Mako Financial Markets Partnership LLP
Equity Comment - 29th November 2005

Equities

Overview

Now that the Thanksgiving holiday is behind us, the market is beginning to focus once again on the economic calendar of events later this week; most noticeably Thursday's ECB meeting and Friday's US payroll data.

In anticipation, volatility has been bid up since the beginning of the week, especially as equity markets have recently reached multi year highs and the probability of a short term market correction increases.

End user activity is now focussing on 2006 and we have seen hedging activity for both short term (March) and full year end across a broad span of markets.

Cross Market

Fixed Income

The rally in the bund market over the last week reflects market concern over ECB policy. With many commentators questioning the need for the ECB to raise rates at this time, there are worries that there may be a slow down in growth. Despite this a rate hike on Thursday is almost a certainty, though expectations for further hikes were lowered following comments from Trichet earlier last week.

Currency

The Euro strengthened 1% against the Dollar yesterday. Should this become the start of a trend then European exporting stocks could be hit hard. The move in the Euro from 1.26 in September to 1.16 earlier this month has proved broadly supportive for European equities.

Flows

Volumes have been thin and markets have been quiet on the way up. However, end-users were active on Friday an Monday, buying puts(spreads) and selling calls, taking advantage of the high levels in the market. On Thursday and Friday long dated premium was in demand on the back of banks covering retail products, steepening the calendar spread.

TUE - ESX MAR06 2700/3800 RISK REVERSAL 1.5 BY 1 TRADED @ 2.0 REF 3450 22350/14900X PAPER BUYING PUTS
FRI - ESX MAR06 3000 PUT TRADED @ 13.1 REF 3468 12000X PAPER BUYING
FRI - ESX MAR06 3350/3250 PUT SPREAD TRADED @ 20.9 REF 3468 PAPER BUYING
MON - ESX DEC05 3550 CALL TRADED @ 11.8 REF 3490 21000X PAPER SELLING

What to Watch

US Retail Sales

Any sign of poor retail sales over the Thanksgiving holiday could take the wind out of the sails of the recent US equity rally. Likewise, aggressive discounting may also hit profit margins going forward.

Nikkei

The Nikkei continues to make new five year highs. A further pick up in the Japanese economy would lead to repatriation of Japanese assets, and subsequent selling of the Dollar and US bonds.

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Overview Statistics

3-Month Equity Volatility

	Implied Volatility		5-Day Realised		Realised - Implied	
	Current	***Change***	***Current***	***Change***	***Current***	***Change***
ESX	12.9	0.2	4.1	-3.5	-8.8	-3.7
FTSE	10.2	-0.2	3.9	-1.4	-6.3	-1.2
DAX	13.2	0.4	4.0	-2.2	-9.2	-2.6
AEX	11.9	0.3	4.1	-2.9	-7.8	-3.2
SPX	10.7	0.0	5.6	-0.3	-5.1	-0.3
NIKKEI	15.4	0.0	8.1	-5.1	-7.3	-5.1
HANG SENG	14.3	-1.2	4.3	-3.7	-10.0	-2.5

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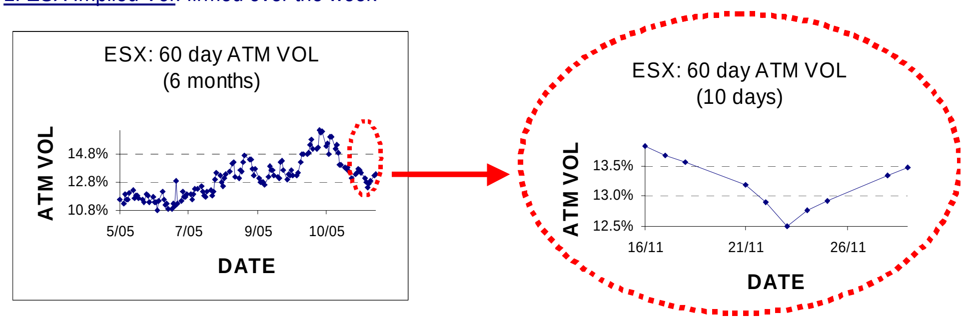
ATM Implied Vol

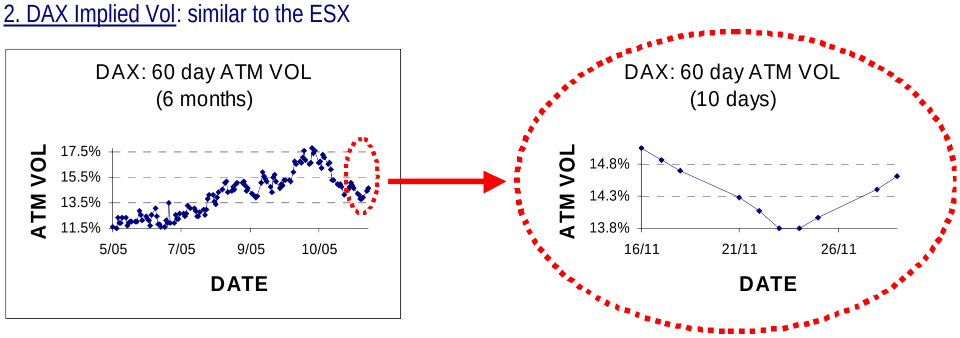
With the Thanksgiving Holiday now behind us European vols are slightly firmer than 1-week ago and the US and Asian vols are broadly unchanged. Realised volatility continues to drift lower, providing limited support to implieds and the gap between close-to-close volatility and implied has widened out by 1%-3% and is now between 6% and 9% vol in the European markets.

We had previously recommended buying US Gamma and had looked at the Jan06 1275Calls. We hadn't recommended adding to this position as vols remained firm into Thanksgiving, but we would recommend holding an existing position - please call to discuss.

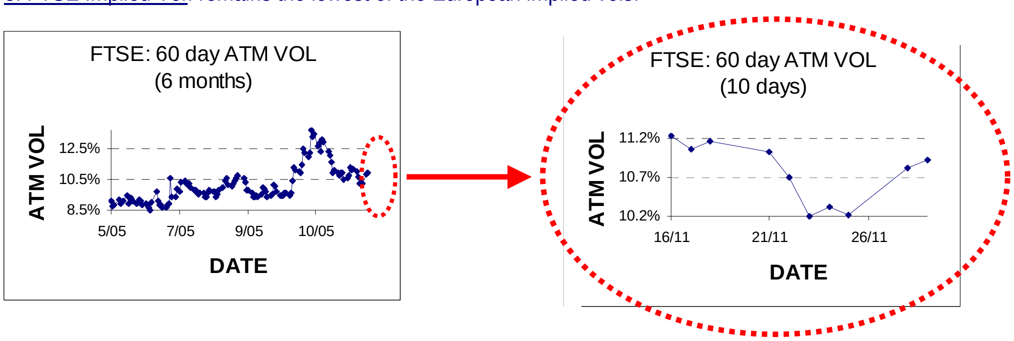
1. ESX Implied Vol: firmed over the week



2. DAX Implied Vol: similar to the ESX



3. FTSE Implied Vol: remains the lowest of the European implied vols.



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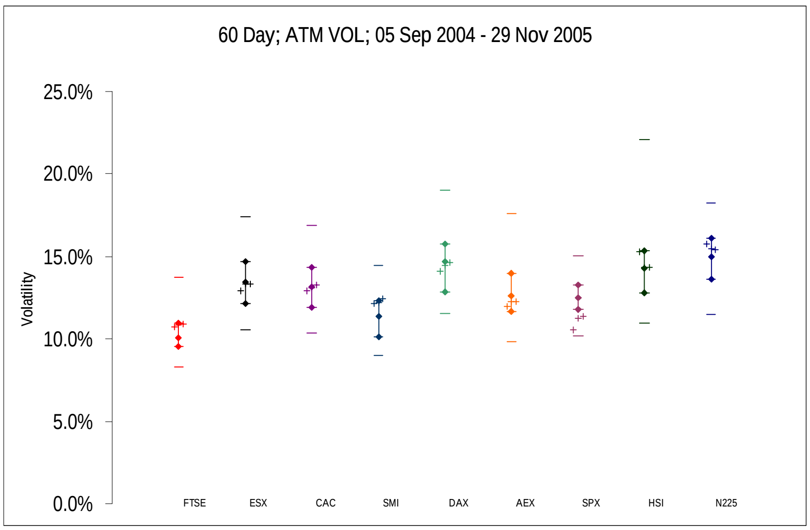
Implied and Realised Volatility

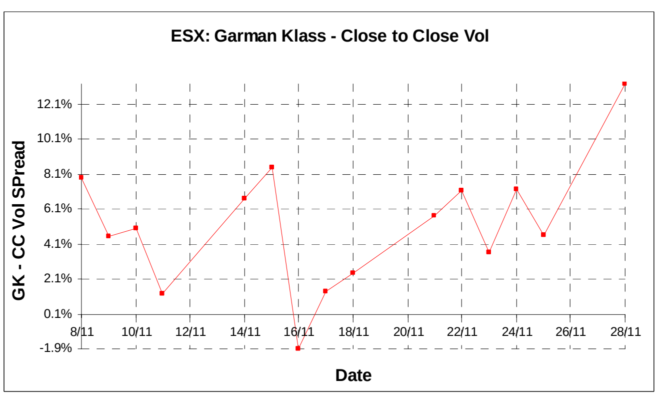
Although volatility softened at the beginning of last week. The week-on-week picture is close to unchanged. ATM volatility continues to sit close to mean levels in the ESX, DAX and the CAC. The outliers are the FTSE where 60 Day ATM vol is relatively high and is up above the 75th percentile level. SPX vol has firmed and has risen from the 10th percentile to around the 25th percentile.

There has been a marked difference between what the market has realised on a close-to-close basis vs. intraday returns. The graph below [fig.2] highlights that over the last 2-weeks intraday returns have been higher than close-to-close in every case except one.

1. 60 Day ATM Vol: S&P low, while the FTSE looks rich against previous levels



2. Intraday hedging - Close-to-Close Hedging: hedging gamma intra day has produced notably higher returns over the last 2-weeks.



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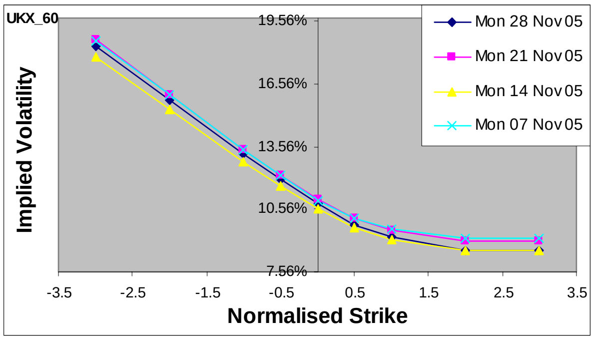
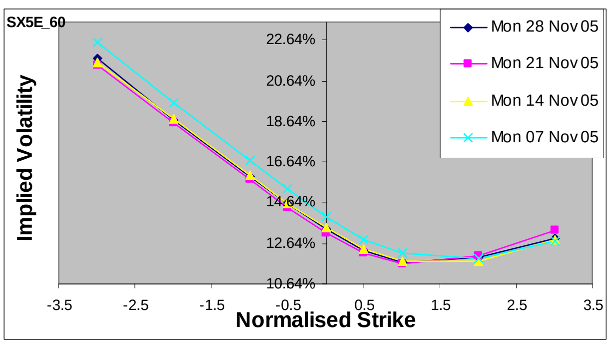
VOLATILITY SMILE

Although call skew has firmed slightly in the European indices, overall little has changed over the last week.

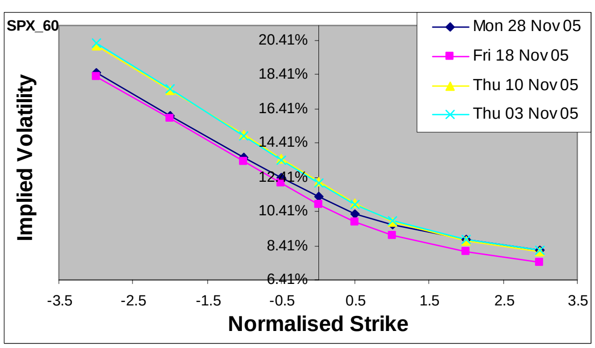
1. FTSE Skew: call skew firmer



2. ESX Skew: again call skew firmed slightly



3. S&P Skew: call skew slightly lower



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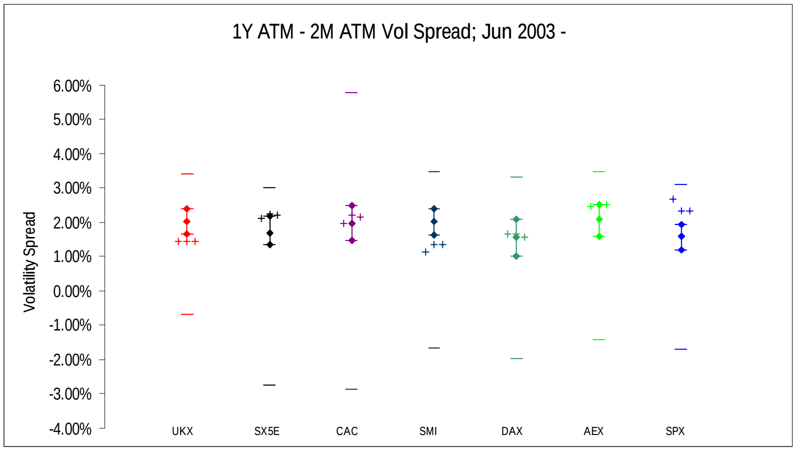
TERM STRUCTURE

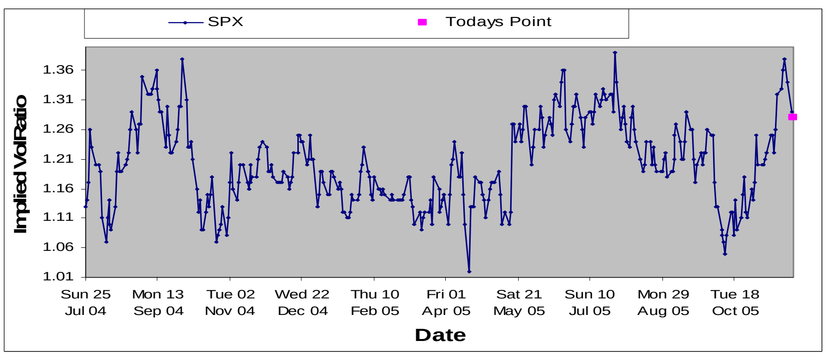
Term structure is steep in all markets except the FTSE where the curve is relatively flat and its down below the 25th percentile level.

The shape of the curve does offer opportunity when structuring positions as there are better buying opportunities in the nearer terms and better selling opportunities in the back-months. Again, please call to discuss further.

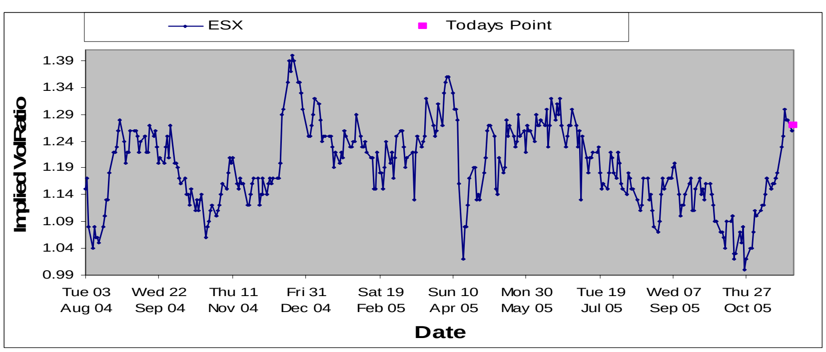
1. Calendars:



2. SPX Calendar: flattened as near term vols have firmed, still steep relative to historic levels.



3. ESX Calendar: steepened over the last week and high relative to historic levels.



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