Bedrock Newsletter

Friday, August 24th 2012

We are closing another summer, another week to go. Thin and declining trading volumes have marked this summer (as usual) and yet, we have been "melting-up" slowly in equities. We were very jittery into Tuesday's release of the Fed's minutes (FOMC) which surprised the markets with their dovish wording- this was interpreted as a promise for an upcoming QE(3)! Bill Gross of PIMCO assigned an 80% probability for easing. The equity indexes which had been down changed direction finishing with nice rises, the US$ fell and commodities starting with oil and gold rallied strongly. Wednesday Bullard of the Fed attenuated this dovish interpretation with words suggesting that no Fed action is imminent. Markets reversed some of their gains, except the US$ which held its new level and US$ denominated commodities continued to rise. What is driving markets, you ask?

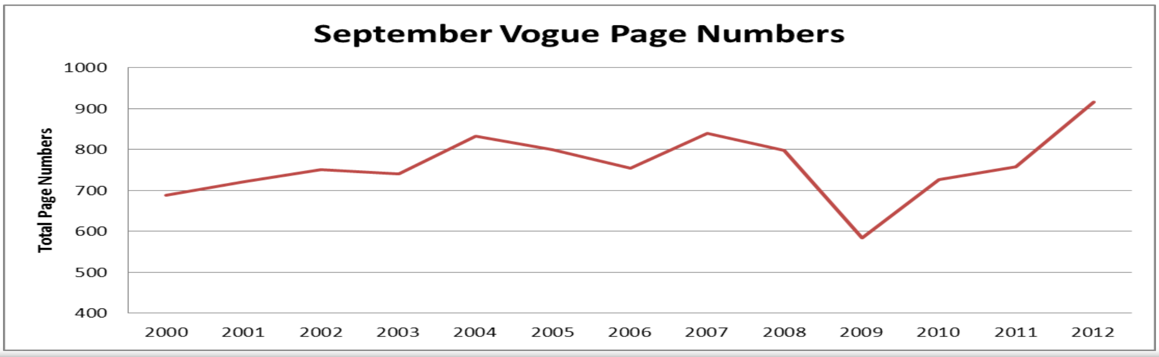
World trade is slowing though, the evidence of which can be seen in the Baltic Dry Index which tracks the cost of shipping. The index is down 51% year-to-date. Is it showing us that China is slowing (as some say) or is it driven by shipping capacity growing faster than the economy's needs? The drought in America is worsening. Food prices have risen and are poised to continue this trend, what with the cost of energy rising as well. The likely outlook is that we will be getting less bread for our dough…

The US Presidential electoral process is heating up, stealing headlines from the dramatically worsening Syrian conflict and the heightened tensions between Israel and Iran. The GOP is gaining some marginal points against the incumbent but are still trailing. Some are saying that the Fed will not enact QE3 before the elections so as not to appear politically driven. But this is silly, as inaction for such a motive is in itself a political act! We place Bernanke on a higher pedestal than that!

Talk in DC about "killing" FNMA and Freddie Mac (quasi government agencies which are mortgage providers) is rising amongst Democrats; allowing substantial mortgage write-offs. We doubt that such a terrible idea would be realized unless Obama falls in the polls… Populist ideas are rarely good for the economy or moral standings. From this stand point we'd rather see Obama hold in the polls.

Some time ago we argued that the changing demographics in the USA and in Europe, namely the ageing of the population, can support a view that raising interest rates could be beneficial to these economies. The US alone shows a $6.6 trillion (this is a VERY big number) shortfall in retirement funds! The average 60 year old American has $117K in his/her 401K retirement account. The cost of the future rises as rates drop… arguably; if rates were to rise the shortfall will be reduced! Again, this is politically impossible to accept. Intelligent wishful thinking…

On the happier side of things we noted that the American Vogue September issue has the largest page-number count ever with 916 total pages, 658 of which are advertising! We charted the progression of pages over time, thinking that this may be an interesting barometer of future economic activity and market behavior. We sense that it may give you reason to smile into your weekend…



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Currencies

- EURUSD used last week's upper bound as the lower bound for this week. We have seen the EUR rally and the USD weaken throughout the week to a high of 1.2590, settling now at 1.2540. With the threat of possible QE3 (or not depending on who you speak to) the USD has dropped throughout the week and looks set to slip a little further.

- USDCHF again was inversely aligned with EURUSD. Trading to as low as 0.9550, where we are currently at 0.9580. The pair is still making lower lows and lower highs; we could see the USD slip further, we certainly expect it to in the short term with negative USD news hitting the news reels.

- Unfortunately for the BOJ, the USD weakness was hit very hard against the JPY. The JPY jumped on the FOMC minutes from Wednesday causing the USD to slide unceremoniously from 79.20 to 78.20 in a matter of minutes. We have recovered a little from the lows, but are trading at 78.55, having been at 79.60 earlier in the week. The EURJPY pair had another great week touching 99.20, almost a two month high, settling back to 98.50 as we write, which is still up for the week.

- AUD was holding steady before the FOMC, after which it jumped from 1.0440 to 1.0520. The AUD is still too high at these levels and as soon as the general mood starts to turn we will see the AUD weaken, it has to. With rate cuts on the horizon, China slowing down and a two speed economy, the AUD will undoubtedly weaken, the question is when… or perhaps we should say *Wen*? Commodity prices should keep a little strength in the currency for now, but this cannot last... perhaps since Wednesday we have seen the first signs of weakness with the AUD printing 1.0390 moments ago.

- GBP had a positive week supported by a weakening USD and little news on the UK side until today. The Pound is now at 1.5850 having been as high as 1.5910 post FOMC release. Weale (of the BOE committee) has stated he would favour a rate cut over further QE. With the elevated levels the GBP is currently maintaining, we see it being set up to fall. EURGBP started this week at 0.7840 - where it started last week, but we are at the high of the week now at 0.7920.

- BRL has had a relatively quiet week moving very little from 2.02, in fact bound by 2.01 and 2.0250 for the week. This week has brought little clarity to the market on Dilma's plan, but the big story in Brazil this week is whether the Brazilian Supreme Court of Justice will file charges against the politicians and close corruption in the Government. If they go after the politicians, Brazil will be stating its intention to become a First World country! We believe that the BRL fundamentally should continue to weaken right up to 2.40 if the rate cuts continue as expected.

- On the TRY we finish the week where we started at 1.80, having seen the USD slip as low as 1.79. The political situation makes it quite difficult to see the path ahead, but for now we look at the long term trends and won't argue with a strengthening USD.

Fixed Income

- US Treasuries headed for the biggest weekly gain in 3 months on speculation the Fed will add to monetary stimulus, with investors expecting such an announcement as soon as in its September meeting. Treasuries rallied across the board with the yields of the US 2-year falling 2.7 bps to 0.26%, the 10-year down 15 bps to 1.66%, and the 30-year down 16 bps to 2.77%.

- In Europe, peripheral EU government bonds rallied on the prospect of the ECB buying struggling countries debt to curb their borrowing costs. However, some gains were given back as Greek Prime Minister asked to be given 4 years instead of 2 to push through painful economic reforms.
- Merkel and Hollande responded with a tough stance, bringing back into focus fears that Greece might not receive its next bailout tranche. Meanwhile, Spanish and Italian 10 years rallied 7.7 bps and 5.7 bps to 6.3080% and 5.70% respectively.
- This week, bonds rallied across the board, with US Corporates and Global Convertibles being the best performers of the week (+1.21% and 1.06% respectively) while Leveraged Loans and EU High Yields rose least (+0.33% and +0.40% respectively).

Equities

- Developed equity markets slid this week, with the MSCI World retreating by 0.38%, as of yesterday's close, as expectations of new stimulus measures from central banks were outweighed by persistent worries over the Euro zone debt crisis.
- The EuroStoxx 50 lost 2.09% for the week. Investors considered the Euro zone economic weakness to be exacerbating the difficulties for struggling Euro zone states to cut their high debt levels. On Thursday, PMI even suggested that the Euro zone looked destined for its second recession in three years, with the economic gloom even spreading through Germany, the region's largest and strongest economy.
- The S&P 500 fell this week, losing 1.13% as of yesterday's close, as the pace of hiring slowed for the fifth month in a row outweighing the slight improvement in US manufacturing activity this month – though new export orders declined for a third straight month because of reduced demand in Europe.
- Meanwhile, Japanese stocks also lost ground with the Nikkei dropping about 1%, retreating from Thursday's three-month closing high as investors locked in gains on expectations for quick stimulus measures from the US Federal Reserve began to dim.
- In terms of sectors, Materials and Healthcare were the best performers of the week (+0.60% and +0.12% respectively), while Energy and Utilities were the weakest (-1.16% and -0.99% 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 short term setbacks.

Emerging Markets

- Emerging Markets rose by 0.50% for the week (as of yesterday's close), as measured by the MSCI EM as investors speculated Chinese and US policy makers will take steps to boost growth in the world's largest economies.
- Chinese shares posted nice gains on Thursday, as data signalled the nation's manufacturing may contract at a faster pace this month, fuelling speculation the People's Bank of China will ease monetary policy – a day after Governor Zhou Xiaochuan said adjustments to borrowing costs can't be ruled out. However, China's stocks sharply fell on Friday, dragging down the

benchmark index to the lowest level since March 2009, after a series of globally weaker earnings. As a result, the Shanghai Composite lost over 1% for the week.

- The Brazilian Bovespa dropped by 1.30% this week, as of yesterday's close. Brazilian stocks sharply fell on Thursday after data showed factory activity in China shrank in August at its fastest pace in nine months, sparking concerns over economic growth in one of the region's key trading partners.
- We remain constructive on Emerging Markets in the medium/long term as most investors keep being attracted by these countries' growth and their relative sovereign-stability.

Commodities

- Commodities advanced by 1.00% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Commodities were mostly supported by Precious and Industrial Metals (+3.92% and +3.74% respectively) on a selloff in the US dollar caused by rising bets on further monetary easing by the Fed.
- Agricultural commodities rose by 1.74% this week as of yesterday's close. Soft commodities rallied due to damage to US crops caused by the sustained drought, as well as Russia's Agriculture Ministry cutting its 2012 gain crop forecast.
- Gold rose 3.2% this week (now trading at $1'667 per troy ounce) to the highest level in 3 months, as investors increased their bets that the Fed will launch an additional bond buying program, causing a selloff in the US dollar.
- Crude Oil remained flat for the week (+0.02%) and is currently trading at $96 per barrel. However, Brent rose 0.85% to $114.70 per barrel (raising the spread over WTI crude to $21.30) on renewed hopes for another round of monetary stimulus by the Fed and increased tensions with Tehran, as reports indicated Iranians have expanded their nuclear capacities further.

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