Securities Lending Today

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September 03, 2011

Guest Author - Weekly Commentary on Financial Markets 29 August - 2 September 2011

Commentary on another volatilve week from Jacob H Schmidt, CEO, Schmidt Research Partners Ltd and FinTuition Hedge Fund course trainer. Jacob is conducting the Performance Analysis of Hedge Funds course on 6 & 7 September and the UCITS III Hedge Fund course on 27 September.

Worsening economic data in US, Europe - QE 3

News of the week: Swiss Franc strengthening again, Gold & Silver rallying, European politics divided on future, Hedge Funds having a tough time.

In the EU the discussion on potential **Eurobonds**, joint liabilities of all countries continues, without any real new information. BTW "Eurobonds" is a very unfortunate name, as the word has been in use for almost 50 years for bonds issued in a currency and structure outside the jurisdiction of the issuer (first structure by SG Warburg in 1963). I'd call them **EU Bonds, Union Bonds or EU Treasuries**. The risk that the Greece restructuring will falter forces – due to the requests by Finland and other countries for more collateral – is real. One option for collateral is real assets, e.g. the pledging of bank shares. Not sure how valuable bank shares are, though. Many Europhiles / Eurocrats believe that the Eurobonds are the solution: socialising the debt. Other like Prof Sinn of the German IFO are critical and believe that cutting prices and salaries are necessary to solve the Greek debt problem. Again, no common line, no comments from Brussels. We do not believe that these are trivial issues, and either way, they require analysis, leadership and vision. **My Grade: C-**

Stocks rallied this week, with some up 30% from their lows (bank shares such as RBS). It looks as if the rally was a month-end window dressing exercise of long-only managers and short covering by HF rather than real investors buying. The daily volume on the exchanges – high volume on down days, little on up days – suggest that those who sold at lower levels, including short sellers, squared their positions, but on light volume. Remember the real investors (Buffet et al) bought in the first two weeks of August at the lows. As the markets started to focus on Friday's job number the markets sold off on Thursday (Sep 1). Today (Friday) markets corrected sharply after the very weak numbers. With Labour Day on Monday in the US, markets will focus snow on Obama's speech and the FED's action, most probably QE 3. Fear is back, markets again very volatile. On the other hand many companies have decent earnings, yields are low and investors want to make money. Because HFT (**high frequency traders**, basically computer programs) have been pushing markets around, investors are nervous. In our opinion HFT are not necessarily adding value as they are NOT liquidity providers but liquidity takers. Regulators seem to miss this important point, rather focusing on banks, hedge funds and other issues, but not the HFT problem (some believe they are part of the HF industry, I beg to differ). We want them in the markets like anybody else, but without privileges. **My grade: C-**

The **European sovereign debt** problem is still centrepiece: little progress on Greece's reprofiling, 2 Y Greek bonds trading at 50% yields. On Thursday a Greek parliamentary commission issued a report covering the situation, budget

cuts and developments which was criticised by the Greek FM as "lacking credible data" used by international observers. Greece also disagreed with the "Troika" (ECB, EU, IMF) on the deficit. Greece follows the **traditional EM / default pattern** as discussed before. Italian and Spanish bonds held at high prices / low yields thanks to Trichet and the ECB. This week's Spanish auction placed 5 year bonds at a volume of Euro 3.6 b at a low yield of 4.48%, **bid cover 1.8.** Not too difficult to understand this: the only buyers are banks which refinance the bonds at the ECB. We said it before: it would be cheaper, and more honest, if the ECB bought the bonds directly, saving expensive new issue fees. There is no value added by pretending that investors buy at these low yields. Italian BTPs weaker again as Italy wants to amend the strict budget cuts with more than 1000 changes. Our concern is that while the ECB's balance sheet is getting bigger and bigger, the problem is not addressed. **My grade: C-**

Commodity markets (Gold and Silver) rallied during the entire week, a combination of bouncing back from the correction and bad economic data. On Friday's weak job number Gold rallied again reaching almost 1900 before easing off. Both Gold and Silver have become the ultimate instruments of speculation – due to ETFs and other cheap ways to get exposure. Many market observers and traders believe that Gold will go up to 2,500, but there are reasonable arguments that we are in a bubble: Gold valued at USD 9 t, no yield, storage cost, most participants got in at elevated prices. While 2,000 is possible, any sharp correction would inflict heavy losses on many investors, retail included. You cannot and should not forbid investments, but you have to warn investors: **these levels in Gold are speculative**. Crude continues volatile, driven rather by political and demand / supply factors, with Brent (London) and US Light (NY) at a wide spread of 26 USD. **My grade: C**

In the US stock markets equities rallied into month-end, driven by "buy" recommendations of market analysts ("stocks are cheap", "great valuations" et al) after the market had rallied 10% from the lows. We all know that on a 3-5 year basis stocks are cheap, but are they cheap after a rally? Bank shares again under pressure, Bank of America, JP and other after news of law suits over mortgages by the authorities against some smaller banks. Bad news for the markets but is it wrong that the authorities want to go after the banks that are responsible for the biggest market crisis since 1929? **My grade: C-**

In the FX markets the CHF rallied again (from USD CHF 0.82 to 0.777), despite the negative CHF rates and news that Swiss banks will charge savers for their deposits. I am concerned that these measures will prove useless, and the SNB spending money without achieving anything. We believe there are much better ways to discourage hot money. Euro weaker against the USD (from 1.45 to 1.42). **My grade: C-**

In Jackson Hole (last weekend's FED conference) Trichet and Bernanke's speeches were eloquent, but with little substance. While Bernanke pushed responsibility to the fiscal tool box, Trichet sounded like an oracle. Interesting only the comments by Mme Lagarde, the new managing director of the IMF who requested a recapitalising of the European banks, but that was less popular in Europe than Trichet's vague analysis. After the bad job numbers QE 3 is very likely, an opinion we have expressed for weeks. Yield curve to be even flatter. Bad news for PIMCO who have been flat/short UST for many months. **My grade: C**

Hedge Funds:

From our advisory work with investors we know that investors are much smarter than assumed. From our work with hedge funds we also know that some, many, not all are less calm, and make mistakes. Some HF had a bad month, down 3-5% at month end, much better than the very weak results we say during the month, thanks to the market rally. Some HF and HFoF reported as early as 31 Aug COB (well done) or yesterday (1 Sep), with very few great numbers, many flattish and down numbers. Inflows in the last months have been very good, mainly due to institutional money. Private clients and most family offices rather at the sidelines. The capital preservation – low vol – low return pitch works with institutions and helps them, but is not for family offices and UNHW. Private banks also careful as they burnt their fingers in 2008 when "good products" blew up. **My grade: B+**

Macro data: Europe looking very weak: French PMI weak, Swiss GDP 0.4% in Q2. China fine-tuning economy, for soft landing. US job number: 0 new jobs, unemployment rate 9.2%, **QE 3** looking very likely after these numbers. **My grade: C**

The news that Tripoli is now in the hands of the NTC and Gaddafi and family having fled are great. The work starts now on all fronts: building a democratic society, managing the country's wealth (e.g. Libya's sovereign wealth fund), recuperating the money stolen. **My grade: A**

Markets:
Risk on – risk off continues. Bond Yields in US heading for 2%, German Bund yields low versus Greek yields at default levels. Stock markets very volatile, but great stock picking opportunities as well as trading opportunities. FX actions in Euro, CHF, USD. Gold and Silver expensive but driven by fear and speculators.

Outlook:
Lower yields will be the main driver: where to put your money. Brazil at 12%, China at 8%, Europe at 1%, US at 0% and Swiss at -%. QE 3 will allow hedge funds and other bond investors to make a lot of money. Companies with high dividends and/ or high growth rates are attractive to the long term / unlevered investor. Greece posing a real risk here, for the banks, Europe, global markets.

Conclusion:
The uncertain political developments in Europe, the debt problem and the upcoming elections in the US will dominate the markets for the near future. We believe that the many dislocations in the markets (great companies, over and undervalued FX, commodities, bonds et al) **offer opportunities for the savvy investor**, either direct, via hedge funds or money managers.

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