Bedrock Newsletter

Friday, November 16th 2012

Another agitated week is coming to a close. Greece has regained its spot in the Sun, starting with Juncker and Lagarde quarreling as to the debt relief we had been led to believe was resolved- Well not quite- The IMF wants the relief to last to 2020 and Juncker wants 2022. Absurdistan is in Europe, as if you didn't know that already…

Tuesday we saw E.ON, the huge German utility falling 11% on its lowered outlook for energy demand in Europe. A precursor for Thursday's release by the EU's statistics office, Eurostat, that showed economic output in the 17-country euro zone fell 0.1% in the third quarter, following a 0.2% drop in the second quarter. Europe is officially in recession, the second time in four years.

Monday also gave us the information that Japan's economy shrank in the third quarter for the first time since last year, adding to signs that slowing global growth and tensions with China are nudging the world's third-largest economy into recession. On Wednesday Japan articulated thoughts of an unlimited QE and a higher targeted inflation rate, Stocks rose 2% and then another 2% the next day… against the headwinds of all other equity markets falling!

The markets clearly do not like Obama... As he spoke on Wednesday, the markets started to melt... DJIA fell 145 points. As of Thursday the market value of US exchanges are down $750Bn since the election... Expensive Obama... Sandy "only" cost $30Bn, to put things in perspective.

Wednesday Fed minutes showed there is a possible QE4 into 2013... Is the situation getting worse? Wednesday also gave us October PPI at -0.2% and retail sales at negative 0.3% Where is the inflation from QE??? It is frightening to think where we might have been without QE1, 2 & 3…

As we write, the flare-up of hostilities between Hamas and Israel is escalating. The latter have fired hundreds of missiles into Israeli territory, two of which reached Tel Aviv causing no damage. Israel has responded with massive air strikes and a build-up of ground forces along its borders with the Palestinian enclave of Gaza. With Iran backing the Hamas and Hezbollah, risks for a broader escalation are mounting. Egypt with its Muslim Brotherhood leadership is trying to mediate, or are they just standing-up to Iran's attempt to gain political power over the region? Strangely, oil prices have hardly reacted, trading steadily around the $85.50 level. Somehow, this is good news in itself as we read the markets to be saying that this flare-up will be contained and short lived. It has also masked the ongoing horrors in Syria, from where Assad has condemned the Israeli aggression…!???

Another explanation for the calm in the oil-pit can be found in the analysis published this week whereby the USA is now poised to be the largest oil producer by 2017 and then oil independent by 2030, clearly reducing the relative importance of the Middle East and its troubles… Well, that is in the long term… as of now, the Middle East still accounts for 30% or so of global production… For us as investors, we must not lose sight of the concept that a long term investment is a series of short term decisions! So for now, we hold on to our long oil options…

Martin Luther, hardly a trader or financial wizard, had said "Even if I knew that tomorrow the world would go to pieces, I would still plant my apple tree…"

Currencies

- EURUSD has had a very quiet week briefly dipping to as low as 1.2680 on Monday only to crawl back to 1.28 prior to the US employment data yesterday. We are currently trading right in the middle of the range at 1.2745.
- EURCHF is slipping further this week. As we stated before, the need for a large move higher in the EURUSD pair is needed for EURCHF to rally heavily. In the absence of a strong EUR the EURCHF pair has moved from 1.2060 to 1.2040. USDCHF has slipped in line with the Risk off momentum seeing the pair move from 0.95 to as low as 0.94 on Thursday and back to 0.9460 as we write.
- The week is all about the Japanese Yen. Finally there is some movement with the Japanese likely new Prime Minister Shinzo Abe applying heavy pressure on the Central Bank to "print unlimited amounts of JPY" in order to eradicate deflation and target an inflation of 3%, three times as much as the target of 1% agreed upon by the BOJ in early September. The JPY moved from 79.20 to a high of 81.45 against the US$ but moved down also sharply against the EUR from levels of 100.35 to 104.00! We believe and maintain that the JPY is overdue for a long and sustained drop against all currencies.
- AUD has finally succumbed to the pressures of the Risk-Off sentiment that has swept through the markets. The AUD fell from 1.0460 to as low as 1.03 after the equity markets tumbled for a third straight day as data was released from the RBA that is sold more than it bought through outright transactions.
- Cable had a poor trading week slipping from 1.5910 to as low as 1.5840 as the Risk sentiment pushed the British Pound lower. However, this week's move was best expressed in a European context as the EUR strengthened amid hopes that Greece and the Funding issues would be resolved and that the European crisis seemed to be heading towards an agreed solution. This saw the EURGBP pair move from 0.7980 to 0.8060 as of Thursday's close and now is trading at 0.8030.
- CNY had another move higher reaching to 6.22 against the USD and saw a large rise on Monday from 6.250 to 6.2290 with the new announced Government wishing to make their presence felt. We expect the slow grind higher in CNY to continue, but at the pace prescribed by the Chinese not by the US.
- The BRL has now seen the move that the market has been waiting for and expecting. The USDBRL broke out of the very narrow trading band after we wrote the newsletter last week see a huge jump from 2.04 to 2.0675, reaching as high as 2.0750 on Wednesday. The general move lower in the BRL is in response to the global Risk-Off sentiment stronger than the Central Banks will to keep the trading band.

Fixed Income

- This week saw short term rates on the 2-year drop from 0.26% to 0.24% as of this morning. Treasury yields on the 10-year moved from 1.61% to as low as 1.57% on Thursday on a relatively quiet week, especially with the Treasury closed on Monday. The 30-year traded in a similar fashion moving from 2.74% to 2.70%.
- The German 10-year Bund seems to have been almost completely unchanged on the week opening at 1.35 and oscillating to as low as 1.32% and as high as 1.37%. With no great

pieces of news the market is waiting to see whether Greece will be able to garner another €5Bn!

- The European Commission has, as UBS' Senior Economist wrote, "graciously acknowledged that the laws of mathematics and economics do not allow Spain to hit a 4.5% GDP deficit target in 2012". Now that this wonderful insight is in the open market it should remove another roadblock on the journey to Spain applying for the bailout! Spanish yields moved quite dramatically during the week but the market looks to be pushing Spain to higher yields moving from 5.82% to 5.96% and ever closer to the bailout.
- Italy started the week at 4.97%% on their 10 year debt rising to as high as 5.05% on Tuesday but generally finishing the week lower at 5.86% post the €5Bn issuance on Wednesday all at lower yields.
- This week the Convertible Bond space was the worst affected at -1.15%, obviously with the high correlation to the equity markets. EU Government were the only positive performers on the week at +0.19%.

Equities

- Global equity markets slid over the week, with the MSCI World down 1.74% (as of yesterday's close). World equity markets fell for a seventh day on Thursday, hit by evidence that Europe's debt crisis has stalled economic growth and by persistent concern over the budget problems in the United States. Investors were focused on the Fiscal Cliff deadline, where $600 billion in tax increasing and spending cuts are currently on the table, threatening to slow US growth.
- European stocks fell, with the Eurostoxx down 1.71% for the week. Growth worries weighed on sentiment, especially over Germany – Europe's largest economy – where growth cooled to 0.2% over the July-September period compared with the previous three months, while data showed the wider 17-nation euro zone has slipped back into recession.
- US shares lost 1.92% for the week – as of yesterday's close – as measured by the S&P 500, sliding to its lowest level since late July on Thursday, driven by uncertainty over US budget negotiations and an escalation of violence in the Middle East. President Obama, in his first press conference since re-election, held to his position that marginal tax rates will have to rise to tackle the nation's deficits.
- Meanwhile, Japanese stocks rallied 3.04% for the week as measured by the Nikkei 225, surging by 1.90% on Thursday and by 2.20% on Friday, after the leader of Japan's main opposition party, seen as likely to become premier after an election next month, called for more monetary policy easing. The call by Shinzo Abe, a former prime minister, for the central bank to push interest rates to zero or below zero to spur lending has pushed the yen to a 6-1/2 month low, sending shares in exporters sharply higher.
- In terms of sectors, Materials, Information Technology and Industrials took the biggest hit (-3.30%, -2.10% and -2.09% respectively), while Financials, Consumer Discretionary and Consumer Staples fared better (-1.23%, -1.29% -1.39% respectively).

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Emerging Markets

- Emerging Market equities performed in line with their developed counterparts, falling 1.68% for the week (as of yesterday's close) as measured by the MSCI EM index. Latin America fell the most over the week (-1.77%), followed by Emerging Asia (-1.57%) and Emerging Europe (-0.79%).
- The Shanghai Composite fell 2.63% for the week, ending at a more than seven-week low on Friday as investors worried about the earnings outlook for domestic companies, though the introduction of new dividend tax rates helped the market regain some losses. Tuesday and Thursday were the most negative sessions – Chinese shares lost 1.51% and 1.22% respectively.
- Meanwhile, the Brazilian Bovespa slid by 1.88% for the week (as of yesterday's close) as a majority of Brazilian companies missed earnings estimates for a third straight quarter, signalling President Dilma Rousseff's interventionist policies have failed to spark the economic rebound she is seeking.

Commodities

- Commodities fell 0.54% this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Agriculture, Precious metals and Energy fell for the weak (-2.44%, -0.81% and -0.28% respectively), while Industrial metals rose 1.48%.
- Agricultural commodities dropped 2.44% for the week as of yesterday's close. The gauge fell as much as 2.1% on Monday following Friday's report by the USDA, raising production and global inventory estimates.
- Gold fell 0.95% for the week, now trading at $1'714 per troy ounce. Gold prices dropped as the World Gold Council reported that demand for the precious metal decreased 11% in Q3 compared to the preceding year. The council attributed the downturn to the economic slowdown in China, weakening global growth as well as lack of inflation.
- Crude Oil dropped 0.72% for the week, and is currently trading at $85.40 per barrel. Oil traded in a choppy fashion during the week, before heading lower, as global growth fears and the IEA cutting Q4 demand outlook, outweighed an escalation in violence in the middle east, which threatens to spread to the oil producing states.

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