Bedrock Newsletter

Friday, May 3rd 2013

Another “noisy” week has gone by. ECB, Fed, data, more new highs. We see with our brains, not our eyes… Let us look through this noise and through all the information to the core subject; we would suggest you consider the topic of Inflation as the centre piece of your thinking- A brief reminder about the meaning of inflation- It is a process of rising prices, or a process of currency devaluation. The root cause for this is found in rising wages or production capacity and at the margin, commodity prices. We look around us and see record high and rising unemployment in much of the industrialized world, we see factories turning far below capacity and then, falling commodity prices in most all sectors. Bond markets around the globe seem to have agreed that zero yields (or thereabouts) is acceptable, i.e., signalling expectations of negative CPI rates, generating positive real returns. And this in the face of massive monetary reflation by all central banks. Critics of the Fed’s pumping seem to miss the point- Had they not done this we would probably be in a massive depression!

We see no change in the inflationary outlook over a distant horizon! As an investor, what should one do? Preserve purchasing power whilst your nominal capital slips, as investments in 2 year Swiss or German bonds imply (negative yield on both!)? We can only see some real and nominal increases coming from equities, but then again, these holdings benefit from inflation, and there is none around… We probably just need to adjust our level of expectations for returns. Do keep this thought in mind as the backdrop of the week’s observations;

Monday markets rallied to new highs... S&P 500 hit a record close and NASDAQ was back to November 2000 levels. It seems as though no one believes this rally... The bond market now shows a different view. The bond market seems to watch fundamentals, equity markets watching the fed and ECB... The fundamentals are recessionary (see above) whilst the central banks are adding fuel which is feeding the equities. We wonder why these guys are working through proxies- Buying bonds, giving us cash which they hope we will then invest in equities, when they could just buy equities directly…

Amongst the slew of Q1 results we saw one amazing report- The Swiss National Bank earned CHF 11.2bn… who says that intervention isn’t good?

The euro-area jobless rate rose to a record in March, increasing pressure on the European Central Bank to take additional measures to boost growth. The euro-area unemployment rate advanced to 12.1 percent from 12 percent in the previous two months.

The Federal Reserve held fast to its ultra-accommodative monetary policy Wednesday, solidified by what board members described as an economy weakened by fiscal policy.

Interest rates will remain at historically low levels while the U.S. central bank will not alter its $85 billion a month asset purchasing program. Language in the FOMC statement after the meeting saw one notable change - a declaration that it would increase or decrease the pace of its asset purchases depending on conditions.

The number of Americans seeking unemployment aid fell last week to seasonally-adjusted 324,000, the lowest since January 2008. Productivity has been under 1 percent since 2010 and well below the long-run trend of 2.2 percent growth a year dating back to 1947. Finally, the March trade deficit fell more than expected, to $38.83 billion. The trade deficit gap dropped as imports recorded their biggest decline since 2009, the latest sign of slowing domestic demand. The Trade gap is the second smallest since January 2010 as exports of goods and services slipped 0.9 percent to $184.3 billion. Exports have been one of the bright spots in the economy, but are being crimped by a slowing global economy, which is hurting manufacturing.

The good thought for the weekend is that the World is now governed by Central Bankers. They are not elected, so they probably don’t have a conflicted agenda! At last, the World is governed by clear opinion…

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Currencies

- EURUSD had yet another incredibly frustrating trading week. We are more or less where we started the week, having moved up from 1.3040 to 1.3090 now. However, on poor US data, poor Chinese, poor German… in fact generally poor data all round… the EUR moved up to as high as 1.3240 prior to the ECB meeting. Post Draghi's comments and on the possibility of negative Bank interest rates, the EUR slipped back to as low as 1.3040 but looks to be settling a little higher this morning. We quote Mr. Keynes yet again, "Markets can remain irrational longer than you can remain solvent". We all believe the EUR should drop… we look for people's pockets to empty and then perhaps we shall be proven right. How interesting then, that the ECB has it within their power to act prior to wiping out the capital base in the pockets of the many, yet they prefer to keep their hands in their own pockets and shrug their shoulders!
- EURCHF moved steadily from 1.23 to 1.22 throughout the week briefly spiking after Draghi spoke. USDCHF looks fairly similar, moving from 0.9440 to as low as 0.9250 on Wednesday, however with the larger weakness in EURUSD, the up move in USDCHF can be seen today as we are as high as 0.9350 as we write.
- USDJPY was no longer front and centre this week, trading on the sidelines between 97.00 and 98.00. With the USD bid after Draghi's, the Yen dropped, moving from 97.20 to as high as 98.40 temporarily. We look to be finishing about 98.00, which seems about reasonable.
- AUD was relatively quiet moving slowly up from 1.0280 to as high as 1.0380, before being knocked of its perch with FOMC and ECB meetings causing a USD bid tone. The domestic data still looks horrendous, the Chinese data underwhelmed again and the commodity price weakness seems to be lingering (despite a slight price spike in copper). The AUD eventually fell to as low as 1.0222 and we look for this trend to continue.
- The Pound surged again this week from 1.5480 to as high as 1.56, only to see the FOMC and a dollar bid cause the USD to strengthen, followed by the ECB commentary which saw the GBP print as low as 1.55.

Fixed Income

- US Treasuries were bought up across the board this week with yields dropping throughout the curve. The 10Yr moved from 1.68% to 1.62% this morning, the 30Yr moving from as high as 2.89% to as low as 2.81%. However, the surprise this week was the short term 2Yr moved to below 0.20% to reach 0.1941%, a level not seen since last July and before that only broken in August and September 2011… is fear back?
- The German 10-year Bund yields got hammered with Draghi's comments yesterday seeing the yield collapse from 1.24% to 1.15% on discussions that they were mooting the idea of negative bank deposit rates. This is not the Risk-On environment that the equity markets seem to be expressing! As if to prove the point, the yield on the 2 Year German paper has traded through -0.04%... yes, Mr Novotny, the market does believe that you could implement negative bank deposit rates and yes that is EUR negative… don't fight the flow.
- The Spanish 10 year is in cloud-cuckoo-land. The 10Yr now yields below 4% having seen buying interest to take the yields from 4.25% to 3.95% this morning. We want nothing to do with this party… a lot of tears will be flowing when the tide turns.

- The Italian 10 Year slumped with the ECB meeting notes. The Italian debt now yields 3.75%, having moved from 4.05% at the beginning of the week to as low as 3.67% post Draghi's comments.
- The best performer this week was again the Global Convertible index with +1.43%!! Clearly as Equities rallied their outperformance should have been expected. The weakest was US Leveraged Loans at 0.09% or practically flat on the week.

Equities

- Developed equities rose by 0.81% this week – as of yesterday's close – as measured by the MSCI World index. Equities gained on the back of strong macroeconomic readings, better than expected corporate earnings, as well as further assurances that policy makers are ready to support global growth.
- European shares rose 1.42% for the week, as measured by the Eurostoxx 50 index. European stock markets notched higher on Monday on relief that a new Italian government was sworn over the weekend. Some gains we later given back as German retail sales fell, PMI remained weak across the board and the Eurozone's unemployment rate rose to a record high of 12.1%. The bleak economic picture caused the ECB to finally cut its benchmark interest rate by 0.25% to a record low of 0.50%, while stating that their monetary policy stance will remain accommodative for as long as needed. The Eurostoxx 50 concluded the month of April up 3.35%.
- The S&P 500 made new highs, rising 0.97% for the week, as of yesterday's close. Gains were made on news that pending home sales climbed, and consumer confidence gained. Employment figures produced a mixed picture of less people than expected have applied for unemployment benefits, but much fewer jobs were added in April. The Fed as well supported the market, announcing that they will maintain the $85bn a month buying program, aimed to keep interest rates low to encourage borrowing, spending and investing. The gauge ended the month of April up 1.81%.
- The Nikkei dropped 1.37% during the short trading week due to Showa day and Constitution memorial day. Japanese equities lost as the Yen gained following Industrial production and corporate earnings figures coming in lower than expected. The Nikkei rallied by as much as 11.8% during the month of April – the best monthly rally since 1999.
- In terms of sectors, Info Tech and financial posted the best returns (+2.81% and +1.29% respectively), while Healthcare and materials lost (-0.26% and -0.18% respectively).

Emerging Markets

- Emerging Market equities rose by 1.46% – as of yesterday's close – as measured by the MSCI World EM index. The best contributing region was EM Europe (+2.22%), followed by EM Asia and Latin America (+1.29% and 1.01% respectively).
- The Shanghai Composite was closed for the majority of the week due to labour Day holidays, and has rallied 1.26% during the latter part of the week. Chinese equities initially sold off as Manufacturing PMI posted another reading of a slowing rate of growth (50.6 vs. 50.9 previously). Shares have later rebounded after valuation dropped to a four month low – overshadowing a slowdown in non-manufacturing PMI - raising investor appetite. The gauge dropped 2.62% during the month of April.

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- The Bovespa rose 1.97% for the week, as of yesterday's close. Brazilian shares gained as Petrobras SA – the heaviest weighted stock on the benchmark gauge – soared after beating analysts' earnings expectations. Half of the Brazilian companies that have reported quarterly earnings so far have beaten expectations, signalling that companies are potentially doing better this year. The gauge retreated on Thursday from a 3 week high on reports that Chinese manufacturing slowed – casting worries for Brazil's exports. The Bovespa fell -0.78% during April.

Commodities

- Commodities were about flat this week, with the S&P GSCI total return index rising by about 0.05%. Agriculture rallied by 3.86% over the week, while Industrial Metals collapsed by 3.37% on growth concerns in US and China. Meanwhile, Energy lost some ground (-0.50%) while Precious Metals rose by 0.86%.
- Agriculture jumped this week, driven up by a rally on Corn (+8.3%) and Wheat (+4.5%), set for their best weeks since July as planting in the US – the largest exporter of grains – slowed and crop conditions deteriorated on wet weather.
- Gold rose by 1% this week, – currently trading at $1'478 per troy ounce – heading for a second straight weekly gain, as a cut in interest rates by the European Central Bank and US Federal Reserve's decision to stick to its stimulus programme revived bullion's appeal as a hedge against inflation and currency debasing. But gains could still be capped by persistent outflows on exchange-traded funds, with investors unsure if a recent surge in physical demand was sufficient to help gold recover towards $1'500 an ounce..
- Oil oscillated between gains and losses and finally rose by about 0.8% this week – currently trading at $93.75 a barrel. US crude oil rose by 1.6% on Monday before plummeting by 3.7% on Tuesday and Wednesday, on signs of sluggish demand growth in the US and China and after the Energy Information Administration's weekly oil report showed a more than expected increase in US crude stockpiles. Oil strongly rebounded on Thursday, surging by 3.3% as investors awaited possible energy-demand clues from the latest US employment report.

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