Bedrock Newsletter

Friday, April 20th 2012

It was Greece which had rattled our markets, then Italy, then Spain flavored with a whiff of Ireland. Well, you ain't seen nothing yet!!! May 7th it the date when France might come under attack! The French Presidential elections commence this weekend. Francois Hollande is in the lead and if he were to win round (II) the markets will remember the "other" Francois (Mitterrand) and the effects of the Socialists on the economy. The "People" forget that socialism is a luxury that only the rich can afford. France isn't rich enough to pay for Hollande's promises. Will Germany finally be invited to annex France?

Election fever is everywhere! Romney will be the GOP candidate and has to face-up to the latest Obama populist rhetoric: Oil prices are high because of speculators. We wonder- will Romney have the presence of mind to retort with an innocent question about natural gas prices? These are at a ten year low in America, probably driven down by the same speculators… (You know the trade: long oil short gas).

Whilst we are on the political roll, we must take a peek at Syria and ask ourselves if Turkey will show some Ottoman reactions and salvage its poor neighbor from tyranny and march its forces across to Damascus? They may even be applauded by the World, as NATO was in Libya… and also, they would be protecting themselves from an inevitable flow of refugees and an unstable neighbor.

Yes, we all smiled when North Korea fired an intercontinental missile into the sea. But the threat hasn't gone away. What if they attacked the South? We can only guess at the damage to the world economy. Remember the effects of components' supply disruption from Japan? And Argentina nationalizing YPF, its most important oil company? The "people" may well like the idea, Spain and Repsol surely don't. Did they forget the Falklands? Yet more systemic cracks from financial stress.

No wonder the markets are jittery. We are in the full swing of earnings' season with Q1 results coming in fast and furious. We should be pleased as 81% of the numbers received so far were ahead of expectations and yet, equities are not rallying. Perhaps we recognized the fact that said expectations were held down and that in reality, the results are hardly ahead of Q1 2011? Or is it that equities are (at last) fairly priced; S&P 500 at 1'375 is trading at 14X forward earnings. Quite all right. Oh, let's not forget that the indices are heavily affected by the drop in Apple just as they had been pushed up by the same. Well, they will give us their results next week…

We are watching the bond markets for clues. Noisy movements in a tight band with US 10 year yields apparently set at 2% +- 10bp. Germany is competing with Japan for the title of most expensive bonds with all-time low in yields, across the curve. Is this a short ahead of Hollande? Spain and France issued bonds this week and were surprisingly well received only to lose ground immediately after. Was it real demand at auction or the ECB?

Well, we must not forget the Fed. In June, operation "Twist" comes to an end. What will follow? The Tango? Or will it be the American Samba? Perhaps when it will end we will understand what Twist was all about…

A thought for these uncertain times- We all know that there are only two certitudes in life- Taxes and Death. Well, the tax preparation industry is doing just fine, thank you, see H&R Bloch. Then there is the Death-Care business: Growing over 1% pa, expected to accelerate as baby boomers fall off...

Have a fine weekend and watch France…

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Currencies

- The EURUSD pair sold off earlier in the week, breaking the 1.30 level only to rebound and remain above 1.31. Today the EUR rallies into the weekend seeing a high print of 1.3180 as we write on a stronger German IFO reading. The movements in the EUR seem to be at odds with the macro data, the possibility of another French downgrade, the OATs (French Government 10 Yr) reaching the widest spread against German Bunds since Jan11, we cannot see how the resilience of the EUR will persist in light of worsening European data… AND on a probable Hollande victory!
- The SNB finally voted in Jordan as the permanent President followed by another statement to reaffirm their willingness to weaken the CHF and maintain the 1.20 floor on EURCHF. EURCHF traded in a tight range of 1.2015-1.2025. USDCHF again mirrored EURUSD and traded up to a high of 0.9250 before returning to 0.9125 now.
- The JPY slipped again this week after a strong start trading between 80.80 and 80.40 to see the JPY weaken steadily to 81.70 against the USD and 107.50 against the EUR. The BOJ signalled they will continue to ease and that fighting deflation is their top priority.
- The AUD was relatively range bound this week between 1.0330 and 1.0410. After last week's surprise data the AUD gave back some of the gained ground to finish the week at 1.0330.
- Cable had a phenomenal week ascending continuously from 1.5850 to 1.61 as we write. Surging retail sales bolstered the GBP with positive data earlier in the week, Jobless claims revised down and actual coming in much better than expected. The BOE also voted 8-1 on asset purchases to lend support to GBP.
- This week saw the BRL come into focus again, cutting the Selic rate by 0.75% to 9.0%. Resulting in a steep sell off in the BRL, having been trading between 1.82/1.83 for over a month, the BRL dropped to 1.89 by close of trading yesterday. It looks like the Brazilian methodology of slowing the fast money flows had its desired effect!
- The South African Rand, however, surged on Tuesday after being included in the CITI global bond index. The 10 Year bond yield dropped 21 Bps meaning the currency rallied from 8.00 to 7.80 in a matter of hours.

Fixed Income

- US Treasury yields fell this week as worse than expected jobless claims figures investors into safer assets, with Net TIC flows the highest since March 11 and prior to that September/November 08! As a result, the US 30-year dropped 2 Bps to 3.12%, 10-year dropped 4 Bps to 1.96% and the 2-year yields fell by 2 bps to 0.262%.
- On the European front, Italian bonds rose steadily through to Wednesday, but again have sharply sold off seeing the yields trading to 5.7% from a low of 5.48% earlier in the week.
- This week's top news from a European perspective was from France. Rumours circulated about another downgrade, the real possibility of Hollande being elected and the result… the widest spread over German Bunds since Jan 11 and a yield breaching 3.17% on the OAT. Our fear here is that France continues to slide and that yields are soon above 4%. Vive La France… at least until Sunday!
- After last week's onslaught on the Spanish bonds, we saw some respite early in the week with rates falling to 5.83% on news that there seemed to be enough domestic demand for their

debt allowing printing of 2.5Bn EUR, but at a 40Bps penalty to the previous prints at 5.7%. However, we are now over 6% and reaching the levels that saw both Ireland and Greece in need of their respective bailouts. It appears that El Toro Rojo is no longer supporting the Spanish debt burden.

- Both Italy and Spain are still struggling to reduce their deficits and debts while also trying to stimulate stagnant growth. Italy in fact reduced its target on inflation today but increased its growth targets, how will this be attained was yet to be included in the report though.
- US reigned supreme this week with Sovereigns, Corporates and HY as the best performers (+0.41%, +0.60% and 0.39% respectively). While the worst performer was EU Government bonds with -0.33% performance, only a muted positive return for the rest of the bond universe.

Equities

- Developed equity markets were slightly positive this week, with the MSCI gaining 0.74% as of yesterday's close, as growing fears regarding Europe's debt crisis and softer than-expected economic data were mitigated by some strong US corporate earnings.
- European equities were down this week, with the EuroStoxx 50 retreating by 0.68% mainly on renewed tensions around Spain deficit issues and on the looming French election. The Index is losing over 8% so far this month. Despite Spain's bond auction saw good demand on Tuesday and Thursday, the IBEX 35 lost close to 5% over the week – bringing losses to almost 14% this month – as it remains the country to watch given its size and the steady deterioration in both its banking system and its economic situation.
- US stocks rose by 0.49% this week as higher than forecast jobless claims and concern over Europe's debt crisis were offset by better than expected earnings from companies including Bank of America and Morgan Stanley. The S&P 500 has gained close to 10% in 2012, boosted by better than estimated economic and corporate data.
- Meanwhile, the Nikkei lost 0.80% on a weak lead from developed marketplaces, but an easing yen helped soothe jitters despite a deteriorating situation in Europe.
- In terms of sectors, Consumer Staples and Healthcare stocks were the leaders this week, while Information Technology and Consumer Discretionary lagged. IT and Consumer Discretionary are still the best performers so far this year. Outperformance of these sectors is due to investors' risk-on approach during Q1, favouring high beta segments. However, the incredible run experienced by these stocks is fragile and could fade away anytime soon.
- Markets' attention is still highly focused on European debt jitters. Now, with "whispers" of a French sovereign debt downgrade and socialists set to win presidential election, we only see markets becoming more nervous. While some correction remains in view, we still 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 slightly declined this week, losing 0.29% as measured by the MSCI EM Index. EM Equities started the week on a negative tone on European debt jitters, but then rose for two consecutive days after the International Monetary Fund raised its global growth forecast and on speculation China and Brazil will act to boost growth.

- The worst performing region was Latin America, down by 1.11% as measured by the corresponding MSCI index, followed by Emerging Europe (-0.34%) and Asia (-0.19%).
- The Shanghai Composite surged this week, up by 2.02%. Chinese stocks rallied on reports policy makers in Beijing may ease monetary policy to support economic growth. A cut in lenders' reserve-requirement ratios may be a first option.
- Meanwhile, the Brazilian Bovespa gained 0.80% on the back of the cut in the Selic rate by 0.75%. This shows the commitment of the Brazilian authorities not to let growth falter and to act in order to weaken the currency to help exporters.

Commodities

- Commodities slumped this week, losing 2.13% as measured by the S&P GSCI broad commodity index. As usual, performance varied quite strongly by type of commodity.
- Agriculture was the biggest decliner this week, down by 2.76% followed by Industrial metals (-2.15%) as signs of slowing growth damped sentiment.
- Gold lost 1% this week, currently trading around $1'641 an ounce. Gold dropped with equities, on concern that Europe's struggle to contain its debt crisis and softer than expected US economic data may dim the global growth outlook. Gold may fall around $1,600 an ounce as precious metals enter a "weak patch" in the short term. Physical bullion demand typically fades after February following the wedding season in India and Lunar New Year in China, both countries being the largest consumers.
- Crude Oil modestly rose this week (0.28%), currently trading at $103.10 a barrel. Oil fell as low as $100.70 on Tuesday as API reported an increase in stockpiles, as well as renewed worries on the EU debt crisis. Crude has slid from $110 last month as tensions eased over Iran's nuclear program. Negotiators from Iran and six world powers met last week and agreed to meet again in May.
- 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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