

# GYC Investment Update

*From the GYC Investment Desk*

## Bear Market Rally Extended

As expected, markets continue to be held hostage by events in Europe. Announcements by ECB and the EU summit have the ability to sway market movements and glue investors to financial news. We have long argued that investors would have to prepare for more pain unless the ECB were to step in to support European bond markets. Events over the past two days may have opened the way for more aggressive actions by the ECB, and therefore possibly prolonging the bear market rally.

The new ECB president, Mario Draghi, signalled last week that the ECB could do more to combat the debt crisis if European governments can commit to fiscal union<sup>1</sup>. We see the latest agreement by the Euro currency users as giving the ECB the green light for more aggressive action to fight the crisis.

Besides more liquidity measures, the key stabilising action that the ECB can undertake is to prevent Spanish and Italian bond yields from rising. Now that both countries have undergone a change in government and are committed to ECB's condition of austerity measures before support is given, we should expect to see less selling pressure on Spanish and Italian bonds.

It is also helpful that Germany has backed down from requiring private sector debt restructuring, whereas in Greece's case, a 50% haircut was imposed. Future bailouts will adhere to the practices of the IMF, which are less onerous on creditors. Again, this will reduce the selling pressure on Spanish and Italian bonds.

Technicals are also signalling better times. Weekly momentum indicators, which are less likely to whipsaw, are showing potential trend reversals in European financials (Figure 1). While the index made a new low in mid-November, momentum indicators like the RSI and the MACD did not. This indicates that selling pressure is exhausting, setting up a potential rebound. On a relative basis, the same signal was observed (Figure 2).

What would keep the market rallying would be more positive news coming out of Europe. Now that the ECB can play a bigger role in this debt crisis, we would expect more intervention in bond markets to contain rising yields and new plans to fund the budget shortfall in Italy and Spain. This has already begun as yields dropped while Europe has coughed up €200 billion for the IMF to lend to troubled European nations via their central banks<sup>2</sup>.

## Macro Strategy Update

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Figure 1: Weekly chart of European financial show potential reversal.



Figure 2: Weekly chart of European financials' relative performance.

Still, we are only 'short term bullish' and count this only as a bear market rally. Markets continue to exhibit defensive signs even in the US, where the economy is currently enjoying a period of stronger than expected growth. Equity investors continue to prefer defensive stocks (Figure 3) to cyclical ones (Figure 4) while bond investors flock to higher quality paper (Figure 5). Furthermore, TED spreads and LIBOR continue to rise, indicating renewed stress in credit markets (Figure 6, Figure 7). Until we see a meaningful change in investors' preference for risks across various asset classes, the odds of a sustained bull market is low.



Figure 3: Consumer staples, a defensive sector, making a new high.



Figure 4: Consumer discretionary, a cyclical sector, failing to better its recent high.

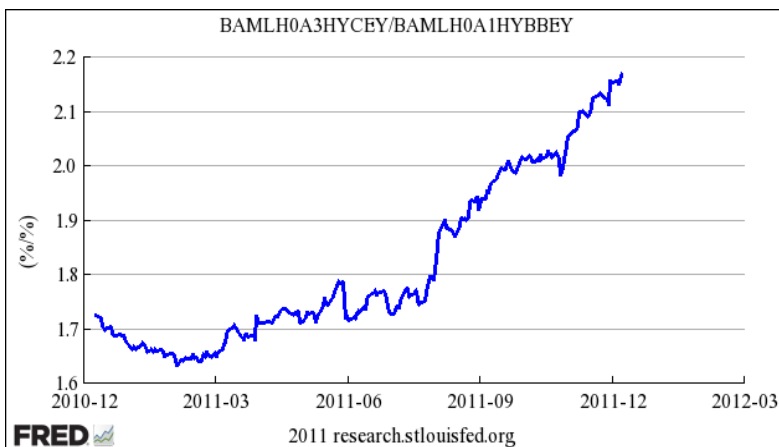


Figure 5: BB-rated bonds outperforming CCC-rated ones.



Figure 6: TED spreads rising.

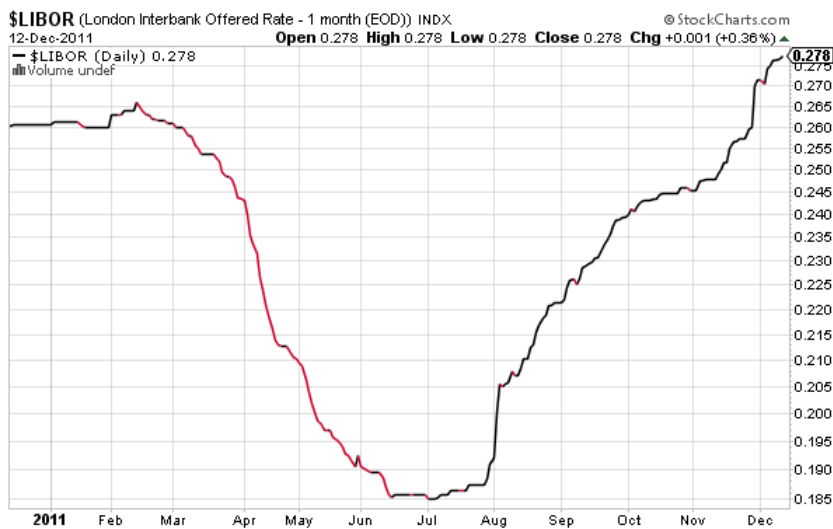


Figure 7: London Interbank Offered Rate (LIBOR) rising.

## Conclusion

Markets should be buoyed by the latest action in Europe. The political posturing in Europe suggests to us that EU leaders understand the severity of the issue. Despite not having the full 27 members agreeing to a treaty change, the current arrangement is sufficient to keep markets and the ECB happy. The bear market rally seems likely to last a little longer for the time being.

There are no changes to our portfolio positions for now.

## References

1. Draghi Signals ECB May do More If Leaders Agree Fiscal Union. 2 December 2011, Bloomberg Businessweek
2. Europe's New Budget Rigor, ECB's Challenge. 9 December 2011, Bloomberg News

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