Bedrock Newsletter

Friday, July 20th 2012

We are clearly entering deeper into a period where economics and financial algorithms are being replaced with political motors. The American presidential elections are in the headlines, alongside the ongoing massacres in Syria and the renewed and escalating Iranian-Israel animosities. Latest of which being a bloody attack on Israeli tourists in Bulgaria, attributed to Iranian driven Hezbollah terrorists. Oil is rising for seven straight days with WTI now over $92/bbl. It is the first time since October 2009 that oil had a sequence of seven straight days of rises. We are now 20% higher than the recent low of a month ago. Strangely, the VIX as a measure of equities' volatility is falling in tandem with oil price rising. Where is the truth?
We have all been Shakespearians mumbling along "To QE or Not to QE?" and we now have an indication from Ben Bernanke that it is Not to QE for now at least. Markets fell in disappointment only to rebound on the thought that things are possibly not as bad as our mumblings of above implied.
We returned our attentions to the "Fiscal Cliff" which America is facing in January. Everyone knows that the Administration and Congress must address this and do so immediately and yet, the only tax-related headlines we see emanating from DC are discussions of Mitt Romney's old tax returns…

Washington should be seriously preoccupied with the US employment picture which is all but rosy. And yet Barack Obama, who found the time to assist in 101 (!!!) Fund Raisers in the past six months has not had a single meeting on the subject. Indeed, a severe lack of leadership in the still number one economy is hardly heart-warming.

Among other issues to contemplate is the strange climate. A bad dry-spell in the US bread basket of the mid-west is destroying crops from wheat to corn. Prices are rising, worries mount for livestock feeding. Are we facing a bout of food-price inflation? Unstable weather is affecting the retail world with throwbacks to manufacturing, garments, travel and other leisure. Is this a one-off, 2012 disturbance or is it just the early signs of a systemic change in weather patterns? A wet canary in the corn fields? Too early to say and then, even if we had a say, what is there to do? Where is the opportunity? What is the hedge?

There is another systemic change in the wings, this one man-made and in the economic world- In the Fossil energy domain; America is on its way to becoming energy independent, without a coherent government policy or plan (again, evidence that the latter is not needed)- The US is restructuring to gas, seeking and finding more oil on shore. In time, this could re-change global capital flows, relative powers and political alliances. If nothing else, at least we now know that the end of "the dead dinosaurs era" is not upon us quite yet…

There is some good news in the air though: Q2 corporate earnings are coming-in fast and furious and mostly beating expectations. This is true for both US and European (!?) companies. The tech world, pharma and even some of the financials- Goldman Sachs flying but Morgan Stanley hurting. Credit Suisse making money and Bank of America not so. Overall though, it looks like a good season… Stock markets are saying so anyway…

Bond markets are continuing their incredible performances with new yield lows on US treasury auctions, some tightening of spreads from periphery Europe into a steady German curve. Currencies are moving and shaking in an imperceptible band, the Euro rallying to a 1.23 level which is hardly different than its range bottom at 1.2180. It is a summer month after all… An intriguing statistical tidbit for your sunny weekend: for the first time ever the average Canadian became wealthier than the average American…

Currencies

- EURUSD is trading exactly where we started the week at 1.2260. Post Bernanke's chat on Capitol Hill the EUR tumbled from 1.2280 to 1.2180, only to rally right back. It would seem that the commentary of Big Ben would imply that his Helicopter will not be flying any time soon. With a few data points and talk of EFSF buying up Spanish bank debt the EUR peaked at 1.2320.
- Bernanke's comments on The Hill were very much in line with the FOMC minutes that were released last week. For now he focuses on his dual mandate (that he takes very seriously, as he mentioned several times) and sees no current need for QE3. When asked on what other stimulus he could bring to the table he said communication, extending the asset purchase program and communication… perhaps the Bazooka has been packed away, for now at least.
- USDCHF again was inversely aligned with EURUSD. This week we also had the Swiss Imports and Producer Prices; both of which declined signalling that "inflation is likely to remain very low for some time to come due to the strong Swiss Franc". A statistic that we probably could have predicted, we also note that EURCHF is still at 1.2008…
- The USDJPY is not listening to the BOJ… the JPY strengthened again this week, seeing the USDJPY trade from 79.30 to 78.50 where we are now. This is not what the CB in Tokyo was hoping for. On a technical front we have traded sideways through a support so for now the picture is muddled, but we await the BOJ's commentary and to see if they can spur the markets into action.
- AUD traded very well this week, moving from 1.0250 to 1.0450 gradually over the week so far. In light of the two speed economy (mining and everything else!) we were surprised to see the AUD trade so strongly. The market view is that AUD should weaken in line with the reduction in rates by the RBA and also the weakening economic situation… it would appear that no one is actually willing to short the higher yielding currency.
- GBP traded well this week, along with other risk assets. Despite the banking pressures and the scandal over the LIBOR fixings, Mervyn King has maintained a steady hand and there seems to be little effect on the currency. It would appear that the currency is maintaining its reserve currency status especially against the EUR. GBPUSD moved from 1.5550 to 1.57 as we write and EURGBP fell from 0.7880 to 0.7800. However, there is no real rationale for the British pound to stay as strong…
- BRL had a storming week trading well against the Greenback, moving from 2.04 to 2.01 as of yesterday's close. Although ZAR was almost unchanged on the week it did marginally strengthen, moving from 8.26 to 8.18, this despite a surprise rate cut yesterday in the benchmark rate to 5%.

Fixed Income

- US yields were quiet this week on a range bound Risk week. The 30Yr rallied, is unchanged at 2.58%, the 10Yr is unchanged at 1.49%, however the 2Yr moved quite dramatically from 0.255% to 0.21%. Where can the US rates go from here? We would venture to say this looks likely to be where we stay for a while, with no QE3 or intervention elsewhere in the world we don't see the situation changing, especially in the doldrums summer months.
- The French seem to be the new safe haven. The yields have more or less collapsed from almost 3% to 2% in just over a month. Since last week we moved from 2.2% to 2.01%, a truly

astonishing move in light of the current socialist government who are over taxing their population. This move does not seem sustainable to us and should reverse course.

- Germany's 10Yr Bund is firmly seated below 1.30%. Post last week's buying frenzy we settled on a range from 1.24% to 1.19%. We are approaching the lows of 1.172%. Will we see new lows in the search for safe haven assets? For now the market is telling us yes, especially as they now have negative interest rates in the market most days.
- After last week's sarcastic comment on the Spanish funding issue, this week they had a truly disastrous auction with 5Yr debt at an average yield of 6.459%. This is the highest level the debt has been recorded at since it has been tracked in 2005. With a weak bid/cover ratio of only 2.06. Even with the EFSF rumours of buying up Spanish banking debt we see the 10Yr at 7.01%. Oh, and that €65Bn that 100% covered everything… well the additional €12Bn for the regional administrators, although an addition, won't be coming out of the loan… they'll find another way of financing that… straws and camels come to mind.
- Last week's Italian downgrade seems to have rocked the boat very little, with the Rating Agencies relegated to reactive entities that follow the market lead. Italy is funding itself at 5.96%, below the warning level of 6%. However, if we look a little further back, only at the end of 2011 Italy was financing at 7.25%, although unsustainable they were able to pay, and they continue to now. Perhaps now is the time to start collecting some taxes to reduce their deficit!
- The outperformers of the week were Global EM and Convertibles both returning approximately +1.15% on the week. The closest positive performer this week was US Corporates with +0.79% for the week and the general trend was US outperforming EU. The exception to this was US Government being flat on the week. On the year, EU HY is +13.5%, Global EM is +10.30% closely followed by US HY at 8.7%.

Equities

- Developed equity markets gained for the week, with the MSCI up 1.82%, as of yesterday's close. Better than expected corporate earnings and a commitment from the EFSF to support Spanish debt obligations, overweighed weaker than expected US data and lack of evidence of further easing by the Fed.
- The EuroStoxx 50 rallied 1.42% for the week, as of Yesterday's close. The EFSF have committed to set aside funds to buy Spanish government bonds, and as well, separate facilities to provide Spanish banks with loans.
- The S&P 500 rose 1.45% for the week. Better than expected reported earnings, mostly among tech companies, and better than expected housing starts lifted US equities. This was in spite of a decrease in US retail sales and reports of more Jobless claims than expected. Earning season is off to a strong start with so far 110 out of the S&P 500 reporting better than forecasted earnings in 75% of the cases.
- The Nikkei ended the week lower (-0.62%), due to a big downward move on Friday (-1.43%) due to China pledging to keep curbs on its property market to prevent a rebound in housing prices. In addition, sustained growth fears have caused the Yen to rally, further dampening the outlook of Japanese corporate earnings.
- In terms of sectors, Info Tech and Energy were the best performers for the week (+2.99% and +2.64% respectively) on the back of strong tech corporate earnings and a rebound in oil prices. Utilities were the only losers for the week (-0.08%).
- We remain constructive on equities on a medium/long-term timeframe, as we expect further quantitative easing from policy makers to support growth. In addition, equity valuations are

cheap (average P/E of 13.98 on the S&P) and companies continue to report strong earnings, with large cash reserves at their disposal.

Emerging Markets

- Emerging Markets gained 1.62% for the week as measured by the MSCI EM. The best performing region was Emerging Europe followed by Latin America (+2.54% and +1.56% respectively), while Asia fared less well at +1.43%.
- The Shanghai Composite declined for the week (-0.79%). Chinese stocks declined earlier in the week, driving the benchmark index to the lowest level in 3.5 years, on the back of earnings concerns among Chinese corporates. Friday saw another downward move after the Chinese government stated that it won't relax property controls.
- The Brazilian Bovespa rallied 1.87% this week, as of yesterday's close. Brazilian better than expected corporate earnings coupled with Brazil Central bank hinting at more interest cuts helped lift Brazilian equities.
- We are bullish on EM equities in the medium/long term as valuations are very attractive (P/E of 11.13 on the MSCI EM and 8.95 on the MSCI BRIC index). However, in the short term these are the most vulnerable to growth slowdown signs.

Commodities

- Commodities surged by 6.54% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index, pushed by a rally on Agriculture and Energy which jumped by 8.49% and 7.12% respectively. Meanwhile, Industrial Metals rose by 2.85% while Precious Metals rose by only 0.87%.
- Agricultural commodities extended their gains this week as drought in the US (the world's biggest producer of corn and soybeans) worsened the outlook of crop output. If these record high crop prices are sustained, inflationary worries are likely to arise. Current drought conditions in the Midwest are the worst since the 1980s.
- Gold started the week on a negative note until Wednesday before regaining strength on Thursday as investors clung to hopes for more monetary easing from the US central bank after weak data in the previous session. Gold is still rising today - currently trading at $1'583 an ounce - but a dollar rebound will likely cap gains.
- Crude Oil rallied almost 6% this week and is now trading at $92 a barrel, after U.S. gasoline supplies unexpectedly shrank and housing starts climbed, signalling fuel demand may increase amid an economic recovery. It also rose as a response to Iranian sabre-rattling in the Middle East. Oil jumped by about 20% since July lows and is rising for the seventh consecutive day - a first since October 2009.
- 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.

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