Bedrock Newsletter

Friday, August 17th 2012

A heat wave is upon us in Europe and the US is having a similar weather pattern. Things are cooking… We started the week with GDP data out of Europe which as a whole isn't doing well but the core economies of Germany and France surprised us with better than expected figures: Germany was +0.30% for Q2 and +1% year on year, France was flat for the third quarter running, pleasantly not negative!

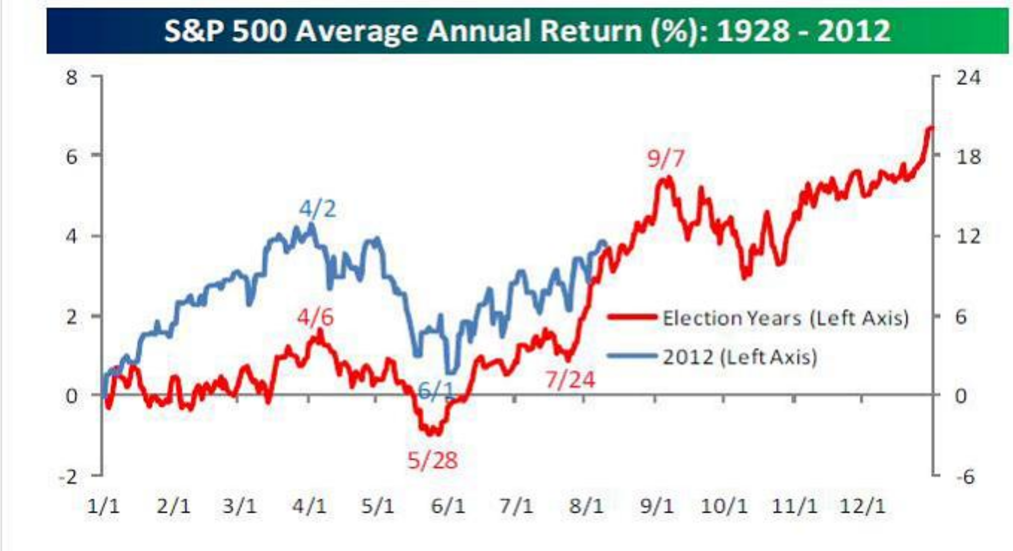
On Monday the VIX (volatility index) fell to 14.75, a 5 year low, only to pursue its slide to 14.29 by Thursday's close in NY. This supports the continuing "risk-on" attitude we have been watching in the equity markets around the globe. Bonds have been acting in a logically inverted manner, falling in prices, making yields rise- the benchmark US ten year Treasury Note reached 1.724% on Tuesday and continued to slide reaching 1.82% by Thursday. Oil prices have been climbing back up to five months' highs, now (un)comfortably trading above $95/bbl for West Texas crude. Gold has stabilized and has been trading in a very tight range around $1'620/Oz. Are we at the inflection point for the markets? Let's hope so…

In support of this less gloomy outlook we had the Brazilian Government announcing a $66Bn stimulus program, to be sensibly(!) injected directly into the private sector. Then on Thursday night, Angela Merkel visiting Canada announced her undying, formal and definitive support for the Euro. Can we consider Merkel and Mario as the M&M candies for the markets?

And we have some more uncertainty removed from our future, now that the Republican Vice-Presidential candidate has been named: Paul Ryan, a man with a "Ronald Reagan view" on the economy- A budget plan, low taxes, cuts in entitlements and similar economically sound thoughts. Even Donald Trump had nothing or little to say against Romney's choice here! The odds in favor of the Republicans have improved. This may be a positive for the markets… Or not, as if Ryan's budget plans see the light of day, it is likely that this will induce a US recession in 2013/14- Historically, the US government has spent 20% of GDP since 1948, running now at a post-war "Democratic high" of 25%; Ryan wants to bring the spend rate back to 20%.

The rise in oil prices can be explained by the rising tensions surrounding the Iranian nuclear issues which seem to have remained stuck nowhere. Israel is toughening its tone and within the country there is a growing apprehension that their leaders might be seriously considering military actions. The Israeli Shekel has fallen heavily in the past few days as well as the local stock market. Viewed from there, risks of conflict are rising.

Let's look for a moment through all the noise and clamor and consider this chart of election years in the USA. It should send you into your undoubtedly hot weekend with an optimistic smile! Dates on the chart are US style (MM/DD/YYYY)



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Currencies

- EURUSD is currently near the highs of the week at 1.2360. Last week's low of 1.2280 acted as a lower bound for the week and with a generally positive momentum in the market we are up. A mixture of little data of interest or in-line with expectation on the jobless data meant another quiet summer week. However, Merkel is buoying the EUR with her "Germany will support the EURO" comments and the general risk-on sentiment continues to support the EUR… We expected the short term rebound and even expect a continuation, but of course that does not change our view that the EUR is over-valued, even at these levels.
- USDCHF again was inversely aligned with EURUSD. Trading to as low as 0.97, where we are currently. The pair is still making lower lows and lower highs; if the positive mood continues we could see the USD slip further, we certainly expect it to in the short term with Merkel on the media offensive.
- Finally the Yen is no longer yawning! USDJPY has moved continuously from 78.10 right up to 79.40 in a straight line throughout the week. With a risk-on feeling in the market, the old funding currency of choice is weakening from its recent strength. The EURJPY pair has hit a six week high at 98.34 from below 98.00 on Merkel's comments and the Aussie and Kiwi are bouncing as well against the JPY on commodity strength.
- AUD followed the Australia medal tally… a little flurry at the end of last week to see it finish lower than expected. The AUD slipped this week from 1.0560 to 1.0440 on RBA comments that they do not feel that direct market intervention to weaken the AUD is the right course of action. Instead sticking with their mandate and confirmed that they would look to cut rates further if necessary (which of course it is). We continue to believe the AUD will weaken and perhaps we have reached that inflection point already.
- GBP was range bound again this week until the ZEW figures caused the GBP to bounce, breaking up through 1.57. We saw 1.5740 before settling back to 1.5720. Over the last month we are almost unchanged, but still very much off the highs from earlier in the year. We still expect the GBP to weaken over the coming months. EURGBP started the week at 0.7840 and had reached 0.7880 only to slip on Wednesday to as low at 0.7825. with the risk-on comments for the EUR by Merkel we see it back to the highs of the week at 0.7880. More BOE stimulus and more QE will be delivered in the 4th quarter, thereby weakening the GBP.
- BRL has had a relatively quiet week up till last night; moving on Monday from 2.0160 to 2.03, only to spend the rest of the week falling back to 2.0160. For now we do not have any vision on what effect Dilma's $66Bn plan will have on the markets today... So we will wait and see for an update next week. We believe that the BRL fundamentally should continue to weaken right up to 2.40 if the rate cuts continue as expected. USDZAR moved in a very straight line from 8.10 on Monday to 2.28 as we write.

Fixed Income

- "A-change-is-a-comin'!"… Not sure we can say it any clearer. Dramatic week for the 2s, 10s and 30s – in fact the whole US curve! – which all continued to slide seeing the yields rise to 0.2850%, 1.86% and 2.98% respectively at the moment. US yields had HUGE bounces this week across the curve. The 30Yr slipped, seeing a move from 2.64% to 2.80%, the 10Yr moving from 1.64% to 1.86%. Even the 2Yr slipped causing the yield to soar again (relatively speaking) from 0.2550% to as high at 0.2925%.

- Germany's 10Yr Bund was not allowed to escape the massive bond selling this week; we saw the yields soar from 1.41% to 1.57%. Last week we said not to hold our breath, well it looks like the markets took a collective sigh of relief and the bonds are weakening. It looks like the markets got their fill of M&M sweets this week!
- The French OAT continues to trade as one of the central European staples but is no longer the poor relation to the Bund. This week saw the yields compress again (three weeks running), but more as a function of the Bund weakening more than the OAT, rather than the OAT strengthening. 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. Although weaker, not materially so at 2.17%.
- Well done Angela Merkel. Amazing how one German can magically wipe off 40Bps on the borrowing costs of another nation with a simple few words. After last week breaking below the magic 7% number to 6.85%, again this week we are at 6.45% and dropping. The fundamentals have not changed and whilst the news is positive for a week, even at these levels the Spanish are still in dire need of help (or default…).
- The Italians probably feel a little like the ugly duckling at the moment, when the periphery sells off, normally so does Italy… when the periphery bounces, normally so does Italy. However, this week the Italians really benefitted very little as Merkel's comments were not directed so much at Italy but more at Spain. The yields only dropped 6Bps from 5.88% to 5.82%, still elevated, but stronger nonetheless.
- On a corporate level we have seen several large names deciding to use their high cash reserves to pay down debt. Not strictly what the flood of cash that the US has injected was designed for. With the money cycle already damaged and corporates essentially dropping out of the funding world, we are seeing the opposite of what it was designed to do. If corporates remove themselves from the market place now, they may not be able to re-enter…

Equities

- Developed equity markets rallied for the week, with the MSCI up 0.72%, as of yesterday's close. Shares rallied as US and EU economic figures came in better than expected, calming market sentiment. Shares were supported most on Thursday when Angela Merkel voiced support for the ECB's bond buying proposals and emphasised that Europe is on the right track to resolve its debt crisis.
- The EuroStoxx 50 gained 0.47% for the week, as of Yesterday's close. Germany and France both reported better than expected GDP figures (0.3% vs. 0.2% exp. and 0.0% vs. -0.1% exp. respectively) thereby managing to avoid a contraction. However, the overall growth rate of the Eurozone is contracting due to weakness in the peripheral countries, raising hopes for further stimulus.
- The S&P 500 rose 0.69% for the week. Shares rallied as US retail sales and Industrial output figures beat expectations, as well as US housing permits rose to a four year high.
- Japanese stocks were the strongest performers of the week, with the Nikkei soaring 3.05%. Shares bounced as the Yen weakened, triggering a short-covering in Japanese exporters. Japanese stocks are expected to recover with any further weakness in the Yen, as valuations are cheap following a weak earnings season.

- In terms of sectors, Info Tech and Financial were the best performers of the week (+1.43% and +1.04% respectively), while Telecoms and Materials were the weakest (-0.03% and 0.00% respectively).
- We remain constructive on equities in the long term due to cheap valuations and expectations of further monetary stimulus which will support share prices. However, in the short term market uncertainty still remains and we should expect to see further volatility.

Emerging Markets

- Emerging Markets weakened 0.35% for the week (as of yesterday's close), as measured by the MSCI EM. In spite of strength amongst developed equities, EM shares showed signs of weakness due to their vulnerability to global growth prospects, which have been reported on the weak side in Europe and Asia.
- The Shanghai Composite fell by as much 2.49% for the week on a deteriorating outlook. Investors have been reported to be pulling money out of China (FDI falling to a 2 year low) and the rate of inward investment fell to the lowest rate since the 2008 global crisis. As a result premier Wen Jiabao increased speculation of further cuts in banks' reserve ratio and further talk of forced development sales at reduced prices to slow loan defaults.
- The Brazilian Bovespa rose 0.28% this week, as of yesterday's close. Equities recovered earlier losses caused by global growth worries, as Brazilian retail sales came in better than expected and reports of a planned stimulus package focusing on investment in domestic infrastructure, spurred investor confidence.
- 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 advanced by 1.75% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Commodities were mainly driven up by Energy (+3.02%), bolstered by hopes of further monetary stimulus, while Precious metals only rose by 0.57% and Industrial Metals were about flat.
- Agricultural commodities rose by 0.91% this week as of yesterday's close, although Corn and Soybeans continued to rise as the drought in the US is seen to be spreading.
- Gold increased by 0.50% this week and is now trading at $1'617 per troy ounce. The yellow metal retreated until Tuesday before firming on Thursday on speculation that central banks may be set to launch more bullion-friendly stimulus measures to boost growth, though mixed US data that dampened expectations for imminent Federal Reserve action kept prices in a range.
- Crude Oil rose by 2.65% this week after a three day winning streak, currently trading at $95.15 a barrel. Oil steadied near a three-month high on Thursday, supported by worries over possible disruptions to supply from the Middle East and a steep fall in US oil inventories. The global crude oil benchmark has risen more than a third in less than two months on escalating worries about a conflict over Iran's nuclear programme.

- However, Oil fell for the first time in four days on Friday, paring a third weekly advance on speculation that its rise to a three-month high was not sustainable after Thursday' almost 1.4% increase to more than $95 a barrel. Oil may slide next week on concern that slower economic growth in the US will reduce demand and as the world's biggest crude consumer is considering a plan to release emergency stockpiles.
- Rising inflationary fears, due to surging soft commodity prices, are likely to support gold prices as most investors use the latter as a hedge against inflation. Also, more stimulus measures from Central Banks should boost commodities in the medium term.
