Friday, June 14th 2013

This was quite an amazing week! We can summarize it in a phrase- Volatility of the volatility, VIX^2… We started the week at 13 or so, raced to 18 and fell back to 15… Why? What? Actually, nothing much, except for a perception that the fixed-income market is about to experience a sea-change. Many players are convinced that the Fed is about to change its stance on QE(n). We at Bedrock hold our view that if and when the Fed will in effect modify said stance, it will be very gradual. We remind the nervous that the Fed has pegged a 6.5 percent unemployment rate as critical to when it will begin normalizing its target funds rate from its current status near zero. Conventional wisdom usually dies hard, but one long-held axiom relating to unemployment may be ready for the graveyard. For years, economists have accepted 150,000 as the benchmark number of new jobs needed every month to keep the jobless rate level. Anything above that was supposed to lower the rate, while anything below added to the closely followed headline number. Not so anymore, according to the Chicago branch of the Federal Reserve. Central bank researchers, in fact, say that because of various factors that number now will be closer to 80,000. We do not interpret this study as a precursor to the Fed accepting an unemployment rate above the 6.5%.

"I think you all should be ready, because rates are going to go up," Jamie Dimon, the chief executive of JPMorgan said on Tuesday. As investors brace themselves for a new era of higher interest rates, global markets in bonds, currencies and stocks have experienced spasms of turmoil. On Tuesday, the catalyst for the market's volatility was disappointment over the Bank of Japan's decision not to take new steps to address rising bond yields. That heightened worries that other central banks — the Federal Reserve in particular — will soon pull back on pumping money into the financial system.

As we had expected and explained earlier this year, the true volatility is showing-up in the FX markets…

Then we saw the new infringements on privacy by the NSA/CIA and other government acronyms. Amazon said that sales of Orwell's "1984" rose by 7000% since the NSA leak... Big Brother indeed...

Then, Greece became the first developed nation to be cut to emerging-market status by MSCI Inc. after the local stock index plunged 83 percent since 2007.

On Tuesday the DJIA fell 117pts... Gold falls, bonds at 2.17%, dollar drops.... Followed on Wednesday by huge swings in stocks, starting with a big up only to swing down. From up 120 on DJIA to down 140 breaking 15'000, the VIX rising to 17+, bonds faltering with the 10 year Note trading to yield 2.20%

On Wednesday the BRL hits a 4 year low vs. US$ which itself has lost ground... Thursday, emerging-market stocks slid to a nine-month low, led by Chinese and Thai shares, after the World Bank cut its global growth forecast and investors weighed prospects for monetary stimulus. The developing-nation index has lost 11 percent this year, compared with an 8.6 percent advance in the MSCI World Index of developed-country stocks. The developing-nation measure trades at 9.7 times 12-month projected earnings, the lowest level since July 2012, according to data compiled by Bloomberg.

Friday's scare came from China's Finance Ministry's failure to sell all of the debt offered at an auction for the first time in 23 months; owing to a cash squeeze that threatens to exacerbate a slowdown in the world's second-largest economy.

An interesting observation through all this- Apple had issued bonds a month ago. The longer duration, fixed rate tranches have fallen by 10% or so… The FRN tranche held steady at 0.20%. Why not sell them short and buy Apple stock with a 2.40% dividend yield… Apple itself is doing this… We leave you with Mark Twain's words on the value of experience "A man who carries a cat by the tail learns something he can learn in no other way…"

Currencies

- EURUSD steadily moved higher from 1.3178 to reach 1.3390 on Thursday. The (marginally) more positive than expected European harmonised figures and the huge moves in USDJPY driving the market sentiment removed any bid in the market for the USD. EURUSD is no longer trading as a barometer of market risk sentiment but more as a direct equity trade. The pair has been sidelined as the focus is on Japan and the "ABE Sovereign Wealth Fund" is taking centre stage. Perhaps the fact that the Eurozone balance sheet shrunk and the US increased also helped the outperformance of the EUR, but how long will that situation remain?!

- The CHF gained on its safe haven status versus its two main trading currencies, the EUR and the USD. EURCHF fell from 1.2485 to as low as 1.2220, with the USDCHF moving 0.94 to as low as 0.9130. Despite the strengthening of the Swiss Franc, there has been no need for the SNB to defend the floor at 1.20 as the EUR has shrugged off any negative news and the brunt of the weakness has been seen in the USD. We continue to believe these are still attractive levels to sell the CHF before a resumption of the down trend in the CHF valuations continues.

- USDJPY is lower on the week – high to low was a rally in the Yen of 5.75%! The self-appointed "Board of Directors" for the Japanese ABE Sovereign Wealth Fund, including PM Abe and BOJ Governor Kuroda could not manage to stem the tide of the equity sell-off. With the PM being politically-handcuffed until the autumn and failing to implement the structural deregulation needed to bolster domestic growth, both the Nikkei and Topix slid further and the JPY strengthened. USDJPY dropped to as low as 93.79 marginally recovering to above 95.00 this morning. EURJPY dropping 4.8% from 131.32 to 124.97 in three trading sessions but retreating a little to above 126.50 this morning. The JPY is driving both worldwide equities and the forex markets at the moment. Volatility abounds and we suggest it is likely to continue, as throw away comments are driving the moves rather than economic reality!

- AUD slipped at the start of the week, moving from 0.9500 to as low as 0.9325 on Tuesday. After better than expected employment data and stronger consumer confidence the AUD bounced, moving up to 0.9660 overnight but settling back to 0.9600 in European hours. With an economy that is teetering on the brink, desperately dependent on mining revenues/China and a currency that has room for rate cuts, we see no way out of this but a depreciation of the AUD. This short term respite for the AUD from the USD weakness may provide a new entry point to short the AUD as the economic backdrop looks nothing but dark and dreary… back the mines then for the Aussies!

- The Pound has continued to surprise market participants as USD weakness drives the Pound higher. The GBP moved from 1.55 on Monday to peak yesterday afternoon at 1.5738. The UK economy has shown relative strength (when compared to the survey of economists), but a negative manufacturing production number and a high % claimant count "doth not, a healthy economy make"! To be or not to be… The Brits are managing with the Slings and Arrows at the moment. Struggling onwards with the property market as the bright spot, let's hope it does not end in Calamity…

- In spite of USD weakness the EM currencies had a tough week. BRL moved to 2.165, a low for the BRL not seen since 2009. The ZAR touching lows not seen since 2009 and almost dropping to levels seen only in the crisis of 2008 or in 2002. The EM world is devaluing at an astounding rate and if it was a race to the bottom then they have outstripped the USD this week even in light of a negative week for the US currency. This has the hallmarks of more volatility to come.

Bedrock Newsletter

Fixed Income

- US Treasuries had a tough week with the bonds being sold heavily at the start, with the 10Yr moving from 2.15% to 2.29% on Tuesday. Only to reverse course after Kuroda's comments and Abe's lack of action; dropping the yields to as low as 2.12% this morning. QE might not quite be off the table yet; but the FED got a pretty nasty insight to market mentality if they thought it would be an orderly exit by market participants upon withdrawal! The 30Yr replicated this move from as high as 3.43% to as low as 3.20%.
- The German 10-year Bund is stronger on the week having moved from 1.55% to 1.53%. However, with the threat of QE removal and the possible slowing of the printing presses we did see a slump in the Bund to 1.65%. Short term paper moved from 0.18% to as high as 0.24% only to be bought heavily again to 0.13% this morning. Only two weeks ago these were negative yielding assets. With equities down, gold unchanged… the cash must literally be in current accounts at 0%. Can you imagine what would happen if there was a deposit grab at this point, a la Cyprus deux?!?
- The Spanish 10 year bonds were almost unchanged on the week at 4.55%. The straws, however, looked to make their presence felt on Tuesday as the yields spiked to 4.76%. A point to raise here is the short term paper for Spain (2 year notes) has risen from 1.46% to 2.25% in 6 weeks. The tide seems to be turning in the short end as well as the long end. This is no longer a buying of duration; the whole of the Spanish curve is lifting… We will mention it again… the straws are burdening the camel.
- The Italian 10 Year weakened this week moving from 4.16% to 4.47% by Tuesday, only to settle back to around 4.30% at the moment. We note that Italy has been sold more aggressively than Spain and at one point they almost yielded the same amount on Thursday (4.46%). We fear that the periphery may well be treated as one unit in the not too distant future and would not advocate their bonds in any way shape or form. If Greece is now an EM country, is it that inconceivable that there are others in the Periphery that would not head in the same direction?

Equities

- Developed equities lost 0.41% for the week, as of yesterday's close, as measured by the MSCI World index. Global stimulus concerns dragged stocks down until Thursday, before a global rebound following upbeat data from the US.
- The EuroStoxx lost 1.53% over the week. European shares rebounded on Friday, after a four-day losing streak, as robust US economic data outweighed persistent uncertainty over the durability of global monetary easing measures. As a result, recently-hammered cyclical banking and mining stocks bounced back.
- The S&P 500 lost 0.43%, as of yesterday's close. US stocks rallied on Thursday after three consecutive days of losses as stronger-than-expected retail sales and a drop in jobless claims helped reassure investors concerned about the expected winding down of the Federal Reserve's economic stimulus.
- Meanwhile, the Nikkei lost 1.48%. Japanese shares climbed 1.9% on Friday, rebounding from a slump in the previous session, as robust data eased concerns over a potential pullback in stimulus by the Federal Reserve. On Thursday, the Nikkei tumbled 6.4% to its lowest close since April 3, the day before the Bank of Japan unveiled sweeping stimulus to revive the economy.

- In terms of sectors, Materials and Financials posted the largest losses (-0.78% and -0.84% respectively), while Healthcare and Utilities were the only positive benchmarks (+0.47% and -0.36% respectively).

Emerging Markets

- Emerging Market equities lost 3.78% over the week, as of yesterday's close, as measured by the MSCI EM index. EM Asian shares posted the biggest loss (-4.36%), while EM European and EM Latin American stocks fared slightly better (-2.84% and -2.90% respectively).
- The Shanghai Composite lost 2.32% for the week. Chinese shares fell over 2.8% on Thursday after a three-day holiday, dragging the index to a six-month low, as government reports showed industrial production and exports trailed economists' bearish estimates. China's stocks rose for the first time in nine days after valuations for the benchmark index dropped to a six-month low and US retail sales beat forecasts.
- Meanwhile, the Bovespa lost 2.33% (as of yesterday's close). Brazilian stocks jumped by over 2.5% on Thursday, tracking sharp gains on Wall Street and in Asia, to snap a four-day decline that had taken the index to its lowest since August 2011. Brazil's benchmark plunged this year (-17.3% YTD) as faltering growth drove down consumer stocks and raw-material exporters.

Commodities

- Commodities were about flat for the week, as measured by the S&P GSCI total return index. Industrial Metals and Agriculture posted important losses (-3.63% and -1.56% respectively), while Energy and Precious Metals fared much better (+0.58% and -0.42% respectively).
- Gold dropped by 0.25% for the week, and is currently trading around $1'380 per troy ounce. The yellow metal extended losses into a second session on Friday as strong US data stoked uncertainty over the outlook for the Federal Reserve's massive bond-buying stimulus. A pull back in bond purchases would hurt gold, seen as a hedge against inflation. Bullion, down over 17% for the year, has been hit by investor outflows in gold ETFs and signs of softening demand in key buyers India and China.
- Meanwhile, Oil rose by 1% on upbeat US figures and is currently trading at $97 a barrel. Crude oil futures switched between gains and losses over the week, but are heading toward a weekly advance ahead of data on US consumer sentiment and industrial production.
