

March Madness

If you thought this year was off to a challenging start for investors, fasten your seatbelts. March could very well turn out to be the most important month of the year. This does not mean there is easy money to be made or low-hanging fruit that can be picked.

To the contrary, the event risks are such that even the most insightful investors may be hard pressed to have much market conviction. Hugging benchmarks and defensive strategies will likely be a preferred strategy of many money managers. At the same time, understanding the significance and the meaning of the events may grant investors insight into the investment climate in the period ahead.

The popular protests in the Middle East and North Africa that have toppled a few regimes already with several more being rigorously challenged, is clearly a major surprise and wild card. Since the political challenges are beyond our ken, we must accept it as part of the backdrop or atmosphere. Leaving these aside, we turn our attention to three regions: Emerging markets, Europe and the United States.

Emerging Markets

Brazil's central bank meets March 2. There has been concern among some investors that Brazil's central bank would rely too heavily on macro-prudential policies, (essentially non-interest rate tools, like reserve requirements). A 50 bp rate hike, which would lift the overnight Selic rate to 11.75%, is the least the central bank can do to ease those concerns that it is not being forceful enough in the face of rising price pressures and robust economic growth. A 75 bp hike, which is considerably less likely, would bolster new central bank President Tombini's anti-inflation credentials.

As goes Brazil, so might other developing countries, especially in Asia, demonstrate greater willingness to raise rates and tighten monetary conditions. The fact that China is also tightening monetary policy, or perhaps fairer, reducing accommodation, will encourage others in the region to continue to do so. South Korea's central bank meets March 9. It disappointed the markets in February by not hiking rates. It is most unlikely to disappoint the markets again.

This policy shift may encourage investors to continue to pare back holdings in Asian equities. Indonesia is interesting in this light. Among emerging Asian countries, Indonesia has been a favorite of foreign investors. The stock market held its own in February, up fractionally, but is still down 7% on the year. If profit-taking among foreign investors continues, Indonesia may be vulnerable. The Indonesian rupiah is also vulnerable. It easily outperformed in February, rising 2% against the dollar, twice as strong as the second best regional currency, the Philippine peso.

Europe

The month begins with the ECB meeting on March 3. Officials have sounded increasingly hawkish in recent weeks. That rhetoric is likely to translate into action. It may put the market on notice by acknowledging it no longer

forecasts inflation to fall back below the 2% level this year. It may also signal that it will continue to normalize money market operations and this means it may signal that as early as April, though possibly May, it will cease offering unlimited funds for three months. A one-week and one-month operations are what the ECB seeks. Over the past week alone, the German 2-year yield rose more than 20 bp as the market priced less accommodative conditions despite the MENA uncertainties and continued pressure on most peripheral countries' bond and CDS markets.

The Bank of England meets on March 10. At the February meeting, 3 of the 9 MPC members voted to raise rates. As the meeting approaches there may be speculation that another may join the dissenting camp and maybe end the call for additional gilt purchases by one member. The vote of course is not announced until a couple weeks after the meeting. Although sterling is not always driven by economic data, given the range of opinion on the MPC, in the weeks ahead it might be more sensitive to data. Given sterling's recent strength and IMM positioning (assuming to be indicative of the speculative community), sterling may be particularly vulnerable to economic data that suggests the slowdown seen in Q4 was not simply a function of inclement weather.

The most important events however, are not in the economic sphere, but the political. The heads of state summit on March 24-25th is the self-imposed deadline for a comprehensive solution to the debt crisis. There are a series of meetings that will lead up to the critical meeting:

March 11	Euro area summit on competitiveness
March 14	Finance Ministers meeting
March 21	(Possible) Finance Ministers meeting

On one level, the key issue revolves around what concessions can be made to secure Germany's support for strengthening the European Financial Stability Facility (EFSF). Germany, with France's support, has put forward a number of proposals to enhance euro zone competitiveness. These include changes to national laws or constitutions to enshrine fiscal prudence, eliminating wage-indexing, common corporate tax rates and raising the retirement age. There has been a strong push back against the Berlin-Paris condominium.

It is not clear what Germany would be willing to concede in exchange. It has reiterated its opposition to allowing the EFSF (or its successor the ESM) to purchase sovereign bond. It does not want to increase the size of the EFSF itself, and instead, will focus on increasing its efficiency/capacity. It does not want to consider any debt restructuring in the periphery or any member reneging on guarantees to senior secured bank bond holders (as the suggested by leaders of the Fine Gael, the likely winner of this weekend's election) .

There seems to be three areas that Germany could be flexible. It could approve the extension of Greek and Irish packages by a decade or so. It could accept a lower rate of interest on the assistance packages. Remember, the EFSF raised funds at about 2.85% and lent them to Ireland for 5.85%. It may seek to make a virtue out of a necessity by renouncing a claim on the ECB presidency when Trichet steps down in October.

There are two main tactics Germany will deploy. The first is brinksmanship. As the main financial power in the euro zone, its greatest influence is to be had before it hands over money/guarantees. It needs to push hard until the very last second. That means that expectations prior to the heads of state summit are likely to be disappointed.

The second tactic is a variant of minimax. Merkel will have to maximize the minimum gains domestically, as her political authority and her party's ability to get legislation passed are likely to be weakened by a series of state elections. Her CDU took a drubbing in Hamburg recently, which it had held for the past decade. In March, there are three more state elections, Saxony-Anhalt on March 20 and Rhineland-Palatinate and Baden-Wuerttemberg on March 27, a couple of days after the summit. The latter is very important. The CDU has governed BW for more than half a century. The loss of BW could be catastrophic for Merkel's program.

It is out of whatever minimal modus vivendi that can be reached, and some agreement will be reached, that it is likely Portugal will become the third member to seek an assistance package. The relaxed terms that will be given to Greece and Ireland will be given to Portugal.

Although sentiment toward Spain has improved as the decline in the bonos (Spanish bonds) correlation with Portuguese bonds has fallen dramatically this year, it is a fragile improvement. On March 9, the Bank of Spain is expected to indicate how much capital the banks need to raise, but it may be postponed as European bank supervisors may announce the details of more bank rigorous stress tests.

United States

There are three areas of that pose event risk for the US. First is the economy. On March 4, the US employment data are reported. The recent string of data suggests that momentum the economy enjoyed in Q4 10 likely carried over into the first quarter. Yet if the nonfarm payroll data does not bounce back strongly from what was thought to be weather-induced weakness, the market may be exceptionally disappointed. The pace at which the unemployment rate has dropped over the last couple of months does not appear sustainable and some backing up should not be surprising.

Second, the Federal Reserve meets on the Ides of March. On balance, and aside from some minor tweaks, the statement it issues afterwards is unlikely to substantively change. Unlike many other countries, US policy makers understand the recent rise in oil prices is, if anything, a headwind for the domestic economy. If the rise in oil prices is sustained and translated simply into first round effects, like higher gasoline and heating oil, it will likely offset in large measure the payroll savings tax cut.

Third and most important is the political brinksmanship over the approaching federal debt ceiling. The current temporary measure appears to run its course by the end of the next week. The Republicans are insisting on spending cuts as the price of any agreement to lift the ceiling.

The Treasury Department claims that it can manage for several weeks after the limit is reached, but a report by the Government Accounting Office warns that it may be bluffing. The GAO's study concluded that the Treasury's ability to maneuver is more constrained now than at similar junctures in the past and that it may have only a few days after the limit is hit.

The House of Representatives, led by the Republicans passed a bill that would cut spending by \$60 bln. The Democrat-controlled Senate is balking. The compromise that is eventually worked out will be important for the economic performance in Q2 and Q3, with some economists already estimating that the Republican measures, if enacted, could cut the anticipated growth rate in half or more.

On one hand then, the reduction of US fiscal accommodation could generate contradictory market impulses. Slower growth could hurt the earnings outlook, which in turn, coupled with marginally reduced borrowing needs, supports bond prices. Higher bond prices could act as a headwind on the dollar through the interest rate differential channel, as the ECB and BOE shift in a more hawkish direction.

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