Bedrock Newsletter

Friday, January 24th 2014

It is Davos week and a wind of optimism and positivism seems to be blowing over this Swiss Alps resort. As every year, heads of State and powerful CEO's flock to this mountain resort in order to debate on the state of the World Economy, and more importantly, to grab the future trends and opportunities. This edition started with Japan's Prime Minister Abe coming to deliver a strong commitment to reforms in order to boost growth and to reassure investors that this time, Japan's rise from the doldrums is for real. Yesterday saw Iranian's President Rouhani come and deliver a very "western" marketing speech on his country. Mr. Rouhani touted the policies his government has ushered in: prudence and moderation, expanding global trade and regional ties and inviting foreign investment. The speech, carried live on Iranian television, attracted intense attention and excitement because no Iranian president has appeared at the forum of world business elites for a decade. The president spoke just days after Iran's interim nuclear agreement with six world powers went into effect on Monday. The deal and ongoing negotiations for a more comprehensive accord are aimed at preventing the country from developing nuclear weapons and offer relief from tight international economic sanctions in return. Both the nuclear deal and the speech at Davos sparked hope in Iran for economic relief.

Davos also nearly produced a near miss between the Israeli and the Iranian delegation as Rouhani, Netanyahu and Shimon Peres were scheduled to speak the same day a few hours apart. Despite their proximity, the two delegations managed to stay safely away from one another. The closest they appear to have gotten was not in Davos, but at the Zurich airport. The leaders' planes were parked next to one another, offering airport visitors a rare view of the Israeli and Iranian flags next to each other. Well, who knows, we remind you that China and the US established relations through Ping Pong.... Maybe the big surprise of 2014 would be the reopening of the Iranian Economy to the West after years and years of economic sanctions.

Back to the markets. This week was a volatile one with currencies, equities and Bonds moving quite a bit, in a reverse situation of the past few weeks where the markets seemed to be in sleeping mode. The market's perception and a few Fed's members confirmation of more tapering ahead continued to hit some emerging market currencies hard, such as the Turkish Lira and the South African Rand. The Turkish Lira hit new record lows both against the USD and the EUR, on the back of political turmoil, while the ZAR weakened on a weakening economy and social turmoil.

The Canadian Dollar, whilst not being an emerging market currency had a "loonatic" drop and hit a 5 year low against the USD, on the back of a weakening economy.

As last week's unemployment news from the US was also disappointing, bond markets across the world rallied hard, against the market consensus for this year. Even Italy and Spain managed to see their 10 year yields drop below 4%.

Equity markets around the world were also hit this week as disappointment in earnings of some big and prominent companies and weaker economic numbers hit investors' confidence. The one bright spot this week came from better than expected economic numbers from Europe (for once!).

Is the long awaited correction finally coming? Well, maybe. As the US is slowly but surely removing the biggest liquidity experiment in history, some ripple effects are bound to happen.

We believe that equity markets will have a positive, albeit volatile year 2014. We see that there are some strains in some currencies which usually underline some problems ahead. No country today wants a strong currency as even Canada and Australia "talk" down heavily their currencies. Is it the start of Currency wars, Part II?

As for Bonds, as long as inflation does not show its head, it may be wise not to throw them away!

We leave you with these thoughts and hope that Davos's optimism will be proven right!

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Currencies

- EURUSD felt like it was Christmas week with no more than a 50 pip movement around 1.3550 for the first half of the week… UNTIL… PMI's proved the undervaluation of the EUR was severe (!) and the pair bounced to over 1.37 within 24 hours. All of the counterparties we speak to say they are bearish on the EUR versus the USD, and yet it creeps higher on every setback. We can't help but feel like the pain trade here is likely to pay off only after the market has a washout higher and the stops are triggered.
- EURCHF bounced from 1.2320 to 1.2380 on Tuesday, only to go lower again this morning having breached the 1.2250 mark a short while ago. The pair weakened on the PMI data suggesting that maybe we should take the data points with a little pinch of salt. The CHF was bought up on the numbers. The USD moved from 0.9150 on Tuesday to sink back again to 0.8900 this morning... we believe this is just a basing exercise from the market and that we will remain fixed around these levels until the USD is ready to mount a resurgence back to parity.
- USDJPY dropped heavily on Thursday from 104.84 to see a low of 102.00 this morning. We feel this is a little like groundhog day and that each week the market chooses a day to drop, only to jump back again… This range bound trading might seem infuriating if you are waiting for the big up move, but for now we view it as even more positive for the uptrend as more participants will likely be involved to push the move higher. The USD should rally and the JPY should weaken – they have the full force of the central bank pushing this matter forward and soon to be a very bullish market on USDJPY, so don't stand in its way. The buying level is approaching here in the range of 100.50-101.50.
- No matter how many times we re-iterate this, we shall say it again… The Aussie is weakening and shall likely continue to do so. The Fundamentals and the further worries about the Chinese shadow banking system have applied further pressure on the Aussie. The pair fell from 0.8888 (lucky for the Chinese…. Maybe not so for the Aussies!) to as low as 0.8660 this morning. The trend is here to stay and again we shall not stand in its way.
- Cable had another superb week, bouncing from 1.6400 to 1.6670 this morning… only to see it sink back below 1.65 moments later. The air is getting thin here and we believe that the next move on the Pound will be down and not up. With central banker Carney removing the forward guidance and employment data seemingly very impressive the Pound had mounted a comeback… The mantra of Keep calm and carry on obviously has been working, but for now let's just forget about the housing bubble in London. If you can't beat them… join them.
- EM currencies had a horrific week, with the BRL moving from 2.33 to 2.4050 at its worst yesterday. ZAR was absolutely decimated with the pair moving from 10.79 to 11.19 more or less in two trading sessions. As the equity markets stumbled, risky currencies were hit very hard. Even the TRY moved from 2.2250 to 2.3220… generally a fairly dismal picture in the EM space. Specifically with the ZAR, our comments from last year do not seem to have been negative enough… our target of 10.50 is long gone and 12.00… 13.00… 14.00 may have been a more appropriate number – safari time methinks! But the currency that really takes the biscuit this week is the Argentine Peso… 6.77 to 8.24 in two days… that is 15% in two days. When we see moves that are this vicious and seem set to worsen yet still further, we feel that we may have found the catalyst the markets have been waiting for.

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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 2.87% on Wednesday prior to the jobs data, only to see the yields drop to 2.71% this morning on the back of the dramatic Risk-Off sentiment that is sweeping through the markets. The Treasuries are not going to be breaking the 3.00% upper bound any time soon, with the negative tone in the equity markets and the Emerging Markets. US Treasuries are set to rally further, seeing the yields drop.
- The German Bund moved from 1.77% to as low as 1.64% this morning. The yields have fallen in the wake of the poor equity performance for this week and the Risk-Off sentiment that has emerged. The Bund had previously set the Benchmark for the periphery to trade at 200Bps over this rate… perhaps we are beginning to see a repricing on the periphery spreads.
- Spanish yields climbed this week from 3.64% to as high as 3.83% as equities had a tough week. We mentioned recently that as the tide comes in all boats float… we feel that as the tide is slipping away this week the yields have proved our point. Spreads over the Bund have exploded from 195Bps to 219Bps… The lockstep trading is not present this week… the real question is, does this signal the change of direction for the markets?
- Italy's 10Yr yields moved from 3.78% to as high as 3.93% again causing the spreads to move up to as high as 229 Bps over the Bund. As we mentioned for Spain, does this mark a turning point or just a hiccup on the road to spread compression?
- UK Gilts moved from 2.90% on Wednesday to as low as 2.73% this morning. Even the UK's retail numbers have not been enough to shake off the general market fear of the week and the yields are lower as bond buyers has caused the prices to rally.

Equities

- Developed equities dropped by 0.41% for the week – as of yesterday's close – as measured by the MSCI World index. Most stock markets sank on Thursday (-0.68%) after a report indicated that China's manufacturing, a mainstay of the world's second largest economy, was likely to shrink for the first time in half a year.
- The EuroStoxx declined for a third day on Friday (-1.91% for the week). European markets slid on concerns of a slowdown in China's manufacturing sector, despite a report showed a pickup in European business activity. As a result, investor confidence in the euro zone's economic recovery was boosted leading to a surge of the euro against the dollar on Thursday.
- The S&P 500 slid by 0.56% as of yesterday's close. US stocks sold off after disappointing US and Chinese manufacturing data sparked concerns for global growth, while earnings season did not prove helpful so far.
- Meanwhile, the Nikkei lost 2.18% on the back of a stronger yen and weak Chinese manufacturing activity data – keeping the market risk-averse before the US Federal Reserve's policy-setting meeting next week.
- In terms of sectors, Financials and Materials stocks were the worst performers (-1.20% and -1.16% respectively), while Utility and Consumer Staples fared better (+1.05% and +0.38% respectively).

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Emerging Markets

- Emerging Market equities declined by 0.85% for the week – as of yesterday's close – as measured by the MSCI EM index. Latin American shares lost the most (-2.35%) while EM European and Asian shares lost 0.69% and 0.53% respectively.
- The Shanghai Composite rallied by 2.47% after the nation's money-market rates extended declines and volumes jumped to one-month highs. Rates slid for a second day after the central bank added more than $42 billion to the financial system to meet Lunar New Year money demand and ease cash squeeze concerns.
- The Bovespa dropped by 1.75%, as of yesterday's close, as China and US weaker manufacturing data (two of Brazil's largest commercial counterparts) weighed on sentiment. World Cup failed to lift Brazilian stocks so far (-6.19% in January), over worries of persistently high inflation, deteriorating growth and government finances.

Commodities

- Commodities rose 1.31% for the week, as measured by the S&P GSCI Total Return index. Energy and Precious metals were the best performing sectors (+1.94% and +0.53% respectively), while Industrial Metals and Agriculture lost 2.26% and 0.10% respectively.
- Gold rose 0.34% for the week, and is currently trading at $1'270 per troy ounce. The metal sold off for the majority of the week due to concerns that a slowing Chinese economy would hurt demand and speculation that the Fed will announce further stimulus cuts in next week's FOMC meeting, which caused the Dollar to rally. On Thursday, gold reversed its weekly losses and rallied to current levels on the back of risk aversion.
- Crude oil rose by as much as 3.30% for the week, and is currently trading at $97.50 a barrel. Oil commenced its rally on Tuesday following the move by China's Central bank to inject credit into the financial system to offset growth concerns. Futures then reached a 3 week high as a new pipeline began transporting 300K barrels of oil a day, reducing the amount of US oil stuck in storage, and data showed a decline in US distillate fuel supplies.