Bedrock Newsletter

Friday, March 11th 2011

If it is not one thing, it is always something. Our mothers were right! Yesterday we thought that the “something” was a titbit of news out of Saudi Arabia about police shooting at rioters, giving some bad flavour to today’s “Day of Rage” demonstrations. Or was yesterday’s discomfort based on disappointing data from China and the US? Or was it the downgrade of Spanish debt by Moody’s? Whatever, we woke up today to the new “Something”, a huge earthquake and tsunami in Japan. Thankfully, tomorrow is the Sabbath… How do we interpret all this? The information is what it is and we need to consider the question to be asked here. The destruction in Japan might be bad, but is this detrimental to the market or is it constructive? Wealth has clearly been destroyed, but then, the rebuilding will create work, values and profits somewhere in the system (Larry Summers just said that this may produce a short-term GDP upswing!). Do we buy? Do we sell? A man once asked his priest if he may smoke when praying. Clearly not, was the answer. Then he asked if he could pray whilst he smoked, to which he was told that prayer is always good! What should we be asking then? The answer will clearly be set by the question itself…

We are trying to establish a view, looking through the fog of ups and downs, through the details of each news story and the noise pollution poured over it all by the media. We observe the following “big picture”: Since the beginning of 2011 we have endured the ongoing and as yet unresolved European finances debacle, the breakdown of Middle Eastern politics, Somali bandits, Chinese slowdown, Global Warming and a cold, snowy winter. And yet, after a bad day (week?) in equity markets, we are basically where we started the year. Some Emerging Markets have been raising interest rates to combat their local inflation, here in Europe the ECB has been rattling its interest rate sabres and yet, interest rates are barely changed year to-date.
Gold you say? Well, surprise! It is trading today off $7.00 of its year-end closing of $1’414/Oz.! Oil? The centre of our worries, moved from $92 at year-end to trade today at $101, in the face of Libya and Saudi unrest. Even the highly volatile and often times “accused of being overvalued” emerging markets have been remarkably stable; the ETF tracking them as a class [EEM] is now at $46 having closed 2010 at $48. Currencies also have been surprisingly stable: The US$/Euro moved from 1.34 to 1.38, the almighty Swiss Franc is exactly where it was on December 31st. Why and how come so stable? We can try and explain this extraordinary resilience with the power of a global economic expansion which must be more powerful than even the most optimists among us dare hint at. Yes, the world is healing. It clearly will be a different place than the one that crashed on us in 2008, probably better balanced and therefore more stable into the future. Yes, we like the future.
We keep our equities, we remain light on G7 sovereign debt, we own corporate paper and hold our faith in the collective wisdom of hedge fund managers, perhaps a little less orthodox now, as they have been slow to regain confidence.

Have a good, non-shaken weekend!

Currencies

- This week was all about a broad risk-off move, as the "re-emergence" of euro-zone debt worries, reports of violence in Saudi Arabia and recent news of a dramatic earthquake in Japan all led to a drive for safe haven assets. Chinese trade data also added to market risk aversion, as China posted a $7.3 billion trade deficit in February, its first since March of last year, which spurred worries that global markets could see a slowdown in Chinese demand.
- The major beneficiary of the risk off move was the US Dollar. The Dollar Index, which tracks the greenback against the currencies of its six major developed trading partners, gained roughly 1% for the week.
- Another gainer for the week was the Japanese Yen, which strengthened versus most of its major counterparts. The massive earthquake which hit Japan on Friday morning drove a temporary move down, but it has already been fully reversed! Indeed, the Japanese Yen went from 115.13 in the beginning of the week to 114.5 versus the Euro, only to go back down to 115 on the earthquake news. However, it has since strengthened dramatically and is currently at 113.42 versus the European currency!
- Declines in the Euro accelerated on Thursday after Moody's cut Spain's credit rating to Aa2 and said its outlook is negative. Speculation that European Union leaders meeting today will struggle to agree on measures to combat the region's debt crisis and weaker than expected trade data from Germany also added to downward pressures. The Euro dropped from 1.40 versus the Dollar in the beginning of the week and is now at 1.383.
- The Euro could remain under pressure if as expected no clear plan emerges from today's meeting and growing tensions in Saudi Arabia might add to pressure.
- The British Pound also declined this week, broadly in unison with the Euro, as the Bank of England kept its key interest rate unchanged this week. The British Pound declined from $1.627 in the beginning of the week to $1.603 currently. It is largely flat against the Euro for the week.
- With the move away from risk positive assets, commodity linked currencies dropped sharply versus the US Dollar, with the Australian Dollar, Norwegian Krone and New Zealand Dollar all seeing large declines. The New Zealand Dollar was close to the weakest level in five months after its central bank cut its benchmark rate to help the economy recover from their own deadly earthquake.

Fixed Income

- Government bonds rallied this week as stocks tumbled, Moody's Investors Service cut Spain's credit rating, China's export growth slowed, and reports indicated Saudi police fired on protesters. A jump in weekly unemployment claims only added to the growing list of concerns.
- The yields on 2yr, 10yr and 30yr US Treasuries all dropped by roughly 10 basis points this week to 0.613%, 3.342% and 4.49% respectively. With the broad risk-off rally, a US 30 year bond sale drew the highest demand since the long bond was reintroduced in 2006…
- Whilst this week saw strong interest in US government bonds, it emerged that Bill Gross, the manager of the world's largest bond fund, had dumped all of his US government related holdings… Well, only in the PIMCO Total Return Fund…

- Meanwhile, Greece and Spain's credit ratings were both downgraded this week and the cost to insure sovereign debt in the euro zone's peripheral countries also went up with CDS spreads widening for Spain, Portugal, Ireland and Greece.
- Greek 10-year bond yields rose to a record this week and it costs more than ever to insure against a default. 2yr yields exceed 10yr levels, suggesting a restructuring may come before the three-year aid program expires.
- With appetite for risk declining sharply, high yield bonds dropped this week, but investment grade corporate bonds appreciated.
- Despite the many negatives in markets, we remain keen on higher yielding bonds, and stay away from government and emerging markets sovereign bonds (the former appear expensive and the latter have increased credit risk). 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 dropped sharply this week, with the MSCI World down close to 2.5% as of yesterday's close. Growing Middle East tensions, renewed European sovereign debt concerns, disappointing economic data from China and the US, and a massive earthquake in Japan all made investors sell risk assets.
- The S&P 500 is down 2% for the week, with the increase in jobless claims and a wider American trade deficit adding to the pessimistic mood. European stock markets did even worst, with the re-emergence of sovereign debt issues adding pressure on continental bourses.
- This week's sharp losses have actually brought some indices into the red for the year to date. Indeed, the Stoxx Europe 600 index has tumbled 5.4% since reaching a 2 ½ year high on February 17th, bringing its 2011 ytd performance to -0.1%....
- Japanese stocks also saw sharp losses, compounded by this morning's earthquake. The Nikkei 225 is down 4.1% for the week, and is now flat for the year.
- Cyclical sectors were the worst performers this week, suffering from the sharp increase in risk aversion. The energy and materials sectors are down over 5% for the week as commodities slumped, while information technology is down 3.3%.
- Conversely, defensive sectors outperformed, with consumer staples, telecoms and utilities only marginally negative for the week.
- Our long term view on equities remains constructive in general, but we are very cautious for the near term given the many negative headlines in the markets.

Emerging Markets

- EM equity markets also dropped this week, but by slightly less than their developed counterparts. The MSCI EM Index is down 2% for the week compared to a decline of 2.6% for the MSCI World index.
- Chinese stocks were amongst the best performers this week, with the Shanghai SE composite index only marginally down for the week. Economic data this week in China was mixed, with higher than expected inflation albeit with some signs of a deceleration offset by better than expected industrial production. Brazilian equities also did better than most.

- Interestingly, despite growing tensions in the region, Middle Eastern stock markets were some of the best performers this week! The Saudi Arabian Tadawul All Share Index was up 15% this week. It is however down over 7% for the year.
- Meanwhile, Asian and Latin American currencies are headed for a weekly decline, led by South Korea's won and the Philippine peso in Asia and by the Chilean Peso in Latam, as signs the global economic recovery may be slowing sapped demand for emerging-market assets.
- Separately, the yield on Brazilian interest rate futures contracts tumbled by 20 basis points, the most in 20 months, after policy makers said they expect inflation to slow by the end of the year.

Commodities

- Commodities dropped this week on higher risk aversion. The S&P GSCI index is down 2.3% for the week. Energy and precious metals were the best performers, down roughly 1% for the week, while agriculture and industrial metals were down 6% and 5.4% respectively.
- Energy prices were range bound in the first part of the week but have tumbled since Thursday. Crude oil prices went from $104.4 per barrel at the beginning of the week to $99.6 currently.
- Agricultural commodities dropped significantly this week, as global inventories are now forecasted to more plentiful than previously expected. Wheat is down by more than 13% for the week, while rice and corn are also down around 10% for the week.
- We believe that the current environment will continue to be supportive for commodities in the medium term as supply and demand fundamentals continue to be in focus but are cautious as to the short term increase in risk aversion.

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