Bedrock Newsletter

Friday, December 20th 2013

This is our last Newsletter for 2013! A few weeks back we announced that we are at "the end of the end-of-the-world" and this week, the Federal Reserve agreed with us;
BOTTOM LINE: The FOMC decided to cut the pace of its asset purchases to $75bn per month but offset this with a qualitative enhancement to the forward guidance.
Half full or half empty? Well, the Taper announcement told us two things simultaneously- The Fed is reducing its purchases by $10Bn/month, but also told us that they will be buying for $75Bn/month… still a huge number!
The Committee's assessment of the economic outlook was somewhat more upbeat. We see the statement as slightly hawkish relative to expectations. They did tell us that the target Fed Funds rate remains at 0-0.25% and added that this level will be maintained "well past unemployment rate going below 6.50%". A steepening yield-curve can be expected as the anchor is held at zero in the short-end and the long-end will have less purchasing power. The fact that President Rosengren dissented, President George did not, is consistent with that.

Then, the Committee recognizes that inflation, persistently below its 2 percent objective, could pose risks to economic performance and it is monitoring inflation developments carefully for evidence that inflation will move back towards its objective over the medium term. So this may be the "change in the tools" that they have mentioned before and not necessarily meant to be taken as a hawkish surprise.
The markets loved the announcement- Equities soared as uncertainty was reduced, the VIX, or a commonly watched measure of risk, fell as did gold whilst bonds fluctuated in a very narrow range. The US Dollar caught a strong "bid" and gained against all counterparts, the Dollar Index regaining its level of a year ago.

Santa Ben delivered a wonderful gift to all. What will this mean for next year, the first year without the Bernanke governance and guidance in many years?
Our outlook is for a gradual return to normal, not the "new normal", the normal "normal". The slowly reducing intervention by the Fed will allow market-economics to regain the reins of markets. Equities are likely to pursue their rise as the economy regains ground (globally), a normalized yield curve will steepen and set fair pricing for capital. A few weeks ago we had calculated that the S&P is likely to finish 2014 at about 2,100, so about a 15% rise from here. So-called defensive assets such as gold are likely to suffer and the US$ may well stabilize or even gain some ground.

The IEA raised estimates for oil demand next year to 92.4 million barrels per day... We reminded ourselves that ten years ago this figure was 80M barrels… Alternative sources? Sure… We are living in interesting times when viewed with energetic eyes- The geopolitics of oil are changing quite dramatically as the largest consumer of hydrocarbons, the USA, is slowly moving towards self-sufficiency in energy. This will affect political alliances, trade balances and may even close the American perennial trade deficit, consequently raising the US$. After the Fed, we wonder what will Mario Draghi do? Running (as usual) about 18 months behind the US… Perhaps letting the Taper support the USD will lighten the Euro and import some inflation?
Well, last week Amazon (a huge internet retailer) showed us its plans for drone based delivery systems. This week Google showed us its robot development program. 2014 is definitely futuristic…

Let's go into our weekend and into next year thinking that yesterday is but today's memory, and tomorrow is today's dream. Merry Christmas and a Happy New Year to all! Wishing you a 2014 better than your hopes ☺

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Currencies

- EURUSD had been waiting for a white-bearded man to step in to support the USD and a "Santa Claus rally"… instead another bearded man stepped in and took away some pocket money for the markets. The USD rallied as the QE tapering program started, seeing the EURUSD tumble from 1.3800 to 1.3640 by this morning. However on the year the USD has been the net loser, with the EUR strengthening from 1.32 on January 1st, to 1.3640 at the moment. We hope that the successor to Bearded-Man continues down the road he has started and that she continues holding the can and not kicking it. Bravo Mr Bernanke, we salute you.
- EURCHF came back from the lows of 1.2167 on Tuesday to trade back to 1.2280 yesterday. On the year the EURCHF pair has moved from as low as 1.2060 to as high as 1.2650 in May to settle back to 1.2260 at the moment. USDCHF has been supported as well by the USD bullish news of the tapering effort by Helicopter Ben... although this time it was a reduction of his ammunition used. The movement was from 0.8850 to 0.9000 this morning, but again on the year the USD is weaker than the CHF, having started at 0.9180, reaching as high as 0.9839, but looks to be coming in at the lows at the moment around 0.9000.
- USDJPY continued its assault on the JPY. The pair passed the 104.00 figure with ease and continues higher seeing 104.59 after Bernanke spoke. The pair has had a stunning year with both political will and economic drivers from the Central Bank of Japan causing the pair to climb from 85.60 to the highs we are seeing now, 104.50. We believe that there seems to be no reason that we can see on the horizon that should stop this massive ascent. Shinzo Abe we salute you, too.
- The Aussie has lost its footing completely, as 2013 comes to an end we see a very sorry picture being painted for the Australian Dollar. For the year we have seen the pair trade from as high as 1.06 down 0.8820… but at least they won the Ashes back from England in the cricket, and everyone knows how important that is! (Ask Harold Pinter!). Unfortunately though we do not see a slowdown in the depreciation of the Aussie, unless the Chinese back track on their economic goals, the slippery slope should continue downwards.
- Cable is again almost unchanged on the week at 1.6350. On the year the Pound is ever so slightly stronger against the USD, having started the year at 1.62. But the reality is that the Pound has been weaker than the USD for 90% of the year and was as low as 1.4814 in July. We are not so sure how long this recovery can last based on the debt issues in the UK. But for now status quo is maintained. We look forward to (and hope for) a steady 2014.
- The BRL has had both a poor week and a poor year. The USDBRL started the year at 2.05, dipping to as low as 1.94 but in August peaking at 2.4550! A bumpy year for the Brazilian Real which seems to settling at about 2.36 for the end of the year.

Fixed Income

- The US 10Yr yield is moving slowly higher and higher, but again is still within out 2.5% to 3.0% band. The yield has moved from 2.82% to 2.94% by yesterday after Santa Ben spoke. Coming into the holiday season we see very little movement from here and the curve is probably likely to steepen, but only next year. For now the yields will remain in the range, but once the Tapering takes effect the curve (which is anchored at 0% in the short term paper) will likely steepen. For the year though, the US 10 has moved from 1.6% to as high as 3.00%.

- The German Bund moved from 1.82% on Monday to as high as 1.89% after the Tapering announcement. The year has seen the longer dated Bund paper move from as low as 1.15% to 2.09%. Although the ECB is probably about 18 months behind the US in terms of economic cycle with regards to policy shifts, we believe that the yields in Germany will start to creep higher as well, with a steepening effect present for the Bundesbank to deal with.
- Spanish yields rose a little this week, along with the majority of longer dated bonds. The yields bumped from 4.08% to 4.16%. However in the grand scheme of 2013, this is not so dramatic. The compression of spreads from the periphery to the German Bund has had a dramatic effect. The Spanish 10 year started the year at 5.2% and we saw a low of 3.94%! With the spread going from 394 Bps to 220 Bps over the German Bund.
- Italy's 10Yr was almost completely unchanged on the week at 4.09%, but seeing the yield bounce from 4.05% to 4.10% on the Bernanke news. The Italian 10 year started the year at 4.50%, slipped to as low as 3.67% in May, surged to 4.95% in June and has settled back towards 4.10%. But interestingly the spread of the German Bund has moved from 350 Bps to 220 Bps as we write now… exactly the same spread of the German's as the Spanish… in extremis, correlation goes to one!
- UK Gilts moved from 2.86% on Wednesday to 2.98% this morning, continuing the slide of the UK gilts. The year has seen the UK Gilts move from 1.60% to 3.04%. The trend is in place and we believe that the trend shall continue. With an exceptionally heavy debt burden a large budget deficit and only the house market bubbling over, 2014 may prove to be a tough year in the UK Treasury markets. We hope Mr Osborne packed a big suitcase…

Equities

- Developed equities rallied by 1.93% for the week – as of yesterday's close – as measured by the MSCI World index. Equities globally rose as investors took US Federal Reserve's decision to trim its stimulus as a vote of confidence the American economy is strengthening. The MSCI World rose by close to 21% so far this year.
- The EuroStoxx surged by over 4% for the week. European shares hit renewed highs from Thursday (exceeding the 3'000 level again), tracking gains on Wall Street in a broad rally after the Federal Reserve announced a cut in its stimulus and hinted it would keep rates low for a longer period. 2013 saw the index rose by close to 11%.
- The S&P 500 rose by 1.93% for the week, as of yesterday's close. US equities hit record highs on Wednesday after the Federal Reserve said the economy was strong enough for it to begin paring its massive stimulus. However, the Fed tempered its pullback by indicating it will keep interest rates close to zero for longer than previously expected. That combination enticed buyers and helped the S&P 500 post its largest gains in two months. The index is up close to 27% this year, on pace for its biggest annual gain since 1998, when it climbed 31%. An accommodative Federal Reserve, paltry returns in assets such as bonds and steady expansion in corporate profits continue to draw investors to equities.
- The Nikkei soared by over 3% for the week – hitting its highest close in six years on Thursday, on the back of a big drop in the yen after the US Federal Reserve announced it would start unwinding its historic stimulus. Buoyed by the Japanese government's massive fiscal and monetary stimulus to revive the economy, the benchmark surged by over 52% this year, gunning for its best yearly performance since 1972.
- In terms of sectors, Industrials and Telecom stocks were the best performers (+2.44% and +2.22% respectively), while Consumer Discretionary and Consumer Staples lagged (+1.58% and +1.31% respectively).

Bedrock Newsletter

Emerging Markets

- Emerging Market equities were flat for the week – as of yesterday – as measured by the MSCI EM index. Latin American shares rose by 0.97%, while EM Europe was flat and Asian shares lost 0.52%. EMs lost about 6% so far in 2013, mainly driven down by growth concerns.
- The Shanghai Composite tumbled by 5% for the week as local money market rates hit a six-month high. Chinese stocks fell for an ninth day on Friday, capping the benchmark's longest losing streak since June, as credit crunch fears pushed up trading costs and raised fears of an economic slowdown. Investors have soured on Chinese stocks, pushing Shanghai's benchmark down 8% from this year's peak in mid-February, as the economic recovery slows and Beijing clamps down on resurgent property prices.
- The Bovespa rallied by 3.07% for the week, as of yesterday's close. Brazilian stocks reached their highest level in over a week on Thursday after the US Federal Reserve said it would begin to taper its monetary stimulus, removing a question mark that had been hanging over the market in recent months. Brazilian equities fell into bear territory during 2013 on growth and inflation concerns, down over 15% year-to-date.

Commodities

- Commodities rose by 1.35% for the week, as measured by the S&P GSCI Total Return index. Precious Metals was the worst performing sector (-3.17%) followed by Industrial Metals (-0.70%) and Agriculture (-0.56%), while Energy was the only sector to be positive (+2.14%).
- Gold slumped by 3.50% this week, and is currently trading around $1'195 per troy ounce, sliding more than 2.4% on Thursday to its lowest since late June, after the US Federal Reserve took its first step away from the ultra-loose monetary policy that had helped drive bullion prices to record highs in recent years. The Fed said on Wednesday that the US economy was finally strong enough for it to start scaling back its massive bond-buying scheme, winding down the era of easy money that saw gold rally to USD 1,920.30 an ounce in 2011. Gold is set to notch its first annual decline in 13 years and its biggest drop since 1981, down close to 29% year-to-date.
- Meanwhile, crude rose by 2.3% and is currently trading around $98.80 a barrel. Crude oil prices jumped on Thursday on signs of more growth, a day after the US Federal Reserve said it would reduce monetary stimulus. Futures rose amid light trading as tight supplies, including US crude stock draws and production outages, kept market players buying oil.