Bedrock Newsletter

Friday, May 10th 2013

It is Friday yet again. Another record-breaking week has passed- The DJIA is comfortably above 15'000, the S&P 500 above 1'600. The Nikkei in Japan is above 14'500, having run-up from 8'660 on November 16th, a 67% rise. We have been experiencing a "Stealth Rally" across the world- we call it "Stealth" in spite of it being in the daily headlines- Few, if any, believed in it- after each 100 point rise, talk of the imminent crash intensifies, only to see another 100 points rise the next day. Nouriel Roubini, the ultimate bear, has altered his language on Tuesday- "Stocks aren't in bubble territory as yet", but a "huge rally in risk assets over the next two years puts markets in danger of a big crash". If you ever wondered what the meaning of "hedging your bets" is, this statement may help…
On Monday, the S&P 500 closed at a new all-time high, then again on Tuesday, then again on Wednesday and paused Thursday.
Even as U.S. stock indexes hit all-time highs, Warren Buffett predicts they'll go "far higher" in the long run. Right now, he very much favors equities over bonds, warning some investors could lose a lot of money in long-term fixed-income assets when interest rates eventually start to rise. In a live appearance on Monday morning's CNBC Squawk Box, Buffett said "You'll see (stock) numbers a lot higher than this in your lifetime." Buffett said that bonds are a "terrible" investment right now because they are "priced artificially" high due to the Federal Reserve's massive asset buying program and could lose people a lot of money when inevitably interest rates start to rise. He doesn't know when that will happen and he doesn't know how much rates will rise, but he's certain they will be going up eventually.
Larry Fink, Chairman of Blackrock, spoke-out this week with a dire warning on retirement savings in the USA. He says that at 3% yields there is no way to have retirements funded. As life expectancy increases and returns shrink, the formula for surviving retirement lies solely in equities. We grant Larry the credit for having turned bullish on equities in mid – 2012.

Another "Stealth Rally" has been inching its way off the radar screens- The Chinese Yuan has pursued it slow but steady rise against the US$, itself rising against most other currencies. This move has been camouflaged with the attention grabbing trade and industrial data from China; China will propose a plan this year for allowing Yuan capital-account convertibility as part of measures to loosen control over its currency and interest rates. China reported economic growth of 7.7% for the first quarter, trailing the 8% median forecast in a Bloomberg News and the 7.9% pace for the last three months of 2012. The nation in March set a target for 7.5% expansion this year.

On Thursday, Spain beat its maximum target at a bond auction in Madrid and its borrowing costs fell after an interest-rate cut by the European Central Bank fueled a rally in bonds from distressed euro countries. The Euro-Zone clearly still has significant issues, but then, rays of summer are dissipating some of the fog. Yes, the Euro is off 2 figures for the year, but that is surely good for what is an export economy.

Currencies remain our concern- With the Yen trading through 101 to the US$, various other exchange rates are affected- the Euro is trading weaker at around 1.30, the Swiss Franc is falling to the Euro @ 1.244, way below the SNB "ceiling" of 1.20

In support of our view favoring increased equity exposure we recite Bill Cosby, "In order to succeed, your desire for success should be greater than your fear of failure" – caveat, Bill Cosby is a comedian…

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Currencies

- EURUSD weakened, moving from 1.3120 to as low as 1.2990 this morning. With two European bank holidays this week the volumes have been lower than normal, but the general positive tone in the equity markets did drive the EUR to as high as 1.3194 on Wednesday. Finally, the ECB have noted that there could be further downside risk to the Eurozone growth, warning that there will be further easing ahead due to the deepening recession… not wonderfully positive news for the EU, but if the EUR continues to slide, a lot of the exporting nations will breathe a collective sigh of relief. We continue to believe that the EUR needs to weaken to support the export and tourism based periphery countries, rather than simply emptying the coffers of the smaller governments and states – even Germany would benefit from a weaker EUR!
- EURCHF is no longer on a slow and steady path. As the JPY collapsed on Thursday, so did the CHF; seeing the EURCHF shoot up from 1.2290 to as high as 1.2440 by this morning. USDCHF looks fairly similar, moving from 0.9350 to 0.9550. As long as the JPY continues to weaken, the funding currencies and the carry trade should come back into vogue. As the equity markets rally and the Yen and CHF cost practically nothing to short, we see no real reason for them to strengthen unless we see a change in sentiment.
- USDJPY… Nobody puts Abe in the corner. Bye bye double digits, hello triple digits! With a wave of the-QE-wand, we see USDJPY move from 98.75 to 101.40. On massive stoploss buying and option protection, the 100.00 figure was taken out rather dramatically. This level might mean a change in the asset allocation habits of the Japanese finance marketeers. Rather than net sellers of foreign assets some of the life insurers have, for the first time, become net buyers of foreign assets… is the Yen weakening overdone? Probably not, and so we see further highs for the USD and further lows for the Yen. Even in light of the EUR weakness, EURJPY managed to power high as well, seeing 132.00 broken for the first time since 2010!
- AUD finally succumbed to the rate cut that we (if not the market) have been waiting for. The AUD was in a state of decline from 1.03 to 1.0175 prior to a strong jobs report for both Australia and New Zealand (accompanied by Chinese CPI a touch higher); which saw the AUD rebound to as high as 1.0255. Only to drop heavily again on the RBA cutting rates earlier than market expectations. We look to be closing out the trading week at the lows of 1.0022, almost touching parity! We have been beating the drum of a weakening AUD for months and finally the AUD is moving in the direction that we expected. Druckenmiller (the man who broke the Pound in 1992 with Soros) stating that this will be trade of the century.
- The Pound had a poor week trading from 1.56 down to 1.5390 this morning as USD bids caused most pairs to drop against the USD. The BOE kept rates the same and unchanged on the asset purchase scheme. For now this is a USD trade as there is little movement in relation to the GBP. However, eventually we believe the Pound shall drop again, but for now the sideways trading and range bound action could continue for a little while longer.

Fixed Income

- US Treasuries continued their slide in light of the massive equity rallies, touching newer and newer highs each day. The 10Yr moved from 1.74% to 1.87% this morning, the 30Yr moving from as low as 2.94% to as high as 3.07%. After last week's surprise drop in short term rates, the 2 year paper is back to 0.22% as the Risk Rally seems to march ever higher!

- The German 10-year Bund yields got truly hammered this week with the bonds selling off mainly over the last two days from 1.24% to as high as 1.34% this morning. Although short term rates remained under pressure this week, the yield moved from -0.01% to +0.02%... Another stellar week then…! However, at least for now, Bonds and Equities are trading in inverse lock step, perhaps the Risk rally has more legs than the bond market was willing to express last week.
- The Spanish 10 year is in no longer quite in cloud-cuckoo-land. The 10Yr now yields 4.25% having started the week marginally above 4%. The spread over the German Bunds has moved out by 15 Bps, so this is not just a movement in line with the general bond sell off. The Spanish bonds were sold more than the Germans, but we still feel that this spread should widen further from these levels as they cannot be sustained over the long run with the current financial instability of Spain.
- The Italian 10 Year has been sold off post last week's low in the yields. The ten year is in fact more or less where we started the week at 3.89%, but this is all relative as last week we were trading at 3.67%! Ignoring the brief dip around the ECB meeting, we are unchanged on two weeks and this feels like a merry-go-round.

Equities

- Developed equities rose by 0.89% this week – as of yesterday's close – as measured by the MSCI World index. Global equities gained on the back of better than expected EU and US economic data as well as a sharp decline in the Japanese Yen.
- European shares rose 1.13% for the week, as measured by the Eurostoxx 50 index. Shares rose as Germany reported better than expected Factory orders and Industrial production figures; pushing the Dax Index to an all-time high of 8,358.
- The S&P 500 made new highs as well – rising by 0.75% for the week, as of yesterday's close. US shares rose as US mortgage application figures rose and Jobless Claims dropped to the lowest level since early 2008. Equities lost some of their gains late on Thursday as the President of the Federal Reserve Bank of Philadelphia said that he favoured scaling back the pace of stimulus. Highlighting the internal debate of the FOMC on the pace of stimulus that has been inflating the Central Bank's balance sheet.
- The Nikkei soared by as much as 6.67% for the week!! – pushing the index to a 5 year high of 14,636. The gauge rose 3.55% on Tuesday's session – catching up on US and EU gains from last week due to the ECB rate cut and better than expected US employment numbers. The Nikkei rose another 3% on Friday's session as the Yen weakened below $101 for the first time in 4 years.
- In terms of sectors, Materials and Industrials posted the best returns (+2.52% and +2.02% respectively), while Utilities and Consumer Staples lost (-1.76% and -0.21% respectively).

Emerging Markets

- Emerging Market equities rose by 1.75% – as of yesterday's close – as measured by the MSCI World EM index. The best contributing region was EM Asia (+2.41%), followed by EM Europe and Latin America (+1.44% and 0.54% respectively).
- The Shanghai Composite rose 1.73% for the week. Chinese shares rose over 1% on Monday on the back of last week's better than expected US employment numbers. Shares were

supported during the rest of the week as Chinese trade data came in better than expected, overshadowing a rise in Chinese CPI. All eyes are now on Monday's reports of Chinese Industrial output figures.

- The Bovespa lost 0.08% for the week, as of yesterday's close. The gauge rose to a six-week high on Tuesday as speculation mounted that policy makers will limit interest rate increases this year. The benchmark later gave back its weekly gains as commodity producers sold off following OGX Petroleo and Gas missing earning's expectations. In addition, losses were attributed to a selloff in raw material producers on concerns that China's growth will falter.

Commodities

- Commodities rose 0.58% for the week, as measured by the S&P GSCI total return index. Energy and Industrial metals were the best performers for the week (+0.84% and +0.62% respectively), while Agriculture remained flat.
- Gold dropped 1.54% for the week, and is currently trading at $1'447 per troy ounce. Gold fell as the Dutch finance minister discussed details for the EU banking project – proving that the leaders will act to contain the region's fiscal crisis - eroding demand for safe haven assets. Gold made further losses as the USD gained following better than expected US employment figures.
- Oil remained flat for the week (+0.10%), and is currently trading at $95.70 a barrel. Reports of a rise in crude oil inventories and views that US supplies are expected to rise offset strength caused by escalating Middle East tensions.

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