



JANUS

EQUITY MONTHLY

# Egypt's Ripple Effects

Perspectives from the Janus equity investment team

At Janus, our goal is to deliver alpha by taking an in-depth approach to fundamental research. We extend this commitment to our clients and partners by providing access to the insights and opinions of our equity research analysts. In this edition of *Janus Equity Monthly*, our key topics of interest include trends in U.S. consumer spending, Egypt's political crisis, and how the flooding in Australia may impact global steel prices.

## INSIDE



The ripple effects of Egypt's political crisis



Australia's flooding may impact global steel prices



## MONTH IN REVIEW: CISCO'S MARGINS; INCENTIVES ON CARS



**Cisco's shares fell 14%** the day after it reported lower than expected gross margins. Cisco's margin pressure was due mostly to product mix, however, not a shortfall in top-line growth. The biggest cause of margin compression was a shift in customer orders to a newer switching product that carries lower gross margins than the older version. Importantly, our survey results and industry contacts tell us that Cisco is not losing revenue momentum or market share, nor is it sharply cutting prices. The market reaction seems to price in a deeper concern and more negative outlook than our analysis suggests.



**Incentives on the car lot.** We have favored automakers for structural changes in the industry and had hoped for a firmer pricing environment. So it's concerning that GM's incentives rose 14-15% in January, suggesting the company was trying to buy market share. Overall, GM's sales were strong for the month and inventories were lean. Industry-wide, incentives fell 3% (while Ford's incentives dropped 13%). All the leading indicators, in addition to our own surveys, suggest that auto sales will continue to recover in 2011. Coupled with lean supplier inventories, the environment appears conducive for pricing discipline to remain intact. Still, we're watching closely.



**Consumers brave the elements.** January's retail sales report bolstered our optimistic view on the U.S. consumer, who shrugged off the winter storms and hit the malls. U.S. same-store sales rose 4.8% in January, ahead of forecasts for a 1-2% rise. The high-low pattern of consumer strength continued, with retailers in the middle (such as Kohl's, J.C. Penney and The Gap) posting more anemic and inconsistent monthly results. One worrisome sign is that cost pressures are building, raising the importance of pricing power and inventory management. We see attractive valuations for many retailers.

## Egypt's Ripple Effects

While the resignation of Hosni Mubarak releases some pressure in Egypt, some of the longer term regional and global investment concerns remain. Our most likely scenario was that Egypt would see an army-backed transition to a democracy, and Mubarak's resignation brings the country in that direction. The unrest highlighted some surprising investment positives in the region but also increased our concerns about some threats to emerging markets.

On the positive side, Middle East markets proved to be more resilient than they may have been a few years ago. Currencies have been relatively stable and stocks in Saudi Arabia, Qatar and the United Arab Emirates have largely reversed the year's losses. This performance confounds the appearance of instability in the street protests. But the investor base is different today. Foreign investment in the region fled during the financial crisis and debt debacle in Dubai, and much of it hasn't returned. The investor base is now more local and accustomed to geopolitical shocks. Stocks in the region carry a hefty political discount, and capital that fled Egypt has shifted to Saudi Arabia, Dubai and Abu Dhabi. Egypt's central bank has also maintained investor confidence and stabilized the currency. Outflows from bank deposits have been lower than expected.

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Egypt's political situation is not resolved, however, so regional political risks remain. While Egypt is not a big oil producer, disruption of supply through the Suez Canal would have broad ramifications, highlighting the risks that Egypt's crisis poses for emerging markets. Countries such as India, China and Turkey heavily subsidize oil, and a spike in oil may squeeze government budgets. Food inflation was a major concern going into this year. Higher oil increases food costs, and adds more inflation and budgetary pressures. Inflation fears drive up rates, as we have seen in China, Brazil and other markets.

All this could raise risk premiums for emerging markets. We think these economies are more mature and less dependent on foreign investment than they were in the 1980s and 1990s, but the risk of a slowdown remains. Global investment flows still matter.

Rising oil and fertilizer prices would benefit producers if the increases don't sap too much economic activity. Russian oil companies, geographically well positioned to supply Europe and Asia, would likely benefit, for example. These stocks have performed well recently, partly reflecting these trends.

The key is how the crisis ultimately plays out. Our best case scenario—that democratic reforms come quickly, with full army backing, and quell the protests—looks more likely but is still less than certain. In this case, foreign investment resumes and oil prices stabilize. More likely is our base case: a slower move to democracy, also with army backing. This too averts many problems. Our worst case is a political vacuum or move to an extremist leadership where Egypt is politically isolated and considered a threat to regional stability. This is the “Iran” model that raises regional tensions and perhaps populist power. If this occurs, it will be a global problem on many fronts.

## Australia's Flooding and Chinese Steel

The floods in Australia could drive up global steel prices. Mines in the state of Queensland supply roughly 40% of global seaborne coking coal. If steel producers have shortages of coking coal, they may have to shut capacity. The impact could be felt acutely in China, where the country's large blast furnaces need the premium quality coal that Queensland supplies. While there are other sources, they tend to be more costly. Restarting flooded mines is harder than many people estimate.

The rise in steel prices is likely to pressure margins for industrial firms, unless they can pass through higher costs.

Global steel prices have risen 10% since the fourth quarter of 2010, in part on increases in coking coal and iron ore prices. We expect steel prices to remain strong and think this will support healthy profits for steel makers in the first half of 2011. For industrial firms, the rise in steel prices is likely to pressure operating margins, unless they can pass through higher costs. For example, the average car uses one ton of steel and, without pricing power, a \$200 increase in steel would shave about 8% off the operating profit on a \$30,000 car.

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See last page for important disclosures.

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Foreign securities have additional risks including exchange rate changes, political and economic upheaval, the relative lack of information, relatively low market liquidity and the potential lack of strict financial and accounting controls and standards. These risks are magnified in emerging markets. In general, emerging market investments have historically been subject to significant gains and/or losses.

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Alpha is a measure of a portfolio's risk relative to the market. An alpha of 1.0 means the portfolio outperformed the market 1.0%. A positive alpha is the extra return awarded to the investor for taking additional risk rather than accepting the market return.

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