



MARKET BULLETIN



ST. JAMES'S PLACE
WEALTH MANAGEMENT

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The calm before the storm

After the wild gyrations of recent weeks, the equity markets were much calmer last week in anticipation of Federal Reserve chairman Ben Bernanke's speech to Central Bankers in Jackson Hole on Friday.

Some commentators had expected Bernanke to announce a further round of quantitative easing (QE3) in yet another effort to stop the US from heading back into recession. In the end, whilst the Fed Chairman stopped short of printing more money, he did confirm his willingness "to employ its tools as appropriate to promote a stronger recovery" and will extend the September policy meeting by another day to reflect on the options available.

The speech was accompanied by further signs of economic weakness, with the US second quarter growth numbers revised downwards from an annualised rate of 1.3% to 1%. The Chairman was clear where much of the blame lies, telling the audience 'Most of the economic policies that support robust economic growth in the long run are outside the province of the Central Bank'. As we have noted before, the solution lies in large part with politicians and the markets are looking forward to the economic policy speech from President Obama on September 5.

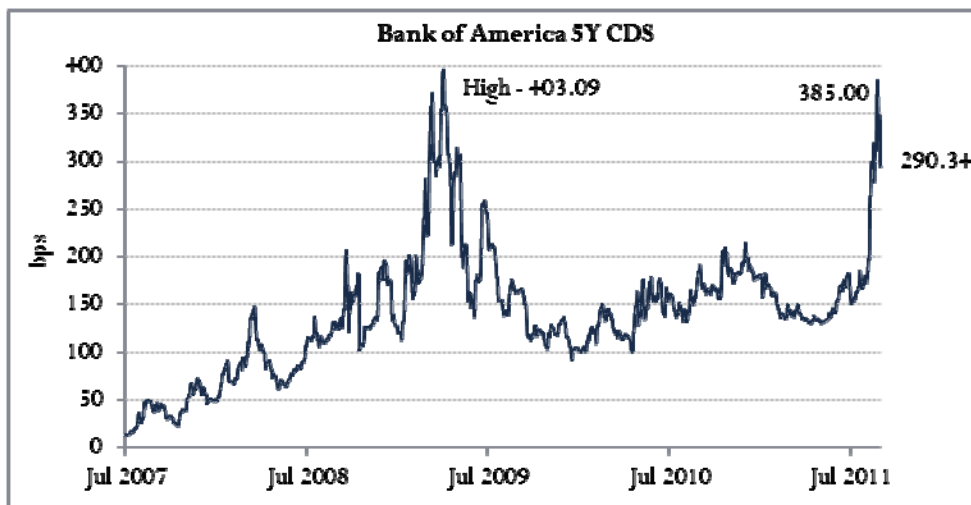
After initially spooking the markets, both the FTSE 100 and S&P 500 rose on speculation that QE3 will follow at some point. The major global equity markets ended the week in positive territory, with the FTSE 100 up nearly 2% and the S&P 500 up 4.78%. With the UK markets closed for the Bank Holiday weekend, global equity markets continued their upward trend on Monday with US Insurers recovering after Hurricane Irene proved not as damaging as expected and data showing rising consumer spending.

Which way for the banks?

Whilst most of the headlines over recent weeks have been taken by the equity markets, there have been conflicting messages coming from the credit markets – and remember, the trigger to the long running problems with the global economy in 2008 stemmed from the lack of liquidity in the financial markets, so investors should pay attention to the more arcane signals being sent from this end of the global financial markets.

Credit Default Swaps is the technical name given to the cost of insuring against a company defaulting on its debt and last week saw the cost of these instruments rise to levels not seen since the dark days of 2008 as investors warned that many banks are struggling to raise liquidity in the money markets. As the chart shows, one of the banks worst affected was the Bank of America (BoA) as investors grew increasingly concerned over losses in its mortgage business, with the cost of insuring \$10bn of loans to the bank hitting \$385,000.

The cost of insuring BoA's debt



Source: Bloomberg 2011

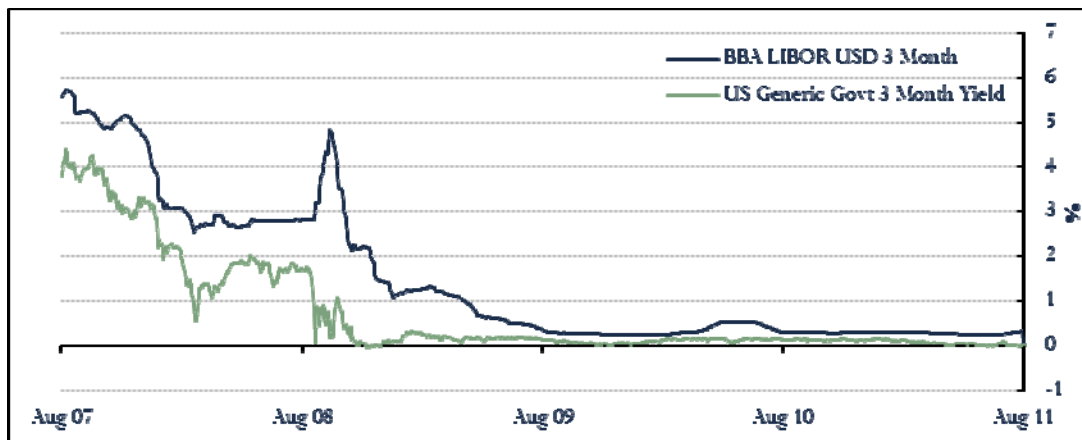
2011 has been a difficult year for the bank and the dramatic fall in the share price triggered legendary investor Warren Buffett to repeat his \$5bn investment in Goldman Sachs in 2008, by buying a similar amount of BoA preferred equity.

“Bank of America is a strong, well-led company. I am impressed with the profit-generating abilities of this franchise, and that they are acting aggressively to put their challenges behind them.” *Warren Buffett*

However, analysts wondered why, if as they state there is no need to raise capital, BoA was prepared to offer such attractive terms – but no-one should underestimate the power of having Buffett as a significant investor and immediately after the deal was announced the cost of insuring the bank's debt fell significantly, accompanied by a rise in its share price.

In a further sign of tightening conditions for many European banks, US money market funds are said to be significantly reducing their willingness to lend to a number of those most exposed to the sovereign debt crisis. However, as we touched on last week, the cost of borrowing between banks, which completely dried up in 2008 as they refused to lend to each other, whilst rising has reached nothing like the level seen then. The traditional measure is seen as the difference between the yield on 3 month Treasury Bills, viewed as a ‘risk free’ investment, and the 3 month LIBOR, the interbank rate. The chart below illustrates just how far off the 2008 crisis days we are.

Yield spreads



Source: Bloomberg 2011

With the new head of the IMF Christine Lagarde warning of the need for a further immediate injection of funds into Europe's banks, and in the UK both the CBI and the British Bankers Association calling for a delay in the proposals to separate out the retail and investment arms of UK banks, the health of the global banking system is likely to remain central stage for the coming months and will be critical to the strength of any economic recovery. Still, news that two Greek banks, Alpha and EFG Eurobank have sealed a merger, was taken as an important first step in shoring up the beleaguered banking sector and the markets responded positively.

All that glitters

Last week saw the sharp reversal in fortune for those who had moved fully into the perceived safe haven of gold as the price fell by \$200 (10%) an ounce from its record high. Despite seeming a one way bet over recent months, the falls reinforce our frequently stated view that investors should always build a well diversified portfolio across a wide range of asset classes and try to avoid overpaying for assets that are at historically high valuations.