Bedrock Newsletter

Friday, March 28th 2014

Another quarter is winding down. It has been an interesting one! What with the Russian hostile takeover of Crimea, a Boeing 777 vanishes, emerging markets collapsing and rebounding, Janet Yellen taking the mystery out of our future and strange gyrations in the currency markets. Now we hear that China is planning to embark on a stimulus program- will they offset Janet's pullback? Or should we look at Q1 earnings starting shortly?
Let us see what really changed in Q1, if anything-
We started the year with Euro/US$ at 1.374 and today, 1.3725, the JPY was 104.3 and now 102.35, Gold was $1'200 rising to $1'300, 10 year US Notes were yielding 3.03% and now at 2.69%, the DJIA is off from 16'570 to 16'265 and the S&P500 now at 1'849 vs. 1'846… Ever wondered how "unchanged" can be destabilizing?

The Fed reduced our uncertainties as to the future of US interest rates and this risk reduction explains the market's rally- prices of the affected asset (bonds) rise as risk drops. Then, equities should have read in this Fed statement that the outlook for the economy is improving, so equities should rise- they didn't though- stable is the word, as the Fed's views successfully offset the realities of the political risks around the Russian/Ukraine debacle.
The FX markets confuse us- The resilience of the Euro and the Australian dollar has stumped analysts, with one saying that currency markets are now living in an alternative world. Meanwhile, the euro has also proved resilient in the face of weak manufacturing activity data from China and a dip in European factory activity data. It gained more than 1 percent against the dollar on Monday and was trading at around $1.3829 on Tuesday. Then down to 1.3715 on Friday. One reason behind EUR resilience may be found in real yields, which have done a better job of tracking the Euro going all the way back to 2007. However, the ECB narrative on the exchange rate has been clearly notched up, most evident in Draghi's Vienna speech a few weeks ago. We would have expected a Dollar up as Ukraine gets more attention- clearly Europe and hence the Euro are more at risk from an escalation in this conflict, and yet, the Euro rose on the invasion news, easing off a week later.
Then, a sharp flattening in the U.S. government bond yield curve this week could be a bearish sign for the dollar, currency analysts say. Yields on five-year Treasuries have shot up since last week's Federal Reserve meeting raised the prospect of interest rates rising sooner rather than later, narrowing the gap with 30-year bond yields to their tightest spread since 2009. Although a rise in yields at the short-end of the yield curve usually boosts the appeal of the dollar, arguably, a fall in yields at the long-end reflects concerns about the economic outlook and this is weighing on the currency. Hedge Funds that bet on macroeconomic trends are now wagering on the appreciation of the U.S. Dollar, according to data from Bank of America Merrill Lynch about hedge fund clients. The firms reversed course after attempting to make money on the greenback's decline earlier in the year. Macro funds also cut their short positions on the 10-year U.S. Treasury note and are, on average, close to a neutral view on the securities, according to BofA Merrill Lynch Global Research.
President Barack Obama said Wednesday that the Russia-Ukraine crisis "is not another cold war we are entering." He added that no amount of propaganda and falsehoods coming out of the Russian government can make right, something the world knows is wrong.
The US Commerce Department said on Wednesday that durable goods orders rose 2.2 percent, ending two consecutive months of declines. The report joined other data such as industrial production, retail sales and employment in suggesting a pick-up in economic growth after an unusually harsh winter chilled activity at the end of 2013 and the beginning of this year.
Merrill Lynch's fund manager survey for March noted that its survey participants believe sentiment toward emerging markets is near a low and may improve soon. It said that 49% of survey participants believe emerging markets are the most undervalued region.

Perspective is the most important attribute in understanding- Think of the two fellows in the savanna, facing a hungry lion; One quickly changes his boots to Nikes… his buddy asks him if he thinks this will help him to out-run the lion? He answered- "Not outrun the lion, just you" ☺

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Currencies

- EURUSD entered a break-step march this week. Jumping as high as 1.3876 from 1.3780 on Monday with US PMI missing expectations, only to be followed by much higher consumer confidence on Tuesday and “less-bad” homes sales figures sending the USD higher. The triggers in fact moved the pair to as lows as 1.3720 this morning. Some of the big banks who have been calling for the EUR to drop for the last 16 months seem to almost be reaching capitulation on the trade… perhaps this might signal the down move that they have all wanted?!
- USDCHF had the same up and down spikes driven by the US economic data points. The general movement saw the USD strengthen this week and the CHF was not an exception to the USD strength. USDCHF moved from as low as 0.8787 after the PMI figures to as high as 0.8900 this morning as the USD continued to rise.
- USDJPY is relatively unchanged on the week. The pair has a quiet week trading between 102.60 and 101.80 with a few big bumps on the way. We are coming to the end of the Japanese trading week and seeing the USD at about 102.40 still.
- The Aussie has started to climb again; the heavily oversold currency has seen a little appetite throughout the week and has very steadily moved from 0.9050 to peak at 0.9300 this morning, even though we are a little weaker at 0.9270 now. The Aussie for the week has disregarded the USD strength.
- Cable weakness was seen only on Monday and Tuesday of this week, marking time and touching as low as 1.6460. This was short lived as the Pound rallied hard to 1.6650 by yesterday. To give back a small amount this morning to be trading at 1.6630 as we are writing. Again the USD strength was shrugged off this week and the Pound moved back towards its recent highs – the BOE seem stumped as to the relative strength of the Pound as savings have dropped there are downward revisions to the GDP data and both fiscal and current account deficits showing a gap of about 5%.
- The RUB has strengthened throughout the week, especially in light of the fact that the media is no longer focusing on the one man with his pistol firing it in the air. The situation is still tense with Political wranglings being thrown about by the world powers, but for the currency the storm in a vodka shot-glass is over for the moment…. Until they shout naszdrovje and we jump back on the merry-go-round.
- The BRL deserves its own mention this week as the BRL has had the largest weekly move this year. The BRL rallied sending the USD lower from 2.33 to as low as 2.25, a high not seen since last October. The Bovespa rallied 4.8% as well this week, so Brazil is centre stage again.

Fixed Income

- The US 10Yr yield slowly traded lower throughout the week as the US Government debt was bought up. The move saw the yield tick lower from 2.78% on Monday to hit 2.66% by yesterday evening higher on Wednesday moving from 2.66% to peak at 2.78%. The bonds have weakened a little this morning to trade to 2.69%, but really this is just in the middle of the 2.5% to 3% band that we have been following, so we count it as a short term move and no ground shaking development quite yet for the long term.

- The German Bund saw the bonds being bought up reasonably aggressively throughout the week with the yield never bouncing upwards at all. The trend has been down for the yields continuously and has moved from 1.67% to as low as 1.51% this morning… If the bond market is leading the equities, will we see further weakness to come?
- Spanish moved lower from 3.37% to as low as 3.20% this morning, mirroring the move lower in yields that the Bund saw. In fact the drop was the same Bps drop in yields so the spread has remained stable at 169 Bps for the week.
- Italy’s 10Yr yields moved in lockstep with the German bund, with both dropping about 17 Bps. The spread of the Italian over the Bund remains fairly well anchored at about 175Bps. They moved from 3.44% on Monday to as low as 3.26% this morning.
- The UK 10 year opened the week at 2.77%, dropping rather dramatically to as low as 2.68% on Monday as CPI rose as did RPI. By this morning the yield had slipped lower and had touched 2.66%, but has bounced higher to 2.70%.

Equities

- Developed equities were about flat for the week – as of yesterday’s close – as measured by the MSCI World index. Global shares declined as positive economic signals from the United States were undermined by concerns about the crisis in Ukraine.
- The EuroStoxx rallied by 1.83% for the week, over possible additional stimulus measures by the European Central Bank and Consumer sentiment in Germany remaining at a seven-year high. ECB governing council member and Bundesbank chief Jens Weidman said Tuesday that a negative deposit rate could be an appropriate way to address the impact of strong gains in the euro.
- The S&P 500 dropped by 0.94% as of yesterday’s close. US shares declined as President Barack Obama said international order was being tested by Russia’s annexation of Ukrainian territory, offsetting the supporting effect of stronger US growth data.
- Meanwhile, the Nikkei surged by 2.80% as of yesterday’s close. Japanese shares soared, bouncing off from a six-week low on the back of a recovery in risk appetite, with market players citing reinvestment by large public pension funds and short-covering in futures as factors behind this sharp reversal.
- In terms of sectors, Consumer Staples and Energy stocks were the best performers (+1.39% and +1.31% respectively), while Consumer Discretionary and Information Technology lagged (-1.08% and -0.96% respectively).

Emerging Markets

- Emerging Market equities surged by 3.21% for the week – as of yesterday’s close – as measured by the MSCI EM index. Latin American shares gained the most (+5.06%) followed by EM Europe (+3.50%) and Asia (+2.48%).
- The Shanghai Composite lost 0.29% for the week. Chinese stocks dropped after industrial profit growth slowed and benchmark money-market rates jumped. Industrial profits rose 9.4% in the first two months of the year, decelerating from 12.2% growth in December. The Chinese benchmark declined by 3.5% so far this year, amid concerns a slowing economy will curb profits and the restart of initial public offerings will divert funds.

- The Bovespa rose by as much as 4.78% for the week, but rose 10% in the last 2 weeks! Brazilian shares gained on further prospects that president Dilma Rousseff will not be re-elected in October, fuelling investor optimism that the nation's economic policies could take a market-friendly turn. Rousseff approval drop (confirmed in a poll released on Thursday), supported equity prices of state-controlled firms, as the current administration is viewed to have been too involved in large companies' businesses, with decisions harming their profitability as well as minority shareholders' interests.

Commodities

- Commodities gained 1.32% for the week, as measured by the S&P GSCI Total Return index. Agriculture and Energy gained the most (+2.45% and +1.39% respectively), while precious metals lost 3.07%.
- Gold slumped by 3.20% for the week, and is currently trading around $1'295 per troy ounce. The precious fell for a second week as the Fed suggested that QE may end by the end of the year and a rise in interest rates might be on the cards soon after. In addition, some losses were attributed to a rise in the dollar, following better than expected economic data.
- Crude oil gained 2.30% for the week and is currently trading around $10.75 a barrel. WTI crude is set for a second weekly gain amid shrinking stockpiles at the US oil storage hub in Cushing. In addition, Brent was also supported this week as Libyan supply disruptions continued.
