Bedrock Newsletter

Friday, May 25th 2012

Shaken, not stirred… Up and down our markets go… Like Escher's staircases we go up and down and end where we started. Last Friday we witnessed the huge mess of the Facebook IPO. The underwriters gave inconsistent information to various investors, the NASDAQ couldn't handle the opening and arguably the greatest IPO of the year disappointed with a dramatic fall on the Monday. The indices rose strongly though…
We could argue that the underwiters (Morgan Stanley) did a great job for their client, Facebook- raising $38 per share when the market actually values it at $32. Investors buying into the expected "pop-up" were disappointed, some to the point of suing Morgan and Facebook and the NASDAQ exchange. Looking at this with our eyes we congratulate Morgan for the acute pricing and marketing… We never quite agreed with the applause granted to underwriters which bring an IPO to market and realizing a huge gain to investors immediately thereafter- For us, an IPO that "pops" 20% means that the underwriter robbed the issuer…

We started the week with a Fitch downgrade of Japan, with US bonds of all sorts continuing to rally- 9 weeks running now with 10 year yields falling to 1.76% on Monday, French 10 year bonds now yielding 2.47% (with a Socialist President!?) and Germany at 1.40%. We even saw a German 2 year note auction this week, offered as a zero coupon note. It was oversubscribed to yield naught point nothing or thereabouts… We wonder at the logic here; these bonds are clearly bought as a preservation of value, but they are denominated in Euros… The latter falling to 1.2510 against the US$, a first since 2010 - this move being driven by a growing apprehension of a Greek exit from the European Union. Now THAT is an oxymoron, European Union…

Gold and oil continued their slide into the "risk off" mode. The same two assets which had been the escape from risk have suddenly become risk in themselves. Actually, Gold in Swiss Franc terms has remained stable over the past two weeks. So it is a US$ move up. We wonder how much more energy can be held in the Greenback, which has a deficit of 8% or so (double the Euro-zone), a huge trade deficit (the Euro-zone is flat) and an impossible fiscal cliff ahead (January).

Our attention is drawn and concentrated on Greece and its potential contagion of countries falling off the European continent. For too long we have been distracted by an American spelling mistake- talk of "too big to fail" should have read "two big to fail"- Will Spain and Italy fall with Greece? THAT is the question…
The Greeks will be holding new elections in an attempt to establish a government which will then be faced with their own "to be or not to be" question. The problem is that each of the Greek Parties is an idealist and as some cynics might suggest, Idealists don't know where they are going but they are on their way! We suggest that the situation is much like our family dinners where we have two choices: take it or leave it…

The good news is that we now have a long weekend without markets to spoil the sunshine!

Currencies

- In the two weeks since we last wrote, EURUSD has slipped 200 points each week, moving from 1.2960 to 1.2540. In a general Risk-Off environment, the weakness in the Eurozone, Greek bailout/exit rumours and poor CPI and manufacturing data from Germany we have seen USD demand skyrocket. The USD trade weighted index moving steadily from 79.75 to a peak of 82.41.
- USDCHF mirrored EURUSD and traded up from 0.93 to 0.96, reaching the top of the short term target we mentioned a few weeks ago. However, with noises/rumours from the SNB that there may be a tax on CHF deposits, EURCHF had a huge move, rallying from 1.2010 to 1.2080 in a matter of minutes only to trade back down to 1.2020 overnight. A storm in a teacup, but it highlights how volatile this pair could become after being so constrained over the last few months… in BOTH directions if the barrier were to be breached.
- In light of the USD demand, the BOJ would have hoped that the JPY would weaken. They have been disappointed, post Philly Fed last week the USD dropped heavily from 80.50 to 79.20. The Yen has traded in a relatively tight range outside of the big move from 79.40 to 79.80. The BOJ will need to see the JPY decidedly weaker for the policy actions to be given credibility; otherwise the economy could enter another lost decade.
- Again the Aussie had a tough couple of weeks with AUD falling in line with USD strength. AUD slipped further from 1.0050 to 0.9750. This is not a pretty picture for the AUD and with more cuts tabled by the RBA we are not positive on the AUD.
- GBP no longer has its “surprising strength” we have mentioned before. It has slid unceremoniously from 1.61 to 1.5650 in a straight line against the USD and has been stuck in a range against the EUR just above 0.8040.
- In the general USD bull mode some of the EM currency slipped as expected… some more than others! USDBRL moved even higher, punching right up to 2.10 only to see it slide back to 2.03, a figure not seen in over 3 years. USDZAR saw a move up from 8.10 to 8.46 and is settling around 8.33.

Fixed Income

- US Treasury yields have shrunk and flattened over the past two weeks. For the week, US 30-year dropped 15 bps from 3.01% to 2.86% (having dropped as low as 2.77%); 10-year lost 13 bps moving from 1.90% to 1.862% while 2-year yields moved UP 4 Bps from 0.258% to 0.30%.
- On the European front, the French OATs rallied heavily as the world seems to have ignored the Socialist State that France has become with yields dropping from 2.97% to 2.43% to trade around 2.47% now.
- Spain unfortunately has not been ignored and the yields are sitting comfortably above 6% peaking at 6.34%. Spanish banks are still struggling; however a large amount of the sovereign debt seems to be contained within the Spanish banking system according to the analysts – the same ones who believed there would be no knock-on effect from the US mortgage market.
- Italy is still at the forefront of the markets’ worries; follow Spain tightly on its heels. The 10 Year Italian bonds actually having touched 5.87% but have marginally strengthened to 5.54% by the end of the week… still not good.

- Greece is still in a tailspin, no government and no direction and the IMF no longer guaranteeing to fund the interest payments. The yields on the 10 year are now soaring back above 30%. We await the elections to be further disappointed by Greece. However the calls to leave the Euro are now being heralded from the global rooftops.
- Higher yielding securities have been the best performer of the year so far with +9.46% in Europe and 4.92% in the US. With European Corporates fairing just better than US High Yield at 5.74%.

Equities

- Developed equity markets rose this week, with the MSCI advancing by 1.11% as of yesterday's close. Equities swung between gains and losses on political uncertainty in Europe, especially regarding a potential Greek exit from the Eurozone, but were supported by encouraging data from the US.
- The EuroStoxx 50 surprisingly gained 1.18% for the week, even though manufacturing in Germany and China indicated Europe's debt turmoil is curbing growth after leaders failed to agree on steps to contain the crisis.
- The S&P 500 surged by 1.97% as jobless claims dipped, indicating the recovery remained resilient even though headwinds from Europe cut into US factory activity growth this month. US equities were also supported by strong earnings released by a few large cap players.
- Meanwhile, the Nikkei lost 0.36%, on concern European leaders won't be able to keep Greece from exiting the monetary union and on Yen strengthening. The Nikkei has fallen 16.5% since hitting a one-year peak on March 27 on worries over slowing global growth and a deepening Euro zone crisis.
- In terms of sectors, Materials and Industrials saw the biggest gains this week (1.88% and 1.83% respectively) while other high beta sectors such as Energy, Info Tech and Consumer Discretionary also rose strongly. On the other hand, defensive sectors such as Consumer Staples and Health Care only rose modestly (+0.24% and +0.35% respectively).
- However, markets should soon move downwards again for a relatively extended period, as several European countries – besides peripheral ones – already tumbled into recession, including Britain and Netherlands, while recent economic indicators have shown that China's days of consistent double-digit growth have come to an end.

Emerging Markets

- Emerging Markets dropped by 0.50% as measured by the MSCI EM Index. EM stocks now underperform their developed counterparts on a year-to-date basis, with the index down by 1.56% compared to +0.75% for developed equities.
- The worst performing region were Latin America and EM Europe, down both by about 1% as measured by the corresponding MSCI index, followed by Asia (-0.33%).
- The Shanghai Composite dropped by 0.52% during the week. Most Chinese stocks fell on concern bank lending is slumping and business conditions are deteriorating, putting pressure on the government to ease monetary policy to avert a deeper economic slowdown.

- The Brazilian Bovespa surged on Monday, before erasing its advance during three consecutive days, closing flat for the week. The selloff was led by consumer stocks on mounting concerns that a deeper global slowdown will curb growth in Brazil and as preliminary reading showing manufacturing activity in China shrank further in May also weighed on sentiment.

Commodities

- Commodities fell 1.88% this week as measured by the S&P GSCI broad commodity index. Commodity prices dropped across the board as investors once again resorted to the USD as a safe haven currency.
- Agriculture lost the most this week, down by 4.23% followed by Energy (-1.57%), while Industrial Metals (-0.88%) fared better.
- Gold fell by 2.04% this week against the USD (currently trading around $1'566 an ounce), however remained flat against the EUR. Gold lost ground as fears over the lack of progression in the Euro-zone dominated the market. Gold prices were slightly supported as the Central Banks were reported to have boosted gold reserves during April, but the main move was a USD one.
- Meanwhile, Crude Oil fell 0.70% – currently trading at $91.20 a barrel – as Euro-zone fears remained and US supplies increased to a 22 year high. Crude prices rebounded on Thursday as Iran's nuclear tension resurfaced due to lack of progress in talks with the world powers in Baghdad.
- 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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