Friday, March 4th 2011

Each week seems to produce its own headline. We haven't seen much about Egypt this week, The Pharaohs having been eclipsed by Libyan event and then all these oil-scary events forgotten because J-C Trichet was interpreted yesterday to have hinted at soon to come interest rate hikes… Will this be as soon as this April? So Libyan skirmishes and resulting oil-prices well in triple digit pricing have taken complete back-seat as we watch the Euro gain in stature and price? Where are Greece, Portugal, Spain and Ireland? Surely higher Euro rates will not help them with their funding problems… Quite a move here- Since visiting 1.285 on January 10th the Euro gained 8.70%!!! Maybe all is well in Euro-land after all? Yes, oil prices are flying… WTI traded yesterday at $102 and Brent at $115 per barrel. Oil services as a group well represented by the "OIH" Exchange Traded Fund reached $165 up in a straight line since trading at $96 in August.
Let's try to look through the words and headlines. We doubt that the ECB will move rates by more than a token 0.25% with little if any to follow in the immediate future. Then Oil, when Saudi Arabia promises to supply any short-dated shortfalls and we can see large stocks available, we think that things and prices might be just a little overdone here. Short term disruptions are bad and expensive but spikes tend to fade away. As to the ECB, well, dramatic as the headlines may seem, we rather think that these are simply words of a return to normal. Much like the US economy seems to have found a new, steady cruising speed. Perhaps at a lower level than in years past but then this may be a more "fuel efficient" mode of growth. Stock markets seem to be supporting this as they continue to rise… Ignoring the oil head-winds!

Ben Graham told a story 40 years ago that illustrates why investment professionals behave as they do. *An oil prospector, moving to his heavenly reward, was met by St. Peter with bad news. 'You're qualified for residence,' said St. Peter, 'but, as you can see, the compound reserved for oil men is packed. There's no way to squeeze you in.' After thinking a moment, the prospector asked if he might say just four words to the present occupants. That seemed harmless to St. Peter, so the prospector cupped his hands and yelled, 'Oil discovered in hell.' Immediately the gate to the compound opened and all the oil men marched out to head for the nether regions. Impressed, St. Peter invited the prospector to move in and make himself comfortable. The prospector paused. 'No,' he said, 'I think I'll go along with the rest of the boys. There might be some truth to that rumour after all'." (Berkshire Hathaway annual report – 1984)*
In short, going into next week we are certain that there will be some new and shocking headline to distract us. What will it be? We don't know but we remain confident that the recovery engine is more powerful and will likely overcome the bumps ahead.
Interest rates may drift up at the short end but not by much out long on the curve. Equities still are inexpensive and are likely to continue edging higher albeit slowly. And oil prices are likely to drift back towards reality…

Have a good weekend!

Currencies

- The European Central Bank stunned financial markets on Thursday by signalling a likely interest rate increase in April, and a far more aggressive stance on inflation than the Bank of England and US Federal Reserve.
- This sent the Euro sharply higher versus most major currencies. The common currency is currently at 1.395 versus the Dollar, having started the week at 1.375 and is at 1.30 versus the Swiss Franc, having started the week at 1.275.
- Given Trichet’s much more hawkish stance on inflation than his counterparts in the US and Britain, we expect the Euro to remain supported. However, the EU’s problems have not been addressed or resolved, as we can see from the high yields being offered on Greek, Irish and Portuguese debt. As such, renewed pressure on the EUR could surface again soon.
- The US Dollar continued to weaken in the first part of the week but then gained versus the Swiss Franc and versus the Japanese Yen after a jobs report showed that employment in the US increased by 196’000 in January, the most since May of last year. The US Dollar weakened to an all time low of 0.92 versus the Swiss Franc, but recovered to 0.931 currently.
- Meanwhile, the Swiss National Bank said Thursday it posted a loss of 19.2 billion CHF in 2010 as the franc's appreciation eroded the value of its foreign-currency holdings, with its unsuccessful currency interventions to help stem the franc's relentless rise against the euro, U.S. dollar and the U.K. pound resulted in exchange-rate losses of 32.7 billion francs in 2010.
- We remain of the view that the Swiss Franc should weaken from these much extended levels, barring any major geopolitical event and/or renewed Debt issues within the EU.
- Commodity related currencies were mixed this week, benefiting from the strong energy price but early in the week but then coming under pressure on the back of Trichet’s comments and the better reading on US employment.

Fixed Income

- Government bonds declined this week as hawkish comments from the European Central Bank, stronger than expected US economic data and a lack of alarming headlines from the Middle East eased investor nerves, sapping demand for safety.
- Yields on 10 year US Treasuries rose by 13 basis points to 3.546% and on 2 year Treasuries by 6 basis points to .776% this week.
- Trichet’s comments drove yields on short term European bonds sharply higher, with the yield on German 2 year Bund rising by 22 basis points to 1.76%, close to a two year high. Market participants are clearly repositioning for a rate rise at the next ECB meeting. While Trichet stressed that a rate increase next month is not a certainty, the last time the ECB said one was “possible” was in June 2008, and it delivered it at the next meeting in July…
- Credit markets were robust this week, with a continued outperformance of high yield bonds over investment grade ones.
- We remain keen on higher yielding bonds, and stay away from government and emerging markets sovereign bond. We find that High Yield bonds of all kinds compensate for their implicit credit risks and will be less sensitive to inflationary concerns.

Equities

- Global stock markets are headed for a weekly gain, with the MSCI World up by 0.8% as of yesterday's close. Thursday saw strong gains for global markets, as a strong reading on employment in the US and a (temporary) drop in the price of oil helped investors breathe a sigh of relief.
- Another positive for the markets this week, although a very "soft" one, was that there was not too much noise coming out of the Middle East. The situation in Libya is deteriorating, but other countries were pretty stable this week.
- American stocks outperformed European ones this week, with the Dow Jones Index up by 1% as of yesterday's close while the Euro Stoxx 50 index is up around 0.2% for the week. US stocks were boosted by the better economic data, while European stocks were weighed down by the ECB's statement that an interest rate increase next month is possible.
- US retailers did especially well this week on the back of the better employment data, and as consumer confidence in the US held close to 3 year highs. Pharmaceutical companies were also strong performers this week, on strong results and attractive valuations. Pfizer this week rose to a 52-week high for example.
- The energy and materials sectors were also strong performers this week, as the prices of the commodities these companies produce remained elevated.
- Conversely, the financials and information technology sectors underperformed this week, despite Apple presenting its second version of the iPad with a very welcomed reception.
- Another positive sign this week was that the VIX index, which measures volatility on the S&P 500 index, declined by 3% over the course of the week.
- Our view on equities remain constructive in general for the year given improving economic growth, attractive valuations and strong corporate health combined with the relative unattractiveness of fixed income securities.
- We nevertheless remain on the cautious side as the Middle East region remains in deep crisis and will undoubtedly continue to be a source of volatility in the near term.

Emerging Markets

- Emerging Market equities outperformed sharply their developed counterparts this week, rising by over 2.5% as of yesterday's close as measured by the MSCI EM index.
- The best performing region this week was Asia, with India's Sensex Index up close to 5% for the week, as hope that slowing food inflation will ease the pressure on the country's central bank to tighten monetary policy. Asia EM equities also were boosted by the better economic data in the US. The Shanghai SE composite index is up around 2.2% for the week, also benefiting from lower inflationary concerns.
- Middle Eastern stock markets however remained under pressure this week as the region remains very tense.
- Meanwhile, Brazil's real jumped to 1.6493 this week per dollar after the central bank raised its benchmark rate for a second straight meeting and signalled it may do the same next month.

- Asian currencies also appreciated this week, led by gains in the Taiwan Dollar and in the Philippine Peso, on speculation central banks will tolerate appreciation and raise borrowing costs to tame inflation.

Commodities

- Commodities rose again his week, led by gains in energy and agriculture. Precious and industrial metals also advanced, but at a more muted pace.
- After initially declining in the beginning of the week, energy prices resumed back upwards. Crude oil went from $98 a barrel at the beginning of the week to a low of $96.4, and is now at $103.50.
- Agricultural commodities were up almost 4% this week, as measured by the GSCI Agriculture index, as higher oil prices and continued supply concerns pushed prices higher. This week also saw the release of a report by the United Nation’s food body, which showed that global food prices rose 2.2% in February from the previous month to a record peak, as it warned that volatility in oil markets could push prices even higher.
- Precious metals rose this week, but price activity was choppy. Gold began the week at $1410 per ounce, and rose to a high of $1440, only to come back down to $1415 currently.
- We believe that the current environment will continue to be supportive for commodities as supply and demand fundamentals continue to be in focus.
