Bedrock Newsletter

Friday, June 29th 2012

ABRACADABRA! The European Commission and the 19th emergency meeting did it and all is well in Euro-land. Amazing- The wizards of Brussels waved their wands and now the yet un-constituted funds with yet unfunded vaults will finance needy European banks directly, will extend maturities on Sovereign borrowings and will get the ECB to regulate all European financial institutions! Whoopee-do… The euro rose over 1% since 04:30 AM, Asian markets rose over 2% and then Europeans followed as US futures suggest significant rises there too… Better yet, yields on peripheral European debt are falling and the German yields are rising. No, this is not a dream- the Sun is out and it is hot!
If you don't believe it, it is real! Germany is capitulating (again?)… They lost to Italy in last night's soccer match too… The champion will be Italy or Spain!

Let's enjoy it whilst the magic lasts, if it does! The Bears were growling very loudly until 30 minutes before the US close last night- the DJIA was down 180 points or so when the news broke that there will not be a press conference from Brussels- interpreted as good news, the meeting didn't blow-out. The DJIA came back 160 points in twenty minutes! Then the magic spell came in the wee-hours, so Angela and Francois will live happily ever after. Maybe.

Egan Jones strikes again! They downgraded Germany on Tuesday by a notch to A+ Perhaps they will re-visit this now that all is good in Euro-land?

Other interesting events occurred last night- The US Supreme Court ruled that "Obama-care" is constitutional. The white house rejoiced that their plan is authorized and amazingly, the GOP and Mitt Romney rejoiced as well- the language of the decision based on the Government being Constitutionally empowered to levy taxes across State-lines, effectively equating Obama-care with a tax! Just like in Europe, everybody finds their own gain somewhere.
Somehow the idea of levying a new tax into a morose economy doesn't seem too clever. We received an analysis prepared by a big think tank showing that 28% of Americans have absolutely no savings and that an additional 20% have less than 3 months' worth of expenses saved-up. i.e., about 50% of Americans are effectively broke. Well, America is the land of immigrants- Irish, Greek, etc., etc., But now, they have at hand the European magical solution should they need it…

Remember the huge trading loss at JP Morgan? Jamie Dimon their Chairman excusing and explaining before Congress… How dignified was that!? Good governance, disclosure and transparency (after the fact) or so it seemed. Yesterday we were told that the huge loss was actually enormous- it is now set at $9 billion, more than double the originally stated disaster. How could a bank not see a $5 billion hole? And they were looking into it! As we had postulated some time ago, the banking behemoths are "too big to manage"… To drive the point further into the financial coffin, Barclays "agreed" to pay a $454 million fine to the FSA (UK regulator) for allegedly manipulating LIBOR. Now HSBC and some other big players are being investigated too. The FSA may collect enough fines to start its own sovereign fund… But the truly big game here will no doubt be in the various class-action suits to follow: Much of the world's borrowing has been LIBOR based for generations, Floating Rate Notes, Swaps (currency and interest rates) are all affected by the LIBOR fixing… Trillions are at stake…

The "fun" isn't over… Do remain cautious! If only there was an efficient way to invest in litigation law-firms…

Enjoy your Summer Sun weekend

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Currencies

- EURUSD was slowly bleeding from the start of the week, slipping from 1.2550 to almost 1.24. Brussels (on the 19th attempt) have finally come out with actions rather than words. Today seeing the EUR pop straight up to 1.26… for now. The "Great Leaders" have dropped the requirement that governments receive preferred creditor status on crisis loans to Spanish banks and the Fund that doesn't exist will solve all the EUR problems…

- The EUR should remain supported at these levels in the short term, but unfortunately all this changes is who foots the final bill with money that doesn't exist yet. The debt burden is still mounting and without a fiscal accord the EUR needs a plan, not just plasters to cover the cracks.

- Very little to say on USDCHF again. The EURUSD twin has mirrored the movements, trading as high as 0.9680 but sliding to 0.9540 on the Eurozone committee's actions. But it should be pointed out that we are almost unchanged on the week since Greece's Parliament was formed, so how much has really changed?

- As we said last week… a bumpy road ahead. USDJPY didn't hold the 79.80 and slipped to 79.15 on news that Cyprus was in need of a bailout on Monday… (not surprising really, as their banks wanted a cheap way to invest in "European-safety-net-debt" so bought Greek debt… naturally!) On the EUR news we have seen USDJPY rally a little and is currently above 79.60.

- GBP followed the risk appetite in the market this week and drifted between 1.5550 and 1.5650, dipping to a low of 1.5490 but rallying overnight in line with the Risk On news. We are, however, back to the levels where we started the week, 1.5600 or thereabouts.

- The Aussie was quiet ahead of the EU summit and remained range bound between 1.00 and 1.01. Only after the summit release have we seen it peak at 1.02. A general commodity currency pattern that has seen them all trade in lockstep. Risk On… Commodity currencies rally…

- BRL and ZAR had a relatively quiet week ahead of the summit (like most of the currencies in fact!). However, the USD bull trend continued against the BRL until yesterday, trading from 2.05 to a high of 2.10 for BRL. ZAR was relatively side-lined and was range bound between 8.40 and 8.50. We will see how BRL reacts later this afternoon when Rio and Sao Paulo wake up, but ZAR has rallied this morning, seeing the USD drop from 8.40 to 8.25.

Fixed Income

- US yields are almost unchanged on the week. However, we saw large intra-week moves in the long end of the curve. The 30Yr rallied heavily, dropping from 2.74% to 2.65%, only to trade back to 2.75%. The 10Yr repeated the pattern moving from 1.65% to 1.57%, then back to 1.64%. Short term paper steadily moved from 0.30% to 0.31% and seems to be unaffected by the EUR news.

- France, unfortunately, having brandished its Socialist flag by siding with the Italians and Spanish, saw its funding costs jump nearly 10 Bps on the release. The French 10 year OATs moving from a low of 2.56% to 2.74% - as we write this has come off slightly to 2.69%. Germany's 10Yr Bund is now trading in a similar fashion to that of the French OAT. Yields rising on sustained selling from 1.44% to 1.63% as we write.

- Spanish yields steadily rose from 6.3% to well over 7%. However, in light of the Summit outcome they are back to where they started the week at 6.55%. With a “solution” that has been viewed as positive for the Spanish, why have the yields not changed on the week?
- Italy also followed the Spanish bond market and the yields fell in line with the “good news” of the summit. However, this week was not a good week in general as the yields remained well above 6% for most of the time. After the news they have dropped to as low as 5.75% but are currently at 5.94%. These levels are not levels that indicate the market believes in the summit “solution”.
- With the data releases overnight, the FI space as a universe is not fully updated so the weekly numbers aren’t comparing like for like. As such, the only points to note are the YTD on US HY and EM debt is almost the same at about +6.8% with EU HY maintaining +11% YTD.

Equities

- Developed equity markets dropped for the week, with the MSCI down 0.47%, as of yesterday’s close, on fears of a non-conclusive EU summit. However, Asian and European markets recovered their losses on Friday as EU leaders agreed that EU banks could be recapitalized via a single banking supervisor involving the ECB, which would aid the banks directly halting dependence on government debt.
- The EuroStoxx 50 rallied 0.92% for the week, after falling by as much as 2.7% earlier in the week due to the S&P downgrade of 28 Spanish banks and Cyprus officially requesting a bailout. The index is set to conclude the month of June up 5%.
- The S&P 500 fell by 0.45% for the week. Fed officials differing on the necessity of further easing to spur growth overshadowed reports on better than anticipated durable goods orders and pending home sales. Post-summit though the futures have rallied and indicate an open equating to a weekly gain of 1.1%.
- The Nikkei rallied 2.40% in spite of Japanese Industrial Production coming in lower than expected (-3.1% vs. -2.8% expected), as positive progression of the EU summit lifted global markets. The Nikkei concluded the month of June up 5.4%.
- In terms of sectors, Utilities and Energy were the best performers (+1.21% and +1.02% respectively). Info Tech and Materials lost most for the week (-2.32% and -1.44% respectively).
- The banking sector received much attention in the press this week. Reports of JP Morgan’s trading loss now predicted to be between $4Bn - $6Bn but possibly as high as $9Bn; compared to $2Bn in previous reports. In addition, Barclays Plc has been fined £290Mn for manipulating the Libor rate, causing the FSA to initiate an investigation for such malpractice amongst the other UK banks.
- We remain constructive on equities on a medium/long-term timeframe, as equity valuations are cheap (average P/E of 13.41 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 to high beta growth stocks.

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Emerging Markets

- Emerging Markets dropped 1.14% for the week as measured by the MSCI EM.
- The worst performing region was Latin America followed by Emerging Asia (-2.47% and -0.62% respectively), while Emerging Europe fared better at -0.56%.
- The Shanghai Composite dropped 1.57% during the week as Citigroup cut China's 2012 GDP forecast to 7.8% from 8.1% due to slowdown in European demand. The index ended the month of June down 6.2%.
- The Brazilian Bovespa dropped as much as 5.05% so far this week. Petrobras dropped as much as 9% on Monday as the company announced it will raise petrol prices for the first time since 2006. OGX tumbled 43% across Wednesday and Thursday's trading sessions following 75% cut of first project production targets.
- We are bullish on EM equities in the medium/long term as valuations are very attractive (P/E of 10.86 on the MSCI EM). However, in the short term these are the most vulnerable to growth slowdown signs.

Commodities

- Commodities rose by 0.67% this week as of yesterday's close – as measured by the S&P GSCI broad commodity index – driven up by a surge in Agriculture (+7.37%). Corn headed for the biggest gain in almost two years. Soybeans jumped to a five-week high. Both on speculation that unusually hot, dry weather will reduce yields in the United States, the world's biggest producer of both crops. Meanwhile Precious Metals (-1.12%), Energy (-0.82%) and Industrial Metals (-0.17%) were all down.
- Agriculture surged by close to 14% during June while Energy slumped by 12%. Energy is still the most negative sector year-to-date, down over 17%, while Agriculture is the only sector to be positive, up close to 4%.
- Gold was about flat until Wednesday before falling on Thursday, hit by worries of an economic slowdown after a US Supreme Court ruling upheld a landmark healthcare law and by fading hopes that a European Union summit will resolve that region's debt crisis. However, Gold rose over 1% today – currently trading around $1'570 an ounce – tracking a surge in the euro after European leaders moved to bring down soaring borrowing costs in Italy and Spain.
- But gold is still on track to post its worst quarter since 2004, as a growing global economic slowdown from Europe to China pushed investors to safer havens such as the dollar. Gold has fallen more than 12% from its 2012 peak of around $1'790, and 18% from an all-time high above $1'920 reached in September 2011.
- Crude Oil rose until Wednesday, before sharply falling on Thursday and bouncing back as of today. Oil fluctuated amid speculation that the European Union's economy will fail to grow, as the region's leaders gathered in Brussels for a summit. As a result, Oil was about flat for the week and currently trades around $79.50 a barrel. With Norwegian strikes, pipeline damage and tropical storms halting production, how long will the low prices be maintained?
- 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. Also, with all Central Banks keeping short term interest rates around 0, real assets can only move up in the medium to long term.

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