Bedrock Newsletter

Friday, June 8th 2012

It has been a strange week, but then again, this is becoming the norm! Last Friday June 1st was a painful day for equities. We were all surprised but, In 4 of last 5 years June 1 had been a big down day…
Monday morning saw Japan's TOPIX hit a 28 year low as a follow-up then the newest rating agency Egan-Jones downgraded the UK to AA- from AA. Only to then downgrade Italy to B+ from BB. Not a happy tone for the week…
Not to be outdone by the newcomer, Fitch downgraded Spain by 3 (!) notches to BBB on Thursday. But they (Spain) successfully auctioned 2 billion Euros worth of bonds that same day. Even China did something strange- they unexpectedly cut interest rates by 0.25% Are they experiencing a faster slowdown in growth than we know of? Or is it that their inflation rate has decreased to reasonable levels?
This news added oil to the broad and powerful equity markets' rally of Wednesday. Or was that only a "Dead Cat Bounce"? This being an expression we last saw in the late 90's…

We learned a few interesting things this week. The ECB has a balance sheet which is bigger than the Fed's and then The Peoples' Bank of China is larger by 50% again.
With this information on hand, it may be easier to understand Ben Bernanke's words in his Thursday testimony which didn't bring forth much hope for QE (III).
What is his problem? Didn't the UK just celebrate with smiles and happiness QE (60)???
Well, maybe it is that monetary policies alone cannot awaken the economy. As we had discussed in the past, very low interest-rates have some negative side effects; from low returns on savings and other retirement portfolios hurting spending capacity of a growing part of the population, very low rates distort economics and choice of efficient projects. And worst of all, when confidence is low there is little demand for leverage even at low costs a problem further compounded with lenders reluctant to advance funds at low returns to themselves.

Both the Fed and the ECB have been raising the tone about required government action on the fiscal side. They should be screaming this again and again- The European leaders can't hear through the Socialist noises arising all around them, the American counterparts can't hear through the fanfare of their upcoming elections. With some luck the Central Bankers' message will come through into 2013.

We also learned this week that fully 35% of all mammal species' on this planet at risk of extinction due to global warming and pollution. In our own corner of the universe we have seen evidence of this sad situation- There are no more bulls around and few bears. We think that everyone has turned into chicken! Clearly, the lack of visibility has attenuated much of the upside expectations and the occasional market "pops" have damaged the hibernating bears. We are all afraid of the next "Breaking News".

Arguably, the equity markets are discounting a reduced earnings' outlook at the same time as bond markets are discounting any inflation risks to zero or below. Is the World facing a big slowdown? Deflation? We would much like to see a global "Marshall Plan"- Say to be led by the World Bank which could issue 30 year bonds in gazillion Dollars' worth, at a carry-cost of under 3% (currently yielding 2.70%)
The proceeds of such an issue should be used to buy mortgage loans from troubled banks and even outright investments in existing housing units around the globe.
What a pleasant dream for the weekend…

Currencies

- Whispers had been circulating again of QE3. With China cutting rates, the Risk-On mode returned and saw EURUSD retrace some of its losses. The EUR moved up from 1.24 to 1.26, only to be knocked back when The Bernanke spoke yesterday and did not confirm outright there would be a policy intervention. There seems to be resistance on The Hill for another FED intervention. Will the Bazooka be wielded again is the question of the moment.
- USDCHF moved in lock step again and saw some of the weakness in the CHF be recouped only to weaken again when the EUR slipped with Bernanke's commentary.
- Finally the JPY enjoyed a little weakness, seeing the USDJPY rise from 78.00 to 79.80 over the week. The Japanese Finance Minister voiced concern with his G7 counterparts on the negative effects of a strong JPY, and reiterated that he will not let that situation continue, hence the ensuing weakness. The JPY needs to weaken – and materially so – over the coming months.
- The Aussie had another short respite at the beginning of the week, rising smartly from 0.9650 to 1.00, also on the back of a very strong GDP report as well as much higher employment figures. However, since risk has been taken off the table today we are seeing it weaken again back to 0.9830.
- GBP recovered slightly after the onslaught of the last few weeks trading up from 1.5320 to 1.56. But today has seen a general Risk-Off mode and GBP has weakened back to 1.5410 after inflation figures released were on the soft side, thereby ensuring low rates for months to come.
- After last week's moves in USDBRL, this week has been quiet with 2.0350 being the mean. The ZAR had a volatile week, seeing the USDZAR pair move down from 8.60 to 8.25, only to see it back up to 8.50 today on a risk off environment.

Fixed Income

- After the blow out on yields this week the term structure has risen. For the week, US 30-year rose 15 bps from 2.52% to 2.67%; 10-year rose 14 bps moving from 1.45% to 1.59% and even 2-year yields rose 2.5 bps from 0.24% to 0.2650%.
- On the European front, the French OATs dropped just as heavily this week as they rallied last week with yields soaring from 2.25% to 2.6%. The movement from the periphery to the central European debt is still the core positioning within Europe though. Although, even the Bund weakened from 1.20% to 1.31%.
- Spain had a better week, auctioning most of the necessary bonds with an average Bid to cover of about 3 times. With the positive rebound in the markets, helping to bring the 10 borrow costs down from 6.43% to 6.13%.
- Italy unfortunately bucked the trend and the yields – although much reduced from the dreaded 6% - did rise again from 5.62% to 5.75%.
- The best performer in the credit space was EU Government, with +0.78% for the week. A very mixed week with US Leveraged Loans coming off worst at -0.87%. Generally for the year EU high yield is still above 9%, with Europe still outperforming the US for the year.

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Equities

- Developed equity markets surged in the middle part of the week, with the MSCI advancing by 2.2% as of yesterday's close. Equities rose as the surprise move by China's Central Bank to cut benchmark interest rates by 25 basis points to shore up slackening economic growth came a day after hopes of more stimulus by central banks drove World Indices in a sharp turnaround from recent heavy losses.
- However, the fact that Fed's Chairman Bernanke did not say anything explicit about further stimulus dampened the tentative rebound and sent stocks back down...
- The EuroStoxx 50 leaped 4.4% for the week as of Thursday close, on hopes policymakers will take action to boost flagging global growth. Market sentiment was also helped by Spain, which met strong demand when it sold 2.1 billion Euros of medium- and long-term bonds, passing a key test of its ability to tap investors.
- Meanwhile, the Nikkei which had advanced by 1.14%, on speculation that euro zone leaders would take policy action to curb the spread of the region's debt crisis, and with a softer yen lending additional support, finished the week down on dashed hopes on immediate further stimulus by the Fed.
- We believe that a major psychological hurdle remains to be cleared in the next 10 days (the result of the Greek election and its remaining in the Euro Zone or not), and until then, markets will remain volatile and on the edge. But we believe that with all Central Banks in the world reducing interest rates further and adding stimulus (as was the case with China yesterday), equities remain a good investment for the medium to long term
- We remain constructive on equities on a medium/long-term timeframe, as equity valuations are cheap and companies continue to report strong earnings, with large cash reserves at their disposal. Due to the current market turbulence we favour high dividend paying and defensive stocks (with the S&P 500 average dividend yield currently at 2.18% compared to 1.65% on the US 10 year treasury...).

Emerging Markets

- Emerging Markets rose by 0.97% (as of Thursday) as measured by the MSCI EM, underperforming their developed counterparts, driven down by Asia poor momentum, even in the face of China's interest rate cut.
- The best performing region was Emerging Europe followed by Latin America (+4.77% and +2.43% respectively), while the worst performing region was Emerging Asia, down 0.56%.
- The Shanghai Composite ended lower this week, ignoring strong gains in US and European markets overnight as concerns about the domestic economic slowdown continued to dominate.
- Emerging Market currencies, such as the Brazilian Real and the South African ZAR, rebounded sharply this week, as risk on was fashionable again. This shows also how quickly market participants can change their minds and how market moves can be very violent in a very short span of time.

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Commodities

- Commodities rose this week until Thursday, only to reverse course after Bernanke's testimony in Congress failed to confirm further stimulus measures.
- Energy is still the most negative sector year-to-date, down almost 11%.
- Gold, which had risen smartly in the past few sessions, dropped again on Thursday after Bernanke refrained from discussing steps the Central Bank might take to bolster the economy.
- Gold dropped this week (trading around $1'570/ounce) after posting its biggest one-day rise in more than three years last Friday after disappointing US jobs data reignited speculation that the Fed would unleash another round of monetary easing.
- Meanwhile, Crude Oil climbed for four consecutive days, up to $86.50, before also reversing course and going back to the lows – currently trading at $82.50 a barrel – again on the back of Bernanke's lack of news.
- We believe that with all Central banks keeping short term interest rates either at 0 or near o, and with the 2 major EM Central Banks reducing interest rates further (China and Brazil), real assets like Gold and Oil will only be moving up in the medium to long term. Moreover, we are convinced that with every country trying to lower the value of its currency, Gold and Oil as real assets will benefit.
- As such we maintain our allocations to both Gold and Oil.
