Bedrock Newsletter

Friday, October 4th 2013

Just as everybody's old aunt says- "If it is not one-thing, it is always something…" Monday shutdown talks into end of Q3 and markets became discombobulated. What does it mean all this political posturing, line in the sand? What a way to close a good quarter- equities rose, bonds held, all was well until this new mess. Did everything else stop? We see no news on Syria, none on Iran, the Arab Spring (or what's left of it into Autumn)… Washington is frozen, the World gets pneumonia…

Tuesday's government shutdown could be just the warm-up act. The failure by Congress on Monday to renew the federal budget into a new fiscal year is expected to be followed in a few weeks—no one knows exactly when—by an even more dangerous stalemate over raising the government's borrowing authority.

Stock market traders and investors don't believe the fight over the debt ceiling will result in a U.S. default, said value investor Bill Miller, hours after the first government shutdown in 17 years. But if for some reason the federal government didn't pay the interest on the debt, he warned, that "would make Lehman Brothers look like a kindergarten show. The real issue is the debt ceiling, not the government shutdown". The Treasury has set Oct. 17 as the deadline for the nation's borrowing authority to be increased.

Treasury figures it will have just $30 billion left on hand by Oct 17—most likely not enough to cover all government spending that day. On a typical day, the government's bills reach $60 billion. The department faces an even bigger wild card every Thursday, when it rolls over about $100 billion in U.S. debt. If bond holders decided they wanted to be repaid rather than rolling over that paper, the Treasury would be on the hook for those redemptions.

Perhaps this is why gold fell on Tuesday? Well, if the debt ceiling is not resolved, one of the ways the Treasury can keep operating is by selling its gold reserves... Talk about an overhang...

The big loser is the US Dollar… But this may please Bernanke, as it brings back some inflation pressures… he does want 2% CPI…

Well, the US Government is in partial shutdown… No NFP figures this Friday… The non-farm payrolls report, a snapshot of employment conditions in the world's largest economy, is widely seen as the most important U.S. economic indicator. It also guides the Fed in its "Tapering"… Well, Wednesday's ADP report implied that employment isn't growing as needed… they gave 166'000 vs. 180'000 expected core non-farm payrolls… Well, there goes tapering, at least for now.

GOP and democrats are like Palestinians and Israelis- both sides have impasses before talking. No one talks before the other agrees with the outcome...

Iran seems to be off the naughty radar! Perhaps this is the trigger of oil's risk-premium fall? It does help in explaining the drop, as the fall in the US$ should have caused oil prices to rise, much like gold!?

Italy is in a mess- politics and Berlusconi, but the REAL Italian problem is that the youth unemployment crossed 40%!!! Well, much of Southern Europe has a similar problem.

And the fun is only beginning- The VIX rose these past few days, now at 17.67, up from a 13 level at the close of Q3. And now we enter earnings' season yet again…

Entering Earnings' season... We remain optimistic… The US has had similar silly political problems many times in the past and invariably, they always got resolved. A budget compromise will be found, the debt ceiling will be raised and then the markets will feel relieved and rise! Let's hope earnings will support the optimism…

A messy weekend thought; The Republicans, just like the Democrats are idealists. Neither knows where they are going, but they are clearly on their way…

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Currencies

- EURUSD glided through last week on no spoken words or real data surprises. This week inaction caused the USD to weaken across the board. As the US game of political chess caused the Government to go into shutdown. However, putting this into context, when Bernanke speaks he can cause the same movement with a single word, or even by omitting a single word… the markets have taken note of the Government shutdown, but really for now are pricing in a conclusion to this rather churlish response. The EUR strengthened from 1.35 to 1.3620 - the majority of the USD weakening came on ADP figures on Wednesday.
- EURCHF briefly regained last week's levels at 1.2280 yesterday only to slide to 1.2240 again this morning. As EURUSD is driving higher still it would appear that perhaps not the entire market is comfortable with the current economic situation, seeing continued demand for the CHF. USDCHF slid lower on the week seeing a move from 0.9080 down to as low as 0.8975, before rebounding back to 0.9035. The Dollar is bound to the headlines and as long as the headlines decry its underperformance, the market will continue to sell its USD.
- USDJPY opened weaker than last Friday at 97.50. After briefly rallying to as high as 98.73 the USD weakness has followed through, seeing the JPY climb to 96.93 this morning. With sales tax rate hikes in Japan foreseen from 5% to 8% this may have a bigger volatility effect on the Yen, but the bigger question is… will history rhyme, will we see the same 13% reduction in spending and the recession caused by the last sales tax hike in 1997? Only time will tell…
- AUD recovered again this week, seeing the USD drop. As the US situation developed and the data out of China seems to be removing the specter of a Chinese collapse (that won't be happening with 7% annual growth!) the pair moved from 0.93 on Monday up to 0.9440 this morning. We do not view this as anything other than a short term bounce before continuing lower in the coming months.
- As we mentioned last week… the markets did indeed have the 1.6245 level in their sights. The Pound peaked on Wednesday at 1.6250 and is now trading at 1.6040. With the momentum traders being the only people to profit from this move and the majority of economists that we see stating that they do not understand why the Pound is valued as it is… we feel that perhaps the time for the reversal is coming and that a lower pound could lie ahead. We wait and see… Maybe Carney has other ideas!?

Fixed Income

- The US Government shutdown seems to have already been priced in the Treasury market and with very little movement it would appear that no one really sees a problem with this Government engine stall. The 10 Yr yields remaining between 2.66% and 2.60% for the majority of the week and oscillating around the 2.62%. The overall trend of between 2.50% and 3% remains intact.
- After the Italian debacle has been thrown out of Parliament, the German Bund has traded slightly weaker seeing the Bund yields go from 1.76% to as high as 1.85% yesterday evening but dropping to 1.82% now.
- Spanish yields dropped this week as the 10 year Spanish debt was well received. The yields dropped sharply on Monday from 4.31% to reach 4.09% on Tuesday. We are stabilising around 4.20% at the moment and the relative strength of Spanish debt to the rest of the periphery is apparent.

- Italy on the other hand had a tumultuous week with Berlusconi being ousted and his party turning against him, with Letta winning and maintaining the status quo… well if you can call it that! However, the market's reaction although positive (seeing the yields move from 4.60% to 4.4%), the Italian 10 year is now more than 0.15% cheaper than the Spanish… a VERY different situation to the recent history! We view this to continue as long as Italy stays in such a muddle!

Equities

- Developed equities lost 0.78% this week (as of yesterday's close) as measured by the MSCI World index, on the back of market attention shifting to the US shutdown and debt ceiling worry. Not surprisingly, equity funds reported their first outflow after 38 weeks of inflows, driven by outflows from domestic US funds (~$1B).
- The EuroStoxx lost 1.06%, as the US government shutdown continued on Friday and a gauge of service-industry activity in the world's biggest economy fell more than forecast, largely offsetting optimism over solid PMI readings in China and Europe.
- The S&P 500 lost 0.77% as of yesterday's close, as the US government shutdown dragged into a third day on Thursday and the nation inched toward a deadline on raising its borrowing limit. Also, data showed weaker-than-forecast growth in service industries and concern grew that the political impasse could lead to a recession.
- Meanwhile, the Nikkei tumbled by 4.98%. While the Bank of Japan kept its monetary policy steady, and as a lack of progress in the US budget standoff raised concerns that partisan politics in Washington could lead to a full-blown crisis in the world's main economy.
- In terms of sectors, Materials and Industrials lost the most (-1.55% and -1.37% respectively), while Healthcare and Utility fared better (-0.33% and -0.32% respectively).

Emerging Markets

- Emerging Market equities rose by 0.54% – as of yesterday's close – as measured by the MSCI EM index, driven up by EM European and Asian shares (+0.63% and +0.73% respectively) while Latin American stocks lagged (-0.07%).
- The Shanghai Composite ended 0.68% higher on Monday amid thin trading ahead of holidays starting Tuesday, with financial stocks up on bargain hunting after their recent retreat, while Shanghai-based stocks extended their losses after plans for a pilot free-trade zone in the financial hub was unveiled.
- The Bovespa dropped by 2.32% (as of yesterday's close), as investors worried about the US budget stalemate, while concerns from a Wall Street agency about Brazil's debt rating hung over the benchmark.

Commodities

- Commodities dropped by 0.10% for the week, as measured by the S&P GSCI Total Return index. Industrial and Precious metals were the worst performers (falling 1.65% and 1.44% respectively), followed by Agriculture (-0.32%) while Energy was the only sector to be positive.

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- Gold lost 1.35% for the week and is currently trading around $1’316 per troy ounce. Gold sank nearly 3% on Tuesday to its lowest level in almost two months as an unusually large trade in the New York futures market rattled investors already edgy over a partial shutdown of the US government. Gold is set for its biggest weekly drop in three weeks but declines have been kept in check by a partial US government shutdown that threatens to hurt economic growth, increasing bullion's safe-haven appeal.
- Crude oil rose by 0.30% for the week and is currently trading at $103.75 a barrel. Crude prices jumped by over 2% on Wednesday as TransCanada said construction of the Golf Coast pipeline was nearly complete. Traders saw the news as bullish, given the pipeline is expected to level off supply fluctuations. However, concern that the US government’s first shutdown in 17 years will slow economic growth and demand for crude weighed on sentiment during the rest of the week.

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