Bedrock Newsletter

Friday, September 7th 2012

Super Mario strikes again! Thursday started with the ECB announcing that it holds its interest rates steady against a backdrop of poor economic data all across the Euro Zone. In the press conference that followed, Super Mario announced the ECB's new, unlimited bond buying program: The ECB will be buying bonds of the weaker sovereigns, 1 to 3 years in remaining maturities whilst assuring the markets that they will be "sterilizing" these purchases- This means that the ECB will NOT be printing money as it will be funding its purchases by selling other assets- Clearly, the ECB is transforming itself into a huge Hedge Fund! It will be buying bonds yielding 4, 5 & 6% whilst selling Bunds and other high grade paper to yield zero to 0.50%... They will end-up with a high-yield portfolio funded at the German rates, earning a spread of 3.50% to 5% WHERE CAN WE SUBSCRIBE???

Mario did say that he will do everything to protect and support the Euro, which is irreversible! He must have credibility, as the Euro is now at $1.2700
Well, the markets just loved it! European equities roared up to 4% higher, the US markets followed with 2% rises across the board and the Far East joined the party. The Chinese announced their own version of stimulus with a huge infrastructure set of projects. The volatility measure, VIX, dropped a couple of notches to 15.60, Gold rose to $1'700 as the US$ dropped. An indirect beneficiary of all this is the Swiss National Bank! These fellows had been selling the Franc for Euros for some time now, protecting the "floor" of 1.20 Francs for a Euro. Well, today the Swiss Franc is trading at 1.212 to the Euro, bagging big gains for the Central Bank.

In short, the ECB has given the markets a "Put Option" on the peripheral government bonds- their yields are capped now. Investors can buy and not worry about price declines. It is a backstop and we can expect a conversion of all European yields towards the Bunds. Spreads will remain, but they will close significantly.
Draghi gave some interesting data on European M1 and M3 Money supply- Both are up, suggesting that the reason for this is the public's preference for liquidity and slow demand for credit. Both are bad news for European GDP growth. To us it appears that it is the ECB which has taken the European governance into its hands. The Germans win again, Brussels ceding its power to Frankfurt!

In the US, the Democrats appointed Obama as their Presidential Candidate. The November elections are upon us now and the next move is up to the Federal Reserve- It is time for them to concentrate on their second mandate of maximizing employment. Here, we got the ADP report yesterday which showed a much bigger than expected private sector employment increase (201'000 new jobs!) and we await the "official" non-farm-payroll data at 2:30PM today, expected at +145'000.
This September may be a good one for markets!

We leave you to your weekend happiness with a thought; G.K. Chesterton wrote "Fairytales do not tell children that dragons exist. Children already know that dragons exist. Fairytales tell children that dragons can be killed..." We add here that the true dragon slayers are Central Bankers!

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Currencies

- Super Mario strikes again, with the ECB holding rates steady and releasing another Bond Purchasing scheme in the form of the OMT, the EUR has strengthened. EURUSD started the week at 1.2570, although having slipped to 1.25 on Wednesday, we are currently making new highs at 1.2715. We are back to the end of June levels post the summer doldrums. Overall the week saw a boost in Risk assets and a weakening in the safe haven currencies. It remains to be seen if the EUR will have the power to climb much more than here, as fundamentally, the economy remains very weak and Europe needs a lower currency. We would not bet on a rising EUR for much longer...
- USDCHF has broken the EURUSD relationship! How long for?... we just don't know. We started the week at 0.9560 and we are again finishing at 0.9560 as we write. The SNB finally were the surprise beneficiaries of the ECB Presidents intervention in the markets. The CHF weakened against the EUR from 1.2010 to 1.2155. The EUR strength has been felt across the board and has therefore provided some respite for the SNB and booked them a paper profit for the first time in a very long time on their currency reserves! This of course is due to the fact that the market finally seems to understand that the EUR is here to stay.
- The BOJ was also happy with Draghi's comments and the support package. The static USDJPY shot up on the OMT information release from 78.40 to 79.00, where it stabilised just under the figure. We are yet to see JPY significantly weaken past 80.00 and beyond, but perhaps this is a step in the right direction.
- AUDUSD gradually weakened for the week from 1.0300 to a low of 1.0175 on Thursday's morning session. However, on stronger employment (or rather weaker unemployment data), followed later on by Draghi and the positive Risk-On momentum the AUD rallied hard from the lows to 1.0350.
- GBPUSD had a flat week until the BOE re-iterated their stance on the low rates and asset purchase plan on Wednesday and with the positive market mood on Thursday followed the 1 figure gain by continued strength. Overall the Pound moved from 1.5825 to 1.5980, not quite breaching the 1.60 figure. In light of the continued strength we wonder how long the lustre of the sovereign currency can last…
- USDBRL is currently flat for the week; however it ventured for Wednesday and Thursday to 2.0450, only to slip back to the lows at 2.0290. USDZAR slipped in line with the USD weakness across the board, moving steadily from 8.44 right down to 8.22.

Fixed Income

- Treasuries fell this week, pushing yields up the most in more than a month, after data suggested US job growth is accelerating and European officials announced plans to buy bonds to curb the region's sovereign-debt crisis. As a result, the US 30 year yield advanced by 18.4 bps to 2.856%, the 10 year was up 18 bps to 1.729% and the 2 year gained 4 bps to 0.272%.
- In Europe, Spain's borrowing costs dropped sharply on ECB purchase hopes, reaffirmed by a strong debt auction on Thursday, where 3.5 billion Euros of bonds maturing in 2014, 2015 and 2016 where sold, raising the top end of the targeted range (between 2.5 billion and 3.5 billion). As a result, Spanish 10 year dropped from about 6.8% on Monday to 5.66% currently! However, any relief may be brief if the European Central Bank fails to unveil a significant bond-buying plan to prop up the euro zone's struggling economies.

- Meanwhile, Italian 10 year dropped from 5.76% on Monday to 5.10% currently, while in Portugal, 10 year yields dropped from 9.15% to 8.22% currently.
- Draghi will provide details on his bond-buying proposal that should have unlimited purchases and be sterilized to ease concerns about printing money. The ECB will refrain from setting a public cap on yields.
- This week, EU High Yield and Global EM were the highest performing sectors (+0.69% and +0.61% respectively) while US High Yield also fared quite well (+0.48%). EU and US Corporates were the most negative sectors (-0.32% and -0.19% respectively) along with US Sovereigns (-0.19%).

Equities

- September started off on a strong foot, with the MSCI world rallying 1.43% as of yesterday's close. Equities rallied on the back of positive developments from all fronts, with the ECB announcing a bond buying program, US employment data showing signs of improvement and China announcing two major construction projects to revive economic growth.
- European stocks posted the largest regional rally, with the Eurostoxx 50 bouncing as much as 5% for the week! European equities started the week in mixed territory as Eurozone manufacturing fell further in August, suggesting a poor outlook for the region. Equity markets posted strong gains on Thursday with Mario Draghi announcing the most aggressive plan so far of tackling the European debt crisis. The ECB has promised open-ended purchases of short-maturity government bonds to keep borrowing cost of struggling countries at sustainable levels.
- The S&P 500 rallied 1.82% for the week, as of yesterday's close, reaching the highest level in 4.5 years. Headwinds from Europe as well as positive US employment data, where more jobs than expected were added in August (201K vs. 140K exp.) and fewer Jobless claims (365K vs. 370K expected), helped the gauge reach pre-Lehman levels. Eyes are set today on the Nonfarm payrolls to conclude the US employment picture for August.
- Japanese stocks posted only modest gains for the week, with the Nikkei up 0.36% for the week. Underperformance arose due to Japanese capital investment figures missing expectations (7.7% vs. 8.9% exp.), as well as yet another week of an unbearably strong Yen.
- In terms of sectors, Financials, Health care and Info-Tech stocks posted the strongest gains (+1.93%, 1.88% and 1.70% respectively), while Industrials and Energy stocks rose the least (+0.48% and +0.89% respectively).

Emerging Markets

- Emerging Markets rose by 0.33% for the week (as of yesterday's close), as measured by the MSCI EM. The gauge posted weaker gains than its developed counterpart due to weekly losses in Emerging Asia (-1.85%) due to growth fears in the region. Emerging Europe and Latin America posted solid gains (+2.79% and +2.05% respectively).
- Chinese stocks posted strong gains with the Shanghai composite up 3.9% for the week. China has announced plans for infrastructure spending, including railroad and subway projects across 18 cities, as well as over 2'000 Km of road construction. Such measures are deemed necessary by government officials, in order revive growth, following additional poor

data this week of PMI Manufacturing indicating a stronger contraction in August (47.6 vs. 49.3 in July).

- The Brazilian Bovespa rallied 2.2% for the week. ECB bond buying plan, as well as Chinese infrastructure spending prospects, supported Brazilian exporters. Market participants are expecting further rate cuts in Brazil to support growth in the country. However the Brazilian central bank announced this week that any further cuts should be done with Maximum caution, as recent spikes in food prices pose inflationary risks in the short-term.

Commodities

- Commodities rose by 0.72% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Energy and Agriculture were the most negative sector (-0.76% and -0.69% respectively), while Industrial and Precious Metals both posted the most important gains (2.26% and 1.47% respectively).
- Agricultural commodities fell this week as Soybeans declined to the lowest level in more than a week, on signs the drought-hit crop in the US - the world's largest grower last year - could be less bad than a government forecast.
- Gold rose by 0.30% over the week - now trading around $1'697 per troy ounce. The yellow metal traded higher this week on news of the European Central Bank's plans for a potentially unlimited bond-buying program although positive US economic data tempered bullion's gains.
- Crude Oil closed the week on a negative stance (-0.61%) and is currently trading at $95.85 per barrel. Oil prices slightly rose until Thursday before sharply falling on Friday, on a stronger US dollar and as the United States considered another release of emergency oil reserves that may potentially be much larger than the last. Crude futures were also vulnerable to profit-taking after they had climbed the previous three day and ahead of US non-farm payroll data due later today.
