Bedrock Newsletter

Friday, February 15th 2013

Last week we warned of increasing volatility in the FX markets. We chose to reduce significantly our exposures away from base currencies- we closed-down our long holdings of Chinese Yuan and cut our positions in NOK, HKD and CAD. The topic of “currency wars” is rising to the headlines.

The world's major economies may be trying to ease concerns about a currency war, but it appears that they are sowing confusion in the foreign exchange markets instead; adding to the wild swings already seen last week. Talk about a "currency war" has intensified this year, triggered by Japan's new government pushing for an aggressive monetary policy. The yen has fallen more than 8 percent against the dollar since the start of the year and about 10 percent against the euro. The problem, say analysts, is that agreement is hard to come by because the G-7 is made up of different economies with different views on recent currency developments.

The Economist from earlier this month published its “Big Mac Index” which analyzes purchasing-power parity around the world- They use a standard commodity, McDonald’s “Big Mac” burger. The table provided in the article shows that in the US this product costs $4.25 whilst in Norway [NOK] it costs $7.84, in Switzerland [CHF] it is $7.12. The bottom of the table is closed with India at $1.67 per burger, but then again, Indians don’t consume beef… In a glance, we are tempted to look at the Russian Ruble [RUB] which seems undervalued with the local cost of a Big Mac at $2.43; reminding us of Jim Rogers’ proclamation of last week that he is shorting US Bonds and buying Russian equities, bonds and the currency.

Well, this index is only indicative as to relative purchasing power. It isn’t a trading tool and must be viewed in the context of many other elements.

On a down equity-market Monday, Dow transports hit yet another new high. It is an orderly rise into 2007 levels. With the DJIA trading around 14’000 and the S&P 500 comfortably over 1’500 one can ask - is this expensive? Maybe not, as corporate earnings are higher than back then, balance sheets are stronger with record liquidity, interest rates are lower globally than they had been in 2007. Maybe a huge rally is in the makings?

Goldman Sachs CEO Lloyd Blankfein gave *his* state of the union on CNBC's "Street Signs" Tuesday; saying the political environment remains difficult as Washington grapples with the sequester but the "economic underpinnings are actually better than they have been for some time." “We could be on the threshold of a bull market," Blankfein said.

On the debt side of the markets we see the US 10 year note oscillate around the 2.00% yield, with a general tone of slow price declines across the bond markets. We see a creeping fear rising in this sector, what with news that the Chinese are curbing purchases of Treasuries. The US is second only to Greece in debt to GDP ratio when unfunded Social security, Medicare, state debt and other entitlement programs are considered. We note with some trepidation that the only viable buyer is the Fed... The US deficit is funded by their Central Bank… Is this the greatest Ponzi ever???

We leave you for a sunny Valentine’s weekend with a thought from Isaac Asimov who said that life, unlike the game of Chess, continues after a Check-Mate. So do markets… And our observation that all recessions and depressions have one thing in common- THEY ALL END! ☺

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Currencies

- EURUSD looks to be closing out the week exactly where is started. The EUR strengthened a little at the beginning of the week moving from 1.3370 up to as high as 1.3520 on better than expected Industrial data for the Eurozone. The Euphoria was short lived as France and the majority of Europe showed contracting GDP figures, sending the EURO tumbling to 1.3315. The general downward direction remains intact for the moment and we believe without a strong Risk-On momentum returning, that the EUR will continue to weaken against most currencies.

- The CHF weakened against both the EUR and the USD this week. EURCHF moving from 1.2260 to as high as 1.2380 on the EU industrial data and slipping to 1.2320 by today. The USDCHF remained relatively unchanged, until the EUR data forced the pair higher to 0.9240. We believe that the general weakening of the Franc is in line with the SNB's goals and the fact that the floor has held implies that the market believes in the Bank's power to maintain a weaker Franc.

- Japanese Optimism (or perhaps better named Pessimism) data was better than expected with the populace less pessimistic than normal. The JPY though has finished the week where it started at 92.50, with a brief dalliance up to 94.45 even Abe could not maintain the weakness with rabble-rousing comments of the necessity to weaken the JPY further. EURJPY followed the same pattern, moving from 124.00 up to 127.00 only to slump back to 123.20. The consolidation phase is likely to last a few weeks and we see a little strength on the horizon… The longer sighted view is for further JPY weakness and the BOJ must, should and will target higher inflation and a weakening Yen. Let the currency wars begin!

- AUD saw a lot of weakness at the beginning of the week slipping from 1.0320 to 1.0230. With no further data on the wires the high yielding currency picked up from Wednesday but has remained very stable at about 1.0340. The economic data and the RBA would both indicate that the AUD has to weaken and we view that weakness as starting to creep in now.

- We have seen a lot of weakness in the GBP this week. Carney's words were noted and were useful for traders to apply new short positions, but otherwise were hollow. This week saw the Pound slip rather unceremoniously from 1.58 to 1.5475. With the quarterly Inflation report on Wednesday knocking 1 figure off cable in a split second. The picture is not looking rosy into the future for the British Pound and any resilience will likely be sold into… The exporters will of course see a little upside, but unfortunately this will not sustain a creaking economy.

Fixed Income

- The week started with a very stable outlook and trading sideways at 1.96% only to see the US 10 year flirting with 2.06% midweek it eventually slid right back to 1.98%. The 30 year however has seen a move from 3.17% to as high as 3.24% only to slip to 3.14% causing a flattening in the curve, both from the 10Y weakening a little and the 30Y strengthening relative to the 10Y.

- The German 10-year Bund sold off in the same manner as the US Treasuries moving from 1.60% to 1.70% only to rally back to 1.60% by this morning. The disagreements within Europe are creating further divides and without a united front we feel that the Bunds have further price upside and that the yield could slip further in the very short term.

- Spanish 10 Year yields dropped heavily this week on relatively good buying of the debt. The yields slid from 5.45% to 5.16% seeing support for the countries debt when Cyprus is in the process of restructuring… how long before Rajoy has to do the same?
- The Italian 10 Year debt was also well received this week with a strong debt auction of €9Bn. The yields trickled down from 4.63% to 4.35% in line with the ECB comment on the EUR not being over-valued and the momentum was maintained through till today.
- This week the strongest performer was EU HY at +0.52% and the weakest was the US Government at -0.09%.

Equities

- Developed equities were about flat this week, with the MSCI World rising by 0.08%, as of yesterday's close. Investors kept a cautious stance this week as many have been forecasting a weaker equity market in February and March due to lingering worries over the Eurozone's sovereign debt crisis, before equities pick up again in April.
- The EuroStoxx was about flat this week, as Eurozone equities are starting to feel the pinch of a strong euro, which threatens already low earnings. Carmakers, technology and luxury goods firms are likely to be the hardest hit. Also, signs that Europe's economic woes have not been resolved were highlighted on Thursday by data that showed a contraction in the Eurozone economy.
- The S&P 500 eked out a small gain for a third straight session on Thursday, helped by a flurry of merger activity, though investors see no catalysts to lift the market further with major averages near multi-year highs. US stocks slowed advance took the S&P 500 to its highest intraday level since November 2007 on Wednesday. The index ended the week up by 0.23% as of yesterday's close.
- Japanese equities were volatile this week, jumping by almost 2% on Monday on a weaker Yen but offsetting gains on Wednesday and Friday as investors pared exposure to exporters and banks while awaiting the weekend G20 meeting. A deepening recession in the Eurozone also dragged down shares, and sentiment deteriorated further on news that a conservative former finance ministry bureaucrat is the leading candidate to head the Japanese central bank.
- In terms of sectors, Industrials and Financials were the best performers (+0.95% and +0.80% respectively), while Telecom Services and Utilities lagged (-1.61% and -0.54% respectively).

Emerging Markets

- Emerging Market equities rose by 0.47% as of yesterday's close, as measured by the MSCI EM Index. In terms of regions, Latin America and EM Europe were the worst performers (-0.68% and -0.94% respectively), while EM Asia jumped over the week (+1.18%), on the back of positive Chinese outlook.
- The Shanghai Composite posted an additional week of gains on thin New Year's trading, up 0.55%. The outlook for Chinese equities remains upbeat after rallying by over 7% so far this year. Among sluggish emerging markets' performance, China stands out thanks to accelerating economic growth, rebounding industrial profits and fresh evidence that the country's real estate market is not a bubble.

- Brazilian equities suffered (again) this week, with the Bovespa falling 0.72%, as of yesterday's close. The index fell as economists raised their 2013 inflation forecasts for a sixth week, overshadowing optimism about the country's growth.

Commodities

- Commodities dropped by 0.07% for the week, where a sharp decline in Agriculture and Precious metals (-2.35% and -2.11% respectively) were offset by a rise in Energy (+0.56%).
- Agriculture dropped sharply early in the week on speculation that record crops in South America will slow overseas demand for US supplies, causing Soybean futures to slump into a bear market. Agricultures gained some strength at the end of the week as Standard Chartered cut forecasts for Soy, Corn and Wheat.
- Gold gradually fell for the week, losing as much as 2.17%, and is currently trading at $1'631 per troy ounce. The metal has commenced the selloff early in the week on the back of weak demand, as well as growing political uncertainties in Europe. Gold continued its downtrend in the latter part of the week on the back of a rise in the USD, as well as on reports that hedge funds managers George Soros and Louis Moore Bacon have cut their gold exposures.
- Oil gained for the week, rising 1.23%, and is currently trading at $96.90 a barrel. Oil rose sharply on Monday as an ECB council member said the EUR is not seriously overvalued, and has warned governments against trying to weaken it. Oil has continued its uptrend midweek – trading as high as $97.50 – as OPEC upped its forecast for oil demand this year. Oil has later trimmed its ninth weekly gain as a report signalled OPEC will cut crude shipments this month.
