

PLK Weekly Newsletter:

Friday, 27th August 2010

Weekly Strategic Outlook:

The M&A bonanza did not hold up sentiment for too long. Another disastrous week in terms of housing data put risky assets under pressure. Due to tax credits waning, existing home sales fell by -27% and new home sales by -12% in July. Maybe symbolically, central bankers are meeting in the Rocky Mountains to discuss the latest developments. No wonder the confirmation of Tiger Wood's divorce ranked #3 on the 'most read' news in Bloomberg for the week: Investors have been in wait-and-see mode so far until Ben's speech. Markets are waiting for a miracle by the US Fed Reserve to drag the economy out of the double-dip scenario. After a dismal set of data in the US and the Irish debt downgrade, all eyes are on Ben Bernanke tonight to "make sure it does not happen over here" ("it" being Japanese-style deflation).

But how will he manage to unnerve markets? More specifically what can he do? Lowering the short term rates and then longer term ones and then mortgage rates? Done, people don't buy it anymore. We come from a generation of bubbles, we have been given twice the opportunity of a revival in our frenetic consumption manners by always borrowing to buy whatever assets is to buy (house, car, furnishings, appliances for our new digs, medical operations, you name it). Now people start to shift their mind to one that is 'owning things is maybe not the way to go. Doing one's job properly, saving for future generations, and laying a solid ground of values for the children'. All in all, stopping the exuberance we've been in for a decade. Therefore, what will M. Bernanke do or say? To some, fiscal policy seems to be the right trick, putting cash directly in the individual's pocket. But fiscal policy has already done a lot. And just like Government spending could do some good, we face the problem that States are almost broke (in fact they are). Then Fed policy also may work to drive down the dollar: given that consumption, investment and government spending are constrained, the only remaining source of growth would be net exports (the S&P 500 companies derive about half their business outside the US). Well, here again, the US are not the first and only one willing to go that way (Europe is driving its mild reviving with a weak EUR and Japan will have to do something with the JPY if it wants to avoid killing its mostly important exportation economy).

To be honest, M. Trichet (Tricheur) who will speak after M. Bernanke is in a better position. His problems are far less tangible than the US ones. They are structural, long term issues. With all the disappointments in the US, we have almost forgotten about PIIGS. No wonder, M. Trichet will take

advantage of that and will maybe even talk about exit strategies today. The EUR could be well bid against the USD.

We sound dramatic but we are not. Markets like nature will find their way. And maybe sooner than the economy as we like to remind ourselves, the economy is not a mirror of the stock markets. It almost shares it equally with investor's needs and psychology. Only Goldman Sachs has the nerve to display almost no short term future growth for the US. We do not believe we are there yet. And let's also be hopeful for people in general. Human beings have the propensity to fight against adversity. That means to work more for less, develop ideas, turn to entrepreneurship, travel for a job, giving up social benefits if it is needed to be. Riots are only for a few among us and most of human beings take on their destiny. This is typical for US who, despite all their opponents, have a fantastic fighting spirit. And beware of those who say that Japan is over. Take a book and discover how it modernized and came out at the end of the 19th century to become one of the most powerful forces. Same situation after World War 2. We can't always ask for Government solutions to take us out of the mess. People can do something about it themselves and we strongly believe they will.

After this outcry of optimism, let's stay honest with ourselves: valuations are attractive, rates are low, cash abounds, but the consolidation we are in is here to stay until some light shows at the end of the tunnel. Investors will not buy another false breakout of optimism (like the one at the end of July) until they see some concrete stuff around the corner.

Equities:

Equities failed to break important resistances and are back into weakness. However, we're still hovering at important supports. Our attitude towards equities is to keep long term weightings and to even add a few % if lows are tested (1010 on the S&P 500 or even lower). Then risk rewards will start to look compelling as even a double dip scenario doesn't indicate more than 950 on the S&P 500 (10% from here).

Let's try and seek a few clues:

- S&P 500: As of Friday 4pm, 1050 is not lost but it better hold as this is a very important medium term pivot point.



- Shanghai is consolidating its recent breakout and remains positive.
- Volatility has come back above its 200 DMA, around 27.
- EUR/USD is holding important levels at 1.26, trying to recover the uptrend line. The odds are it will (fundamentals) at least temporary.



- Dollar index consolidating but still ok considering this week's flow of bad news:



- CRB (commodity index) and Copper (high correlation to the health of the economy) have only consolidated on their breakout levels (no material damage, this is a good point).
- Crude trying to climb back above the important USD 75 threshold.
- Gold is back on track.
- Commodity currencies (AUD and NZD which have often been leading indicators for risky assets), are holding up ok.
- Interest rates in the US went deeper again suggesting a flight to quality.

All in all, the situation has again slightly deteriorated. We could see some lower grounds but do not see a plain crash. We are rather opting to buy severe weakness.

Fixed Income:

The yield of the 10-year Treasury note fell to 2.45% this week, the lowest since the “Treasury bubble” at the end of 2008 when the yield briefly fell to 2.05%. As it was in 2008, right now the decline of bond yields is exacerbated by technical factors. The demise of Lehman caused a factual standstill of the markets for commodities, derivatives such as credit default swaps, and ultimately corporate bonds. Traders and investors alike desperately tried to reduce their exposure in such instruments, looking for the single most liquid instruments - US government bonds. This “rush for Treasuries” lasted for several weeks. We are currently witnessing a second run for Treasuries that looks to last even longer. Also

US money market funds have become less attractive for US private investors, who are shifting out of the funds into US Treasury holdings that are liquid and as default-proof as possible.

In addition to that there seems to be an even bigger shift into Treasuries by commercial banks and insurance companies again. The regulators are redefining banking regulation worldwide and new regulation on solvency and liquidity seem to oblige banks and insurance companies to hold more government debt and other risk-free assets, regardless of the yield level.

The massive decline in bond yields is not in the interest of the central bank or the US administration. The Fed needs a steep yield-curve to allow banks to generate sufficient revenues to restore their capital base. The last thing the US Administration wants is a recession at the time of the midterm elections.

We therefore do not believe that the Fed will soon push down the Treasury bond yields aggressively as seems to be anticipated by the market. Neither do we believe that the regulators will push banks and insurance companies to hold more government debt for solvency reasons. In the medium term, we still believe in a correction of the government bond market. The correction will not be limited to Treasuries, however, as the high-grade segment has become expensive as well.

For these reasons we prefer staying on the sidelines of this asset class.

Foreign Exchanges:

USD:

US economic data have continued to hit a soft patch. However, we do not believe in decoupling and either US data will improve or data in the rest of the world will weaken. If either scenario materializes, USD will benefit. That being said, the timing of such effects is uncertain, so we have shifted to a more neutral USD stance (We closed half of our short EURUSD). Fed Chairman Bernanke's speech at Jackson Hole today could be very crucial on the future direction of monetary policy, and as a result, the USD.

EUR:

Euro-zone economic data have surprised positively, led by the robust growth of its largest economy, Germany. While it is likely that European data will eventually slow if the current bout of weakness in US data continues, it might take a while to feed through. As a result, we have tactically moved to the sidelines in EUR.

CHF:

CHF is one of our favored positions, as we believe it can outperform in dual scenarios. First, CHF will likely gain as its economic recovery continues. Indeed, Swiss PMIs are the strongest in the developed markets, domestic demand is robust, and the labor market is improving. Additionally, in periods of risk aversion, CHF will likely be bid for its safe haven status. GDP on 2 Sep will be a major risk event to keep an eye on.

JPY:

Japanese real interest rate being more attractive than in the US and no interest for Japanese to buy foreign bonds at these levels, plus the unwinding of carry trades makes the JPY supportive at the moment. Should Japanese authorities opt to embark upon QE and/or intervene in the currency, USD/JPY can move sharply higher.

AUD:

Short AUD positions remain one of our highest convictions, especially as risk aversion persists. AUD remains vulnerable to a slowdown in China and there is evidence of a housing bubble waiting to be popped. Additionally, political uncertainty, as a consequence of a hung Parliament, may weigh on confidence in the country. As a result, we believe AUD should correct lower from its current elevated level.

NZD:

We do not believe the underlying economic fundamentals justify the rich price at which NZD trades. Indeed, the labor market remains weak and New Zealand's PMI is the only one in the developed markets with a reading under the critical 50 level. Moreover, we are seeing evidence that the RBNZ will likely follow in the RBA's footsteps and remain in a holding pattern. As investors scale back tightening expectations, NZD will likely depreciate.

Alternative Investments:

Over the past months, physical commodity consumers have postponed their purchases as long as they could due to concerns of a double-dip recession. Now on-site inventories are depleting and consumers are starting to buy in the open market again. For instance, this is visible in industrial metals where inventories tracked by the London Metal Exchange are falling.

While our general outlook for the asset class is positive, performance is unlikely to be a straight line upwards. As the economic recovery is entering a more advanced stage, the momentum of economic growth is slowing from previously unsustainably high levels. This is, in our view, a normal development at this stage of the business cycle and not an indication for a double-dip recession.

All in all, however, we believe that fundamental factors for commodities in general and for cyclical markets in particular are rather supportive. After the bottom in July, technical analysis is also slowly improving. Momentum is now positive for most markets and the longer-term trend ratings are gradually improving as well. We think the major commodity indices can close the year with positive performance.

Gold:

Current Gold prices trade well above the long-term real average. For us it is rather a question of “when” than of “if” that gold will return to its long-term real average, which should happen as soon the dust of the credit crisis finally settles, leading to a normalization of risk perception and – most importantly – to a normalization of real interest rates. So far, we see no structural event that suggests a paradigm shift in the trend of gold’s real value. Hence, the insurance gold provides to the investor’s wealth comes at a relatively high price. As an action, we don’t buy more but do not sell it for investors owning it.

Energy:

US Natural gas: Warmer temperatures in the USA are boosting cooling and thus electricity demand for. But supply remains strong, limiting the upside potential for prices.

WTI Crude Oil: Oil demand started to recover in OECD countries, which we see as supportive factor for oil prices in the long run. But high spare production capacity should limit upside potential in the months ahead.

Soft Commodities:

Wheat prices are spiking as a heavy drought in Russia is disrupting supply. We think that prices may be overshooting to the upside.

Sources:

- Morgan Stanley
- Credit Suisse Global Research
- Crédit Agricole
- Goldman Sachs
- Julius Baer
- UBS Investment Bank

- PIMCO
- Barron's
- Le Temps
- Wall Street Journal
- The Economist
- Global Equity Research
- Greed & Fear
- Gloom & Doom

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