Bedrock Newsletter

Friday, September 28th 2012

Today is the last effective day of Q3. Whilst the quarter didn't bring us any economic consolations, the markets did well for those few investors who had risk exposures. This observation brings us back to a fundamental flaw in financial thinking where many if not most market participants follow the logic whereas the state of the economy defines market movements. Our logic reverses this proposition and proclaims that the markets are the leading indicators for the state of the economy. Is the observed rise of equities the precursor of renewed economic growth? Possibly, but unfortunately, this logic cannot help us in predicting time-frames…

Watching the news we cannot remain purely logical- We are seeing social unrest erupting in Spain in protest against austerity and a revival of the same sentiment in Greece. In France we see rising unemployment data, analysis of the US equivalent implies a worsening of the employment (officially the unemployment rate is at 8.10% whilst many are falling-off the roster- CNBC offered an analysis explaining that the "true" rate should be over 10%). The new French Government is about to present its budget which will attempt to close a 30 billion Euro deficit- They are expected to try this by using a 20Bn tax increase and a 10Bn expense reduction. Clearly their already optimistic 0.80% GDP growth assumption will be hard to attain with tax increases and cost cutting… Can the West maintain social order under growing duress?

With Iranian nuclear issues back on the front-stage (UN General Assembly in NY) and Netanyahu explaining red-lines, we are observing rather wild swings in political-risk premiums on oil prices.

Time is flowing. The American elections are now just one month away. Not much time for the GOP to catch-up with Obama's lead. Important stuff this election, so big in effect that it is hiding the elephant of the "fiscal Cliff" looming two month further down the time-line: in January all sorts of tax cuts expire, spending limits click-in and the US could experience some significant disruptions. Would we hire into such uncertainty? Probably not, is the resounding response from employers.

Then, there is the brewing China-Japan conflict we mentioned last week…

With these uncertainties, should we really read the market Tea Leaves to predict a better future? Arguably all these bits of information are included in the markets' behavior. That and the Central Banks around the globe pumping monies into the pipelines of commerce. The Fed's QE(III) promises $40Bn per month, open ended. In reality, this program has yet to commence. The promise is clearly discounted but the flow of Dollars has yet to start. This activity has been nicknamed everything from QE3 to "QE Infinity" to "QEternal" and some on Wall Street question whether the unprecedented move will be QEnough. We think that if not, there will be a QE4 to re-extend the hopes.

We also observed the launch of the iPhone5 and wondered at the long lines in front of Apple stores. Apple shares raced up in anticipation through $700 and then fell back to $660.

We wonder just how bad can things be if so many are willing to spend so much for so little (extra)?

Enjoy your last weekend of Q3!

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Currencies

- The EUR had a wobbly week slipping from 1.2975 to as low as 1.2850 on news that Spain was likely to miss its targets, slightly weaker EUR data and a lack of any news in the market. With the EUR drifting lower and the Risk-Off sentiment from Wednesday we see a little life breathed into the pair to finish the week with almost no movement at 1.2950. Spain has been in discussions about its budget… the likely misses and the likely targets that will be met… For now they have some breathing space but the likelihood is that they will request "Assistance" (The new word for a "Bailout") towards the end of October or beginning of November. We will likely see a drifting of the EUR and a trading range until there is some new concrete data in the market.
- With the EUR relatively unchanged on the week, EURCHF was no exception and slipped gently to 1.2080, only to settle back to 1.2100 at the moment. USDCHF was relatively quiet most of the week between 0.9340 and 0.9400, only to settle back to 0.9340 as we write.
- If USDJPY was treading water last week, obviously the clothes are getting heavy! USDJPY is slipping again, and against all the BOJ's hopes the JPY is creeping higher. This week saw the USD gently sliding from 78.20 to a low of 77.45, we have managed to bounce a little on Friday morning back to 77.70, however this may be short lived. We believe the BOJ rhetoric will kick into action when the USD heads closer to 77.00 and they will protect this level by buying dollars. The next few weeks should therefore see the pair trade higher especially if the Risk on momentum stays intact.
- AUDUSD is completely unchanged on the week, having finally broken below 1.04 to trade as low as 1.0330 on Wednesday. As the Risk sentiment trades…. So does the AUD, however we have finally broken to a new low, so perhaps the slow slippage will begin over the coming weeks. We watch this space…
- GBPUSD is also completely unchanged on the week having sold off to 1.6140 only to settle now at 1.6230. The resilience of the Pound seems to be more about diversification that a core economic believe in the British economy.
- USDBRL is still range bound, stuck in even tighter bands than usual, 2.0220 to 2.0360. With the intervention and reduction in reserve requirements the BRL from last week, this seems to have been completely consigned to history as the currency is back to 2.03. The interventions are having less and less effect…

Fixed Income

- Treasuries rallied again this week, the 10Yr rallied from 1.75% to 1.63%, the 30Yr mirrored the movement from 2.94% to 2.81% and the short dated 2Yr actually moved from 0.2575% to 0.2440%.
- In Europe, the French OAT 10 year traded in lockstep with its US counterpart, with the bonds rallying causing the yield to drop from 2.28% to 2.19%. We are currently at 2.20% and we continue to 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 in light of their fiscal deficit really the increase in taxes and reduced spending should push the yields higher.
- The German Bund traded similarly and rallied from 1.57% to 1.42% as Spain and Greece start to see social unrest again. We note that this week's trade was to sell periphery and by core within Europe… perhaps we see a fear creeping in again, at least till the next QE or OMT!

- After the Italian's statement last week about no European country asking for a bailout until they had the water around their necks, we mentioned the need for care about forcing the market's hand with the implication being that the yields would rise. Unfortunately, our comments were echoed by the market. The bonds slid immediately and the 10Yr yield moved up from 4.95% to a high of 5.25% only to rebound a little, settling at 5.16% as we write.
- The media attention around the Spanish financial situation is drawing many conclusions… none of which end with the Spanish yields coming down (without the holders taking a hit!). They look to be increasingly likely to need a bailout by the end of October, reflected in the yields moving from 5.80% to 6.10%... The periphery is creeping higher again, the OMT effects are in the history books even though they were proclaimed as a success within a week of announcement and before any money made it to the street!
- This week saw the HY weaken and the IG/AGG/Gov space benefit at their expense. The best performers were US corporates at +0.65% and US Government at +0.53%. Convertibles were the largest loser this week at -1.19% followed by US HY at -0.69%.

Equities

- Equity markets continued to slide this week, with the MSCI world down -1.34%, as of yesterday's close. Euro zone worries roared back into focus over the week as the feel-good factor of recent central bank stimulus gave way to renewed uncertainty over Spain's willingness to submit to a politically painful rescue program.
- However, investors breathed a sigh of relief on Thursday as market sentiment was boosted by Spain's new budget plan and hopes for further stimulus from China, snapping a multi-day losing streak.
- European stocks faltered this week, with the Eurostoxx 50 down 2.53%, amid protests against austerity measures in Greece, Spain and Portugal. The IBEX 35 fell the most among European indices (-4.34%), along with the MIB (-3.21%) and the PSI (-3.14%) while the SMI proved quite resilient, down only 0.74%.
- The S&P 500 lost 0.89% for the week, as of yesterday's close. US stocks started the week on a negative note amid Europe unrest and weaker home sales before getting some boost from Spain budget and China liquidity injection on Thursday.
- Japanese stocks slumped this week, with the Nikkei down 2.64%. The Nikkei sagged as concerns about falling revenues for Japanese companies in China outweighed market approval of Spain's new economic reform plans.
- In terms of sectors, Materials, Information Technology and Consumer Discretionary stocks posted the biggest losses (-2.54%, -1.86% and -1.85% respectively), while Healthcare and Utilities fared much better (+0.04% and -0.64% respectively).

Emerging Markets

- Emerging Markets lost -0.84% for the week (as of yesterday's close), as measured by the MSCI EM, outperforming their developed counterparts, lifted by China. The best performing region was Asia (-0.45%), followed by Latin America (-1.20%) and EM Europe (-2.41%).

- Chinese stocks rallied strongly this week, with the Shanghai composite up 2.93%, the most in three weeks, on the prospect regulators would announce measures to bolster equities including halting initial public offerings. Meanwhile, China's money-market rate headed for the biggest weekly drop in almost a year.
- The Brazilian Bovespa lost 1.76% for the week, as of yesterday's close. Bank shares weighed on Brazil's benchmark on lingering concerns over government pressure to reduce banking spreads. Also, a mixed bag of US economic data later in the week left investors cautious.

Commodities

- Commodities lost 0.56% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Agriculture commodities and industrial metals were the main cause for the weakness in commodities (-3.29% and -0.91% for the week), while Energy and precious metals posted modest gains (+0.22% and +0.13% respectively).
- Agricultural commodities fell as slowing growth in China and Europe, as well as high grain prices, may reduce demand for US supplies. However, soft commodity traders are eyeing today's USDA report confirming quarterly stockpile figures.
- Gold increased by 0.54% this week and is now trading at $1'781.64 per troy ounce. Gold lost ground earlier in the week over global growth fears as well as concerns over sovereign debt in Europe, causing a rally in the USD. On Thursday, gold bounced as much as 1.5% on news of Spain unveiling a program of spending cuts and tax hikes, raising prospects for a bailout request. We remain bullish on the metal at these levels, as the monetary easing programs initiated worldwide should cause currencies to weaken, and therefore support the price of gold.
- Crude Oil lost 0.29%, currently trading at $92.62 a barrel. Crude saw weakness earlier in the week over renewed concern that the European crisis will reduce energy demand. In addition, supplies were reported to remain above the upper limit of the average range, overshadowing a drop of 365.2 million barrels of crude oil inventories last week. Oil prices were supported on Thursday and Friday due to the Spanish budget announcement, as well as Israeli-Iran tensions returning to the spotlight over speeches made at the UN by the two nations' leaders.

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