A B L V

BANKING / INVESTMENTS \ ADVISORY

Global Financial Market: Topical Issues of February

Leonīds Aļšanskis, Dr. Math.
ABLV Bank, AS, Chief Analyst

Contents

Results of February 2012	2
Situation in financial and economic system	3
Greece: It’s a swap-up!	5
Global stock market	8
Global bond market	11
Global currency market	13
Gold	15
Silver	16
Oil	17
Review information	18

Results of February 2012

Macroeconomic reports published in February, including those on GDP 2011, confirmed the increasing economic problems in Europe and Japan, while situation in the economies of U.S. and developing countries was more positive.

According to preliminary estimates, euro area GDP fell in Q4 2011 by 0.3%, but grew by 1.5% over the year, mainly due to the economies of Germany and France, which showed an annual increase of 3% and 1.6%.

Japan's GDP declined in 2011 by 0.9%, that of UK rose by 0.9%, while in the U.S. grew by 1.7%.

Much better results in 2011 were shown by the economies of developing countries, including the BRIC countries showing GDP growth of 2.9%, 4.2%, 7.4%, and 9.2% respectively.

At the corporate level, the situation looked more positive in 2011, but the reports for Q4 2011 showed slower growth of companies' profits (+4% of S&P 500, versus 14% in Q3 2011).

The major topic of the month remained the restructuring of Greece debts, which was finally approved in February, and it was agreed to write off 53.5% of private debt, i.e. about € 107 billion.

But this event has already been taken into account by the market, and the absence of other negative news and decisions of central banks of Great Britain, Japan and the euro area to inject liquidity contributed to the growth of positive sentiment in global financial markets.

As a result, February was the second consecutive month of strong growth in the global stock market, and many of the world's leading indexes were able to show double-digit percentage price increases from the beginning of the year.

Positive trends also dominated on the bond market, including emerging markets in the sector and the PIIGS sector, with a slight fall in prices of the U.S. securities.

In the currency market, the month was relatively quiet, and the dollar showed mixed performance against both developed and developing currencies, with a slight fall to the euro and noticeable increase to the yen.

In the commodity markets, the month was more volatile, and gold prices resumed growth, the price of an ounce jumping by 11% to reach $1740.

Silver demonstrated even greater price increase, where the price of an ounce increased by 19% over the month!

In the oil market, diverse movements in prices of Brent and WTI oil were observed in January. Price of barrel of the former increased by 2% during the month, while that of the latter declined by 3%, resulting in the spread between them growing from $11 to $14.

A powerful injection of liquidity performed by the ECB (i.e. printing of the euro) and the agreement on the Greek PSI really eased tensions in the euro area debt market.

However, the statement made by the EU president Herman Van Rompuy on "turning point in the crisis" being reached does not look convincing, and only time will show whether it is true or false.

Situation in financial and economic system

In February, Bank of England and Bank of Japan decided to extend the programs QE (quantitative easing), increasing the volume of buying government bonds from the market in response to the weakening of their economies.

The former is to throw in the economy extra £50 billion, bringing the total QE program to £325 billion, while the latter – another ¥10 trillion (about $130 billion), increasing the total amount of purchases from ¥55 trillion to ¥65 trillion.

The ECB also continued to strengthen its balance sheet, although in some other way – in the framework of long-term crediting of commercial banks – Long-Term Refinancing Operation (LTRO).

On 29 February, at the second no-limit 3-year auction, the ECB lent €529.5 billion at 1% to 800 banks (at the first auction on 21 December 523 banks borrowed €489 billion), "printing" more than €1 trillion during two months!

In fact, the said central banks repeat, albeit belatedly, the strategy of the FRS (except for the BOJ, which was actually the first to launch QE back in 2001) first strongly criticised, especially by the ECB.

It is possible that a more "aggressive" policy used by the FRS in last years allowed the U.S. economy to show better results, which prompted other major central banks to perform similar actions.

The U.S. winning strategy was also confirmed by February reports: in January unemployment in the U.S. fell to a 3-year low of 8.3%, while in the euro area it reached a new historic high – 10.7%.

Two other important indicators – manufacturing and services PMI – in the U.S. remain above 50 since the beginning of 2010, and in February those were equal to 52.4 and 57.3, while in the euro area they have fallen below 50 since mid 2011, and for February amounted to 49 and 48.8, standing for continued stagnation.

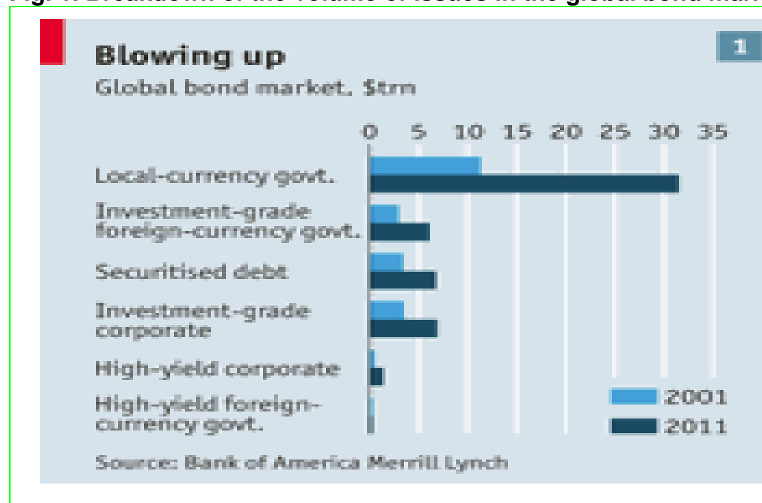
Whereas economies of developing countries continue to show even more positive dynamics after the crisis, even compared with the U.S.

According to preliminary data, GDP growth of Russia in 2011 amounted to 4.2% – the best indicator among G8 countries, and two other members of the BRIC countries – India and China – showed strong growth by 7.4% and 9.2% (in Brazil the increase was only 2.9%).

Another important negative factor and serious risk for developed economies, unlike developing countries, is constituted by public debts accumulated in recent years (which exist mainly in the form of bonds).

According to the Bank of America, over the past 10 years, the amount of the bond market of public debt has tripled and is about $40 trillion (see Fig. 1).

Fig. 1. Breakdown of the volume of issues in the global bond market



The fact that these are mainly debts of developed countries can be clearly seen from Table 1, according to which the general public debt of 11 developed countries most burdened with debts is about $38.5 trillion.

Table 1. Table of public debt and budget deficits of some countries with high debt

	2011 (forecast)			2010		2009		2008		2007	
Country	Public debt	Public debt to GDP	Budget to GDP	Public debt to GDP	Budget to GDP	Public debt to GDP	Budget to GDP	Public debt to GDP	Budget to GDP	Public debt to GDP	Budget to GDP
Japan	$12 trillion	233%	-10%	220.3%	-9.5%	216.3%	-10.3%	195%	-4.2%	187.7%	-2.4%
Greece	€345 bn	165%	-7.4%	142.8%	-10.5%	127.1%	-15.4%	110.7%	-9.8%	105.4%	-6.4%
Italy	€1.9 trillion	121%	-4.4%	119.0%	-4.6%	116.1%	-5.4%	106.3%	-2.7%	103.6%	-1.5%
Ireland	€177 bn	106%	-10.8%	96.2%	-32.4%	65.6%	-14.3%	44.4%	-7.3%	25.0%	0.1%
Belgium	€355 bn	100%	-3.9%	97.1%	-4.1%	96.2%	-5.9%	89.6%	-1.3%	84.2%	-0.3%
USA	$15 trillion	100%	-10.3%	91.6%	-10.6%	84.6%	-12.7%	71.2%	-6.4%	62.2%	-2.7%
Portugal	€156 bn	93%	-5.6%	93.0%	-9.1%	83.0%	-10.1%	71.6%	-3.5%	68.3%	-3.1%
France	€1.7 trillion	87%	-6.0%	81.7%	-7.0%	78.3%	-7.5%	67.7%	-3.3%	63.9%	-2.7%
England	£1.3 trillion	86%	-8.4%	80.0%	-10.4%	69.6%	-11.4%	54.4%	-5.0%	44.5%	-2.7%
Germany	€2.1 trillion	85%	-2.3%	83.2%	-3.3%	73.5%	-3.0%	66.3%	0.1%	64.9%	0.3%
Spain	€693 bn	68%	-6.1%	60.1%	-9.2%	53.3%	-11.1%	39.8%	-4.2%	36.1%	1.9%

Source: Bloomberg, Eurostat, EconomyWatch

At the micro level, the situation in developed countries still looks more positive, and in post-crisis years there was an increase in corporate profitability, many companies already having exceeded pre-crisis levels.

Simple calculation of the dynamics of S&P 500 companies' profits, presented in the diagram in Fig. 3, shows that the average amount of profit in Q4 2011 equals 115% of the profit in Q4 2006.

But part of this growth has been achieved by reducing costs – including layoffs that will definitely have negative effects on demand, and hence the profitability of companies in the longer term.

In this context, the Bloomberg forecast on the dynamics of profits of S&P 500 companies may be too optimistic.

Greece: It's a swap-up!

In February, a final agreement between Greece and representatives of private investors was reached on a "voluntary" restructuring of the bond debt under the PSI program.

Instead of the old bonds, investors will get new Greek bonds maturing in 2042 (a partial redemption will begin in 2023) and two short EFSF papers, with a total of 53.5% of face value of old securities being written off.

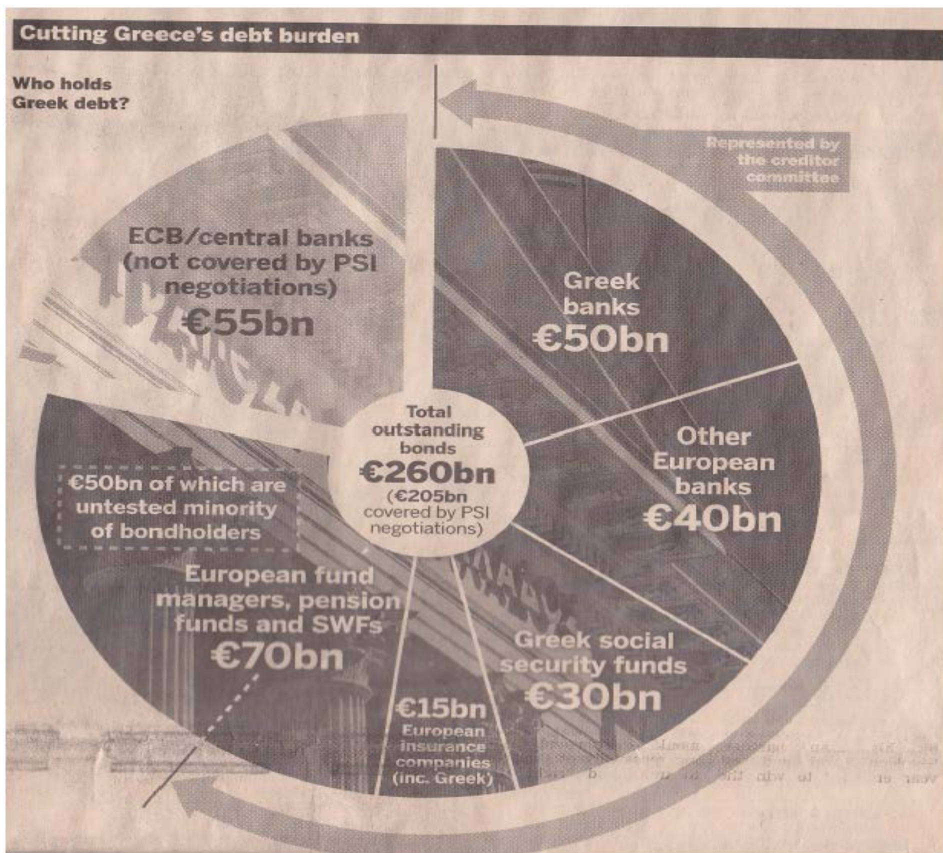
But, as the head of Commerzbank Martin Blessing has noted, "The participation in the haircut is as voluntary as a confession during the Spanish Inquisition."

This agreement may also be compared to a situation where you "voluntarily" share your property with a gang of robbers.

Since the securities held by the ECB and central banks of other euro area countries will be exchanged without the write-off (maybe they are gang members?), the total amount of "forgiven" debt will be about €107 billion (see Fig. 2).

As current public debt of Greece is around €350 billion, i.e. 160% of GDP, it will be reduced by 31% – to reach about 130% of GDP, whereas it is supposed to be reduced to 120% by 2020.

Fig. 2. Breakdown of holders of Greek government bonds



Source: Financial Times

Write-off of such a large amount of assets will be a serious challenge for the European financial system, especially for the banking systems of Greece and Cyprus, the most overloaded with Greek bonds.

This is the first time in modern history when such a large debt of a developed country is written off, which could set a dangerous precedent for the global financial system, overburdened with public debts of developed countries (see Fig. 2).

In addition, the "asymmetry" of write-offs could seriously undermine investors' confidence in the euro area financial system, with corresponding negative consequences for the single currency itself.

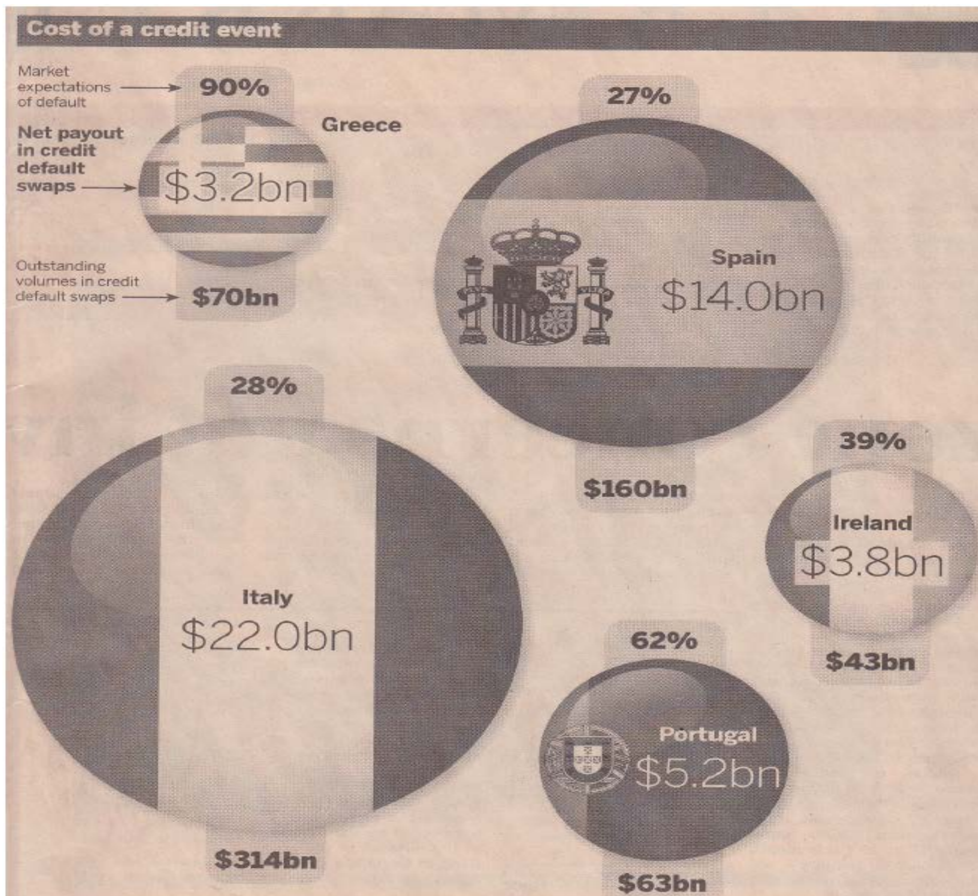
Given such situation, on February 28 S&P has already downgraded Greece rating to "selective default" SD (however, warning that after completing the exchange the Greek rating can be upgraded to CCC).

However, ISDA, which is to make the decision on starting payments on CDS, responding to two inquiries made by investors in February (including those on unequal exchange), has not yet recognized the situation as a credit event.

To date, the market volume of Greek CDS is estimated to be $70 billion, and 99% of this amount is held by five U.S. banks: JP Morgan, Bank of America, Citibank, Goldman Sachs and HSBC Bank.

However, after netting of sold and bought CDS held by one person, according to the Depository Trust Clearing Corp, the amount in question will be reduced to only $3.2 billion (see Fig. 3).

Fig. 3. Charts of the outstanding CDS on bonds of PIIGS countries



Source: Financial Times

USA: unsuccessful struggle with deficit

Despite the plan on reducing budget deficits by $2.4 in the next 10 years adopted in the U.S. in 2011, significant decrease of deficits has not been achieved yet.

In the current fiscal year 2011-2012 ending in September 2012, the deficit could reach $1.33 trillion (8.5% of GDP), and this will be the fourth consecutive year when the budget deficit exceeds a trillion dollars!

In February, President Obama submitted to Congress a draft budget for fiscal year 2012-2013 with a planned deficit of $900 billion.

The plan involves tax increases that will apply to wealthy Americans and reduction of costs under budget items that are supposed not to cause any social tensions.

However, the Republican majority has already criticized the plan, claiming it to be a part of election program and putting forward sharp alternative proposals that do not involve tax increases.

Therefore, it will be extremely difficult even to adopt, much less execute the next budget with a deficit below the trillion.

Especially since in February Obama himself announced another initiative – to lower the corporate income tax from 35% to 28%, which may reduce the revenues of the budget.

In case of adopting this initiative, the average rate of taxation of income of producers (including provided incentives) in the U.S. will be 25% against the current 32%.

The White House offers reducing financial losses that will follow the decline of the tax by means of fighting tax violations and eliminating 12 most popular tax breaks.

However, this part of Obama's plans may run into stiff resistance from Republicans.

Another problem lies in the fact that actual steps to reduce the deficit may adversely affect the currently fragile recovery of the U.S. economy.

The slowdown of the economy will also lead to a substantial reduction in budget revenues and, consequently, to an unexpected increase in the budget deficit.

Global stock market

February was already the second consecutive month of strong growth in the global stock market, and many of the world's leading indexes were able to show double-digit percentage price increases from the beginning of the year (see Table 2). And for the Japanese N225 last month was the best February since 1991.

Table 2. The dynamics of movements of several leading world stock market indexes

Stock index	P/E (Bloomberg)	Div.Yeld (Bloomberg)	2003-2007	2008	2009	2010	2011	January 2012	February 2012	2012
DJI (USA)	13.3	2.5	59.0%	-33.8%	18.8%	11.0%	5.5%	3.4%	2.5%	6.0%
S&P 500 (USA)	14.1	2	66.9%	-38.5%	23.5%	12.7%	0.0%	4.4%	4.0%	8.6%
Nasdaq Comp. (USA)	24.1	1	98.6%	-40.5%	43.9%	16.9%	-1.8%	8.0%	5.4%	13.9%
GDAX (Germany)	12	3.6	178.9%	-40.4%	23.8%	16.1%	-14.7%	9.5%	6.2%	16.2%
N225 (Japan)	25.4	2	78.4%	-42.1%	19.0%	-3.0%	-17.3%	4.1%	10.5%	15.0%
FTSE (England)	11.1	3.8	61.5%	-31.0%	23.2%	9.0%	-5.6%	2.0%	3.3%	5.4%
CAC (France)	10.9	4.5	83.2%	-42.7%	22.3%	-3.4%	-17.0%	4.4%	4.7%	9.3%
RTS (Russia)	5.9	2.2	537.9%	-72.4%	128.6%	22.5%	-22.0%	14.3%	10.0%	25.7%
MICEX (Russia)	5.2	1.9	492.3%	-67.2%	121.1%	23.2%	-16.9%	8.0%	5.5%	13.9%
SSEC (China)	12.7	2	287.4%	-65.4%	80.0%	-14.3%	-21.7%	4.2%	5.9%	10.4%
HSI (Hong Kong)	9.9	3.2	198.4%	-48.3%	52.0%	5.3%	-20.0%	10.6%	6.3%	17.6%
KOSPI (Korea)	22.6	1.2	202.3%	-40.7%	49.7%	21.9%	-11.0%	7.1%	3.8%	11.2%
TWII (Taiwan)	19.1	4.1	91.0%	-46.0%	78.3%	9.6%	-21.2%	6.3%	8.0%	14.8%
SENSEX (India)	15.9	1.4	500.7%	-52.4%	81.0%	17.4%	-24.6%	11.3%	3.3%	14.9%
BOVESPA (Brazil)	11.7	3.6	467.0%	-41.2%	82.7%	1.0%	-18.1%	11.1%	4.3%	16.0%
IPC (Mexico)	18.7	1.4	382.1%	-24.2%	43.5%	20.0%	-3.8%	0.9%	1.1%	2.0%
TOP40 (South Africa)	12.8	2.9	202.4%	-25.9%	28.6%	14.6%	-0.6%	6.0%	1.2%	7.3%
MSCI WD (World)			100.6%	-42.1%	27.0%	9.6%	-7.7%	4.9%	4.7%	9.8%
MSCI EM (Emerging)			326.6%	-54.5%	74.4%	16.4%	-20.4%	11.2%	5.9%	17.8%

Source: Thomson Reuters,Bloomberg, ABLV Bank

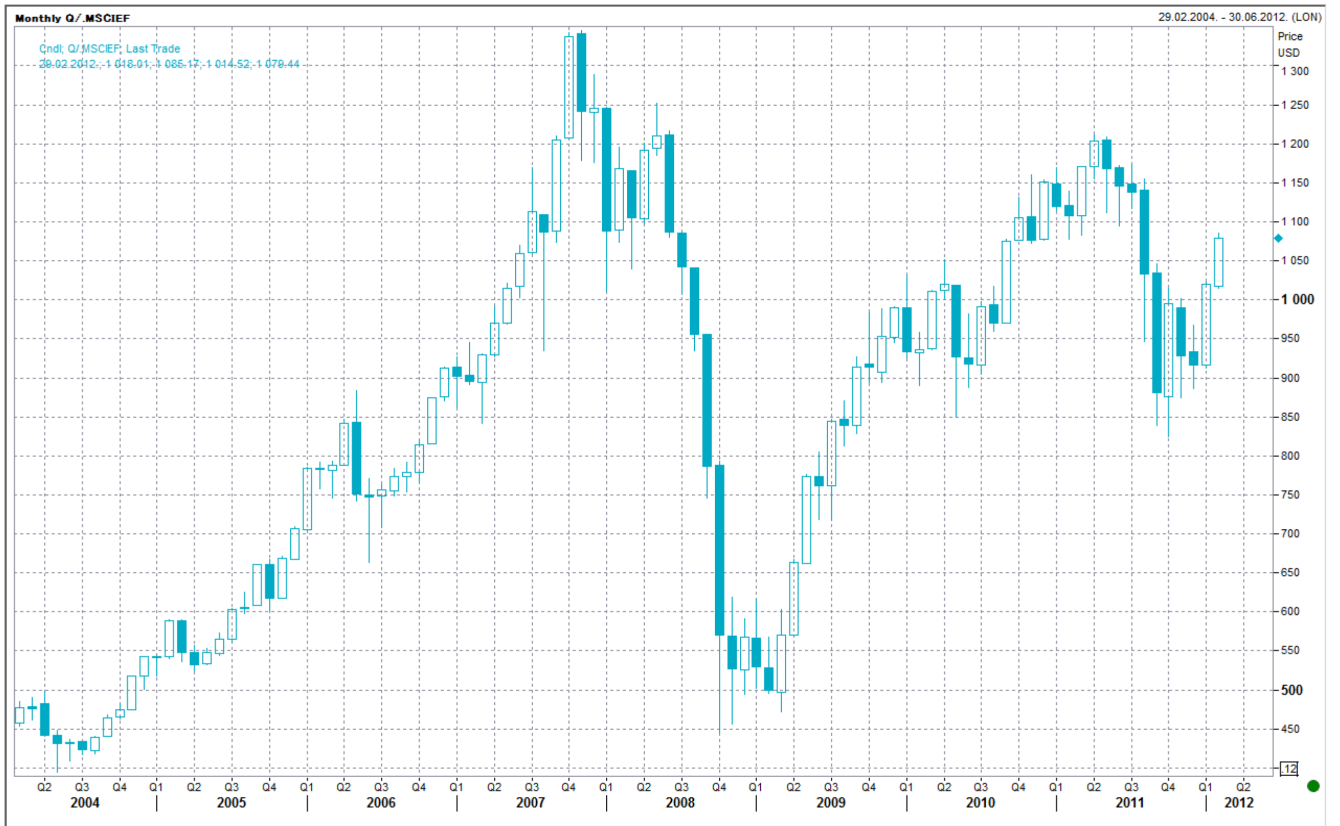
The rise in prices on the world MSCI World Index for the month was 4.8% (see Fig. 4) that, together with growth by 4.9% in January, let index rise by 9.8% since the beginning of the year, compensating all the losses of the index for 2011 (-7.7 %).

Fig. 4. Dynamics of the MSCI WORLD index, monthly bars

Source: Thomson Reuters

Prices of the index MSCI EM have increased slightly more – by 5.9% (see Fig. 5) that, together with an increase by 11.2% in January led to the index growth by 17.8% since the beginning of the year.

Fig. 5. Dynamics of the MSCI EMERGING MARKETS index, monthly bars



Source: Thomson Reuters

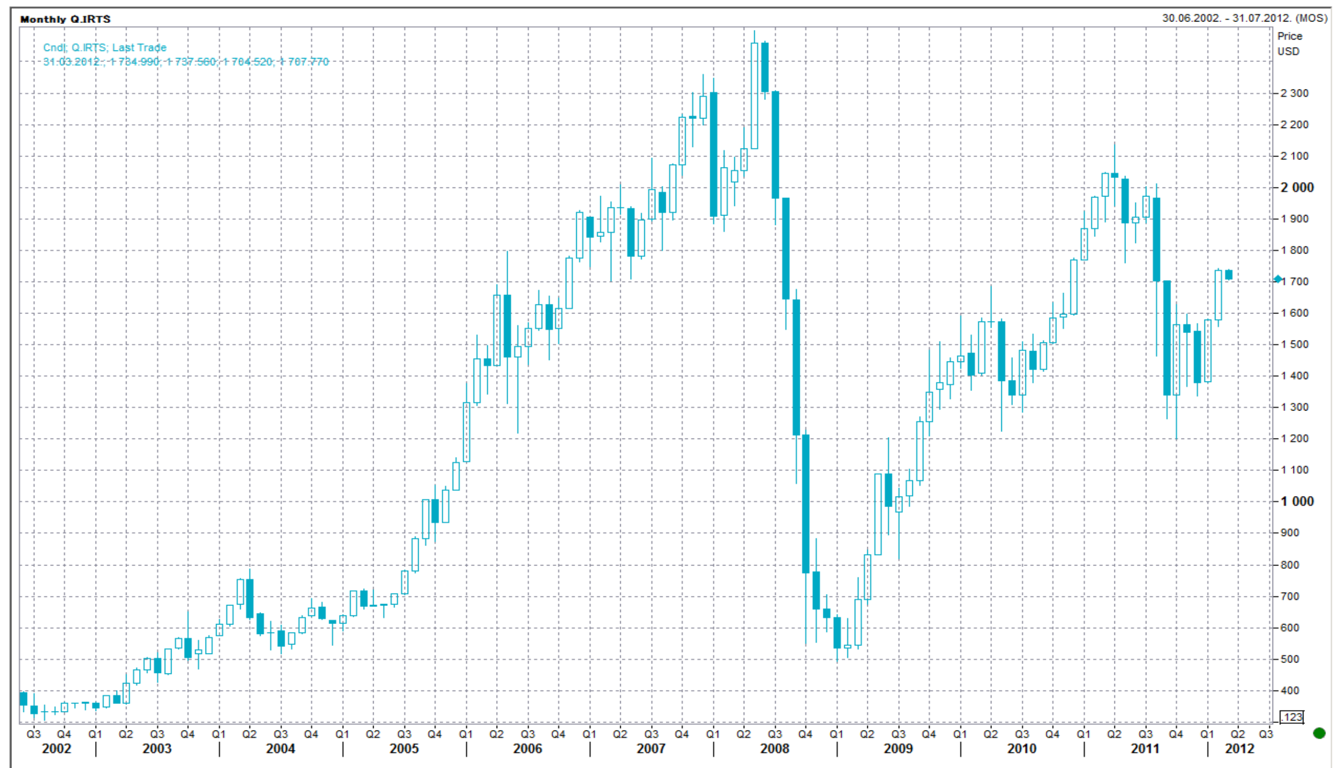
In February, the highest growth among the indexes monitored by us was demonstrated by Japanese N225, which grew by 10.5% (see Fig. 6). For the index, February 2012 became the best February since 1991 in terms of growth.

Fig. 6. Dynamics of N225 index, monthly bars

Source: Thomson Reuters

The second-largest monthly increase among the indexes monitored by us was shown in February by the Russian RTS, which grew by 10%, allowing the index to take first place in terms of growth since the beginning of the year: +25.7% (see Fig. 7). However, almost half of this growth was ensured by growing rouble, and rouble index of the Russian market MICEX rose only by 13.9% over the first two months.

Fig. 7. Dynamics of RTS index, monthly bars



Source: Thomson Reuters

Our assessment of future scenarios

Despite the significant rise in prices in early 2012, the situation in the global stock market remains highly uncertain. On the one hand, the observed growth of monetary base of leading currencies contributes to increased demand for stock assets as well. On the other hand, the possibility of increasing debt crisis in the euro area can bring back strong negative trends to the market.

However, one can continue to adhere to our proposed strategy for entering the market, choosing the "strong" companies (or indexes) with low P/E and high Div. Yeld (for many of the indexes, these figures are still very attractive, see table).

Even if negative trends return to the market, the high level of dividends will allow investors to outwait long period of market decline, receiving a steady cash flow in the form of dividends, which exceeds coupon yield on government bonds of the leading countries.

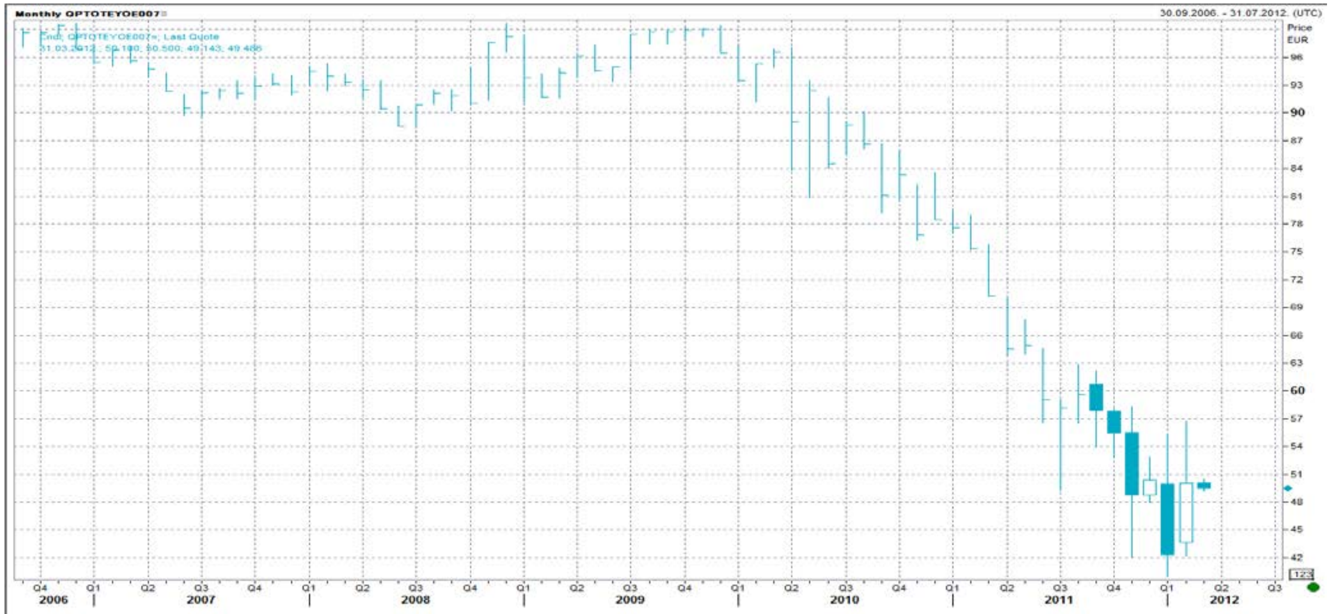
Whereas in case stable growth is observed, the investor will gain considerable profit due to increase in stock prices.

Global bond market

The situation in the global bond market in February, given declining crisis in the euro area, was positive both in the developing sector, and for the securities of most PIIGS countries.

The largest growth among the latter was shown by securities of Portugal, soaring by 19%, which, however, only compensated for the equally considerable loss in January, when the price fell by 16% (see Fig. 8). Over the month, the yield of these securities fell from 16% to 13%. However, it is still very high and does not leave the country a chance to go back to the loan market.

Fig. 8. Dynamics of price movements of 10-year bonds of Portugal, monthly bars



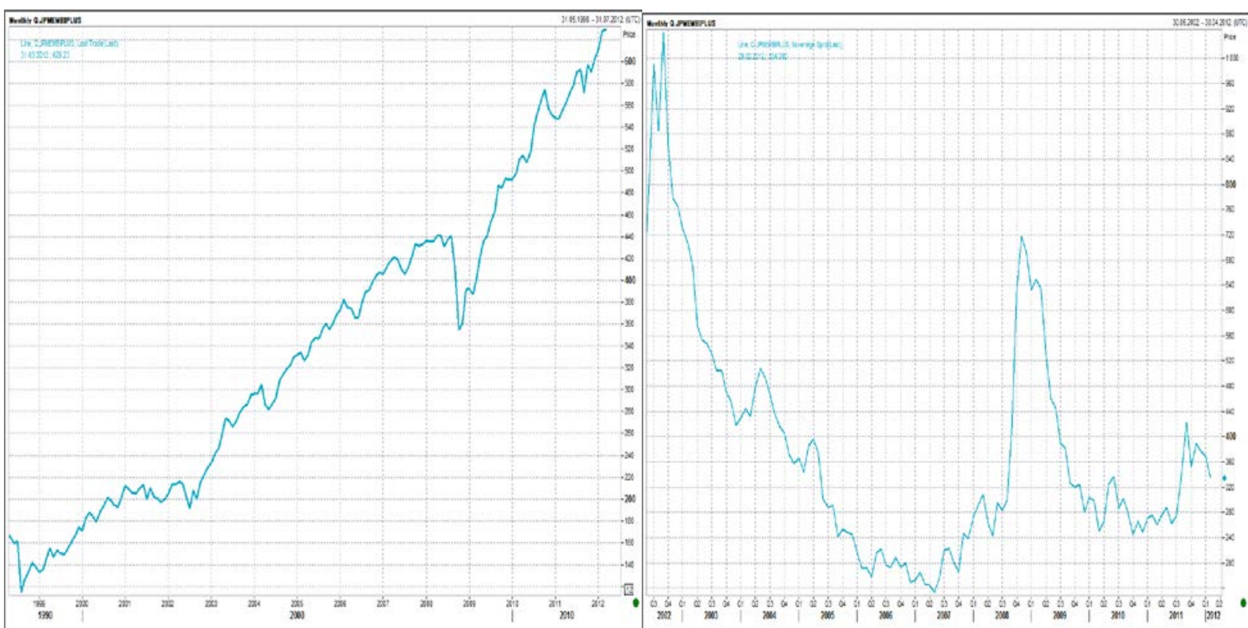
Source: Thomson Reuters

Italian bonds also demonstrated substantial increase, 10-year securities rising by 5.4% after growing by more than 6% in January, and their yield declining below 5% for the first time since October 2011.

10-year securities of Ireland showed significantly lower growth – by 2%, while those of Greece and Spain closed the month almost at the opening level.

In the sector of public debt of developing countries, the growth was smaller, and the index EMBI + rose by 2.7% over the month, and its spread to treasuries narrowed by 34 basis points to 3.34% (see Fig. 9).

Fig. 9. Dynamics of the EMBI + index spread, the monthly closures line

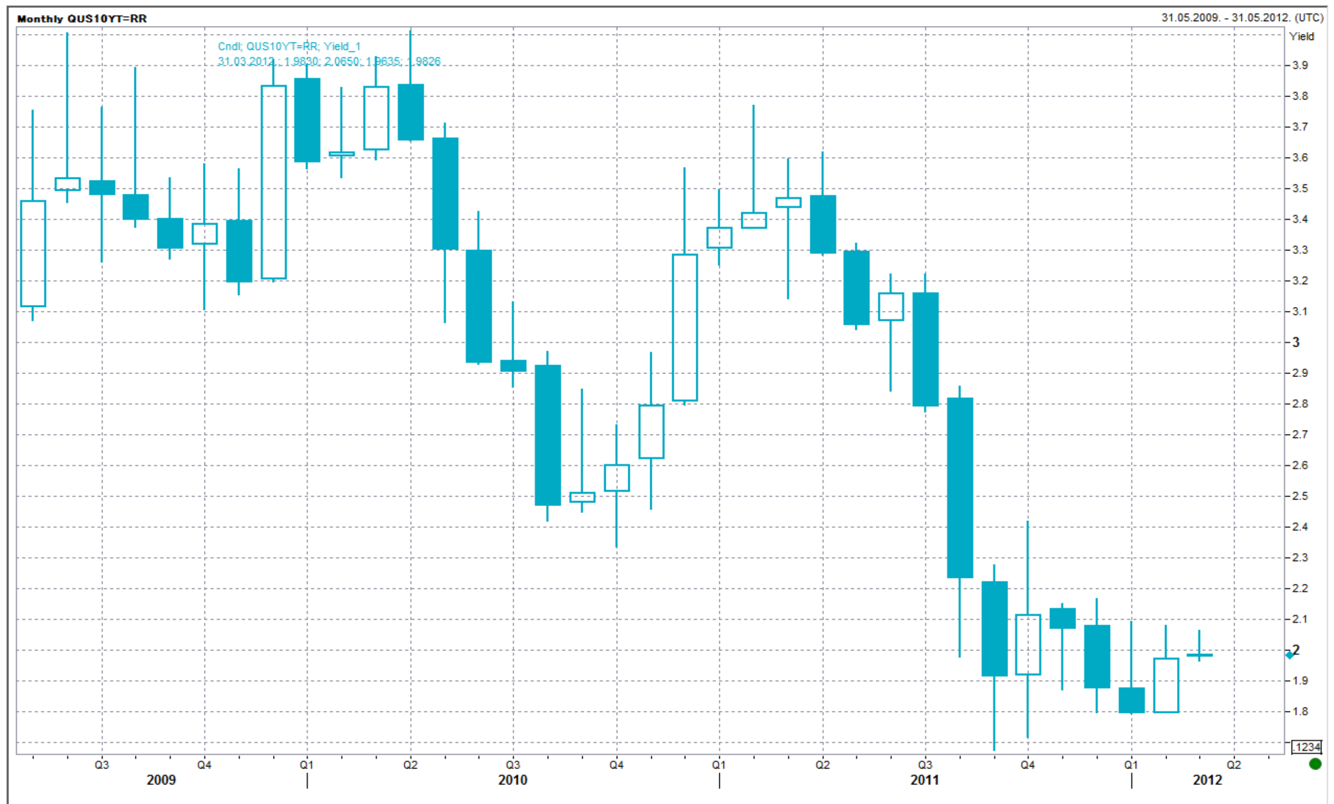


Source: Thomson Reuters

Growth in emerging market corporate bonds has been less significant this time, and the index CEMBI rose by 2.5% over the month, whereas RUBI index of Russian corporate securities increased by 2.4%.

In the U.S. bond markets, on the contrary, there was a slight drop in prices and 10-year treasuries fell by nearly 2%, their yield growing from 1.8% to 2% (see Fig. 10). During the last few months on the market of these securities, there has been a highly visible lateral movement, with the yield corridor of 1.8%-2.2%.

Fig. 10. Yield dynamics of the U.S. 10-year government bonds, monthly bars



Source: Thomson Reuters

30-year U.S. securities also showed a fall, and their yield increased from 2.9% to 3.1%.

In the German securities, playing the role of safe haven in the euro area, the movement was small, and the yield on 10-year bunds remained near the level of 1.8%, and on 30-year securities – near 2.4%

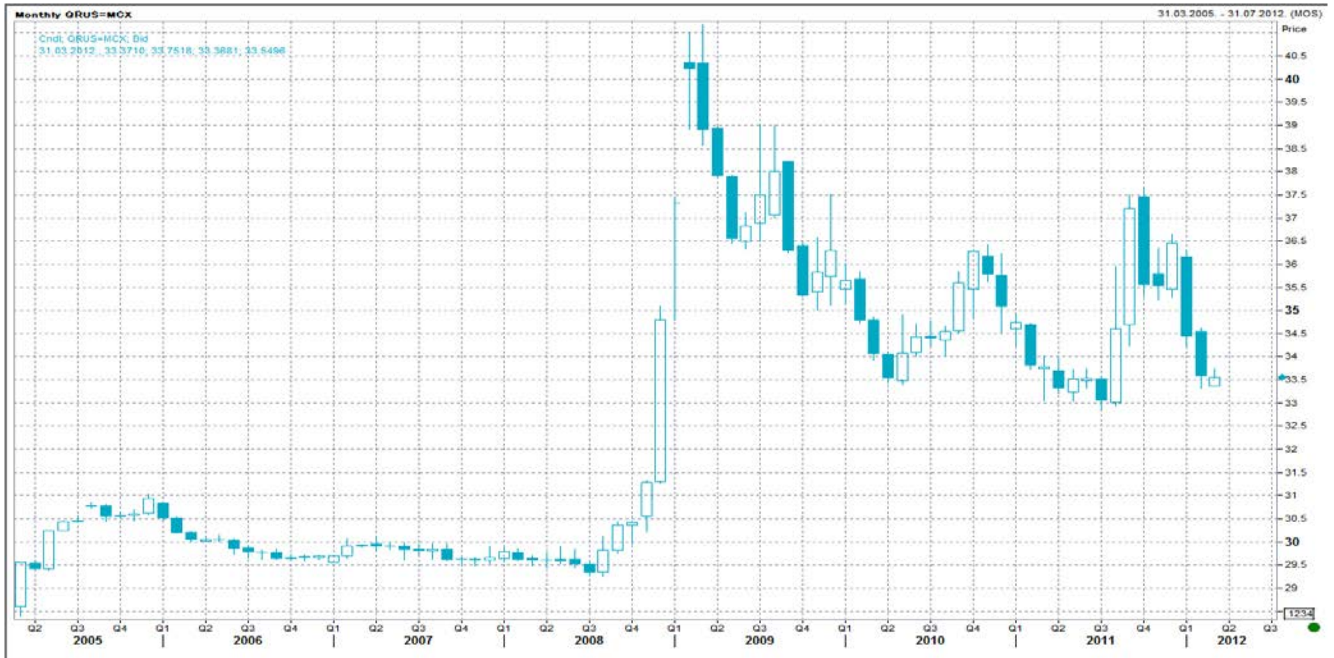
Global currency market

On the global currency market February was marked by different movements of the dollar against both developed and developing currencies, with some predominance of the U.S. currency weakening.

The highest monthly increase to the dollar was shown by both developed Norwegian krone (+5.3) and developing currencies – the Polish zloty (5%) and South African rand (+4.8%).

Russian rouble also rose against dollar, but just by 3.7%, and its growth to the euro-dollar basket reached almost 2.4% (see Fig. 11).

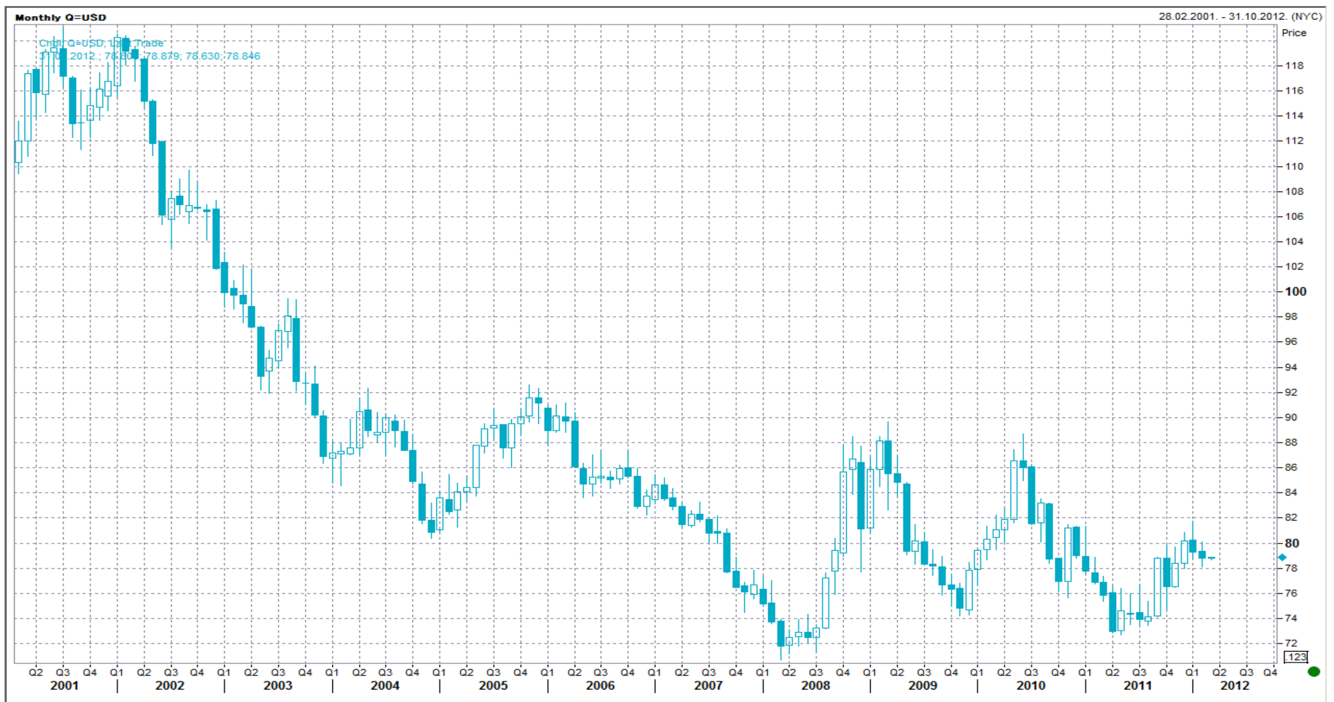
Fig. 11. Dynamics of the Russian rouble to euro-dollar basket, monthly bars



Source: Thomson Reuters

The dollar index – dollar's rate against six leading world currencies – fell by 0.6% over the month (see Fig. 12).

Fig. 12. Dollar index dynamics, monthly bars



Source: Thomson Reuters

Such a slight drop in the dollar index has been largely ensured by significant increase in the dollar against the yen (the first one over many months), which equalled 6.5% and returned prices to levels of June 2011 (see Fig. 13).

Fig. 13. Dynamics of the dollar against yen, monthly bars

Source: Thomson Reuters

As for the main rival of the dollar – euro, the fall of the U.S. currency was around 1.8% (see Fig. 14).

Fig. 14. Dynamics of euro against dollar, monthly bars

Source: Thomson Reuters

Our assessment of future scenarios

Our main scenario for the euro-dollar market remains unchanged. According to this scenario, the dollar minimum reached in July 2008 at the level of 1,6040 EUR/USD, is the end point of the long-term trend of the dollar falling against euro and the beginning of the trend for its long-term growth.

Consequently, we do not change our fundamental outlook for the market, according to which exchange of the euro to the dollar will fall to parity-close levels (1 EUR/USD) in 1-1.5 years.

Gold

Almost all February long, gold traded in a narrow side corridor dominated by rising prices, but a sharp drop in prices in the last day of February, nearly by 6%, led to a monthly fall in prices by 2% (see Fig. 17).

Fig. 17. Dynamics of gold prices, monthly bars

Source: Thomson Reuters

Our assessment of future scenarios

Gold prices have already entered the corridor of $1750-$2000 per ounce, which at the beginning of the year 2011 was considered a target one for the current growth trend and a level where the basis for the trend reversal will be formed. However, given the strength of the growth trend, it is still very likely that prices will continue to grow, reaching the level of $2000-$2500 per ounce.

At the same time, the speculative nature of the movement in gold prices suggests that prices will not remain at high levels for long. Later, we are likely to see a rapid fall in prices, often observed in other speculative bubbles. Of course, it is possible that prices do not go back to previous levels of $300-$400 per ounce, but return to levels near $1000 is very likely.

A possible signal for the bubble break can be a sharp rise in prices for a short time, similar to that of August, but with greater amplitude and during a shorter time.

Silver

Movement of the price of silver in February well correlated with the movement in gold prices – with a predominance of growth during the month and a sharp fall on 29 February. However, greater growth and a relatively smaller drop allowed silver to close the month with an increase by 4% (see Fig. 18).

Fig. 18. Dynamics of silver prices, monthly bars

Source: Thomson Reuters

Our assessment of future scenarios

The sharp rise and the subsequent strong drop in the price of silver in 2011 indicate that the price bubble of 2010-2011 actually burst in this market.

However, the dynamics of further movement in prices is still uncertain and may depend on price movements in the gold market.

Oil

In the oil market in February there was a significant rise in prices, amounting to almost 11% on Brent (see Fig. 19), which brought the price close to the local maximum of April 2011. As far as the spread between Brent and WTI is concerned, it continued to grow and has grown over the last month from $14 to $17.

Fig. 19. Brent price dynamics, monthly bars

Source: Bloomberg

Our assessment of future scenarios

The rise in prices in February greatly reduces the probability of our previous scenario, according to which prices were supposed to be adjusted below $100, before exceeding the maximum reached in April 2011. However, we continue to believe that the current growth will not be a long-term one, and a strong corrective wave for the fall in prices with the targets below $100 per barrel will be formed in the market soon.

Review information

This review is supposed to be for information only and cannot be treated as investment advice, investment research, or a consultation on investment.

The review author is ABLV Asset Management, IPAS (legal address: 23 Elizabetes street, Riga) officer Leonīds Aļšanskis, Dr. Math. The information contained in the review is obtained from sources considered to be trustworthy in financial markets, but ABLV Asset Management, IPAS or its officer shall not be held responsible for accuracy and comprehensiveness of the obtained and provided information.

ABLV Asset Management, IPAS or its officer shall not be held responsible for any losses resulting from this review being used in one's own investment transactions.

The review author will not inform on changes in the situation and opinion included in the review.

The issuers mentioned in the review are not acquainted with the same.

Information on risks associated with investment transactions is available at **http://www.ablv.com/en/services/investments/brokerage/risk**.