

BLACKROCK

Week in View - 23 July 2010

The tone of risk assets last week was generally upbeat. US equities were up over 3%, with similar performance in the UK and Europe. Asian equities posted slightly lesser gains, with Hong Kong up in excess of 2.5% and increases in Korea and Japan. Government bond markets were on the back foot, with US 10-year treasuries up 7bps and gilts up 10bps. Currency markets were little changed, though sterling was one of the main gainers and the yen the major loser.

Market Movements

Markets	23 Jul 2010	% Change
S&P 500	1102.66	3.55
NASDAQ	2269.47	4.15
TSE 1st Section	841.29	0.08
FTSE S&P World Europe	307.47	2.57
FTSE All-Share	2743.57	2.97
DAX	6166.34	2.09
Hang Seng	20815.33	2.79
Citi World Govt Bond Index All Mats	578.18	-0.09
Bonds**	23 Jul 2010	19 Jul 2010
US	2.99	2.43
Japan	1.07	-1.84
Germany	2.71	3.44
UK	3.52	2.65
Currencies	23 Jul 2010	19 Jul 2010
USD/Euro	1.28	-1.03
GBP/Euro	0.83	-1.41
JPY/USD	87.29	1.01
USD/GBP	1.54	0.38
JPY/GBP	134.46	1.40
Commodities	23 Jul 2010	% Change
Oil (Brent Crude)	77.39	2.11
Commodity Futures (CRB) Index	484.09	1.12
Gold	1190.8	-0.16

Ahead of the stress tests, why were investors in such bullish mood? Perhaps the main driver was the positive news coming from corporate earnings as a range of companies, from Apple to UPS, from Akzo Nobel to Caterpillar not only beat analyst expectations for earnings and revenues on a backward looking basis, but also raised their forecasts for later in the year. While Apple's upbeat mood is often difficult to extrapolate to other companies, there appeared to be a consistent theme in the industrial sector of apparently robust investment spending in the corporate sector. With governments and households still counting the pennies, the health of business spending has been widely identified as the key to whether the escape from recession can be sustained.

Macro data was also broadly supportive. In the UK, Q2 GDP came in ahead of expectations, based on a sharp resurgence in the moribund construction sector, while in the US there were mild positive surprises from the housing market in building permits and existing home sales. Fed Chairman Ben Bernanke noted the uncertainties but did not see the need to announce any additional stimulus.

In any other week, these items would have been the main focus on our roundup. However, this week investors were especially focused on the Council of European Banking Supervisors' stress tests for 91 European banks. The tests looked at key capital ratios for the banks under a baseline scenario for 2010 and 2011, and under adverse shocks including an economic double-dip and a renewed sovereign panic. They found that seven banks would not retain sufficient capital in the stress scenarios, of which five are Spanish, one German and one Greek. The total amount of capital that these firms need to raise in order to rebuild their buffers is less than €4bn. But what were the tests meant to achieve? Many commentators have noted that in times of crisis like 2008, it's not really the capital base of banks which hurts them, but liquidity, in terms of their short-term ability to access funding in the markets. It raises the question of why a test of overall solvency which does not stress liquidity was thought worthwhile. The answer is that ultimately worries over solvency are the prime driver of a liquidity squeeze for a troubled institution. No one wants to lend to a potential case of corporate failure even for short periods. The hope, then, is that by providing a seal of approval on banks' solvency, the supervisors can encourage the private sector to keep liquidity flowing to the banks.

Have the tests been successful in restoring investor confidence? It would be fair to say that the €4bn of required capital falls well below most market estimates of what is required - and that on balance, most investors see this as evidence that the tests were a little lax rather than that the banks are in fantastic shape. While the stress assumptions are not implausible, there was scope for greater severity in the assumptions around economic downturn, market volatility and sovereign losses. In particular, the tests look at rising yields on sovereigns held in the trading book, but not at outright defaults and not at the far larger holdings of government bonds held in the traditional banking book.

Does this mean the tests are a waste of time? Not exactly. The tests have provided a significantly higher level of detail about the holdings of sovereign bonds in the banks, allowing analysts to conduct their own stress tests and differentiate between institutions. This should be a meaningful step forward to isolating at least some banks which are relatively secure, even if others which officially "passed" are more borderline. UK banks, for example, seem to fare reasonably well even under more stringent scenarios, perhaps reflecting the capital they were forced to raise in 2008 and 2009.

Will this prove to be a major catalyst for banks? In reality, it will take analysts some time to figure out their own conclusions about the banks, and these are likely to be highly name-specific. There will be clear winners and losers emerging. Most likely, getting the tests out of the way will take focus away from the financial sector back to the real economy, where investors continue to be wary of global double-dip risks.

On this score we are perhaps a little more confident than the average investor. You have to believe in outright falls in earnings to see equities as expensive at this stage, and the news from companies on their outlook suggests that this is not the most likely outcome.

Therefore, we are continuing to build equity positions gradually, with the gradual approach of a pause in Chinese policy tightening providing an entry into Asian equities, while supportive news from the tech sector also supports our positions. We're also seeing interesting opportunities in more cyclical parts of the bond market such as high yield and local currency emerging debt, which offer attractive yields in what looks increasingly like a low yielding world.