Bedrock Newsletter

Friday, July 5th 2013

Yesterday was US Independence Day, the 4th of July, the day that the United States of America declared Independence from the Kingdom of Great Britain. The Great and the Good take a day off from the markets to spend time with friends and family – a chance to reflect. If it's good enough for the US to do, then Bedrock shall use this week's letter to reflect as well… on where we stand now, since the start of the credit crunch, and where we have been.

The half-way point of 2013 has passed… and in our ever optimistic view, the world is not coming to an end, but rather continuing upwards at a steady pace – well at least for the US and Japan this year… We have oft-said that Equity markets are the forebears of what is yet to come and the Fixed Income markets quantify, with mathematical precision, the size of any moves that might occur. US Equities continue to rise and their European counterparts continue to struggle, and yet… the US Bond market is struggling of late just as much as the European market seems to be, but "steady" over the last year. Nothing ever happens in a straight line, but relative to where we were prior to 2008, how bad has it been, and how have we come back from the brink? What have been the drivers and are we at a point where the free money pumping or QE could safely be withdrawn?

Well, 2007 saw the DJIA peak at 14,164, we are now at 14,988 and have been as high as 15,409 in 2013 and as low as 6,547 in 2009. We slid from 1,565 to as low as 666 on the S&P 500 in less than two years… and yet we reached new highs recently of above 1,670. The same pattern repeats for Europe, with the Dax having reached new highs of 8,530, more than doubling from the lows of 3,666 in early 2009. But what has the cost of that equity rally been? Interest rates must be able to quantify how we have reached this point… what have the bonds done and what do they show us? Although it has not been a one way street, we have seen the US 10 year – historically seen as risk free bonds… (Depends on what you understand by the meaning Risk!) – move from 5.30% to as low as 1.38%. The Germans are in exactly the same boat sliding from 4.68% to 1.16%! Cheap money or Quantitative Easing as the Journalists/Economists have nicknamed the money printing has kept the equity markets afloat.

Now, with the discussion of Tapering (the new buzzword for the removal of QE) on the markets' lips we have seen the markets apply their own discounting to the value of money. Yields have risen again… BUT not to levels that are alarming (just yet). The equity markets are showing that based on forecasted cash flows, the US is steadily producing 100 USD at 15 times earnings for the S&P 500. The bond markets are forecasting the continuation of low rates for the foreseeable future… below 2% on the US 10 Year bonds means that the market accepts rates for 10 years at that level!

So what other news is there that will leave clouds on the horizon? Not Egypt, they have removed Morsi with a Military Coup… Something the US obviously agrees with as they are continuing their US$1.6Bn a year "care package". Not North Korea, we have not heard a peep – perhaps Kim Jong-Un is watching a new hit US TV series. The only clouds are "Greece take-two" – but we have seen that movie before and there should be no great surprise here. The European periphery is struggling to find support in the open markets for its debt – well there is the OMT, just like the US TARP. "Sometimes falling flat on your face allows you to see things from a totally different perspective"… Perhaps, the world is steadying… We at Bedrock remain hopeful, but watchful…

So we leave you with the following thought for this sunny "Independence" weekend from Linda Poindexter in the US: "Refuse to ruin a perfectly good day today, by thinking about a bad yesterday."

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Currencies

- The EUR fell to a 5 week low (1.2885 currently) against the USD. The pair saw some strength at the start of the week – rising from 1.3010 to 1.3075 - caused by better than expected EU PMI Manufacturing data. EURUSD then commenced its move lower as encouraging US data triggered speculation that the Fed would scale back the stimulus program later this year, causing the Dollar to rally. The final blow to the EUR came on Thursday when Mario Draghi made an unprecedented pledge to keep interest rates low for an extended period, causing the EUR to gap down more than a figure to current levels. With the last nail in the coffin resounding heavily with the market of, "0.50% is NOT the lower bound of interest rates". The clearest sign yet was also backed up with wording that implied the possibility of negative interest rates!
- The CHF saw further weakness this week, with EURCHF rising from 1.2300 to 1.2375 and USDCHF from 0.9450 to 0.9590. The Swissie lost ground as additional signs of improving US and EU economies caused investors to reduce their holdings of the safe haven currency.
- USDJPY had a volatile week, with the Yen falling by mid-week from 99.25 against the Dollar to 100.80, as speculation grew that the Fed will reduce monetary stimulus while the BoJ maintains it. Yen weakness was short lived as political tensions in Egypt and Portugal sent investors back to the Yen's safety, eliminating previous weekly losses. USDJPY has since stabilized around 100.00 thanks to better than expected US employment data and reduced political uncertainty.
- The AUD is set to conclude the week where it started (0.9150 against the Dollar). The Aussie rose at the start of the week to as high as 0.9250 on the back of Dollar weakness. The AUD quickly reversed and fell to as low as 0.9050 (a fresh 3 year low) as the RBA left the interest rate unchanged at 2.75% while stating that further depreciation is still on the cards. The pair has since recouped its weekly losses on the sentiment that it fell "too fast" – not that it was undervalued!
- The Pound tumbled to a 3 month low. GBPUSD saw some strength mid-week – rising from 1.5205 to 1.5295 - thanks to a surprisingly bullish PMI Services report, adding to signs that the economic recovery is gaining momentum. The Pound plunged by more than a figure and a half (from 1.5250 to below 1.51) on announcement by the BoE which signaled that it will keep interest rates at a record low for longer than investors had expected. GBPUSD has since failed to attract bidders and is currently trading at 1.4980. Happy 4th of July Mr Carney… what a welcome to the Bank of England.
- The BRL has continued its weakening this week, gradually falling from 2.23 to 2.27 (the lowest level since 2009). On Thursday, the Central bank intervened in the Forex market as the continued weakness was inconsistent with gains made in other EM currencies, and has sparked inflationary fears.

Fixed Income

- US Treasuries declined for the week amid speculation that June's employment report may be strong enough for the Fed to scale back its asset buying program. The US 10yr yield rose from 2.49% to 2.55%, the 5yr from 1.40% to 1.46% and the 30yr from 3.50% to 3.52%.
- The Spanish 10 year bonds gained for the week, with yields falling from 4.759% to 4.577% on the back of better than expected June manufacturing report. On Wednesday the 10yr bonds reversed their weekly gains following the resignation of two Portuguese ministers which

sparked a political scare and caused Portugal's 10yr bond yields above 8% for the first time since November. Spanish bonds have since resumed their gains (currently at 4.617%) following the ECB's pledge to keep monetary policy accommodative for a prolonged period.

- The Italian 10 Year traded in a similar fashion, with yields falling from 4.54% to as low as 4.34% currently.

Equities

- Developed equities rose 1.02% this week, as of yesterday's close, as measured by the MSCI World index. Global stocks rose after two of Europe's most important central banks (the ECB and the BoE) surprised the market by assuring investors they were in no hurry to wind down stimulus.
- The EuroStoxx gained 1.88%. The index slid on Tuesday and Wednesday on worries over signs of slowing growth in China and deepening political turmoil in Portugal, where talks over the government's future threatened to reignite the Euro zone crisis. European shares then rallied almost 3% on Thursday in their best showing in 11 months after the Bank of England and the European Central Bank both offered unprecedented forward guidance on market stimulus plans.
- The S&P 500 gained 0.57% as of Wednesday's close, with the markets shut yesterday for Independence Day. Stocks rose in a shortened week as investors weighed better-than-expected jobs data against political turmoil in Portugal ahead of Friday's key jobs report.
- Meanwhile, the Nikkei surged by 4.63% - its third consecutive weekly upward move - recovering from the sharp correction that pushed the market into bear territory last month. Japanese equities climbed to a five-week high, supported by unexpectedly strong commitments to keep easy money policies from European Central Banks.
- In terms of sectors, Consumer Discretionary and Information Technology posted the largest gains (+1.89% and +1.36% respectively), while Utility and Healthcare lagged (-0.69% and +0.58% respectively).

Emerging Markets

- Emerging Markets equities lost 1.94% for the week, as of yesterday's close, as measured by the MSCI EM index. Latin American and EM Asian stocks posted the biggest losses (-2.45% and -2.32% respectively), while EM Europe was slightly positive (+0.10%).
- The Shanghai Composite was in recovery mode, gaining 1.6% this week, following perilous declines in June sparked by a domestic liquidity squeeze. Chinese stocks capped their first weekly gain since May, as concerns about the cash crunch basically eased, providing some relief to the market and sparking a rally in property firms and material producers.
- Meanwhile, the Bovespa slumped by 3.57% for the week (as of yesterday's close), after losing as much as 4.24% on Tuesday – the index biggest drop in nearly two years – after shares of oil producer OGX extended a rout that caused the stock to fall over 50% this week alone.

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Commodities

- Commodities rallied by 2.96% over the week, as measured by the S&P GSCI Total Return index. Energy, Industrial and Precious Metals surged (+3.94%, +2.54% and +2.17% respectively), while Agriculture was the only sector to be negative (-0.62%).
- Gold was about flat this week and is currently trading around $1'240 per troy ounce. The metal rose until Wednesday as previous month's slump spurred purchases, but lost during Thursday and Friday on a stronger dollar. Bullion slipped 26% this year and over 11% during June, after some investors lost faith in the metal as a store of value as Fed Chairman Bernanke said the central bank may slow asset purchases this year.
- Oil strongly rallied this week, surging by 4.69% and currently trading slightly over $101 a barrel. Crude-oil futures jumped to a 14-month high and broke the key $100 level after the year's largest decline in US stockpiles and amid concern that political unrest in Egypt will disrupt Middle Eastern shipments.
