Bedrock Newsletter

Friday, October 5th 2012

An eventful week! Economically and politically speaking, that is.
First, in terms of Macro Economic backdrop, we continued to see this week some weak PMI's numbers in Europe and China, thereby confirming the fears of a global slowdown. The one bright spot came from the US, where the PMI actually rose, the first increase after 3 consecutive monthly drops.

In Brazil also, things look to be better, following a very aggressive action by both the Government who came with different stimulus programs, infrastructure projects and a heavy intervention to lower the value of its currency, and the Central Bank who lowered the interest rates to a record low. These actions really helped the economy getting a lift as the PMI there also increased for the first time in 3 months, and were firmly in expansion territory again.

In Australia, things do not look so rosy anymore, as weak economic numbers, from retail sales to building approvals, continue to come in weak, thereby prompting the Reserve bank of Australia to lower interest rates, even to the surprise of many economists who did not foresee that move. The Central bank justified the move by blaming the very uncertain global economic backdrop, especially citing the slowdown in China and Europe.

We continue to see the actual scenario of a weak global economy worldwide being fought aggressively by all the major central Banks in the world and all short term interest rates from the major developed economies converging to the Zero bound, while Emerging market countries drive their short term interest rates to historic lows. We believe these actions will, as is evidenced in Brazil, provide some help and will fuel an economic recovery. This is why equity markets are holding well, in anticipation of this worldwide recovery and not really paying attention to the very weak actual state of the world.

Meanwhile in Iran, this week saw the biggest drop in the value of its currency, dropping by close to 60% against the USD and sparking riots, especially in the Teheran Bazaar. These demonstrations marked the first time in three decades that the conservative merchant classes, a backbone of the Islamic revolution in 1979, have publicly turned against the Government. Protesters chanted antigovernment slogans and called for the President to step down. These events had big repercussion on the price of Oil, which dropped more than 4% on Tuesday to 88$ a barrel, on assumption that the Regime in Iran would not last long in the face of such dire economic conditions and suffering of the population. However, when the market realized that these things do not happen overnight, oil prices rebounded and recovered all the lost terrain of the past few days.

In the US, interestingly, 67 Million people turned on their TV's to watch the first of three debates between Obama and Romney. It was the highest audience for such a debate since the 1980 debate between Carter and Reagan. What was also very interesting is that Romney, again against all expectations (people should really turn to betting shops now!), won the debate in a big way by being more aggressive and attacking the economic record of Obama. Romney was very clear in saying that he would not raise taxes and that it was the worst thing that Obama could do. He argued that the deficit would actually shrink under his mandate as he would be much more pro growth and pro business than his counterpart. The Market actually liked that and cheered as all major indices rallied for the first time in a few days as a Romney victory was not seen as farfetched as it might have seemed a few days back.

Interesting times indeed…..

Stay tuned and have a relaxing week end.

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Currencies

- The week commenced with poor manufacturing data from China and Japan, indicating a continued state of sub-par growth, causing the EURUSD pair to see the lowest level in a month (1.2808). During the rest of the week the pair gradually strengthened on the back of better than expected Euro zone PMI, retail sales, and US employment figures, as well as hopes of Spain willing to request a bailout, at the cost of implantation of severe austerity measures. The EURUSD saw the highest level on Thursday (1.3030) as ECB president Mario Draghi emphasized once again that the common currency is irreversible and stated he is ready to commence with the bond buying program.
- EURCHF saw little change, yet modestly gained along with the rise in the EUR, rising from 1.2087 at the start of the week to 1.2116 currently. As a result, the USDCHF pair resumed its usual mirroring of EURUSD, gradually falling from as high as 0.9437 on Monday to 0.9316 currently. The existence of a cap in EURCHF is proving a success story, with CEO of Swatch group stating on Wednesday the cap has saved Switzerland's manufacturing and tourism industries from the threat of extinction.
- The Yen weakened for the week against both the USD and the EUR on hopes the BoJ will start buying foreign bonds to try to stop the appreciation of the Yen. USDJPY and EURJPY rallied from 77.45 and 100.16 respectively to as high as 78.80 and 102.25 respectively at the latter part of the week. However, on Friday the BoJ refrained from taking any action causing the JPY to strengthen to 78.45 and 102.00 currently.
- Further weakness in Chinese manufacturing data has caused commodity prices to fall, raising fears that Australia's mining boom is slowly fading. As a response, the Reserve Bank of Australia surprisingly cut its benchmark lending rate by 25 basis points to 3.25% on Tuesday. AUDUSD dropped from 1.0373 to 1.0316 on the news and has continued to weaken throughout the week to as low as 1.0187 before recovering to 1.0250 currently on weakness in the USD.
- The GBPUSD pair is now trading roughly where it has started the week (1.6151 vs. 1.6180 currently). The pair did however see weakness on Wednesday as UK PMI services came in lower than expected (52.2 vs. 53 exp.) sending GBPUSD to as low as 1.6070. The pair then recovered due to USD weakness and BoE leaving rates unchanged at 0.50%.
- USDBRL traded in a tight range for the week seeing to the highest level on Monday (2.0345) before gradually weakening to 2.0189 currently. Expectations still weigh on a further weakening of the BRL with further evidence of a deteriorating state of affairs, with reports of lower than expected industrial production and contracting vehicle sales, spurring bets that policy makers will cut borrowing costs further.

Fixed Income

- Treasuries started the week on a strong foot as the Fed bought $19bn worth of treasuries as part of operation twist, and fears over European sovereign debt rose. As a result, treasury yields fell with the 2-year, 10-year and 30-year trading as low as 0.226%, 1.594% and 2.79% respectively. On Thursday, Jobless claims increased less than expected and the ECB stated that they are willing to start buying peripheral sovereign bonds, causing risk appetite in the market and sending yields higher (0.246%, 1.68% and 2.895% on the 2-year, 10-year and 30-year respectively).

- In Europe, Spanish and Italian bonds traded in a choppy manner: In the beginning of the week bonds rallied on speculation of a Spanish bailout request. Yields on the Spanish and Italian 10-year dropped to as low as 5.692% and 5.031% respectively. Bonds later fell, with yields rising to 5.886% and 5.125% respectively, as the nation resisted seeking a bailout, and the ECB said that Spain is still facing significant challenges. However, the bonds finally resumed their weekly rally as consensus among market participants increased that the bond purchase program is soon to come.
- This week European high yields and Emerging market bonds were the best performers (+0.89% and 0.86% respectively), while US sovereigns and leveraged loans lost (-0.08% and -0.04% respectively).

Equities

- Equity markets rose this week, with the MSCI World up 1.33%, as of yesterday's close. Markets were supported by the ECB's decision to keep rates at a record low and by upbeat US manufacturing data.
- European stocks surged over the week, with the Eurostoxx 50 up 2.94%, as investors positioned for a sentiment boost from key US jobs data later in the day and took heart from ECB assurances that it is ready to buy the bonds of troubled Euro zone members. The IBEX 35 and the SMI rose the most among European indices (+3.11% and +2.08% respectively), while most other European countries rose between 1.60% and 1.80%.
- The S&P 500 rose by 1.44% for the week, as of yesterday's close. US stocks climbed for a fourth consecutive day of gains, as jobless claims came in slightly under expectations and the European Central Bank kept interest rates unchanged. Also, US stocks got some support after Romney was largely perceived as the winner of this week's debate against Obama.
- Japanese stocks were about flat this week, with the Nikkei down -0.08%. The Nikkei fell to a three-week closing low on Wednesday as investors remained cautious ahead of a series of key events, including policy meetings by the ECB and the Bank of Japan. However, the benchmark recovered from losses incurred earlier in the week on Thursday and Friday, lifted by gains in cyclical stocks.
- In terms of sectors, Financials and Healthcare stocks posted the biggest gains (+2.16% and +2.11% respectively), while Materials and Energy remained subdued (+0.30% and +0.55% respectively).

Emerging Markets

- Emerging Markets rose by 0.29% this week (as of yesterday's close), as measured by the MSCI EM, underperforming its developed counterpart, driven down by Brazil. The best performing region was EM Europe (0.99%), followed by Latin America (0.83%) and EM Europe (-2.41%).
- China Market was closed this week but there is a high probability that last week's rally will continue after the Golden week holiday that ends Friday.
- The Brazilian Bovespa lost 1.87% for the week (as of yesterday's close), falling by 1% on Wednesday as changes in rules for utilities continued to weigh down the index, alongside continued concern about the financial health of European governments. On Thursday, the

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Bovespa failed to track gains in overseas markets as investors remained cautious ahead of economic data releases despite positive signs from Europe and the US.

Commodities

- Commodities were about flat this week as of yesterday's close – as measured by the S&P GSCI broad commodity index – as gains on Industrial and Precious Metals (0.50% and 1.31% respectively) were counterbalanced by Agriculture and Energy weakness (-1.02% and -0.09% respectively).
- Agricultural commodities continued to slide this week as demand issues primarily drove trading amid worries of slowing growth in China and Europe. Also, the record pace of US harvests kept a lid on prices.
- Gold increased by 1% this week and is now trading around $1'790 per troy ounce. Gold consistently rose this week, hitting its highest since last November on Thursday, with sights set firmly on the key psychological level of $1,800, as the European Central Bank elected to keep interest rates at ultra low levels. We remain bullish on the yellow 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 1.59% this week, currently trading around $91 a barrel. Oil lost over 4% on Wednesday, representing the largest one-day fall since December, as news from Iran riots offset the supportive effect of an unexpected decline in US oil inventories. On Thursday, the barrel rebounded by over 4%, erasing the previous session's heavy losses on the prospect of unrest in Syria and Iran spreading into the wider region – but this could not totally overshadow a continued fragile demand environment.
