

Rally or Dead Cat Bounce?

It seems to be business as usual. At least on the surface. After the dark days of early March, when stock markets around the world traded at levels not seen in years, spring seems to have arrived. Sunny weather in the Northern hemisphere and the change in the clocks have precipitated a healthy bounce in most markets and a major rally in the financial sector.

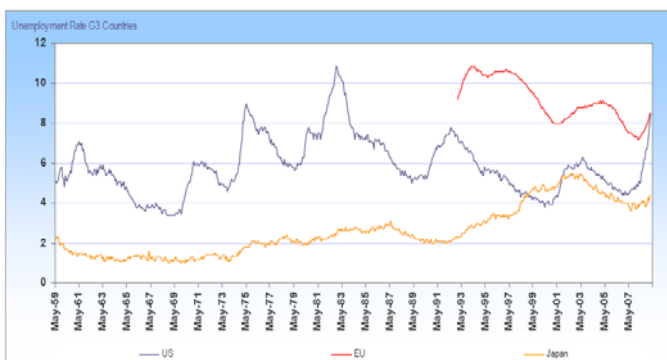
What seems strange is that this is taking place against a background of weakening economic data out of most countries, a very bleak forward looking assessment from the IMF and rapid deterioration in the credit metrics of most sovereign issuers.

I wonder if we are experiencing a “dead cat” bounce, or whether there really is ground for optimism.

Are the combined effects of zero interest rates and quantitative easing finally adding lubrication to the credit markets? True, some of the key measures for assessing the levels of credit markets have improved: TED Spread, corporate bond spreads or bank stock prices. But the real economy measurements continue to deteriorate: unemployment, small company insolvencies, corporate capex plans put on ice, etc.

As investors, we always try to know the future and usually try to extrapolate from the immediate past, with the result that we tend to be too positive on the upside and too negative on the downside. I wonder whether we have now reached the *inflection point* where markets start to recover convincingly, or whether we have merely seen a sucker rally fuelled in the equity markets by real money managers scrambling to get their cash invested?

Long-only money, managed relative to a benchmark, should never be about timing markets — that is the role of the asset allocator — but should be about adding alpha through good stock and sector selection.



Source: Bloomberg

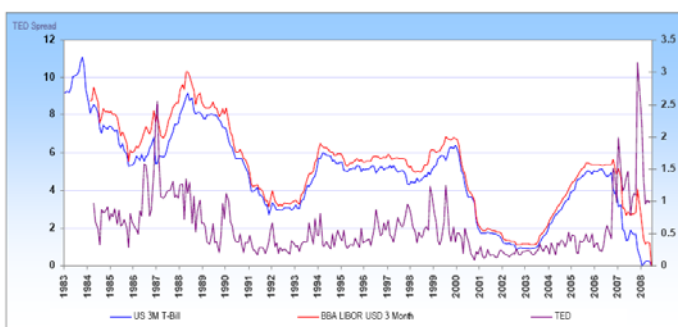
Figure 1. Unemployment Rate in G3 Countries

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In reality, long-only money always has some element of timing. Many managers were positioned defensively so far this year, either in their stock selection, or in their beta risk. It seems the recent market movements have been amplified by long-only funds increasing their risk exposure, thus pushing not very liquid markets higher.

Hedge funds are generally still very under-invested, or have only very limited net long exposure and so have missed much of the rally of the last few weeks. It is also true that many also missed the sell-off as well. Will hedge funds follow their long-only counterparts and increase their net long exposures? It is difficult for investors to remain negative indefinitely. And many managers have the added requirement to take risk in order to get paid.



Source: Bloomberg

Figure 2. TED Spreads

Recent hedge fund data shows the first outflows from CTA strategies for months and inflows into equity long/short for the first time since March 2008. This may be only profit-taking or it could signal the start of a new period of risk taking. Whatever the case, money is being put to work.

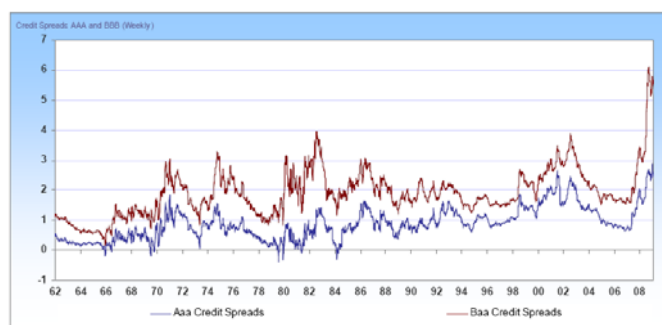
If the inflection point has indeed been turned in the equity/risk markets, I would expect to see a number of other supporting factors. One of these would be the default rate in the corporate bond markets, as well as the spread on these assets. This piece is still missing from the puzzle. Default rates are still languishing in low single digit territory, which is surprising, given the huge speculative issuance of the last few years and the collapse in

economic activity. True many bonds and loans in the sub investment grade sector were issued with relaxed covenants. Nonetheless, end of cycles are usually accompanied by defaults and restructuring. Perhaps this is just about to happen, and will test the effectiveness of credit refutation policies implemented around the world. As corporate bonds need to be refinanced, either investors will step up to the plate and roll over the debt, or the company will need to find alternative sources of capital to repay the loans, including selling assets, using cash flow, debt for equity swaps and default.

Whilst the various debt swap programmes make it possible for banks to post bonds and loans as collateral with Central Banks, as of yet the Central Banks are not acting as direct financing sources for the corporate.

Until we see this next and possibly final stage of the cycle, any equity rally could have difficulty in continuing.

James M.M. Edwards - *Chief Investment Officer*



Source: Federal Reserve

Figure 3. Credit Spreads AAA and BBB (monthly)

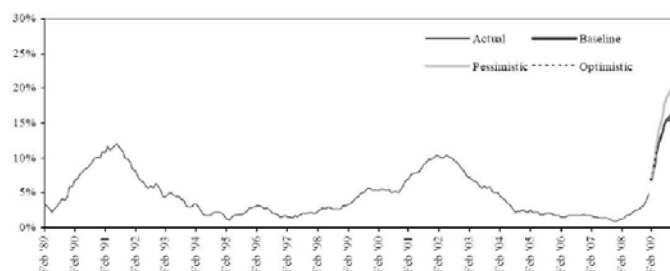


Figure 4. 89-09 Defaults Rate Speculative Grade