

HIGHER OIL PRICES TO SPIKE THE MARKET'S RISE?

- Greek crisis and price of oil provide downside risks
- Cash pours into global economy
- Bank of Japan provides further significant monetary stimulus
- Retail investors persistent buyers of equities
- US economic news good but with a tinge of loss of momentum



We continue to caution against chasing markets after such a strong run-up in recent weeks. For sure there is a growing confidence that the worst Euro zone outcomes may have been avoided. However there are also head winds to markets that will at the very least slow progress. The recent 10% rise in oil prices if sustained will detract from global growth and slow the pace of interest rate cuts in the emerging countries. The situation in Greece is better but still far from secure and any significant setback in negotiations could lead to some rapid profit taking. However what is also clear is that the days of investors hiding in 100% cash or near cash are behind us. Central banks have collectively provided such significant amounts of stimulus to the global economy that some risk taking by investors bored with near zero interest rates was inevitable. The cash continues to seek higher yield in bonds and equities driving prices higher.

To the benefit of financial markets there is still a good deal of cash chasing around the global economic system. Global liquidity remains strong with all of the major central banks continuing to provide support. Last week the Bank of Japan to the surprise of the market formalized an inflation target and announced a Yen 10 trillion asset purchase program. Even for the Japanese authorities who have been fighting an economic crisis for over a decade the new measures were a major step up in activity. The scale of the asset purchase program is quite staggering, sufficient to buy up all of the new bond issuance by the Japanese government over the next year. In the coming few weeks the European Central Bank will push ahead with a further tranche of asset purchases. Central bank action has forced down government bond yields and encouraged investors to take more risk by investing in higher yielding bonds and equities.

The rise in the oil price has the potential to crack or at least moderate the rise in markets seen in recent weeks. The oil price has risen 10% in the last two weeks as stronger than expected global demand growth has met supply worries. The rising market concerns about the Iranian situation has led to a spike in oil prices to \$120 per barrel, the highest prices since May 2011. If the oil price rise is sustained then there could be quite a challenge to the markets. Higher oil prices means higher inflation, higher inflation would apply a brake to the reduction of interest rates that we have been witnessing in the emerging markets. China's latest inflation data was higher than expected. Only with lower inflation can the Chinese authorities press ahead with a further easing of monetary policy through lower interest rates and less of a restraint on lending.

Although in recent weeks some good progress has been made on propping up Greece there remain hazards ahead. European leaders meet on February 20th to discuss a further package of measures for Greece to meet in order that a Greece receives sufficient funds to take it through its next bond redemption on March 20th. In April Greece faces a general election where it is possible that due to public dissent a very different government takes office that could renege on some of the promises of the current administration. Also bear in mind that whilst the current politicians may promise to cut spending and increase taxes it is open to debate as to whether the measures achieve the improvement in the government deficit needed.

Irrespective of some of the challenges ahead it is clear that retail investors are back buying equities. As an example flows of investor money into equity mutual funds that invest in emerging markets have seen inflows year-to-date of some \$19 billion equivalent to 60% of the total outflow of last year. Institutional investors have we understand been slower and more circumspect in rushing back into equities. Most surveys show that holdings are back to a more neutral position rather than overweight. We expect institutional investors to wait for a more sustained improvement in the situation in the Euro zone before committing to further purchases of equities.

Investor confidence continues to be helped by the US macroeconomic news. After the disappointment with the November/December retail sales figures there was better news with a strong improvement in January. Retail sales in January increased by 0.6% month-on-month and car sales rose at the fastest pace of the current up-cycle. The only concern is that the recent rise in gas prices may detract from consumer spending and confidence in the coming month. Industrial output remains strong with January data showing a 0.8% month-on-month increase equivalent to an 8.6% increase year-on-year over the last three months. Industrial confidence has also maintained its vibrancy with the latest Empire survey showing the fifth straight improvement in industrial confidence in the New York area. However not all features of the survey were strong with new orders and employment surveys showing some marginal weakness.

Amongst the emerging markets we still have a high level of conviction about Latin America. Some of the markets may have performed strongly but on any setback we would look to add to positions. In Brazil consumer-spending data has been stronger than expected showing that internal demand growth can still underpin another year above 3% growth.

Recent research suggests that the credit crisis may be good for us after-all. Recent research reported in an article in the Financial Times (Could we live without cash? February 18th) shows that we possibly take more prudent decisions where we are forced to use cash rather than credit. In an experiment carried out by Drazen Perlec and Duncan Simester they found that people using credit are often prepared to pay as much as 100% more for something compared to a person who has only got access to cash. Less access to credit due to the credit crisis dampens inflation and could make our money go further!

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