Weekly Investment Bulletin

17th September 2012

MITHRIL ASSET MANAGEMENT

Market Roundup:

Well there you have it. After months of to-ing and fro-ing, the market which begged, got what they finally wanted. The closing paragraph of the opening section of last week's bulletin speculated on the enormous pressure on the Fed to act as the sustainability of economic recovery came further and further into question.

We didn't feel that the Fed would act now in favour of acting post US election in early 2013. However Bernanke, worried that improvement in the unemployment rate had ground to a halt, announced a third round of bond purchases on Thursday in an effort to bring down long-term interest rates and boost economic growth. The Fed said it would buy additional mortgage-backed securities at a pace of up to $40 billion per month.

If markets liked what Draghi had to say last week, Bernanke's announcement would be close to euphoric.

In addition to bond purchases, the Fed said it intends to keep the benchmark short-term interest rate, known as the federal funds rate, at nearly zero until mid-2015. In addition to bond purchases, the Fed said it intends to keep the benchmark short-term interest rate, known as the federal funds rate, at nearly zero until mid-2015. The Fed said it would keep low rates in place for a "considerable time," even after the economic recovery strengthens. There's that wondrous market wooing notion of 'unlimited' liquidity once again.

In a game of 3's the next hurdle lies with Spain. Abiding by the terms of the ECB's new bond buyback plan, member states must request assistance and its Prime Minister continues to stall with the terms and conditions attached to Draghi's latest grand plan to include further fiscal discipline.

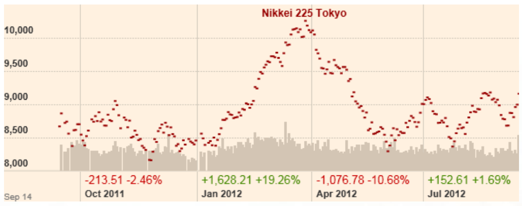
Market Data (12 month):

S&P 500:

FTSE100:

FTSE Eurofirst 300:

Nikkei 225:



Shanghai Composite:

Source: www.ft.com

Too Unlimited:

The initial market response to QE3 has been positive. It's a little ironic therefore that there is currently no timeline for when this will begin. We already have Operation Twist in effect, how will QE3 fit in with those efforts?

The seemingly flexible nature of this program gives the impression that the Fed plans to adopt the good old 'whatever it takes' attitude to spur is faltering economy. Interest rates are now being kept artificially low until at least mid 2015 and gives the impression that the amount of purchasing possible to have almost no ceiling. Looking at the summary to the right, the Fed is comfortable with adding as much as $125bln dollars each month until the end of the year.

The 'extended' nature of the plan (dependant on a marked improvement in the employment market), could end up with a large bill indeed.

The basic aim is to keep longer-term interest rates at lower levels and preventing any strain in the financial markets. Keeping long-term yields at low levels would minimise interest outflow and allow the Federal Reserve to keep caps on interest rates and government debt.

We have always said that QE3 would be saved for when the Fed *really* needed it. Given that US data had been lacklustre, but hardly a disaster, an expensive bond buyback program was expected early next year. However the recent jobs report forced the Feds hand. The numbers should be worse but were saved a little face when 7 million workers didn't even bother to file jobless claims.

Really QE3 doesn't have a direct effect on the jobs market, only in offering deterrents for lending institutions to not lend and offering markets and adrenaline shot.

QE3 Summarised:

- To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate

- Increase policy accommodation by purchasing additional agency mortgage-backed securities at a pace of $40 billion per month.

- The Committee also will continue through the end of the year its program to extend the average maturity of its holdings of securities as announced in June, and it is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities.

- These actions, which together will increase the Committee's holdings of longer-term securities by about $85 billion each month through the end of the year, should put downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

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Cont:

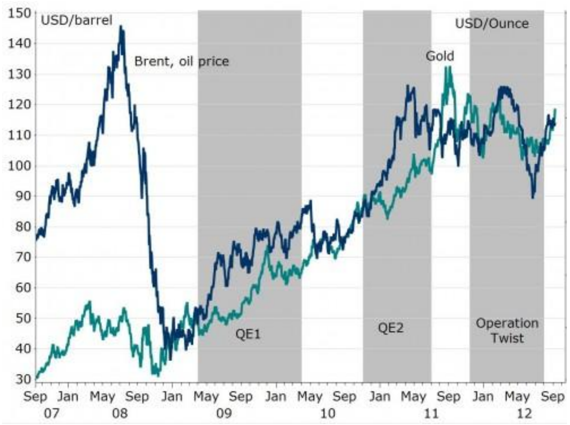
If the Fed is open to keeping the current program running until 2015, it's a sure sign that anaemic economic growth in the US is set to remain. The renewed flip side will be juggling that and high inflation. The Feds balance sheet is now at a very uncomfortable $2.8 trillion, and the current program would easily see that figure travel beyond $3 trillion over the next 6 months.

That inflation fear is reflected in US 10 year treasuries, and a surge in the price of gold, both of which leaped on the announcement of QE3. Indeed precious metals should continue to benefit followed by an uptick in industrials as economic (hopefully) edges higher.

On the energy front, natural gas mainly tracks industrial demand. But given the current slump, investors will likely need patience here. Crude has jumped on the initial announcement as it did during the last Fed stimulus, which started in early 2009. But the jump coincided with the Arab Spring and a conflict in Libya. Now the latter is still of concern today in the Middle East and will have a far more profound effect than QE3.

However when all is said and done, the main benefactors of QE all point to increased business and household inflation, which in truth isn't conducive to a program obsessed with getting unemployment significantly lowered.

QE, Gold and Oil:



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Currencies:

EURUSD

FX markets will be reacting sharply after Fed movement. EURUSD continues its upward movement from 1.2042, and the rise extends to as high as 1.3168. Further rise is likely this week, and next target would be at 1.3400 area. Support levels are now at 1.2940 and 1.2830, as long as these levels hold, the uptrend will continue.

EURGBP

EURGBP's rally continued last week as expected and reached as high as 0.8114. Initial bias remains on the upside this week for 0.8152 key resistance next. On the downside, below 0.8044 minor support will turn bias neutral and bring consolidations at the 0.7962 area.

GBPUSD

GBPUSD's upward movement from 1.5268 extends to as high as 1.6254, and is now facing 1.6301 resistance. Consolidation of the uptrend could be expected this week, and next target would be at 1.6500 area.

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USDCHF

USDCHF continues its downward movement from 0.9971, and reaches as low as 0.9238. Further decline is likely this week, and next target would be at 0.9000 area.

USDJPY

USDJPY may be forming a cycle bottom at 77.14 on daily chart. Further rise to test the resistance of the downtrend line from 80.61 to 79.65 could be expected this week. However, as long as this holds, the rise from 77.14 could possibly be consolidation of the downtrend, and one more fall towards 76.00 is still possible.

USD Weighted Index

Unsurprisingly, USD weakened against three of the four components, led by a 1.16% rally in the Euro, while JPY bucked the trend as market participants raised their appetite for risk. As market participants turn their attention to the Bank of Japan interest rate decision scheduled for the coming week, there's growing speculation that the central bank will act this month amid the persistent strength in the local currency, with increased pressure to intervene in the FX market.

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Gold:

Gold gained $35 on the week making it the fifth positive week. We expected prices to be pressuring the $1700 level at this time but the Fed saw it differently. Do not rule out a probe above $1800/ounce.

Crude:

November Crude traded above $100 barrel Friday, but settled below that level. Meanwhile, rising political tensions in the Middle East and North Africa continue to underpin oil prices with investors casting a cautious eye on the supply side.

Summary:

So the market now has what it wants. In the past fortnight both Europe and the US have showed their aces. They wanted details on how they intended to deal with the current economic situation and now they have them. Japan is now next up and is likely to intervene in its FX market much like it did 12months ago.

Both Europe and the US have offered the bazooka of potentially huge proportions. Should the wider economic situation fit, expect risk assets such as peripheral economies to benefit as well as physical commodities. Much unloved regions such as emerging European debt will be an area hugely undervalued. However the reluctance of Spain to decide on whether it needs a bailout should be a consideration before a bull run on Europe. The strings attached to assistance are now a little more public and stringent, putting even more pressure on an already deeply troubled economy.