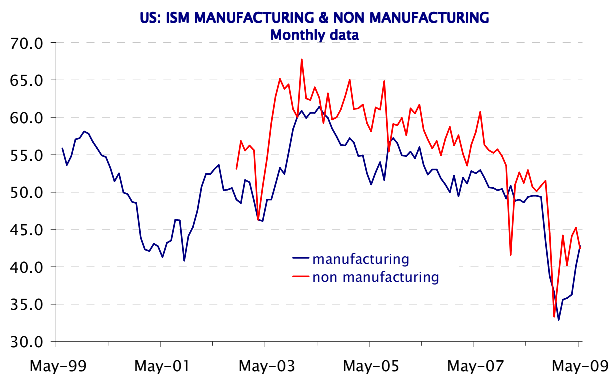
North Star News

June 2009

Dear Investor / Intermediary,

Is the crisis over, or is this merely a pause in a longer downturn? This newsletter takes a look at the scenario in the US and Europe and assesses the message of the markets against this background. As usual we begin with the US, move on to Europe, and finalise with a look at financial markets.

The US: looking for green shoots
Several key economic indicators have moved in a more positive direction lately. Principal among them, and the first to change, was the ISM manufacturing index which bottomed at 32.9 and reached 42.8 in May, after 5 consecutive months of improvement. This has been followed by signs of improvement in consumer confidence, tentative signs construction activity may be stabilising and last, but not least, better than expected data from the labour market. Most of the so-called hard data have not followed suit, however. Industrial production and capacity utilisation remain at levels consistent with pronounced recession, retail sales have shown no sign of turning around, and home sales remain generally weak with continuous downward pressure on house prices. While indicators are generally less negative than a few months ago, they still signal a slower pace of decline rather than an actual upswing. Second quarter GDP figures look likely to show yet another contraction, albeit a moderate one in comparison with the sharp drop seen in the first quarter.

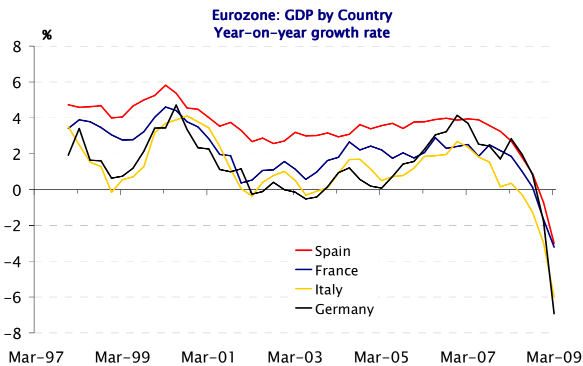


Still, a technical exit from the recession does seem to be at hand this year, probably showing up in the figures for the third quarter of this year. This prompts the question of what sort of recovery should be expected, and as usual the market is divided in at least two groups. The most optimistic expect a V-shaped recovery in line with what has been seen in the past whereas the most pessimistic look for a low to zero growth with the possibility of a second downturn – the double-dip scenario. We are closer to the pessimistic camp than the optimistic one. Firstly, we believe both the monetary and fiscal stimulus implemented, even if considerable indeed, will prove less powerful than in the past. Lower short term interest rates, and the unconventional measures of quantitative easing undertaken by the Fed, have surely helped partially to normalise conditions in the credit markets. Witnessing this is the reduction between interbank rates and official rates, the narrowing corporate bond spreads, and the drop in the prices of credit default swaps (CDSs). But interest rates on mortgages, both short-dated and fixed rate, remain unusually high and surveys continue to signal tightness in bank lending. The *credit crunch* is thus arguably still intact and continues to curb the access to credit on the part of consumers and small-to-medium size businesses.

Secondly, even though consumer confidence has improved, consumer spending will be facing important obstacles going forward. On the one hand, higher unemployment and downward pressure on wages and salaries will imply a slower growth in personal incomes. On the other hand, consumers are likely to continue the process of increasing their saving rate in the face of declining house prices. Overall, GDP looks likely to contract by around 2.5% this year after growing only 1.1% in 2008. For 2010 we would look for growth around 2%, well below potential.

The Eurozone: a differentiated down-turn
The crisis has affected individual Eurozone countries in different ways. Peripheral countries with housing bubbles, like Spain and Ireland, have been hit particularly hard by the downturn in construction activity and the increase in unemployment this has led to. Germany, on the other hand, is suffering the decline

in demand from exports particularly hard, while all countries are affected by the weakness of the banking sector, the restricted access to credit and the general gloominess on the part of consumers. While the problems of consumer indebtedness, past excesses in housing and the crisis in banking are all generally less pronounced than in the US, monetary and fiscal authorities have also been less aggressive in their counter-cyclical measures. All in all, this points to an equally weak recovery down the line, and one that is likely to lag that of the US.

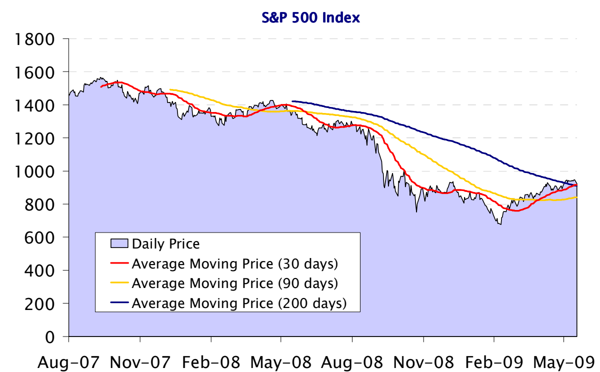


Equity Markets: un-doing 2008
Equity markets began an impressive recovery from March this year which has taken the main stock market indices into positive territory since the beginning of the year. The S&P has rebounded approximately 2.5%, the Eurostoxx 0.5% and the Nikkei no less than 13% Financials and cyclical sectors like technology, autos and basic resources have generally done very well whereas defensives like utilities, health care and consumer staples have underperformed or sold off. In a similar vein, commodities prices, with oil at the forefront, have spiked and the general flight to quality trade of 2008 has been replaced by a reduction in risk aversion.

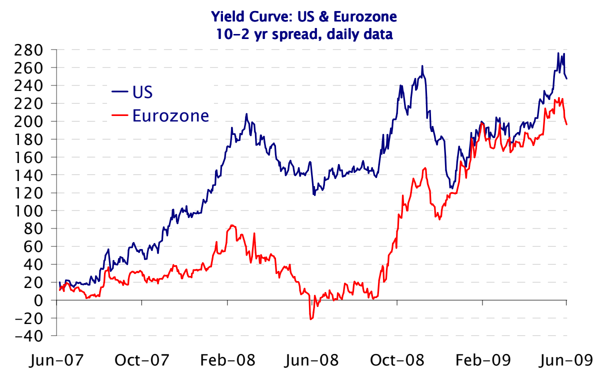
The general factor behind this scenario has been a sense that the economy has bottomed on the basis on the economic indicators discussed previously, and better than expected earnings figures from the banking sector which, in the US case, appears to have passed the much awaited stress-test reasonably well. Our feeling is that the positive momentum may have somewhat further to go, especially since the risk of bad news from the banking sector now appears much lower than only a few months ago. Looking towards the end of 2009, however, we expect equity markets to meet serious headwinds from sluggish earnings growth both among financials and real sector stocks and from valuations which after the recent market rally begin to look stretched. Overall we would expect the main stock indices to end the year not far from their current level.

As to the technical picture the S&P 500 Index is interesting to watch in the near future. The recovery of around 40% since March of 200 (i.e. from 675 to 945) is shown in the chart which also includes the moving average price lines of 30, 90 and 200 days, which all three have been broken by the actual price.

However, it will now be of some importance for the further recovery if the 30 days moving average can penetrate the 200 days average. A temporary downward correction of up to 2/3 of the movement since the bottom in March – i.e. down to around the 780 level – cannot be excluded.



Bonds: pricing in higher inflation
The developed markets in government bonds have seen a generally poor performance this year. In general, the significant bid that was the result of flight-to-quality in the second half of 2008 has been unwound since March, as risk-aversion receded. Moreover, the quantitative easing of the Fed has prompted fears of longer term inflation which has added a risk premium to the yield on long-dated bonds. The result has been a significant steepening of the yield curve which is itself seen as a sign of recovery by a part of the market.



Our feeling is that the rally which took US 10-year yields close to 2% towards the end of 2008 was probably overdone, even taking the dire cyclical situation into account. But the present fears of inflation are equally, or more, unjustified in our view. When a credit crunch is caused by banks' balance sheets being

contaminated by "toxic" assets, the liquidity created by quantitative easing merely boosts banks' reserves at the central bank. The reserves are not passed on in the form of loans to the private non-banking sector, because banks cannot grow their asset base given their already too high level of risk. In monetary terms, the money base grows but not the money supply. This happened in Japan in the late 1990s and early 2000s as it is now happening in the US. Rather than create inflation this practice is more likely to prove ineffectual. Headline inflation is likely to creep higher after the summer months of this year, as the "base effect" from last year's peak in oil prices is replaced by the subsequent drop in the energy cost. But the core rate, which excludes energy, is likely to continue lower and could go below 1% next year. Against this background, we believe 10-year government bonds both in the US and in Europe represent value and will return to a yield level around 3% before year-end 2009.

Currencies: indices of risk aversion

Short term exchange rate movements are frequently counterintuitive. The intensification of the financial crisis from September of 2008, with the US at the "epicentre", did not lead to further weakening of the US dollar but to a recovery instead. The principal reason was the repatriation of capital back into the US which was prompted by the extreme market stress. The reversal of the situation from March this year has led to renewed dollar weakness, lately exacerbated by concern over US public finances and fears of a sell-back of dollar-assets by foreign investors. Our view is that such a sell-back is unlikely on anything but a minor scale, but we would nonetheless look for a somewhat weaker dollar against both the euro and the yen up to year-end 2009, based on the general economic and financial scenario in the US. Within the European sphere, we would look for a somewhat weaker Swiss franc against the euro, while the British pound looks more likely to hold up or even strengthen from here.

Yours sincerely,

North Star Fund Managers (Cayman) Limited

Mogens Kjøller-Petersen
Chairman

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