Bedrock Newsletter

Friday, August 3rd 2012

Last week we reveled in a global, all sector rally which was driven by Mario Draghi's words of ECB leadership in containing the European Fiasco. We applauded the "Power of the Word"… On Tuesday we closed-out July on a down note but holding equity indices in positive territory for the month whilst Treasuries hit new all-time yield lows (ten year T. Notes traded to yield 1.4450%) and oil joined the declines.
But then, Ben Bernanke didn't follow in Super Mario's tracks, holding silent on further support. Somehow the markets sailed through this disappointment still looking ahead to the ECB's talk scheduled for Thursday.
Well, an old proverb says "what you don't see with your eyes, don't invent with your mouth…" and Thursday came and we saw that indeed, we hadn't seen anything- Super-Mario didn't deliver! The Euro rose to $1.2405 during the speech only to fall away below $1.2130, European equities reversed course from what had looked like a nice morning rally into a 2% drop or so. US equity futures joined in disapproval predicting the falls in the indices.

Quite an interesting summer week… In the US, Knight Capital a big broker-dealer had a computer glitch which caused significant trading disruptions on the NYSE. These resulted in $440 million in losses to Knight and much credibility and trust questions to the automated, computer driven system as a whole. The Facebook fiasco of a few weeks earlier was also pinned on system failures (UBS told us this week that they took a $350 million loss on this IPO); we all remember the "flash crash" of recent memory. Perhaps our computers need some human intervention? High-speed trading sounds good, but let's learn from Formula 1 racing, where they keep adding restrictions to reduce the speed of these ultimate racing cars…

India, a pillar of the BRICS, had a huge power outage this week. More people than all the Europeans combined had lost electricity for more than a day. Luckily, the BRICS still are emerging markets and they survived this breakdown. We can hardly imagine how the USA would manage if the whole country lost power for an hour, never mind a whole day… Well, perhaps Knight Capital would still be in business?
The city of San Bernardino in California filed for bankruptcy protection on Wednesday, citing more than $1 billion of debts. Is the European financial debacle reaching the US?
Days keep slipping away and the US Presidential elections are coming into the market sights! Mitt Romney's tax plan vs. Obama's ideas; both are vague and unclear and yet, each candidate is utterly critical of his opponent's ideas… How do they do that??? Both candidates are facing the so-called "Fiscal Cliff" in January and neither they nor Congress have any words about the quite huge problem looming over the immediate horizon. The main topic of discussion remains the sorry state of employment or lack thereof. We wonder if we are the only ones to see that with this Fiscal Cliff so close, no reasonable CEO will commit to staffing-up? Where are the grown-ups???

Luckily the corporate world is doing reasonably well. Earnings are generally running ahead of expectations and the consensus view on 2013 earnings for the S&P 500 is at $99.00 Using a reasonable P/E multiple of 15, the S&P should be at about 1'485 or 8.5% above where it is now. With 10 year treasury yields at say 1.50%, the P/E of money is arguably at 66. Stocks are definitively (or not?) quite cheap… It may be a good time to start "nibbling"?

May your first weekend of August be a warm and fuzzy one!

Currencies

- We could almost repeat our opening statement from last week… EURUSD was having a very normal boring week until Super Mario stepped in with what Bernanke would call a "communication tool"… however it did little to temper the markets. On the expectation that he would come out with an immediate bond buying program the EURUSD pair drove up to 1.24, only to be disappointed with no need to enlarge the current programs. EURUSD dropped like a stone to 1.2130 on the negative market reception. However we are still higher than before he spoke last week and the EUR has crept up slowly to trade back at 1.2280 now.
- As we said last week (which turned out to be correct), there was no definitive additional program to back up comments made last week. If you take out the original Draghi comment and the meeting yesterday, we are over a figure higher in the EUR. Surely yesterday has to be positive for the market as there is no need to interfere as relative stability is seen by the ECB in the short term! Mr Draghi could not have been more explicit yesterday, "The EUR is irreversible, you will not go back to the Lira or Drachma… it is pointless to be against the EUR"… HOWEVER, anybody remember Norman Lamont's comments from 1992, luckily Soros didn't listen to him either!
- USDCHF again was inversely aligned with EURUSD. Trading to as low as 0.97 prior to the speech only to jump to 0.99 after the question time. However, for the first time in a long time we saw the EURCHF pop higher to 1.2029. This was again muted by the speech and is back to the trading range about 1.2010.
- A short term bounce in the USD from Friday afternoon through till Monday morning saw the JPY weaken to 78.50. Only to strengthen back to 78.15 where we have been monitoring it for the last couple of weeks. On the FOMC (non) announcement the USD rallied again up to 78.50 only to drop back to 78.30 where we are now. The JPY is really in a trading range now, bound roughly by 78.00 and 78.50. This is NOT what the BOJ is looking for. They have now increased the working age to 65, which should hopefully release some pressure on the aging nation.
- AUD and NZD traded almost in lockstep for the first half of the week. However the AUD weakened against the NZD by the end of the week. AUD remained about 1.05 for the first half of the week until the FOMC made it drop to 1.0460. On the expectation of the ECB it rallied to 1.0580 only to slump back to 1.440. We are now back just above 1.0520 as if nothing had happened. The Aussie economy simply does not warrant a currency this high, with the commodity prices slipping and the rate forecasts to drop, we do not foresee it remaining this elevated for long. From a technical point of view we should see both AUD and NZD resume downward paths for the next few weeks, but no one seems to be selling the high yielding currencies.
- GBP traded negatively slipping from 1.5750 to 1.55. EURGBP started the week at 0.7820 and has subsequently managed to claw back to 0.79 prior to Draghi, only to slip to 0.7820 post comments. We are currently at 0.7860 and hopefully should see a continued revival in the EUR vs. GBP as there is no real rationale for the British pound to stay as strong. Economic figures this week and last kept coming in a very soft way. More stimulus and more QE will be delivered in the 4th quarter, thereby weakening the GBP.
- We feel like a broken record but yet again the BRL followed the same pattern that is becoming familiar, 2.02 up to 2.05 and so the rollercoaster continues. We believe that the BRL fundamentally should continue to weaken right up to 2.40 if the rate cuts continue as expected. USDZAR weakened a little over the week from 8.15 to 8.2550. On the Draghi spike it went as weak as 8.43.

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Fixed Income

- After we finished writing the letter last week the 10s and 30s continued to slide seeing the yields rise to 1.59% and 2.67% respectively. US yields dropped significantly this week across the curve from the end of last week, but are almost unchanged from when we wrote the letter. The 30Yr rallied, seeing a move from 2.64% to 2.60% having been as low as 2.50% on Draghi's comments, the 10Yr mirrored the picture moving from 1.54% to 1.50% but having been as low as 1.44%. However, the 2Yr was unchanged on the week at 0.23%. We repeat the thoughts from last week: Where can the US rates go from here? We would venture to say this looks likely to be where we remain for a while, with no QE3 or intervention elsewhere, but perhaps "a-change-is-comin'?".
- The French OAT seems to be taking up the slack from the German Bund. Where there is still room to squeeze the spread. This week saw the yields compress even further and we are currently at the lows for the OATS at 2.01%. We simply do not see this as sensible, especially with the tax reforms the new Government is implementing, but whilst the market searches for safe haven status and yield, perhaps this could continue only in the very short term.
- Germany's 10Yr had swings during the week but is almost where it started. We saw the extremes created by Draghi up to as high as 1.37% and as low as 1.23%. However we are little changed so far on the week. We remain at 0% rather than negative real yields in Germany, clearly this is not healthy situation and one that cannot remain in the long run….
- Without UHU, without sticky back plastic and without glitter Draghi has let the Spanish yields slide back to 7.14%. The straws will continue to pile up and at the moment any bridge that is being built is a bridge to nowhere. Without concerted support from the ECB the Spanish simply cannot support these elevated levels of debt financing. With continued demands from the domestic Cajas we have not seen the bottom of their troubles yet.
- The Italians are almost back to the highs again after no life vest being thrown by Draghi. The market in no uncertain terms thinks the Italians are still in trouble forcing the 10Y yields right back to 6.33%. The major difference between Italy and Spain is that Italy could reduce its deficit if it actually chased its tax receipts.

Equities

- Developed equity markets lost ground for the week, with the MSCI down 1.20%, as of yesterday's close. Global equities sold off as policy makers failed to offer new monetary stimulus and economic figures remained soft.
- The EuroStoxx 50 fell 1.64% for the week, as of Yesterday's close. European shares fell as the ECB stopped short of offering any immediate aid to combat the European debt crisis. However, suggestions have been made that the central bank may buy shorter term debt, at the discretion of the EFSF, if member states request market aid.
- The S&P 500 fell 1.51% for the week. The Fed refrained from offering new monetary stimulus, however signalled that additional bond buying may be on the table to support economic recovery. As for economic figures, ISM Manufacturing and factory orders confirmed slower US growth; however employment reports came in better than expected. All eyes are on today's Payroll figures to conclude July's employment situation.
- The Nikkei fell 0.13%, as Japanese industrial production came in lower than expected (-0.1% vs. +1.5% expected). Japanese equities continue to report week earnings with shares prices

tumbling following the reports (Sharp and Sony -28% and -7% respectively), as the strong Yen continues to hurt earnings. As a result, Japan's finance minister repeated warnings that Tokyo will take decisive steps to curb the Yen's excessive strength, if necessary.

- In terms of sectors, Utilities and Energy were the worst performers for the week (-1.98% and -1.94% respectively), while Telecoms and Info Tech fared better (-0.02% and -0.43% respectively).
- In spite of this week's disappointment of no signs of further monetary stimulus, we believe this to be the eventual outcome and shares prices should be strongly supported.

Emerging Markets

- Emerging Markets gained 0.33% for the week (as of yesterday's close), as measured by the MSCI EM. This week there has been a big discrepancy in performance according to region. Latin America and Emerging Europe fell by as much as 3.09% and 1.73% respectively, while Emerging Asia rallied 2.25%.
- The Shanghai Composite gained 0.18% for the week. Chinese Manufacturing and non-Manufacturing PMI both confirmed a deteriorating growth picture. As a response, the Chinese government pledged to ensure stable economic growth, which supported share prices.
- The Brazilian Bovespa lost 1.82% this week, as of yesterday's close. Shares sold off as Brazilian Industrial production came in lower than expected and the Fed and ECB refrained from announcing additional support measures.

Commodities

- Commodities fell 1.78% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Commodities sold off across the board, with Industrial and precious metals taking the biggest hit (-3.26% and -1.95% respectively) due to further signs of a slowdown in growth and the lack of new monetary stimulus measures.
- Agricultural commodities lost 1.39% for the week as of yesterday's close. Corn and Soybean traders' bullish stance continued as the drought in the US is seen to be spreading.
- Gold lost 1.74% this week and is now trading at $1'595 per troy ounce. Gold sold off due to the Fed and ECB inaction, causing a rally of the US dollar. On the bullish side, South Korea has added 16 tonnes of gold to its reserves, to take advantage of falling prices.
- Crude Oil fell 2.26% this week and is now trading at $88.09 a barrel. Crude oil as well sold off on lack of policy actions. However, the Brent/WTI spread increased to $18.50 (the largest since Sep 2011) due to a rally in Brent prices caused by drop in output.
- Rising inflationary fears, due to surging soft commodity prices, are likely to support gold prices as investors use the latter as a hedge against inflation.

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