Weekly Review

Week ending 1st April 2011

Issues concerning sovereign debt in Europe remain a key talking point for markets as we move into the second quarter. The European Union has in place emergency support systems that, in essence, could require a taxpayer in Europe's 'core' to help governments in the periphery meet their obligations to creditors. The rationale for such a system of burden sharing is considered in brief below:

At its inauguration, the European Union was foremost a political project, an attempt to subdue turbulent 'high' politics using coordinated and mutually beneficial 'low' politics. A contraction of the Union's membership, with a portion of countries forced to abandon the euro and pursue competitive devaluation of new national currencies, would raise questions over the Union's viability, if not ultimately marking the end of this period of enhanced cooperation. A second consideration is the value of the single currency. The euro's value is derived from the collective wealth of its backers, the Union's members. A credit event in one part of the zone would be likely to result in the sale of euro-denominated assets, devaluing the total assets of the Union on an exchange rate-adjusted basis and increasing the price of imported goods. Thirdly, we must consider the role of systemically important institutions. A small subset of interrelated institutions exists at the core of Europe's monetary system. Taxpayers' interests in their domestic banks – in the form of deposited savings – are distributed in part to peripheral European governments through the extension of credit. If peripheral sovereign debt were to experience a credit event, the assets of banks in Europe's core would fall in value, putting pressure on their ability to fulfil existing obligations to depositors and to make new credit available. Finally, were the levels of defaults of high quality rated debt in Europe to depart significantly from their low historical averages, the cost of borrowing could be expected to rise throughout the Union to reflect this elevated risk. This would lead to a less liquid environment, lower broad money creation, and ultimately less economic activity.

The current situation in the peripheral European sovereign debt market may appear stressed, but this does not necessarily preclude investment opportunities. A study published last week by Deutsche Bank shows that market implied default rates for sovereigns are currently well above their historical averages, suggesting that parts of the market may offer attractive risk-return characteristics. This assessment, however, is predicated on a number of key assumptions that should not be overlooked: firstly, investors must decide whether to rely on the historical data or whether they believe this time around things are different. Currently, the market is discounting the historical data in expecting between three and five credit events during the course of the next five years (depending on the level of recoveries). Next, investors need to decide on the length of the present business cycle. Were the current business cycle to roll over earlier than the market expects, some form of default scenario becomes more likely. Developed markets have enjoyed elongated business cycles in the last three decades due in large part to the disinflationary impact of imports from emerging economies. With these same economies now appearing to export inflation, Western governments may be required to be more judicious with their use of monetary and fiscal tools. Finally one needs to understand what the terms of any default are likely to be in order to successfully gauge the range of outcomes that are available.
Looking at markets, ongoing events in the Middle East prompted the oil price to climb higher over the course of the week, whilst admissions of low inventories for a number of key agricultural softs by authorities in the US also supported rises in most commodity prices. Equity markets posted strong gains, led by emerging markets and Asia (excluding Japan). Elsewhere, the spread between the yield on non-government debt and treasuries continued to contract in the US, whilst property valuations in the country enjoyed upwards revisions in spite of recent weak data for new home sales. Both fixed income and property investors in the United Kingdom alternatively suffered losses in Sterling terms. Finally the Japanese yen had depreciated by 3.8% versus the US Dollar by the end of the week.

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. April 2011.

Returns to 1 April 2011

Asset Class/Region	Index	Currency	Week	Month to date	Year to date
Equities					
United States	S&P 500 NR	**USD**	1.4	0.5	6.3
United Kingdom	FTSE All Share TR	**GBP**	1.7	1.6	2.7
Continental Europe	MSCI Europe ex UK NR	**EUR**	1.6	1.3	3.2
Japan	Topix TR	**JPY**	1.7	-0.8	-2.9
Asia Pacific (ex Japan)	MSCI AC Asia Pacific (ex Japan) TR	**USD**	3.4	1.0	3.7
Global	MSCI World NR	**USD**	1.3	0.5	5.3
Global emerging markets	MSCI World Emerging Markets TR	**USD**	3.7	1.2	3.3
Bonds					
US Treasuries	JP Morgan United States Government Bond Index TR	**USD**	0.0	0.0	-0.2
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	**USD**	0.6	0.4	2.5
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	**USD**	0.1	0.1	0.9
US High yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	**USD**	0.4	0.2	4.1
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	**GBP**	-0.5	-0.1	-0.9
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	**GBP**	-0.3	-0.1	0.9
Euro Government Bonds	Citigroup EMU GBI TR	**EUR**	-0.6	-0.1	-1.3
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	**EUR**	-0.2	-0.1	0.0
Euro High yield	Merrill Lynch Euro High Yield 3% constrained TR	**EUR**	0.4	0.3	4.4
Japanese Government	JP Morgan Japan Government Bond Index TR	**JPY**	-0.2	-0.1	-0.7
Australian Government	JP Morgan Australia GBI TR	**AUD**	-0.3	-0.2	1.6
Global Government bonds	JP Morgan Global GBI	**USD**	-1.5	-0.7	-0.1
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	**USD**	-0.9	-0.4	0.8
Global Convertible bonds	UBS Global Convertible Bond	**USD**	0.7	0.2	4.7
Emerging Market Bonds	JP Morgan EMBI +	**USD**	0.3	0.3	1.1

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. April 2011.

Returns to 1 April 2011

Asset Class/Region	Index	Currency	Week	Month to date	Year to date
Property					
US Property securities	MSCI US REIT TR	**USD**	2.6	0.1	6.3
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	**GBP**	-0.4	0.7	6.6
Europe ex UK Property securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	**EUR**	1.2	0.6	3.8
Australian property securities	FTSE EPRA/NAREIT Australia TR	**AUD**	-0.7	0.1	3.6
Asia Property securities	FTSE EPRA/NAREIT Developed Asia TR	**USD**	0.8	0.4	-3.2
Global Property securities	FTSE EPRA/NAREIT Developed CR	**USD**	1.5	0.2	2.5
Currencies					
Euro		**USD**	0.0	-0.3	5.4
Sterling		**USD**	-0.3	0.0	2.4
Yen		**USD**	-3.8	-1.7	-3.8
Australian Dollar		**USD**	0.8	0.2	1.1
Rand		**USD**	1.7	0.5	-1.7
Commodities					
Commodities	RICI TR	**USD**	1.2	0.4	10.2
Agricultural Commodities	RICI Agriculture TR	**USD**	1.0	0.2	5.7
Oil	Brent Crude Index (ICE) CR	**USD**	1.1	1.5	25.0
Gold	Gold index	**USD**	-1.3	-1.5	0.5

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