Bedrock Newsletter

Friday, June 15th 2012

The week is winding down into the Greek elections. Such a small country and yet, seems to be controlling the fate of so many and of so much. The outcome is binary- will Greece depart from the Union or remain. The outcome does not assure a result though as either vote will generate many possible outcomes thereafter.

Late Thursday a rumor circulated that the main central banks are preparing a coordinated intervention which would provide a wave of liquidity. US markets shot up (200 DJIA points) only to fade back some as the thought was digested. Somehow the markets have convinced themselves that if the Greek vote will be perceived as being "bad" then the said bankers will make it good. Either ways, the markets will rise on Monday. Maybe…

On Thursday Moody's cut Spain's rating by 3 notches to Baa3 and Cyprus by 2 to Ba3. Hardly news we say. Away from the Mediterranean we saw that the US has moderate CPI and PPI data, removing any lingering concerns about inflation, so maybe the Fed will embark on QE(III)? More American data fed our anxieties- The US government posted a budget deficit of $125 billion in May, more than twice the level registered in the same month last year. So far this fiscal year, the budget deficit stands at $844.5 billion, narrower than at the same time a year ago.

Then the Fed published some upsetting data about the state of the American people- Median family income fell to $45,800 in 2010 (it had been about $50'000 in 1986!) and that the same "Median Family" had a net worth of $77,300 in 2010, compared with $126,400 in 2007- The richest nation on the planet is getting to be less rich in absolute terms and as the Emerging masses are gaining both income and in capital, the relative economic strength is declining fast…
Jamie Dimon was grilled by a Senate Committee about the trading loss at JP Morgan Chase. All that was gained was TV time for some Senators. We were not surprised; It only reinforced our belief that a Committee is best defined as a group that keeps minutes and loses hours…

Let's try and read the markets and form a view on the state of the future; Equity markets are telling us with their declines that the expected future is one of slower growth than was expected just recently. We note that the bond markets show a deflationary outlook as well- yields on ten year high grade debt is hovering below 2% everywhere. Historically these instruments had returns of 3 percentage points above inflation, so "reverse thinking" suggests that the expected inflation is negative, 1 to 2%... this view strengthens the reluctance to buy and own equities which are considered inflation hedges. Scary scenarios are built and priced into valuations, or so it seems.

The flip side can be found in some resulting silly numbers:

- The market cap of the Italian Financial sector is now the same as the market cap of Colgate-Palmolive ($47bn).
- The market cap of Portugese equities ($16.4bn) is the same as that of Whole Foods, the 191st largest stock in the S&P 500.
- The market cap of Greece equities ($5.8bn) is the same as that of TripAdvisor, the 400th largest company in the S&P 500.

We remember the "good old days" when the Berlin Wall came tumbling down. At that time, the market capitalization of Russia which included about 30% of the then known oil reserves of the world was less than that of Coca Cola ($100Bn at the time). That was a silly level too…The Bond markets are being silly too: Dutch 10 year yields are at a 500 year low (1.61%), German 10 year at a 200 year low (1.20%), France at a 260 year low (2.36%). If it wasn't scary, these valuations seem comical! We leave for a warm and sunny weekend with the thought that comedy is simply a funny way of being serious ☺

Currencies

- Gapping higher on Monday with the Spanish Bank bailout of €100Bn EUR, EURUSD opened at 1.2640. Initially, EURUSD moved from 1.2650 to a low of 1.2450, only to see it rally back to where we started the week at 1.2650. We had positive USD figures on Monday with higher small business optimism, only to see PPI drop more than expected and Initial Jobless numbers much weaker than expected. And on the EUR side, Eurozone production "less bad" than expected, CPI inline and Labour costs lower than expected. The Spanish Bank bailout is all but forgotten now as it will not fully address the systemic risks in the economy.
- This week, SNB's Jordan reiterated the minimum exchange rate will be maintained with the utmost determination. This time they added that the SNB "stands ready to take further measures". The CHF was relatively unchanged, being fixed to the EUR at 1.20, and the USDCHF simply a function of EURUSD. We will need a concerted market move on the currency to see a change in trading patterns.
- The JPY had a relatively quiet week against the USD trading around 79.50 until the BOJ's Shirakawa and Nakao spoke today. Unfortunately, not in the direction the BOJ would like with no further rhetoric on how to weaken the Yen in the speeches. Keeping the policy unchanged, the JPY has strengthened seeing USDJPY drop to 78.80.
- GBP was range bound this week trading between 1.5580 and 1.5480. However, any strength the GBP was showing disappeared when BOE's King spoke last night. He has said the Bank is ready to offer support to the economy. The first steps are monthly auctions of "Extended Collateral Facilities" in unlimited amounts. This surely leaves the door open for more QE at the July meeting, another £50Bn perhaps?
- The Aussie was quiet this week trading around 0.9950, finishing the week on the highs at 1.0030. The AUD having been supported by the temporary positive market mood and the BOJ comments this morning.
- After the last few weeks major moves in BRL and ZAR, this week they have been very quiet. BRL essentially between 2.05 and 2.07 and ZAR trading between 8.45 and 8.35.

Fixed Income

- US yields gapped significantly on the Monday. Opening 12 Bps higher on the 10Yr and 30Yr, but short term paper was unchanged on Spanish bank bailout news. For the week, US 30-year dropped 14 bps from 2.85% to 2.71%; 10-year dropped 12 Bps moving from 1.72% to 1.60% and 2Yr yields rose 2.5 bps from 0.2650% to 0.29%. Essentially unchanged from the closing of last week except for the shorter term rates.
- On the European front, the French 10Yr OAT bonds dropped again this week. Yields rose from 2.55% to 2.65%, having peaked at 2.74% midweek. The movement from the periphery to the central European debt is still the core position within Europe. But with the weakening in the OATs, does this mean France is slipping to the periphery? The Bund weakened from 1.31% to 1.48% - meaning the spread over the German Bund compressed this week, so France maintains its status, for now.
- Spain should have seen a reduction in funding costs this week with a bailout package for the Banks at €100Bn; Unfortunately, the bells are tolling in the Spanish bond market. Yields soared this week after the expected package was smaller than needed - at less than half of

the required to save the Cajas – moving briskly from 6.37% to 6.80%. 7% is on the horizon, could this be the level that sees Spain lose access to the global debt markets?

- Italy also saw the yields slip this week; spending the majority of the week above 6%. We moved from 5.93% to 6.05%, but seem to be settling at 6% for the close of the week.
- A reasonably quiet week in the general world bond markets except for EU government which dropped a massive -1.55% on the week. The only outstanding performer this week was Global EM which rose 0.63%. On the year the EU HY is still the standout performer at +9.71% with Global EM the closest at +6.14%.

Equities

- Developed equity markets rallied for the week, with the MSCI gaining 0.60% as of yesterday's close. Global equities traded in a choppy fashion as fears over a potential Greek exit, post Sunday's elections, coupled with surging Spanish and Italian borrowing costs were offset by optimism over global monetary intervention.
- The EuroStoxx 50 rose 1.11% for the week. Gains from early in the week were quick to lose momentum as news of a Spanish bank bailout package of €100bn was shortly viewed by the market as insufficient to tame the EU debt crisis. Losses were covered on Thursday's trading session on reports on the Central banks set to collaborate on liquidity operations in the event of a credit shock after the Greek election.
- The S&P 500 gained 1.07% for the week. Weaker than expected retail sales and employment reports raised speculation that the Fed are likely to resume stimulus to support growth in the US.
- The Nikkei rallied 1.30%, as Japan's machinery orders jumped 5.7% (1.5% expected) and Japanese carmaker production rose to record output.
- In terms of sectors, Telecoms and Consumer Staples were the best performers (+2.28% and +1.46% respectively). Info Tech and Consumer Discretionary lost for the week (-0.73% and -0.30 respectively).
- We remain constructive on equities on a medium/long-term timeframe, as equity valuations are cheap (average P/E of 13.42 on the S&P) 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 defensive stocks.

Emerging Markets

- Emerging Markets rose 0.92% as measured by the MSCI EM as signs of a global slowdown raised hopes for policy makers to take action and provide stimulus.
- The best performing region was Emerging Europe followed by Emerging Asia (+1.55% and +1.31% respectively). The worst performing region was Latin America, down 0.27%.
- The Shanghai Composite rallied 1.08% during the week. Chinese exports rose more expected in May. However, Chinese inflation, industrial output and retails sales reports all signalled a second month of a slowdown in growth, raising hopes for additional stimulus measures.

- The Brazilian Bovespa rallied 2.21% as homebuilders and consumer stocks rallied on speculation that policy makers will reduce interest rates further to protect the Brazilian economy from the global slowdown.
- We are bullish on EM equities in the medium/long term as valuations are very attractive (P/E of 10.88 on the MSCI EM). However, in the short term these are the most vulnerable to the slowdown of the global growth.

Commodities

- Commodities fell by 1.18% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index, driven down by Agriculture (-2.09%), Industrial Metals (-1.18%) and Energy (-1.12%) while Precious Metals fared much better (+1.67%).
- Energy is still the most negative sector year-to-date, down over 12%, followed by Agriculture (-7.4%) and Industrial Metals (-4.3%).
- Gold is set to climb for a sixth day in the longest winning run since August on speculation central banks may take steps to buoy economies as Greece prepares for elections that may determine whether the country leaves the euro. Gold advanced by 1.75% this week currently trading around $1'624 an ounce.
- Meanwhile, Crude Oil fell until Wednesday, before bouncing back during two consecutive days on speculation that the US Federal Reserve may take more steps to stimulate the economy and on OPEC's call for members to cut production in excess of quotas. Oil rose by 2.25% this week, currently trading around $84.60 a barrel.
- We believe that with all Central Banks keeping short term interest rates around 0, and with China and Brazil reducing interest rates further, 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, and as such we maintain our allocations to both.

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