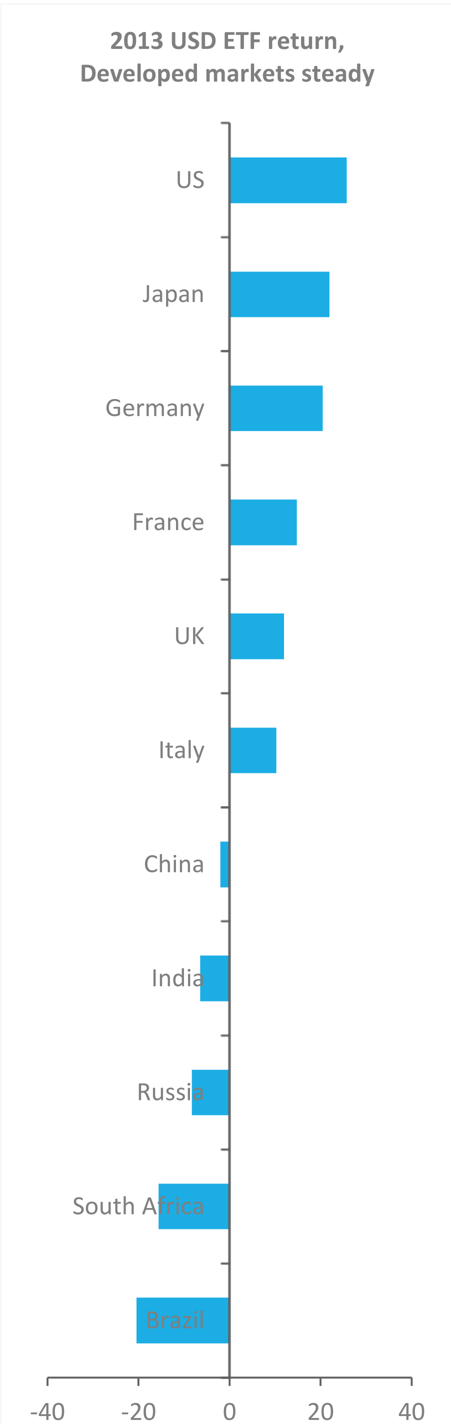
SIS LIMITED

Synaptic Investment Services Limited

DECEMBER 2013



MARKETS RESILIENT IN SPITE OF SCEPTICISM ON RALLY

The Standard and Poor's index is up 25% since the start of the year and has been making new highs over the past month in spite average economic data being released. In Germany, it is the same story with the DAX (ETF up 20%) and the UK is not behind with the FTSE 100 flirting with its all-time high. Even France and Italy, two countries plagued by fiscal issues, returns for the year have been 15% and 10% respectively.

What are the risks which could stop the current rally?

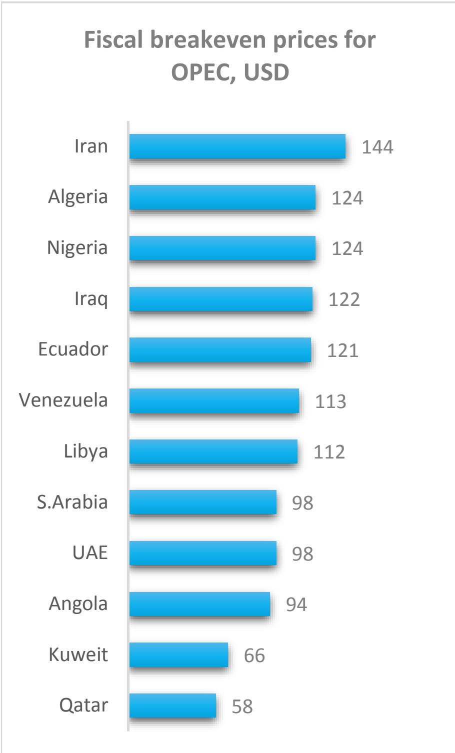
The global rally started with the Federal Reserve Bank of the United States embarking on its asset purchases program known as QE3 at the end of last year. A monthly injection of USD 85 billion in the treasury and mortgage backed securities market has ensured ample liquidity in the US and across the globe. Crucially, the unemployment rate has fallen half a percent year to date and is just under a percentage point below the FED comfort zone of 6.5% which would trigger a reduction in asset purchases. Inflation, the other mandate of the FED currently is 1%, a full point below the FED's comfort zone.

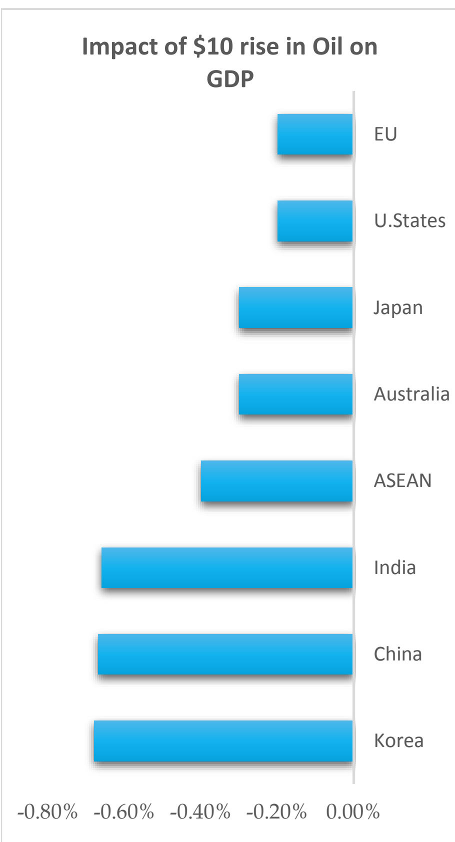
Tapering of size of asset purchases

There have been echoes of tapering the size of FED asset purchases since July but this was postponed as interest rates started rising abruptly affecting negatively the economy particularly housing. Furthermore any tapering action is also likely to correlate with the action of the European Central Bank which might launch another round of Long Term Refinancing operation in the first half of next year.

Debt limit

The other important upcoming event is linked to the debt ceiling situation in the United States. In October, the U.S politicians brokered a last minute deal and kicked the can till February 7th. We are likely to witness another similar situation at the start of the year with the same outcome.





TAPERING, NOT TAPERING….AND PRETENDING TO TAPER

The FED would taper if

1. Unemployment rate fell to below 6.5%.
2. Inflation expectations rising above the 2% implicit target of the FED.

Currently we are nowhere near fulfilling these conditions.

There are however unintended consequences from the asset purchases of the FED. In particular what happens at the margin creates volatility in emerging markets with whom developed economies have material trading relationships.

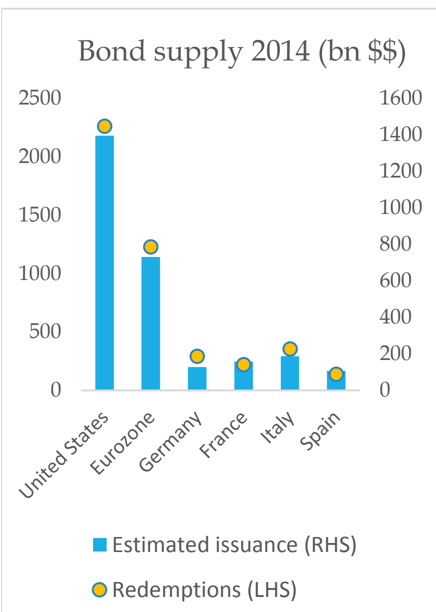
Furthermore, the amount of liquidity injected in the global financial system requires coordination among central bankers. Since the onset of the crisis, The FED and ECB have taken turns to ease as otherwise, there would be too much liquidity resulting in an unorderly rise in asset prices and commodities.

Oil is one of the indicators which is used to determine policy decisions. The key levels which are important are USD 80. According to APIC, the breakeven price varies between USD 85 per barrel for Saudi Arabia to USD 100 for Bahrain. It follows that when prices reach these minimum levels, there will be grumblings from the producers to reduce production and influence prices.

Equally, the other extreme is when oil prices rises above equilibrium affecting GDP in the US and globally. This is one of the unintended consequences of asset purchases by the FED which has adverse effects on global trade and constraints global GDP. The impact varies between countries. Other major indicators include rates and forex.

Pretending to taper

It should also not be forgotten that one of the weapons of monetary policy is guidance, or as the cynical would say, mis-guidance. As we saw in May of this year, growth started accelerating prompting interests to spike. With unemployment still high and economic slack, it was however quite clear that there would be no taper anytime soon. Given the nature of the recovery with many investors being forced to leverage, no one wanted being caught holding the bag if it was interpreted that the recovery was sustainable and the FED would taper. What happened was a phased process when the FED hinted at tapering to reduce interest rates. Afterwards, the FED through its numerous governors hinted that the recovery was not strong enough to reduce monetary support. This maneuver at the zero bound (or liquidity trap) is possibly why Chairman Bernanke alludes to ‘escape velocity’.



The implications of reduced liquidity has a direct impact on the carry traders who are likely to unwind positions. Given that the fund flows involved, we are likely to witness some degree of volatility particularly in countries who have fragile current account balances which will put them in a weak position to defend their currencies.

"WHAT IS LIKELY TO HAPPEN:

IF THE ECONOMIC PICTURE DOES NOT WORSEN WITH RISING RATES AND COMMODITY PRICES, FED MAY COORDINATE WITH ECB AND TAPER AROUND THE TIME OF LTRO."

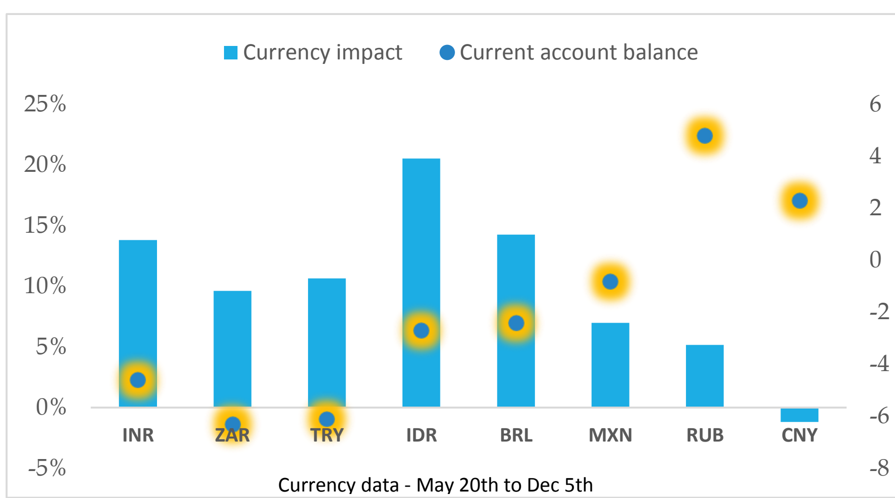
The worrying aspect of the European situation is that although this sea of liquidity has stabilised the financial system in the sense that we no longer have European leaders returning from their all-important vacations to broker eleventh hour deals for the Greek club, credit growth has been lackluster. In fact it has been falling consistently and the threat of deflation is being taken seriously by Mr. Draghi & Co.

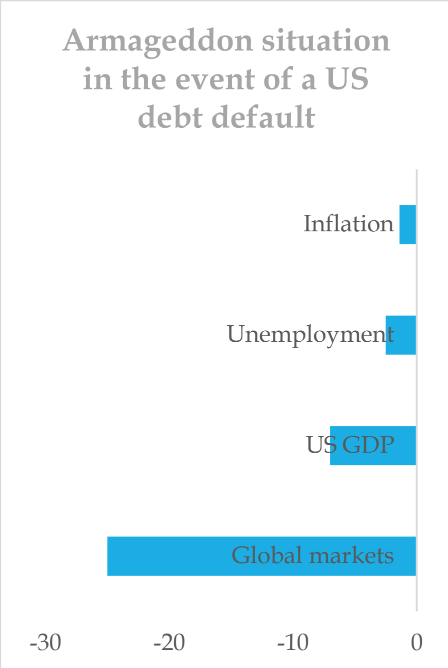
This is why a new program of long Term Refinancing Operation is being discussed with conditions attached; This time banks having access to the LTRO window will be required to use the funds for providing credit to industries, retail and services businesses.

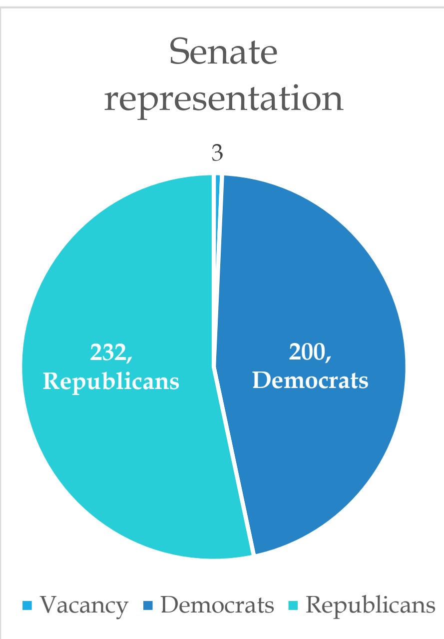
Banks are themselves under pressure to comply with the new Basel accord by cleaning their balance sheets and improving their reserves. The risks and reserves requirements of effecting such loans come at a cost to capital

Additionally the ECB will weigh the risks of financial stress in line with issuance and redepmtions of bonds across major economies as this will influence liquidity and hence rates, forex and commodities.

EMERGING ECONOMIES WHICH ARE AT RISK







THE DEBT LIMIT

The US politicians will invite themselves to our TV screens and newspapers again in January after the distraction of October's debt limit which culminated in a government shutdown. The previous debt limit was USD 16,699 tn and this was suspended from 17th October to the 7th February 2014. The amount of cumulative borrowing through that period will be reset at that date. If no further legislation is passed before that, the treasury can implement extraordinary measures to allow it fund itself for another month.

The OECD estimates that a deadlock for a year would bring down an armageddon situation with the following parameters:

- Global financial markets fall by 25%,
- US GDP contracts by more than 6%
- Unemployment rate close to 10%
- deflation

It is safe to believe that the above simulation of the OECD is optimistic in a scenario of a year's deadlock as in a real world this would prevent the government from funding itself, create a credit crunch and bring down the systemically important financial institutions.

In truth, House speaker J. Boehner had given assurances to Republicans during October that he would not allow a default. In effect this implies breaking the Hastert rule, an informal procedure which implies that he would have to obtain a majority within the Republicans before bringing a proposal for vote. If the Speaker were to team up with the Democrats, he would require the help of just 17 republicans to pass any legislation. An Armageddon situation is therefore unlikely. Not exactly a bold prediction but rather a common sense outcome.

We can safely assume some volatility around that time though as the newswires go in overdrive.

Synaptic Investment Services Ltd is an investment management company based in the indian island of Mauritius. If you would like to know more on this report or about us, visit our website www.synaptic-mauritius.com or email a.gujadhur@synaptic-mauritius.com

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