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Global Strategy and Investment Trends by David Fuller www.fullermoney.com

Please note: This is a compilation of Comment of the Day for Subscribers, which appeared on the www.fullermoney.com website during the last week. Subscribers are encouraged to login at their convenience, to read the daily coverage and use the many other site facilities, including the Library of charts.

Monday 12th January 2009

Commentary by Eoin Treacy

The Daily Telegraph: Reform plan raises fears of Bank secrecy - Thanks to a subscriber for this interesting article by Edmund Conway, covering the proposed UK Banking Bill. Here is a section from the opening:

The Government is set to throw out the 165-year old law that obliges the Bank to publish a weekly account of its balance sheet - a move that will allow it theoretically to embark covertly on so-called quantitative easing. The Banking Bill, which is currently passing through Parliament, abolishes a key section of the law laid down by Robert Peel's Government in 1844 which originally granted the Bank the sole right to print UK money.

The ostensible reason for the reform, which means the Bank will not have to print details of its own accounts and the amount of notes and coins flowing through the UK economy, is to allow the Bank more power to overhaul troubled financial institutions in the future, under its Special Resolution Authority.

However, some have warned that it means: "there is nothing to stop an unreported and unmonitored flooding of the money market by the undisciplined use of the printing presses."

It comes after the Bank's Monetary Policy Committee cut interest rates by half a percentage point, leaving them at the lowest level since the bank's foundation in 1694.

With the Bank rate now at 1.5pc, most economists suspect the Government and Bank will soon be forced to start quantitative easing - directly increasing the quantity of money in the economy - in a drastic attempt to prevent a recession of unprecedented depth.

My view - When the Federal Reserve stopped issuing M3 figures, it was taken as a clear indication that they were deliberately obfuscating the data they provide about monetary policy. The same strategy may now be about to be followed by the UK, and it is a step backwards in terms of governance. Quantitative easing may be needed to combat the threat of deflation to the UK economy. But if so, let's make sure everyone knows what is going on, so that

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the likely inflationary pressures it will unleash are recaptured when these policies are no longer needed.

Part of the reason for the breakdown in the financial system has been the destruction of trust between participants. Keeping such important data secret will not help rebuild the trust lost between the investing public and the institutions charged with ensuring health of the economy.

Soybeans, Corn Climb as Dry Spell Hurts South American Crops - This article by Sungwoo Park and Jae Hur for Bloomberg covers the recent activity in the grain markets. Here it is in full:

Soybeans advanced to the highest in more than three months on speculation that hot, dry weather in Argentina and Brazil will damage crops and boost demand for U.S. exports. Corn and wheat also gained.

High temperatures and lack of rain in Argentina have hurt corn crops and delayed farmers' plans to sow soybeans, lowering potential yields, a government weather forecaster said Jan. 9. Argentina is the second-largest exporter of corn after the U.S.

"The dry weather news is boosting grains, coupled with speculation that yields will be lower than previous years," said Chris Yoo, a manager at the global commodities with Samsung Futures Inc. in Seoul.

Soybeans for March delivery jumped as much as 2.3 percent to $10.6025 a bushel, the highest price since Oct. 1, in after- hours trade on the Chicago Board of Trade. Futures traded at $10.5575 a bushel at 3:20 p.m. in Seoul. Last week, soybeans gained 6 percent, the fifth straight weekly advance.

Rainfall in Argentina over the next five days will be lighter than forecast with much of the country failing to get enough moisture to counter above-normal temperatures, Drew Lerner, the president of World Weather Inc. in Overland Park, Kansas, said Jan. 9.

Corn for March delivery advanced as much as 1 percent to $4.15 a bushel and traded at $4.1250 a bushel at 3:25 p.m. Seoul time. The price dropped 0.4 percent last week.

In late Asian trade, declining crude oil prices and the strengthening dollar against the euro trimmed early gains in soybeans and corn. A rise in the U.S. currency may reduce interest among overseas buyers, while lower oil prices may curb demand prospects for the crops as a source for biofuel.

The dollar was at $1.3396 per euro from $1.3476 late Jan. 9 in New York. Crude oil traded down 2.2 percent at $39.94 a barrel at 3:37 p.m. in Seoul, extending last week's 12 percent loss.

Wheat for March delivery rose as much as 1.3 percent to
$6.375 a bushel and last traded at $6.325. The contract gained 3 percent last

week, extending a rally for the fifth straight week.

In the export market, South Korea is seeking to buy 110,000 metric tons of corn for feed production at a tender.

My view - Grains performed spectacularly well throughout 2007 and hit new highs early in 2008. This bull-run initiated speculation in a number of other agriculture related sectors such as fertilizers. All have now suffered considerable setbacks and many of the grains falling 50% and more before finding support.

Soybeans fell from a high of 1600¢ to near 800¢ in early December before rallying impressively to today's highs. 1000¢ is a natural area of reassessment and it will have to sustain a move back above that level to suggest that the bulls have regained the upper hand. In the absence of an immediate countermanding upward dynamic, today's key day reversal probably caps the short-term advance.

Corn more than halved from its highs near 800¢ to its December low near 300¢ and rallied well to test the 400¢ level. Today's downward dynamic, which has seen the market locked limit down most of the day, caps the short-term advance and a sustained move back above 400¢ is needed to question scope for some further downside.

Wheat has been the worst performing grain, falling from a high near 1350¢ to a December low near 280¢. It also rallied well over the last month but encountered resistance last week near 650¢ and broke back below 600¢ today. A sustained move above the former level is needed to question scope for some additional downside.

Since all three of the major US-traded grains have experienced downward dynamics today, on a commonality basis, the benefit of the doubt should be given to the downside, at least in the short term.

Coffee Rises to Three-Month High as Brazil's Exports to Decline - This article by Yi Tian for Bloomberg covers the recent activity on the coffee markets. Here it is in full:

Coffee rose to the highest price in almost three months as exporters forecast a drop in shipments from Brazil, the world's largest grower.

Brazil will export 25.1 million bags of beans in 2009, down from a record 26.1 million bags last year, the country's Coffee Exporters Council said yesterday. Coffee futures dropped 18 percent in 2008, partly because shipments increased from the Latin American nation.

The forecast is "helping the market a bit," and "there's expectation money is going to start flowing into commodities again," said Marcio Bernardo, a broker at Newedge USA LLC in New York.

Arabica-coffee futures for March delivery rose 3.45 cents, or 3 percent, to $1.169 a pound on ICE Futures U.S. in New York. Earlier, the price reached $1.195, the highest for a most-active contract since Oct. 14.

Coffee output in Brazil may drop as much as 20 percent to 36.9 million bags as most trees enter the slower half of a two- year growth cycle and farmers use less fertilizer to cut costs, the Brazilian government said yesterday. A bag weighs 60 kilograms (132 pounds).

Index funds may have sold 4,000 coffee contracts in a move to rebalance holdings at the beginning of the year, Bernardo said. "It looks like the market is able to withstand the selling," he said.

Coffee may rise to $1.30 in mid-July, he said.

My view - Both Arabica and Robusta coffee's uptrends from 2002 and 2004 respectively were characterised by a progression of rising major reaction lows. Both varieties accelerated from late 2007 to hit important medium-term peaks in late February and early March. Arabica broke its progression of rising lows in mid-September and found support near 100¢ in early December. Robusta broke its sequence of higher lows in October and found support later than month above $1500.

Arabica has been ranging for most of the last four months and is currently testing the upper side of the congestion area. A sustained move above 120¢ is needed to indicate demand is regaining the upper hand.

Robusta found support above the October lows in late December and rallied well to test the $2000 level. A sustained move below $1750 would now be needed to question potential for some further higher to lateral ranging.

Email of the day (1) - on credit default swaps:

"I am not a full subscriber but read with interest the CDS report from the link in Thursday's daily comment and would like to offer my own perspective.

"Of course Credit Default Swaps in and of themselves are not to blame but the widespread application of them has been imperfect. I think we can consider ourselves fortunate that, so far at least, the excessive creation of these instruments relative to capital (which debunks the analogous link between creating CDS and investing in a loan of the Reference Entity) seems to have passed its first stress test. Is it a bullet that kills or the finger that pulls the trigger? A tighter regulatory framework on these instruments must be a welcome safety catch.

"The suggestion that the price of a CDS should be taken as an assessment of the market's opinion on the creditworthiness of a reference entity is also dangerous. It seems to me that the more 'daisies' there are in a 'chain' the higher the markets perceived risk of a default by the reference entity must be. Is it right then to assess the credit worthiness of the entity by third party needs

that may not be connected to the entity itself? Could this not create an unnecessarily higher cost of capital for the entity? To my mind that adds inefficient noise and a 'fast food' form of information that could be substituted for good old fashioned due diligence.

"With best regards and thanks once more for a thought provoking email. Optimism they say, won't change the outcome but it does make the waiting easier!"

My comment - Thank you for a thought provoking email contributed in the spirit of Empowerment Through Knowledge and we look forward to may be welcoming you as a subscriber at some point in the future. Your view rhymes with my opinion expressed in the Subscriber's Area on Thursday January 8th.

Email of the day (2 & 3) - on additions to the Chart Library:

"Can you please add to the chart library UBS (CH) Equity Fund - Latin America?

Bloomberg Ticker UBSELAI SW
Reuters Id UBSFUNDS15

Thank you so much!

And

"Would you be kind enough to include the chart of Anooraq Resources (AMEX: ANO), in our library? Thanks and regards"

My comment - Thank you both for these interesting suggestions which have now been added to the Chart Library.

Email of the day (4) - on finding a fund in the Chart Library:

"I am trying to find iShares Global Inflation-Linked Bond (IGIL) in the chart library. However, a search on IGIL returns a different equity: Vigilant Technology Limited.

"I am wondering if this is an error in your database perhaps?"

My comment - Thank you for an interesting question. The reason Vigilant Technology Limited comes up in your search is because it is picking up the IGIL in Vigilant. The iShares Global Inflation-Linked Bond Fund has now been added to the Chart Library so it should now also appear in your search.

Email of the day (5) - on the 2yr Gilt Yield chart:

"in the UK 2yr yield graph GUKG2 there seems to be a big gap. Is this real or is it a data error? Thank you,"

My comment - Thank you for an interesting question. I checked this chart on Bloomberg and they also show the jump in yields over the New Year. Considering the timing of the move and potential for a change in the benchmark reference bond, I suspect that this jump is due to significantly difference coupon when the referenced benchmark bond changed early January. The current yield of approximately 1.55% is correct.

Here is the answer I received from the Bloomberg Help Desk: "There were several benchmark changes such as 1 month, 3 month, 6 month, 1 year, 2 year, 3 year, 4 year, 5 year and 6 year. Therefore, you will see differences in yields from Jan 2 2009 to Jan 5-6 2009 for 2 year and 5 year GGR tickers. The yields are accurate as well."

Today's interesting charts - Commodities almost all pulled back today and these moves can best be monitored in the Chart Library.

Oil - breaks back below $40 but would need to sustain a move to a new low beyond the very short-term to question potential for base formation development not to be underway.

Gold - breaks downwards from the short-term range and needs to sustain a move back above $900 to offset scope for some additional lower to lateral ranging.

Platinum - encounters at least short-term resistance near $1000 and needs to sustain a move above that level to indicate demand has regained the upper hand.

Last week's signups for the Free (Abbreviated) Comment of the Day - For the week of January 4th new signups, including subscribers and pre-subscribers, live in the following countries or regions: Australia, Canada, Hong Kong, India, Ireland, Japan, Netherlands, Singapore, the UK and the USA - 10 in total. In descending order, which topped the list in terms of the last week's new signups? It was the UK, the USA and India.

Thousands of people around the world receive Fullermoney's Free (Abbreviated) Comment of the Day, and their numbers steadily increase. Why do so many sign up? It is primarily due to word of mouth or word of press mention, from people who like Fullermoney's global perspective and our Empowerment Through Knowledge theme. Incidentally, on receiving our free daily email, you will not be contacted or solicited with advertisements and other marketing material. No one else will have access to your email address. We respect your privacy.

Please note - David is away today.

Tuesday 13th January 2009

Tim Price: Dealing with ermflation - These notes, published by PFP Wealth Management, are often witty in addition to being informative. Here is the opening:

In "Alice Through The Looking Glass?, the White Queen admits that she has sometimes believed as many as six impossible things before breakfast. She would be at home in today's markets. Last week, pornographers Larry Flynt and Joe Francis lobbied Congress for a $5 billion bailout in line with that sought by the auto sector. "As long as the government is handing out money, we want to be there to take it," said Francis. You can't fault his logic. The appeal may have been brazen, opportunistic and self-serving - so perhaps he should really be working on Wall Street.

It turns out that Ronald Reagan had most of the best lines in anticipation of the current economic black comedy. "A recession is when your neighbour loses his job," he said in 1976; "A depression is when you lose yours. And recovery is when Jimmy Carter loses his." Refreshingly for a politician, he also suggested that "The ten most dangerous words in the English language are "Hi, I'm from the government, and I'm here to help?." And on the same topic, he described government as "like a baby. An alimentary canal with a big appetite at one end and no responsibility at the other." Where we stand today, a problem caused primarily by the unconstrained greed of the private sector is now being addressed by the dubious intentions of the public sector. History suggests it will not be handled well. When money is spent, it can only be under one of three conditions. You can spend your money on yourself. You can spend your money on other people. Or you can spend other people's money on other people. This last version is the very definition of government spending.

My view - I suspect readers will be particularly interested in what Tim Price has to say about equity selection in the current environment:

Indeed the trick in 2009 will be to treat equities *like* bonds, as primarily income-generating assets (and something has to replace those deposit accounts at dodgy banks, which is to say all of them). So if the stocks in your portfolio are unlikely to maintain their dividend, or worse still don't even pay a dividend, you would be well advised to eject them with extreme prejudice.

I am in general agreement, particularly when deploying additional capital. I would certainly favour companies with good, sustainable dividends, as these are likely to outperform in a recessionary to low-growth environment. Similarly, I would also favour equity income funds. For growth, I would consider some of the Asian and resources-based emerging markets, which often have competitive valuations today.

Tactically, with stock markets rangebound, I prefer nibbling on setbacks. Also, to generate some additional return, until indices trend once again, it is probably a good idea to take some short-term profits when markets rally, as we last saw at yearend.

(*See also the World Equity Index Valuations Tables published by Eoin each month.*)

Barron's Roundtable 2009: Hang on Tight! - You may also find the introduction to this Roundtable a bit coy but the ten participants make some interesting points and are not always in agreement. It is posted without further comment but here is the introduction:

ONCE UPON A TIME, WE LIVED IN A WORLD where asset-price inflation begat leverage, which begat more asset inflation, in a virtuous circle known as the great bull market. We bought bad art, good wine and vacation homes (many), and stocks "on the dips," which made us rich. And geniuses, of course.

Then the big, bad wolves -- greed and excess -- came and popped our bubble, and the markets', and all the pretty assets fell to earth. The fairy god-mother -- bearing a strange name for a godmother, Uncle Sam -- tried to clean up the mess with great gobs of money, but little success. The pain, suffering and deleveraging continued, inflation went bananas, everyone shopped at Wal-Mart and the Hamptons returned to scrub and sand. And no one lived happily ever after -- except for incredibly savvy stockpickers -- at least for a good five years. And that, kids, was the story they told at this year's Barron's Roundtable.

Oh, yes, the details: "They" are the 10 investment experts depicted here, who sat down with the editors of Barron's in New York on Jan. 5 to make sense of the epochal events in the economy and financial markets in 2008, predict what will happen in 2009 and share their investment ideas for the new year, which so far looks much like the old. The day was rife with history lessons and warnings -- and optimism, too, that those who find bargains amid the rubble will reap rich rewards. Or, as Meryl Witmer nicely put it, "It is an exciting time to be a stockpicker."

My personal portfolio: Stops triggered in silver, and ArcelorMittal - As investors, most of us would like to run trends and I am no exception. However in this environment, there are far more ranging rather than trending markets. To perform, we need to trade on a buy-low-sell-high basis, more than most of us would wish to. Having been away on Friday and Monday, I find that three stops have been triggered, meaning that I have allowed paper profits to elude my grasp. Here are the results:

In silver, half my long position in the March contract was stopped out yesterday at $10.70, against my purchase at $10.66 on 23rd December. Today, the remaining March position was stopped out at $10.445 against my purchase at $10.40, also on the 23rd. This morning, two-thirds of my ArcelorMittal long was stopped out at €18.16 for a June position against my purchase at €17.94 on 2nd January.

For the record, I think that both silver and ArcelorMittal are in buying ranges, but I expect the volatility to continue. Prices above include all spread-bet dealing costs.

Additional Commentary by Eoin Treacy

Deutsche Bank Fundamental Credit Spread: 2009 Outlook - Thanks to a subscriber for this heavyweight, 79-page report on the credit markets by Jim Reid, Nick Burns and Adekunle Adermakinwa. Here is a section:

Figure 15 shows the implied default rates on the iBoxx indices split by corporates, financials as well as by rating band. We also show the same for HY and the CDS indices. The most extreme implied default rates are those in the IG space. We have shown the data for both average and zero recoveries. In reality one may want to split the difference between the two for a realistic assumption of recoveries in this unique crisis. For BBBs we are broadly pricing 30-50% defaulting over the next 5 years. The worst 5-year period since 1970 saw 5.8% default. This was seen between 1986 and 1990. This was the worst period for defaults since the Depression. For the Depression we do not have the same granularity of cumulative 5-year default data but our estimate based on the data we do have is that no more than 10-15% of BBBs would have defaulted over a 5 year period. So across the IG spectrum we are pricing in extraordinary default risk.

Our view on IG is that because it employs so many people, it will be a frequent beneficiary of bail-outs/support from the authorities. We are reminded of the debacle in the Telecom sector between 2000-2002. The large European IG Telecom companies had seemingly terminal debt problems but saw their balance sheets repaired almost at a stroke by the huge Government sponsored rights issues across the sector. The smaller European HY Telecom sector (that employed a significantly lower amount of people) saw the majority of its bonds defaulting. We need to bear this in mind when looking at the relative value between IG and HY. In Figure 75 and Figure 76 of this report we list the constituents of the iBoxx IG indices and include a column which shows how many people each company employs. This may be a useful reference figure when assessing the likelihood of a bail-out if the need arises.

For HY, the implied default rates are also extreme but it is not inconceivable that we will see cumulative defaults that get close to the implied default levels seen in Figure 15, especially the ones based on the zero recovery assumption. The worst modern day year for Global HY defaults saw around 12% default over the 12 months ending July 1991. We also saw this rate above 10% in 2002. We could easily see a year (probably 2010 or 2011 given the redemption schedules and decent short-term liquidity profile) that eclipses the 1991/2002 peaks. Although it is unlikely such a peak will be sustained over a 5-year period, it could remain high for long enough to easily see a 5-year cumulative default figure above the 30-35% range seen in the early 1990s and the early part of this decade. Figure 16 shows the cumulative 5-year HY default rate since 1920.

In the Depression we saw over 45% of HY companies default over the worst 5-year period commencing in 1931. The HY market back then was very different and predominantly consisting of fallen angels, so we have to be careful with comparisons. Nevertheless it is not hard to see a cumulative 5-year default rate of well over 35% as a result of this crisis. Whether it gets above 50% will depend on the severity of the economic malaise, but the chances are far higher of such an occurrence than seeing the IG cumulative 5-year default rate climbing into double-digits.

My view - Cash being made available by governments to increase credit market liquidity continues to grow as all the stops are pulled out in order to avoid the credit / solvency crisis' worst case scenario. Politicians have, to some extent, been chastened by the size of the market's reaction to some high profile bankruptcies and efforts to avoid other such failures are likely to continue in the immediate future. However, the chances of default in less systemically important companies remains high, particularly in the high yield market. Perhaps the best way to judge this is by looking at a number of important yield and spread charts.

US$ Composite BBB 10yr spreads broke upwards from historically lows levels in 2007. While they paused briefly near 300 basis points in early 2008, they have since surged to around 575 basis points. This move has been losing momentum since November which is a Type-2 top formation characteristic (as taught at The Chart Seminar) and a sustained move above 600 basis points is needed to offset scope for some compression. In absolute terms, the yield hit a medium-term peak in November and would need to sustain a move to new highs to question scope for some further downside.

US$ US Bank BBB spreads remain in a relatively consistent uptrend and while the current range has gone on slightly longer than pervious consolidations, a sustained move below 600 basis points would be needed to question potential for additional expansion. In absolute terms, the yield moved into a steep uptrend from January 2008 and accelerated to a peak in late November. The current reaction is larger and lengthier than previous pullbacks and from a higher level. A sustained move above 9.5% would now be needed to question scope for further lower to lateral ranging.

US$ US Finance BBB 10yr spreads were at historically low levels from 2004 - 2007, at least in part due to the flood of available liquidity. However, the spread began to widen in early 2007 and spiked higher from mid-2008. It has been losing momentum over the last 6-weeks, but needs to sustain a move below 800 basis points to break the progression of higher lows. In absolute terms, the yield continues to post high new highs and a sustained move below 10% would be needed to suggest that that the risk premium attached to this sector is lessening.

US$ US Finance BB 10yr spreads are testing 1000 basis points and are looking very overextended. However, a downward dynamic would be needed to check momentum beyond a brief pause. In absolute terms, the yield remains in a relatively consistent uptrend and may have entered another consolidation. A sustained move below 11% would be needed to question the

integrity of the overall move.

US$ US Industrial BBB 10yr spreads hit a high near 475 basis points in December but have been losing momentum over the last three months. A sustained move to new high ground would be needed to question scope for some further contraction. In absolute terms, yields peaked in late October and have returned to test the upper side of the May 2006 - September 2008 range. This is a natural area of potential support and it would need to sustain a move below 6.5% to question potential for some firming in this region.

US$ US Retail BBB spreads broke upwards in 2007 and have since expanded to more than 550 basis points. A sustained move below 520 would be needed to damage the integrity of the uptrend and question scope for further upside. In absolute terms, yields have been in an uptrend from the 2003 lows which accelerated from September 2008. The peak near 870 basis points appears to be of medium-term significance and a sustained move to new high ground would be needed to hinder further lower to lateral ranging.

US$ US Retail BB spreads remains in a tight uptrend and continues to post new highs. The first downward dynamic is likely to signal the onset of a medium-term correction. In absolute terms, the yield paused near 12% in the last week, but a sustained move below 11% would be needed to question upside potential.

These spreads and yield charts suggest that the high yield, retail and banking sectors are coming under considerably more selling pressure than the wider market. On the other hand, the risk attached to Investment Grade Industrials has contracted markedly over the last 6-weeks and yields have returned to the upper side of the three-year range. Further contraction would look more difficult from here, implying that the best bargains have been found but this continues to be a sector worth watching for future opportunities. The instruments under more intense pressure are also worth keeping an eye on, because if the slew of defaults predicted by these ultra wide spreads do not materialise, then value is being created. Thorough due diligence and a common sense appraisal of default risks are likely to prove fruitful in this environment.

Volatility Points to S&P 500 Gains With Widest Gap Since 1987 - This article by Jeff Kearns for Bloomberg covers the interesting spread between current and future volatility expectations. Here is a section:

Options traders are betting stock swings in the Standard & Poor's 500 Index will decrease at the fastest rate since the aftermath of the market crash in 1987, a sign that equities may keep rallying.

The difference between the benchmark index's historic volatility and a gauge of so-called implied volatility based on expected swings rose to the highest in 21 years, according to data compiled by Credit Suisse Group AG and Bloomberg. The gap widened as investors paid less to insure against price declines, sending the Chicago Board Options Exchange's Three-Month

Volatility Index lower.

Historical volatility must fall 25 percent to bring the measures into accord. The last time the difference was this wide, stocks climbed for two quarters, according to data compiled by Bloomberg. Declining volatility is usually bullish for equities because it shows growing investor confidence.

"We know a lot more than we knew four months ago," said Michael McCarty, chief equity and options strategist at Meridian Equity Partners Inc., a New York-based brokerage. "Any time you have less uncertainty you have less risk, which is positive for equities."

The S&P 500 gained 16 percent since reaching an 11-year low on Nov. 20 after President-elect Barrack Obama pledged to spend more than $1 trillion to revive the economy. The index still posted its worst year since the Great Depression in 2008 after lending froze and the U.S., Europe and Japan entered the first simultaneous recessions since World War II.

Lehman Collapse
Stock swings increased as the collapse of Lehman Brothers Holdings Inc. in September and government actions to bail out banks heightened concern losses would worsen. The S&P 500's three-month historic volatility has more than quadrupled since June to 62.97. That's 15.62 points higher than the CBOE's Three- Month Volatility Index, a measure of expected swings in the S&P 500. They were as much as 29.7 points apart in the past month.

Stocks rallied the last time the difference was this large, just after the S&P 500 plunged 20 percent on Oct. 19, 1987. The index climbed 4.8 percent in the first quarter of 1988 and 12.4 percent that year. The VXO, a predecessor of today's benchmark volatility index, decreased 31.7 percent in the first quarter and tumbled by 53 percent in 1988, its biggest annual drop.

My view - The 'Old VIX Index' hit a peak of 173 in 1987 before falling back to its mean level near 20 over the coming year. Stocks rallied well in the year following the '87 lows, in conjunction with this fall in volatility. In 2008, volatility did not reach the same highs as measured by the 'Old VIX index' but it has stayed relatively elevated for longer, perhaps in response to the economic problems being faced on this occasion.

However, as long as the trajectory for volatility continues to decline, a headwind for equity markets is diminishing. A sustained move above 80 would be needed to question this view. When we look at the spread of 3-month S&P 500 volatility (VIXV) over S&P 500 volatility (VIX), we see a tremendous spike in October as bets that high volatility would persist hit a peak. Since then the spread between the two measures has contracted to its mean, suggesting that expectations for prolonged high volatility have been completed scaled back.

Email of the day (1) - on real interest rates and interest rate differentials:

"Is it possible to get REAL Interest rates on Govt. debt (Interest rate - year over year CPI or GDP deflator). It would be nice to have this for the 2 year and 10 year notes for a few major currencies (USD, Euro etc.)?

"Currency X rates are often dependent on the real interest rate differentials. Even though we can graph real interest rates, as both the interest rate and the YOY CPI are in the chart library it is currently very difficult to graph real interest rate differentials."

My comment - Thank you for these suggestions which I'm sure will be of interest to other subscribers. I added 30yr, 10yr, 5yr and 2yr spreads over CPI YOY% for the USA, EU and UK to the spreads and overlays section of the Chart Library today.

These spreads illustrate the extent to which deflationary fears have already been priced into the market. Not surprisingly, CPI on a year-over-year basis is a lagging indicator of inflationary expectations and anyone looking at bond yields will be under no illusion as to how serious the economic contraction is. Nonetheless, these spreads can add value.

It is interesting that this is the first time since 1980 that the US 10yr has shown a negative real yield. The fact that is has not had anything close to the size of the move, relative to CPI, as seen in 1974 or 1980 is also worthy of notice. Of course back then, high inflation expectations were much more of a factor in the movement of the spread, but that is certainly not the case today.

We do not have the same length of back history for the Eurozone but to date none of the spreads have moved into negative territory.

In the UK, real yields have turned negative for the first time in a number of years across the range of maturities covered. This suggests that deflation rather than inflation is the predominant concern at present. These will be interesting spreads to watch for when they reverse because it will signal a return of inflationary concerns.

As for interest rate spreads, we have a large number of interest spread charts which we download from Bloomberg in the interest rate spreads section of the Chart Library. The problem with this series is that the scales are meaningless for anyone seeking information about the relevant spreads. I have been promising myself to take the time to create these spreads using the actual respective central bank target rates, but have not yet gotten around to it. I will make a start on this tomorrow.

Email of the day (2, & 3) - on additions to the Chart Library:

"Is it possible to have an inflation adjusted chart for the DJ Industrial Metals index?"

And

"Could you please include China Overseas Land & Investment Ltd (0688.hk) in the Chart Library? Thanks very much."

My comment - All of these interesting suggestions have now been added to the Chart Library.

Wednesday 14th January 2009

Is there a bubble in gilts? - My thanks to a subscriber for this item from the Investors Chronicle, which includes opposing views from John Redwood (yes) and David Kaunders (no). Here are the opening comments from both commentators:

YES, says John Redwood, MP for Wokingham and chair of the Conservative Party's economic competitiveness review

"The flight to 'quality' allied to aggressive interest rate cutting by the Bank of England has taken gilt yields down to unusually low levels. Today, you could get 1 per cent for lending to the government for one year, just over 2 per cent a year for lending to them for 3 years and a little over 3 per cent for ten years. Why would you want to do that?

The optimists about government bonds say that investors have no choice. Cash on deposit will yield next to nothing if rates fall further. If we go into a slump and stay there, and if inflation slows or turns to deflation, then bonds yielding 2-3 per cent are a good bet.

So what could go wrong for the gilt bulls? Governments like the UK may hurl so much more money at the problem, ballooning the Bank's balance sheet, printing notes and otherwise expanding the money supply, that they will start to generate inflation, forcing interest rates to rise again.

A bubble is when an asset class moves outside its normal price range and values, only later to fall back to earth. A few months ago, many told us oil had to keep on going up above the $140 a barrel it had reached, because the Chinese needed so much of it. Today, bond bulls tells us gilt yields will have to go down, because they are the only safe investment in a world of very low and falling interest rates and plunging inflation.

NO, says David Kauders, partner in Kauders Portfolio Management

Financial bubbles require total conviction by everyone that "there is no alternative" and in order to produce bubble conditions in the gilt market, extensive recommendation of gilts to the exclusion of most other investment classes is required.

Financial conditions have changed fundamentally. People are gradually moving away from the belief in borrowing to buy assets; caution is replacing the "have it now" attitude. This cultural change means that it is no longer possible for easy credit to fuel inflation. The deflation threat is real.

The flight to quality resulted from a combination of widespread losses, plus the rediscovery of risk following the various banking liquidity problems that started with Northern Rock. Governments have joined forces with the economic establishment and commentariat in proclaiming that more lending and more spending can lead the world out of the current pickle, restarting the good times and so bringing renewed prosperity.

Saner individuals are rightly questioning the need for more lending. Do we really want more bad debts on mortgages? Of course not. Will you vote for ever higher taxes to pay for higher public spending? Unlikely. Do we really want to force savers to spend their savings, perhaps through penal taxation as one pundit has argued? By any historical test, savings are already far too low.

My view - Readers will have their own view on this subject, which applies equally to all other OECD government bonds, and it may be influenced by their investment positions. In other words, it is harder to be objective about a bubble in which we are participating. Conversely, from the perspective of one on the sidelines, many powerful rallies will look like "bubbles".

Nevertheless, I think David Kauders drifts from the question, whereas John Redwood partially defines a bubble. I would add that in addition to moving "outside its normal price range and values", a bubble also encourages a dramatic increase in supply.

Here are charts for UK 10-year Gilt yields (monthly, weekly & daily). I am unable to provide data before 1989, so here is a monthly chart of US 10-year Treasury yields over 50 years.

What can we conclude?

Objectively, there is no doubt that government debt yields in the UK, USA and a number of other countries have moved well outside their historic, normal price ranges and values. This indicates a bubble, which some have described as a "return-free risk".

We need no reminding today that dire economic circumstances have contributed to these ultra-low yields. Indeed, governments have encouraged the move, with rate cuts and talk of quantitative easing, as part of their reflationary efforts. We also know that governments need to issue considerably more debt to finance their programmes, and they want to do this as cheaply as possible.

My conclusion is that those who are lending to governments at record or at least near-record low yields, are walking into a trap. The government bond bubble has yet to burst, judging from the charts, but it will burst. With bubbles, it seldom pays to delay one's exit until the downtrend is evident to all.

Major gold report: What Happened Last Time? - My thanks to a subscriber for this authoritative, blockbuster (100-page) report from CIBC World Markets. Here is a brief sample:

The current financial mayhem could be described as unique in the annals of history but there are enough similarities to suggest that we have been down this road before. While the street may have received new pavement, the potholes have an eerily familiar shape to them.

Looking back at the Great Depression, there were few gold stocks that can be used as a proxy for what happened. The one exception would be Homestake, which behaved much the way one might expect in a period of uncertainty and lost confidence. When the market crashed in October 1929, Homestake behaved much as the other stocks and declined by 30%. To holders of the stock, this offered little cushion to the 50% decline in the broader markets but nonetheless shows the outperformance that gold can offer in troubled times. Subsequent to the sell-off in Homestake, holding on to the shares offered a 44% return over the subsequent 2.5 years, while the Dow continued its fall through to 1932. From the Dow's lows of 1932, both it and Homestake rose about 350% in the next five years. Over the course of the entire dirty 30s however, the Dow lost 40%, while Homestake was up 500% all with only a modest adjustment in the gold price from $20.67/oz. to $35/oz.

A theme that seems to permeate broad sell-offs for the market is that all stocks are affected in a similar fashion when there is a liquidity crisis. Gold stocks in these circumstances behave just like any other stocks and fall victim to selling pressures as investors first worry about what to sell rather than what to buy. It therefore should not come as a surprise that gold stocks have behaved poorly in not only the recent financial crisis but also in past market corrections. In both the Asian Contagion of 1998 and the tech bubble blowout of 2000, gold stocks underperformed the broader market for a while before reasserting their strength when volatility settled down (Exhibit 4 and 5).

My view - The AMEX Gold Bugs Index (weekly & daily) has been a major outperformer since global stock markets established at least medium-term lows in October and November. However, it cannot move higher on its own and has lost upward momentum recently in line with the global trend. A sustained break above 300 is required to reaffirm recovery prospects.

Today's interesting charts - Fullermoney charts can be resized for your reports. Use the 'Options' feature shown upper-left for each chart that you access. Then click on 'Custom'. Change the size to suit and click on 'Save'.

DJ Euro Banks - This important index has fallen back from the upper side of its recent range to test the November low. An upward dynamic and / or move above 160 is now required to reaffirm that support and to remain consistent with base formation development. Conversely, a sustained downward break would reaffirm the overall downtrend.

UK (FTSE 100) - Possibly temporarily overextended following today's sharp drop but needs another upward dynamic to offset scope for a further test of underlying trading.

Germany (DAX) - Same as above, only somewhat weaker.

USA (S&P Diversified Financials) - Eroding support within range and needs upward dynamic and / or close above 265 to offset slide and indicate continued base development.

USA (S&P 500) - Eroding support following failed break above December highs and needs an upward dynamic to check risk of a further test of Nov-Dec lows.

Summary and conclusion - Renewed selling has more that wiped out the yearend and January 2nd rallies. The weakness of financial shares, which we regard as lead indicators, is of particular concern. Upward dynamics are required to check this self-feeding slide and to remain consistent with base formation development, rather than a redistribution within the overall downtrends. (*See also Eoin's chart review below.*)

Additional Commentary by Eoin Treacy

CBS News 60 Minutes: Did Speculation Fuel Oil Price Swings? - Thanks to a subscriber for this interesting report by the 60 Minutes team covering some of the reasons for the run up in the oil price in 2008 and the subsequent collapse. Here is a section:

In a five year period, Masters said the amount of money institutional investors, hedge funds, and the big Wall Street banks had placed in the commodities markets went from $13 billion to $300 billion. Last year, 27 barrels of crude were being traded every day on the New York Mercantile Exchange for every one barrel of oil that was actually being consumed in the United States.

"We talked to the largest physical trader of crude oil. And they told us that compared to the size of the investment inflows - and remember, this is the largest physical crude oil trader in the United States - they said that we are basically a flea on an elephant, that that's how big these flows were," Masters remembered.

Yet when Congress began holding hearings last summer and asked Wall Street banker Lawrence Eagles of J.P. Morgan what role excessive speculation played in rising oil prices, the answer was little to none. "We believe that high energy prices are fundamentally a result of supply and demand," he said in his testimony.

As it turns out, not even J.P. Morgan's chief global investment officer agreed with him. The same that day Eagles testified, an e-mail went out to clients saying "an enormous amount of speculation" ran up the price" and "140 dollars in July was ridiculous."

If anyone had any doubts, they were dispelled a few days after that hearing when the price of oil jumped $25 in a single day. That day was Sept. 22.

Michael Greenberger, a former director of trading for the U.S. Commodity Futures Trading Commission, the federal agency that oversees oil futures, says there were no supply disruptions that could have justified such a big increase.

"Did China and India suddenly have gigantic needs for new oil products in a single day? No. Everybody agrees supply-demand could not drive the price up $25, which was a record increase in the price of oil. The price of oil went from somewhere in the 60s to $147 in less than a year. And we were being told, on that run-up, 'It's supply-demand, supply-demand, supply-demand,'" Greenberger said.

My view - We took some flack for stating that the massive run-up in oil prices was being fuelled by speculation. From May it was becoming increasingly obvious that inflation had entered the public consciousness and that politicians were looking for a way to mitigate its effects. When Michael Masters gave his testimony before the Committee on Homeland Security and Governmental Affairs it initiated a massive debate on the role of commodities as investments. (Also See Comment of the Day on May 23rd 2008 and subsequently). The threat of legislation to curb commodity investment was enough to motivate a large number of speculators to liquidate their positions. The subsequent deepening of the credit / solvency crisis put further pressure on holders of commodity tracking investments.

This article assumes that the only reason for the massive run-up in oil prices was speculation but big moves do not happen without a sound fundamentally driven story to sustain interest. Peak oil remains a valid theme in terms of the rising cost of production but oil's price acceleration caused demand destruction which continues to challenge upside potential today.

Oil fell remarkably consistently from the highs near $147 to the lows below $34. However, the recent activity has been enough to break the consistency of the trend. Oil has now posted a higher high and a bigger rally than any seen in the last few months. This is enough to say that the base building process has probably begun. However, in past cycles, it has take oil a significant amount of time to recover and a lengthy convalescence is also likely on this occasion.

Gasoline and heating oil have held up better than oil over the last weeks. While oil is now retesting its lows, these products have sustained their gains. In relative terms, gasoline bottomed against oil from November and is now rallying strongly, a downward dynamic would be needed to question scope for further upside. Heating Oil broke upwards against oil in October and rallied to 3.3. It is now testing the upper side of the 6-week range and would need to sustain a move below 3.2 to question further upside potential.

Investment Postcards from Cape Town: Credit Market Watch: Gaining Positive Traction - Thanks to Prieur du Plessis for his thoughtful letter which contains a number of Fullermoney charts. Here is a section:

Despite the interbank lending rates having declined from their peaks, banks have significantly curtailed the amount of money they are actually lending. The US Depository Institutions Aggregate Excess Reserves continue their ascent at levels far in excess of the amount that banks need to keep on deposit to meet their reserve requirements (see chart below). This measure indicates that the balance sheets of banks remain under pressure, especially in view of the fact that the value of some assets is not known. As mentioned before, a peak in the Excess Reserves graph should coincide with a turning point in the recovery of banks.

Not illustrated by a chart, the spreads between ten-year Fannie Mae and other Government Sponsored Enterprise (GSE) bonds and ten-year US Treasury Notes have also tightened significantly over the past few weeks.

The national average rates for a US 30-year fixed mortgage yesterday declined to 5.08% from 5.33% a week ago and 6.46% in October last year. However, the rate is still 399 basis points higher than the three-month dollar LIBOR rate. According to Bloomberg, this spread averaged 97 basis points during the 12 months preceding the crisis, indicating that lower rates are not being passed on to consumers.
As far as commercial paper is concerned, the A2/P2 spread measures the difference between A2/P2 (low quality) and AA (high quality) 30-day non-financial commercial paper. The spread has declined markedly to 2.23% from almost 5% at the end of December

Similarly, junk bond yields have also declined, as shown by the Merrill Lynch US High Yield Index. The Index dropped by 22.9% to 1,682 from its record high of 2,182 on December 15. This means the spread between high-yield debt and comparable US Treasuries was 1,682 basis points by the close of business on Tuesday. With the US 10-year Treasury Note yield at 2.32%, high-yield borrowers have to pay 19.12% per year to borrow money for a ten-year period. At these exorbitant rates it is extremely difficult for companies with a less-than-perfect credit status to conduct business profitably.

My view - This is a useful conglomeration of credit measures, most of which are available in the Chart Library. Since Prieur helpfully points out that a chart of Fannie Mae spreads over Treasuries was not available, I added one today. This spread spiked to a high near 190 basis points in November before collapsing back to the its 2yr trend near 60 basis points. The spread has widened again since the New Year and a sustained move below 75 basis points would be needed to question scope for further upside. Fannie Mae is in all but name government guaranteed so one has to question how high spreads will go before significant demand is generated for these products.

Some measures of credit conditions have improved over the last few months, particularly the TED spread. However, banks are still hoarding cash and making the terms under which they are willing to lend very difficult. This continues to put pressure on cash strapped companies and in effect is exacerbating the economic problems.

Stock market investors turned their attention to these issues again in the last week, with most indices selling off rather heavily. In many cases, today's move breaks the short-term progression of rising lows from the December nadir. Upward dynamics are needed to question scope for some further short-term downside.

Interest Rate Differentials Update - Interest rate differentials are about the only hard fundamental in the currencies markets, so we regard it as a priority to display relevant charts for the most interesting currency pairs in the Chart Library.

Today, I added spread charts for interest rates between the USA, Eurozone, UK and Japan over Australia, Canada, Switzerland, Denmark, Eurozone, UK, Japan, Norway, New Zealand, Sweden, South Africa, India, Singapore, Brazil and Russia. These can all be found in the FOREX Interest Rate Differentials section of the Chart Library. I will continue to expand this matrix over the coming days.

Today's interesting charts - The Chart Library has two Search Engines. One searches the more than 17,000 equities, funds and ETFs in the International Equity Library. The other searches through the rest of the Chart Library for indices, commodities, currencies bond prices and yields, ratios, spreads and overlays. You can also customise these charts and save any of them in your Favourites section. Check the Library's Help section for further details.

FTSE 350 Banks - breaks downwards from the three-month range and an upward dynamic is needed to check momentum beyond a brief pause.

China A-Shares - continues to show the best signs of base formation development and would need to sustain a move to new lows to question this hypothesis.

US Dollar per 1 New Zealand Dollar - the New Zealand Dollar is testing the lower side of the three-month range and an upward dynamic is needed to reaffirm prior support and offset the risk of some further downside.

Email of the day (1,2 & 3) - on additions to the Chart Library:

"Please would you add these 2:

"Japan index linked 1.2% 2017
Japan index linked 1.4% 2018"

And

"Could you please add Sino-Ocean Land Holdings (3377 HK) to the chart library? Thank you."

And

"Could you add the following US listed symbols, HAP and PXR."

My comment - Thank you for these interesting suggestions, all of which can now be found in the Chart Library.

Email of the day (4) - on chart updates:

"Can you please update the charts for the Horizons BetaPro Global Mining Bull Plus ETF and the Horizons BetaPro DJ-AIG Agricultural Grains Bull Plus ETF as they have both had a 4 to 1 reverse split."

My comment - Thank you for alerting us to this change. The relevant adjustment has been made to the chart data.

Thursday 15th January 2009

The Blossoming of Nuclear Power - My thanks to a subscriber for this informative report by Robin Blumenthal, which appeared in Barron's this week. Here is the opening:

THE U.S. STANDS AT A PIVOTAL MOMENT for the advancement of nuclear energy. President-elect Barack Obama has put forth a goal to reduce carbon emissions in the U.S. by 80% by 2050, using $150 billion over 10 years to create a "clean-energy" future. Nuclear plants are the biggest producers of energy that doesn't emit any greenhouse gases.

"Nuclear power is in a renaissance," says Tom Neff, a physicist and research affiliate at MIT's Center for International Studies. In fact, 17 applicants are seeking government approval to build 26 nuclear plants, meeting a Dec. 31 deadline for federal tax credits and potentially ending a 30-year hiatus in the construction of new U.S. nuke facilities.

That adds up to a big investment opportunity. Even if it takes 10 years for the first of the new crop to be built -- a distinct possibility -- some of the power companies operating the 104 existing nuclear plants look tempting right now. Their stocks are cheap and their competitive advantages are many. They have lower costs than rivals such as coal-fired facilities, putting them in a better position to ride out the recession. They'll come out much better than the competition if a carbon tax is imposed. And they're better-prepared for the long haul in the new era of nuclear power.

"Owning companies that already own nuclear is the sweet spot for investing in utilities," says Mark Finn, utilities analyst at T. Rowe Price.

My view - One of the biggest bubbles in the last bull market was in anything associated with uranium, particularly uranium miners, due to a bull run for this energy metal and renewed interest in the nuclear industry. The bubble burst,

needless to say, and this has made the nuclear industry interesting once again.

Robin Blumenthal has focussed on the USA's leading nuclear-energy players in the report above. He is probably right to do so, as nuclear utilities are a conservative way to participate in this industry during troubled times for the overall economic outlook. After all, they have defensive characteristics, pay decent dividends that are reasonably covered, and should have a bright future.

Here are the shares listed: Entergy / ETR (weekly & ratios), Exelon / EXC (weekly & ratios), Southern / SO (weekly & ratios), Duke Energy / DUK (weekly & ratios), Constellation / CEG (weekly & ratios) and FPL Group / FPL (weekly & ratios).

Under normal economic conditions, I would say these shares represented very good value. However these are most certainly not normal economic conditions, as we all know. Looking at the chart patterns above, we see potential bases, although I am not quite sure what to make of Southern, which has mostly ranged in a choppy fashion. My conclusion is that value investors who share Robin Blumenthal's view, which I do, could nibble at these shares, or their equivalent in other countries, on retests of the lows.

Email of the day (1) - On gold:

"I try to mentally follow your trades. Curious if you still have a gold position? I can't find a sell/stop reference."

My view - My personal trades and investments are usually mentioned in advance, in terms of interest, and always listed in Fullermoney as they occur. These can be found in the site Search facility under the heading - My personal. I do trade gold futures and currently have a small long position.

Email of the day (2) - Also on gold and an earlier email:

"I loved your reader's appreciation of my analysis. It is a perfect description of what contains the financial policy for the last 40 years of the American government and others which has brought us to the financial currency collapse we have today. Getting real is the question. What does one do if a policy is not working? Answer: a little bit more of the same...

"In particular, I love the attributes that were given to cash, i.e. of yielding a dividend and compensating for inflation. Forgetting income tax, of course, and capital gains... Has it? It was the argument for the Swiss National Bank to sell its 1000 tons of gold at $250 or $300 an oz, in order to get a "real" income of 5-3% in dollars. Wow! What a good deal! Apparently, for our critics the dollar going from 4.30 Sfr to 1.10 Sfr couldn't be called an inflation either.

"Gold is not an investment. It is a life saver of one's earned money. Yes, it's

hard to imagine going back to shuffling gold bars around countries, but using it as mercury in a thermometer is something quite different and practical. But these ideas will have no following until God forbid total desperation manifests itself. I think that companies with hard assets and cheap book values will probably explode up first when people begin to have "real" doubts, which is another use of the word getting real to face the real buying power of their currencies. If used as a question: who will be getting real? It is marvelous because we will soon finally be supplied with a possible uncontestable answer."

My view - Respectful debates are healthy (after all, we have shared objectives in terms of wealth preservation and creation) and are a welcome feature on this site. One of the key points that you and your fellow subscriber referred to above have in common, I believe, is a belief that good stocks at attractive valuations will lead the eventual recovery.

I share your views on gold, and well said.

Additional Commentary by Eoin Treacy

2009 credit Outlook: The Sovereign Floor - Thanks to a subscriber for this interesting report by Jeffrey Amato for Goldman Sachs covering the credit markets. (Please note that the author makes use of a large amount of fixed income related market terminology. For those interested, the terminology can be looked up in www.investopedia.com) Here is a section:

A warning to those with less experience of the fixed income markets,
Our positive view on financial credit is largely predicated on government support. Governments have the incentive to support funding markets and investor demand for Tier 1 securities. This is not only because of the debt guarantees and direct investments the authorities have made in the sector. Getting funding markets to function smoothly and keeping the Tier 1 market viable are also important goals in seeking resolution of the credit crisis. Longer-term regulatory risk remains a key issue in the sector, but this is unlikely to be a major worry for creditors, especially in 2009.

Further deterioration in the credit cycle will challenge the asset quality of banks and insurance companies. Pro forma Tier 1 capital ratios in the banking sector are now quite large on average and have room to absorb a sharp increase in loan impairment rates (Exhibit 9). However, there is increasing focus on core Tier 1 and tangible common equity ratios as both have generally been much lower in Europe (see Exhibit 9). Core equity is likely to be needed for many banks.

While CDS has rallied from autumn 2008 highs, cash spreads still do not reflect the high degree of state support largely due to the presence of high liquidity premiums (Exhibit 10). For investors with balance sheet capacity, these high premiums present an attractive opportunity on a 12-month holding

period. A "barbell strategy" is sensible at this stage, with good risk-reward tradeoffs present in senior and Tier 1 debt securities.

Government-guaranteed issuance is likely to remain healthy throughout 2009. This new class of securities has opened up a new source of funding for banks by appealing to other classes of fixed income investors. As the lower yield on guaranteed paper holds less appeal for traditional credit investors, we also expect to see increasing issuance of nongovernment guaranteed senior debt. The non-guaranteed market is already active in Europe at the start of this year, with sizeable premiums back of CDS. So while we continue to see attractive valuations in secondary markets, there should be even better opportunities to add senior debt exposure in the primary market in H1.

Tier 1 securities offer the best absolute return prospects within the investment grade universe. Current valuations are attractive across many names in the space, especially in those cases where governments have made capital injections either subordinate or pari passu with respect to existing Tier 1 securities. The market is pricing in a substantial risk that securities will be left outstanding. Improvement in market liquidity of Tier 1 securities is likely to be modest, at best, in the near term; but as we have noted before, the high absolute yields achievable in subordinated financials will increasingly attract interest from alternative investors. For instance, according to the iBoxx indices, the average yield on Tier 1 securities is currently 18.4% (Exhibit 11), which compares with an expected dividend yield of 4.1% (market-cap weighted) across the European coverage universe of our bank equity analysts.

Tier 2 securities also offer attractive yields although we are more cautious owing to less visibility in this part of the capital structure. The decision by Deutsche Bank not to call a Lower Tier 2 issue last December raised fears about callable securities. In general, we believe the risk of maturity extension in Tier 1 securities is relatively low as most banks will not want to put funding costs at risk or limit access to this segment of the market; Tier 1 will remain an important source of capital for banks in coming years. That said, risk is not zero, and there is a chance that dividends do not get paid or securities called.

My view - The core of any fixed income strategy comes down to the risk of whether the issuer will default on its debts. CDS' tell us how much protection is being bought against such an event, but does not give us an objective idea as to the likelihood of such a scenario. It is too easy to become mired in the maths and models of the fixed market and forget to employ the most useful tool we have; common sense.

Default rates had fallen to historically low levels before the credit / solvency crisis but are now rising as the global recession deepens. Default rates always rise during a recession for obvious reasons. What sets this occasion apart has been the level of government intervention to support credit markets. A government guarantee has been put behind a large number of banks and financial institutions, forcing a reassessment of their default probabilities. The collapse of Fannie Mae spreads in the latter half of the year exemplifies the re-pricing of such instruments.

The need for a Swedish solution to the credit crisis (Also see Comment of the Day on September 30th 2008) is being debated in a number of countries. This would see the banks nationalised, shareholders wiped out, but creditors protected. If such a scheme were put in place on this occasion, there is no guarantee that bond holders would be protected but it does seem likely. Politicians are, for now, unwilling to flirt with the idea of allowing a large financial institution to go bankrupt following their Lehman Brothers experience. This does not preclude nationalisations, but in that event, they will not want to risk a deepening of the crisis. The possibility of a 'Swedish' being implemented in a country makes holding bank's equity considerably more risky than holding the respective corporate bonds.

High yield and systemically unimportant financial companies would appear to be most at risk of default and continue to see spreads widen as investors choose comparatively safer sectors. However, high yield will provide excellent returns whenever the economy begins to recover, and these spreads are worth watching as a potential lead indicator for the wider market.

JPMorgan, Wells Fargo Lure Risk-Averse With 'Almost' Treasuries - This article by Alexis Leondis for Bloomberg covers the opportunities available for investors looking for a comparatively secure investment when compared to what is available in the Treasury market. Here is a section:

Investors seeking higher yields than U.S. Treasuries with comparable risk should consider bank bonds backed by the Federal Deposit Insurance Corp., said Gary Pollack, head of fixed-income trading and research at Deutsche Bank AG.

American Express Co. issued FDIC-backed bonds in December with three-year maturities yielding 2.501 percent and JPMorgan Chase & Co.'s three-year notes are yielding 1.821, according to data compiled by Bloomberg. That compares with yields of 1.027 percent for three-year Treasury notes.

"We're buying these for our clients because they're 'almost' Treasuries with better yields, said Pollack, who helps oversee $12 billion at Deutsche Bank AG's Private Wealth Management unit in New York.

At least sixteen banks and FDIC-approved financing units, including San Francisco-based Wells Fargo & Co., New York-based JPMorgan, Goldman Sachs Group Inc., Citigroup Inc. and Stamford, Connecticut-based General Electric Capital Corp., have raised $114.7 billion through the FDIC's Temporary Liquidity Guarantee Program, based on Bloomberg data. The program, announced in October to help thaw the credit markets, assures investors they will get a timely payment of principal and interest should an issuer go bankrupt.

The FDIC protects each bank depositor up to $250,000, a limit which is set to drop to $100,000 at the end of this year. FDIC-backed bonds allow investors to maintain the federal guarantee above $250,000, according to Jonathan Krasney, a certified financial planner at Mendham, New Jersey-based

Krasney Financial, LLC.

Bank customers can obtain more FDIC coverage by opening accounts in different ownership categories, such as joint accounts, individual retirement accounts and revocable trusts.

Higher Yields
While FDIC-backed bank bonds may offer higher yields than Treasuries, certificates of deposit provide better yields than both bonds, said Debra Brede, a wealth manager in Needham, Massachusetts. "I like to diversify, but there's no reason to include Treasuries or FDIC-backed bank bonds in your portfolio right now -- you can get the same government backing with CDs," Brede said.

Three-year GMAC bank CDs are paying 3.34 percent with an annual yield of 3.4 percent, based on Bankrate.com data.

The benefit of FDIC-backed bonds is they can be traded without penalty, unlike CDs, said William Larkin, a fixed-income portfolio manager at Cabot Money Management in Salem, Massachusetts, which manages $500 million in assets. Cashing out a CD that has a term of at least two years before its maturity may incur a penalty of six months' interest, according to Bankrate.

My view - The FDIC program gives a considerable advantage to corporations using it because they get to borrow at such low rates compared to what they would normally be able to do. In an environment where investors continue to favour the security of Treasuries, receiving an additional yield for bonds with a hard government guarantee must be appealing to some.

The comparatively low coupon on these bonds makes them unlikely to perform if the perceived risk of default in other fixed income sectors relaxes. However, for risk averse investors looking for a better return than that on Treasuries, they may be a viable option today.

I added two of the bonds mentioned in this article, as representative of the sector, to the Chart Library today. These are the American Express FDCI 3.15% 2011 and the JPMorgan Chase FDIC 2.125% 2012. Both have only been in existence for a short time, so there is very little back history.

Obama Takes Aim at Last Reason to Own Bank Shares - This article by David Pauly for Bloomberg covers the potential for the new US administration to put limits on dividend payments and executive pay. Here it is in full:

There's no end to the sufferings of bank shareholders. Banks have traditionally paid hefty dividends. In the years before the onset of the subprime mortgage crisis, payouts by Bank of America Corp., for instance, yielded about 3 percent to 4 percent of the company's stock price and grew steadily.

Now President-elect Barack Obama plans to take away even that attraction, Lawrence Summers, who will head the new administration's National

Economic Council, informed Congress this week.

Obama -- not unreasonably -- will order the Treasury Department to limit dividends paid by commercial banks and investment banks that receive "exceptional assistance" from the government to "de minimis amounts."

While investors have known that current yields were ballooned by falling share prices and that massive bank losses made some payouts unsustainable, many may have bet that relatively stronger banks would still maintain nice returns.

Yields now reach 13 percent at Bank of America and 14 percent at Citigroup Inc. -- even after both reduced payouts. JPMorgan Chase & Co. shares yield 5.9 percent, Morgan Stanley's 6.3 percent. Both companies have kept payments steady.

Now, what dividends, if any, banks can pay may depend on how extraordinary "exceptional" may be interpreted and how trifling "de minimis" may turn out to be.

Numbers Game

Is the $45 billion in U.S. bailout funds dropped on Citigroup more exceptional than the $25 billion put into Wells Fargo & Co., allowing the latter bank to keep its dividend yield at 5.9 percent? Will Morgan Stanley, recipient of a mere $10 billion, be reined in? It seems likely that dividends of all the major bank recipients of Washington rescue money will be restricted.

Goldman Sachs Group Inc. might think its yield of 2.5 percent qualifies as minimal. It's less than the 8.3 percent average yield on the 29 stocks in Standard & Poor's 500 Diversified Financials Index and 3.4 percent on stocks in the broader Standard & Poor's 500 Index. Still, Obama's Treasury might say the company, now a commercial bank, should use more of the $830 million or so it pays in annual dividends to shore up its capital.

The government might want other banks to conserve more, too, considering the industry's poor earnings outlook. JPMorgan Chase's annual dividends now cost $5.7 billion, Wells Fargo's the same.

Obama's Treasury may want to assure the banks have enough money to pay the dividends they owe U.S. taxpayers. The preferred shares in financial institutions that the government bought in the rescue effort pay 5 percent dividends for the first five years, 9 percent after that.

Not to Worry

Though dividend losses will hurt, the new government may be doing the banks a favor. Dividends are the last thing they should worry about given the state of their finances.

At last count, commercial and investment banks worldwide had written off $736 billion in mortgage losses. Federal Reserve Chairman Ben Bernanke and Fed Vice Chairman Donald Kohn this week said illiquid debts still held by

banks cloud the true value of the companies' shares. They recommended further government aid, perhaps the purchasing or guaranteeing of bad loans.

Even with the aid it already has received, Citigroup is desperately raising capital. It's merging its Smith Barney brokerage business with that of Morgan Stanley this week, getting $2.7 billion and recording a $5.8 billion net gain in the bargain. The bank is shopping other assets such as the CitiFinancial consumer loan business, according to people familiar with bank strategy.

Summers also told Congress that Obama would place restrictions on banks' executive pay, stock buybacks and acquisitions of financially strong companies. Amen. Government dictates were sure to follow the welfare checks. They may be what's needed if banks are to live to pay decent dividends again.

My view - One of the reasons restrictions have not already been put on bank dividends is because of successful lobbying from the pensions industry who rely on the yield. However, it is politically unfeasible to expect tax payers to fund massive capital injections without measures being put in place to make sure that the cash is put to the best possible use. One can also expect some move on the populist call to limit executive pay. Millions being paid to CEOs who have run their businesses into the ground is a legitimate bugbear for most of us.

Email of the day (1) - on oil's contango:

"Today's Financial Times has an article on how the Contango in WTI crude prices has opened up arbitrage opportunities.

"Is it possible to get a graph of the spread they discuss in the article i.e. Spot price - 1 year forward price for the WTIC? Thank you"

My comment - Thank you for this interesting email. I believe the story you refer to is by Javier Blas and titled Traders profit as ship-stored oil doubles. Here it is in full:

Oil companies and traders are storing enough oil in supertankers to supply the world for one day, in one of the most striking signs of supply outstripping demand as the impact of the economic crisis overshadows a string of Opec production cuts.

According to Deutsche Bank's oil trading desk "over 80m barrels of oil is now on floating storage", double the industry assessment of about 40m-50m last month.

Jens Martin Jensen, managing director of Bermuda-based Frontline, the world's largest operator of supertankers, confirmed the figure of 80m barrels, saying that the oil was stored in supertankers capable of carrying about 2m barrels - known as VLCCs - and in smaller tankers of 1m barrels, known as Suezmax.

"We are getting many enquiries about floating storage," Mr Jensen said. "Players are looking for anywhere from one month to six months floating storage arrangements."

Companies such as Shell and BP, and big traders such as US-based Koch or Dutch-Swiss Vitol are storing oil in tankers, with shipping brokers reporting the hire of several supertankers as floating storage in the past few days.

Mr Jensen said investment banks were joining oil companies and traders and entering into floating storage deals. Shipbrokers said that Phibro, a commodities unit of Citigroup, had also started hiring tankers for storage in the North Sea.

Traders are profiting from a record price difference between spot oil and future contracts that allows them to arbitrage physical barrels - buying spot oil and putting it into storage while, at the same time, selling a forward contract to lock in a profit.

The spread - which is in a condition called a contango, where future prices are higher than spot prices - is at a record high.

The difference between the price of West Texas Intermediate oil for immediate delivery and the one-year forward contract - a key indicator - yesterday widened to about $21.5 a barrel, the largest difference since US oil futures started trading 25 years ago.

The large spread is in part the result of the credit crunch, which has distorted the physical arbitrage process as some market participants - particularly private equity groups and hedge funds - cannot secure loans to finance oil storage, traders said.

The International Energy Agency, the western countries' oil watchdog, said last month that the "increase in floating storage has developed as a result of abundant prompt supplies having a hard time finding customers".

Reports of oil being held in tankers have been circulating for a while. With the difference between the short and long end of the futures curve at such a wide level, and tanker rates at such low levels, this arbitrage is likely to continue. However, if tanker rates begin to advance, they could put significant pressure on this trade as profit margins are squeezed. This means that tanker rates will be just as important to monitor as the relevant oil prices for those participating in this trade. This earlier article, published on December 4th has some additional reporting on relevant storage costs.

Email of the day (2) - on additions to the Chart Library:

"In the 12 Jan. commentary the dollar denominated ETF was added to the library. Can you please add the GBP denominated iShares Global Inflation Linked Bond Fund (SGIL)? Thanks"

My comment - Thank you for this suggestion which has been added to the Chart Library.

Friday 16th January 2009

Commentary by Eoin Treacy

Deutsche Bank Global Economic Perspectives: Implications of Obama Fiscal Expansion for Treasury Yields - Thanks to a subscriber for this interesting report by Peter Hooper and team covering the effect on treasury yields of higher debt levels. Here is a section:

Implications for the Treasury market
How troublesome are these impending debt levels? Do the magnitudes envisioned risk becoming large enough to have a substantially negative impact on the market for US Treasury securities? Will global investors be able to absorb them without a substantial increase in the "risk premium" on US national debt? Will they become a significant source of pressure on the Fed, perhaps to the point even of leading down a slippery slope of monetization of the debt? Such questions are rife in the market currently, so we felt it would be useful to review some of the empirical evidence on this point.

Past episodes of surging national debts
We consider first what has happened in other cases where national debt levels have risen sharply, indeed often substantially more than in the projections we have just outlined: namely, (1) the more than tripling of the US national debt, from around 45% of GNP during the 1930s to 150% of GDP just after World War II (Chart 4), (2) the more than doubling of the US debt ratio from less than 25% to around 50% following the Reagan tax cuts in the early 1980s (also Chart 4), (3) the surge in Japan's national debt from 60% of GDP to more than 160% during the past decade and a half (Chart 5), and (4) the doubling of Sweden's debt from 40% of GDP to 80% during its financial crisis in the early 1990s (Chart 6). The results are mixed, but largely disappointing. In the US WWII and Japan cases, there is little or no evidence of a positive association between surges in debt and either nominal or real government bond yields (the results for nominal bond yields, not shown, were more negative than those for real rates). Perhaps this is not surprising; in the US case, the financial sector was heavily constrained via government intervention, high reserve requirements, capital controls, credit ceilings, and so on; in Japan's case, the economy was undergoing a decade-long economic slump, and high Japanese national and household savings rates would have diffused any concerns about excessive government debt levels. In the cases of the US in the 1980s and Sweden in the 1990s, however, there are some hints that real rates rose with the rise in debt ratios.

My view - The degree to which government debt levels are rising is a worrying trend and investors are rightfully asking where the money is going to come from to repay it. The other side of that equation is, are the USA's and Europe's largest creditors going to be happy with such paltry yields on long-term debt. Fears of depression and a desire to put one's cash where the principal is protected, at any cost, have helped to drive prices to such historically high

levels. Considering the incredible growth in supply, the ability of sovereign bonds to maintain such elevated levels will in no small part be related to the extent to which economic fears can continue to get worse.

In terms of the technical action, 30yr Treasuries found support in June 2007 near 105 and rallied to the upper side of the multi-year range where they consolidated for most of 2008. They broke above 120 successfully in November and accelerated to nearly 142. The 10yr Treasury has a relatively similar pattern. It encountered resistance above 128 and has since posted a third lower high. A sustained move above 128 is needed to question scope for further downside.

An acceleration out of a well defined trading range, particularly one that has persisted for a lengthy period, would normally be a sign that a new uptrend is beginning. However, when we look at the longer-term history, bonds have been in an uptrend for more than two decades. Therefore, this is an acceleration following a massive bull-run, rather than a breakout from a base, and should be viewed as an ending signal of short, probably medium and potentially long-term significance.

The 30yr's pullback to 132 was by far the largest in the course of the move from the October lows and checked the advance in the short and probably medium term. The subsequent relief rally needs to continue to encounter resistance below the highs to give further weight to this medium-term call. In terms of the 10yr yield, the acceleration to 2% is overextended and at least a relief rally appears likely. If for whatever reason, inflationary fears gain the upper hand or foreign creditor nations demand a higher yield, there is potential for yields to rally considerably.

US Treasuries, in common with many other bond markets, rallied from the June 2007 lows, but they outperformed their international counterparts by sustaining the gain for most of 2008 and then accelerated impressively. US government bonds have now had the most extreme pullback when compared to other sovereign markets. It may be instructive, on a commonality basis, to examine how other markets are performing.

The Canadian government bond market most resembles the Treasury market, in terms of its performance from the June 2007 lows. Both rallied well and consolidated for most of 2008. However, for Canadian bonds this occurred above the 2005 highs while, for Treasuries it occurred below. The Canadian 10yr broke upwards to a new high this week and while it looks overextended in the short-term, a sustained move below 124, is now needed to question scope for some additional upside. Canadian yields remain in a downtrend which has been gathering pace over the last few months. The long tail posted three weeks ago had no follow through and the market posted a new low this week. The first upward dynamic, which is sustained beyond a couple of days, is likely to signal a low of at least medium-term significance.

UK Gilts retested their 2007 lows in June 2008, before rallying strongly towards the 2006 highs. Following a relatively brief consolidation below 115, the market rallied impressively, to test the 1998 and 2003 highs. The loss of

momentum following such a massive move is an inconsistency. However, the bulls will point to the fact that this range is no larger than that which occurred between late August and early November. A sustained move below 120.8 would break the progression of rising lows, and push back into the previous range. A sustained move below 119.1 would violate the MDL (Mid-Point Danger Line stop, as taught at The Chart Seminar), while a sustained move to new high ground is needed to reaffirm the uptrend. UK yields found support near 3% at the beginning of the year but, have so far been unable to sustain a rally beyond a few days. However, a sustained move below 3% is now needed to question scope for some further higher to lateral ranging.

In common with UK Gilts, Euro Bunds rallied well, having tested the 2007 lows. They initially consolidated between 114 and 118 before accelerating to near 126. Euro Bunds broke upwards from the most recent range on Wednesday and would now need to sustain a move below 122.5 to question scope for some additional upside. Eurozone yields continue to consolidate in the region of the 2005 lows and a sustained move below 2.9% is needed to question further potential for some additional higher to lateral ranging.

JGBs briefly retested the 2006 and 2007 lows in June before quickly rebounding to range between 136 and 140. The 10yr moved closer to the upper side of the range from October and remains in a tight consolidation below 140. A sustained move above this level is needed to indicate that the bulls have seized the initiative. Japanese 10yr yields rallied impressively from the lower side of the 6-year range last week and would need to sustain a move below 1.2% to question scope for some further higher to lateral ranging.

The Australian 10yr appeared to be breaking downwards from an extended top formation in March but found support in June, moved into a consistent uptrend and is currently setting new highs. To date, the move has been consistent and a sustained move below 95.6 would break the progression of higher lows which have been the hallmark of the advance. Australian 10yr yields broke the psychological 5% level in November and broke below 4% this week. While the move is losing momentum a sustained push above 4.35% is needed to break the progression to lower highs.

From these charts we see that US Treasuries showed relative performance from 2007 and now show the most topping characteristics of any government bond market covered in this analysis. Other markets are either losing momentum, or continue to accelerate. On a yield basis, we do not have conclusive bottom signals but there are enough signs for us to be more cautious of the potential downside relative to the potential upside - vice versa for prices.

Hoisington Quarterly Review and Outlook - Thanks to a subscriber for this interesting report from Hoisington Investment Management Company which argues the bullish case for Treasury bonds over the coming decade, assuming a Japan style bust. It is posted without further comment, but here is a section from the conclusion:

In the world's three most recent debt deflations - the U.S. from the 1870s to the 1890s, the U.S. from the 1920s to 1940s, and Japan from the 1980s to the very present - the low in long term interest rates occurred about 15 years after the end of the debt mania (Chart 5). Even 20 years after the end of the debt boom, interest rates were not much above their yearly average lows. Using this history as a guide, it would not be surprising to experience a decade of low and declining interest rates.

During 2008, long term Treasury bond yields fell from 4.5% to 2.7%, producing an extremely strong total return for such investments, as typified by the Wasatch-Hoisington Treasury Bond Fund (WHOSX), which returned 37.7%. Credit problems affected returns elsewhere in debt markets, limiting returns on the Barclays Capital U.S. Aggregate Bond Index (formerly the Lehman Index) to 5.2%. The decline in long Treasury yields reflected the intensification of recessionary forces as well as a collapse in inflationary expectations.

While the historical record indicates that the ultimate low in Treasury yields lies years away, the path to the ultimate low will be anything but smooth or linear as significant volatility continues. As the experience from U.S. and Japanese history indicates, many "false dawns" will occur, with investors assuming that the long-delayed cyclical recovery in economic activity is at hand. During these pleasant but relatively short interludes, stock prices will probably rise dramatically and bond yields will increase. If history is a guide, however, these episodes will further drain wealth and will be thwarted by the persistent forces of the debt deflation. With yields in the long Treasury market very low in nominal terms, the real return will be greater if deflation sets in. Moreover, in Japan from 1988 to the present, as well as in the U.S. from 1872 to 1892 and 1928 to 1948, the total return on Treasury bonds exceeded the total return on stocks. Such a condition cannot happen for the long run, but it did happen in these three instances spanning two decades. As a hedge against a recurrence of a prolonged debt deflation, some investors may want to consider even larger positions in high quality, long term Treasury securities.

Roseman Eruptions: Seeds for a Powerful Rally Lay in Money-market Fund Assets - Thanks to a subscriber for this article by Eric Roseman which includes a number of helpful statistics. Here is a section:

For the first time since 1994, U.S.-based money-market fund assets exceed the total under management in stock funds. That statistic in its own right is a heavily contrarian signal, suggesting stocks are heavily oversold.

According to the Federal Reserve, data through November show total money-market fund assets at $3.7 trillion dollars compared to $3.6 trillion dollars invested in stock mutual funds; equity fund assets almost halved over the last 12 months from $6.9 trillion dollars in late 2007.

It's no surprise to learn that many hedge funds have been shorting money-management stocks since late 2008 as earnings compress amid a deluge of investor redemptions. Worse, the big fund complexes now have to contend

with money-market funds yielding almost nothing as management fees exceed the effective yield paid by those funds. Not a pretty picture for fund company earnings.

My view - The mountain of cash sitting on the sidelines will provide the fuel for the next big market rally. The timing of this move will best be monitored using charts. The most noteworthy thing most stock markets did in the last month was to rally consistently from their December lows to the top of their three-month ranges and fail at these levels.

The Dow Jones Industrials and S&P500 found support yesterday near 8000 and 820 respectively and rallied to finish the day relatively unchanged. These levels have been important areas of support since October and would need to be violated on a sustained basis to question scope for further lateral ranging.

Sentiment since early October has been swung around in line with markets. As indices move towards the upper side of their ranges, the possibility of an upward break is countenanced. However, as we saw this week, when markets fall on consecutive days sentiment can return to ultra bearish extremely quickly. It will take time but a sustained move above 9600 and 1000 respectively is needed to indicate that demand is gaining the upper hand beyond a short-term relief rally. Once this occurs, investors sitting on cash and happy with that decision are likely to be tempted back into the market in greater numbers which could fuel a significant rally.

ECB Has Emerging Asia Decoupled? - Thanks to a subscriber for this educational report by Gabor Pula at the ECB covering the lessons learned from using the Asian International Input-Output table. Here is a section:

The main findings of the paper are the following. First, only about one-third of the value added in emerging Asian countries is determined by external demand, significantly lower than the 50% exposure suggested by the aggregate trade data, while domestic demand contributes around two-thirds to the value added. Second, the dependence of emerging Asia's value added on export markets has steadily risen since 1995, a phenomenon in line with increasing global trade integration, and a clear evidence against the decoupling view. Third, although intraregional and Chinese markets have both gained importance, they still account for only around 7% of the final demand. This share is also below the one suggested by trade data. As regards extra-regional markets, the G3 economies accounted for 16% of total final demand in 2006, with an increasing dependence of emerging Asia on the EU15, and a declining importance of US and Japanese markets. Moreover, demand from the rest of the world has recently grown substantially, accounting for 14% of total final demand in 2006 - a share equal to that of the G3 countries.

As it is evident from these results, the paper finds no support for the decoupling view. At the same time, however, it finds that, if the bias in trade data due to the segmentation of production is accounted for, the exposure of emerging Asia to external demand is significantly lower than suggested by trade statistics. In other words, on the one hand we find no evidence of

decoupling, but on the other hand we calculate that emerging Asia is less "coupled" with the rest of the world than suggested by trade data.

When interpreting the results, one should note the caveat that the analysis with the AIO table can only capture the direct trade effects, i.e. neither any "second-round" effects of an export slowdown on domestic demand via lower employment, wages or investment, nor any financial market or policy related channels are accounted for.

Our findings on the production structure of the Asian hub and the role of China within it, also add some interesting insights to the literature. The "backward linkages" of production indicate a changing role of China in the Asian hub. Rather than being a last stage assembler, China increasingly takes over the role of Japan and supplies inputs for the production in other countries of the region. This finding is in line with the changing structure of global production networks and the downsizing of manufacturing activities in advanced economies.

My view - The global recession will probably set back the development of trade ties between emerging Asia and the rest of the world Ex-G3. However, I believe it is safe to assume that this trend will reassert itself when growth returns and will become of increasing importance over time.

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