Bedrock Newsletter

Friday, August 10th 2012

Another hot summer week is winding down… Noisy but uneventful… Last Friday we had suggested that the time may be ripe to start switching some fixed-income holdings back to equities, arguing that the former are looking attractive in the light of earnings whilst the later are looking expensive. Well, this uneventful week played into our wishes with equities rising and bonds declining. Nothing dramatic mind you, as the DJIA rose a small 0.35% and the S&P 500 a small 0.50% The bonds, measured by the US 10 year T. Note showed a rather stronger move rising in yield from a low of 1.47% to an intraday high of 1.75% yield, suggesting a 2.50% price decline.
Volatility continued to drop as measured by the VIX, falling from a level of 19 on August first to 15.28 this Thursday. The Euro which had rallied past $1.24 has fallen back to $1.2275 as we write, gold is steady at 1609 or so and oil is slowly rising again- now at $93
Banks remain in the headlights, this time it is Standard Chartered which is being accused of naughtiness- It allegedly has been laundering huge amounts of “bad Iranian monies”. The allegations were brought forward by a newly created New York State watchdog, surprising even the usual agencies like the US Federal Reserve, Treasury Department and the FBI (to name just a few of the usual regulators). The UK is upset and is implying that the US has embarked on a UK bashing route. After the LIBOR scandal erupted the Banking Industry really didn’t need this…
We also received new statistics out of China. Their balance of payments turned negative for the first time since 1998. This number has a scary ingredient, as the current account (net trade) remains positive, we can deduce that the country had net capital outflows. This figure was likely $110Bn, sufficient to “eat-up” the trade surplus and then some for a net total of negative $11Bn. Are rich Chinese expatriating their wealth? The Yuan is regaining some of its very recent declines. We remain “long”. Thursday we saw Chinese data suggesting that the slowdown in growth which started late last year is accelerating. The rebound that most economists had expected in China in the second half following rate cuts in June and July has failed to materialize. The “good news” imbedded therein is based on the hope that the Chinese government will start its own easing program- this may offset the markets disappointment from the Fed’s inaction and the ECB’s words and nothing else. We wonder though if we should build our futures on Quantitative Easing, American, European or even Chinese, or look at QE as alimony, this in Groucho Marx’s eyes who once said “Alimony is like buying hay for a dead horse”...

As the Olympics are winding down in London, there are fresh “noises” concerning the UK’s possible break from the European Union. Nomura issued a report this week suggesting that this is a probable event. After all, Britain never gave up the Sterling nor did they sign the Schengen treaty. What will this eventuality do to markets? Hard to even postulate. It is just another unit of uncertainty to bake into our cake of the future. The positive thought is found in the perception that Europe is inching its way closer to a credit plan which may avert a worsening of the financial crisis.
Another subject is crowding the headlines- Syria. Early in the week we heard that Bashar Assad and wife were killed. The rumor whilst welcome was never confirmed. More horrors and deaths continue in that country as the World argues. The dangers of a complete meltdown therein, accrues daily with scary possibilities of it becoming a lawless zone which will become a nesting area for Al Qaeda and other fanatics. Here, worse than elsewhere as the Syrian regime controls nasty chemical weapons and delivery systems. Syria ridding itself of Assad may be good for some but an uncontrolled “After Assad” could be dangerous.

We leave you with a continued optimism into the next week and for the balance of 2012. We retain our evolving positive equity outlook and remain cautious on high-grade bonds. Enjoy your weekend!

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Currencies

- In general we are on low summer volumes and this translates to skittish markets. EURUSD is currently at the lows of the week, but in line with where we were this time last week at 1.2280. With the general Risk-On momentum gained over the weekend EURUSD had traded as high as 1.2440. In light of slightly weaker Chinese data and as expected US jobs, we have weakened off the highs of the week. Lacklustre on the data front and truly Summer Holiday trading translates into a very quiet week.

- USDCHF again was inversely aligned with EURUSD. Trading to as low as 0.9660 prior to moving slowly up to 0.9780. The pair however seems to be making lower lows and lower highs, perhaps if the positive mood continues we could see the USD slip further, we certainly expect it to in the short term.

- Looking at a graph of USDJPY, you could be forgiven for thinking it had a rough week. Unfortunately though, the scale is just very small and therefore any move looks like a large move! Range bound between 78.30 and 78.70. At least the lower range bound is slowly creeping up in the direction the BOJ wants.

- AUD maintained its elevated position at or around 1.0580 for the majority of the week, only to weaken on the poorer than expected Chinese export data, growing a mere 1% MoM. We currently see the AUD almost a handle lower than last night, currently printing at 1.05. The AUD is too strong; there may be some bid tone for the next week or so as the euphoria in the Risk On market continues. However, the shine will dull on the Aussie before too long and we should see lower rates soon enough. Perhaps we should look to the Olympics as an example, their dominance in the medals has slipped this year, perhaps this will reflect in the economy soon enough!

- GBP was range bound again with 1.5570 seemingly the lower bound and 1.5680 clearly the upper bound. The institutional and governmental buying for CCY diversification purposes seemingly maintaining the bid tone on the lower bound. Once this buying finishes though… who else will step in to buy the British Pound? EURGBP started the week at 0.7920 and has subsequently slipped only on weaker than expected German Industrial Production, having been as high as 0.7960 we are now printing 0.7875. More stimulus and more QE will be delivered in the 4th quarter, thereby weakening the GBP.

- And so the rollercoaster continues for BRL. This time trading down from 2.0450 to 2.0150, where we closed last night. We believe that the BRL fundamentally should continue to weaken right up to 2.40 if the rate cuts continue as expected. USDZAR was almost completely unchanged on the week at 8.15, slipping briefly to as low as 8.10, but we are back at 8.15 now.

Fixed Income

- After we finished writing the letter last week the 10s and 30s continued to slide seeing the yields rise to 1.57% and 2.65% respectively. US yields bounced significantly this week across the curve (even from closing last week). The 30Yr slipped, seeing a move from 2.64% to 2.80% bouncing only on the weaker Chinese data to be at 2.73% as we write, the 10Yr mirrored the picture moving from 1.56% to 1.73% but rallied to 1.64% as we write on the Chinese data. Even the 2Yr slipped causing the yield to soar (relatively speaking) from 0.23% to as high at 0.28%. We repeat the thought from last week: perhaps “a-change-is-a-comin’?”… Is this the first step in a change of direction?

- The French OAT continues to trade as the poor relation to the Bund. This week saw the yields compress but only marginally and we are currently almost back at the lows for the OATS at 2.06%. 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… but only in the very short term.
- Germany's 10Yr had swings during the week but is almost where it started at 1.38%. We saw the yields go as high as 1.48% on Wednesday but weak German data led to a return to lower yields. However, we are little changed so far on the week. As we said for the US last week, perhaps there is change in the air, we are not holding our breath just yet, but maybe, just maybe…?
- On a slow and news free week, the Spanish have lowered the yield the market sees them financing at. Breaking below the magic 7% number again this week to be at 6.85% as we write. Very quiet news this week, but the fundamentals have not changed and ultimately straws don't make much noise when they land!!
- The Italians defied the general market tone this week seeing their yields drop from 6.33% to 5.88%. The general positive market has seen the pressure taken off the Italians. We also note that very slowly Germany's tone is changing, with a split between the Bundesbank and the Politicians growing larger by the week. Perhaps Draghi has actually managed to make the impossible happen… risk Bonds and Equities rallying at the same time?!

Equities

- Developed equity markets advanced this week, with the MSCI up 1.44%, as of yesterday's close. Global equities were generally in positive territory on hopes of new monetary stimulus and release of encouraging economic figures (except for the Chinese this morning).
- European shares rose by 2.7% (as measured by the EuroStoxx 50) this week until Thursday, nearing their highs for the year on stimulus hopes, after Chinese economic data speculation kept alive talk that central banks will have to ride to the rescue again; five years after the financial crisis began. Unfortunately though, another round of weak Chinese data showing that the trade surplus narrowed sharply. This prompted concerns about global growth on Friday. As a result, the EuroStoxx rose by 1.22% for the week so far.
- The S&P 500 rose by 0.85% over the week, breaking the 1'400 level and hovering near a four-year high, as weak Chinese figures were seen as a sign that officials would do more to stimulate the world's second-largest economy, which has been losing momentum since the start of last year. However, Wall Street found little reason to continue the gains of the previous three sessions amid lukewarm US productivity data and downgrades in economic growth forecasts in Europe.
- Meanwhile, the Nikkei surged by 3.93% breaking the 9'000 mark on Thursday as Chinese inflation data signalled possible easing ahead and as Investors were eyeing the conclusion of the two-day Bank of Japan meeting. Although few policy changes are expected, especially after the US Federal Reserve and the European Central Bank held fire last week.
- In terms of sectors, Materials and Energy were the best performers for the week so far (3.81% and 2.40% respectively), while Consumer Staples and Healthcare fared less well (0.08% and 0.04% respectively).
- Developed companies – especially in the US – continue to report strong earnings, with large cash reserves at their disposal.

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Emerging Markets

- Emerging Markets gained 2.78% for the week (as of yesterday's close), as measured by the MSCI EM. The best performing region was Asia (3.65%), followed by Emerging Europe (2.38%) and Latin America (1.71%).
- The Shanghai Composite rose by 1.69% this week, as hope that a drop in consumer inflation in July would pave the way for the government to loosen its monetary policy in the weeks ahead.
- The Brazilian Bovespa advanced by 2.69% this week (as of yesterday's close) as the recovery by local oil heavyweight PetroBras from a steep selloff and favourable factors abroad helped boost the local market. In light of being forced to sell the imported goods at less than cost PetroBras should be able to return to much better earnings as it will adjust the domestic cost and pass on some of the foreign price fluctuation to the end users.
- We remain constructive on Emerging Markets in the medium/long term as most investors keep being attracted by these countries' growth and relative sovereign stability.

Commodities

- Commodities rose 2.30% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Commodities rose across the board, with Energy leading the gains (+3.05%), bolstered by hopes of further monetary stimulus, followed by Industrial and Precious Metals (1.25% and 0.73% respectively).
- Agricultural commodities only rose by 0.48% this week as of yesterday's close, although Corn traders' bullish stance continued as the drought in the US is seen to be spreading.
- Gold rose by 0.46% this week and is now trading at $1'610 per troy ounce. The yellow metal quietly rose until Thursday before inching down on Friday, taking its cue from Asian equity markets that had paused for breath after recent rallies. It remains on track for a second weekly gain (after last week's surge), bolstered by hopes China could move to stimulate growth.
- Crude Oil rose by 2.76% this week and is now trading at $92.70 a barrel. Oil prices got a boost after China said annual consumer inflation hit a 30-month low last month and industrial output grew at it slowest pace in some three years, as markets saw that as a sign that officials would do more to stimulate the world's second-largest economy.
- 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.
