Bedrock Newsletter

Friday, June 22nd 2012

This past week was a busy one in terms of news. It started with a bang on Sunday night with the results of the Greek tragedy/election/saga which proved to be, at least temporarily, a relief for the markets. The Euro opened more than one big figure up above 1.27 to the US$ and world Equity markets rallied until… the Monday afternoon, where selling re-emerged from buyers who had (correctly) predicted a few days back a defeat of the Extreme Left and the Anti Europe Camp. Then we also had the results of the French Parliamentary elections (but who really cares about them now?) which also gave a comfortable majority for the Socialists to push their agenda for the next 5 years.

Then, on to Los Cabos and the G20 meeting, where frankly, there was no earth shattering news to speak about. There was the normal reassurance that the "world powers stand ready to act as appropriate" and emphasis was put to restore Growth and Confidence in the world economies.

Wednesday, Big Ben (Bernanke) gave a press conference following the decision by the Fed to do Twist 2 after QE2. Essentially, the Fed judged that the economic evidence was still blurry and that a small decision only was warranted; hence the extension by 6 months for "Operation Twist". The Market first reacted negatively on disappointment that there wasn't a larger stimulus program (addiction anyone?), only to reverse course and finish flat as participants realized that if no big change was implemented, maybe things weren't that bad after all?...
And finally, the big moves came on Thursday after the Philly Fed report (economic activity in the Philadelphia region) showed that manufacturing conditions weakened sharply in June. This, followed by Moody's announcement that it would downgrade 15 Western Banks (5 US, 1 Canadian, 2 Swiss, the rest in Germany, England and France), resulted in a big downfall in US equity indices yesterday. However, there was no big follow through in Asia last night and in Europe this morning.
Amid all this news intensive week, it is worth noting that for the Month to Date, major equity indices are all positive by between 1.5% to 5%...

So where does this all leave us? We think that the best thing is to continue keeping a very well diversified portfolio between Equities, Fixed Income, Hedge Funds and Commodities as we can see that despite all the volatility that we have seen, all these Asset Classes are still positive apart from the Commodities for the Year to Date. In terms of Currencies, we continue to favor the US$ in this still uncertain environment, coupled with some selected Emerging Market Currencies.
We also believe that after weeks of angst due to the possible Greek exit from the Euro, this possible outcome has been pushed back for a while and that most of the negative news has already been out. We saw the other day that 95% of market participants were bearish and negative for the future. Usually, this is a sign that a turn is near….

One final thought for the week end:
An ancient Greek once postulated that with a proper lever he could move the World. Did he mean leverage as we are seeing now?

Have a very nice and sunny week end.

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Currencies

- The Greeks voted, they continue to stay in the EUR, they continue to support austerity… BUT EURUSD after the initial euphoria sold off 200 points sliding from 1.2750 to 1.2550. This was followed by worse than expected Philly Fed and a Jobs number that was as expected on Wednesday and we finish the week at the lows between 1.25 and 1.2550. Also in line with market disappointment that the rumours of QE3 were unfounded, the USD seems to have caught a bid again.
- All in all, the EUR remains in a fragile state and we expect more losses in the months to come.
- Very little to say on USDCHF. The EURUSD twin is back to the highs, the CS ZEW heavily negative, but Exports up MoM and imports flat. We are trading now at 0.9575.
- The USDJPY was kicked into life on Wednesday after a rumour of an historic tax-hike bill in Japan. The extension of the USD Twist campaign and the USD bid meant that USDJPY broke up from 78.60 through to 80.35. As long as the pair remains above 79.80 we believe that the JPY should continue to weaken, slowly but surely – a bumpy road ahead.
- GBP was soaring on Monday after the risk of a Greek Tragedy was averted (again for the umpteenth time). However in light of the resuming USD positive trend Cable sold off to finish the week still positive from last week but not at its highs. We are now at 1.5620, having been as high as 1.58 at the beginning of the week.
- The Aussie traded along with risk assets trading steadily up to 1.02, only to see it back to parity post Philly Fed and the general Risk-Off momentum of Thursday.
- BRL and ZAR seemed to have a wild ride this week, both strengthening substantially with the Greek News. However, they were not able to escape the general USD bull trend of the last trading sessions and are now where they started at 2.06 and 8.40 respectively.

Fixed Income

- US yields gapped significantly on the Monday – exactly the same as the previous week. Opening 8 Bps higher on the 30Yr and 7 Bps higher on the 10Yr. Short term paper was unchanged on the news but finished the week +2.75Bps at 0.30%. For the week, US 30-year dropped 8 bps from 2.76% to 2.68% (exactly where it finished last week); US 10-year dropped only 2 Bps moving from 1.64% to 1.62%, finishing 4Bps higher than last week's finish.
- France was relatively quiet with yields moving from 2.61% to 2.67% only to revert to its initial pricing at the beginning of the week post FOMC. Germany, however, saw a sustained selling of the Bund and yields rose from 1.41% to 1.53%. The spreads from the periphery not only decreased due to better appetite for Spanish et al bonds, but also due to the extremely over bought nature of the Bund.
- Spanish banks have been officially audited and need a further (minimum) €65Bn for the banking sector. We do not believe this figure to be large enough. The Spanish banks have more than €3Tr on their books in asset related loans… that is a very large number. If 25% of the population are not employed and have mortgages do we really believe the default rate would only be 5.5%?!? For now the market is giving them some respite and the yields have fallen from 7.15% (unsustainable) to 6.66% (hmmm… number seems familiar).

- Italy also followed the Spanish bond market and the yields fell in line with the “good news” that Greece has a Parliament and that it is pro-bailout and pro-Euro, for now at least. The yields, although initially above 6%, have settled firmly below and stand around 5.83%, having been as low as 5.64% before the FOMC.
- High yield (in either US or EU names) was the place to be this week, both returning +1.18% on the week. Only to be beaten to the top spot by the convertibles that returned +1.50%. Corporates were stronger in the US than EU, coming in at +0.74% vs. +0.20%. However, EU Government outperformed US by +0.73% versus +0.05%. On the year, however, the clear leader by nearly 5% is EU HY, coming in at a stunning +11% YTD.

Equities

- Developed equity markets started the week by rising strongly on Tuesday, buoyed by expectations that Central Banks would take steps to stimulate the world's economy. Then, major markets collapsed on Thursday after data showed Chinese, European and US manufacturing activity slowing further, just a day after the Federal Reserve extended its monetary stimulus program. As a result, the MSCI World lost 0.14% over the week as of yesterday’s close.
- The EuroStoxx 50 is closing the week about flat as we write this. The index hit a one-month closing high on Wednesday after lower yields on Spanish and Italian debt bolstered sentiment and disappointing German economic data rekindled expectations of more monetary stimulus. However, investors hoping for action from the ECB are likely to have to wait at least until its July 5 Governing Council meeting.
- The S&P 500 lost some ground this week, dropping by 0.27% as Fed’s decision to extend its “Operation Twist” program was deemed disappointing by most market participants.
- Meanwhile, the Nikkei rallied 2.67% reaching a five-week high, as sentiment was buoyed by a softer yen after the US Federal Reserve held back from more aggressive stimulus steps to prop up the economy.
- In terms of sectors, Consumer Discretionary, Healthcare and Financials were the best performers (+0.71%, +0.70% and +0.65% respectively), while Energy, Utility and Consumer Staples were the main laggards (-2.56%, -0.80% and -0.71% respectively).
- We remain constructive on equities on a medium/long-term timeframe, as equity valuations are cheap (average P/E of 13.55 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 0.77% 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 Latin America followed by Emerging Asia (+0.86% and +0.76% respectively). The worst performing region was Emerging Europe, down 0.40%.
- The Shanghai Composite dropped 1.53% during the week, as China's shares ended sharply lower Thursday on concerns that the domestic economy may face a worse-than-expected slowdown, after a preliminary gauge of the country's manufacturing activity showed further weakness in June.

- The Brazilian Bovespa rose 0.28% this week. The index reached a five-week high on Tuesday on hopes the Federal Reserve would take steps to shore up growth in the US (Brazil's second-biggest trading partner), before sharply falling on Thursday as raw-material producers declined as signs of a slowdown in China and the US rekindled concern the global recovery will falter.
- We are bullish on EM equities in the medium/long term as valuations are very attractive (P/E of 11.25 on the MSCI EM). However, in the short term these are the most vulnerable to growth slowdown signs.

Commodities

- Commodities plunged by 3.93% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Reports of weak economic data from the US and China coupled with the Fed failing to announce a further round of quantitative easing, drove investors to the safety of the US dollar.
- Energy and Precious Metals took the biggest hit this week (-6.19% and -3.63% respectively). However, the GSCI Agriculture index rose by as much as 4.75% on the back of weaker than expected weekly crop-progress and conditions reports resulting from dry weather in the Midwest.
- Gold fell by as much as 4%, mostly attributable to the sharp USD rally on Thursday, which contributed to Gold's biggest weekly loss since December. Gold is currently trading at $1'570 per troy ounce, flat since the beginning of the year.
- Crude Oil sold off sharply this week by as much as 7.37%. Crude has been hurt on all fronts this week as stronger USD and growth fears dampened demand outlook. In addition, the Energy Department reported the highest level of inventories in 22 years! Crude is currently trading $78.55 per barrel, the lowest level in 8 months, and down 20% since the beginning of the year.
- We remain constructive on gold and oil in the medium/long term as we believe global growth will pick up in the second half of the year due to the likelihood of China further reducing their deposit rate and the Fed setting the groundwork for a potential new round of quantitative easing.

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