Bedrock Newsletter

Friday, April 19th 2013

What a week! Gold collapsing, crude oil and other commodities trading down, equities worldwide falling with a huge increase in volatility! Then explosions at the Boston Marathon with several dead and many injured… Was it an act of terrorism? Uncertainty added fuel to the down-drafts…Then a huge explosion at a fertilizer factory in Texas, causing many casualties. As Grandma would have said: "What is the world coming to?"

Do the events and markets of this week present us with a sea of change? Has perception of recovery waned? Has the fear of inflation been replaced with worries of deflation? Has the outlook changed?
Well, we also had weaker than expected GDP growth out of China, up "only" 7.70%. What were the analysts expecting? China is no longer a minnow which can grow to be a big frog… it is big now, its growth rate MUST slow… Even before the Boston hiatus, gold prices broke below $1,400 on Monday, the lowest level since March 2011. "Here we are under [$1,400]," Gartman observed. "Who would have thought it? Not I. There are a lot of people throwing up their hands and throwing positions overboard. Panic is everywhere, I've never seen anything like this. I mean it."

The US informed us that the Consumer Price Index rose by 1.7%, which is below the Fed's target level of 2%; where is all the QE money going? Clearly, this isn't an inflationary policy! Inflation protected bonds in the US, "TIPS", have been falling hard this week- Last month's gem turning to coal? We looked around at other bonds and find the US 10 year note rallying anew, now yielding 1.63% again! 2 year Swiss Government notes now trade to negative yield to maturity! Wednesday's news of European car sales falling to levels last seen 20 years ago combined with a further rise in unemployment support the deflationary outlook now upon us. Falling equity prices further substantiate this outlook- Equities thrive in moderate inflationary environments and suffer in deflation (look at Japan's recent 25 year experience).

But then, we are in the midst of earnings' season- So far, Q1 results show 72% of reporting companies beating on earnings, 22% coming-in under and 6% matching expectations. One easy conclusion is that analysts are not getting any better at their jobs!
It looks rosy, but when looking through the EPS figures we do see a clear slowdown in "top-line" revenue growth and profits rising only modestly.
The three gorillas IBM, Google and Microsoft reported on Thursday after the close. MSFT did well, GOOG was OK and IBM disappointed.

Volatility's prolonged absence from the stock market appears to be coming to an abrupt end. After being largely invisible for the past nine months—coinciding with a sharp equity rally—several signs indicate that instability is coming back. Volatility in the FX markets remains high with 2% daily swings in the Euro/US$ exchange rate. Only the bond markets retain subdued volatilities.

Adding fuel to an already contentious debate over whether tough austerity measures are helpful or harmful to an economy,is a new revelation that there was a mathematical error in an influential economic research study, often cited as having paved the way for fiscal policies pursued by the U.S. and Europe. The charge was raised in a paper by the University of Massachusetts that called into question the findings of Harvard economists Carmen Reinhart and Kenneth Rogoff's 2010 paper "Growth in a Time of Debt," which concluded debt over a certain level was dangerous for countries. Reinhart and Rogoff admitted they made a bad calculation, but stand behind the central theme of the paper that too much public debt will slow economic growth. Our long-standing distrust of statistical analysis is vindicated!

Goldman Sachs comes to the rescue of our mood with its newly published outlook: they see 9 percent annual total returns for the S&P 500 ahead, pushing the index up 20 percent to 1900 by the end of 2015. They see even bigger returns for Japan, Europe and the rest of Asia. The firm sees 21 percent annual returns in the Asia ex-Japan region over the next three years, followed by 19 percent a year in Europe and 15 percent annual gains in Japan. We really want to believe them… But we do have a dismal view of analysts…

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Currencies

- EURUSD looks set to finish the week where it started at 1.31 level. The EUR swung up to as high as 1.32 on Tuesday night on the JPY trade triggering stops on the way up and forcing the EUR higher even in the face of higher CPI and a very poor ZEW survey. Otherwise the pair has traded in line with Risk sentiment, with little news out this week the pair is range bound for now.
- EURCHF oscillated around 1.2160 and moved very little on the week. In light of the absence of market moves the safe haven status of the CHF has been mildly brushed aside. We feel that this is unwise and that in the not so distant future the SNB may need to defend the 1.20 floor they have so successfully maintained. USDCHF moved exactly inverse to EURUSD and fell from 0.9320 to 0.9210 but is now almost back to where it started the week at 0.9300.
- This was another rather incredible week for the JPY. Both EURJPY and USDJPY fell heavily on Monday moving from 129.00 to 125.00 and 98.50 to as low as 95.80 respectively. In light of little change in the markets both are now higher than the start of the week, seeing the JPY weaken to almost the lowest point again. We are currently at the lows of the week for Yen at 99.25 and 129.95.
- AUD slumped heavily on Monday as the USD took a massive big in the market on the back of Gold price massacre. The AUD fell also on lower growth figures from China and poor domestic numbers. The Monday move alone saw the AUD fall from 1.0525 to 1.0290 and further moves lower on Thursday to 102.69. With Risk turning negative we could see a large scale correction be starting.
- The Pound is almost unchanged on the week at 1.5350, having seen two moves lower to 1.53 and then as low as 1.5217 on Thursday. Although the Pound does not seem to want to break lower it is certainly not making new highs; in fact each high has been a lower high and each low a little lower. We fear that when the GBP does move down it shall be swift and brutal.
- Both BRL and ZAR had a negative week, seeing the BRL move from 1.9725 to 2.0190 yesterday and the ZAR moving from 8.90 to 9.2475.

Fixed Income

- As we said last week, with the 2 Year yields at the recent lows, negativity building in the markets finally took hold again and the yields on the US 10 Year moved from 1.79% to as low as 1.67%. The 30 Year moved from 3% to 2.84% and the 2 Year remained at or around 0.22% for the majority of the week. With this much demand for US short term paper and short term CHF rates at negative levels, we really are worried about the fear that is building in the bond markets. This does not mean that the yields cannot go lower before a correction arrives, but the big move will surely be higher in yields, but perhaps not before a final washout in equities.
- Japanese yields dropped a little this week after last week's mammoth moves. We started the week at 0.64% but slowly drifted lower to 0.58% this morning. The yields are likely to rise on the JGBs and we would not want to own such assets with a purely negative move likely, the glacial pace of moves in the JGB market are a thing of the past… they have volatility back!
- The German 10-year Bund yields moved from 1.31% to as low as 1.22% on Thursday as Risk assets sold off and fear re-entered the market. These levels are closing in on the all-time lows

of below 1.20% and this is with the equities almost having touched all-time highs… this is the recipe for disaster!

- The Spanish 10 year remained well received in the market with the yields moving from 4.75% to as low as 4.61%. With Cyprus headlines all but side-lined for now, we are nervous that when the tide turns the Spanish are going to be swimming without their trunks…
- The Italian 10 Year yield finished last week at 4.21%, much lower than we expected, but this week has seen the Italian bond auctions print at their lowest for a very long time. Reaching as low as 4.18%% on Thursday having been as high as 4.38% at the beginning of the week.
- The best performer this week was US Government at +0.57% and the weakest was EU HY at -0.70%.

Equities

- Developed equities fell 3% for the week, as of yesterday's close, as measured by the MSCI World index. Shares lost on the back of rising global growth fears on the back of a weaker than expected Q1 GDP figures for China, coupled with the IMF lowering the global growth forecast, as well as weaker than expected data from the US and Europe.
- European shares fell, with EuroStoxx index losing 2.52% for the week. Equities commenced their selloff at the start of the week as China's GDP figures came in lower than expected, sparking fears over global growth. European shares posted additional losses as the IMF lowered its expectations for Eurozone economic growth and German investor sentiment fell sharply. The gauge lost over 2% on Wednesday as Germany's central bank stated that European policy maker may cut rates if needed. Shares recovered some losses at the latter part of the week due to a rally in Asian equities, following supportive comments on Chinese growth by a Chinese government economist.
- The S&P 500 lost as much as 3% for the week, as of yesterday's close. US stocks lost as much as 2.3% on Monday on weak data from the US and China, and the price of gold and other commodities plunged, unnerving investors. Stocks regained some ground on Tuesday following strong housing data and upbeat corporate earnings. The benchmark however resumed its downtrend as global growth fears increased following negative IMF comments on expected growth, and several corporations missed earnings estimates.
- The Nikkei posted its first weekly loss (-1.25%) in a month. Japanese shares lost, however outperformed their developed counterparts as Japanese exports rose more than expected – due the continued weakening of the Yen – and the IMF increased their Japanese growth Forecast. In addition, Japanese shares were supported as global policy makers refrained from censuring the slide in the Yen.
- In terms of sectors, Materials and Energy posted the biggest losses (-5.58% and -4.07% respectively), while Telecoms and Health care fared better (-0.97% and -1.30% respectively).

Emerging Markets

- Emerging Market equities fell 2.2%, as of yesterday's close, as measured by the MSCI World EM index. EM Europe and Latin American shares were the worst contributors, both falling close to 4.5% for the week, while EM Asia fared better (-0.73% for the week), as the region was supported by a rally in Chinese shares.

- The Shanghai Composite rallied 1.71% for the week. Chinese shares started the week on the weak side on reports that the nation's economy grew 7.7% in Q1 (8% expected), and Industrial production rose less than expected (8.9% vs. 10.1% exp). Shares reversed their losses and posted gains as consumer stocks posted gains following better than expected corporate earnings, proving the government's immense efforts to bolster the sector are successful. The gauge rose more than 2% on Friday on the back of better than expected corporate earnings and following a government economist forecasting that growth will rebound this year in the second and third quarters as he expects the government to stabilize money supply growth and loosen fiscal policy to boost economic growth.
- The Bovespa lost as much as 3.25% for the week , as of yesterday's close. Brazilian shares lost more than 3.5% (the most since 2011) on Monday as worse than expected Chinese GDP figures weighed on Brazilian exporters. The benchmark recovered 2% in the following session as commodity prices revered earlier losses, boosting the outlook for Brazilian producers. Shares resumed their selloff at the latter part of the week as the IMF cut its forecast for global growth. Internally, some optimism arose as Brazilian policy makers raised borrowing costs less than expected by some analysts, spurring speculation that the monetary tightening will be limited.

Commodities

- Commodities tumbled this week, with the S&P GSCI TR Index losing 2.75%, as investors globally dumped assets across the commodity complex due to broad-based risk aversion and lingering concerns over growth in China. Precious Metals and Energy were by far the most negative sectors with heavy losses of 7.85% and 3.25% respectively, while Agriculture and Industrial Metals fared much better (-1.06% and -1.26% respectively).
- Gold fell -4.47% over the week, and is currently trading around $1'414 per troy ounce. The yellow metal experienced an historic fall, losing about 5% last Friday and over 9% on Monday as Cyprus' plan to sell excess gold reserves led to speculation other indebted Euro zone countries could follow suit. The sell-off was also exacerbated as the futures dropped below $1'500/oz, triggering numerous stop losses. These two unprecedented sessions led Dennis Gartman (editor of the Gartman Letter) to comment: "We've traded gold for nearly four decades and we've never seen anything like what we've witnessed in the past two trading sessions".
- Gold prices dropped as low as $1321.95 per troy ounce early on Tuesday – hitting a 2-year low – before bouncing back from Tuesday until today, with strong physical buying set against exits from exchange-traded funds. Gold is set for a 4th consecutive week of decline and lost 11.4% so far during April.
- Oil sharply fell this week, dropping by over 3%, and currently trading at $88.45 a barrel, as concern about the global economy weighed on the outlook for demand, after growth projection for China was trimmed to 8% from 8.2%, while the growth outlook for the US was lowered to 1.9% from 2%. Crude Oil hit a weekly low at $85.61 a barrel on Thursday, the weakest level since December 13, before recovering by as much as 3.4% to touch a session high today at $88.54 a barrel, following news that members of the OPEC are discussing holding a special meeting to address the recent steep decline in oil prices.

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