Bedrock Newsletter

Friday, November 1st 2013

Welcome to the penultimate month of 2013! Let us try to give you a perspective where we are now in comparison to the start of the crisis we are so desperately trying to overcome- At the end of December 2007 the said crisis was exploding around us. Here is where we were then and are now;

1. Yield on 10 year Treasury as at December 31st 2007 was at 4.023% (now 2.55%)
2. Three months' US$ LIBOR at that date was 4.70% (now about zero %)
3. S&P 500 level at that date was 1'468.36 (now 1'756)
4. S&P EPS at that date was $82.54 (now +-$110.00, expected +$121.00)
5. S&P P/E was +- 17.79 now 14.50

The yield-curve was clearly inverted back then and is now positive and exceptionally steep at that. Long-rates are now very low and many of the equity markets are at all-time highs, but in reality not as expensive as the absolute level may lead an observer to conclude- the Price/Earnings ratio is now lower than it was at the onset of the financial calamity and if further adjusted to the almost 50% decline in the discounting factor, well then, equities can appear cheap, at these all-time highs!
Monday, Dow transports hits a new all-time high! It is usually a leading indicator for the economy as a whole and the markets in particular!
Tuesday gave us record highs on the DJIA and S&P 500… and this in face of the "Obamacare" mess; Systems don't work, the "affordable health-care for all" is actually more expensive for most than before... Uproar... Many can't keep their existing coverage contradicting Obama's promises that they could. He knew... He lied? Will this become the Obama-Gate?
To the surprise of virtually no one, the Federal Reserve kept its cheap-money policy in place, but markets interpreted language in the decision to mean that the end may come sooner than expected. Where once the market had expected a retreat on quantitative easing to begin before the end of 2013, consensus had been that tapering won't begin until at least March 2014, though that may change now. Some investors interpreted the remarks as "at least" slightly more hawkish in terms of economic prospects and Fed policy response. Equities fell, bond yields moved higher and the Dollar rallied. Is the Fed dangerously irresponsible or admirably resolute in keeping rates so low?
Job growth faltered in October, with the private sector adding just 130,000 new positions, according to the latest report from ADP and Moody's Analytics. Economists expected ADP to show that private business had created 150,000 new jobs in October. The actual count represented a downward drift from September's number, which was revised lower from 166,000 to 145,000.
Was Thursday's sudden fall in equity indices half an hour before the close due to an alleged Israeli airstrike on a Syrian military missile cache? October closed up… if down for the day. 10yr note closes @ 2.55%, down 6bp for the month. The big change in the last two days is the US$ rally and the slap to the Euro, on expectations of no Fed action and ECB actions to add liquidity.
It is important to periodically remind ourselves that Fed officials are not interested in financial-asset prices as an ultimate objective. Rather, they regard them as a means to generate higher growth with stable inflation. At a time when political polarization undermines comprehensive policy responses, financial markets are the Fed's only large-scale conduits to the real economy — albeit highly imperfect and distortionary conduits.
Q3 earnings are still trickling in, and some analysts now predict the S&P earnings may reach $121! Applying a multiple of x15, the S&P 500 could be explained at 1'815… Above its recent all-time-high!

"The one thing worse than being talked about is not being talked about", as says Dorian Grey. Why aren't Spain and Germany feeling good about being spied on by the NSA?

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Currencies

- EURUSD cruised through Monday and Tuesday barely moving from 1.38. With true fanfare almost complete with a US Marching Band, the FOMC meeting brought a resounding start to the USD rebound. As the rumours hinted at a rate cut by Draghi next week, the EUR lost even more ground. Between the FOMC (non)decision – there really was nothing new there – and the EUR rumours, the sustained drop in the EUR has been a welcome respite for the weary holders of USD. EURUSD moved to as low as 1.3505 this morning, a 3 figure move in barely 3 days… we will wait to see if the market continues this selloff before stating that we are moving lower (in line with data fundamentals).
- EURCHF is unchanged on the week at 1.2320, however we saw highs of 1.2370 and down to 1.23 on the EUR rumours. USDCHF on the other hand was almost a straight line gentle trading up from 0.8925 on Monday to spike past 0.91 this morning. The USD rebound has been swift and although expected (hoped for), some participants may have missed this opportunity to participate. We will see if the USD uptrend fully is in place, before the expected levels near parity are seen again.
- USDJPY had a choppy week with the FOMC being the only real movements coming from the FOMC meeting whereupon the USD moved to 98.68. This morning we have retraced most of the gains but still stand up on the week at 98.30. We look for further appreciation of the USD against the Yen in the coming months.
- AUD started the week at the heady heights of 0.9623… at these levels the air is thin and the AUD is hungry for air – must be the Chinese smog... The AUD dropped to as low as 0.9440 by this morning and the weakness (even with Chinese data outperformance) is weak and we expect it to continue so in the coming weeks.
- The GBP had a tough week, especially in light of the USD strength we saw across the board with FOMC tapering noise. The Pound has had a resounding success in the last few months in terms of its strength moving from below 1.50 to above 1.63. We are now just below the 1.60 figure at 1.5970 and as long as these levels hold then the Pound may be able to maintain its highs for a little longer. We fear that the talks of EU referendums and the volatility in the domestic housing bubble could consign these levels to a distant memory by the end of the year…
- USDBRL was steady all week until yesterday where the BRL rather swiftly dropped in value, seeing the USDBRL shoot up from 2.18 to 2.24 throughout the trading day.

Fixed Income

- The US Government shutdown storm in a tea cup, turned out to be a slight foamy mist in a single shot macchiato cup. With all of that news seemingly completely forgotten the yields have been quite subdued, seeing them stuck in a band between 2.48% and 2.51%. Step in Big Ben and the FOMC… the inference from the wording has meant that the tea leaves (or perhaps coffee granules) now mean tapering sooner than the last set of leaves said. The yields jumped from 2.48% to as high as 2.58% this morning… another meaningless move. The US 10 year is still in the range between 2.50% and 3.00%. It will remain there… for now.
- The yields on the German Bund seem to have broken their monotonous repetition and finally the yields broke lower. The move saw the yields move from 1.77% to as low as 1.65% yesterday. The break down in yields follows the weakening of the EUR against the USD.

- Spanish yields seemed to follow the direction and speed of the German Bund – not that we would ever suggest that they were synonymous – moving from 4.15% on Monday to as low as 3.97% yesterday morning. Spain seems to be holding a steady ship at the moment, unfortunately the state of their economy and their unemployment figures makes it very unlikely that this situation is maintainable for the foreseeable future and we worry that these yields tend to make the paper expensive for the longer term.
- Italy followed suit with a drop in yields from 4.24% to as low as 4.08% this morning. Relative to the Spanish debt it still yields more than 8bps higher (this means a weaker bond, i.e. they pay more for their debt). They are now at 4.10% this morning and we feel that relative to the Spanish debt there is more downside here even at these levels.
- The UK Gilts have not really been noted here in the past. Perhaps this is something we should rectify. We have been mentioning for a long time that there is a straw out there about to break the proverbial back of the camel in Europe. Both Italy and Spain have debt levels above 300% of GDP – we can hear you gasping from our desks. The UK now has a shade over 500% of GDP in outstanding debt, including private sector borrowings this figure shoots up to 900%. With a yield of 2.62% on the 10 year debt, we are beginning to wonder if this is sustainable. The Weimar Republic only managed to maintain 918% of GDP (granted the times were different)… but perhaps there may be a trigger in the coming years of interest rate rises that could cause the unwinding of the UK debt burden… I would want to own a wheelbarrow business at that point in time!

Equities

- Developed equities fell 0.32% for the week – as of yesterday's close – as measured by the MSCI World index. Equities fell on the back of increasing speculation that the Fed will start tapering, overshadowing better than expected Macro data and corporate earnings.
- The Eurostoxx index gained 0.80% for the week, and has concluded the month of October up 6.04%. European stocks advanced to a 5 year high as corporate earnings beat analysts' estimates, overshadowing weak German Retail and Consumer Climate data.
- The S&P 500 lost 0.19% for the week (as of yesterday's close), but has gained 4.46% for October – heading for the best yearly gain in a decade. The gauge made fresh highs at the start of the week on positive corporate earnings and due to weaker than expected economic data which raised speculation that the Fed will maintain stimulus at their meeting. US Stocks reversed their gains at the latter part of the week as investors interpreted the fact that the Fed omitted their concerns regarding credit conditions in their statement as a hint that they will begin cutting stimulus, even though they maintained the same pace of monthly purchases, as expected.
- The Nikkei gained 0.80% for the week, and has concluded October down 0.88%. Japanese shares gained as a weaker Yen boosted exporters and corporate earnings beat expectations.
- In terms of sectors, Materials and Financials were the worst performers for the week -1.25% and -0.93% respectively), while Telecoms and Info Tech gained 0.37% and 0.11% respectively).

Emerging Markets

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- Emerging Market equities dropped 0.68% for the week – as of yesterday's close – as measured by the MSCI EM index. EM European shares lost 1.16%, whilst EM Asian and Latin American shares gained 1.34% and 0.14% respectively.
- The Shanghai Composite gained 0.77% for the week, and lost 1.52% in October. Chinese shares gained on the back of rising investor speculation that the government will introduce measures to boost economic growth and may ease property curbs. Stocks saw some weakness during the week as the Central Bank's first injection of funds in two weeks failed to alleviate a cash squeeze.
- The Bovespa gained 0.19% for the week, as of yesterday's close. The Brazilian gauge was supported as Petrobras rallied as it sought approval from the government to raise domestic fuel prices and corporate earnings beat expectations. Brazilian shares gave back some gains, driven by OGX's selloff as the company filed for bankruptcy. The Bovespa ended the month of October up 3.66%.

Commodities

- Commodities dropped 0.29% for the week, as measured by the S&P GSCI Total Return index. The main losing sectors were Agriculture (-2.83%) and Precious Metals (-2.29%), while Industrial Metals were about flat and Energy rose by 0.26%.
- Gold dropped by 2.50% and is currently trading around $1'322 per troy ounce. Bullion fell as a dollar rise and encouraging US consumer spending data prompted investors to take profits, while policy makers maintained their $85 billion-a-month bond buying program. Gold tumbled 21% in 2013 after rallying for 12 years, as unprecedented money printing failed to spur inflation and as investors sold metal at a record pace from exchange-traded products.
- Crude oil lost 1.50% and is currently trading at $96.40 a barrel. Crude prices reached a four-month low as an increase in China's manufacturing index failed to counter concerns about rising crude supplies in the US, the world's biggest oil consumer.

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