Bedrock Newsletter

Friday, May 31th 2013

The month of May is closing today, with a downward bias in the equity markets- about 1% across Europe's morning and a similar expectation in the US futures. This said, the old adage "Sell in May and go away" wasn't such a clever idea... the S&P 500 gained about 3% for the month…
After a day-off on Monday, Tuesday arrived with a thunder clap- the DJIA broke to new record highs, as did the S&P. This was the 20th consecutive Tuesday of gains! We would point out that in the Old Testament, in the story of the Creation, Tuesday is considered the doubly-blessed day, as the Good Lord blessed his work twice! Perhaps religion should be re-considered?
Well, the bond traders may dispute this view, as market yields rose with falling prices on this Tuesday- A rather strong slap with 10 year US Treasury Notes trading to yield as high as 2.20%. In the equity markets, utility stocks were also slapped as they are considered a proxy for bonds. Will the next pain be found in other dividend-paying stocks? The "must-haves" of the last few years may be in for a price adjustment to reflect rising yields…
Some analysts have commenced using the term "Frankenstein" for the Bond Markets- a man-made monster which may be at risk of implosion! We would argue against this fearsome view- Yes, yields may rise somewhat, but we doubt that the rates will rise in any significant manner in near future.

We return to the theme of faith and Biblical concepts- The same Old Testament set a 7 year cycle to things, using the euphemism of 7 fat years to be followed by 7 thin ones. Well, the Great Recession commenced in 2007; 7 skinny years should therefore end by 2014. That is seven months away… It is difficult to remain agnostic in the face of the big rise in equity markets which clearly appear to be discounting a better future just around the corner… Some data came yesterday to support the markets' pricing- The U.S. economy expanded at a 2.4 percent annual rate during the first quarter, down a tenth of a point from an initial estimate, according to revised figures from the Commerce Department released on Thursday.
Treasury Inflation-Protected Securities show investors anticipate an average increase of 2.28 percent in consumer prices for the next decade, up from 2.23 percent on May 23; which was the least since Aug. 9. The Fed's preferred measure of inflation, the personal consumption expenditures deflator, fell in April for a second month by 0.2 percent, according to the median forecast of 32 economists in a Bloomberg News survey.

We would dispute the validity of either inflation measure (CPI and PCE). The baskets of goods and services which are priced therein are at best incomplete- One major expenditure item is ignored! This is the cost of the future, or the price today of assuring one's retirement! Here is some basic algebra- In order to "buy" $1'000'000 of retirement benefits in 40 years, using 3% yields one needs to save $1'079.80 per month. Using 7% yields, one would need to save about $381.00 per month. In the past decade, yields on the US 30 year Bond have fallen from 7% to 3%, implying about a 300% increase in the cost of a person's required monthly payment for his/her future. This is an average annual increase of 30% in an expense item which is (or should be!) at least 10% of one's basket… That is another 3% per annum in your true CPI…
At some point, the Fed will decide the economy has recovered well enough to shut off the money pumps. That's why, ironically, recent strength in the economic data has spooked investors. They're afraid that when the Fed turns off its money machine, the resulting rise in interest rates could create yet another headwind to growth.

Have a thoughtful weekend… the weather here at least will not permit much other activities…

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Currencies

- EURUSD weakened from 1.2940 to as low as 1.2840 by mid-morning Wednesday. Whereupon, a mixture of statements from senior Fed officials reminded the trading world that any removal of stimulus had not been confirmed but that it would be orderly in its execution; and the resumed Gold attempt to break through 1,400, meant that the USD was offered. The pair strengthened to as high as 1.3050 by this morning. With strong IFO Business data the EUR was helped higher. Unfortunately, the German employment data was weaker than expected (and the French unemployed rose to a record this morning!) and the markets have largely ignored this figure in the current "statement-driven-market". The shine of the Risk environment is beginning to lose its lustre and we look for continued weakening in the EUR over the coming months.
- EURCHF is where it started the week at 1.2440, having seen 1.2570 with the risk rally of the first half of the week. As Risk was taken off the table in the latter half of the week the CHF saw demand as a safe haven currency and as such the EURCHF and USDCHF weakened. For now we view these as opportunities to sell the CHF at higher levels. The SNB have not had to protect their self-imposed floor in many months, in fact they are posting record profits… you might be forgiven for thinking this sounds like a Sovereign Wealth Fund; This is better… a Central Bank Wealth Fund. A Fund that can print their own money!
- USDJPY is lower on the week, having started at 100.75 we have broken to the lows of 100.30. The week saw large scale selling of JPY on Monday and Tuesday as the Nikkei and the Topix rebounded from their epic meltdowns last week, touching 102.50 only to see the Japanese equities continue their slide and the strengthening of the Yen to 100.30 this morning. If the Swiss have the Sovereign Wealth (Central Bank) Fund, then the Japanese have the Asian Banking Economics (ABE) Fund; We see a continued slide in the long term valuation of the Yen against nearly all other currencies, after a short term rebound.
- AUD slipped again this week, moving from 0.9650 on Monday to as low as 0.9530 on Wednesday. After briefly revisiting 0.97 on Thursday we are again pushing lower in the AUD as we trade to 0.9575. There has been a huge move down on the AUDUSD (10% in the last 6 weeks!). Although we feel that the AUD has a long way further to fall we could see (in the very short term) a rebound in light of the heavy selling pressure seen in the markets; but this will not change the long term future of the Aussie – it is down down down-under for the Aussie and we see much lower levels around the corner. No need for a Central Bank Fund here to weaken the currency as the Aussie economy is already crumbling… it will just happen naturally!
- The Pound remains in its range bound trading, seeing lows of just above 1.50 only to bounce back to 1.5240. As there is very little data in the market and only speculation on what will be implemented by the new Governor of the Bank of England, Mr Carney, the Pound is pretty range bound - until the smoke clears and the precipice is visible again, of course! As Mr Carney is used to the mining and drilling country of Canada, we are sure that he will feel right at home when he takes office to be greeted by the massive hole in which the BOE now stands… perhaps he will dig right through to Australia and in so-doing, drop the Pound with him!
- USDZAR, a few weeks ago we mentioned the fact that the ZAR looked like it was heading to 10 to the USD… in one day the ZAR collapsed by 3%, followed by 2.5% this morning. USDZAR is now trading at 10.20 having been at 9.59 on Monday – a massive appreciation of the USD by 7.5% in 5 days!! On the same day that the ZAR dropped, the Gold reserves in South Africa were bolstered. We wonder if there is another shortage of gold for the Kruger

Rands that are so prized by Gold Bugs… Whichever way you look at this the Rand has lost a whopping 13.5% in one month and the trend looks set to continue.

- The Brazilian economy unexpectedly slowed due to price hikes hitting consumers in the back pocket. Despite this fact, the Central Bank has lifted the Selic rate from 7.50% to 8.00%. With inflation surging, this rate rise should help curb inflation. However, the Real fell and as a result has dropped 5.2% in May alone. The USDBRL now stands at 2.11 having been at 2.0450 on Monday. The Central Bank have said they will not use the exchange rate as a method to bolster their economy… the market seems to be devaluing the Real even in light of rate rises!! Another Central Bank fund playing Liar's Poker…

Fixed Income

- With the US shut on Monday this was a 4 day trading week. US Treasuries continued their slide in line with the equity rally, with the 10Yr moving from 2.02% to 2.23% on Wednesday but giving back most of this to be trading at 2.06% this morning. The 30Yr replicated this move from as low as 3.17% to as high as 3.36% only to be 3.23% as we write.
- The German 10-year Bund saw heavy selling causing the yield to rise from 1.43% to as high as 1.55% on Wednesday but back to 1.46% this morning. Although short term rates remained under pressure last week, the 2 year paper spent all of this week selling off from 0.02% to 0.09%. The short term Yields are now positive again and we wonder where this short term paper is flowing to… cash, gold or equities?
- The Japanese 10 Year bonds slumped from 0.84% to 0.96% by Wednesday. The bonds have rebounded a little, moving back down to yields of 0.86%.
- The Spanish 10 year bonds were quiet this week with very few ECB announcements or Spanish politicians speaking and thus the debt remained 5 cents either side of 4.35% - the quietest week in a long time! As we have said before though… straws don't make much sound.
- The Italian 10 Year weakened this week moving from 4.13% to 4.23% by Wednesday, only to settle back to around 4.13% at the end of the week.

Equities

- Developed equities were about flat this week, as of yesterday's close – as measured by the MSCI World Index – as worries about latest data pointing to an economy that continues to struggle were balanced by hopes that central bank stimulus measures will likely stay intact in the immediate future.
- European shares were about flat, dropping by as much as 1% today. Month-end factors and low volumes added to the data disappointment, but shares remained on course for their 12th straight month of gains having outperformed other parts of the world in recent weeks.
- The S&P 500 rose over the week (+0.29%), extending a monthly rally as reports indicated the American economy is growing at a pace that will not hasten the end of Federal Reserve stimulus. The index advanced 3.6% this month, poised for a seventh straight monthly gain for its longest rally since 2009.
- Meanwhile, the Nikkei dropped by as much as 5.7% on mounting concerns over the country's economic turnaround plan, ending a 9-month winning streak. The index has fallen 13.6% since hitting a 5-1/2-year peak on May 23, during a selloff that was triggered by the Fed stimulus worries and slowing growth in China, Japan's second-biggest export market.

- In terms of sectors, Information Technology and Materials posted the biggest gains (+0.98% and +2.16% respectively), while Consumer Staples and Consumer Discretionary lagged (-1.69% and -0.49% respectively).

Emerging Markets

- Emerging Market equities lost 1.04% for the week, as of yesterday's close, as measured by the MSCI EM index. Latin American and EM European stocks were the main laggards (losing -3.07% and -2.77% respectively), while EM Asian shares fared much better (+0.15%).
- The Shanghai Composite advanced by 0.73% as of today's close. The index started the week on a positive stance after China announced it would expand a trial of a Value Added Tax nationwide in a reform that could save enterprises around 120 billion yuan (US$20 billion) of tax payer money per annum. The VAT reform is part of the government's efforts to invigorate the country's small and medium-sized enterprises, most of which are privately owned, and upgrade the economic structure. However, Chinese shares fell on Friday, paring the benchmark's biggest monthly gain this year (+5.6%), before tomorrow's manufacturing report. Property and technology companies, among the best-performing shares in May, led losses.
- The Bovespa tumbled by 3.14%, as of yesterday's close. Brazilian stocks posted the biggest decline in six weeks on Wednesday after data showed Latin America's largest economy grew less than expected in the first quarter, while a sharp drop in Brazil's Real currency hurt shares of those companies that hold dollar-denominated debt.

Commodities

- Commodities lost 0.31% for the week, as measured by the S&P GSCI total return index. Weakness was attributed most to Energy and Agriculture (-0.64% and -0.13% respectively), while Industrial and Precious metals gained (1.71% and 1.65% respectively).
- Gold rose by 2.00% for the week, and is currently trading around $1'415 per troy ounce. The metal rallied on the back of strong demand from China (and other Asian countries) taking advantage of the lower prices to increase their reserves. Some of the strength was also attributed to speculation that the Fed will maintain its bond purchases program, causing a selloff in the dollar.
- Oil lost 1.1% for the week and is currently trading at $93.10 a barrel. Oil lost on the back of fears of slowing demand growth following the IMF's warning of slower Chinese GDP. Crude recovered some of its weekly losses on news of tighter North Sea and Nigeria supply as well as a drop in US inventories ahead of the summer months.

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