Bedrock Newsletter

Friday, March 18th 2011

The week's information was swamped by images of the Japanese disaster and impending nuclear meltdown. Libyan and other insurgencies were set aside, so dramatic were the images out of Japan. The unthinkable- Israeli naval vessels commandeered a boat in international waters, carrying arms and the story didn't reach the media and the act was not unanimously condemned. Perfect timing or, further evidence that CNN is running the world?
Well, overnight the Japanese nuclear risk appeared to be controlled and the financial world is breathing upwards. The G7 agreed on concerted efforts to stem the rise of the Yen and the UN decided to intervene in Libya where the insurgency appears to be hurt by Qaddafi's forces.
Stock markets globally have been tracking the temperatures inside the Japanese reactor, falling as these rose. Actually, on Wednesday all the major indices had fallen far enough to eliminate all of 2011 gains, only to rebound Thursday and into Friday. Oil has been dropping all week as investor attentions were diverted from the Middle East turbulence, only to rebound Thursday on Libya and Abu Dhabi news. Let's stand back and consider. China has put its nuclear program on hold pending review. The US is re-visiting the question. GE stock as other purveyors of nuclear wears are hurting, and logically, if the market believes that nuclear will be reduced, oil MUST go up as the sole viable alternative in the short-run. Sure, solar and wind alternatives will ride the wave and will rise. Or collapse if and when the Japanese reactor will cool down and come back on-line…
The equity markets fall-back is explained as a "risk-off" move by investors, a view corroborated by a rise in safe haven bonds and Swiss Francs. Or is it simply the long awaited "correction" after a 6 month-long rally? Probably the latter triggered by the former. In reality, the resilience of equities in the face of the Middle Eastern crisis, high and rising oil prices and the yet undefined effects of the Japanese disaster is absolutely astonishing. We would argue that there is clearly a very powerful and broad-based global economic motor at work here. Some would argue that the Japanese event will delay all Central Banks tightening intents and that interest rates in Europe and the US will likely remain as they are, for quite some time to come.
We did see some rather high inflation data out of the US between the reports on Japan. The Fed has succeeded in averting deflation it seems- we should rejoice! This rise in CPI and PPI should keep our monies out of long dated bonds and further direct our sights on equities! Some analysts are of the view that the Fed should not exit QE (II) and even plan to follow-up with QE (III) to offset the Japanese event.
We stay with equities and hold back on bonds. Commodities? Well, we remain constructive on energy as with economic growth continuing and political unrest persisting in the Middle East, we can hardly turn bearish on the black stuff. Other commodities? Well, the rebuilding of Japan will happen and steel, copper and other materials will be in demand. Food stuff commodities? Battered a little this week as risk-off trades took profits where they were found. Probably a temporary set-back on a long-term up-trend.

We end this letter with a thought on Black Swans and other birds- So many of these Swans they no longer are a cause for fear. But watch out for the Pink Dodos!

Have a good weekend.

Currencies

- This week was all about the move in the JPY. As market participants were worried about the impact of repatriation funds(and by the way, we do not subscribe to this view), the JPY rose and broke the all time low to the USD on Wednesday night after the close of NY at 79.80. Massive stops were triggered and in a matter of minutes the USDJPY pair collapsed to 76.60 (a 4% move!) before rebounding a bit and stabilize in the 78.50-79.50 range. Then, on Thursday, the G7 convened and agreed to intervene to stop this dramatic rise in the JPY, as it would only compound the damaging effects of the terrible events that hit Japan and its economy.
- It should be noted that this FX intervention is the first one to take place on a coordinated basis (i.e., all G7 Central banks participated) since the year 2000 when they collectively intervened to stem the EUR's decline 8 at the time, the EUR was trading at 0.82 to the USD...) this also marks the return of US action, the first after the longest period of inaction since the 70's.
- What we infer from that is that the 80 level should be considered as the line in the sand that should not be crossed, and it should be! We absolutely believe that Japan needs a sharply weaker JPY in the coming months in order to get passed this massive economic shock.
- The BOJ said this morning that there" would be no limit on size of FX intervention", a sign that they are to be taken seriously.
- Following this intervention, the JPY weakened from 79 to 81.80, a move of 3.5%.
- As intervention was also conducted in the EURJPY pair, the effect on the EURUSD was to take that pair higher from 1.3980 to 1.41. We remain very surprised at the resiliency of the EUR, especially on the face of continuous problems in the periphery Euro Zone countries and on mounting risk aversion. In our view, the strength of the EUR should not last.
- The Swiss Franc was also the big performer of the week as the EURCHF collapsed to the 1.25 level after starting the week at 1.2950 and dropping to record lows against the USD at 0.8920 during the JPY panic move on Wednesday. It has since given back some of these huge gains and currently stands at 1.2720 and 0.9030. The CHF is definitely too strong but given all the anxiety surrounding Japan and the events in the Middle East at large, the CHF finds it very difficult to weaken.

Fixed Income

- Government bonds rallied more this week as the Japanese situation evolved and stocks tumbled. Investors scrambled to the safe haven status of US treasuries as well as other Government bonds, including Japan's, as the BOJ flooded the market with massive liquidity injections.
- The yields on 2yr, 10yr and 30yr US Treasuries all dropped this week to 0.58%, 3.24% and 4.42% respectively.
- In Japan, Five-year dollar-denominated sovereign CDS widened to 140 basis points, compared with 77.5 on March 10, the day before the quake.
- The Bank of Japan injected more than 200 Bio USD in liquidity since Monday, in order to stabilize the financial markets., 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.
- In the Middle East, CDS protection on Saudi Arabia, as well as on Bahrain, also rose this week following the events there, to 137 and 355 respectively.
- CDS protection costs also increased this week for Greece, Italy, Ireland Portugal and Spain, a sign that the Euro zone debt crisis is far from abating and should regain steam in the next few months.

Equities

- Global stock markets dropped sharply this week, with the major indices losing close to 5% before rebounding somewhat yesterday and today, thereby reducing the losses.
- Of course, the deep worries concerning Japan's nuclear reactors were at the forefront of the loss of confidence, and Japan was the largest hit with a combined loss of 16% on the 2 days after the quake. This 16% 2 day loss was the largest since the records began in 1949!
- On Tuesday, Japan started to rebound after the BOJ took steps to stabilize the financial markets. The Nikkei 225 rebounded and finished the week at 9200, a loss of 12% since the earthquake happened.
- Should the situation regarding the Nuclear reactors stabilize for the better, we expect the markets to restart going up, as Japan and other government around the world will continue to provide ample liquidity to the markets for a long time.

Emerging Markets

- EM equity markets also dropped this week, following closely all the events in Japan.
- China just announced that it will raise the Banks' reserve requirements, the third hike this year, as inflationary pressures remain in the spotlight.
- The PBOC raised the reserve requirement ratio six times last year, and benchmark lending and deposit rates three times since October. The previous reserve ratio hike took effect Feb. 24.

- China's official reserve requirement ratio for most banks will be 20% after the latest hike takes effect.
- Meanwhile, Asian and Latin American currencies are headed for a weekly decline, as tensions in the market drives flows out of the Emerging market space.
- The BRL slid from 1.6500 to 1.6800 to the US$ while the CNY remained stable at 6.5700 to the US$.

Commodities

- Commodities dropped at first this week on higher risk aversion, and declining markets. Heavy liquidation occurred in all commodity markets with precious metals and agriculture leading the decline.
- Energy prices dropped also, although we believe that following the Japanese nuclear events, Oil and Gas will more than ever before be in demand as countries around the world reassess their nuclear energy plans.
- Oil dropped to 97$ before rebounding to 103$ following the rebound in equities and the UN agreement on a no-fly zone over Libya.
- We believe that continued tensions on Libya and in the Middle East in general will continue to put a floor under oil prices as will higher energy demand due to Japan events.
- Gold dropped to $1385 on panic selling and liquidation before rebounding today to $1'420. We still believe that Gold prices will not go much higher current levels for the time being.
- Agricultural commodities dropped significantly in the first part of the week, only to rebound sharply yesterday and today on higher equity markets and a feeling that the worst has been averted in Japan.
- We believe that Commodities in general will continue to be in demand as supply–demand forces are not in equilibrium, and especially so in the Energy space.
- We also think that non precious metals will continue to rise due to the high demand that will emanate now from Japan for all the reconstruction effort.
- We have reduced our allocation to agriculture due to the sharp increases that happened in the last few months and we have repositioned the proceeds into energy and industrial metals.

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