Bedrock Newsletter

Friday, July 6th 2012

It was a holiday weekday with the USA celebrating its birthday, so thin markets and a short effective trading week. We are thinking of all the pessimists who recited “Sell in May and Go Away” as the month of June progressed to finally close the second quarter on a high note- the best June since 1997 for US equity indices and then, into July we sail with poor economic data flows on both the industrial and services sides of the economies (US, Europe and China). But then, arguably, much of this news had already been discounted and the continued M&A deal flow gives the markets a strong floor. Yes, the equity market valuation appears cheap and corporations are cash rich. The retail investor appears to have lost equity appetite and is hiding in money market funds and Treasuries.

This week was weak for bonds; they are definitively expensive except under a scenario of depression. This scenario seems to be held at bay, at least for now, as the markets appear to be somewhat appeased by the EU’s political machinations. Even in the US there are some indications that the Fiscal Cliff due after the elections may be manageable. All said, we are now into the normally slow, low liquidity summer months. Volatility is likely to rise as price action might be more erratic, in bonds, equities and exchange rates. Let’s not read too much into these movements; it is likely that by the end of these two months we will find ourselves yet again at the levels we started- Groundhog days continue! We are, however, mindful of the “Summer Curse”, touted to have led to famous events such as the Russia Crisis/Long Term Capital Management in 1997 or the Fannie Mae “Jolt” which lead to the Lehman fiasco. With Senior Management on holiday and thin trading markets we can see erratic moves without a steady hand to guide the ship. What could be the triggers in the Summer months this year? Well, below are five possible White Elephants in the (trading) room:

- The Eurozone – How much time has the politicking provided for the debt funding for Spain, Italy et al., could we see a panic with further weak data and banking strains?
- US politics and Debt – With Obama and Romney already sailing in choppy waters could the Volcker/Ravitch report shock the market into falling off the Fiscal Cliff?
- China Slowdown – Markets wait with baited breath for sub 8% growth, but what will that mean on the ground in China, is there a lurking MBS styled crisis in Guangzhou?
- Libor Scandal – We have seen heads roll at Barclays and the BOE, but could this freeze the debt markets and dry up liquidity if others across the pond are indicted?
- The Olympics – London has a Victorian transport system and is suspending Gilt auctions in case liquidity is a problem as traders cannot reach the City on the steam train. What about the other markets that can’t “suspend trading”? Will we see the world’s largest Foreign Exchange trading centre lose liquidity?

We can argue in favour of adding risks at these levels as we sense that current prices include premiums for much bad news which is likely not to materialize, at least not in its entirety. Yes to more equity and commodity positions and fund this with reductions in bond holdings: yes, it is enticing and likely profitable with a horizon set to year-end. But then, we would advocate more patience and restraint: We would rather wait for the summer months to end and reconsider this positioning into September; enjoying the summer months and the Olympics in the meantime.

We are reminded of an old Yiddish proverb “Man plans, God laughs…”

Currencies

- EURUSD obviously had a nosebleed from the altitude of being above 1.2650 and slid to 1.25 through to Thursday. On the (expected) ECB interest rate cut of 25Bps to 0.75% and reduction to 0.00% on the deposit rate, the EUR simply gave way and dropped to 1.2350. Causing the kneejerk risk on momentum the market hoped for (not that it lasted very long!).

- The EUR seems to have shrugged off the news that the Spanish collateral requirements were lowered last week, that the Spanish banks have received over 100Bn EUR in aid, that the Greeks have a parliament that is pro EUR, that Ireland has not really been in the headlines for months, all it sees is the 6 inches in front of its face (or trading hours ahead). The EUR's trajectory is downwards and no amount of good news seems to halt the decline except temporary euphoric pops.

- Very little to say on USDCHF again. The EURUSD twin has mirrored the movements, trading from 0.95 to 0.97 on the ECB committee's actions. We are only 70 pips from the year high on USDCHF and should we see the EUR further given, then we will see that high of 0.9772 taken out and parity will be in the sights of the market.

- A relatively quiet week for the Yen. Only Lagarde's comments today saying that a selling of the Yen as an intervention is justifiable, as long as concerted with other colleagues. I.e. please check with us first so we don't get caught offside! Even so, the USDJPY traded 20 pips either side of 79.80, briefly venturing to 80.10. However, this week saw the EURJPY break the technical levels and traded down from 101.00 to 98.75.

- Whilst on the Asian Front, the PBOC cut the commercial banks' interest rates yesterday less than a month after the last surprise cut. 1 Yr benchmark lending rates were lowered by 31 Bps to 6% and the deposit rate was lowered by 25 Bps to 3%. How else do you maintain 8% growth?

- GBP followed the path of least resistance this week and sold off from 1.5700 to 1.5520 in light of the extended Asset Purchase target from 325Bn GBP to 375Bn GBP and unchanged on the rate at 0.50%. Amazing… another 50Bn GBP purchased from thin air… Magic again this week.

- The Aussie was quiet this week, trading between 1.0240 and 1.0280 with two spikes around news flows that really had very little impact. We finish where we started.

- BRL soared as we expected last Friday on the open, with the USD collapsing 5% to close out last week at 2.0050. Other than the small USD rebound this was a very quiet week finishing yesterday at a shade under 2.02.

Fixed Income

- US yields reacted quickly post very poor ISM data, but after this (with little else to focus on) they remained relatively unchanged. The 30Yr rallied heavily, dropping from 2.74% to 2.65%, only to trade back to 2.74% and to now be trading at 2.70% (almost the same as last week). The 10Yr repeated the pattern moving from 1.65% to 1.55%, then back to 1.63% and now trading 1.58%. Short term paper bucked the trend and moved to 0.2830%, down from 0.31%.

- "Vive La France" is not something the foreign homeowners or the wealthy in France shall be chanting this week. With broad sweeping tax hikes for the wealthy and the second home owners (legally unconstitutional, but as yet unchallenged) the market seems to have reverted to the French 10 year OATs as central rather than periphery, yields moving from 2.70% to 2.41%.

- Germany's 10Yr Bund is now trading in a similar fashion to that of the French OAT. Yields falling on sustained buying from 1.58% to 1.37% as we write.
- Spanish yields did in fact revert back to below 6.5% at the end of last week. However, in light of the ECB and various market worries around the poor debt auction, they are back to the highs, just below 7%. The Spanish Saga continues…
- Italy maintained a financing yield below 6% this week… until today. After the ECB cut rates the yields went soaring from 5.70% to 6.00%. We remain at these elevated levels and simply await the proverbial straw for the EUR periphery..

Equities

- Developed equity markets gained for the week, with the MSCI up 0.54%, as of yesterday's close. The index was up by as much as 1.3%, up to mid week, as investors expected major central banks to take further policy steps to support the economies due to the slowdown in global growth. On Thursday, European and Asian central banks came through with the expected interest rate cuts, and loosening of monetary policy, yet this failed to reassure investors.
- The EuroStoxx 50 rallied 0.30% for the week. The ECB cut its benchmark rate to record low (0.75% from 1%) and deposit rate down to 0% on Thursday, following an additional week of weak economic reports of a contracting manufacturing sector and record unemployment rate of 11.1%. Speculation is rising that the ECB may follow the UK with large-scale asset purchases.
- The S&P 500 advanced 0.40% for the week. US equities were mainly supported by expectations of monetary policy interventions by major central banks. Economic reports were mixed during the week with contracting ISM Manufacturing, but better than expected Factory orders, as well as better ADP and Jobless claims. All eyes are on today's reports of change in Non-farm payrolls and Unemployment rate, to conclude the picture of US unemployment during June.
- The Nikkei ended the week little changed (+0.16%), where profit taking on the latter part of the week offset earlier gains due to better than expected Tanken Manufacturing index (-1 vs. -4 Exp.).
- In terms of sectors, Materials and Info Tech were the best performers for the week (+1.57% and +1.21% respectively). Utilities and Health care lost for the week (-0.96% and -0.11% respectively).
- We remain constructive on equities on a medium/long-term timeframe, as equity valuations are cheap (average P/E of 13.78 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 gained 1.90% for the week as measured by the MSCI EM.
- The best performing region was Latin America followed by Emerging Asia (+1.99% and +1.85% respectively), while Emerging Europe fared better at +1.28%.
- The Shanghai Composite ended the week flat (-0.08%). Earlier losses due to fears over slowing growth of the second largest economy, were offset by the PBOC surprisingly lowering its 1 year lending rate by 0.31%
- The Brazilian Bovespa soared 3.72% this week, as of yesterday's close. Brazilian equities rallied as monetary interventions from the EU and China boosted the outlook for Brazilian exports. Petrobras and Vale, the two largest stocks in the composite, gained as much as 7.4% and 3.4% respectively.
- We are bullish on EM equities in the medium/long term as valuations are very attractive (P/E of 11.27 on the MSCI EM and 9.08 on the MSCI BRIC index). However, in the short term these are the most vulnerable to growth slowdown signs.

Commodities

- Commodities soared by 3.46% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Soft commodities were mainly supported by drought conditions in Midwest US, Russia and the Black sea, reducing grain forecasts. In addition, escalation of tensions with Iran, drove up oil prices.
- Agriculture and Energy were the biggest gainers this week (+8.84% and 3.04% respectively). Industrial and precious metals rallied modestly (+0.48% and 0.31% respectively).
- Gold fell 0.32% for the week, and is now trading at $1'592 an ounce. Gold gave back earlier gains as the US dollar rallied following the better than expected ADP report, lowering expectation of further quantitative easing.
- Crude Oil surged 3.30%, and is now trading at $85.70 a barrel. Oil rallied as Norway's largest oil company said it will begin to shut down production, due to a labour conflict. Additionally, tensions between Iran and Western powers have intensified, as Europe implemented a ban on buying Iranian oil and the latter responding by test-firing ballistic missiles.
- We remain constructive on gold and oil in the medium/long term as we believe global growth will pick up in H2 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.
