Bedrock Newsletter

Friday, March 23rd 2012

A strange week, at least from an emotional point of view. It had seven days as usual but then, the tone or the sentiments moved in an erratic manner: On Monday it was the US recovery clearly overriding all worries. By Wednesday we felt that the Chinese data will have bad repercussions on any hopes of a global recovery. Equity markets rallied and fell in tandem, bond markets which had taken the view that we were in a bubble reversed course and bounced up (in price) as equities faltered. Well, what has actually happened?

We passed the first day of spring, the weather is glorious and the Iranians celebrated their New Year on the hour of the equinox. Perhaps in the spirit of their holidays they decided to back-off somewhat from their naughty rhetoric? They did falloff the headlines and that is a step in the right direction. But oil prices didn't collapse. We believe that the real driver of oil prices is the growing global demand which is faced with a stagnant supply. We note that China has become the second largest oil consumer, reaching 25% of the total 90 million barrels burned per day, closing-in on the US demand. We believe that whilst 320 million Americans are seeking economies of energy usage, they cannot offset the nascent demand of 1.3 billion Chinese. Stay long oil!
We had heard over the past few months that Central Banks had been buying gold, in partial explanation of the long rise in its price. Well, perhaps the observed increase in gold reserves is not measured in ounces but rather in Dollar value? As Gold rises in price, so do the reserves of gold rise… Perhaps they were not buying, just marking-to-market?

Market fears of being in a bond bubble have pushed longer yields up. Even the bullet-proof German Bunds have fallen in price to yield through 2% as US 10 year Notes rose in yield to 2.30% Some analysts have been warning of a burst of the bubble, words of the imminent collapse in bond prices are permeating the media. Whilst everything is possible, we would argue against a collapse, expecting a slow steepening of OECD yield curves which will remain anchored in the short end at the zero percent base for some time to come (years). Italian yields are coming down and Spain is rising. There is talk of Portugal following the Greek model- PIMCO says that the implosion of Portugal will occur in 2012… We hold the view that bond prices react to inflation expectations more than to anything else. The latter, whilst showing some rises, is devoid of wage pressures so is likely to hold at moderate levels so there is little risk of bond price collapses. Portugal asides … We lightened-up on bond holdings as we sense that the expected returns therein will remain at the coupon yield as the capital gains experienced in the last few years from yield compression has probably run its course. The expected forward-looking returns will likely be contained in the hardly inflation beating levels. The risk/reward ratio here has turned and is no longer enticing. Stay in cash at an opportunity cost of 2-3% pa whilst removing the risk of capital losses.

Another financial event occurred this week and somehow remained in the fine-print: The closing event for the Greek restructuring event- The Greek CDS sold at auction on Monday at 21.5% meaning that issuers of said insurance pay 78.5% of the debt's nominal value.

Into the weekend we depart, reassured with the thought that the power of money supply is driving the markets!

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Currencies

- The EURUSD pair stayed in a narrow range of 1.3080-1.3280 for the week and reacted to the economic news flow coming from the US (positive) and from China and the EU (negative). The release of the German PMI on Wednesday put a dent on the string of positive economic surprises coming from Germany and Europe. News from China was also on the soft side. Today's Wall Street Journal runs a report which says that market participants underestimate the risk of a property crash in China. We expect the EURUSD pair to come down in the coming weeks due to the slower growth worldwide, the recession in Europe and the widening spread between the 10 Year interest rates of the US and Germany.
- The AUD was the big mover this week as the Government there passed the 30% tax into law for the mining sector, in order to redistribute the wealth coming out of natural resources. On top of that, the same day, BHP Billiton announced that the demand for iron ore coming from China might have seen its peak. On this news, markets in Australia tanked and the AUD plunged against the USD from a high of 1.0635 early this week to a low of 1.0335, a 2 month low. We also expect this move down of the AUD to continue.
- The JPY first weakened to 84.20 against the USD but then strengthened again on some profit taking and risk off trades. The USDJPY went down to 82.40 and we believe it can go down a little more to levels around 81.50-82 before the weakening trend of the JPY reasserts itself. Let's not forget that the JPY went down 10% in the space of 6 weeks and that a pause is more than normal and necessary.
- The UK Pound did not really move much following the release of the budget by Chancellor Osborne as it bit did not come up with major surprises either way. The GBPUSD pair remained stable around the 1.5800 level.
- The general USD bid tone meant that the EM currencies did weaken further this week, with the ZAR posting a 2 month low at 7.75 to the USD and the BRL weakening to the 1.82 level.

Fixed Income

- US Treasuries flattened somewhat after last week's sell off in the bond market. Although the short end of the curve was remarkably lacklustre, finishing exactly where it started, the 10Yr and the 30Yr both rallied causing the yields to drop. -10 bps for US 30-year yield to 3.35%, -6 bps for the 10-year yield to 2.27% and flat for US 2-year yield at 0.36%.
- On the European front, Italian and Spanish government bond yields bounced after the euphoria of the last week. The Italian 10-year yield jumped 30 basis points this week to 5.12%, losing nearly half of the gains for the month of February and March. The Spanish 10-year lost some ground in a similar fashion to Italy, trading now above 5.50%, taking us almost to the highest yields for 2012.
- The Portuguese 10 Year Bond however seems to have taken a breather this week dropping to 12.63%, almost 100 Bps below last week. However we should not lose sight of the fact that it is still trading well above its Mediterranean European counterparts by over 700 Bps!
- This week was relatively quiet and saw little movement, corporates in general outperforming the government bonds with both US and EU HY being almost flat on the week. The highest performer being EU corporates at +0.22% and the weakest being EU governments at -0.22%.

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Equities

- Developed equity markets slid this week, with the MSCI losing 1.26% as of yesterday's close, amid reports showing that manufacturing activity contracted in Europe and China.
- European equities slumped, with the EuroStoxx 50 retreating by 2.99% after gauges of German and French manufacturing unexpectedly contracted. Germany's manufacturing purchasing managers' index dropped to 48.1 in March from 50.2 and the CDAF purchasing & services managers' index for France fell to 47.6 in March from 50 the previous month, whereas both had been forecast to increase.
- The S&P 500 lost about 0.81% last week, closing below the 1'400 level it breached last week, as fears about slowing growth worldwide offset the impact of encouraging unemployment data which dropped to the lowest level in four years, providing further signs the US labour market is picking up.
- The S&P is still poised for a fourth straight month of gains, the longest winning streak since September 2009. The index has risen about 2% in March, extending its year-to-date advance to almost 11%, amid economic and corporate data that exceeded projections. The benchmark gauge is also headed for the best first quarter since 1998.
- Meanwhile, the Nikkei was slightly negative this week losing 1.17% on shrinking Europe production, although Japan posted an unexpected trade surplus.
- In terms of sectors, Energy and Materials stocks were the main laggards this week, while Information Technology and Telecom were the only sectors to be positive. IT, Financials and Consumer Discretionary are the best performers so far this year. Outperformance of these sectors is due to investors keeping a risk-on approach and therefore favouring high beta segments, such as cloud computing and internet names. We however advise caution on these stocks as the incredible run they experienced since the beginning of the year could fade anytime soon.
- It looks that after a very decent first quarter in terms of performance, equity indices could start a correction down soon, which might take prices down by 5%.

Emerging Markets

- Emerging Markets' equities were negative this week, down by 2.14% as of yesterday's close – as measured by the MSCI EM Index – underperforming their developed counterparts. However, Emerging Markets still outperform the Developed World by some distance on a year-to-date basis (13.55% vs. 10.29%).
- The worst performing region was Emerging Europe, down by 5.34% as measured by the corresponding MSCI index, followed by Latin America (-2.47%) and Asia (-1.36%).
- The Shanghai Composite was negative this week, as the Chinese manufacturing index indicated a worse contraction than expected this month. However, this event bolstered the case for Premier Wen Jiabao to add measures to sustain growth even as he prolongs a campaign to cool property prices.

- Meanwhile, the Brazilian Bovespa gave back 2.33% on China's growth concerns, dimming the outlook for Brazilian exports and especially weighing on raw materials producers and industrial companies which led the decline.
- Our view on EM assets is unchanged. While EM economies will undoubtedly be affected by a slowdown in Europe and in the US, these economies overall are in a much healthier state than developed economies. Valuations seem more attractive in the Emerging world with a PE ratio of 11.9 on average for the MSCI EM compared to 15 for the MSCI World. Therefore, we maintain our exposures to EM equities and EM corporate bonds, as well as our CNY and SGD positions.

Commodities

- Commodities were negative this week, losing 0.75% as measured by the S&P GSCI broad commodity index. However, performance varied strongly by type of commodity.
- Industrial Metals took the biggest hit this week down by 3.82% driven down by Copper and Aluminium which slumped by close to 4% and 5% respectively, while Agriculture slid by 1.84% on Corn prices' drop.
- Gold dropped by 0.55% this week, currently trading around $1'651 an ounce. Gold futures dropped to the lowest price since January as signs of slowing growth from China to Germany sent the dollar higher, curbing demand for the precious metal. Meanwhile, Silver dropped by 2.5% and Palladium slumped by close to 6%.
- Crude Oil lost 1.2% this week, currently trading at $105.80 a barrel. Oil fell steeply on Thursday and was set for its lowest close in more than two weeks after weak Chinese data sparked fears that a global slowdown could dent global energy demand.
- We remain constructive on oil given supply/demand dynamics as well as Middle East tensions, and on gold, which should continue to find support on the medium to long term as global central banks provide liquidity to markets.

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