Bedrock Newsletter

Friday, April 26th 2013

This week we found out that Spain now has 27.2% unemployment, an all-time record, and France at 11% has broken its own record. US inflation as measured by the CPI is at 1.70%, below the Fed's target of 2.00%; Japan's CPI is at minus 0.50% year-on-year, way below the BOJ's target of 2.00%. Deflation with unemployment? A clear recipe for social unrest and upheaval! This risk is the true driver of all the world's central banks. Clearly, the risk for rate rises is mute!
Tuesday Euro-area services and manufacturing output contracted for a 15th consecutive month in April as the currency bloc struggled to emerge from a recession. A composite index based on a survey of purchasing managers in both industries held at 46.5, London-based Markit Economics said today. That's in line with the median of 26 economists' forecasts in a Bloomberg News survey. A reading below 50 indicates contraction. The euro-area economy has contracted for five quarters, and confidence has been shaken by political turmoil in Italy and the bailout of Cyprus. The International Monetary Fund last week lowered its global growth forecast and urged the European Central Bank to pursue an "aggressive" monetary policy. Another observation supporting the deflationary outlook can be found in Italian 10-year government bonds advancing, pushing the yield on the securities below 4 percent for the first time in almost 2 1/2 years. The yield fell to 3.889% and this in a country that still doesn't have a government!
Then on Wednesday, US durable goods came in poorly, down and lower than expected. The recovery is clearly slowing.

The earnings cycle has been better than expected on top line earnings but there are significant problems. Before Thursday's earnings we had seen 132 S&P companies report. 67% of those had beaten estimates on earnings thanks to cost cutting. However, only 42% have beaten on revenue. That is far lower on revenue than the average of 62% expected according to Thomson Reuters. That is the lowest in years and suggests trouble ahead. An even more troubling statistic is the guidance. The negative to positive guidance ratio is 14:1 compared to a historical average of 2:1. That is a MAJOR red flag for the rest of 2013.

Near multi-generational low bond yields, driven at least in part by US Federal Reserve asset purchases, have pushed the question of whether or not the bond market is a bubble to Top of Mind. Three experts were asked if there is a "bond bubble": Martin Feldstein (Harvard and NBER) – yes and the Fed is entirely to blame; Francesco Garzarelli (GS rates strategy) – no, but yields look expensive and the market is too complacent about rate hikes; and Paul McCulley (former PIMCO partner) – absolutely not and the Fed has done everything right, but could take the lead from the Bank of Japan (!) and do even more (even more imperative for the European Central Bank). We look at it from the Fed's point of view (very low yields are exactly what they intended, and they believe that they have tools to cope with any signs of trouble), assess how vulnerable we are to a repeat of the 1994 bond "massacre" (not very) and ask if gold is the real bubble (potentially).
Go figure… we feel as though we are playing Chess without the dice… ☺

Then there is the global witch-hunt of tax evasion and avoidance. From a moral and fairness view-point this is a good thing happening. Arguably, the timing is quite poor, as the so-called "black economy" drives 8% of US GDP and significantly more elsewhere- when an engine sputters, removing more oil is not a good idea…
Well, the US has found a solution- The U.S. economy will officially become 3 percent bigger in July as part of a shake-up that will for the first time see government statistics take into account 21st century components such as film royalties and spending on research and development. Billions of dollars of intangible assets will enter the gross domestic product of the world's largest economy in a revision aimed at capturing the changing nature of U.S. output. We ask ourselves if there are other threats on the horizon if growth of GDP will be driven by accounting methods.

Currencies

- EURUSD had another incredibly frustrating trading week, for most of the week flirting with the 1.30 figure. On poor French PMI, the EUR rallied, on German PMI it rallied further only to about face and drop from 1.3080 to 1.2980 in a matter of seconds. The trading does not make sense to us, poor data is seen as marvelous, good data is proof that the market should be rallying and everything else can "just be ignored as white noise". WHERE HAS THE MARKET COMMON SENSE GONE?! The Eurozone numbers are weak and getting weaker, Spain's unemployment levels are at the highest recorded and Italy does not have a government (may not be a bad thing if you look at Belgium!). A materially weaker EUR should be on the horizon and perhaps the ECB rate cuts that are forecast might just be the necessary trigger to do so.
- EURCHF moved briskly higher on the positive mood of Tuesday, seeing the pair move from 1.2180 to as high as 1.2350. USDCHF looks almost exactly the same on a graph seeing the CHF weaken against the USD. Moving from 0.9335 to 0.9500 on Wednesday. With the USDCHF we feel that higher levels could be ahead and look to see the USD bid tone continue in the market with parity squarely in the sights.
- USDJPY started at the highs of 99.90, nearly reaching to the mythical 100.00 figure only to slip back a little to 98.60 by Friday. There are too many option strikes at 100 that will need to expire in the coming weeks before the BOJ assault finally breaks through. BUT, break through it shall and we believe it shall continue to force the JPY weakening as it introduces a further 1.3Tr USD worth of easing policy that it still has in the armoury. EURJPY moved down from 130.50 to as low as 128.00 this week.
- AUD remained under pressure during the week, even with a Risk-On mood in place, slipping from 1.0280 to 1.0220 by Tuesday morning. With a positive mood it recovered a little to make it as high as 1.0340, but any strength has been sold into and the pair keeps moving back TO 1.0280. With weakness in the commodity prices, poor domestic employment figures and Chinese data less attractive than expected we are worried that the AUD will underperform and slip below parity as the need for a rate cut becomes more likely.
- The Pound, having been as low as 1.5200 this week, soared higher on positive GDP data on Thursday, jumping from 1.5280 to 1.5480 by the afternoon. The data surprise was only from 0.1% to 0.3%, however, with such negative positioning in the market any stop-loss buying would have and did cause a huge jump in the Pound. We said the next move would be sudden… just not in this direction. We fear an over-reaction and with revisions likely that the life of the pound shall be short-lived at these levels.

Fixed Income

- US 10Yr treasuries were almost unchanged on the week, stuck trading around 1.70%, as high as 1.73% and mostly above 1.68% (Except for the moments when someone hacked the news networks and declared that the White House had been attacked, the yields dropped briefly to 1.64%). A similar pattern emerged for the US 30 year being stuck in a range of 2.88% to 2.92% and briefly dipping to 2.82%.
- Japanese yields followed suit of their US trading partners, moving very little on the week between 0.58% and 0.60%... although I suppose that one could say these are massive moves historically, we are in a new Abe-regime now and this should be viewed as a steady week for the Japanese bonds.

- The German 10-year Bund yields moved off their lows of 1.19% on Tuesday as the equities rallied to as high as 1.2850%, unfortunately this was short lived (even with equities maintaining their highs) and the Bund is now yielding only 1.22%... Equities high, bonds higher, I guess the question is… who has to breathe first? With little to no air at these levels the first to flinch will have nothing left in the tank when the stimulus plans have lost their lustre. Look out equities.
- The Spanish 10 year seems to have maintained a semblance of positive receipt in the markets with yields dropping to as low as 4.27%... we are a little confused. For a country that has about 30% unemployed, banks that are essentially frozen, a country that will require a bailout/in (although we are not sure if there is anything to bail in with!), it would appear that the search for any yield is being blindly taken with complete disregard for the associated risks. We would not touch the Spanish debt as one day soon (and we hope we are wrong), the tide will go out…
- The Italian 10 Year yield crept to as low as 3.90% on news that there would be a new government formed. We are back to above 4.15% even with a Risk on mood. Apparently in Italy we are back to the boom years in terms of the yields. Interesting how most people in the country seem to be struggling to get through week by week!
- The best performer this week was the Global Convertibles with +0.88%, clearly as Equities rallied their outperformance should have been expected. The weakest was US Government at -0.08% or practically flat on the week.

Equities

- Developed equities rose by 2.60% this week – as of yesterday's close – as measured by the MSCI World index. World stocks soared, buoyed by forecast-beating results on both sides of the Atlantic and as grim economic data raised hopes of fiscal stimulus measures and a European interest rate cut.
- European shares surged by close to 5% over the week, as investors grew more hopeful of an interest rate cut from the European Central Bank after another weak business survey for Germany, Europe's biggest economy. European markets have also been buoyed in recent days by progress in Italy to produce a government after inconclusive elections in February.
- The S&P 500 rose by 1.92% this week (as of yesterday's close), up for a fifth straight session, as lower jobless claims, an increase in new US home sales and strong corporate earnings across a range of industries lifted investors' sentiment. On Wednesday however, the index ended about flat as disappointment over durable goods order was compounded by quarterly results that included a subscriber slump at AT&T and a weak profit forecast from Procter & Gamble. The index neared two-weeks high on Thursday, close to its highest level ever.
- The Nikkei jumped by 4.26% this week, climbing to its highest level in nearly five years on robust US company earnings and as the yen resumed its downward slide towards 100 to the dollar. The index has surged 58% and the Yen has weakened 24% versus the dollar since mid-November, when Shinzo Abe who became prime minister in December, promised bold monetary and fiscal expansionary policies during his election campaign.
- In terms of sectors, Energy, Materials and Financials posted the highest gains (+3.85%, +4.34% and +3.34% respectively), while Healthcare and Consumer Staples lagged (+0.68% and +0.51% respectively).

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Emerging Markets

- Emerging Market equities rose by 1.60% – as of yesterday's close – as measured by the MSCI World EM index. EM Europe shares were the best contributors, rising by 2.26% for the week, while Latin America and EM Asia rose less strongly (+1.13% and +1.53% respectively).
- The Shanghai Composite tumbled by 3% this week, after data showed growth lagging in the world's second main economy. Chinese stocks climbed by 1.55% on Wednesday on expectations that the central government might take action to boost the Chinese economy. But confidence in Chinese stocks is fading as evidence mounts that the country's economic recovery is stalling.
- The Bovespa jumped by 1.92% this week (as of yesterday's close), climbing for a sixth day as mining giant Vale posted earnings that beat analysts' estimates and higher commodities boosted producers.

Commodities

- Commodities rallied this week, with the GSCI total return index rising by as much as 2.91%. The largest contributors to the gains were Precious metals and Energy – rising 4.8% and 3.88% respectively – while Agricultures lost 1.34% on signs of improved weather conditions for field work.
- Gold rose 4.25% for the week, and is currently trading at $1'463 per troy ounce. The metal resumed its rebound from oversold levels as central banks were reported to have added to their reserves (with India adding an amount exceeding its previous record by 20%), triggering short-covering by speculators and re-entry of long term holders.
- Oil rose by as much as 5.35%, and is currently trading at $93.00 a barrel. Oil prices commenced their rebound at the start of the week as traders expect Japan's stimulus program to boost demand of the world's third largest oil consumer. Oil posted sharp gains on Wednesday and Thursday's sessions as the Energy Information Administration said gasoline supplies fell 3.93 million barrels last week – the biggest drop in a year. In addition, gains were attributed to US equities keeping up a 5 day winning streak, giving markets a sense of general optimism. The Brent – Crude spread has dropped below $10.00 for the first time in 15 months amid the restoration of North sea output, as well as diminished Middle East political tensions.

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