

# Fortnightly Market Wrap Up

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Warwick  
Investment  
Club

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Comment

## The Bonus Cap and what it means for the City

By Max Stainton, Co-Editor

As most of you I'm sure know by now on the 27th February the European Parliament secured agreement on a mandatory 1:1 ratio on variable pay relative to salary for all banks based in the EU, which can rise to 2:1 only after an explicit shareholder supermajority. Critically, this also applies to international offshoots of EU-based banks, as well as US or Asian banks operating in the EU. Furthermore, on the 5th March the UK failed to torpedo the Parliaments move at a critical meeting of finance ministers in Brussels, with only George Osborne, the UK's chancellor, questioning the logic and impact of the cap. Consequently, Michel Barnier, the EU commissioner responsible for the reforms, concluded that it was "crystal clear" that the cap will be imposed, the only concession being the possibility further discussions surrounding the more favourable treatment of long-term pay within the bonus cap. This not only has the potential to affect those of you considering a career in finance, but also has more profound implications for the City of London as a global financial centre and, indeed, the place of the United Kingdom in the EU.

The severity of these implications derives not only from the actual details of the bonus cap, but from the political and economic context within which the cap was negotiated. Considering the details first, while in all probability fixed salaries will simply rise so that overall compensation can stay at the same level within the 2-to-1 ratio, these have implications both in terms of competitiveness and financial stability. The clearest implications are those to do with competitiveness. While the declared aim of the bonus cap is to dampen the incentives for reckless risk-taking that in the past led to bank bail-outs and costs to the taxpayer. In practice, the choice facing banks is either to find a way to compete with rivals that are not bound by the cap, or to risk losing star employees to competitors abroad. These forces will be felt most acutely for London based banks whose international

staff will be most able to up sticks and move to a bank/domicile that isn't affected by the cap. Emphasising this point Peter Sands, the CEO of Standard Chartered, the emerging markets focused bank based in London, has already come out saying that "we [Standard Chartered] are concerned about our ability to be able to be competitive in attracting and retaining talent" because of the bonus cap.

However, the cap also has profound implications for financial stability. As already noted, the cap's primary effect will be to drive up fixed salaries at the big UK banks. Andrew Bailey, who will head the Prudential Regulation Authority when it opens next month, has estimated that these increased fixed costs are likely to amount to £500m per annum. This will not only have the perverse effect of limiting the possibility of increased variable pay, recognised by both banks and regulators as critical for financial stability, but also has the potential to undermine the system of bonus clawbacks for misbehaviour and poor performance. Now you may be thinking that as a potential employee this could all be quite positive. However, it is necessary to point out that the reason why banks put such great emphasis on variable pay is because the revenues associated with banking, particularly investment banking, can be incredibly volatile. Consequently, if banks no longer have the possibility of adjusting their cost base via variable pay, then they will ultimately turn to redundancies and firings. This possibility I fear, is much more harmful for potential employees than any amount of variability in one's pay.

With the impact of the details of the cap fully analysed, we can now turn a consideration of the political and economic context within which the cap was brokered. In the past the UK has had an effective veto over essentially all financial regulation within the EU, primarily because of London's overwhelming financial size vis-a-vis other European capitals. Evidence of this can be found as recently as December last year when the UK won important safe guards and opt-outs in relation to the European banking union. Consequently, the fact that such an agreement was reached, even after explicit British disagreement and the fact that more than 90% of those likely to be affected by the cap are based in London seems to indicate a weakening of Britain's influence within the EU, particularly in relation to financial regulation. This is deeply concerning for the City of London whose 50-year expansion to become the world's

leading international financial centre has in large part depended upon it being an entrepôt for foreign banks seeking exposure to Europe. Consequently, if this marks a shift for the UK to the permanent outer sphere of the EU, something that many commentators now fear, then the potential negative impact on the City as a global financial centre could be large. This shift can be seen in other aspects of European financial regulation such as the current ECB move to push any clearing house responsible for euro securities to sit within the Eurozone. In practice, that would pull trading in euro bonds and derivatives to Frankfurt. Much of this is the logic of the euro emerging a dozen years after its launch whereby the financial crisis impelled the Eurozone towards a banking union while the country for which financial services are most vital is increasingly pushing itself, and being pushed, towards the European periphery. The consequence of this isolated position is the increasing inability of British policymakers and diplomats to protect the City's interests. The result could be a slow dismemberment of the City with its euro listing and trading businesses switching to Frankfurt while its international and emerging markets operations move to New York or Hong Kong to evade EU-wide regulations. Such a scenario, while no means certain, would have been unthinkable only 5 years ago. Consequently, over the next few months and years those of you considering working in the City will have to pay increasing attention to London and Britain's relationship with the EU. While none of this is a foregone conclusion, the possibility now exists. **WIC.**

***About the author:** Max is a 2<sup>nd</sup> year BSc Economics, Politics and International Studies student at the University of Warwick. Max has interned at Goldman Sachs Global Investment Research Division's Economics Department, has well as Merrill Lynch's Wealth Management Division and Triodos Bank UK. Last year, while studying abroad at the University of California, Santa Barbara he was appointed the Portfolio Manager for A.S. Investment Advisory Committee. He also manages his own paper fund which focuses on global macro investing. Additionally, Max enjoys horse riding, swimming, jet skiing and the theatre.*

## The World Equity Markets

### Buyback Season

By Swasti Gupta

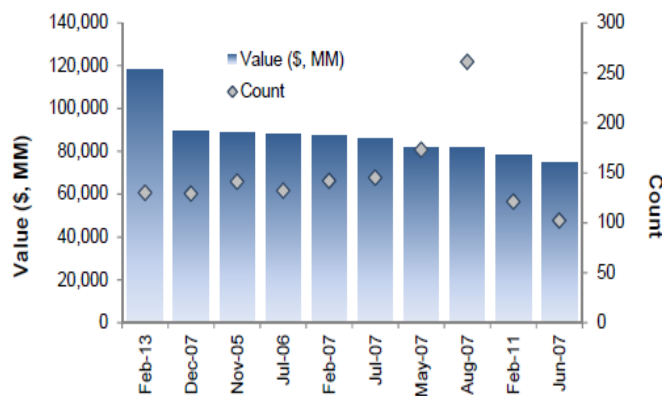
The S&P 500 closed just 5 points shy of its previous 1,565 peak in October 2007, bringing US equities under the spotlight once again as investor confidence continues to grow amidst "buy-back" season, positive stress test results from banks and strong recovery data in [labour markets](#) and retail sales from the US.

Needless to say, the US equity rally has had a huge spill over effect globally: the Japanese markets gained 13.5% and the FTSE All World Index rose to its highest level since June 2008 at 238.47, even though emerging market equities fell almost 3% this year due to slowing growth and recovery. Despite risk adverse investors in Europe, the picture in the UK looks brighter with the FTSE 100 reaching a 5 year high at 6529.41.

**The equities rally**, which began earlier this year during [January earnings season](#), has seen a new surge of momentum, this time from corporate share buy-backs. At first, this seems to resemble [January effect](#) we witnessed at the start of the year where firms looked to repurchase assets they sold at the end of 2012 to offset capital gains tax. However, February 2013 has seen a record total of \$117.8 billion of share buy-backs, recorded by Birinyi Associates to be a 103% increase from the \$68 billion in February 2012 and highest since the crisis.

[The [Top Ten](#) Repurchase Authorisations]

**Largest Monthly Authorizations: 1999 to Present**



**Figure 1 Source: Cardiff Garcia, The FT**

*What is a share buy-back?*

In conducting a share buy-back (also known as stock repurchase), the issuing firm buys back equity from the existing stockholders in exchange for cash, thereby reducing supply of shares in circulation and increasing earnings per share ratios. With 10 year US treasury yields floating in the 2.01-2.06% range, the surge of buybacks has been fuelled by persistently loose monetary policy by the Fed, as low interest rates reduce the cost of borrowing to purchase assets.

*Some highlights...*

**Bank of America and Citi** plan to buy-back \$5 billion and \$1.2 billion stock respectively, with Bank of America redeeming an additional \$5.5 billion of preferred shares. Both banks received \$45 billion in government bailouts, and face increasing pressure from investors to return to profitability. However, with new Basel III capital requirements of 4.5% and 2.5% buffers, banks have to pass the Federal Reserve "[stress tests](#)" to prove sufficient liquidity before they will be authorised repurchase. The Fed's stress tests model banks' capital ratios under stressed economic conditions, and both Citi and JP Morgan were part of the 14 banks to pass the stress tests. In total these banks will be buying back a total of \$30 billion worth of stock.

**BAE Systems** after its failed merger with EADS, holds significant cash reserves and plans to buy back shares worth £1 billion over the next three years. The BAE undervalued stocks, with forecasted P/E below industry average, rose 6% after the announcement, a sign of restored investor confidence amidst military spending cuts in the US and the UK.

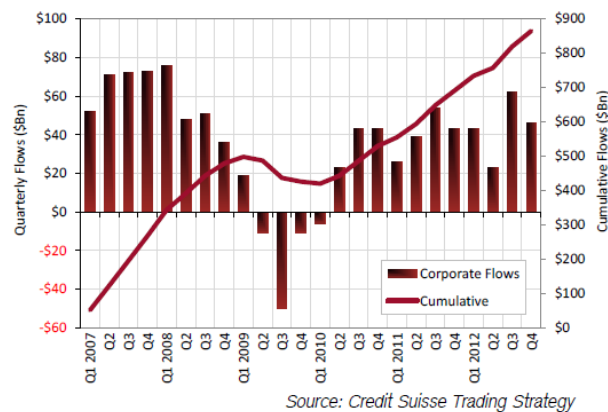
**Michael Dell** perceived his company to be undervalued, and with private investor Silver Lake aims to buy back complete control of Dell for \$24.4 billion, a 25% premium on current valuation. If it passes regulatory approval, it will be the biggest leveraged buyout since 2007.

However, on the flipside, firms can use this technique to artificially inflate their earnings per share, which may not reflect true fundamentals; **GSK**, who bought 3% of their

equity actually saw price per share fall from \$14.80 to \$13.60 in 2012. In another move, the London-based pharmaceutical giant issued \$3 billion debt for the first time in US markets. This raises further questions about the nature of stock buy-backs in the current climate. Do firms simply lack alternative productive uses of capital? Is it the first step on a long road towards the return of M&A or are firms looking to "de-equitise", instead raising funds by issuing debt.

Under the current low yields, de-equitisation seems unlikely unless there is huge volatility in the markets—currently the [VIX volatility index](#) is at its lowest in almost 5 years at 11.30. Instead, the research group Dealogic found that [\\$12 billion](#) this year so far has been raised for IPOs and follow on offerings as private equity groups sell additional shares, often at a discount of 25% compared to typical levels of 15% to incentivise large share sales.

**Exhibit 13: Corporate Flows (\$Value of S&P 500 Net Share Changes)**

**Figure 2 Corporations as net buyers of stock**

With liquidity seizing in the aftermath of the financial crisis, it now seems that corporations are no longer hoarding cash. Credit Suisse have shown that corporations are actually net buyers of stock (share buybacks + cash M&A – IPOs – Secondary share offerings has been positive and growing). Whether this trend continues into the remainder of 2013 depends on whether the large discounts on IPO offerings will do enough to entice investors. Or will greater economic confidence in recovery boost M&A activity, driven by corporations investing in their own growth. For the first quarter at least, it seems that the corporations are taking advantage of the low interest rates,

further fuelling momentum for the equities rally and increasing investor appetite. **WIC.**

*About the author: Swasti Gupta is a second year economics student at Warwick university, with specific interest in equities and global macro. Thoughts and comments are welcome.*

## Asia

# Should China push for economic change?

By Andrei Damaschin

The announcement of China's new economic team this week will open a window for serious financial liberalisation – and poses an early test of President Xi Jinping's commitment to reforms essential to the country's growth prospects. China is well-positioned to draw on the rich precedent of 1990s reforms, particularly to its banking system. And today Beijing has every incentive to change if it is to meet rapidly rising public expectations that the government will adopt a new and fairer economic model.

Why are the 1990s relevant? There are two main reasons. First, some of that decade's reforms were prompted by the 1997-98 Asian financial crisis. China could not then wall itself off from volatility beyond its borders – and this is even harder to imagine today. Its \$8tn-plus economy cannot remain immune to fiscal and growth problems afflicting the combined \$35tn economies of the US, Europe and Japan. Second, with Beijing facing a crisis of credibility in the 1990s following several political crises in the 1980s, public expectations were sky-high. And they are high once again partly because, for all China's successes, a rising middle class faces diminishing returns on the current growth model.

The lack of investment options for ordinary citizens, coupled with inflation (now at a 10-month high) and low interest rates on deposit accounts, means the return on their savings is negative. Meanwhile, Chinese companies, especially state-owned enterprises, can gain access to cash at below-market rates. This oversupply of low-cost capital

removes market discipline necessary for the long-term competitiveness of these companies. It also undermines the efficiency of the economy by steering capital away from more productive investments in private companies, which fuel innovation and represent the nation's economic future. Current global challenges, not least austerity in Europe and US fiscal problems, demonstrate China's need for bolder financial reforms such as liberalising foreign capital flows and assuring greater flexibility in the exchange rate.

To its credit, Beijing has made significant progress, from bank restructuring to developing domestic debt and equity markets, asset managers and a regulatory system. It is committed to currency reform, too, because it recognises capital markets will not otherwise function efficiently.

But the global turmoil of recent years should make financial reforms more, not less, urgent. In the aftermath of Beijing's \$586bn bank-lending stimulus in 2009, the country faces difficult side-effects. These are hard to deal with for two reasons. First, with official intervention leading to a weakened currency, the central bank has been denied a useful monetary tool to fight inflation. Second, without sufficient oversight of non-bank or "shadow" lending, it is more difficult for policy makers effectively to tighten liquidity. Shadow lending is also problematic because it is not transparent, and generates credit risks and, potentially, bubbles.

This new team will face early tests, and three reforms will be critical. The first is interest-rate liberalisation. This is essential to promote the efficient allocation of capital – and ensure lending is directed to a dynamic private sector that has been starved of capital. Second, China must reform municipal finance because ballooning local debt will hinder its ambition to make urbanisation the main growth driver for a more consumption-driven economy. A legitimate local government bond market, decentralisation of budget authority, and a more equitable division of tax revenue are needed. Nonetheless, the essential ingredient of reform is opening up to foreign competition. Joint ventures yield suboptimal results so it is in China's best interest to eliminate requirements for foreign financial firms to operate on this basis. It should also do away with remaining restrictions on where these firms can operate and allow them to function as they do in other leading financial centres, subject to domestic regulations.

Reform will pose political and economic risks. But the country's underlying development challenges cannot be met without deepening and restructuring capital markets. Acting too slowly poses a greater risk than many in China believe. The new economic team must draw on the lessons of the 1990s, seize this moment of opportunity and take bold action. **WIC.**

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## The Eurozone

### Premature Optimism

*By Wodzik Kicinski*

With unemployment rate ranging from 17% in Portugal to 27% in Greece, negative economic outlook for output growth in the Eurozone expected to contract by 0.2% this year according to the International Monetary Fund (IMF), weak competitiveness and persisting high levels of public as well as private debt the situation in Europe is improving.

Yes, improving, at least that is what the Eurozone leaders say. Looking half a year back the market pressure on euro has declined since the European Central Bank president Mario Draghi has pledged to do "whatever it takes" to save the euro and introduced the Outright Monetary Transactions (OMT), a conditional programme of unlimited purchases of applying member states. Since then the spread between peripheral Eurozone bonds and German bunds has lowered significantly and Mr Draghi could announce that "the darkest clouds over the euro area have subsided".

But is it really justified to be optimistic about the euro? The improved market sentiment can be explained more by analysing investors' psychology than economic fundamentals listed in the introduction. The truth is that European leaders proved resilient and able to act when pushed against the wall by all those who bet against the euro. And as money was lost by euro-bears the sentiment in the market pragmatically adjusted.

The real question is whether such positive market attitude can be accompanied by better economic results in the common currency area. One already visible sign of

improvement is adjustment of trade imbalances, decreasing trade deficits in southern states and gradually falling labour costs. However the greatest challenge for the politicians is a sensible structural reforms framework that can address inefficiencies of peripheral economies.

"Compact for Growth and Jobs", adopted in July 2012, includes country-specific recommendations for reforms, targets restructuring of the banking sector and fiscal consolidation. But it just as other responses to the euro crisis it has a drawback of being only a little step in the right direction. The framework does increase the European Investment Bank Capital by €10 billion and further increases its lending capacity by €60 billion, but just a recent €10 billion bailout for a small Cypriot economy shows little relative capacity of these numbers.

What is more structural reforms needed so badly in peripheral states are particularly hard to implement given their results being visible only after couple of years and austerity fatigue among peripheral states electorate, seen only recently in Italy.

Fiscal consolidation by cutting expenditure and increasing taxes is only likely to depress demand due to high fiscal multipliers during the crisis and can be very dangerous if it spurs social unrest. Export sectors are also weak in southern states with their GDP share varying from 10% to 14% compared to Germany's healthy 20%. In addition appreciating euro does not help the industry.

Structural reforms of labour regulations and public administration restructuring are undeniable for Europe, however it is important to understand that even if duly implemented at a reasonable pace there would still be a slow process of stabilisation and subdued growth, during which fickle markets can always change their sentiment. It is yet too early to hail a victory in Europe. **WIC.**

*About the author: Wodzik enjoys discovering complexity of financial markets as an Analyst of the Warwick Investment Club and mastering public speaking skills in debating tournaments, like World Universities Debating Championship in Berlin. In his little free time Wodzik trains fencing and prepares for his first marathon.*

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