Friday, September 21st 2012

A strange week… We experienced Islamist rioting around the globe after the release of a bad YouTube video-clip insulting the Prophet Mohammed. This erupted with the murder of four American embassy staff in Libya. The Arab Spring is turning into the Arab Fall…
Much is going on around the world; Syria is going from bad to worse, the Iranian nuclear issue remains a hot potato, the US presidential elections are heating-up and the infamous “Fiscal Cliff” is fast approaching. Economic data from everywhere keeps coming in in shades of grey, Europe showing economic activity retracting to early 2010 levels, China’s growth is now clearly slowing and the Bank of Japan has joined Bernanke and Draghi with its own QE.
And then, a few small rocks in the China Sea might yet become the Princess Sissy of the 21st century- China and Japan have escalated their long-standing quarrel over these stones. The US finds itself dragged into the argument and must carefully weigh its position here- the fact that both Japan and China each own about $1.12T of US Treasury bonds, both countries huge trading partners and Japan with a defense treaty… Is it time to worry? Is China deflecting its economic uncertainties towards a territorial dispute? Demonstrations in China and Japan are increasing, the former hardly likely to be spontaneous. We also hear of disruptions in Chinese factories which produce components for Japanese companies- a coincidence or an economic war? We remember that China has similar claims on other islands near Vietnam and that they are building an aircraft carrier… Should we be seriously worried here?
Well, the Chinese Yuan (CNY) has resumed its ascension against the US$, now at 6.306 and we observe Gold rising to $1’775 as oil fell back to $92 from almost $100 last week.
Strange week indeed… Ben Bernanke has been expressing his concerns about the Fiscal Cliff in rising tones. He stated that the Fed does not have the power or the tools to offset the effects of Congressional inaction. In any case, it clearly isn’t within the Central Bank’s mandate to set the nations fiscal policies… unfortunately perhaps… We added a special page today to try and explain the truth about the American Tax debacle and you may transpose this to most all parts of the World.

We found in last week’s Economist a “help wanted” advertisement soliciting candidates to replace Mervyn King as Governor of the Bank of England (June 2013). Perhaps the Americans should follow this example and place an advert seeking a new President?

We have read many articles and heard views as to the “true outlook” after all the QE from around the globe. Some express concerns that the fact of these actions implies truly poor conditions, others believing that with so much money being poured into the pipes of the system, growth will return. We recalled that Harry Truman wished for a one armed economist, so he can’t say "on one hand and then on the other..." Enjoy your weekend and smile at the tax explanation…

Bedrock Newsletter

Our Tax System Explained: Bar Stool Economics

Every day ten men go out for beer after work and the bill for all ten comes to $100. If they paid their bill the way we pay our taxes it would go something like this:
The first four men (the poorest) would pay nothing.
The fifth would pay $1.
The sixth would pay $3.
The seventh would pay $7.
The eighth would pay $12.
The ninth would pay $18.
The tenth man (the richest) would pay $59.

So, that's what they decided to do. The ten men drank in the bar every day and seemed quite happy with the arrangement, until one day, the owner threw them a curveball. "Since you are all such good customers," he said, "I'm going to reduce the cost of your daily beer by $20." Drinks for the ten now cost just $80.

The group still wanted to pay their bill the way we pay our taxes so the first four men were unaffected. They would still drink for free. What about the other six men - the paying customers? How could they divide the $20 windfall so that everyone would get his 'fair share?' They realized that $20 divided by six is $3.33. But if they subtracted that from everybody's share, then the fifth man and the sixth man would each end up being paid to drink his beer.
So, the bar owner suggested that it would be fair to reduce each man's bill by roughly the same amount, and he proceeded to work out the amounts each should pay.
And so:
The fifth man, like the first four, now paid nothing (100% savings).
The sixth now paid $2 instead of $3 (33%savings).
The seventh now pay $5 instead of $7 (28%savings).
The eighth now paid $9 instead of $12 (25% savings).
The ninth now paid $14 instead of $18 (22% savings).
The tenth now paid $49 instead of $59 (16% savings).
Each of the six was better off than before. And the first four continued to drink for free. But once outside the bar, the men began to compare their savings.
"I only got a dollar out of the $20,"declared the sixth man. He pointed to the tenth man," but he got $10!" "Yeah, that's right," exclaimed the fifth man. "I only saved a dollar, too. It's unfair that he got ten times more than I got" "That's true!!" shouted the seventh man. "Why should he get $10 back when I got only two? The wealthy get all the breaks!" "Wait a minute," yelled the first four men in unison. "We didn't get anything at all. The system exploits the poor!"

The nine men surrounded the tenth and beat him up.
The next night the tenth man didn't show up for drinks so the nine sat down and had beers without him. But when it came time to pay the bill, they discovered something important. They didn't have enough money between all of them for even half of the bill!
And that, ladies and gentlemen, journalists and college professors, is how our tax system works. The people who pay the highest taxes get the most benefit from a tax reduction. Tax them too much, attack them for being wealthy, and they just may not show up anymore. In fact, they might start drinking overseas where the atmosphere is somewhat friendlier.

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Currencies

- The mist clears and the EUR sinks. From the giddy heights of 1.3170 on Monday we have seen the EURUSD pair trade lower throughout the week. As the USD took back some of its losses we saw the EUR drop to as low as 1.2920 and are currently at 1.2950. With the Spanish Treasury and Government in discussions with the ECB about how to bail them out, we find it slightly strange that only a week ago no bailout was needed! Nevertheless the fact that they are discussing takes some uncertainty out of the market as we know it will happen now, it is just HOW they do it that matters. The EUR seems well supported for now and as long as the Risk-On momentum is maintained the EUR should remain bid, with range trading likely until there

- With the EUR pulling back from its recent highs on most crosses, EURCHF was no exception and slipped gently from 1.2170 to 1.2110. However, USDCHF was relatively quiet most of the week between 0.9260 and 0.9300, only to break upwards to 0.9340.

- USDJPY is treading water again, with a brief interlude on Wednesday when the BOJ kept rates the same at 0.10% but with a surprise intervention in the market. The BOJ extended the tenor by 6 months, increased the APP by 10 Trillion Yen (roughly $126 Billion) and removed the minimum bid yield of 10Bps. However this 50 point rally in the USD to 79.20 was short lived and we are currently almost at the lows of the week, just above 78.00.

- AUDUSD traded weakly without the Bernanke effect to support it. We saw the AUD slip from 1.0550 down to as low as 1.0370 on Thursday only to give back some of the losses to trade right back to 1.05. For now we see the AUD trading in line with Risk, so we expect the pair to drop again in the coming weeks.

- GBPUSD followed better than expected (or rather not as bad as feared!) data yesterday, to see the GBP rally again having lost some ground with the USD strength mid-week. The GBP is now at the highs of the year having breached the 1.63 level and topping out at 1.6309. For now the British Pound is rallying even in the face of the interview given by the Governor of the BOE, Mervyn King, who stated that the British economy is in a much worse state than the general public fears or believes!

- USDBRL is still range bound, even with the largest 1 day depreciation of the BRL for several months. With the intervention and reduction in reserve requirements the BRL dropped over 1% from 2.01 to 2.0320 in a matter of hours. However, the BRL has strengthened over the last few days and is now at 2.0210. Even a bank intervention seems to have less impact on the market, how much longer will they work?

Fixed Income

- Treasuries actually rallied into the close last week after we finished our letter. Relative to where we wrote last week the change was de minimus. However on the week the 10Yr rallied from 1.89% to 1.78%, the 30Yr mirrored the movement from 3.10% to 2.96% and the short dated 2Yr actually moved from 0.2350% to 0.2580%.

- In Europe, the French OAT 10 year was “relatively” stable this week, moving only 2Bps either side of 2.27%. We are currently at 2.28% and for now we believe the status quo will remain until either Spain rocks the boat, or the boat simply sinks because no one is willing to ask for help! However, the German’s Bund did see some resumed interest as the small doubts resurfaced over Spain, with the Bund moving from 1.70% to 1.60% on the week so far.

- The Italians issued a statement this morning saying that no European Country will ask for a bail out until “the water is around their necks”. Italy has said that neither they, nor Spain would give up their sovereignty without attempting first to satisfy their funding requirements through the open market. They would use every tool at their disposal before requesting a bailout, no matter how justifiable a bailout was, as it would simply undermine the Governments and would not be part of the populist vote. This is ok for Italy at the current funding levels of 4.95% - down from 5.15% mid-week – but they need to be careful that with their words they don’t push the yields higher.
- In light of the renewed worries over Spanish debt, the yield on the 10 year moved higher to above 6% for the first time since Super Mario stepped in with the OMT ECB solution. On Wednesday it was quietly announced that Spain was in discussions with the ECB about how they *might* construct a bailout from the OMT. For now the market believes that the backstop that Mario will provide is enough to keep the Spanish debt near the lows and it is currently at 5.75%.
- After last week’s great performance on the convertible market, again this week it is the best performer at +0.82%. Other top performers were EU HY and US Corporates at +0.60% and +0.48% respectively. The only losing sectors were EU and US Governments at -0.06% and -0.07% respectively. On the year though, EU HY has finally passed the +20%, outstripping its nearest rival (Global EM) by over 6%.

Equities

- Equity markets gave back some of last week’s strong gains, with the MSCI world down 0.97%, as of yesterday’s close. A combination of a contracting Chinese manufacturing sector, as well as falling Japanese exports, encouraged investors to take profit on the recent equity rally.
- European stocks fell, with the Eurostoxx 50 down 1.23% for the week. Euro zone PMI manufacturing data came in at 46, reflecting yet again a contraction and dampening the growth outlook for the region. Further worries arise on reports of an accelerating flight of deposits from the peripheral countries to the core countries, causing further disintegration and divergence within the Euro zone.
- The S&P 500 lost 0.38% for the week, as of yesterday’s close. US posted poor data this week with Weekly Jobless claims increasing to 382K (375K expected) and Empire manufacturing posting a sharper decline than anticipated (-10.41 vs. -2 exp.).
- Japanese stocks fell, with the Nikkei down -0.54% for the week. The bank of Japan surprisingly announced strong easing measures on Wednesday, where they are set expand its asset purchase program to ¥80tn. The announcement failed to lift sentiment on reports of Japanese overseas shipments falling 5.8% due to weak demand from china and Europe. Sentiment fell further as geopolitical tensions arose in the region due to a dispute over Islands with China, claimed by both countries, threatening to interfere with trade relations between the two nations.
- In terms of sectors, Energy and Financials stocks posted the biggest losses (-2.57%, and -2.31% respectively), while Consumer Staples and Healthcare fared better (+1.10% and +0.75% respectively).

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Emerging Markets

- Emerging Markets lost 1.56% for the week (as of yesterday's close), as measured by the MSCI EM. EM stocks lost more than their developed counterparts on the back of growth fears in China and Peripheral Europe.
- Chinese stocks fell sharply with the Shanghai composite down 4.57% for the week. Last week's reports on QE3 had a negative impact in China as a resulting increase in commodity prices would make Chinese imports more costly. In addition, Chinese manufacturing data signalled a further contraction and tensions escalated with neighbouring Japan over disputed Island ownership, threatening trade ties between the two.
- The Brazilian Bovespa lost 0.67% for the week, as of yesterday's close. Brazilian equities lost ground as they country's two biggest sectors (mining and energy) suffered from Chinese growth and geopolitical fears as well as a sharp weekly drop in oil prices.

Commodities

- Commodities slumped by 5.16% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Energy and Agriculture took the biggest hit (-6.10% and -4.91% respectively) while Precious and Industrial Metals fared much better (-0.11% and -1.82% respectively).
- Agricultural commodities plummeted this week as a stronger dollar and news of better than expected harvests weighed on trading. Grains and soybean prices had surged to records two weeks ago, buoyed by a drought in the US that has eroded crops this summer, as well as strong China-led export demand.
- Gold stood still this week – slightly falling by 0.10% – and is currently trading around $1'772 per troy ounce. Earlier in the week, the yellow metal climbed toward the highest in almost seven months (reaching $1'779.50 on Wednesday) as economic data supported the case for more stimulus by central banks around the world, increasing demand for Gold as a store of value.
- Crude Oil tumbled by 5.87% this week hitting a six-week low – currently trading at $93.18 per barrel – amid renewed economic fears as data showed China's manufacturing is still contracting, putting further pressure on an oil market that was weakening due to Saudi Arabia's pledge to cool oil prices.