

Stock Market Review



Edward Rizzo

Mr Rizzo is director of Rizzo, Farrugia & Co. (Stockbrokers) Ltd.

Volatility across the currency markets

Currency markets have always been volatile but this seems to have increased markedly since the international financial crisis in 2008. Investors seek to take advantage of such wide bouts of volatility although the timing of such movements is always very difficult to predict and many analysts often have opposing views on the likely direction of certain currencies.

The two main currencies on the radar screens of local investors are undoubtedly the US dollar and the pound sterling, although we understand that local investors have also ventured into other currencies such as the Australian and New Zealand dollar and the Norwegian and Swedish kroner among others. Exchange rate movements are very difficult to predict since the value of a nation's currency is impacted by a congruence of factors such as the state of the economy and government finances, political tensions, expectations of interest rate hikes and various others.

The two charts track the movements of the euro against both the US dollar and pound sterling and clearly show the wide fluctuations within a relatively short period of time. The recent movements in the EUR/USD exchange rate may have surprised many. During 2009, the dollar weakened significantly to a value above \$1.50 but this was completely reversed during the first six months of 2010 as the value of the US dollar versus the euro gained following the onset of the sovereign debt crisis that hit the eurozone and the risk of contagion among the periphery nations.

By last summer, the US dollar had strengthened to below the \$1.20 level against the euro only to reverse most of these gains once again during the second half of 2010. Apart from the closely watched data from the US and eurozone economies, much of this fluctuation could also be attributed to expectations of the first interest rate hike by the major central banks. Inflation has started to gather momentum causing some commentators to put increasing pressure on central banks to start lifting rates. Despite this, all major central banks have so far postponed such a decision.

With many local investors retaining a considerable exposure to pound sterling, the value of the British pound against the euro is also given particular prominence

locally. The euro has fluctuated less against the GBP during the first few weeks of 2011 but in the second half of last year the pound had strengthened to £0.81 only to drop back to a value of £0.89 by October. The Bank of England has a serious dilemma in the coming months.

The English Central Bank has so far held rates steady at 0.5 per cent and critics have assailed the bank for maintaining this stance as inflation hit 3.7 per cent and is expected to rise to the five per cent level in the coming months. Although many investors may have been bullish on the pound on the expectation that interest rates in the UK will rise quicker than those in the US and in Europe, some UK economists do not believe that it is a foregone conclusion that an interest rate hike will benefit sterling.

Britain's unemployment rate is still high at 7.9 per cent and the UK economy unexpectedly contracted again in the final quarter of 2010 although this was exacerbated by the severe weather conditions. Furthermore, there is little evidence that inflation is feeding through into increased wages and the UK economy may experience headwinds in the months ahead as the government's austerity programme gathers momentum and could have a larger impact on consumer confidence. Rising inflation, weak growth and fiscal retrenchment are not normally attractive for foreign exchange investors and the growing risks of stagflation may put pressure on sterling once again going forward.

Despite the reluctance from central banks to start increasing official interest rates, financial markets have already been impacted by growing inflationary fears and expectations of such future interest rate hikes by all major central banks. Bond yields have risen strongly from the lows in the summer months. The yield on the 10-year German bund (the eurozone benchmark) had dropped to an all-time low of 2.089 per cent on August 31 and since then it has advanced remarkably towards a level of 3.30 per cent in recent weeks. This has had an effect on global bond markets (including Malta's).

Many sovereign bond prices have declined significantly in recent weeks as yields climbed. The prices of Malta Government Stocks have similarly tumbled from their recent all-time highs in the summer as evidenced by the drop in the Rizzo Farrugia MGS Index. Since August 31, 2010, this Index



declined by 3.95 per cent to a 19-month low.

Expectations of interest rate hikes also have an impact on investor behavior between one asset class and another. As inflation negatively impacts fixed-interest securities, there has been a shift internationally from bonds into equities, particularly those offering sustainable dividends to shareholders. This may have also started to gather momentum in the local context. The lack of corporate bond issuance in recent months may have also led investors to look more favourably towards the equity market and it may not be a coincidence that the level of trading activity in the equity market last week hit its highest level in the past three years.

Higher interest rates positively affect bank profitability levels and bank shares are normally favoured ahead of such developments. During the first few weeks of 2011, share prices of some international financial institutions that had suffered share price declines last year have rebounded strongly from the declines in 2010. Locally, the share prices of HSBC Bank Malta plc and Lombard Bank Malta plc have also

got off to a bright start ahead of the 2010 full-year results publication by HSBC due tomorrow.

Meanwhile Bank of Valletta plc's equity has been volatile on very high trading activity as the market reacted negatively to the announcement that during the first quarter of their financial year, the profitability of the BoV Group was in-line with the previous year but below expectations largely as a result of mark-downs on the investment portfolio.

Investor sentiment towards BoV may also have been dented by the news that the MFSA has finalised its initial report on the La Valette Property Fund. On the other hand, the share prices of Malta International Airport plc and Maltapost plc continued to perform strongly possibly as investors increase their exposure towards equities providing an attractive dividend yield.

Financial markets and currencies are very likely to continue to be impacted by the outcome of the sovereign debt crisis in the months ahead and investors must be well positioned to protect their portfolios ahead of further volatility in most asset classes.

“

Investor sentiment towards BoV may also have been dented by the news that the MFSA has finalised its initial report on the La Valette Property Fund.

”

Rizzo, Farrugia & Co. (Stockbrokers) Ltd, "RFC", is a member of the Malta Stock Exchange and licensed by the Malta Financial Services Authority. This report has been prepared in accordance with legal requirements. It has not been disclosed to the issuer/s herein mentioned before its publication. It is based on public information only and is published solely for informational purposes and is not to be construed as a

solicitation or an offer to buy or sell any securities or related financial instruments. The author and other relevant persons may not trade in the securities to which this report relates (other than executing unsolicited client orders) until such time as the recipients of this report have had a reasonable opportunity to act thereon. RFC, its directors, the author of this report, other employees or RFC on behalf of its clients, have

holdings in the securities herein mentioned and may at any time make purchases and/or sales in them as principal or agent. Stock markets are volatile and subject to fluctuations which cannot be reasonably foreseen. Past performance is not necessarily indicative of future results. Neither RFC, nor any of its directors or employees accept any liability for any loss or damage arising out of the use of all or any part thereof and no

representation or warranty is provided in respect of the reliability of the information contained in this report.

© 2011 Rizzo, Farrugia & Co. (Stockbrokers) Ltd. All rights reserved

www.rizzofarrugia.com

