NEW MINERVA REPORT

Market Linkage

The problems in markets are that they are all now so interconnected. This is due to the liquidity that has built up in the system. Much of that liquidity has been created by the so called carry trade, which we have discussed before. Some have likened the carry trade to ‘picking up pennies in front of a steam roller”. Everyone knows the steamroller is coming, and they all believe they can get out of the way before the steamroller gets to them They all think the steamroller will get someone, but it won’t be them. The continued upward move of markets since the low last year had made many of those in front of the steamroller jumpy. The interest rate increase by the Bank of Japan by 0.25% in February, whilst not in itself sufficient to make the carry trade unprofitable, did remind people they were near the end game. Some investors still remember in October 1998 when the steamroller arrived, and in just three days the yen rose by 11% against the dollar. The current moves in markets has seen the yen appreciate by only 3.6% against the dollar. Not really on the same scale. In all probability this means that the steamroller has not arrived. After a week or so the penny pickers will be back at their game. What we have learnt however is that there is a high likelihood that fears of the steamroller will periodically beset markets over the coming year. This is one of the reasons why we believe that higher volatility will be seen in the markets this year.

Why should ordinary investors have concern about the carry trade? The reasons are risk and contagion. Every asset should price in a level of risk. Theoretically, the greater the risk, the greater the potential return. But if one asset gets overbought and does not have sufficient risk priced in, it can affect other assets, because many investors look at relative valuations. A good example of this is the argument put forward by some institutions that equities are cheap because they are at historically cheap levels, when compared to fixed interest bonds. What that argument fails to take into account is that bonds might be too expensive, and not have sufficient risk priced into them. This is in fact what we believe to be so. As for contagion, this is what happens when funds that have to cover their losses are forced to unwind profitable, and/or liquid positions. A good example of this in the recent slide has been the fall in the price of gold.

Oil

One event that has not been mentioned much in the past week has been the strength in the oil price. Fears of an escalation in US action against Iran has heightened investors’ worries that oil supply could be disrupted. It was only six weeks ago when we were hearing that the oil price was in free fall and likely to head back to $30 a barrel. The problem with the price of oil is that its moves may not always produce the expected results. The initial reaction of markets is that a falling oil price is good because it reduces the level of inflation and thus the potential level of interest rates. However, as the price falls, it acts as a stimulus to the economy as consumers have more income to spend. This could induce central banks to increase interest rates to cut off spending, thus producing the reverse effect one might initially expect. Unfortunately, this may not work in reverse because central banks are charged with stopping inflation, and therefore a rise in the oil price, which could reduce spending, is still likely to raise inflation, and therefore interest rates are more likely to rise as well. The best thing for markets would be if the price of oil stabilised.

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