



## **Global Securities Market Bulletin**

October 15, 2010

Issue No.73

**Courtesy: Global Securities Research**

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### **COMMENTARY – Powering to Parity: Loonie’s ascent reflects “risk-on” trade** **Elvis Picardo, CFA**

In recent months, the terms “risk-on” and “risk-off” have found their way into market lexicon, as they are increasingly used to refer to the overall risk appetite of investors.

In the “risk-on” trade, appetite for assets with a somewhat higher risk profile such as stocks and commodities surges noticeably, and in the “risk-off” trade it reverses dramatically. The biggest driver of risk appetite recently, generally speaking, has been global growth prospects, especially those in the biggest economies such as the US, Europe and China. As we have witnessed in recent months, concerns about growth in any of these economic engines leads to a stampede out of risky assets.

The charts below trace the movements of three proxies for moderately risky assets – the MSCI World Index, crude oil (one-month futures) and the CRB Commodity index – as well as the Canadian dollar, since the beginning of 2010. These proxies and the C\$ are tracked against our proprietary FAIL<sup>®</sup> Indicator, which measures concerns about global systemic financial risk.

As Figure 1 shows, the MSCI World Index and Canadian dollar have moved in virtual lockstep since the beginning of this year. Figure 2 shows similar price action for the CRB index and crude oil. The MSCI World Index topped out in April, a time when the loonie also traded above parity with the greenback, while crude oil reached a 19-month high of \$87.15 on May 3.

This topping out process occurred a full month or more after the FAIL<sup>®</sup> Indicator touched an 8½-year low of 0.63 on March 15, well below the level of 1 that denotes a heightened sense of complacency and considerable investor appetite for “risk-on” trades. Risk appetite reversed course altogether in May and June, triggered by the euro’s woes and concerns about a double-dip recession in the US, leading to a near-collapse in prices for stocks and commodities. Crude oil, for example, plunged 26% in a little over two weeks in May, reaching a low of \$64.24 on May 20. Not surprisingly, the FAIL<sup>®</sup> Indicator reached a one-year high of 2.75 on June 7, indicating significant risk aversion.

Since September 21, when the Fed announced that it continues to be on hold, optimism about the effects of QE2 and a consequent run on the US dollar (the DXY Dollar Index is down 5.5% since September 21) has pushed asset prices up across the board. Look at the gains in the three weeks since September 23 – S&P 500 +4.3%, TSX +4.5%, MSCI World Index +6.1%, CRB Index +7.4%, crude oil +12.8%.

The loonie yesterday traded briefly above parity with the USD. As noted earlier, market sentiment reversed sharply shortly after the loonie traded above parity on the previous occasion in April. **Whether the loonie powers through parity (and beyond) or whether it reverses course in the weeks ahead depends to a considerable extent on the position of the market risk “switch” – will it continue to remain in the “on” position, or will it be abruptly switched off? We believe there is a growing possibility that another bout of risk aversion lies ahead before year-end.**

**Figure 1: MSCI World Index and C\$ versus FAIL<sup>®</sup> Indicator**



Source: Global Securities Research, Bloomberg

**Figure 2: CRB Index and Crude Oil versus FAIL<sup>®</sup> Indicator**



Source: Global Securities Research, Bloomberg

**(Trade Update) Galleon Energy (TSX: GO, \$3.85) – Reiterate Buy**

**Galleon Energy (TSX: GO, \$3.92)** rose 10% yesterday on heavy volume of 4.3 million shares. Today in fact marks the third successive day of heavy trading volumes, with over 2 million shares traded on Wednesday and 1.6 million traded so far today. Trading volumes in Galleon over the past three days have been significantly higher than Friday's 20-day average of about 700,000.

The only news of note from Galleon in recent weeks has been a drilling and production update released on October 6, wherein it essentially reiterated guidance released at the time of its Q2 earnings report on August 12.

The company said it drilled and cased 17 wells in Q3, with a success rate of 100%. Production based on field estimates for Q3 is about 13,850 boe/day (71% natural gas, 29% crude oil and NGLs), and net of expected minor asset sales, is forecast to average over 14,000 boe/day in the second half of 2010. Production for the week ended October 2 was in excess of 14,000 boe/day, while there were 7 wells in the process of being completed that are expected to be tied in during Q4.

Galleon reiterated its forecast for year-end production to range between 14,000-14,500 boe/d, of which 25%-30% will be crude oil and NGLs. This forecast excludes about 900 boe/d that is shut in pending regulatory approval. Operating costs in the second half of 2010 are forecast to be below \$10 per boe. The company expects year-end net debt to be about \$128-\$143 million, up from its earlier forecast of \$125 million.

The company also provided an update on its hedge position. For the second half of 2010, it has hedged 14,000 Mcf/day of natural gas at an average fixed price of \$6.13/Mcf, and has also hedged 3,000 barrels/day of crude oil at an average fixed price of \$75.40/ bbl (WTI Cdn). Galleon has also hedged over half of its 2011 production – specifically 33,000 MCF/day of natural gas and 2,500 barrels/day of crude oil – at average fixed prices of \$5.73/Mcf and \$82.90/bbl respectively.

**We continue to hold the view that Galleon is significantly undervalued at current levels, and reiterate our Buy rating with a target of \$5.50.**

**Market Snapshot at 12:00 pm**

<b>S&amp;P TSX</b>	<b>12608.55</b>	<b>-11.14</b>	<b>Commodities</b>			<b>Yields (%)</b>	<b>Can.</b>	<b>US</b>
<b>TSX Venture</b>	<b>1816.20</b>	<b>-5.83</b>	<b>Canadian \$</b>	<b>98.70</b>	<b>-0.91</b>	<b>90 Day T-Bill</b>	<b>0.89</b>	<b>0.13</b>
<b>DJIA</b>	<b>11044.28</b>	<b>-50.29</b>	<b>Gold (Spot)-US\$</b>	<b>1364.75</b>	<b>-16.40</b>	<b>2-Year Bond</b>	<b>1.43</b>	<b>0.36</b>
<b>S&amp;P 500</b>	<b>1173.73</b>	<b>-0.08</b>	<b>Oil (WTI-Nov.)</b>	<b>81.25</b>	<b>-1.44</b>	<b>10-Yr. Bond</b>	<b>2.79</b>	<b>2.57</b>
<b>NASDAQ</b>	<b>2460.92</b>	<b>+25.54</b>	<b>CRB Index</b>	<b>296.06</b>	<b>-3.87</b>	<b>30-Yr. Bond</b>	<b>3.49</b>	<b>3.99</b>

**Thought for the Day**

“Sometimes your best investments are the ones you don’t make.” – Donald Trump

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