



## Market Review, April – July 2008

**Overwhelming concerns about slackening economic growth and falling corporate profits still prevail on the global stock exchanges. There has been a shift in the focus now as the concerns over a sharp increase in oil and food prices are at the forefront.**

**Stock prices are a pre-emptive indicator: they start to fall before economic slowdown is reflected in the statistics and they climb upwards before economic growth is captured in the statistics. Therefore, in order to ensure a good long-term return, it is also important to increase the proportion of shares in due time. It is worth noting that we keep to the long-term strategy that envisages undertaking of risk of fluctuations in stock markets according to the guidelines set out in the investment policy of each particular pension scheme and we do not permit substantial changes as regards this risk.**

Early this year the largest problem was unexpectedly high losses suffered by US banks and other banks involved in the US sub prime mortgage-backed securities market. After identification of the range of problems, investors regained positive assurance about a long-term growth and a rapid increase in stock prices started and lasted for two months from March to May when the stock price index MSCI World in euro currency boosted by 15 %. The increase in stock prices evaporated along with a sharp increase in oil prices. In 2Q oil prices skyrocketed by 38 % and over the last five years they have tripled. As the fuel prices increased, so did the food prices as well and this cuts the spending which may be used by consumers for other needs. As a demand for goods slacken, corporate profits and stock prices fall. Rapid increase in oil price triggers overwhelming concerns about worsening outlook for profits in the future and thus causes even faster drop in stock prices. From May to Mid-July stock prices fell by 17 % and returned to the level where they stood in March.

Stock prices are a pre-emptive indicator: they start to fall before economic slowdown is reflected in the statistics and they climb upwards before economic growth is established in the statistics. Often stock market reaches the bottom point when the situation in the economy and the background of news is extremely gloomy. It is not possible to precisely establish the bottom point of any recession and the stock market may give positive signals prematurely. Three months ago we wrote in our previous market review that there is no sufficient ground for an increase in stock prices because the difficulties faced by the US are not of a temporary character. By reducing our position in the stock markets during this period of increase in stock prices we have reduced losses from a fall in stock prices over the last two months.

Oil price increases are supported by increasingly large global demand which is fuelled by rapid development of economy over the last decade. Increase in the oil prices is, on the other hand, fostered by the fact that pace of oil extraction lags behind from the pace dictated by the demand. Large shares of oil fields are located in politically instable regions and this hampers attraction of investment in the field of oil extraction. All these factors have been known already for a long time, and this makes some analysts think that price increases over the couple of years have been, to a great extent, speculative and may not sustain in the future. Moreover, consumption of oil has started to slow down in the US because economic instability forces to save on fuel costs. Thus oil prices may also plummet which may be a substantial and favourable factor for the stock market.

Still the end is not put to the credit crisis in the USA where the winding up of banks still continues and prices of securities related to sub-prime mortgages experience a further drop. Financial results reported by US banks for 1Q 2008 disappointed the investors because of large losses. Results for 1H 2008 are soon to be released, however, there are very few who hope for any profits.





Level of inflation has surged almost everywhere in the world. Negative effect of inflation, however, has been more pronounced in the countries where food accounts for a majority of consumption basket, namely, in the emerging markets. Investments in the stock markets of these countries has enjoyed increasingly large popularity because rapidly growing number of residents and development pace have supported the belief that long-term growth of stock markets in the group of these countries (China, India, Brazil etc.) will be more rapid than anywhere else. However, one must take into account also the fact that these countries have less developed ability to adapt to inflation if compared to the developed countries with liberal market economy, and it is a substantial risk in the short-term. This is partially compensated by positive export balances and low level of external debt, however, the turtle-like pace of development of the economy in the US, Europe and Japan is a major threat to the growth rate of exports by emerging countries.

Under influence of inflation investors may enjoy increased rate of return from their low risk investments. Return rate for German 1 year bonds increased from 3.77 % in late March up to 4.68 % in late June. This reflects the forecast increase in inflation rate by investors. In June, annual inflation in Eurozone reached 4.00 % and the European Central Bank forecasts that inflation will be on average 3.4 % in 2008 and 2.4 % in 2009. Investors, however, are rather doubtful about slackening inflation and ask for a larger premium for undertaking a higher inflation risk. This is also reflected in falling prices of euro long-term bonds which consequently increases the expected yield at maturity. Yield at maturity for German 10 year bonds increased from 3.9 % to 4.62 % in 2Q as the bond price fell by 4.2 %. Other low risk and high risk bonds also experienced a decrease in their value, thus it was one of the rare quarters when prices fell both for stocks and bonds.

In previous quarter, we reviewed the range of investment funds available in the portfolios and we made changes by attracting other management companies with efficient global selection strategies for stocks by reducing the proportion of stock index-linked funds. Tactically we reduce the share of emerging markets in the portfolio to prevent problems which may be caused by high inflation. We avoid long-term bonds as there are good opportunities in the markets of short-term public and corporate bonds.

It is worth noting that we keep to the long-term strategy that envisages undertaking of risk of fluctuations in stock markets according to the guidelines set out in the investment policy of each particular pension scheme and we do not permit substantial changes as regards this risk. We are often reminded that investment portfolios would have experienced considerably better earnings this year if the proportion of stocks had been reduced. Selling of stocks has been an easy solution, however, to ensure a good return in the long run it is important to increase the proportion of shares at the right time and here we should say that there is no permanent ability to forecast increases and falls on the global stock markets, it is an illusion that it is possible to forecast the direction of the market and a sheer luck usually stands behind the majority of successful attempts. Luck is not an investment strategy, therefore, in our portfolios we strictly follow the established risk guidelines.

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Detailed reports on the 3rd pillar pension schemes are available here:  
<http://www.hansabanka.lv/fondi/fondi-prospekti-hp-lv13.php>

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