Aileen Wang and Simon Rabinovitch. "China tells U.S. not to make yuan a scapegoat." *Reuters* (London), October 15, 2010. <http://www.reuters.com/article/idUSTRE69E0PK20101015> (accessed December 18, 2010).

interest rates may increase because of lower demand for Treasuries and dollars.⁴ Also, China's growing middle class will be able to consume more domestically-produced goods if incentives to export goods decrease.

However, according to *The Economist*, one must not take exchange rates at face value. It is important to factor in changes in prices of the US and China (i.e., inflation rates). As mentioned, the nominal exchange rate has been marginal since the peg was removed, but according to *The Economist's* calculations, the appreciation in real terms has been greater (see Figure 1 below). This is because China's unit labour costs have risen at a faster rate than those in the US (The Economist has not included price movements in goods and services which are non-tradable; rather, that is the focus of the consumer price index (CPI) instead).

Figure 1: Yuan-Dollar Exchange Rates



*Of course, China and America do not trade only with each other. China's big surpluses and America's big deficits depend on the real exchange rate between them and all of their trading partners.*⁵

In conclusion, the currency situation and what it does to Sino-US trade relations is a complex topic, which will receive considerable attention during the coming year. One danger is the prospect of currency wars, but *The Economist* suggests that there are other factors that impact trade. If the US is to become less dependent on China for consumer goods, which is what an increase in the real yuan-dollar exchange rate implies, then it will have to readjust policymaking to focus more on domestic production (which will also decrease unemployment) despite the dangers regarding Treasuries and interest rates.

⁴Peter D Schiff., and John Downes. *Crash proof 2.0: how to profit from the economic collapse*. Hoboken, N.J.: John Wiley, 2009.

⁵"Nominally cheap or really dear?." *The Economist*, November 4, 2010. <http://www.economist.com/node/17420096> (accessed December 18, 2010).

Macro Strategy

Trends to Watch for 2013

Part 2 – Eurozone Crisis

By Daryl Chia, Editor-in-Chief, 2nd year MORSE

In the second of this two-part article, we discuss a third trend to watch for 2013 – how the European sovereign debt crisis will shape up.

Firmer Financial Conditions – But Not Economic

Financial conditions have improved markedly since the summer, when Spanish and Italian spreads over Bunds peaked and a Greek exit was openly considered. Still, economic conditions remain fragile. In Spain, while spreads over Bunds have collapsed 250bps from their peak prior to Draghi's now-famous [speech](#), its economy continues to be mired in a deep recession with high and rising unemployment: 25% nationwide and 50% for youths. Further still, Greece continues to see no end in sight to its depression – output has fallen 25% since 2006 – and the recession in the periphery is spreading to the core through trade and confidence mechanisms. France and Germany's PMI figures presently stand in contraction territory, with the former forecasted to grow a mere 0.2% in 2013. Alas, it is likely that liquidity and capital shortages will continue to lead peripheral banks to contract credit and sell assets, EZ-wide business and consumer confidence will stay weak and internal devaluation cum structural adjustments – which promise to restore productivity only in the long run – will sap growth on the backdrop of an aging European demographic. Such only promises to make the Eurozone's journey to debt sustainability a treacherous one.

Politics to Stay at the Forefront

While the ECB continues to play an essential role in backstopping the crisis beyond its influence on the refi rate – through OMT, official sector involvement (OSI) in debt restructurings and its part in building a path to an EZ fiscal, political and [banking union](#) – political actors and their electorate in the core and periphery continue to play a major role in determining where the EZ ends up in 2013. Bailout and austerity fatigue in the core and periphery respectively promises to overshadow elections in Italy and Germany and as the Greek coalition holds on for survival. In Greece, a depression exacerbated by harsh [conditionality-imposed austerity](#) may lead to social uprising that could replace the present coalition government with Syriza. The inexperienced party's hard bargaining with their paymasters may then drive a disorderly breakup. On the

other hand, if Greece lives up to its reputation and continues to underperform fiscal targets, Germany may decide to pull the plug on it post German elections and after Spain and Italy are sufficiently firewalled in late 2013. Even today, German [backsliding](#) on commitments to form the banking, fiscal and political union necessary for drawing a line under the crisis shows how political will to keep Greece in the EZ may dry up. Still, Germany must consider how a Grexit will set a precedent watched not only by investors in Italian and Spanish debt, but also by Balkan states looking to join the EU. Beyond Greece, Spain once again raised its deficit target in earnest late this year – however, it may still be unable to meet targets for 2013, further testing Germany's and the Troika's patience.

Last but not least, as if to reinforce the unpredictability and sheer significance of the role of politics in this crisis, the technocratic government of Mario Monti [fell early-December](#) as ex-PM Berlusconi announced the withdrawal of his centre-right Freedom Party's support of Monti's budget reforms. This means Italian elections in February, giving way to the possibility that Monti, his government and the well-informed gradual structural adjustments he has put in place to calm the markets may cease to exist in present form early-2013. Such further intensifies the existing uncertainty as to how the EZ will shape up in the coming year.

Our Other Neighbours: On Rocky Ground As Well

Closer to home, French bond yields have remained dormant despite its downgrade – with a highly technocratic government at power, France looks to put through €50bn of spending cuts and an equal amount in tax increases to achieve budget balance by 2017. Implementation poses risk however – there is significant risk that the relatively benign environment today can quickly give way to widening spreads as bond vigilantes are roused before France decides on where to enact the cuts.

On the northern front, the Nordics have held up well but continue to remain exposed to an EZ shock as approximately half of their GDP comprises of exports to the EU. While Norway is buffered from EZ headwinds by its emphasis on less-cyclical oil and gas related exports, and with the Nordic banking sector as a whole having only low single digit exposure to peripheral debt, Sweden looks to be the most vulnerable to an export crisis, reflected in its sizeable consumer product and capital goods exports to the EU in terms of GDP (which led to a double-digit y/y fall in output immediately post-Lehman). Still, given the Nordics' relatively strong fundamentals, 2013 could see a regime change where Nordic currencies adopt safe-haven status against the Euro – much like the US Dollar or Yen are, with the latter of which losing its said status thanks to [Abe's inflation targeting](#) (itself another trend to watch).

Alas, amid the crisis and conundrum, 2013 promises to be as exciting and educational as any post-Lehman year so far. Happy New Year!

Debt Special

Depressed Yields and their Implications

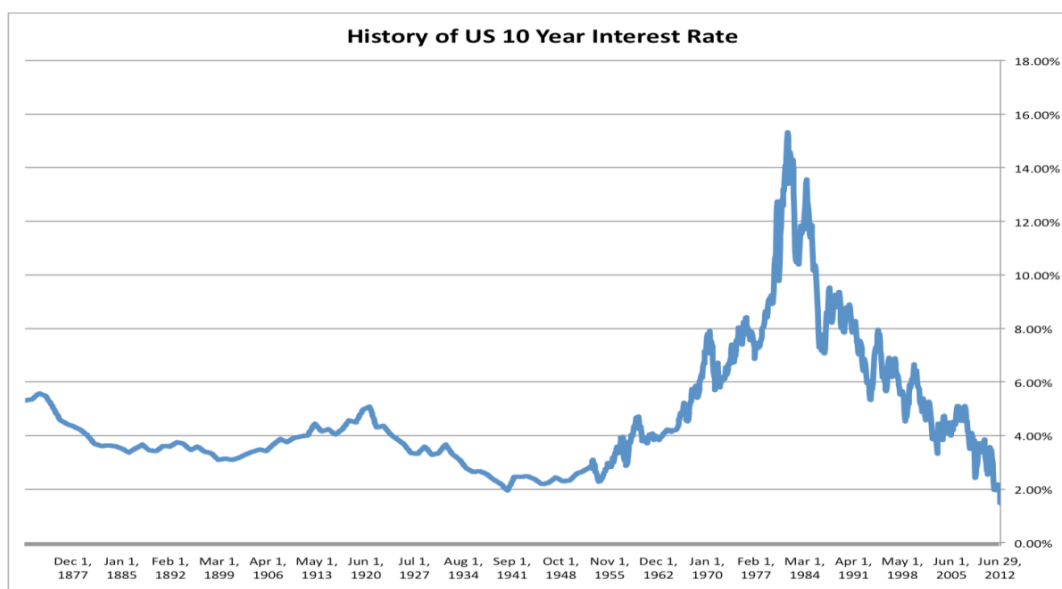
By Marco Ross, Co-Editor 3rd year Accounting & Finance

Background

A forceful bull run has characterised most developed nations' bond markets since the 1980s as inflation came under control. The recent financial crisis and ongoing global economic uncertainty exacerbated this move, leaving the financial world in an environment of historically extremely low-yielding 'safe' government paper (yields move inversely to bond prices).

During 2012 the benchmark (10-year) bond yields of Britain, the US and Germany all reached new all-time lows (see Figure 1 for historical 10-year US yields since the 1870s) at 1.47%, 1.38% and 1.13%, respectively, with equivalent Japanese Government Bond (JGB) rates remaining subdued at 0.80% as of the end of the year. Remarkably, short-dated paper of countries such as Germany, the Netherlands, and Switzerland even experienced negative yields⁶, meaning investors paid the countries for the privilege of lending to them.

Figure 1: 10-year US yields since the 1870s⁷

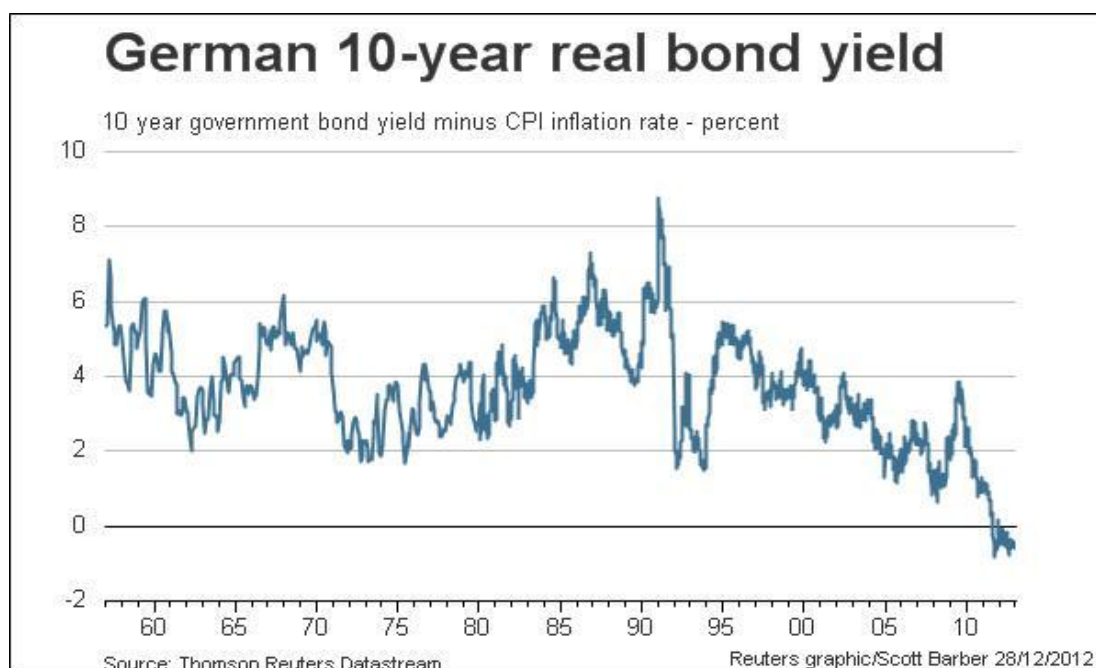


⁶ It is interesting to note that negative yields for AAA-rated Eurozone nations' paper may be pricing in an implied foreign exchange option, as investors consider the possibility of a Eurozone break-up and return to domestic currencies during the holding period (in such a scenario, repayment of principal would occur in domestic currency, which could be expected to appreciate strongly in the case of economically more robust and fiscally sound countries such as Germany and the Netherlands).

⁷ Source: http://1.bp.blogspot.com/-IKIMuAO0eNQ/T--W5Oukg_I/AAAAAAAAABIQ/iLtmR6DWSCg/s1600/Long+Term+10+Year.png

Declining bond yields are commonplace during times of grim economic outlook as inflation expectations recede and demand for safe-haven assets mounts. As such, it comes as no surprise that yields for highly-rated government debt shrank during the crisis – especially when considering the additional impact of massive quantitative easing (QE) programmes throughout the developed world which pump funds directly into the bond market, and of recent regulation forcing commercial banks and insurance firms to hold safe government bonds. What remains perplexing however is the unrelenting demand for safe “govies”, despite their strikingly low rates of return and fairly constant inflation expectations; in the UK, US, and Germany, real bond yields are already in negative territory (see Figure 2 for historical benchmark German real yields). Nevertheless, being firmly anchored in a low-yield environment, several thought-provoking implications arise – in focusing on UK Gilts, US Treasuries, German Bunds and JGBs, macroeconomic expectations and implications, consequences for pension funds, government policy implications, and the possibility of a bond bubble will be explored.

Figure 2: Benchmark German real yields

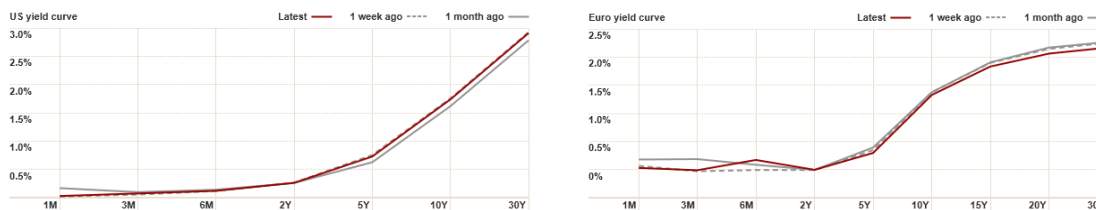


Macroeconomic expectations and implications

Bond yields, and especially the term structure of yields, serve as a credible reflection of investors' macroeconomic expectations with regard to growth and associated inflation. By observing several developed states' yield curves (see Figures 3 and 4 for US and German yield curves) it becomes evident that investors expect sluggish growth with subdued inflation to persist at minimum in the short-run given that, up to 2-year maturity, yields are floored around

the 0% mark. However, this 'standard' shape of the yield curve also implies expectations of moderate recovery in the long-run as yields rise quite starkly beyond the 5-year maturity point⁸.

Figures 3 and 4: US yield curve (left) and German yield curve (right)



In this context it is worth revisiting the aforementioned quantitative easing programmes. Thus far, the Fed injected roughly \$2tn into the economy, the Bank of England's QE programme stands at £375bn, the European Central Bank's Long-Term Refinancing Operations amounted to over €1tn and the Bank of Japan is on its 10th round of QE with a total size exceeding 100 trillion Yen. The ability of such efforts to spur growth has been meagre at best, with inflation also presently muted. However, given the undeniable massivity of the aforementioned monetary injections it would likely be a mistake to pay no attention to inflationary pressure that are amassing and that may well pose a serious threat to bond prices once growth picks up.

Finally, it is noteworthy that despite fairly stable inflation⁹ and inflation expectations, yields have been broadly declining – especially until the end of the first half of 2012 – underlining the strong demand for safe assets in the face of global economic uncertainty.

Consequences for pension funds

Pension funds have traditionally been a major player in the bond market as they seek to match their liabilities to retirees with secure cash flows due from government debt. The presently low yields therefore present a major problem for the funds as it becomes more difficult to offset future liabilities solely with low-yielding bonds, leading to rising deficits. Aggravating the problem, pension funds' liabilities are valued using market rates; as such, lower bond yields (read discount rates) increase the present value of liabilities which in turn forces pension funds to increase government bond holdings ultimately further depressing yields. Denmark and Sweden moved to counteract this effect with the latter flooring the discount rate applicable; such measures may also come to fore in the UK though the pensions minister recently downplayed the chance of near-term action on the matter.

⁸ The higher yields are however in part ascribable to increased interest rate risk due to longer maturities and possibly also to the factoring in of credit risk for such longer-dated paper.

⁹ Inflation has been somewhat more volatile in the UK than in the US, Germany or Japan as inflation peaked at 5.2% in late 2011 before retreating to below 3%.

Regardless, the fundamental issue of insufficient return remains. To combat this crippling effect, rotations into, for instance, junk bonds or equities may be worth contemplating. However, the former market has been witnessing strong demand in recent times and thus declining yields-to-maturity, while the latter is still mired in considerable uncertainty. Moreover, the inherent riskiness of the two alternative asset classes, when compared to safe bonds, may be inappropriate for pension funds' required risk profile – nevertheless, at minimum a partial investment in alternative asset classes seems unavoidable and even advisable.

Government policy implications

Low yields bring with them cheap funding for nations considered safe havens. It is increasingly facile for nations to finance historically very high budget deficits and the significant question is whether such cheap funding should be used to boost economies via fiscal expenditure in an era plagued by low and fragile growth. A notable proponent of this view is China which seeks to sustain rapid economic expansion by fiscally, rather than solely monetarily, stimulating the economy – the government announced a CNY 1tn stimulus package as recently as September. Japan's new prime minister, Shinzo Abe, who voices an aggressive conviction to revitalise the economy, is also seeking to employ fiscal measures alongside monetary stimulus. Abe intends to make use of the low-rate borrowing available to Japan, having already requested the removal of the JPY 44tn new issuance cap.

However, following the financial crisis, which may at least partly be blamed on excessive leveraging, as well as the Eurozone crisis, an austerity theme seems to have swept the world and especially Europe, in spite of low yields. It is clear that the market is telling nations that are considered safe to increase borrowing; despite the potential political difficulties that would be associated with such borrowing such policy action appears worth pursuing in the current climate, leaving growth-limiting austerity for more expansionary times. Nevertheless, it is certainly a balancing act as excessive borrowing would result in financing troubles with yields rocketing up.

Is it a bubble?

The northward move in bond prices for the last three or so decades may well seem overdone. Considering the current environment however, it is questionable to what extent, if any, the trend reflects irrationality (i.e., a bubble) as demand for bonds is easily justifiable in an uncertain financial world with low inflation.

Once more robust growth returns it can be expected that bond prices will retreat and a full trend reversal may not be wholly surprising given the very low yield levels. An important

factor capable of compounding this effect in the long-run is government finances throughout the developed world. Without adequate austerity – particularly during boom times, as advocated above – countries will risk debt spiralling out of control. The problem is more accentuated in the US and Japan than in the UK and Germany with the debt piles as a percentage of GDP of the former considerably larger. Adding to this, in the American case, foreigners own 43% of Treasuries which substantially increases the chance of a confidence crisis – the problem is less pressing in Japan where the overseas-held debt amounts to only 8% of the total. However, in Japan, Abe is pushing for a formal 2% inflation target and increased fiscal spending via new bond issuance despite a 200%+ debt/GDP ratio. Coupled with worries over the Bank of Japan losing its independence, doubts over the debt sustainability of the world third-largest economy may well emerge. Overall, not lacking a return to more solid growth, the initiation of a long-term bond price decline is expectable though it is questionable whether this would represent the bursting of a bubble.

Hedge Funds

Mud Throwing

Muddy Waters vs. Olam

by Richard Low, Analyst, MSc Finances & Economics

Mud throwing – Muddy Waters vs. Olam

Last month, Muddy Waters, a hedge fund well known for aggressive shorting activities, accused Olam, a large Singapore-based agri-business, of being “a black hole [of investors’ money]”. The short seller even likened the world’s second largest rice trader to the infamous Enron. Both sides have since responded with lengthy reports¹⁰ trying to discredit the other party’s claims and initiated libel lawsuits; more interestingly, Olam issued an unplanned combination of debt and warrants. This has raised new issues about short selling and this article will attempt to shed light on Muddy Waters and then highlight the role that Olam’ shareholder Temasek has played in this event.

Identifying the Muddle in the Mud

Muddy Waters has a good track record (see Figure 1) identifying Chinese companies with “fraudulent accounting practices” and several of its previous targets have been delisted from their original exchanges as a result of its research. From 2010, any investor that answered Muddy Waters’ rallying call would have netted an average of 37%¹¹ from each position that fund initiated. Its most prominent target, Sino Forest, filed for bankruptcy within a year and today, the Ontario Securities Commission is taking regulatory action against Sino-Forest’s former management and auditors.

¹⁰Muddy Waters’ research report can be accessed here:

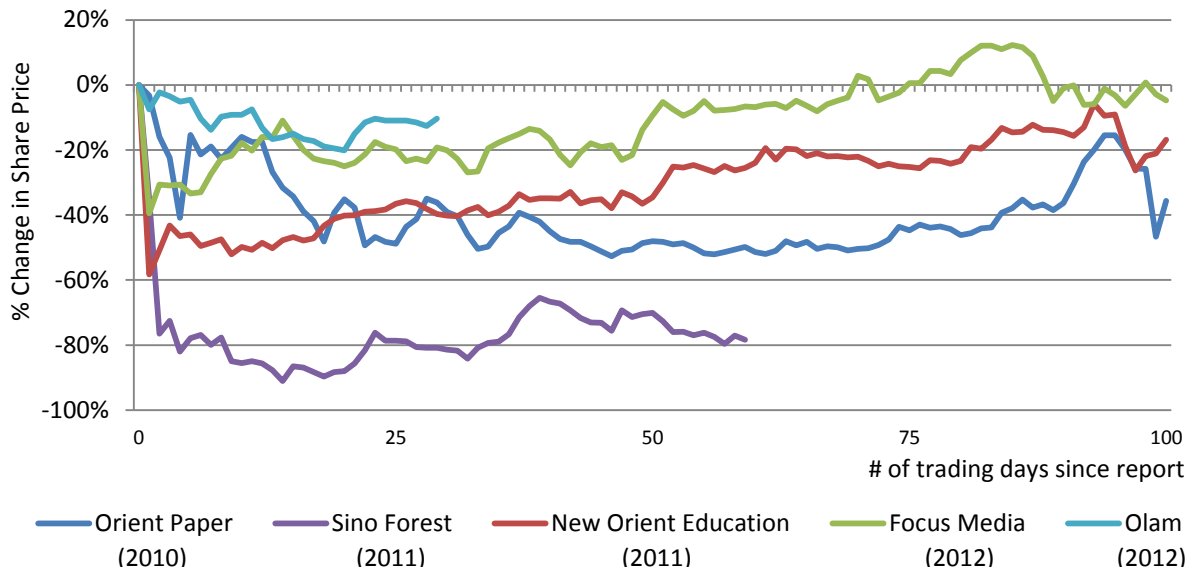
<http://www.muddywatersresearch.com/research/olam/initiating-coverage-olam/>

Olam’s response can be accessed here:

<http://olamonline.com/olam-dismisses-muddy-waters-findings>

¹¹ This assumes that the investor is able to short the stock at the previous day closing price and holds the position for one month after the report has been released.

Figure 1: Selected Past Targets of Muddy Waters¹²



However, despite the fund’s excellent track record, the current attack on Olam has not been as profitable as past targets. Since the accusations emerged, Olam lost as much as 20% of its value but trades at a discount of 10% today. At this point, it is worth highlighting that Olam had a bad year (see Figure 2), losing over a quarter of its value since the start of the year and thus, depending on when Muddy Waters built up their position, it still remains a profitable short.

Figure 2: Olam’s Share Price YTD



¹² Sino-Forest filed for bankruptcy in March 2012 and its stock lost nearly 80% of its initial value before trading was suspended.

At the same time, the smaller impact might be due to a shift in the fund's strategy, with Olam being a non-Chinese and a much bigger target. The move away from mainland targets is due to what Mr Carson believes to be a more recent phenomenon of the Chinese government willing to take the side of fraudulent companies and making his previous strategy less profitable.

Underestimating the role of Temasek?

Since the report by Muddy Waters, Olam stock price has declined, but it has since recovered some ground after a USD 750 million bonds and rights issue and the backing of Temasek, one of the world's largest Sovereign Wealth Funds (SWF).

Muddy Waters probably made the mistake of underestimating the relationship between Temasek and Olam. Throughout this episode, Olam has enjoyed the backing of its long time shareholders, especially Temasek. Temasek's support quintessentially represents the stamp of approval of the Singapore government. From a government perspective, winning this "battle" with the short sellers is important because it sends a strong message that SWF investments have more complicated dynamics; SWF might intervene and support their investments and there could be additional risks for short sellers.

Still, Muddy Waters has remained defiant, calling the commodity player "a sick core business" and claiming that Olam will never be "a bail out success".

Conclusion

This is probably the last time that Muddy Waters targets a company with large institutional investors, who have the determination and means to fight back and understanding the shareholders of your next investment could make a significant difference.

Investment Strategy

Merry Christmas

by John Peter Ong, Analyst, 1st year Economics

December is a particularly significant month for financial markets, and not just because of the Christmas carols. Call it what you may – the “Santa rally” or “December effect” – but the festive season, historically, tends to bring with it rising stock prices, on top of good tidings.

There are several hypotheses for this phenomenon. The first, and perhaps most frivolous, explanation is that the holiday spirit discourages pessimism, inducing cheerful investors to drive up equity prices. It is, however, doubtful that this exuberance would addle the entire population; seasoned players would simply sell into the upswing, putting downward pressure on prices. Overall, markets would be unlikely to break resistance levels, implying insignificant deviation.

Still, market psychology may yet have a contributory role. It is possible that investors, being aware of the December effect, buy into the bull run in hopes of capital gains, resulting in a self-fulfilling prophecy of higher prices. While this stand seems more defensible than the former, since it involves some form of financial rationality, it is ultimately tenuous and complements other explanations at best. Clearly, from a strategic standpoint, a rational investor would hope to invest in the period before the rally, leading to an infinite regress of monthly “effects.”

But what if investors only received an inflow of capital in December? This is certainly true for households that receive Christmas bonuses. In this case, the issue of infinite regress is eliminated. Notably, an analogous reasoning can be applied to the January effect, during which employees receive their year-end bonuses; this supports the idea that investors, upon receiving cash in December, are likely to invest in equities immediately in order to profit from the anticipated January effect.

Another possible factor is institutional window dressing, where asset managers endeavor to improve reported year-end portfolio performance. In general, this involves switching positions toward performing stocks, causing their prices to rise further. Also, it is conceivable that funds tacitly collude to raise prices of blue chip stocks for the accounting day, given that they have pricing influence when aggregated and that fund managers have a vested interest in higher prices. In the least, funds would be unlikely to apply downward pressure to markets, thereby allowing the upswing from earlier effects to dominate.

Simple business fundamentals are also likely to contribute to the December effect. Indisputably, a large variety of companies enjoy increased sales during December. On top of the usual suspects that benefit from the legion of bustling Christmas shoppers, financial companies also

experience an influx of clients who may wish to balance their accounts and offset taxes before the year's end. Arguably, in perfect markets, this heightened earnings period should already be priced in. Nonetheless, it is possible that investors become more confident and willing to invest as the holiday season provides an opportunity to gauge consumer sentiment and business viability.

All in all, while this analysis is by no means complete, it offers us perspectives from which to understand the December effect, allowing us to test assumptions implicit in season-investment decisions. Also, it is prudent to note that it describes a tendency, not a guarantee. Given the uncertainty surrounding the US fiscal cliff negotiations, it is likely that markets will be more affected by governments this Christmas than jubilee. One could hope that the democrats and republicans will put aside their differences and forge an agreement before the holidays, but that might be asking for more than a Christmas miracle.

Note from the Team

We are always looking to improve; our team of analysts is dedicated not only to producing exceptional research but also to tailoring information to what best suits our readers.

We would appreciate any helpful feedback you may have as we strive to grow the quality and usefulness of our weekly market wrap-ups.

Please send this feedback to **D.Chia@WFSocieties.com** and the subject as “Fortnightly Wrap-up Feedback”.

Many thanks and a Happy New Year!

The Warwick Investment Club Research Team

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