Bedrock Newsletter

Friday, January 11th 2013

Welcome to 2013!!! We are back into the New Year and glad to find the “Fiscal Cliff” off the headlines (it had become quite tiresome), upset to find Syria still enflamed, as is Australia (otherwise), weather patterns still unusual and the markets showing some direction- equities rising, prime sovereign bonds declining with gold and the Euro strengthening. The VIX, a common measure of risk has fallen further to 13.50 or so, implying that fear (complacency?) is down. Central Banks are all supporting the global economy, even the BOJ is now pressured by the new Japanese government to support the economy, under threat to lose its independence by Abe. We recall our classes which taught us that the market is a discounting mechanism; we wonder if yesterday’s 5 year closing high of the S&P is a prediction of the global economy having come out of its mess or is the explanation elsewhere?

Timothy F. Geithner’s replacement by Jack Lew as Treasury Secretary will end a period of unusually strong ties between the department and the Federal Reserve. For the Fed, the result may be less insulation from critics, yet greater influence in financial market regulation. Geithner’s departure means the central bank will lose a strong ally inside the executive branch who helped protect the Fed from efforts by both Republican and Democratic lawmakers to rein in its power. Is Obama taking the Abe route?

The most important part of the Federal Reserve-watching game is now this: figuring out how long it will take for the unemployment rate to drop to 6.5%. That's the benchmark that the Fed's rate-setting Open Market Committee pegged in December as the one that will prompt it to begin raising the Fed funds rate, now set between 0 and a quarter of a percentage point. Two new pieces of research – one from Morgan Stanley, one from CNBC – suggest it could be years, in fact, at least half a decade, before the economy hits that mark.

Brighter economic prospects, diminishing fears about a U.S. fiscal crisis and the idea that the beginning of the end is in sight for a period of ultra-easy monetary policy have sent government bond yields racing higher at the start of the year. Well, not all- as Spanish and Italian yields have come-in further, their new issuances for 2013 being well received at falling rates. Perhaps the European conundrum is coming to rest? Yesterday the ECB Chairman, Mario Draghi, surprised us by NOT cutting rates and then suggesting that whilst not rosy, the European economy is mending well into late 2013. The Euro gained a couple of figures against the Greenback.

Earning Season opens yet again with Alcoa meeting expectations and then showing an optimistic outlook. It added fuel to market sentiment, especially Alcoa’s Chairman suggesting that the company is seeing revived demand from China! This rosier outlook was closely followed by data that China's exports in December blew past expectations, rising over 14% year on year, compared with forecasts for an increase of just 4%. And guess what? Behind these blow-out trade numbers a surprising surge in demand from the country's top trading partner - the United States.

With a bird’s eye view, the world is looking less scary into this new year… we venture forward optimistically into this year with the words of Martin Luther King “Faith is taking the first step even when you don't see the whole staircase” and wish you a good climb this year…

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Currencies

- EURUSD seemed to be relatively range bound between 1.3050 and 1.3110 at the start of the week. With little news on the ticker tapes this remained the case until Thursday when the US Initial Jobless claims came in more or less in line but the continuing claims dropped. However, the Draghi speech eclipsed both these sets of data with the ECB President stating that the "Euro-Area Economy should recover later in 2013". This news sent the EUR flying higher, eventually peaking at 1.3280 in the evening. Seeing the level unchanged this morning, we really wonder how long the EUR will maintain these heights before running out of oxygen and falling in search of 1.20… or lower? We watch this space.
- EURCHF moved in line with general EUR strength or weakness. Moving between 1.208 and 1.2090 for the first 4 mornings. However, again with Draghi's comments the EURCHF pair has flown up to 1.2175 this morning – something the SNB will be very happy about. USDCHF slipped on the Draghi news but less than normal as the EURCHF has taken most of the move, slipping only 80 pips from 0.9220 to as low as 0.9140 but recovering this morning to 0.9180.
- The Yen is subject to two movers at the moment, the words of PM Shinzo Abe and the inferred rhetoric of the BOJ. We believe that this will tend towards becoming the same thing, as Abe pushes the BOJ either to execute their mandate in line with his orders… or he will replace them with a Board that does as he says. In light of the further stimulus measures, the continued political assault and the market opinion we saw the JPY weaken even further this week from 88.00 to 89.50 this morning. We are aware that this cannot only move in one direction forever. We believe that any consolidation would simply be used as a springboard to weaken the Yen further.
- AUD was caught in a narrow trading band between 1.0470 and 1.0520 awaiting the Chinese Export/Import data on Thursday morning. Upon the, quite frankly, incredibly bullish data (three times expected exports % increase and twice the expected % import increase) the AUD rallied from 1.05 to 1.06 across the day. For now the higher yielding currency maintains a luster that keeps it at elevated prices, when the rate cuts from the RBA continue throughout the year perhaps the market will move to fair value, but not for now.
- Cable had a positive week, moving steadily from 1.6075 to 1.6180. The pair has since retraced down a little, standing at 1.6110 on the back of slower economic numbers out of the UK this morning. We fear more weakness ahead though as the BOE has signaled the economy could see weakness in the year to come.
- The South African Rand weakened yesterday with Fitch downgrading the country to BBB. The Rand lost a little more than one per cent. We believe that the Rand should weaken further in the near term.

Fixed Income

- This week saw short term rates on the 2-year open at 0.27% but drop slightly to 0.24%, post the Fiscal Cliff news settling. Treasury yields on the 10-year were completely unmoved from 1.90%, however, these levels are obviously elevated from last year after the Fiscal Cliff is now consigned to the past. The 30-year bonds dropped very heavily this year having seen the yield jump from 2.95% to as high as 3.17% post the FC news. It has since stabilized at 3.08%.
- The German 10-year Bund sold off this week seeing the yield move from 1.52% to as high as 1.58%, contrary to the periphery which has been bought up causing a larger compression in rates than normally seen.

- Spanish yields moved down as the market seems to further support the Spanish debt in the New Year. The buying saw the yields tumble from 5.15% post Draghi's comments to as low as 4.90% almost back to the lows of last year at 4.85%! With the nation selling more two year notes than originally planned this week and the debt being overly well received. However, we worry that this belief in the market support is not well founded and that they may stall further on applying for a bailout. Complacency is not what the market needs at the moment.
- The Italian auction really should not be something to focus on but in light of the Spanish yields tumbling, the Italians have done so in sympathy. We see the 10 year moving from 4.30% to 4.13% this week. However, we are not certain these levels can be maintained.
- This week European High Yields were the best performers at +1.04% followed closely by US Leveraged Loans at +0.56%, the largest loser was Global Emerging Market debt at -0.31%. Year to date the outperformer has been European High yield again at +1.9%.

Equities

- Equities rose modestly over the week after developed markets started the year on a strong foot, with nearly all of them surging by 2-3% on the 2nd of January, as a last-minute fiscal cliff deal bolstered investors' hopes. As a result the MSCI World advanced by 0.61% last week, but already stands at +2.99% year-to-date.
- European stocks saw mixed price action as the European Central Bank and the Bank of England both left monetary policy unchanged Thursday, while investors also digested well-received debt auctions in Spain and Italy. As a result, the Euro Stoxx was up about 0.14% for the week and currently stands at +2.82% for the year.
- The S&P 500 advanced by 0.39% this week (as of yesterday's close), hitting a five-year high on Thursday after US shares got a boost from reports suggesting the outlook for economic growth may be improving, amid better-than-estimated data on Chinese exports. The index is up 3.22% year-to-date, and stands at its highest level since December 2007.
- Japanese stocks jumped by 1.4% on Friday after Prime Minister Shinzo Abe announced a massive spending package intended to breathe life into the country's moribund economy. As a result, the Yen accelerated its weakening, boosting exporters. The Nikkei ended the week up 1.06% and currently stands at +3.91% year-to-date.
- In terms of sectors, Healthcare and Financial stocks led the gains (+1.92% and +1.34% respectively), while Utility was the worst performer (-0.93%). Financials, Healthcare and Energy are currently the highest performers year-to-date (4.28%, 4% and 3.05% respectively), while Utility and Consumer Staples are lagging (+0.86% and +1.92% year-to-date).

Emerging Markets

- Emerging Market equities were about flat this week, as of yesterday's close. In terms of regions, Asia and Latin America were down to flat (-0.24% and -0.01% respectively), while EM Europe rose by 1.73%. The MSCI EM started the year on a strong note, rising by 2.12% on the 2nd of January, currently standing at +2.07% year-to-date.
- On Monday, the Shanghai Composite hit its highest level since June, led by health care and financial firms, on speculation that a rebounding mainland economy will help end a three-year bear market. However, the index finally dropped by 1.45% over the week, as Chinese shares tumbled on Friday after data showed China's inflation continued to trend upward in December,

fuelling concerns that the government may hold back further monetary easing to check inflation. The index currently stands at -1.15% for the year.

- The Bovespa started the week on a negative note, falling to a one-week low after analysts lowered forecasts for Brazil's economic growth this year, adding to concern that a sluggish recovery may hurt corporate earnings. But starting Wednesday, the index snapped a three-day losing streak bolstered by a rally among utilities on speculation that investors overreacted few days earlier to potential energy rationing measures in Brazil. As a result, the index lost 1.35% over the week and stands at +1.19% year-to-date.

Commodities

- Commodities rose by 0.91% this week, as of yesterday's close, as measured by the S&P GSCI broad commodity index. Commodities rose across the board with Precious and Industrial Metals leading the gains (+1.96% and +1.12% respectively).
- Agricultures rose as Soybean and Wheat Export Inspection figures came in higher than expected outweighing lower than expected respective Corn figures.
- Gold rose 0.84% during the week, and is currently trading at $1'670.5 per troy ounce. Gold rose the most in 2 months on Thursday (+1.07%) as ECB president Mario Draghi said economic weakness in the region will continue, increasing speculation policy makers will take action to revive growth. The metal was also supported by better than expected Chinese trade figures spurring optimism for an increase in demand for raw materials.
- Oil rose 0.75% for the week, and is currently trading at $93.78 a barrel. Oil gained its support on Thursday (+0.77%) on reports of a rise in Crude Oil inventories, rising by 1.3mn barrels last week.

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