Bedrock Newsletter

Friday, January 17th 2014

It is Friday and we feel like James Bond's Martini- Shaken, not stirred… Quite a bouncy week… We are closing the week with the S&P500 basically flat for the year but then, the surprise into the first month of the scary "tapering", the US 10 year Treasury Note yield has fallen from 3.05% at year-end to 2.85% and then all the frightening peripheral Europe bonds rallied hugely. What is going on here? Well, some important fundamentals are emerging from the primordial sea of statistics;
On Monday we saw that The U.S. government ran a $53.2 billion surplus in December, signaling further improvement in the US' finances. The surplus was the largest since September and a record for the month of December. For the first three months of the budget year, which began on Oct. 1, the Treasury has run a deficit of $173.6 billion. That's 40.8 percent below the $293.3 billion deficit run during the same period last year. Are bonds rallying as supply is falling (less deficit to finance?)- is this a trend to continue? We think so…
On Monday we digested the horrific Jobs data from Friday which gave us substantially less new jobs but also much less in the unemployment rate. Markets fell, but we also read that the 6 nations negotiating with Iran have reached an agreement- less sanctions in exchange for some promises. Will oil be pressured downwards with new supply coming to market? We believe so…
Tuesday gave us a rebound in equity prices and a rally in the US$- Well, a stronger US$ lightens inflationary pressures in the USA (being a net importer), so no inflation makes bond yields attractive. Then Wednesday data on wholesale prices in the U.S. climbed 0.4% in December for the first time in three months, to cap the smallest annual increase in five years, showing companies face little pressure to charge more.
Wednesday we were told by the World Bank that global growth is set to accelerate in 2014 as advanced economies turn a corner five years after the global financial crisis. Growth is projected to strengthen to 3.2 percent this year, 3.4 percent in 2015, and 3.6 percent in 2016 - up from 2.4 percent in 2013. We also tracked the Q4 earnings coming at us fast and furious- They appear to us to be with a Ph7- neutral… The interesting feel we get here is that earnings are coming in a little disappointing but the top-line or revenues are starting to exceed expectations; a reversal of what we were seeing last year- growth of sales, suggesting GDP growth is sustainable. Wednesday we also noted that the DOW Transport index hit a new high, and as you know, this sub-index is largely considered a leading indicator for the market as a whole…
For those who worry about equity markets being at or near their all-time highs we suggest drawing all indices on a chart; stand back a few feet and look at it. All the charts move up from left to right- A Bull market by definition! It will continue, as per Dennis Gartman, until it stops. He says there is a long run forward. We concur with Dennis and say "stay the course!".
Thursday the IMF warned of Deflation risks... Watching European bond yields fall and US treasuries rally raises the question if this risk is real? Hold some bonds to mitigate this risk, at the price of some opportunity cost of not being more in equities or hedge funds.

The U.S. Labor Department said last Friday that the unemployment rate fell to 6.7 percent in December—but does that rate tell the real story? A number of economists look past the "main" unemployment rate to a different figure the Bureau of Labor Statistics calls "U-6," which it defines as "total unemployed, plus all marginally attached workers plus total employed part time for economic reasons, as a percent of all civilian labor force plus all marginally attached workers." In other words, the unemployed, the underemployed and the discouraged — a rate that still remains high. The U-6 rate was unchanged in December at 13.1 percent. 6.7% or 13.1%? How long is a piece of string?
We do look into 2014 and beyond and think that the Master Theme to consider is the US energy story; As domestic production is ramping-up, US oil imports are declining, improving the trade deficit and in this, helping the US$ at the same time; a major industry in America is reviving, giving jobs and ultimately, reducing energy costs to both industry and population. This may be a "game changer" with global geo-political ramifications.

Abraham Lincoln had said "Most folks are as happy as they make up their minds to be". We go into our weekend smiling happily.

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Currencies

- EURUSD had another relatively quiet week, being range bound between 1.3600 and 1.3700. With little data that the market perceived as either being accurate (Christmas lag always skews data) or important the pair only really moved lower from 1.3660 to briefly touch 1.3580 on Wednesday. As the USD rallied with a small sell-off in Asia on Wednesday morning after ever so slightly weaker than expected Chinese money data the move was swiftly ignored and traded back to 1.3600.
- EURCHF bounced from 1.23 to 1.238 by Thursday. The pair is more or less unchanged on the week, maintaining the middle of the road position even after the SNB's Jordan mentioned that the floor was not a move towards the EUR and that the CHF was still high. The USD moved from as low as 0.8990 on Monday to peak above 0.9108 on Wednesday. We seem to be trading at about 0.9060 for the end of the week and with little data on the horizon for today we believe we should close at or around these levels. Is this a good basing point for the USd to mount a rally back to parity in 2014? We believe it might be, we just need to see a solid base put in at these levels.
- USDJPY dropped heavily on Monday to see a low print of 102.86 (having been above 105.00 last week). This was truly short-lived and the resultant up move saw the pair back to its highs of 104.92 again within two days. We are trading at 104.30 at the moment and believe that the uptrend is well placed and see no reason for it to stop. The Government and the Central Bank of Japan are on a high-speed magnetic train to devalue the currency… nothing should stand in their way, we certainly won't.
- The Aussie briefly managed to resume a little of its lost ground getting as high as 0.9086 on Monday (this seems to be the theme at the moment!). Unfortunately the highs were short lived and the pair traded to as low as 0.8777 by yesterday and unfortunately for the Aussie we are still at the lows, trading 0.8800. The AUD dropped heavily on bad unemployment figures this week, thereby increasing worries about the Australian Economy. As we said last year, the Aussie is fundamentally weakening, and doing so at a steady pace.
- Cable has started the week horrendously, slipping from 1.6508 to 1.6350 in a matter of hours and eventually hitting 1.6310 this morning. However, the retails sales figures this morning wiped our nearly all the losses to see the pair back to 1.6440. With the US deficit dropping and a retail driven economy bouncing, we wonder whether the UK retail buyer will be able to outspend the deficit reduction clerks in the US to continue the upward moves in cable!

Fixed Income

- The US 10Yr yield is a little lower than at the start of the week, but again is still within our 2.5% to 3.0% band. The yield has moved from as high as 2.901% on Wednesday prior to the jobs data to see the yields drop to 2.83% post US figures on Thursday. Again we see the Treasuries being stuck in the 2.50%/3.00% band and until the deficit diminishes or the Administration changes a fundamental financing rate this shall continue to be the case.
- The German Bund moved from 1.85% to as low as 1.76% this morning. The yields have fallen a little in the wake of the average equity performance for this week. The Bund simply sets the Benchmark now for the periphery to trade at 200Bps over this rate. We don't see it really dropping too far below 1.65%, much like the US, until there is a fundamental administration change or forward guidance this shall continue to be the case.

- Spanish yields dropped this week from 3.84% to as low as 3.71% as equities had a tough week. Yet again this would seem that the market is pricing all peripheries at about 200 Bps over the Bund… As we have said many times, as the tidy comes in, all boats float!
- Italy’s 10Yr slipped from 3.93% to as low as 3.82% again trading at or about 200 Bps over the Bund. Nothing really new here, the Bund is the price driver and the yields follow.
- UK Gilts moved from 2.87% at the beginning of the week to as low as 2.80% ahead of the UK Retail figures. As the UK’s retail buyers were out in force, boosting the Government coffers and reducing the deficit, the yields bounced strongly from 2.79% to 2.85% in a straight line. As we mentioned for Cable, we are not sure how long the retail buyer’s strength will remain, but for now it seems to be stable and positive causing the yields to strengthen a little.

Equities

- Developed equities gained 0.25% for the week – as of yesterday’s close – as measured by the MSCI World index. Equities gained following better than expected US Retail sales data, as well as positive corporate earnings.
- The EuroStoxx gained 1.6% for the week. European stocks gained as the World bank raised its global growth estimates for 2014 and the ECB played down deflation concerns for the Eurozone. In addition, European bank shares were supported on news that regulators have eased a Basel leverage ratio rule, enabling banks to report lower levels of overall risks.
- The S&P 500 made fresh highs, rising 0.19% for the week, as of yesterday’s close. US stocks sold off sharply at the start of the week on stock valuation concerns, as the vast majority of companies which have reported earnings so far have lowered their forward guidance. Equities were soon to recover as better than expected retail sales figures, coupled with positive corporate earnings, reassured investors. The six major US banks reported earnings this week, providing a mixed picture for the sector.
- The Nikkei lost 1.12% for the week. Japanese stocks lost more than 3% on Tuesday’s trading session catching up on losses in the US following a weak employment report. Shares recouped most of the weekly losses following positive global growth outlook.
- In terms of sectors, Healthcare and Financial stocks were the best performers (+1.67% and 0.80% respectively), while Materials and Telecoms suffered the most (-1.85% and -0.93% respectively).

Emerging Markets

- Emerging Market equities gained 0.46% for the week – as of yesterday’s close – as measured by the MSCI EM index. EM Asian shares gained 1.17%, while EM Latin American and EM European shares lost 1.02% and 0.43% respectively.
- The Shanghai Composite lost 0.23% for the week. This week has been non-eventful for Chinese equities, where some attention was given to market nervousness about upcoming IPOs in an environment of tight liquidity.
- The Bovespa remained flat for the week, as of yesterday’s close. Brazilian shares traded in line with the US market, slightly underperforming as the Central bank raised the base Selic

rate by 0.5% to 10.5% annually, viewed by analysts as an aggressive move to tackle the high inflation rate.

Commodities

- Commodities rose by 0.51% for the week, as measured by the S&P GSCI Total Return index. Agriculture and Industrial metals were the best performing sectors (+0.74% and +1.44% respectively), while Precious Metals was the only sector to be negative (-0.59%).
- Gold fell 0.50% for the week, and is currently trading at $1'242 per troy ounce. Bullion prices settled lower with strength in US equities, a rise in retail sales and comments from Federal Reserve to officials pointing the prospects of further tapering of the central bank's bond-buying program. Lower US inflation on Thursday briefly revived interest in gold, but faded away as it could also prompt Federal Reserve to change the pace of the rollback of its bond-buying program.
- Crude oil rose by close to 2% for the week, and is currently trading at $94.50 a barrel. Crude futures jumped on a robust US manufactory report coupled with falling US inventory figures. As a result, oil prices went up on hopes that demand may be picking up in the world's largest consumer of crude.

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