

Market Risk Report

February 2007

Executive Summary

- We skipped an issue due to the holidays, and in the two months since the last one it's been back to bull markets. Western bond prices and Oil fell, but just about every other asset class saw big gains in December and January. Volatilities were consequently low with the one notable exception of Oil, which hit a 12-month high.
- Equity volatility fell over the Christmas period. All regions and all sectors are still below 12-month average levels of volatility, and some are at 12-month lows (again). The exception was the Energy sector where volatility rose sharply in line with the Oil price volatility. The VIX remains low implying continued low volatility levels.
- Bond yields rose and volatility dropped to very low levels as the bond market changed its view from a hard to a soft landing in the US. Emerging market spreads also continued to fall rapidly.
- FX volatility was mixed as market emphasis shifted between currencies. It appears the carry trade with the Yen has pushed down the Yen (and its volatility) against the US\$, while the surprise rate rise in the UK pushed up the Pound and UK£/US\$ volatility.
- Option volatility is likely to have been moderate judging by equity market price movements and the low volatility of volatility.
- Commodity volatilities were varied: that of Oil rose sharply to 12-month highs as prices fell and rose again; Gold and Copper volatilities remained near 12-month averages.
- Real Estate prices rose strongly but smoothly: volatility remained near 12-month low levels.
- In summary: prices were up and volatilities were down with the exception of Oil.

In next month's issue: The Return of Inflation?

Author: Niall O'Connor

Key News (Major Volatility-Driving Events)

Back to the Bull Market

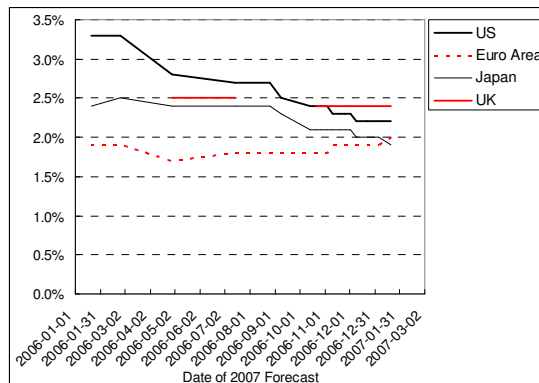
In our December issue we got excited: for the first time we were able to write about rising volatilities. However, the New Year has brought back the old pattern: a bull market with rising asset prices in almost all asset classes (with the notable exception of US bonds and Oil) and accompanying lower volatility.

Still the story of a slowing US economy, but buoyant Europe

GDP forecasts for the Eurozone continued to rise over the last months (from 1.9% to 2.0% for 2007) while those in the US continued to fall (from 2.3% to 2.2% for 2007). The IFO survey in Germany (an excellent leading indicator of industrial production) continued to hover around 15 year highs. US housing starts hit a 6-year low.

The weaker macro picture in the US was confirmed by weak results from Energy and Pharma companies, and a worse than expected fall in existing home sales.

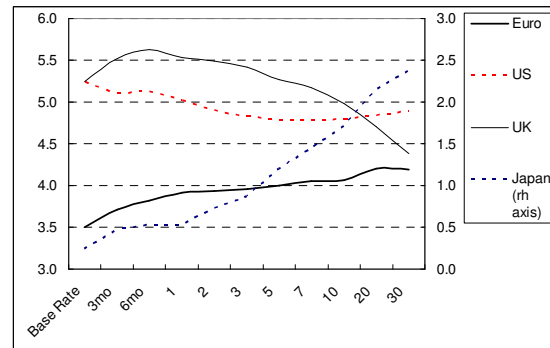
2007 GDP growth estimates for the US (and Japan) continue to fall while those for the Eurozone rise



And the bond market broadly agrees: the yield curve in the US remains inverted suggesting falling growth, or at least lower inflationary expectations.

However, the bond market, which had previously been pricing in a somewhat heavier landing than we are now seeing, has changed its view and yields rose sharply. The 2006Q4 US GDP figure of 3.5% sealed this.

Yield curves also suggest inflationary pressures in the UK, but a weaker growth environment in the US



Oil prices down, and now out of the inflationary equation?

Oil prices dropped sharply to \$50 during January, spiking later to \$55 on President Bush's announcement of an increase in the US strategic reserve, and now \$58 after Saudi confirmed production cuts. Most significantly, even the slightly higher current price represents a 15%-ish drop year on year. Oil had been inflationary year-on-year from 2004 until September 2006. This has now changed.

Politics and the Weather

Neither politics nor weather has had a major impact over the last couple of months, perhaps not surprisingly given the holiday period and the relative deadlock in US politics.

(No) Disasters

There were no major shocks or disasters since our last report.

Equities

2006 Overview

Equities had a good year in 2006, excepting a small wobble in the Spring. Continuing good corporate profitability and high M&A activity continued to drive up equity markets (and European M&A exceeded US M&A in 2006). (Bond prices also rose as inflationary fears subsided.)

Over the last two months this bullish trend has continued.

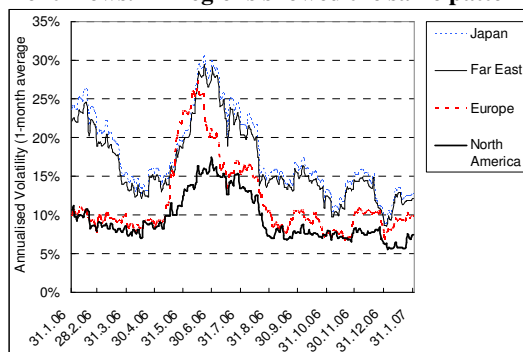
Major Index Performance (Local FX)

	END-05	END-06	CHANGE
Dow Jones	10,718	12,463	16.3%
S&P 500	1,248	1,418	13.6%
Eurostoxx 50	3,579	4,120	15.1%
FTSE100	5,619	6,221	10.7%
Nikkei	16,111	17,226	6.9%
US 10-year bond (yield)	4.70%	4.39%	-6.6%

Volatility: Regions

Consistent with a general bull trend, volatility fell over the last two months, for most regions reaching new 12-month lows in early January. North American equity volatility is now at just 7.4% (12-month average 9.4%).

Volatility dipped sharply in early January. Since then it has risen slightly, but is still close to 12-month lows. All regions showed the same pattern



Note: based on MSCI regional indices

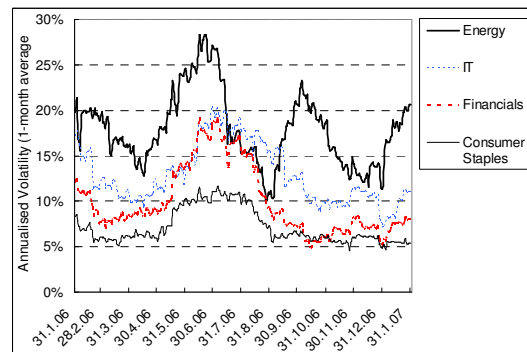
Volatility: Sectors

Sector-wise, Energy volatility rose to 21% as first the price fell and then subsequently rose on

the announcement of a proposed increase in the US strategic reserve and Saudi production cuts.

Other sectors saw lower and/or relatively stable volatilities of between 5% and 11%, all below 12-month average levels.

Energy sector equity volatility rose: other sectors fell or remained low

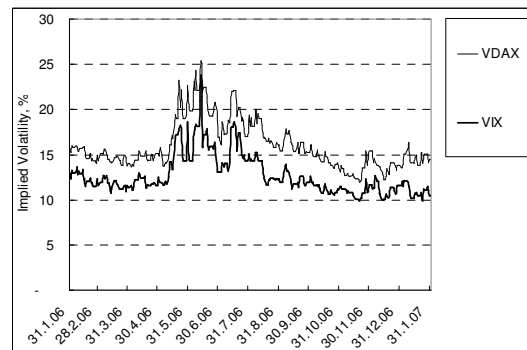


Implied Volatility (Market-Implied Near Term Outlook)

The VIX and VDAX indices show the expected volatility of the S&P500 and DAX respectively over the next 30 days based on options' prices.

Both have stabilised (at 10.4% and 14% respectively) over the last 2 months, well below 12-month average (12.7% and 15.9%). The VIX briefly touched a 12-month low of 9.9% in January.

The VIX (US) and VDAX (Germany) are both implying that equity volatility will remain low over the next month



Fixed Income (10 Year Government Bonds)

Prices

Bond prices fell over the last two months in Europe and the US, but were flat in Japan. The bond market had previously been betting on a hard landing in the US: this view now seems to have changed to one of a softer landing, and the accompanying less weak economic outlook hit prices.

10-Year bond prices fell in the US and Europe fell while those in Japan were flat



Interest Rate Expectations

US markets still seem to indicate a rate cut is actually a possibility within the next year, although this has been talked down in the US in order to avoid further downward pressure on the dollar. And the markets are now shifting to a view of stable rates, and some commentators are even talking now of rate rises. The Fed kept rates on hold at 5.25% at the end of January.

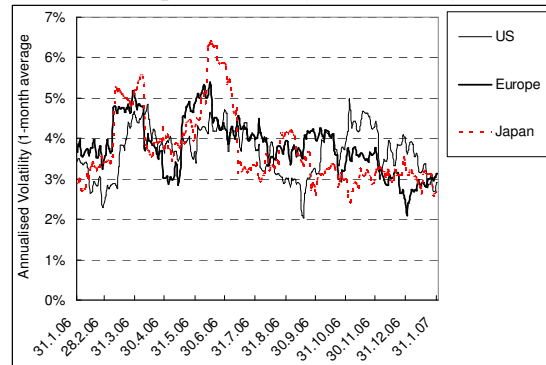
In the UK a surprise 25bp rate rise to 5.25% led to raised expectations of further rate rises, with the market now expecting rates of 5.75% within 6 months.

In Europe the yield curve looks more "normal" (upward sloping) but again rate rise expectations have increased with rates expected to rise from 3.5% to 4.0% within a year.

Volatility

The lack of any significant news affecting interest rates led to bond price volatilities falling (or at worst flat) over the month. 10-year bonds in all major regions saw volatilities at just 2.7%-3.1%.

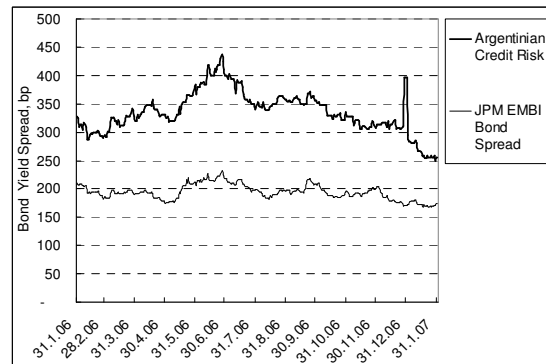
10-Year bond price volatility remains very low



Spreads

Spreads of Emerging Market bonds over Developed (JPMorgan EMBI index) re-continued their long and steady decline over the last 5 years. Argentinean spreads also fell again: and are now at only 250bp.

This suggests that the market is not pricing in significantly more volatility in 10-year bonds if they are Emerging Markets rather than Developed.



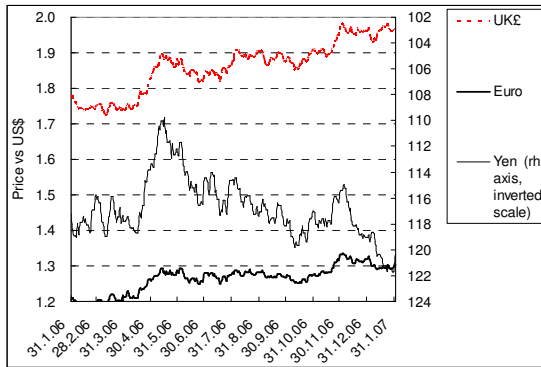
FX

Prices

Interest rate differentials continued to push currencies as hawkishness in the UK and Europe contrasting with a slowing growth outlook in the US kept the Euro above 1.30 against the dollar (and Sterling at close to 2.00).

The Yen continued its slide against the Dollar, apparently as the total size of the carry trade (borrowing low-yielding Yen to buy high-yielding e.g. Australian Dollar) continued to increase. At end-January it was fractionally above ¥120 to the Dollar.

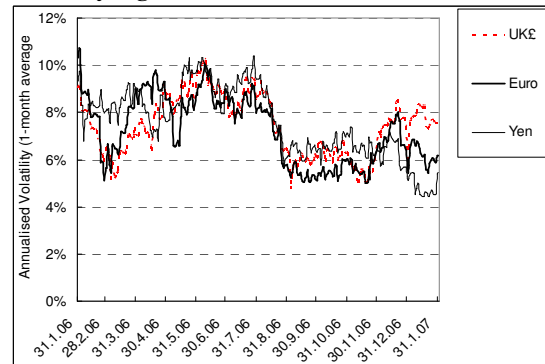
The range-bound behaviour of currencies relative to the dollar broke in November. The Dollar weakened but the Yen weakened more



Volatility

Volatilities diverged during January: Yen/\$ fell to 5.5%, Euro/\$ stayed flat at around 6% and UK/\$ rose during December to stay at a relatively high 7.6%.

Currency volatility has continued to fall despite relatively big directional moves

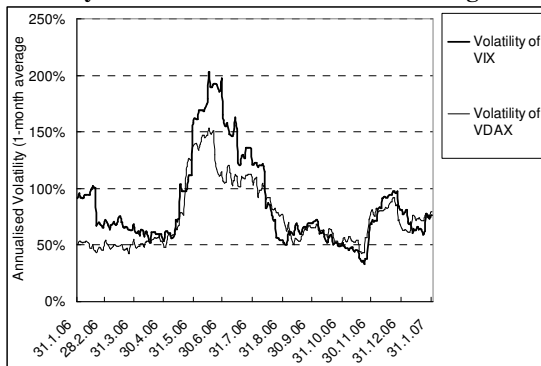


Volatility of Implied Volatility

Perhaps unsurprisingly, the chart of this looks similar to the VIX and VDAX, showing a peak in late June and a large drop of volatility since then.

A spike in late November took levels well above 12-month lows, suggesting option volatility rose. Since then levels have fallen back to close to 12-month average levels.

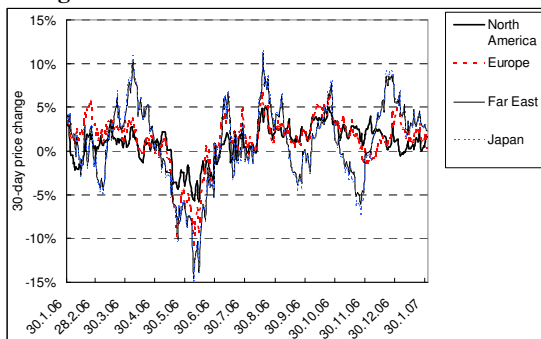
After a spike in late November, the volatility of volatility has fallen back to 12-month average levels



Major Price Swings

Equity prices have been relatively stable over the last month, suggesting (equity) option deltas should have been relatively stable. In general prices have risen slightly, so calls will be more in the money and puts out of the money.

Upward price swings in December have given way to relatively stable markets over the last 30 days in all regions



Note on Treatment

Options show more complex behaviour than the other instruments we look at in this report, so we make some simplifying assumptions. As Calls and Puts are in effect polar opposites and in and out of the money options behave very differently, it is hard to generalise all options' behaviour. However, we look at the two key drivers: volatility of implied volatility and major price movements.

Implied volatility (via the option Vega) drives all option prices, so a big indicator of option price volatility is the "volatility of implied volatility".

Of course the biggest driver of individual option prices is the movement of the underlying (via the option Delta): a move in either direction will cause the option to go in or out of the money (and a corresponding change in the option Delta and position volatility). As a proxy for this, we look at the 30-day price swing of various equity market indices: options on bonds or FX could of course behave differently. Note that Calls and Puts will respond in opposite fashions: calls becoming more volatile as prices rise.

Note on Convertibles

Convertibles are in effect a combination of a bond and a call option, with the bond portion usually making little contribution to the instrument volatility unless the option is out of the money. As such, convertible portfolios volatilities will normally behave similarly to call option portfolios, and the commentary can be applied to convertibles as well as options.

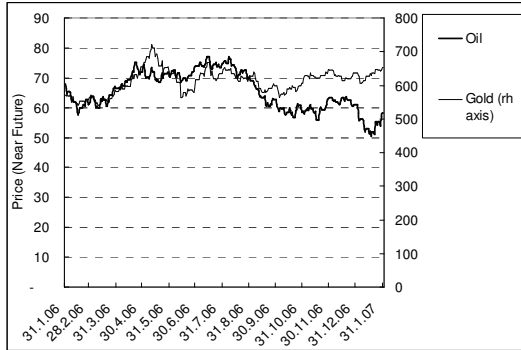
Commodities

Prices

Oil prices fell in January while Gold rose slightly. Speculative positions on commodities may have largely unwound now.

Oil prices however spiked to \$55 on President Bush's announcement of an increase in the US strategic reserve. Saudi also re-affirmed its commitment to cut outputs towards OPEC targets, pushing the price back up to \$58 by month end.

Oil prices are still falling; Gold prices are rising gently



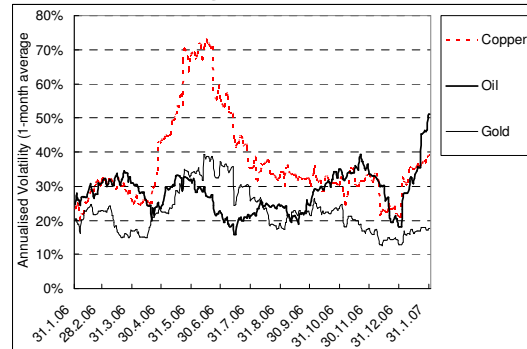
Volatility

At the peak of the market in June volatility levels were very high, with Copper reaching 73%.

Volatility levels are now back close to 12-month averages, or in the case of Gold 12-month lows.

Oil is the exception, where volatility has risen over the last month: volatility is now at a 12-month high of 51% compared to a 12-month average of 28%.

Volatility levels for major commodities are now back to close to 12-month low levels, except for Oil which is at a high





Real Estate (Real Estate Share Prices)

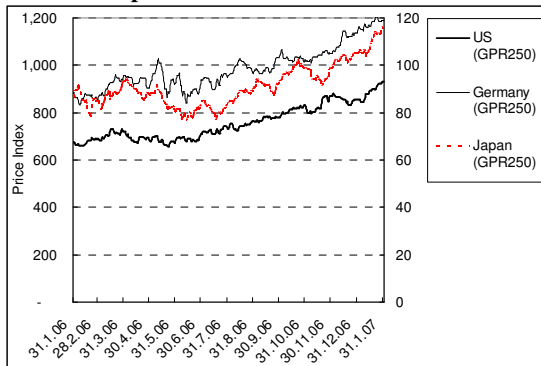
Note

Note that for property we just look at indices of the share prices of property companies, and not the underlying property directly, for which little good data is available. This is usually consistent with funds which tend to invest in property indirectly, e.g. via REIT's.

Prices

Prices rose in all major regions over the last two months. Recent weakness in US residential property data looks as if it never filtered through to the listed property market, which has been driven up by rising equity markets, and a residential market which wasn't as bad as some had feared.

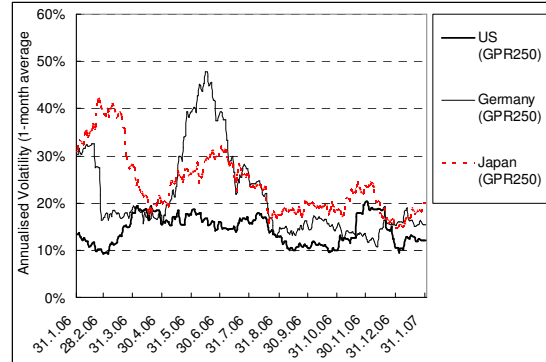
Real Estate prices continued to rise



Volatility

Price rises were consistent and orderly, so volatility remains very low in the market with all regions below 12-month averages.

Real Estate volatility levels remained very low





Notes

Definitions

To avoid repetitions, the term volatility refers to annualised, 30-day average realised volatility in local currency unless otherwise specified.

Charts show data up until 1st February 2007 and the commentary was written on 1st February 2007.

Disclaimer

The commentary does not constitute and is not intended to constitute investment advice.

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