Friday, July 29th 2011

There is only one story in town - the US debt ceiling and the politics around it. Will the US default on its obligations come August 2nd? Will it be downgraded from its “AAA” status? Well, one thing is certain - all the bickering and theatrics around the subject are definitively harming the credibility of the US governance! The Dollar is sinking further with each Presidential statement, “Boner’s” proclamations and follow-ups from rating agencies as to the downgrade of the USA. Talk about contagion! If the US gets downgraded, many Money Market Funds will have to reduce their holdings of US securities, as will banks and other pension funds. Then, if indeed the USA becomes a “AA”, can France remain “AAA”? as ratings whilst absolute, are definitively relative…

The FX market is showing disdain for the US currency and this week the bond markets gave us a hint as to their view with the ten year Treasury nudging 3% again.

Well, some perspective is due here - there are several types of default. Clearly, the current situation is not the inability of the USA to honour its current obligations. It is purely an administrative matter where a simple (?!?) decision to allow the Treasury to borrow more than it currently owes would suffice to defer the issue. Arguably, the Federal Reserve could sell some of its huge portfolio of US Government securities and lend the proceeds to the Treasury (no new issuance here…). This is NOT the Greek situation, where the country simply cannot find the funds with which to pay its obligations.

This said, it is a horrifying sight where elected adults (?!) can’t agree to set aside their convictions for a while and just approve the inevitable. What would happen if and when they were faced with a real problem? Can the US currency be respected as a global reserve with such poor governance? Would you hold-on to your shares in Google if you see on TV that their President and the Chairman disagree on the earnings of the company? Credibility is the point here! Even Europe managed to resolve their political discords in connection with Greece. Possibly a poor decision or simply an incomplete decision, but a decision none-the-less.

The Euro is holding up better than the USD…

The equity markets are holding-up in the face of these baffling risks. This steadiness can be attributed to the overwhelmingly powerful corporate results. Arguably, had Congress reached the inevitable decision of raising the ceiling, the S&P 500 could have risen by a significant amount.

The GOP refuses to accept tax increases and block the process. Silly, actually, as the bickering has contributed to the decline of the US$ and the inevitable increase in Oil prices. For the Americans, as the price hit $100 again. A tax on all Americans, proceeds of which are sent overseas. Oil in Euros or Yen has hardly moved… So the GOP is accepting a tax increase and simultaneously sending the receipts away from the USA. There must be a hidden logic therein, but we are yet to uncover it…[1]

If the Congress were to resolve their differences, the US$ may rise but not by much, as credibility has been damaged. Stock may rally and yields stabilize. Let’s see…

Much else is happening - Gold trading at daily new highs, the Swiss Franc is ridiculously strong, Syria is still killing its resurgent people as is Khadafi doing to his people. Oh yes, there is a new famine brewing in Africa.

[1] Please note that this text was written on Thursday before the US House postponed the debt-ceiling vote.

Currencies

- In the post 2008 era, we have been used to periods of either US Dollar strength vs Euro weakness or Euro strength vs US Dollar weakness. But over the last few weeks, and even more so over the last few sessions, we have been seeing US Dollar and Euro weakness together.
- Indeed, the US Dollar in the beginning of the week was under pressure as its politicians played Russian roulette over the debt ceiling. As we write this no deal has been reached and the Dollar has declined versus most major currencies.[2]
- The Euro was quite strong in the beginning of the week, after the seemingly positive resolution of last week's European council meeting, but has been selling off as markets recognize that the euro zone's debt crisis are far from being resolved. Again Spain and Italy are back in the eye of the storm.
- The biggest gainers from the turmoil in the US and Europe were the Swiss Franc and the Japanese Yen, the traditional "risk haven" currencies, which are reaching quite astonishing levels.
- Indeed, the Japanese Yen is at 77.8 versus the US Dollar, after having edged near its post World War II record high of 76.25 reached on March 17th. Against the Euro the Japanese currency is now at 111.35 having begun the week at 113.
- The Swiss Franc meanwhile is hovering around 0.8 versus the USD and is at 1.15 versus the Euro, having reached an all time high of 1.1425 versus the common currency on Thursday.
- The other major gainers were currencies which are perceived as being "risk positive" assets! Indeed, higher yielding currencies such as the New Zealand, Canadian and Australian Dollars and the Norwegian Krone continued to rise versus the Greenback and the Euro.
- These currencies are being bought given the strength of their countries balance sheet and on interest rate differentials with the US and Europe.
- We find the current environment simply amazing, and really not sustainable. Ultimately there will be some solution to the US debt ceiling, but we are baffled by how irresponsible US politicians are being, and believe that the US Dollar will be hurt by their behaviour, even as some sort of deal will emerge.
- Separately the reversal in the Euro, so quickly after what was initially perceived as a successful meeting last week is of great concern. Therefore, we expect currency markets to be very volatile and do not recommend adding any currency risk wherever in these crazy markets!

Fixed Income

- Bond markets were highly volatile this week as the US debt ceiling crisis just got more and more ridiculous day by day, while the European sovereign debt crisis came back to the fore.
- Yields on 10year US government bonds went from roughly 3% in the beginning of the week to 3.04% on Tuesday, only to drop to 2.94% currently. While the 10year note gained during this

[2] Please note that this text was written on Thursday before the US House postponed the debt-ceiling vote.

period, the price to protect against a default on these same securities jumped 80% over the week!

- All in all, US, German, French and German government bonds all dropped this week, largely erasing the big jump in yields of the previous week. The moves were even larger in the “good” European countries, with for example the yield on 10 year German bonds dropping 24 basis points. Last week these had risen by 20 bps…
- With contagion risks in the euro zone back on the rise, yields on Italian and Spanish bonds jumped, as S&P, a ratings agency, announced that Greece will partially default on its debt once the European Union plan is implemented.
- Credit markets were robust despite the amazing events and volatility on government bonds. Investment grade corporate bonds are marginally positive for the week while high yield corporate bonds are moderately lower for the week.

Equities

- Developed equity markets plummeted this week, with the MSCI World down by -2.67% as of yesterday’s close. The Index lost about -1.4% month-to-date, with Europe being again the major laggard. The MSCI is now up 2.54% for the year.
- The S&P 500 lost -3.28% this week as US lawmakers called off a vote on House Speaker John Boehner’s plan for raising the debt limit. The delay fuelled concern that a compromise by the two parties will not be reached before the August 2nd deadline for a possible US default.
- The Euro Stoxx lost -4.18% during last week, as investors speculated that Europe’s sovereign-debt crisis will derail the economic recovery and as concern mounted that US lawmakers will fail to agree on the federal government’s debt ceiling by next week’s deadline.
- The Nikkei declined by close to 3%, extending earlier losses after the Yen gained against the Dollar and the Euro.
- MSCI Sectors Indices were all in negative territory last week, with Financials and Industrials being the biggest laggards, while defensive sectors such as Consumer Staples and Healthcare pulled through the week relatively well. Healthcare remains the best performing sector for the year along with Energy and Consumer related sectors while Financials and Utility remain the worst performing ones.

Emerging Markets

- Emerging markets equities outperformed their developed counterparts this week, with the MSCI EM Index down by -0.67% while the MSCI World was down by 2.67% as of yesterday’s close. For the year, the MSCI EM continues to lag, down about -0.5% while the MSCI World index is up about 2.5%.
- Performance across EM regions was negative overall, as signs of slowing economic growth and the political stalemate on the US debt limit further eroded investor confidence.
- Latin America lagged as Brazil continues to be penalized by higher interest rates pulling down Brazilian banks and retailers. The Bovespa lost about -2.6% and is down over -15% year-to-date. Brazilian stocks have tumbled as inflation reached the fastest pace since 2005 even after the central bank lifted interest rates eight times in 15 months. Brazil became the first

among the largest emerging economies to fall into a bear market this year as the government adopted new measures to stem currency gains and inflation quickened.

- Nearly all Asian marketplaces were negative this week. Chinese stocks fell by -2.5% as fresh worries about Chinese local government debt weighed on financials, while Hong Kong shares were about flat, shrugging off weakness in global markets as earnings-driven strength in utilities helped the benchmark recover early losses.
- Meanwhile, Asian currencies continued to gain, as shown through the Bloomberg JP Morgan Asia Dollar Index, as many of the component currencies experience higher inflation rates and as interest rates go higher.

Commodities

- The S&P GSCI commodity index is down slightly for the week, with energy down and industrial as well as precious metals up.
- Oil fell this week, heading for the first weekly decline in five, on concern a failure to reach a deal on raising the US debt limit may cause the nation to default, threatening the economy of the world's biggest crude consumer. Crude oil is down -2.35% for the week, at $96.87 a barrel currently.
- After having climbed to a record $1628.05 an ounce on July 27 on debt concerns in the US and Europe, Gold declined as this week's rally prompted some investors to take their profits. Gold which gained some ground this week – currently at $1616.50 – is up for the first month in three amid US debt deadlock.
