Bedrock Newsletter

Friday, March 30th 2012

The first quarter of 2012 is drawing to a close. Accompanying the warmer and nicer weather than usual for this period (except for the 2 weeks big freeze in February), the first quarter delivered strong returns for equity markets around the globe (save for Spain), and very decent returns in the Fixed income sector (particularly the High Yield space), except for a slight drawdown in the US Government bond markets. Commodity prices were strong with energy and Gold also posting strong gains. And Hedge Funds in general delivered their 1% per month return that they are supposed to do in normal times.

But are these normal times? Or at least, are we going back to more "normal" times?

Well, we believe that although the monetary winds that are blowing very strongly are certainly helping to repair the wounded economies in Europe, US and Japan, we are seeing some cracks appearing in some "growth" areas, which is troublesome.
China's Shanghai index has come down by 8.5% in the last 15 days, on fears that the slowdown in China is gaining more traction. This has had ripple effects in Australia, where interest rates eased and the Australian Dollar weakened. The same is true for Brazil which saw both its Bovespa Index and the Brazilian Real weaken sharply in the past 15 days.
European markets have started to roll down on fears that the austerity measures passed in Spain and Italy will have quite negative effects for the local economies there. And even the number of surprisingly positive US economic figures has started to come down a bit.

So what is in store for the Second Quarter?
We believe that after such a strong uninterrupted run in equity prices (since December 20th), the time is ripe for a pause/correction and that we are seeing the first signs of it. However, we don't believe in a structural change of direction as monetary policy around the world is still very accommodative and is set to be even more so (in Europe, Japan, Australia, China). US growth, in our opinion, is for real and will gather more steam in the months ahead. Japan is finally serious with their will of having a lower currency and create some inflation. And Emerging markets in general, although having a lower rate of growth, will still provide a decent absolute growth rate.
Commodities will remain supported for a few reasons. Gold will benefit from low worldwide interest rates, and even negative real interest rates in some large parts of the world. It will also benefit from Central Banks adding Gold to their reserves. Energy will remain supported by geopolitical fears surrounding the Iranian situation, and also due to the very tight supply/demand forces which could become really problematic in case Iran starts blocking the Hormuz Straight.
We also think that US government bond rates have seen their lows and that the path of least resistance is up. We don't see any more upside from around these levels.
As for currencies, we see a resurgent US Dollar due to the strengthening US economy and due to its relative strength compared to Europe and Japan. We believe that we will see a stronger Dollar across the board and that the weakest currencies going forward will be the Euro, the Japanese Yen and the Australian Dollar.

The first part of the second quarter starts with Easter holidays and Passover. So enjoy the vacations, the sun and the (well deserved) rest. Bedrock's Newsletter will not be published next Friday (6th of April) due to the Good Friday holiday. See you back on Friday the 13th!!

Currencies

- The EURUSD pair stayed in a narrow range of 1.3200-1.3380 for the week, losing some ground earlier in the week on poor economic data from Europe and reminders that the debt crisis is not yet resolved. However, the currency found some support later in the week as euro zone finance ministers prepare for high-level debt talks.
- The AUD weakened further this week on speculation the RBA would carry out some more easing. On top of that, slowdown concerns over China continued to weigh. As a result, the AUD/USD started the week at 1.0535 and slid all the way to 1.0305, before rebounding a bit to 1.0405 where it currently stands.
- Meanwhile, the JPY appreciated against most of its major counterparts as concern increased that Europe's sovereign-debt crisis could threaten global economic growth and stocks dropped amid safety demand. Japan's currency reached an almost three-week high versus the dollar to 81.85.
- The UK Pound rose strongly this week, breaking the 1.6000 level against the Greenback. We do not see those levels as being sustained.
- The same move happened on the CHF which appreciated against the USD from a level around 0.9150 last week to 0.9025 currently, while it maintained its floor level against the EUR, trading at or around 1.2050.

Fixed Income

- US Treasury yields fell this week as worse than expected jobless claims figures and lower durable goods orders drove investors into safer assets. The US 10-year dropped 7bps, bringing the yield to 2.168%. US 2-year decreased 1bp to 0.344% and the US 30-year fell 2 bps to 3.284%.
- On the European front, yields rallied among the PIIGS nations as the S&P suggested that Greece may have to restructure its debt once again. Italian government bond yields rallied despite successful auctions of €8Bn worth of bonds. The Italian 10-year yield increased 12 basis points this week to 5.138%.
- Spanish 10-year lost some ground on weaker auctions than expected, signalling investors are not as willing to hold long term Spanish debt. Yields increased 7 bps to 5.394%.
- The Portuguese 10 Year Bond strengthened on the back of positive comments from Italian Prime Minister Mario Monti signalling further stabilisation in the block. Yields dropped 105 bps to 10.845%.
- German 10-year yields dropped 5bps to 1.815% as German consumer confidence came in lower than expected and rushed investors into bunds.
- US Corporates and US Sovereigns were the best performers this week (+0.69% and 0.54% respectively), while the worst performers were EU High Yield bonds (-0.14%) and Emerging Market bonds (-0.06%).

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Equities

- Developed equity markets slid this week, with the MSCI losing 0.22% as of yesterday's close, daunted by reminders that Europe has not solved its debt crisis and the US economy is far from healed, despite progress on both fronts.
- European equities slumped, with the EuroStoxx 50 retreating by 2.88% extending a three-week low, as Standard & Poor's said Greece may have to restructure its debt again and as an indicator of economic confidence in the euro region unexpectedly declined in March, according to the European Commission.
- The S&P 500 rose by 0.44% last week, closing slightly above the 1'400 level. The index started the week by performing quite strongly on Monday, but then fell three days in a row amid American jobless claims topping economists' projections and disappointing economic data from Europe.
- The S&P is poised for a fourth straight month of gains, the longest winning streak since September 2009. The index has risen about 2.75% this month, extending its year-to-date advance to almost 12%, amid economic and corporate data that exceeded projections, heading for the best first quarter since 1998.
- Meanwhile, the Nikkei started the week surging by almost 2.5% on a weaker Yen, before declining from its one-year peak on Thursday, as traders took profits from exporters towards the end of a first quarter which is the best in more than two decades. The index rose by 0.72% for the week.
- In terms of sectors, Energy, Telecom and Materials stocks were the main laggards this week, while Information Technology and Healthcare led the gains. 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. 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%. However, we believe that the US are poised for a secular bull market with the housing sector bottoming, a manufacturing revival underway, the potential for an energy boom in North America thanks to shale gas and a new wave of technology growth in internet and cloud computing.

Emerging Markets

- Emerging Markets' equities were negative this week, down by 0.90% 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 (12.68% vs. 10.39%).
- The worst performing region was Emerging Europe, down by 2.44% as measured by the corresponding MSCI index, followed by Asia (-0.79%) and Latin America (-0.64%).
- The Shanghai Composite slumped this week, down by 3.74% falling to the lowest close in almost two months amid concern China's economy is slowing as most companies missed earnings estimates. China's lost close to 7% in March on concerns growth is losing more and more traction.

- Meanwhile, the Brazilian Bovespa gave back 1.43% on China's slowdown concerns and a gloomier economic picture for Europe, dimming the outlook for Brazilian exports and especially weighing on raw materials producers 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 11.7 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, dropping 1.70% as measured by the S&P GSCI broad commodity index. However, performance varied strongly by type of commodity.
- Agriculture was the worst performer this week dropping 3.5% followed by WTI crude and Brent Crude futures (-3.19% and -1.65% respectively), the only positive performer for the week being Precious Metals (+0.82%).
- Gold increased 0.21% this week, currently trading around $1'667 an ounce. USD weakening and speculation of an end to a strike by Indian jewellers helped the precious metals regain its strength. Gold is headed for a quarterly gain of 6.5%.
- Crude Oil lost 3.19% this week, currently trading at $103.4 a barrel. Oil fell on French Government statement that several countries are moving closer to an agreement on a release from emergency stockpiles to combat rising prices. In addition, the Saudi Oil minister claimed they as well would like to see more reasonable oil prices to stop its implications on global growth.
- 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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