Bedrock Newsletter

Friday, December 7th 2012

With just a few weeks of trading left, 2012 is looking a lot like 2011 in one key regard: Investors still don't believe in a stock market that keeps moving higher. This year has been even more profitable than its predecessor, with the 12 percent gain in the Standard & Poor's 500 easily outdistancing the modest rise in 2011. If the party is so good, where is everybody? Still, volume remains low and money continues to pour out of equity funds and into fixed income and cash. How can this be happening?
After a 30 year rally in bonds, how come everybody keeps piling in? The question has been asked often around Wall Street this year, with total equity fund outflows totalling $125 billion and nearly $300 billion pouring into bonds. Cash parked in money market funds, with near-zero interest rates, also has been on the rise, with $2.61 trillion tucked on the sidelines, according to the latest numbers from the Investment Company Institute.
With interest rates as low as they are, with credit spreads as tight as they have been, the expected returns on fixed income assets are close to their respective coupon yields, i.e., close to nothing. Perhaps it is driven by the fact that central banks around the world seem to have everyone's backs--and bonds. No risk (low risk rather!) implies low expected returns, as per “Finance 101” in college. But is the risk really as low as its returns imply? We have our doubts…
Let’s not forget that the Fed’s Operation Twist ends next week... What is next on the menu? We know that they are still buying bonds at a frenetic pace of $40Bn/month...

All we can say into the close of 2012 is that 2013 looks to be more of the same foggy outlook. Germany now expects to reach a balanced budget in 2013! They definitively are doing something right (if you are a conservative), yet Mario Draghi expressed yesterday the ECB’s rather dire outlook for growth and activity in 2013… Well, the Euro took it on the chin, sinking back to November levels of $1.29.
In America, Geithner and Boehner are giving us the usual Dog and Pony Show each arguing in his own corner the merits of his “team’s” views. President Obama is the moderator, also in his own corner and after these long and tiring statements, the markets appear to be shrugging it off; it has become like a tourist attraction, no longer an exciting bungee jump.
We all know that they (the debaters above) know that there is a solution, a middle ground which will be reached. The question remains as to where this middle is… They are getting mired in details which are each generating political dilemmas. For example, raise tax receipts by removing deductibility of mortgage interest. Should satisfy the Republicans as tax rates don’t rise… Sounds good? Yes, until you analyze the effect on house prices, R/E tax receipts, construction activity etc... The Democrats should like this, as deductibility is a subsidy to the housing industry and homeowners. Can’t they see that it is regressive, taxing the rich (who have bigger mortgages) by more than the poor (those with less than $250’000 incomes)!?
When will they learn? Experience is a comb that nature gives us once we are bald. Unfortunately, both President Obama and Boehner have full heads of hair!

We are reading many analytical works from which we synthesize these analysts’ expectations for the S&P 500 earnings in 2013 to be in the range of $100 to $105. There is also a prevailing view that P/E multiples should and could expand. Well, if we are to be optimists and place some faith in these analysts, why the, the S&P 500 should trade in the range of 1’500 and 1’600 or some 10 to 15% up from now!
But it is all in the hands of politics and governments… We recall Milton Friedman’s quip that “only government can take perfectly good paper, cover it with perfectly good ink and make the combination worthless...”

Do have a festive weekend! Go shop & spend, support the economy! It’s now morally ok…

Currencies

- EURUSD started on a a positive trend, rising from 1.2975 to a high of 1.3125 reached on Wednesday, on improved sentiment in the Euro zone as Greece started a bond buyback plan to reduce half of its debt owned by private creditors and amid expectations of weak US non-farm payrolls due to the impact of Hurricane Sandy. However, the uptrend sharply reversed on Thursday on Draghi’s speech. The Euro fell hard on the back of downward revisions in the Euro zone’s GDP in 2012 and 2013 and statements that another cut in interest rates – including the deposit rate – was discussed by the ECB at its monthly meeting. As a result, the EUR/USD collapsed, falling from 1.3085 all the way to 1.2935 currently.
- EUR/CHF rose over the week due to delayed reactions to news Monday that Credit Suisse would charge clients a fee for franc deposits. EUR/CHF also rose on Euro strength, surging near 10-week highs at 1.2170 on Wednesday, proving Euro demand is coming from across the board. The pair then quickly came back to more recent levels, currently trading around 1.2085.
- After reaching December’s highs at 82.60 early Thursday, the USD/JPY has been trading in a flattish way. However, we do not see lots of reasons for a strengthening of the Yen, quite the opposite! Comments from BOJ Deputy Governor Nishimura, who said in a speech that the central bank will use the latest policy measures that it introduced as a way of pursuing powerful monetary easing, should be a factor weakening the Yen.
- The Aussie rose this week after the RBA statement announcing it cut the cash rate to 3.0% on Tuesday was more neutral than markets had been expecting. The AUD/USD jumped from levels around 1.0430 to a high at 1.0515 on Thursday as surprisingly strong jobs data was at odds with economist expectations of further rate cuts. Employment rose 13’900 versus expectations of no change, while the jobless rate fell to 5.2% versus 5.5% expected by the market. Since then, the pair came back below the psychological 1.0500 level, currently trading around 1.0470.
- The pound started on a strong foot on Monday, surging from 1.6000 to 1.6115 against the Greenback. The GBP then erased gains against the US dollar on Thursday, following downbeat comments by European Central Bank President Mario Draghi and after the Bank of England left its monetary policy unchanged. Cable pulled away from 1.6130, currently trading around 1.6035.
- The BRL sharply strengthened against the USD over the week, from 2.1385 on Monday to 2.0775 currently. The central bank's interventions on Monday were probably intended to discourage speculators, slow the real's recent weakening and keep companies from being punished too much by a stronger dollar, as December is a month with a lot of dollar-buying as multinationals repatriate profit and dividends. Also, Brazil’s central bank said keeping interest rates unchanged at a record low is the best strategy for monetary policy suggesting policymakers had no plans for more reductions in borrowing costs anytime soon.

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Fixed Income

- US benchmark Treasury yields dipped to near their lowest in three weeks on Thursday, supported by expectations the Federal Reserve will announce a new bond purchase program when it meets next week. The Fed made two bond purchases on Thursday as part of its Operation Twist program, which involves buying long-term debt, and funding the purchases with sales of short-dated notes. As a result, US 10-year fell from 1.621% to 1.581%, US 30-year from 2.809% to 2.764%, while US 2-year eased from 0.250% to 0.238%.
- Spanish bond yields rose back above 5.50% on Thursday from low yields of 5.20% seen earlier in the week. Spain auctioned fewer bonds than it hoped to on Wednesday, prompting markets to ditch the country's debt as investors fret over the timing of an expected aid request by the government.
- Italian borrowing costs were hovering near their lowest in nearly two years on Monday and Tuesday at levels around 4.40% as appetite for higher-yielding Euro zone debt persisted, buoyed by an improvement in sentiment towards riskier debt after a deal on the next tranche of Greek aid last week was seen as reducing the systemic risk in the region. Italian yields then rose above 4.60% on Thursday, as investors started reducing their holdings of peripheral debt after the Spanish auction in the previous session saw weaker-than-expected demand.
- Meanwhile, Greek yields eased from 15.84% to 14.33% as a bond buyback plan meant to shave a few billion Euros off Greece's debt burden is seen as likely to succeed, a circumstance that would pave the way for the International Monetary Fund to approve the next tranche of bailout financing. Greece hopes that with its 10 billion Euros debt buy back running until today, it can attract as much as 30 billion in bond offers, thereby shaving off 20 billion of debt.
- This week, bonds rallied across the board, with EU High Yield, US High Yield and Emerging Markets Debt being the best performers, rising 1.01%, 0.92% and 0.59% respectively, while US and EU sovereigns rose the least (0.18% and 0.23% respectively).

Equities

- Developed equity markets gained for the week, with the MSCI world up 0.28%, as of yesterday’s close. Equities were supported by positive Macroeconomic figures from the US and China, as well as expectations for Greece to buy back its bonds.
- European stocks rallied 1.10% for the week, while trading in a choppy fashion. The week has been rich with economic figures, indicating a continued state of contraction, with PMI manufacturing and Services coming in at 46.2 and 46.7 respectively and Q3 GDP at -0.1%, as expected. The sole surprise has been a bigger than expected fall in Euro zone retail sales dropping 1.2% in October (only -0.2% expected). On Thursday, the ECB maintained its benchmark rate at 0.75%. However, Mario Draghi spoke soon after, cutting growth and inflation forecasts and saying that further rate cuts are on the table.
- US shares lost 0.16% for the week, as measured by the S&P. With little to no progress on the fiscal cliff front, most attention was given to the economic figures. Reports have been mixed for the week as US manufacturing contracted for the first time in 3 months. Factory orders surprisingly rose 0.8% in October, and Jobless claims fell more than expected (370K vs. 380K). All eyes are on today’s Nonfarm Payroll figures, where expectations are low due to the effects of superstorm Sandy.

- Japanese stocks rallied 0.86% for the week, as measured by the Nikkei 225 index. Japanese equities continued their uptrend as the Yen remained week, supporting manufacturers, as well as optimisms from the US. The sole important economic figures has been Capital spending which rose less than expected (2.2% vs. 4.4%), signalling that Japanese companies started being more cautious about fresh investment.
- In terms of sectors, Financial and Industrial stocks led the gains (+0.99% and +0.82% respectively), with the former being supported by spike in the stock price of Citigroup on news the bank will shed 11K jobs to cut costs. The biggest losers were IT and Consumer discretionary socks (-0.46% and -0.19% respectively), led by a sharp drop in Apple's price on Wednesday.

Emerging Markets

- Emerging Market equities rose by 1.41% for the week, as of yesterday's close. In terms of regions, Emerging Europe was the best performer (+2.18%), and Latin America and Asia closely followed (+1.50% and 1.03% respectively).
- The Shanghai Composite jumped 4.12% for the week. Chinese shares gained as PMI Manufacturing rose to 50.6, indicating additional expansionary growth. In addition, cement stocks strongly gained on expectations for further policies related to urbanisation.
- The Brazilian Bovespa rose 0.32% over the week. The gauge was supported early in the week by a rally in homebuilders on speculation Brazil's government will take further steps to boost the economy's recovery. The index gave back some gains as Brazilian Industrial production figures came in lower than expected (0.9% vs. 1.2% expected for October).

Commodities

- Commodities dropped 2.21% this week, as of yesterday's close, as measured by the S&P GSCI broad commodity index. The main contributor was due to a sharp drop in Energy (-3.24%), while Agriculture and Industrial Metals fared better (+0.46% and -0.53% respectively).
- Gold fell 1% for the week, and is currently trading at 1'697 per troy ounce. The metal traded relatively flat for the week, with the drop occurring on Tuesday following weak reports of US factory output, driving gold down to a one month low.
- Crude Oil futures fell 3.14% for the week and are currently trading at $86.1 per barrel. Oil fluctuated between gains and losses earlier in the week on mixed economic signals from China and the US, as well as API reporting a drop in Inventories. On Thursday, oil dropped almost 2%, as the ECB cut its growth forecasts for 2013.

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