

BLACKROCK

Week in View

The theme of risk aversion continued last week, and was represented in the currency markets, where sterling and the euro dropped by a further percent against the US dollar, taking the pound towards the US\$1.50 level. Meanwhile, the Japanese yen was the standout, gaining over 3% against the "greenback". Further confirmation of investors' concern came in the bond markets, with 10-year Gilt prices up 2% on the week and all the major 10-year yields now 18bps-20bps off their highs.

The moves in equities were relatively subdued: US, Japanese and UK markets ended down less than 0.5%, while Europe was the only major laggard, losing 1.8%. Asia showed some signs of a recovery, with China and Hong Kong up more than 3%.

Market Movements

Markets	26 Feb 2010	% Change
S&P 500	1104.49	-0.42
NASDAQ	2238.26	-0.25
TSE 1st Section	894.1	0.56
FTSE S&P World		
Europe	306.22	-1.19
FTSE All-Share	2736.8	-0.17
DAX	5598.46	-2.16
Hang Seng	20608.7	3.59
Citi World Govt Bond Index All Mats	563.81	0.72
Bonds*	26 Feb 2010	19 Feb 2010
US	3.61	3.78
Japan	1.30	1.32
Germany	3.10	3.28
UK	4.03	4.27
Currencies	26 Feb 2010	19 Feb 2010
USD/Euro	1.36	1.35
GBP/Euro	0.90	0.88
JPY/USD	88.87	91.99
USD/GBP	1.52	1.54
JPY/GBP	135.29	141.81
Commodities	26 Feb 2010	% Change
Oil (Brent Crude)	76.2	-0.48
Commodity Futures (CRB) Index	478.32	-0.41
Gold	1105.5	-1.22

Most weeks, there is either too much to discuss in a short weekly call, or too little. Either all markets are moving dramatically, or they all wait in tight ranges for important news in the near future. So this week was something of a surprise, given the combination of sharp

moves in the bond and currency markets, but relatively limited volatility in the equity and commodity markets.

The focus was mainly on economic developments. In the US, a range of data for January has come in well below expectations. Consumer confidence, home sales and durable goods orders all disappointed consensus estimates.

Meanwhile, Fed Chairman Ben Bernanke continued to reassure investors that US interest rates would remain low for an extended period, and that current shifts in policy are not intended to tighten financing conditions. Certainly, these factors all helped to continue the recovery in government bonds.

The currency markets are also inclined to see a weak US economy as a force for still greater weakness elsewhere and, therefore, as positive for the dollar. Economic releases were also supportive of this move, with European manufacturing apparently past its point of maximum acceleration, as indicated by the German Ifo business survey.

Equally in the UK, fourth-quarter business investment showed one of the most dramatic declines since records began, although this has been somewhat at odds with survey data and did not stop an upward revision in the data that indicated Britain's exit from recession. This placed significant pressure on sterling, with the key exchange rate versus the dollar breaking through US\$1.54 towards the benchmark US\$1.50 level.

But with these moves good enough to validate sharp reactions in some markets, why were equity and commodity markets more subdued? There are three main reasons for this. The first is that the data themselves are open to interpretation. One of the coldest northern winters for years is recognised as having a significant dampening effect on economic activity, as shoppers stayed at home and work schedules were disrupted. It probably won't become clear until February data is released how much of an impact this had.

The second point is that not all the news for equity investors has been bad. Sluggish economic activity is undoubtedly challenging, but that is tempered by the reassurance that interest rate rises seem further and further off. One of the restraints on equities in previous weeks was the rise in government bond yields as a potential threat to financing costs, so bond-friendly news doesn't automatically mean equity-negative news.

We're also in the middle of a corporate earnings season, where in general both profits and revenues are beating expectations, and to a greater extent than in previous quarters. So there is some evidence at the micro level that firms are finding a way to grow even with a fragile economy. Investors recognise that the current economic uncertainties could ultimately challenge the sustainability of this pickup, and few companies are willing to predict robust recovery at this stage. But

investors looking to take profits are struggling somewhat to find attractive alternatives for their portfolios.

The end result of this push-pull in the equity markets is that volatility has dropped dramatically. Option implied volatility for the US stock market has dipped below 20%, but this is lagging realised volatility, which over the last few weeks has been closer to 10%. In other words, if the current size of daily moves is maintained, this would mean that the US market would only have a one-third chance of moving more than 10% either way over the next 12 months.

That seems unlikely to us. It appears more plausible that investors are waiting, either for signals from companies and the economy, or from each other. At this point, we continue to believe that the likelier break of the range comes to the upside, but first investors will need to feel that issues as varied as European fiscal challenges, US joblessness and Emerging Market policy

tightening are starting to be fully priced into the market. This may take some time!

In the meantime, as the bond markets proved this week, the best policy is to look for tactical opportunities when markets become overbought or oversold, rather than positioning too strategically.

So our overweights in equities and the emerging markets remain, but in moderate scale. We did take advantage of the bond sell-off to create trading positions, which have benefited recently, but still see bond markets as challenged in the longer term. The last theme which is starting to emerge is greater differentiation among regional markets. At this point, we see Europe as more "growth challenged" than the US, and as such we are underweight European equities into the US.