HIGHLIGHTS OF THIS ISSUE

In this issue, we briefly update our existing themes. We then present in the spotlight piece our **Reservoir Dogs** theme, which attempts to delve into the effects of oil prices on a large array of asset prices.

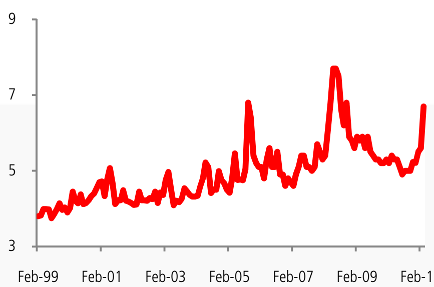
- As promised, solid macro support ultimately kept market risk alive during the past eventful month. With most risky assets approximately recovered to pre-tsunami levels, the calculus of risk is still problematic. This is no time for heroes.
- In our **Earth, Wind & Fire** theme, the catastrophe in Japan will likely affect positively the infrastructure-cum-energy theme; however, the counterweight, within our **Paying the Piper** theme, is that Japan will need to find a way to pay for this.
- In our **By & Large** theme, in theory, we should be seeing a lot more M&A deals this year. The theory is nonetheless missing one ingredient.
- In our spotlight piece, it is all about oil prices. Oil prices are very high; however, they could be going higher in the near term. Is there a tipping point? We opine on the level of oil prices which changes things for the rest of the markets and it is closer than most think. Finally, and most importantly, we explore the effect of oil prices on equity, currency, fixed income and commodity markets.

Current Theme Update

It appears that global sentiment is already up despite the multitude of regional risks hitting the markets this month. As promised solid macro support ultimately kept market risk alive. With most risky assets approximately recovered to pre-tsunami levels, the US Federal Reserve, the market's *Dirty Harry*, is about to rightfully ask us if we feel lucky (Chart 1).

Chart 1. 'Do You, Punk?'

US Inflation Expectations, Conference Board, %



Source: Bloomberg.

This is obviously no time for risk-taking heroes. By now, irrespective of one's views on the likely evolution of the various regional shocks, the most obvious late cycle dynamic is inflation and indeed a likely result from the lack of more convincing global rebalancing. Therefore it appears that our **Price is Right** theme is evolving. Developed market deflationary forces are no longer neutralizing the emerging market inflationary pressures.

'It Gets Late Early Out Here'

This raises additional uncertainty about the stage of the global cycle. Looking through the lens of domestic inflationary pressures in the emerging world is already difficult, given the prevalent use of government regulated prices. So we have to focus on goods that are less subject to price regulations.

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Globally traded commodity prices are the most obvious candidate and those markets increasingly look late-cycle.

Consider energy as an illustration. Oil prices have risen sharply in the early stages of this cycle, up nearly three times from the cycle low in 2009 to a relatively high level. It was nearly 7 years into the last US expansion that we reached current levels of real oil prices, and we are now less than two years into the expansion.

If it Rhymes it Must Be Right

It isn't that this time is different – every time is different. The challenge is to find what rhymes with past history. A long period of relaxed macro policies leads to asset bubbles. The question is to figure where they reside.

The commodity complex and its inputs (e.g., land) are the most likely candidate as even hardened policy-makers in the emerging world will hesitate to face these price pressures directly (treating them as exogenous).

The good news is that unlike asset price bubbles of recent memory, a commodity boom-bust has more of an immediate destabilizing impact on the global economy. So a commodity bubble, if we are upon one, is more likely to be brief. The fact that Libya, at less than 2% of world oil output, is important to the global outlook tells us a lot about the stage of the cycle – the energy market is tight (for more on this see **Reservoir Dogs** below.)

And Now for the Rebuilding Efforts

Taking a closer look at one of these regional shocks, the economic impact of the catastrophe in Japan has already attracted confusion.

Typically, the growth impact in such events tends to be V-shaped. The most relevant component from an activity standpoint is the ability to bring infrastructure back (such as electricity) and this determines the degree and the duration of decline. Ultimately, though, the activity impact lasts one to two months.

Estimates on the effect on the 2011 GDP ranges from a 0.50-2.5% decline in the growth rate, starting from a pre-quake consensus estimate of +1.50%. Global GDP could decline by 0.4-0.5%.

This is the flow issue. The first confusion is separating the flow from the stock impact. Even with a V-shaped recovery, the degree of wealth destruction is undeniable and it has come at a time that Japan could ill-afford a decline in asset values.

The destruction of fixed capital will likely have a long-lasting negative impact on the Japanese production possibility frontier. Japan is the third largest economy and accounts for 9% of global GDP, approximately. Initial estimates placed the cost of the earthquake to €100-150bn while more up-to-date government estimates indicate €130-215bn, up to 5% of GDP and double the Kobe's damage back in 1995.

This brings us to issues related to the subsequent demand for infrastructure (**Earth, Wind and Fire**) and, in turn, its fiscal financing (**Paying the Piper**).

With respect to the former, fixed capital formation with newer and more efficient equipment and inventory rebuild might take a couple of quarters to begin, but will comprise a significant positive demand shock.

Looking at the aftermath of the 1995 Kobe incident as indicative of the steps followed, demand for infrastructure, building construction materials and steel and raw materials jumped. Households replaced cars, furnishings and consumer staples destroyed by the earthquake.

We also need to consider that Japan accounts for 33% of global LNG imports and 10% of consumption of nuclear energy. Energy needs are very substantial and, although the total demand could initially fall, it will be just a first-round effect, as Japan will ultimately need to restore its energy capacity to rebuild the economy.

Who is to benefit from this reconstruction effort? An initial assessment would point to: Australian and Brazilian commodity exporters, US and South Korean steelmakers, European industrials, Taiwanese semiconductor suppliers and Chinese retail exporters.

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The loss of confidence in nuclear energy has brought forth the strengths of 'greener' forms of energy, hence natural gas, among others. US, Russian and Kazakh companies could also potentially benefit.

How Japan funds its reconstruction efforts (debt financing, fiscal tightening or monetization) will also be key.

In our opinion, herein lies another source of confusion. The fiscal response will likely be quite different from 1995 given the starting point of government balance sheets. Could Japan afford the same government spending program this time around? No. So they'll need help and the Bank of Japan is it. We could see a substantial degree of monetization over the coming quarters and thus a weaker JPY.

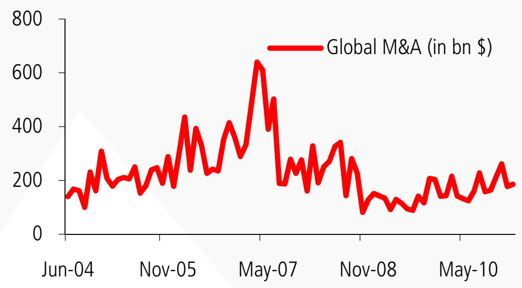
Other People's Money

In **By and Large**, the upturn in global M&A activity that started in 2010 continues in a healthy fashion this year with the latest announced banner deal from AT&T, which agreed to buy T-Mobile USA for USD39bn, USD14bn higher than the estimated value of the latter company.

Overall, the recovery in this type of activity has been very slow (Chart 2). In theory, we should be seeing even more M&A deals this year for a number of reasons:

First, large cap companies have continued to accumulate significant amounts of cash. Presumably, they have to put them to use in order to increase their net income, as cash returns remain low.

Chart 2. Nothing Like the The Good Old Times



Source: Bloomberg.

Second, free cash flow has risen with the spread between operating cash flow yield and corporate bond yield remaining high, which shows that companies could engage in profitable deals that will generate attractive returns using debt issuance.

Third, positive macroeconomic data have enhanced business confidence and should support expansions. Given that most companies have lowered their costs significantly through personnel and/or capital expenditure reduction coupled with healthy prospects for global growth, the pressure on management teams to find new ways to increase earnings should increase.

Fourth, especially for the US, the extension of the Bush tax cuts ends in 2013, putting some pressure to companies to go forward with any related decision in 2011 or 2012.

The theory is nonetheless missing one ingredient. The banking sector, especially in the US (but also in parts of Europe) is still not fully functional, maintaining a high degree of risk aversion on management teams, and thus likely the chief constraint for a more pronounced wave of corporate actions.

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Reservoir Dogs: The Effect of Oil Prices on Other Assets

A whiff of a three-digit oil price is typically sufficient for a flurry of analyst reports on the effects of oil prices on the economy and to a lesser extent on asset prices. Given the interrelation and feedback between oil prices and the rest of the economy and the markets, these are typically difficult and often unsatisfying exercises.

In this spotlight, we concentrate on the latter inquiry with an eye to capture the effect of oil prices on a wide array of assets, mostly on the short to medium term (within 2011). Aside from the aforementioned feedback, the potential additional problematic issues are multiple and often daunting: presumably it makes a difference on whether one examines oil price

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movements driven by supply (the seventies) or demand (emerging market consumers in 2008) shocks, on whether the price movement is temporary or more persistent, or even on the speed, the degree and the origin of policy response (e.g., is it the US or the Philippines raising rates?) in each case, etc.

Data Talks and Wall Street Walks

These issues, while difficult, should not though stop us from trying to imagine the future. Our first defense, in our data-intensive exercises, is to try to account for limitations statistically to the best of our ability and in some cases to rely on simulations. One of our main defenses is that we will rely on relative rather than absolute results in our little data farming project. Our final defense will be Charles Babbage adage that "errors using inadequate data are much less than those using no data at all."

There Will Be Blood

Before jumping to our data exercises, it is worth briefly revisiting some of the expected economic effects of oil price shocks. Martin Wolf of the Financial Times offered a nice summary on the subject in one of his columns this month. He notes that "*an oil shock has complex economic effects: it transfers income from consumers to producers; it lowers overall spending, as consumers normally cut their spending more quickly than producers increase theirs; it shifts spending away from other goods and services; it makes net oil exporting countries richer and net oil importers poorer; it raises the price level; it lowers real wages and the profitability of energy-using industries; and it reduces supply as capacity becomes uneconomic.*"

What we would add from an economic perspective, given that nowadays it is rarely highlighted as an effect from a significant oil price increase, is the impact of the latter on global savings.

When a global demand shock – like that caused by the recent US Federal Reserve's second round of quantitative easing – already potentially lowering the global pool of savings, is met by an expansion of fiscal policy in oil-producing countries (income inequality exacting its revenge) and a potential (temporary) supply disruption shock, the probability of a reduction in (the growth of) global savings becomes a near theoretical certainty in nearly any economic model we could think of. The end result is a likely increase in global real interest rates in the coming period, unrelated to any assumption we may postulate on how strong cyclical forces are in the near future.

What we would add from a statistical perspective is that, in the broad array of asset values we tested, the effect of oil prices on these assets has shot up over the past 5 years; and, more importantly it shows significant persistence. So, in other words, as far as 2011 is concerned, having an understanding on the interplay of oil prices with other assets as well as a solid view on oil prices is simply priceless.

The Tipping Point (USD110-120bbl)

From a short-term perspective, our thought process is simple. Even if there were little noise emanating from the neighborhood of energy-producing countries (MENA) and the tragic accident in Japan had not occurred, the demand side of the oil price equation suggested a high probability of continuous oil price gains in the coming months.

While it is easy to understand why the MENA political pressures raise the specter of supply constraints and thus additional price pressures, presenting the events in Japan as possibly relieving price pressures in the oil sector is probably misplaced in our view. Under most reasonable scenarios, over the coming quarters, the Japanese reconstruction efforts would necessitate an increase in demand for traditional energy and, in particular, oil demand. The bottom line is that oil prices are likely heading up over the near term.

Further out, in the absence of a significant setback in global growth for other reasons, we should also expect a positive impetus for oil prices in the coming months. Arguably, going into the second half of this year, such an expectation for global growth would appear progressively more optimistic.

Nonetheless, assuming a benign global growth framework for the balance of the year also implies

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higher oil prices. Inevitably we would have to assume that oil prices would rise enough to be harmful to this positive global framework and thus to the market's appetite to take risk. So, what is this harmful level of oil prices at this juncture?

Even simple eyeballing of the historical data indicates that large swings in oil prices do not have the same impact on asset returns as smaller ones. This asymmetric response motivated us to look for threshold effects in the relationship between oil returns and the returns of various target assets. In essence we looked for 'behavioral changes' as a result of cumulative oil price gains and relative volatility patterns whereby the statistical characteristics of the target asset (autocorrelation, positive feedback of own volatility, etc) abruptly change.

Note that all oil price references in this spotlight, correspond to the WTI oil price. The bottom line from a range of these exercises (mostly linked to the equity and FX market behavior) indicate that one of the most reliable thresholds for oil prices is not a level indicator but rather a concentrated increase in the oil price within a tight time frame. Specifically, we expect that when the three-month rolling return of oil exceeds 30%, we should expect a 'tipping point.' The true threshold range is 20-40%. For the coming month, if the WTI price begins trading around or above the USD110-120bbl range, all bets are off. This is a much tighter level than what most observers have assumed in the global analyst community.

The Rest of the Agenda

In what follows, we attempt to make intelligent comments on the effects of the oil price on four broad asset categories: equities, FX, fixed income and commodities. For each asset class, we first rank the relative importance of oil prices in the variation of each investment option within the asset class in question. We also focus on how this has changed over time (it has increased in almost all cases).

We then make a comment on the very short-term impact of oil prices on each sub-asset class investment option. Think of this as an elasticity exercise (e.g., 10% decline in oil price, 3.5% decline in Brazil's Bovespa).

Finally, and only when interesting, we examine the relative impact of two oil price scenarios that we find the most relevant for this year: one where oil prices stay stable at approximately current levels through year end and one where oil prices spike higher over the coming three months and then decline in the balance of the year to much lower levels. This translates to scenario 1 assuming a WTI price of USD100bbl for the rest of the year and scenario 2 assuming a spike in the price of the same variety to USD150bbl over the coming three months and then a linear reduction to USD60bbl through year end. These scenarios are by construction stylistic, but we believe informative on market impact, especially on a relative value basis.

Mr. Orange: Equities

Within the equity space, we split our exercise in three groups: a selection of developed markets, of developing markets and S&P industry sectors (Table 1, next page).

In terms of **developed equity** markets, we detect an increasing impact of the oil price over time on the volatility of all equity markets. Oil price moves tend to impact more the Canadian stock market (TSX) at a nearly double the rate of other peer markets. Given the relatively large energy exposure of this index, this is an anticipated result. The rest of the markets do not show significant differences in the relative weight of oil price volatility on the overall volatility of these markets. The short-term sensitivity exercise shows similar results. As a proxy of a long (short) oil price play, overweighting (underweighting) the TSX index may be the appropriate idea.

Looking at the two stylized oil price scenarios (stability at high levels and spike followed by substantial drop) and with a view to navigate defensively through either of these scenarios, DAX, the German stock market index would appear the safest bet within developed equity markets. When the dust settles, the oil price effect would either prove to be positive or neutral (compared to the rest of our developed market options).

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Table 1. Oil Prices & Equity Markets

Equity Markets

How Much of Index Volatility due to Oil Price Volatility?			Short-Term Pass-Through of Oil Price on the Index	Scenario 1: Stable Oil Prices Through Year-End	Scenario 2: Upcoming Sharp Spike followed by Linear Decline through Year End
Equity Markets, Developed					
	2005-2011	*1995-2011*	*Effect*	*Effect*	*Effect*
S&P500	9%	2%	Between 10-20%	Neutral	Negative
DAX	8%	2%	Between 10-20%	Positive	Neutral
FTSE100	11%	3%	Between 10-20%	Neutral	Negative
CAC	9%	3%	Between 10-20%	Neutral	Negative
TSX	24%	8%	Between 20-30%	Positive	Negative
ASX	11%	4%	Between 10-20%	Neutral	Negative
NIKKEI	8%	2%	Between 10-20%	Slightly Negative	Negative
AEX	8%	2%	Between 10-20%	Neutral	Negative
Average	11%	3%			
Equity Markets, Developing					
IBOV	27%	3%	Between 30-40%	Positive	Positive
MEXBOL	10%	3%	Between 10-20%	Positive	Very Positive
JSE	22%	6%	Between 20-30%	Positive	Positive
RTSI	31%	5%	Between 50-60%	Positive	Slightly Negative
WIG	15%	2%	Between 20-30%	Positive	Slightly Positive
ISE	15%	2%	Between 20-30%	Positive	Positive
SENSEX	14%	3%	Between 20-30%	Positive	Positive
TAIEX	8%	1%	Between 10-20%	Slightly Positive	Neutral
KOSPI	10%	2%	Between 10-20%	Positive	Positive
HANGSENG	14%	2%	Between 20-30%	Slightly Positive	Slightly Negative
SHANGHAI	2%	0%	Between 10-20%	Positive	Positive
Average	15%	3%			
Equity Markets, S&P Sectors					
INFO/TECH	8%	2%	Between 10-20%	Positive	Positive
FINANCIALS	4%	1%	Less than 10%	Neutral	Slightly Positive
CON/STAPLES	4%	0%	Insignificant	Positive	Very Positive
ENERGY	33%	19%	Between 20-30%	Positive	Slightly Negative
INDUSTRIALS	6%	1%	Less than 10%	Slightly Positive	Positive
CON/DISCR	5%	1%	Less than 10%	Slightly Positive	Positive
MATERIALS	16%	3%	Between 10-20%	Neutral	Neutral
TELCO/SERV	6%	1%	Less than 10%	Neutral	Slightly Negative
BANKS	1%	0%	Insignificant	Neutral	Slightly Positive
TRANSPORT	3%	0%	Insignificant	Positive	Very Positive
AUTO	5%	1%	Between 10-20%	Neutral	Negative

Source: Bloomberg and own calculations. Note: ASX and AEX are the Australian and Amsterdam (Netherlands) indices, respectively. IBOV, JSE, RTSI, WIG, ISE, SENSEX, TAIEX, and KOSPI are indices in Brazil, South Africa, Russia, Poland, Turkey, India, Taiwan and S. Korea, respectively.

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In terms of **developing equity** markets, we detect an even more intense increase in the impact of the oil price over time on the volatility of all equity markets. Stock indices in Russia and Brazil (RTSI, IBOV) tend to move more aggressively with oil price volatility, while peers in China and Taiwan tend to move the least. The exercise of the short-term sensitivity of each index to the oil price, clearly suggests that the 'long oil price play' in this group is overweighting the RTSI index and vice versa.

Looking at the two stylized oil price scenarios (stability at high levels and spike followed by substantial drop) and with a view to navigate defensively through either of these scenarios, the first result is that selective exposure to the emerging market equity indices is probably a better strategy than leaning heavily on developed market indices. Within the group, a relatively defensive posture covering both scenarios suggests a larger relative exposure in Mexico, India, and China (MEXBOL, SENSEX, and SHANGHAI) within an EM stock market portfolio.

Finally, in terms of sectors –using the **S&P sectors** as examples,– we detect an increasing impact of the oil price over time on the volatility of all sectors. Oil price moves tend to impact more the volatility of the Energy and secondarily that of the Materials sector. Those two sectors are essentially those which bring up the overall oil price effect on the S&P index. Using the results of the short-term sensitivity exercise, we find that we could (unsurprisingly) use the Energy sector as the best long (short) oil price play. Indeed, the expected pass-through is very similar to that using the Canadian stock market.

Looking at the two stylized oil price scenarios (stability at high levels and spike followed by substantial drop) and with a view to navigate defensively through either of these scenarios, two sectors stand out as likely candidates: consumer staples and transport. On a relative basis, these are the likely best defensive choices.

Mr. Pink: Currencies

Within the currency space, we split our exercise in two groups: one selection of developed and one of developing FX markets. We examine the impact of all currencies against the USD (the numéraire in this case). The main result here across all currency crosses is that the USD in trade-weighted terms is overall mildly negatively affected by higher oil prices (Table 2, next page).

Specifically, in terms of **developed FX** markets, we detect an increasing impact of the oil price over time on the volatility of all G10 currencies. Oil price moves tend to impact more the volatility of NOK and secondarily CAD, SEK & AUD. The effect on JPY is minimal. Among the most affected, the first two are well explained by their exposure to energy and the latter two as good proxies to global growth (in turn also affecting oil prices).

When it comes to the short-term impact of oil prices, the short-term sensitivity exercise reveals a pretty similar pass-through to all four crosses. As a short-term proposition, it appears that adding long positions in NOK, CAD, AUD & SEK (against the USD) are incorporating a long oil price exposure and vice versa.

Looking at the two stylized oil price scenarios (stability at high levels and spike followed by substantial drop) and with a view to navigate defensively through either of these scenarios, one may consider going long USD-SEK (neutral and very positive for the USD for each scenario, respectively). Secondarily, going short EUR-USD and long USD-CHF could also be considered as an oil price-defensive strategy.

In terms of **emerging FX** markets (EMFX), we similarly detect an increasing impact of the oil price over time on the volatility of all EMFX. Nowadays, oil price moves tend to impact more the volatility of the Brazilian, Russian, South African and Polish currencies.

When it comes to the short-term impact of oil prices, the short-term sensitivity exercise reveals that overall the average impact is higher in developed rather than emerging crosses. Within EMFX, the largest pass-through is to ZAR, POL and BRL (less in TRY and RUB as most seem to suspect). As a short-term proposition, it appears that adding long positions in

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ZAR, POL, BRL (against the USD) is equivalent to incorporating (to some degree) a long oil price exposure and vice versa.

Looking at the two stylized oil price scenarios (stability at high levels and spike followed by substantial drop) and with a view to navigate defensively through either of these scenarios, one may consider going long USD-ZAR (slightly positive and very positive for the USD for each scenario, respectively). Secondarily going short USD-SGD could also be considered as an alternative.

Table 2. Oil Prices & Currency Markets

Currency Markets

How Much of Index Volatility due to Oil Price Volatility?			Short-Term Pass-Through of Oil Price on the Cross	Scenario 1: Stable Oil Prices Through Year-End	Scenario 2: Upcoming Sharp Spike followed by Linear Decline through Year End
FX Markets, Developed					
	2005-2011	*1995-2011*	*Effect*	*Effect*	*Effect*
EURUSD	10%	3%	less than 10%	Neutral	Positive
USDJPY	2%	0%	less than 10% (-)	Negative	Positive
USDSEK	20%	7%	Between 10-20% (-)	Neutral	Very Positive
USDCAD	22%	10%	Between 10-20% (-)	Negative	Positive
GBPUSD	11%	3%	less than 10%	Slightly Negative	Very Positive
USDCHF	6%	1%	less than 10% (-)	Negative	Slightly Negative
AUDUSD	18%	9%	Between 10-20%	Negative	Positive
USDNOK	29%	10%	Between 10-20% (-)	Slightly Negative	Very Positive
FX Markets, Developing					
USDINR	2%	0%	Insignificant	Neutral	Slightly Positive
USDIDR	2%	1%	Insignificant	Neutral	Slightly Positive
USDMYR	5%	1%	less than 10% (-)	Slightly Negative	Slightly Negative
USDKRW	5%	2%	less than 10% (-)	Slightly Positive	Positive
USDTWD	5%	1%	less than 10% (-)	Slightly Negative	Neutral
USDPOL	15%	4%	Between 10-20% (-)	Slightly Negative	Positive
USDBRL	16%	3%	Between 10-20% (-)	Negative	Neutral
USDMXN	9%	2%	less than 10% (-)	Slightly Positive	Positive
USDTRY	6%	1%	less than 10% (-)	Slightly Positive	Positive
USDZAR	13%	2%	Between 10-20% (-)	Slightly Positive	Very Positive
USDSGD	7%	1%	less than 10% (-)	Negative	Slightly Negative
USDRUB	15%	0%	less than 10% (-)	Neutral	Positive

Source: Bloomberg and own calculations. Note: INR, IDR, MYR are the currency abbreviations of India, Indonesia and Malaysia, respectively.

Mr. White: Fixed Income

Within the fixed income space, we examined the impact of oil prices on long-term yields in developed markets, on total return metrics for three popular sub-asset class fixed income alternatives, as well as Greek fixed income assets (Table 3, next page).

Starting with the latter, the oil price effects on Greek government paper were insignificant and we do not report them. With respect to the effects of oil prices and its volatility on various yields, the effects appear moderate with the exception of Japanese rates, where the effect is minimal (obviously, the remaining possible external issues in this case nowadays are daunting, so no analytical gains here). Probably the most interesting result from our exercise in the yield

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space is that a sharp spike in oil prices now followed by a substantial decline from current levels (scenario 2), translates into a more noticeable effect in **US Treasuries** (decline of 60bp in the 10-year yield) compared to other developed markets.

We also examined the oil price effects on **Emerging Market** (EMBI plus), and high-rated **EU and US corporate** fixed income. The former category has an average rating just below investment grade, while the other two are comfortably above the investment grade rating threshold (BBB-/Baa3). In general, very little of the volatility of these investment options is linked to oil price volatility. Nonetheless, we do find that on a very short-term horizon, oil prices have a negative and to some extent sizeable pass-through on (the average) Emerging Market fixed income asset. In this sense, being long the EMBI plus index carries potentially an oil price short position.

Looking at the two stylized oil price scenarios (stability at high levels and spike followed by substantial drop) and with a view to navigate defensively through either of these scenarios, one may consider going long all three of these assets, with an overall preference of the EMBI plus, then US corporate and finally EU corporate paper.

Table 3. Oil Prices & Fixed Income Markets

Fixed Income Markets

How Much of Own Volatility due to Oil Price Volatility?			Short-Term Pass-Through of Oil Price	Scenario 1: Stable Oil Prices Through Year-End	Scenario 2: Upcoming Sharp Spike followed by Linear Decline through Year End
10-Year Yields, Developed					
	2005-2011	*1995-2011*	*Effect*	*Effect*	*Effect in Basis Points*
US10GENYIELD	9%	1%	Between 10-20%	Neutral	-60
GE10GENYIELD	9%	1%	Between 10-20%	Neutral	-37
JN10GENYIELD	1%	0%	less than 10%	Neutral	-8
UK10GENYIELD	6%	0%	Between 10-20%	Neutral	-47
FR10GENYIELD	7%	1%	Between 10-20%	Neutral	-25
Other Fixed Income Options					
EMBIPLUS	10%	5%	Between 30-40%	Slightly Negative	Significantly Positive
EUCORPS	1%	0%	Insignificant	Slightly Positive	Positive
USCORPS	0%	0%	Insignificant	Slightly Positive	Positive

Source: Bloomberg and own calculations. Note: US, German, Japanese, UK and French 10-year yields.

Mr. Brown, Mr. Blonde & Mr. Blue: Commodities

Within the commodity complex, we examined selectively oil price effects on **metal**, **agricultural** and **energy** commodities (Table 4, next page).

The first possibly surprising result is that looking at the origin of variation of prices among different commodities, it is not natural gas the commodity with the price variance mostly explained by oil price movements. Copper and nickel have this honor. Silver and gold show a similar attribution to oil price movements as the trade-weighted dollar (DXY).

Turning to the pure short-term impact of oil prices on commodity prices, nickel is the major surprise in terms of the very high degree of short-term pass-through with copper, natural gas and silver following in the second group. Gold prices demonstrate the least near-term impact from oil price movements.

Looking at the two stylized oil price scenarios (stability at high levels and spike followed by substantial drop) and with a view to navigate defensively through either of these scenarios, cotton, silver, corn and gold are the commodity assets that are the most likely to outperform within the overall commodity complex.

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Table 4. Oil Prices & Commodity Markets

Commodity Markets

How Much of Commodity Volatility due to Oil Price Volatility?			Short-Term Pass-Through of Oil Price on the Commodity	Scenario 1: Stable Oil Prices Through Year-End	Scenario 2: Upcoming Sharp Spike followed by Linear Decline through Year End
	2005-2011	*1995-2011*	*Effect*	*Effect*	*Effect*
SILVER	16%	6%	Between 30-40%	Positive	Very Positive
GOLD	11%	4%	Between 10-20%	Positive	Very Positive
NATGAS	7%	5%	Between 30-40%	Neutral	Very Negative
COPPER	22%	9%	Between 30-40%	Positive	Neutral
NICKEL	22%	9%	Between 40-50%	Slightly Positive	Negative
COTTON	8%	4%	Between 20-30%	Positive	Very Positive
WHEAT	5%	3%	Between 10-20%	Slightly Positive	Positive
CORN	8%	2%	Between 20-30%	Positive	Very Positive
SUGAR	7%	3%	Between 20-30%	Positive	Positive
COCOA	8%	2%	Between 20-30%	Positive	Positive
DXY	12%	3%	less than 10%	Slightly Negative	Positive

Source: Bloomberg and own calculations.

Maybe with one exception, there is not an obvious investment allocation here to be initiated; however, the investment implications for any portfolio should be easy to understand. As usual, we leave the actionable part of our investment theme to our internal use only, upcoming companion issue number 28.

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GAD's word

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Theme Glossary & Reference

Name of Theme or Subtheme	Initiated:	Description	Active in Portfolio? (Yes/ No)
Paying the Piper	Feb '10	Fiscal travails continue and spread; however, recent intervention leads closer to a European fiscal union.	Y
The Gem of GEMS	Feb '10	Global growth drivers shift from developed to Global Emerging Markets (GEMs). GEMs which rebalance their growth profile towards domestic demand stand to gain most.	Y
By and Large	Feb '10	Funding asymmetries for *Borrowers*. Access to global credit markets affords a new premium to large, internationally oriented corporations. Big is beautiful & it buys you discounts.	N
The Price is Right	Feb '10	The fallacy of the upcoming inflationary pressures presents fixed income opportunities for both savers & lenders in the developed and emerging world.	N
Fleeced by Gold	Feb '10	Being long gold is not a "cheap option" for any outcome.	N
Earth, Wind & Fire	Mar '10	GEMs control the fiscal bullets & invest in their capital base. Infrastructure investments and energy benefit. They also withstand headwinds better in a lacklustre global scenario.	Y
Say Swiss!	Apr '10	The CHF offers value beyond its typical safe haven status & thus it becomes a cheap insurance option.	N
PIGS vs. Bacon	May '10	The market is under-appreciating both the Greek chances for fiscal success &, maybe more importantly, Europe's ability to institutionally re-invent herself.	Y
The Spread Looks Bright	Jun '10	The corporate debt market offers defensive pockets of opportunity that fit well with the expected near-term macro backdrop.	Y
Passing the Buck	Aug '10	Funding asymmetries for *Lenders*. Impaired (DM) vs. (EM) healthy banking systems.	Y
The Reflation Riddle	Oct '10	Economic and policy undercurrents as well as perceived market dynamics will likely lead to higher US yields over the coming months.	N
Going Loco	Nov '10	Low duration defensive opportunities in selective EM local markets.	Y
Buy the DIVs	Feb' 11	Exposure to high dividend equities, the portion of the equity asset class that does not forgo the yield and thus (presumably) emphasizes income over capital gains, offers a partial protection from rising inflationary pressures in a still uncertain economic environment.	Y

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