Bedrock Newsletter

Friday, May 11th 2012

We started the week under the shadow of French presidential and Greek parliamentary elections. The fears that France turn Socialist was realized with Hollande winning (with a small margin), whilst Greece couldn't sort itself out, showing ambiguous results. The latter included a frightening 7% vote for the Nazis. Will Germany maintain its support under these conditions?

Last week we quoted from Churchill: "*Socialists are like Christopher Columbus - When they leave port they don't know where they are heading and then, when they get there, they don't know where they are"* and received from a reader the next part of this quote *"but they don't care, it is not with their money..."*

To our astonishment, the markets didn't collapse! The French CAC 40 actually rose by 3% or so. Well, Tuesday was the awakening and markets fell harshly as did oil and gold and the US Dollar rose. Greek equities fell to their previous low of 1992, a twenty year fallback! The VIX or the "fear index" rose by 7% in American trading as louder talk of Greek default and subsequent exit from Europe permeated the system. The "talk" developed such hypothesis to suggest that if Greece does it, then why wouldn't Ireland, Portugal and Spain follow suit? Scary indeed and markets returned to risk-off mode.

Strange movements in the US markets with large drops in the early hours, followed by fast rallies into the close on both Tuesday and Wednesday: Some were saying that retail was selling and the pros came in to buy.

Then we heard that Bank of America is offering significant help to bad debtors. Up to $150'000 write-downs of mortgages to those who have not been paying their debts. Rewarding people for not meeting their commitments is a moral hazard! Being a bad credit used to be a stigma. This action makes it a wise move! Not paying is rewarded… Is the world evolving new social norms? To think that many revere the American way… or are they simply the best address in a bad neighbourhood?

As the week evolved, China gave us a trade surplus of $18Bn for April, up from the $5Bn we were shown for March. The markets fell further as behind this number we could identify a slowdown in imports and exports. Maybe this oriental motor is stalling? Well US Jobless Claims are slowing, perhaps reaffirming that the US economy is slowly improving after all? We all have been told that rising oil prices act on the economy as a tax hike. Worse than taxes though, as the monies taken from the people are not redistributed within the same economy. So now, with oil prices falling into rising natural gas prices we should see a re-boot, like a tax cut? Let's hope so…

Well, talking about taxes, the attention is starting to focus on the "US Tax Cliff" due in early 2013 as tax breaks expire unless Congress does something and soon… Imagine what dividend tax rates rising from 15% to 43% might do to valuations? And what will happen to the retirees and pension funds which loaded-up on high dividend yielding equities. Baby Boomers? How about Baby Boomed?

We woke up today to a new bombshell: JP Morgan Chase, the darling of the banking industry just uncovered a $2 billion loss in its hedging activities. Maybe even another 1Bn, they don't really know… Egg on Jamie Dimon's otherwise shiny face? Perhaps we should worry not about "Too Big to Fail" issues but about "Too Big To Manage" questions?

We wish you a well-managed weekend!

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Currencies

- As stated last week, there was a sensation that perhaps the market was turning. It appears to have played out that way. EURUSD finally broke the 1.30, dropping heavily from 1.3110 to 1.2955 on Monday on the realisation of Hollande as the new French President. There was a short respite back above 1.30 only to see the EUR slide for the rest of the week to 1.2905. Negativity about the Euro Zone abounds, and now the market seems to take notice by simply selling the facts.
- We also recommended buying put options on the EUR at the end of last week. On top the EUR going down, 1M vol jumped on Monday an enormous 25% and settled at a 12% increase since last Friday.
- USDCHF again mirrored EURUSD and traded up from 0.9170 to 0.9305, reaching the bottom of the short term target we mentioned last week. EURCHF is still unchanged at 1.2010 and remains in its 5 pip range of 1.2010-1.2015.
- The Yen strengthened this week, rallying from 80.10 through to a low of 79.40 on Wednesday. Only to slide back a little at 79.85 this morning. The comfort zone in the market seems to be oscillating around the 80.00 figure. The BOJ will soon need to see the JPY weaken for the policy actions to be given credibility, otherwise the economy could enter another lost decade.
- Again the Aussie had a tough week with AUD falling in line with USD strength. AUD slipped from 1.0230 to 1.0015. For all intents and purposes the AUD and the USD are trading at parity for the first time in 2012 and with more cuts tabled for the RBA we are not positive on the AUD.
- GBP was side-lined this week and traded in quite a tight range between 1.6180 and 1.6120, with the exception of a quick drop to 1.6060 that saw it back within the range by the end of the UK trading day. GBP seems to be trading fairly resiliently at the moment and although not the safe haven currency as the USD, it does seem to be exhibiting surprising strength.
- In the general USD bull mode (DXY rallying from 79.60 to 80.30) some of the EM currency slipped as expected. USDBRL moved even higher to reach 1.9700, a figure not seen since July 2009. USDZAR saw a large move up from 7.80 right up to 8.10.

Fixed Income

- US Treasury yields had a bumpy ride this week with very little to show for it at the end. For the week, US 30-year dropped 3 bps to 3.036%, 10-year lost 2 bps at 1.862% while 2-year yields remained the same at 0.258%.
- On the European front, although Sunday's Socialists' victory at French elections, OATs stood surprisingly still, dropping by only 1 basis point at 2.797%.
- On the other hand, Spanish yields surged by 25 bps at 5.935%. Concerns about Spain's ballooning budget gap and the health of its banks have propelled the recession-mired country to the forefront of the euro zone sovereign debt crisis in recent weeks. The cost of borrowing Spanish government debt has doubled in the past three months.
- After Spain, Italy remains many investors' biggest concern in Europe because of its huge debt, culminating at 120 percent of the country's GDP. As a result, yields on the ten-year bond spiked by 5 bps to 5.454%.

- Meanwhile, Greek yields surged by 345 bps to 23.33%, as the nation's leaders struggled to form a new government amid speculation they may decide to withdraw the nation from the single currency bloc.
- With such rumours, a tone of risk off is increasingly creeping back into the markets. The Greeks have not managed to stabilise the domestic growth slide and with the ability to weaken their currency, the call for them to leave shall only get stronger.
- Higher yielding securities experienced the biggest losses this week, with Convertibles dropping by 1.40% while EM Debt and European High Yield bonds lost 0.47% and 0.32% respectively. On the other hand, US and EU Sovereigns rose the most (+0.29% and +0.31% respectively) while Corporates stood still. On a year-to-date basis, European High Yield saw an increase of 12.29% so far and remains the top performing fixed income sector.

Equities

- Developed equity markets fell for the week, with the MSCI losing 1.58% as of yesterday's close, as risk aversion escalated on political uncertainty in the Euro region. Socialist candidate Francois Hollande claiming victory in France and Greece unable to form a government, have raised fears over the region's stability. Further losses occurred in today's overnight session as JP Morgan has revealed a loss of $2Bn on trades by its CIO office.
- The EuroStoxx 50 dropped 1.06% for the week. For the first time, an ECB executive board member has raised the possibility of Greece exiting the Euro, as the latter's left-wing party leader called to abort the austerity program. However, some losses were recovered on Wednesday where the board of the EFSF have agreed to release a scheduled payment to Greece so they can meet their near term obligations.
- The S&P 500 dropped by 2.41% and the Nasdaq by 3% to the lowest level in a month, as headwinds from Europe outweighed a drop in jobless claims.
- The Nikkei lost as much as 4.55%, mostly due to Japanese equities catching up on last week's losses where Japanese markets were closed. Further, Japan's current account surplus shrinking, and strengthening of the Yen weighed on the markets.
- In terms of sectors, Materials and industrials were the worst performers this week (--2.84% and -2.37% respectively) on weak Chinese data. Telecoms and Utility were the best performers (+0.45% and +0.17% respectively).

Emerging Markets

- Emerging Markets dropped by 3.19% as measured by the MSCI EM Index. EM stocks are paring YTD gains vs. their developed counterparts with the index up by 7.02% compared to +5.28% for developed equities.
- The worst performing region was Asia, down by 3.60%% as measured by the corresponding MSCI index, followed by Latin America (-2.94%) and Emerging Europe (-1.16%).
- The Shanghai Composite fell by 2.33% during the week. Growth fears due to weak Chinese trade data outweighed an ease in inflation data (3.4% for April vs. 3.6% in March). Chinese exports rose only 4.9% in April (8.5% expected) as economic slowdown in Europe curbs exports.

- The Brazilian Bovespa dropped 3.87% for the week to the lowest level since January. More than 50% of the Brazilian companies who have so far reported earnings, have trailed estimates. As a result, some of the index constituents have reached multi-year lows. Additionally, Brazilian markets were weighed as Consumer Prices rose more than expected.

Commodities

- Commodities slumped by 3.30% this week as measured by the S&P GSCI broad commodity index. As usual, performance varied quite a lot across sectors.
- Energy lost the most this week, down by 3.83% followed by Agriculture (-2.79%), while Industrial Metals (-1.41%) fared better.
- Gold fell by as much as 3.80% this week (currently trading around $1’577 an ounce), reaching a four month low. The deepening European debt crisis drove investors to the greenback and gold continues to trade in the same direction as riskier assets. However, we believe that Gold will not drop much further and that a substantial rebound could be in the cards soon.
- Meanwhile, Crude Oil fell 2.66% – currently trading at $96 a barrel – and is heading for a second weekly decline. Lower than expected demand as well as an increase in supplies drove prices downward. OPEC has been reported to produce more oil during April than the ceiling level that was set earlier in the year. We also believe that the weakness in oil prices should be over and that the uptrend will restart soon.
- 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.
