

Q1, 2009 Market Report

FTSE100 – (-)11%
DJIA – (-)11%
N225 – (-)1%

If, indeed, ignorance is the parent of fear then the breadth and opacity of the current economic crisis has led to some very frightened children. Following a typical (and widely predicted) Christmas rally, global equity investors could be forgiven for feeling somewhat seasick at the subsequent gyrations of the markets.

At the quarter's lows, following the unplanned USD20bn bailout of Bank Of America and second round bailout of insurer AIG, both the DJIA and FTSE100 were showing losses of over 25% on the year. Since then, a further raft of stimuli and co-ordinated PR assaults from major governments culminating in the London G20 agreements have restored a little confidence. Most importantly, particularly in the US, the message appears to be that the villains of our current predicament (Financials) may have turned a corner.

In the last few weeks, Goldman Sachs, Wells Fargo and most recently JP Morgan and BOA have released 1Q results above and beyond analysts' expectations. Furthermore, the majority of US Banks look set to receive a relatively clean bill of health following the recent round of treasury stress tests (NB that this is not confirmed and there may be individual nasty surprises yet to surface). While this is certainly positive, 'green shoots' however apparent, still look to be at risk from further spring frostsA healthy dose of skepticism would seem to be well warranted when considering this precarious sector.

Concerns:

- The suspension of mark to market accounting for 'distressed' assets in the US has undoubtedly had a positive effect on both Banks capital positions and bad debt provisions. With the continued decrease in economic activity and rising unemployment it is doubtful that many of these assets will ever fully recover and one could argue that not valuing them according to NAV of the underlying loan pools is just pushing the problem forward to a later date. Furthermore, some of the one-off gains amongst financials (such as booking gains against the deterioration of their own debt quality) look dubious to say the least and are unlikely to be repeated.

- There is still no floor to depreciating asset prices (read property) in either the US or UK. Despite some recovery in activity, Case-Schiller in the US is still falling as are Halifax and Nationwide indexes in the UK. Particularly in the US there remains a huge logjam of repo property held away from the market and any sustained recovery in price is unlikely until this works its way through the system. Eastern European finances remain in dire straits and are offering a notable health warning for many of the western European banks / governments that have provided financing. Lots of work for the IMF ahead...

- Lack of transparency amongst government bailouts is continuing to negatively affect both interbank and corporate lending. The piecemeal nature of many of the interventions and seemingly deliberate obfuscation about subsidies (eg conversion of Citi preferred stock to common at above market price) make it difficult to fully trust many of the new quarter's financial statements. It is only with transparency that that lending can re-commence and provide underlying economies with the fuel needed to recuperate.

Wine Market:

Certainly 2009 to date has presented a considerably less gloomy picture in the wine trade than the wider economy. The shocks to prices experienced in October and November have not escalated and indeed for some lines a demonstrable recovery has become evident. In line with our predictions in the January Market outlook, it has been business with the Asia Markets that has underwritten activity in the fine wine market over the first 3 months of the year. This shift east has manifested itself in a notably less diverse universe of traded Chateaux and vintages than was apparent same in the quarter 2008, when other markets participation and buying habits were of greater significance. While an asymmetric reliance on new markets would not be entirely healthy, the focus on their very consumer driven purchasing patterns has provided some useful data points in analyzing market trends and buying habits in the region.

Looking at Q1 08 vs 09 we can see that as a percentage of sales by value, Chateau Lafite has moved up considerably as a percentage of turnover. In the same period Latour has dropped comparably and Margaux even more steeply. Mouton, conversely, has evinced considerable growth and top second growth Pichon Lalande makes a new addition to our top 20, with a creditable 3.5% of turnover. Considering the differential in relative unit price vs say Chateau Margaux, this is a considerable flow of wine!

Looking at the vintage profile by Chateau, we can see an increase in demand for fully mature, top Chateau (such as Lafite and Latour 1982) and also an increase in more affordable drinking vintages (such as 99,01,02,04 Lafite etc). This speaks broadly of a market that is driven by prestige gift giving and consumption. In fact, it is of great comfort that the hard evidence provided by repeat orders and more circumstantially, conversations with local traders indicates there is not an overhang of invested stock accumulating in the region.

On the En-Primeur front, it seems that ignorance is no longer bliss for the Chateau owners and early releases for Latour, Mouton and Lafite were back at levels that did deliver value to the consumer. As we suggested in our En-Primeur analysis report in February, geographical demand for the 2008 vintage appears to remain relatively narrow but prices for the 1st Growths and dominant brands certainly worked and stimulated sufficient demand in the UK for the small first tranches to be substantially over-subscribed.

In addition, Robert Parker's first (and very controversial) reviews have been pivotal. Rating brackets amongst the highest awarded in the last decade have sparked occasional windfall gains for early purchases of the small first tranches. According to our various analyses, we considered Lafite and Mouton to hold the greatest investment potential and pursued new allocations aggressively. We are still neutral on Margaux and despite positive reviews, neutral again on Haut Brion. Away from the 1st Growths we consider Pichon Lalande, Leoville Poyferre, Lynch Bages, Calon Segur, Leoville and Langoa Barton and latterly Pavillon Rouge to represent decent value.

Bordeaux is now working extremely hard to capitalize on the momentum the scores have generated to sell through substantial portions of the vintage at progressively higher prices. Given current wider economic conditions we consider that there will be a ceiling price for the new vintage regardless of ratings and that this ceiling will be highest for those wines most aggressively traded in new markets. We further note that the controversy over scoring of the vintage will provide neither confidence nor succor to the market over the mid term. While polar discrepancies in critical opinion are not unprecedented, 2008 offers a schism unparalleled all the way back to 1982. Most would argue that Parker's call on 1982 was the correct one; however it does present an enigma that despite the increased critical saturation and more transparent meteorological data extant today, that until his reviews were published, not even the Chateaux themselves were claiming that 2008 was anything more than 'good'.

Particularly for the first growths, there remains a concern that as 1st tranche quantities were small, market expectation of further releases may cause negative feedback on other vintages already in the market. While it is plain that a considerable downwards correction is already underway for 2007 and to a lesser extent 2006, establishing a purely deflationary trend in new releases must eventually be negative for all comparable vintages. Again, in our opinion, we believe that the extremely high ratings accorded to 2008 will contribute towards greater uncertainty in future pricing. Looking at the mean Parker score for a basket of 1st Growths and top right banks (taking the middle of the 08 score ranges) we can see that 2008 scored exactly in line with 2005 despite the manifest difference in climatic conditions over the year of vintage. Looking in greater depth at the weather for 08, although it seems many Chateaux were 'lucky' with conditions at certain key junctures during the year, the profoundness noted by Robert Parker appears unprecedented in recent history. The discrepancy in prices for these 2 vintages in particular, remains troubling.

Outlook for the next quarter will depend on several key factors:

- Maintenance and continued expansion of market activity in Asia regions. Cyclically speaking Q1 and Q2 are normally the busiest for these markets with activity tailing off into June as physical shipment ceases. All indicators suggest that the market remains healthy and we can see no obvious pitfalls.

- Continuing recovery (or at least more benign activity) in financial markets (The elephant in the room.) Considering it was undoubtedly the financial crisis that precipitated the raft of redemptions and liquidations of positions underlying the shock in prices over Q4 2008 we would wish to see a continuation of the 'green shoots' seen peppering the speeches of Mssrs Obama and Brown most recently. Any further material deterioration in the economies of the key fine wine markets will no doubt eventually have a correlating effect on wine fund positions and overall sales. A further round of large redemptions from wine funds could well spark further price shocks to the downside if not met by organic demand. Ironically however, handled correctly, these could provide investors with the most advantageous investment opportunities of the year.

- New investment activity. Already, there has been much speculation regarding wine as a safe haven asset and we are aware of several new funds in the set up / development stages. All considered on the supply side, if even 50% of these new businesses projections are met the effect on prices should be notably positive.

In terms of turnover trends at BI, Q4 2008 turnover was notably lower than Q1 2008 whereas Q1 2009 has recovered markedly. A clear trend of improvement (returning confidence) shows March 2009 outperforming March 2008 when price-adjusted. NB - One has to be careful in comparing different quarters in the same year as the market is strongly cyclical.

Turnover by unit (case) has closely reflected change in prices - indicating that the type of wine purchased has not changed significantly (stability of favoured brands etc.)

Through the course of 2008-2009 business represented by Asian customers has increased. Percentage of business in Europe and UK has declined.

Circumstantial evidence indicates stock sold from proprietary holdings declined through Q4 2008 but has since recovered sharply through the latter half of Q1 2009 to levels above the average for 2008. This reflects a greater risk appetite across the trade that must be considered positive.

In summary for Q2, we believe that we may see some more modest price recovery amongst 1st growths, with an emphasis on Lafite and Mouton. It is clear that en-primeur has enjoyed much greater success than recent vintages but will not create much in the way of upwards price pressure in extant vintages. We do expect a slowdown towards the end of the quarter as trade in Asia tails off for the summer (this is very much seasonal and inventories will be managed carefully to limit impact). Finally we will continue to monitor prices on 2nd wines and middle vintage 1sts to observe whether demand is growing sufficiently for these to support any upward movements in price.

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