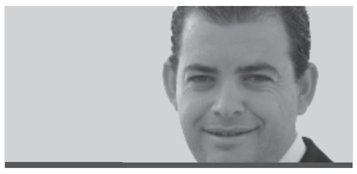
Stock Market Review



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The return of the equity market

The total value of trades executed in the equity market in 2009 shrunk to €24.9 million, 50 per cent below the volumes registered in 2008 and a far cry from the healthier trading activity seen in previous years as depicted in Graph 1. This had peaked at €192.1 million in 2006 at the time of the second bull market when an extraordinary €93 million worth of trades had passed through the market in the first quarter of the year.

Quarterly trading activity shrunk to below €8.5 million since the bankruptcy of Lehman Brothers in September 2008 with volumes rarely surpassing the €2.5 million level on a monthly basis. However, during the first week of 2010, volumes were particularly encouraging with €1.1 million worth of trades and continuing high activity at the start of this week. This may be indicating a return to healthier levels of volumes across the local equity market.

This increased interest in the equity market boosted a number of share prices and the MSE Share Index posted a significant upturn of 5.6 per cent in the first five trading sessions of 2010. The local equity market is clearly in a new cycle following the significant downturn during the six-month period between the final quarter of 2008 and the first three months of last year at a time when international markets were also falling rapidly. The market has since recovered by over 40 per cent but the index is still substantially below the levels pre-2008.

Many investors hold on to their investments over the long term. However, the performance of local equities between 1999 and 2009 has been disappointing as the index rose by only 5.6 per cent during this 10-year spell. The more active investors should have done better with the market having been so volatile over the period.

Given the sharp movements in the market during the last 10 years, investors should perhaps consider becoming more active in order to take advantage of market highs and lows as these do provide profitable trading opportunities. This is also evident from the share price movements of BoV and HSBC in recent months which have risen strongly from their April 2009 lows.

In more recent weeks, the rally in Go's share price from the all-time low of €1.40 to a level of €2.20 is another case in point. However, the most extraordinary upturn has been in Middlesea Insurance. This equity had tumbled to its rights issue price of €0.60 on December 7 (-70.6 per cent during 2009) but has jumped by 57 per cent from this low to a price of €0.94 last Monday.

Although the rights issue was disappointing as many small investors did not take up their entitlement, the resultant effect was that BoV and Mapfre increased their shareholding to 30 per cent each as both these institutions underwrote the issue. The increased involvement of these two institutions as well as the management changes announced so far seem to have brought a renewed air of optimism in recent weeks, helping the equity jump on substantially higher levels of activity. However, the shares lost 3.4 per cent on Tuesday on the back of the company announcement late on Monday afternoon that their Italian subsidiary experienced a higher level of claims than anticipated during the fourth quarter and this will most likely lead to a greater loss for 2009 by the Middlesea Group than the €41.8 million forecasted as recently as November.

While a number of share prices recovered strongly from their recent lows, two of the larger companies have continued to disappoint many investors. FimBank's US dollar denominated equity is still languishing just above its recent multi-year low of $1.10 while the share price of International Hotel Investments (IHI) continues to trade at a substantial discount to its nominal value.

The underperformance of these two equities continued in the first week of 2010. In fact, IHI's equity was the only one to end in negative territory (-7 per cent) in the first five trading sessions of the year.

Although FimBank's equity edged 1.8 per cent higher, volumes remained particularly low with only 1,900 shares changing hands in the first five sessions of the new year. The main theme of the first week of 2010 was undoubtedly the renewed optimism across the financial sector with the share prices of BoV, HSBC, Lombard Bank, Middlesea Insurance as well as GlobalCapital all trading higher. FimBank plc remains an exception and the positive sentiment in the market has so far failed to spill over into this equity although it has so far edged up a further 3.6 per cent this week.

What is contributing to this underperformance of IHI and FimBank? Is the market understanding their respective business models and internationalisation strategies? FimBank conducted a highly successful bond issue in March 2009 and the proceeds from this exercise were earmarked to help the bank pursue its strategy of setting up a number of factoring companies overseas. FimBank explained on various occasions that it placed factoring at the core of its future strategy since it is the fastest growing product in trade finance. In all ventures, FimBank aims to attract a strong partner in each of the targeted jurisdictions and possibly also involve the International Finance Corporation (World Bank) as a minority shareholder. Following the bond issue, FimBank announced the establishment of a factoring joint venture in Russia, FactorRus.

The Russian company is a joint-venture between Transcapitalbank, FimBank and the International Finance Corporation (IFC). FactorRus intends to commence operations during the first quarter of 2010 and recently announced the appointment of its CEO. In November 2009 FimBank had also announced the setting up of a factoring joint-venture company in India with Punjab National Bank (PNB), Banca IFIS and Blend Financial Services Ltd incorporated under the name India Factoring and Finance Solutions Private Ltd (India Factoring).

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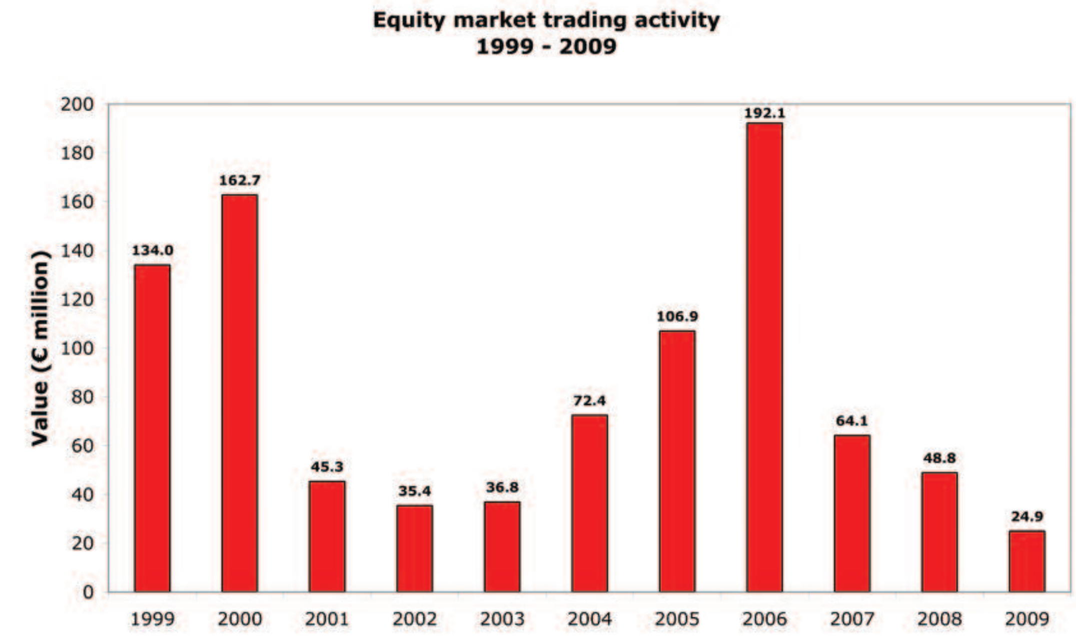
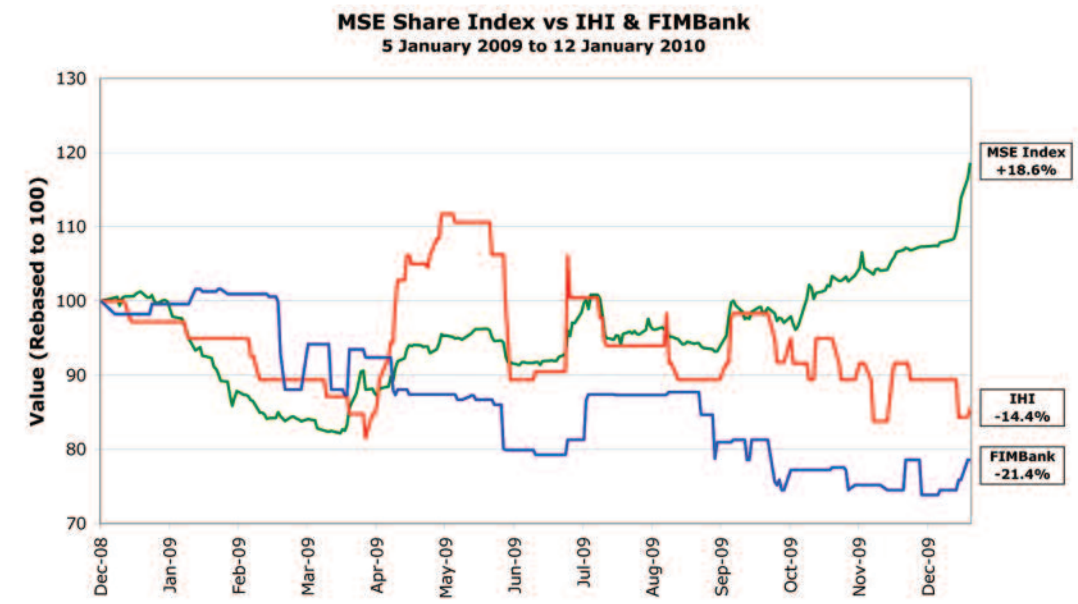


Graph 1: MSE Equity Market Trading Activity, 1999 – 2009



Graph 2: Performance of IHI and FIMBank vs MSE Share Index, January 5, 2009 – January 12, 2010

> **The performance of local equities between 1999 and 2009 has been disappointing as the index rose by only 5.6 per cent during this 10-year spell.**

Comment/Stock Market Review

Kenneth Rogoff

The author is professor of Economics and Public Policy at Harvard University and co-author of This Time is Different: Eight Centuries of Financial Folly.

Chess grandmasters and global growth

As the global economy limps out of the last decade and enters a new one in 2010, what will be the next big driver of global growth? Here's betting that the "teens" is a decade in which artificial intelligence hits escape velocity, and starts to have an economic impact on par with the emergence of India and China.

Admittedly, my perspective is heavily coloured by events in the world of chess, a game I once played at a professional level and still follow from a distance. Though special, computer chess nevertheless offers both a window into silicon evolution and a barometer of how people might adapt to it.

A little bit of history might help. In 1996 and 1997, World Chess Champion Gary Kasparov played a pair of matches against an IBM computer named Deep Blue. At the time, Kasparov dominated world chess, in the same way that Tiger Woods – at least until recently – has dominated golf. In the 1996 match, Deep Blue stunned the champion by beating him in the first game. But Kasparov quickly adjusted to exploit the computer's weakness in long-term strategic planning, where his judgment and intuition seemed to trump the computer's mechanical counting.

Unfortunately, the supremely confident Kasparov did not take Deep Blue seriously enough in the 1997 re-match. Deep Blue shocked the champion, winning the match 3.5 to 2.5. Many commentators have labelled Deep Blue's triumph one of the most important events of the twentieth century.

Perhaps Kasparov would have won the re-match had it continued to a full 24 games (then the standard length of world championship matches). But, over the next few years, even as humans learned from computers, computers improved at a far faster pace.

With ever more powerful processors, silicon chess players developed the ability to calculate so far ahead that the distinction between short-term tactical calculations and long-term strategic planning became blurred. At the same time, computer programmes began to exploit huge databases of games between grandmaster (the highest title in chess), using results from the human games to extrapolate what moves have the highest chances of success. Soon, it became clear that even the best human chess players would have little chance to do better than an occasional draw.

Today, chess programmes have become so good that even grandmasters sometimes struggle to understand the logic behind some of their moves. In chess magazines, one often sees comments from top players such as "My silicon friend says I should have moved my King instead of my Queen, but I still think I played the best 'human' move."

It gets worse. Many commercially available computer programs can be set to mimic the styles of top grandmasters to an extent that is almost uncanny. Indeed, chess programmes now come very close to passing the late British mathematician Alan Turing's ultimate test of artificial intelligence: Can a human conversing with the machine tell it is not human?

I sure can't. Ironically, as computer-aided cheating increasingly pervades chess tournaments (with accusations reaching the highest levels), the main detection device requires using another computer. Only a machine can consistently tell what another computer would do in a given position. Perhaps if Turing were alive today, he would define artificial intelligence as the inability of a computer to tell whether another machine is human!

So has all this put chess players out of work? Encouragingly, the answer is "not yet". In fact, in some ways, chess is as popular and successful today as at any point in the last few decades. Chess lends itself very well to internet play, and fans can follow top-level tournaments in real time, often with commentary. Technology has helped thoroughly globalise chess, with the Indian Vishy Anand now the first Asian world champion, and the handsome young Norwegian Magnus Carlson having reached rock-star status. Man and machine have learned to co-exist, for now.

> **Despite a rough start from the financial crisis there is no reason why the new decade has to be an economic flop.**

Of course, this is a microcosm of the larger changes that we can expect. The horrible computerised telephone-answering systems that we all now suffer with might actually improve. Imagine, someday you might actually prefer digital to human operators.

In 50 years, computers might be doing everything from driving taxis to performing routine surgery. Sooner than that, artificial intelligence will transform higher learning, potentially making a world-class university education broadly affordable even in poor developing countries. And, of course, there are more mundane but crucial uses of artificial intelligence everywhere – from managing the electronics and lighting in our homes to populating "smart grids" for water and electricity, helping monitor these and other systems to reduce waste.

In short, I do not share the view of many that, after the internet and the personal computer, it will be a long wait until the next paradigm-shifting innovation. Artificial intelligence will provide the boost that keeps the teens rolling. So, despite a rough start from the financial crisis (which will still slow global growth this year and next), there is no reason why the new decade has to be an economic flop.

Barring another round of deep financial crises, it won't be – as long as politicians do not stand in the way of the new paradigm of trade, technology and artificial intelligence.

IHI and FimBank underperforming

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The joint venture in India is also expected to commence operations in the first few months of this year. A few months ago Fimbank had also reported that it aims to establish another joint venture in Brazil and the bank had also informed stockbrokers that a privately-owned Brazilian bank had agreed to partner FimBank and the IFC in this company.

Moreover, FimBank reportedly intends to introduce factoring in various territories across the African continent and the bank has also been in discussions with an established Pan-African bank with whom it is intended to set up a joint venture company together with the participation of the IFC. Through the equity stakes in these factoring companies, FimBank aims to replicate the success it had when it first invested in India through Global Trade Finance. The other factoring ventures established a few years ago in Dubai and Egypt have already started contributing positively to the Group.

Meanwhile, IHI's property portfolio – currently consisting of operational hotel assets in Lisbon, Budapest, Malta, St Petersburg, Tripoli and Prague – is shortly expected to extend to London as well as Benghazi in a few years' time. Initially IHI aimed to expand its international portfolio of hotels, however, the Corinthia Group subsidiary now seems to be diversifying into real-estate development with the aim of eventually generating a higher percentage of revenues from rental income, hotel management as well as the realisation of capital gains on the sale of the property development aspect as opposed to the operational income generated from its owned hotels. This strategy entails on the one part moving into real-estate developments not solely focused on hotel business and, on the other hand, undertaking further management contracts of third-party owned hotels through IHI's 70 per cent owned subsidiary CHI Ltd.

The opening of the London hotel, due in October, is expected to strongly promote the Corinthia brand in a major destination especially for corporate travellers. With this in mind, IHI is also seeking further property acquisitions in other major cities including Paris, Rome, Milan, Madrid and New York. With respect to rental income which is currently only being generated from the Tripoli Commercial Centre, the latest acquisitions in London and Benghazi will place an increased focus on the property development aspect while the recent refurbishment in St Petersburg also included a large commercial centre which is shortly expected to be leased out.

In London, IHI is constructing 12 exclusive residences which will be sold or leased upon completion while in Benghazi, IHI and LFICO plan to construct a mixed-use development including 30 residential apartments, commercial offices as well as retail space. Moreover, during the annual general meeting held last May, IHI's chairman Alfred Pisani had indicated that the company could take a 25 per cent shareholding in the Medina Towers development in Tripoli which was awarded to the Corinthia Group last year. CHI's management of a growing number of hotels together with the increased focus on property development should help improve shareholder returns in the coming years.

Trading activity and the positive momentum in the equity market could be aided in the coming months by the current low interest rate environment which is expected to persist through most of this year. While this scenario positively impacted the local bond market in 2009 as a record number of issuers tapped the market and raised €295 million, historically low interest rates could now also be positively impacting the local equity market as low interest rates generally tend to get investors to move their money out of cash and into other assets, possibly including those companies offering attractive dividend yields.