Bedrock Newsletter

Friday, July 13th 2012

It is Friday the 13th… As if we needed any more "scary" emotions… Yesterday was a "Thursday the 12th" and it wasn't a nice day. Actually, the whole week was an extension of a rather unpleasant year. What else can hit us is the question. It "feels" as though the markets have gone into a kind of coma, showing indifference to news, good or bad; Italy's Credit Rating was cut severely by Moody's- two notches to Baa2 from A3 last night and then today the Italian government issues new bonds at declining (albeit high) yields. Is the market so efficient that all the bad news is already discounted?

This is a possibility, as we see the volatility collapse (as measured by the VIX index), now at 18.33 with a chart showing a rather steady decline since its recent peak of 45.50 in late September 2011. But the fear must still be with us: On Wednesday the US Treasury auctioned ten year notes which received a huge 3.6X cover (the highest ever) and the resulting yield was set at 1.49% the lowest ever at auction! The French issued shorter dated notes with a negative yield, like the Germans had a couple of weeks back. How will pension funds meet their future obligations? Our future looks much like the present then: if you discount a future event at zero it become equal to the present… The bright side (well, not bright, just less dim) is that governments will have reduced deficit-funding costs, which unfortunately might have the perverse effect of the same governments increasing their debt load whilst holding the debt funding costs steady. This must be what Francois Hollande is banking on with his growth plans. These were not heard by Peugeot-Citroen (French auto maker) which announced yesterday significant firings and plant closures.
Wednesday also gave us the Federal Reserve's minutes: In a nutshell, things are slow but not bad enough to warrant QE(III). The equity markets didn't like this. We wonder how many points in the DJIA or the S&P 500 can be attributed to QE(I) and QE(II)?

The US Federal Deficit for June was disclosed at $60Bn, up 40% from June 2011 where it was at $43Bn. In the "old days" such news would have affected the US$ with a huge slap and then a bigger hit would follow on the Treasuries' prices. This time around? Well, the Dollar gained ground especially against the Euro, breaking through the 1.22 level for the first time in years. The bonds rallied further.

Then the city of San Bernardino in California declared bankruptcy. It is the third Californian town to go this route in the past three weeks. The market said "so what"… Maybe Meredith Whitney was right two years ago scaring the Municipal Bond markets with her doomsday predictions… We wonder if she will now be invited back to speak on CNBC?

Then this morning China gave us its own economic news- GDP grew at its slowest pace in three years in the second quarter, but other less-cited indicators are already signaling that the world's second-largest economy may be starting to turn around. The economy **grew 7.6 percent** in the April-June quarter, slower than the 8.1 percent in the first quarter and 8.9 percent in the fourth quarter of last year.

Why are some speakers talking about a Chinese slowdown? Growth of 7.6% is huge! What has changed is the second derivative of the Chinese growth chart- the change is in the acceleration of the growth rate, i.e., the change between measurement periods is declining in percentage terms. Arguably, the GDP growth in simple $ terms is actually increasing- 7% of 100Bn is more than say 10% of 50Bn. The Chinese GDP is now a huge number… Maybe it isn't a problem after all?
The new elephant in the room is the growing LIBOR fixing scandal. It brings us to quote Ernest Hemingway "A thing is true at first light and a lie by noon" and we wonder if this "fixing story" (now estimated at $22Bn in damages) will not evolve into a "Story of Fixings" and encompass currencies, Gold and the like "Fixable" assets… **Kryptonite!!!** And food for lawyers…
But doesn't Bernanke also "fix" rates? Talk of "Moral Hazard".

Currencies

- EURUSD ground lower through what has been (so far) the quietest trading week for a long time. With little news and fewer politicians speaking (chance would be a fine thing!) the EUR has slid from 1.2325 to a low of 1.2180. Even with the Chinese data coming in approximately as expected overnight (as if there was really ever any doubt) the EUR remains weak and suppressed at 1.2190.
- The Dollar news this week from the FOMC leaves the market with no uncertainty that for now the committee does not see the need for any asset purchase expansion or for anything more than the extension of Operation Twist that they executed last month. In general the US economy is strengthening, the Jobless Claims were the lowest for a long time (since March 2008), the hours worked have gone up, so although the unemployment rate is stable and not going down, people are working longer… perhaps there is more work to come?
- USDCHF is heading in the direction that we mentioned last week. The year high was taken out cleanly and parity is back in the sights of the market. Looks like in the absence of any news to trade around, the trend continues of USD-bid is firmly in control. We are now at 0.9850 coming into the weekend
- The USDJPY traded 20 pips either side of 79.50, briefly venturing to 79.90 on the "non-news" of a switch in BOJ asset purchases, however spending the majority of the week on the lower side of centre and now at 79.30. Without any market intervention or structural changes we see this as a good base level, but may trade sideways for a little longer. This week saw the EURJPY trade down even further from 98.00 to a recent low of 96.50, where we are currently.
- Australian employment dropped 27K rather than no change as expected. The Unemployment Rate although in line with expectations was a rise from last month at 5.2%. Both causing a weakening in the AUD from 1.0250 down to 1.01. We are seeing a little buying before the weekend as profit taking, now at 1.0175.
- GBP continued the down trend from last week slipping from 1.5550 to a low of 1.54. We are now trading at 1.5450 on USD strength. Perhaps though by looking at the EURGBP pair we get a better sense of the rankings within the safe haven currencies, the USD may have supremacy but the GBP is definitely faring better than the EUR - levels not seen since the dark days of 2008 - now at 0.7900 and slipping!
- BRL saw the Brazilian CB cutting the Selic rate from 8.5% to 8.00% on Thursday. This resulted in the USD rising against the BRL from 2.035 to 2.05 only to finish exactly where it started, we will need to see what today's trading day brings, but the ascension of the USD against the BRL looks set to stay for now.

Fixed Income

- US yields dropped across the curve in light of the generally negative tone that was struck this week in the equity markets. The 30Yr rallied, dropping from 2.65% to 2.55%, the 10Yr moved from 1.54% to 1.46%, and the 2Yr moved from 0.285% to 0.2540%. We are at historic lows on the 10Yr and the room for profits on the longs here seems to be diminishing rapidly with a greater and greater chance of sustaining losses if we see a rapid change in market sentiment.
- Ahead of the Bastille weekend the market seems to have continued to buy up the French 10 year OATs as central rather than periphery paper, yields moving from 2.41% to 2.21%.

- Germany's 10Yr Bund is now trading in a similar fashion to that of the French OAT. Yields falling on sustained buying from 1.32% to 1.22% as we write.
- Spanish yields flew up past 7% at the start of the week on the risk off sentiment and more talk of the Spanish banking bailout. We have come back below the 7% mark to be about 6.67%; all on a very firm confirmation that they 100% percent, definitively, will not need more than €65Bn extra to bailout out the Cajas. Phew! Thank goodness for small mercies, we all thought there might have been a funding issue!
- Italy has been downgraded yet again by Moody's… still classified as Investment grade (just!). They financed another €7Bn in an open market auction; however we remain at 6% on the 10Yr. Last week we wrote that we were waiting for the proverbial straw… Moody's are piling on as many straws as they can, we watch this space.

Equities

- Developed equity markets declined this week, with the MSCI down by 1.78% - as of yesterday's close - on global growth slowdown worries.
- The EuroStoxx 50 lost 0.31% over the week. European stocks declined the most this week after minutes released by the Federal Reserve disappointed investors seeking a more definitive signal for further quantitative-easing measures.
- The S&P 500 dropped by 1.47% during the week, sending the S&P 500 to the longest slump since May as concern intensified about a slowdown in the global economic recovery and American corporate earnings even if jobless claims figures were better than expected – reaching 350'000, the fewest since March 2008.
- Meanwhile, the Nikkei traded lower for the sixth day in a row, experiencing its sharpest month's drop on Thursday after the Bank of Japan left its asset purchase plan unchanged and offered no new stimulus. The index lost about 3.29% over the week.
- In terms of sectors, Materials and Info Tech were the worst performers this week (-4.19% and -3% respectively), while Utilities, Healthcare and Telecoms fared much better (-0.26%, -0.29% and -0.32% respectively).
- Equities however remain positive for the year and continue to offer investors a good risk reward for the next 6 months, even if the Asset Class will continue to remain volatile due to all the macro uncertainties and the issues surrounding Europe.

Emerging Markets

- Emerging Markets fell sharply this week, losing 3.38% as measured by the MSCI EM as of yesterday's close.
- The worst performing region was Asia (-4.04%) followed by Latin America (-2.31%), while Emerging Europe fared better at -1.74%.
- The Shanghai Composite dropped by 1.69% this week, but finished flat today as pessimism about the latest Chinese growth figures proved to be exaggerated.
- Meanwhile, the Brazilian Bovespa fell by 3.56% reaching a two-week low as Brazilian mining companies followed a drop in metal prices amid renewed concern global growth is faltering. The Central Bank yesterday lowered the Selic Rate for an 8th time since last August to 8%.

- Emerging Markets continue to be the World's engine growth and as such we remain confident that the second half of the year will see acceleration in the positive outlook for this region and for its equity markets.

Commodities

- Commodities rallied 1.84% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Agriculture and Energy were the biggest gainers this week (+3.43% and +2.07% respectively) while Industrial and precious metals fell (-0.29% and -0.63% respectively).
- Soft commodities extended their gains as drought in the US dampened the outlook of crop output. The GSCI Agriculture index rallied as much as 10.42% so far this month. If these record high dry crop prices are sustained, inflationary worries are likely to arise.
- Gold fell 0.68% for the week, and is now trading at $1'579 an ounce. Precious metals lost ground this week as the Fed refrained from announcing further easing, causing the US Dollar to rally.
- Crude Oil rallied 1.62%, and is now trading at $86.50 a barrel, as reports of a larger than expected decline in inventories outweighed an earlier selloff due to Norway ending its energy strike.
- We remain constructive on gold and oil in the medium/long term as we believe global growth will pick up during the H2 of the year due to the likelihood of China further adding stimulus and other CB's continued easy monetary policy.

Disclaimer
This document is for information purposes only and has been prepared by Bedrock SA, representing the opinions and investment views of Bedrock SA as applied in its investment advisory and management activities. It is a private publication intended for private circulation only. It does not constitute a company survey, a financial research, an offer, a solicitation or a personal recommendation to buy or sell specific products or securities. Bedrock SA disclaims all liability for any losses or damages of any kind relating to such information, which may be changed at any time without notice. The risks inherent in certain investments, particularly derivative products, may not be suitable for all investors. The contents of this publication may have been used for transactions by Bedrock SA prior to their communication. Distribution or dissemination of this document and/or the sale of certain products mention herein are subject to restrictions. Copyright 2012 All rights reserved. Approved for circulation in the UK to professional clients only by Bedrock Asset Management (UK) Ltd which is authorized and regulated by the Financial Services Authority. This presentation is being made to you solely for your information and must not be copied, reproduced, further distributed to any other person or published, in whole or in part for any purpose.
© 2012 Bedrock S.A. 4, ch. Des Vergers, 1208 Geneva, Switzerland, T: +41 (0)22 592 5455 F: +41 (0)22 592 5459, www.bedrockgroup.ch