the technical analyst AWARDS 2011 FINALIST

7th July 2011

Market Update:

UPDATE
Technical
Fundamental

A cross-roads for the Bund?

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SEVEN DAYS AHEAD

A cross-roads for the Bund?

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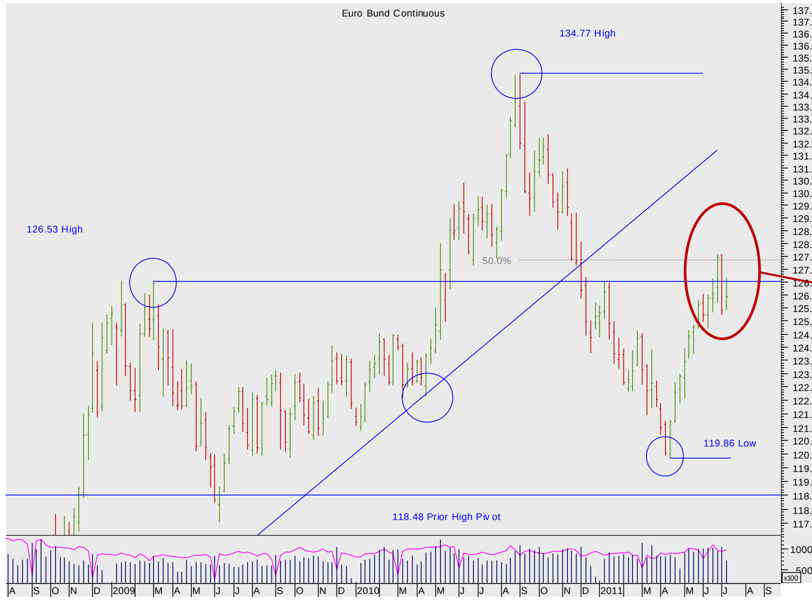
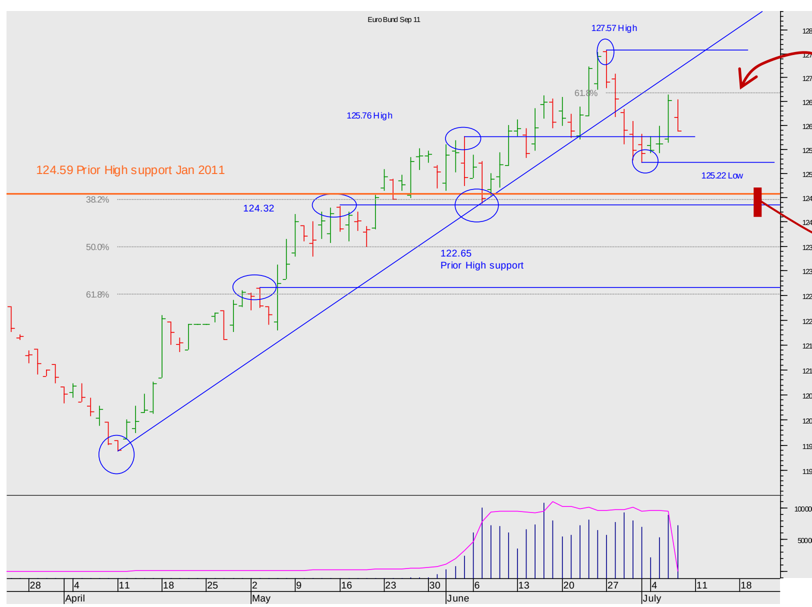


WEEKLY CHART

The retracement and failure at the 50% Fibonacci retracement resistance is clear.

The failure is especially significant as it is a weekly Key Reversal…



DAILY CHART

The day chart **encourages the bears still further.**

Note well the rally back up to the 61.8% Fibonacci resistance - and the failure so far, there.

We anticipate a retest of the band of support from the Prior Highs 124.59- 124.32.

And note too the Fib support there – coincident at that levels making it **<u>very significant for the bears.</u>**

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More

FUNDAMENTALS:

Last week the Greek Parliament voted to accept the austerity measures demanded by the EU/EZ/IMF as a condition of the financial rescue package designed to avert a Greek government default. The Euro rallied, stocks rallied and Bonds sold off as traders moved out of safe haven assets and back into riskier asset classes.

A week later and equities are holding their gains, but the Euro has weakened against the Dollar and the Bund has staged a limited recovery, what has happened?

It has long been our opinion that the rescue deals cobbled together at the last minute by the EU/EZ/IMF are not addressing the root of the sovereign debt problem that has dogged the Euro zone for more than a year.

In truth, Greece, Ireland and Portugal have been lent massive amounts of liquidity to provide them with breathing space to cut their budget deficits and reduce their debt build up. <u>But the terms attached to each rescue are very austere</u>, so much so that <u>growth has shrunk</u>. That shrinkage has meant that the deficit has increased as a percentage of GDP making it more, not less, difficult for the hapless three to service their debts, hence the reason why Greece has required a second rescue.

Both the rating agencies and the markets see the flaw in this process. Portugal has seen her debt downgraded to junk this week by Moody's as they judge Portugal will soon require a second rescue too and Ireland will also in the near future.

This has seen Irish and Portuguese Bond yields rise to Euro era highs <u>and is primarily the reason why the Bund has held up so well even as stocks continue to recover.</u>

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FUNDAMENTALS: CONTINUED

But if the Bund is seeing a fresh wave of safe haven buying, why isn't the Bund future much higher than it currently is.

Well, there are reasons:

The ECB has today hiked rates a further 25bp despite on going concerns about the debt crisis. Their view is the debt crisis is a political problem for politicians to solve, their job is to keep inflation at or below target, and they are right.

The ECB has also said it will continue to accept Greek bonds so long as there is no default - technical or otherwise - which means debt-restructuring.

For now, traders have re-focused back to stocks. The Q2 corporate reporting season has just begun. Interest rates in the US and UK are set to remain on hold for a considerable time and traders are still relieved that a Greek default has been averted.

But we judge the crisis will resurface sooner than expected. Portugal and Ireland will likely be forced to apply for a 2nd rescue due to sky high financing costs, making the rating agencies' fears self-fulfilling. Moreover, it is by no means clear that the Greek people are willing to suffer the sacrifices demanded of them or the loss of Sovereignty implied by accepting the rescue.

At some point the debt burden in the Euro zone needs to be dealt with at its root. Certainly, budget deficits need cutting and the state needs to move away from being a major economic force in the weaker peripheral economies, but the debts of the weaker countries will likely need to be rescheduled so that there is a chance they can be serviced without constant recourse to rescue funds.

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FUNDAMENTALS: CONTINUED

If this doesn't occur, because the Euro zone wont allow it, the risk grows that one or more of the weak periphery will leave the Euro zone.

What would be more damaging to Euro zone credibility?

1. A restructuring of debt, which would allow the Euro zone to remain together and remove the distraction of organising repeated bailouts, or
2. An untimely exit from the single currency of one or more of its members.

We judge option two would damage credibility the most. It would prove what many said of the currency union at the start to be true; it was ill-thought out and couldn't last, and moreover the Euro zone authorities lacked the will or vision to solve their problems.

Whereas a debt restructuring would show there is political will among all members to solve problems collectively and learn from mistakes, rather than punish with punitive measures and move on together.

What then for the Bund?

<u>The answer lies in the way the authorities handle the crisis moving forward</u>. There is a body of opinion that holds the view the Bund sovereign debt would be better and stronger without the weaker economies diluting the Eurozone.

On the other hand, a debt-restructuring is bearish because it would would reduce the need to buy bunds as a hedge against the threat of default. **But until one or other route is chosen we see the Bund as likely to remain a crisis-driven bull market**.

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