Bedrock Newsletter

Friday, March 25th 2011

At one point on Wednesday, the news flow was so intense that TV and Radio commentators did not know with which subject to start. The Nuclear reactor fallout in Japan? New tensions surrounding Irish and Portuguese Debt? The Coalition Bombing Campaign in Libya? The emerging revolt in Syria with its bloody repression? Or the first terrorist attack in a very long time in Jerusalem? And yet, on the face of all this, markets kept on climbing as did commodities in general.

Honestly, we would never have thought this would be possible if someone would have told us that this would happen 3 months ago.

In Europe, Portugal has just seen its Prime Minister resign as he could not pass the tough measures needed to cut its deficit and mounting debt. Irish 10 Year Yields hit a new record high at 9.8%, breaking the highs of last November at the height of the crisis.

What is happening to Portugal and Ireland has all the hallmarks of something that might start to get ugly. It is pretty sure that Ireland does not have the ability to meet its obligations. On top of that, as the year started there was pretty much market consensus that the dynamics in Europe would deteriorate and that EURUSD would head towards parity. As it happened things stabilised and the EUR caught the market by surprise rallying to the recent high at 1.4250

Now as the cracks are appearing and the ECB may be set to revisit the policy move of July 2008 (when it tightened policy just before the Lehman crisis happened), absolutely everyone loves the Euro.

Indeed a very strange world....

So again, we ask the question, are the markets able to digest all this and keep on rising? Or are we living in “lala land” and the payback that will ensue will be very harsh?

We believe that as long as short term interest rates remain low and liquidity provided by the Central Banks remain abundant, markets will keep on rising or at least will not drop much from current levels.

We still have the US Fed, the Bank of Japan, the Bank of England and the ECB that are sticking with ultra low rates, and we do not foresee an imminent rate rise anywhere, even in Europe (or it will be a mistake...)

The economic data around the world remains friendly and the US recovery is gaining steam (apart from the housing sector).

Oil prices will keep on rising, maybe to $120 per barrel of oil (WTI) and Base metals will continue to be in high demand due to the massive reconstruction that will happen in Japan, this on top of an already booming demand from India, China and Brazil.

So, in conclusion, yes we do face tremendous challenges ahead, both on the economic and geopolitical front, but in the same time, we (still) have good growth emanating from the Emerging space as well as from the US. We will start to get really worried if Oil keeps on rising to $120.

Then, definitely, we will see a slowdown as this is a further tax on the economy.

Meanwhile, enjoy the (finally) coming spring and sun.

Currencies

- The US Dollar, Euro and Japanese Yen traded back and forth this week on mixed news. The Japanese nuclear situation remains extremely problematic but the worst seems to have been averted while the Middle East remains a hotbed of instability. US economic data was mixed, with better expected Q4 growth data and a decline in jobless claims challenged by an unexpected drop in orders for long lasting goods. Meanwhile, the Euro area crisis worsened and higher inflation and expected policy response added another twist!
- The Euro was very slightly under pressure as speculation swirled that Portugal will be the next victim of the debt crisis. The problems were compounded as European Union leaders cut the start-up capital for the future euro emergency aid mechanism, bowing to German demands. The Euro dropped from a high of 1.4250 to a low of 1.405 on Thursday against the Dollar. It has recovered to 1.415 currently as market participants anticipate that the ECB will soon raise its benchmark rate on rising inflation.
- The Japanese Yen was lower versus the US Dollar and slightly lower versus the Euro, although price activity was choppy during the week. The Yen is at 81.20 versus the US Dollar and at 115 against the Euro.
- The British Pound was one of the major losers this week, slumping to the weakest level versus the Euro since November as UK retail sales dropped in February by more than expected. The Pound Sterling dropped from 0.8650 at the beginning of the week to 0.88 currently versus the Euro, and from 1.6400 to 1.6070 currently against the US Dollar.
- The Swiss Franc also dropped this week, from 0.90 at the beginning of the week to 0.915 currently against the Dollar and from 1.275 to 1.294 currently against the Euro. This move is welcomed given the amazing strength seen in the Swiss Franc over the last few weeks and we expect the Swiss Franc to remain weak.
- Higher yielding currencies, such as the Australian and New Zealand Dollars were the major gainers this week as stock markets rose worldwide and sentiment improved sharply. The New Zealand currency also benefited as its central bank governor said the nation’s economy will get a boost next year from a very big construction boom after earthquakes struck at Christchurch.

Fixed Income

- Government bonds are headed for their steepest weekly loss in almost two months as stock markets gained around the world, eroding the demand for the safety of government debt and on inflationary concerns.
- Yields on 10 yr US Treasuries rose by 14bps this week to 3.4% and on the 2 yr bond by 11bps to .695%. German, French and UK government securities saw similar moves.
- Meanwhile, the European debt crisis intensified as Portugal was downgraded and is said to require as much as $99 Billion to be bailed out by the European Union. However, there is uncertainty as to how much the EU will commit, as the EU has just decided to cut start-up capital for future euro emergency aid… Ireland was also in the news as it was discussed to lower the rate charged on its debt to ease its burden.
- Consequently, the yields on Irish and Portuguese bonds shot up and the cost of insuring against default also increased.
- Meanwhile, high yield securities outperformed investment grade credit this week as sentiment improved sharply. The iBoxx liquid high yield index is up 0.5% for the week while the

investment grade equivalent is down by 0.45%. Separately, the cost of protecting corporate bonds in the US from default declined this week significantly as first time jobless claims fell.

Equities

- Global stock markets rebounded sharply this week on encouraging earnings and some positive economic data. The MSCI World index is up 2.9% for the week to yesterday's close and many stock markets are on heading for the largest weekly gain since September of last year.
- Japanese stocks rose, driving the Topix index to its biggest weekly gain since July, on the outlook for orders to rebuild following the country's worst earthquake, and after a US report showed falling unemployment claims. It also emerged that foreign investors bought a record amount of Japanese stocks last week after the nation's equities markets tumbled in the wake of the March 11 earthquake and resulting nuclear accident.
- European stock markets outperformed American stock markets this week, with the Euro Stoxx 50 up close to 4.5% as we write this while the Dow Jones Industrial average is up 2.6% as of yesterday's close. A plus for European stocks was the sense that some sort of resolution may be coming for the Euro zone debt crisis.
- Cyclical sectors outperformed more defensive one this week on the much higher appetite for risk. The best performing sectors this week were those that may benefit from the rebuilding efforts in Japan such as construction, engineering and material companies. Information technology also outperformed on strong corporate earnings and positive outlook.
- On the flipside, defensive sectors such as health care and consumer staples lagged this week.

Emerging Markets

- EM equity markets were also sharply up this week, outperforming their developed counterparts. The MSCI EM index is up 3.3% versus 2.9% for the MSCI World index.
- Asian stocks rose, set for the biggest weekly gain since November, as construction firms gained on optimism for orders when Japan rebuilds after its worst earthquake, and amid signs the US economy is strengthening.
- Brazil lagged this week, with the Bovespa up by 1% on mixed earnings and as a report showed that unemployment had risen in February. Meanwhile, the Brazilian Real rose against the US Dollar from 1.675 to 1.66…
- Asian currencies also appreciated on the back of higher appetite for risk.

Commodities

- Commodities appreciated this week with the GSCI broad commodity index up by 2.4% for the week.
- Energy commodities saw the biggest gains, with the GSCI energy index up 2.7%. WTI crude oil rose from $101.8 per barrel to $105.6 currently. Interestingly, moves on Brent crude oil were much more muted, going from $113.9 at the beginning of the week to $115.6 currently. Oil prices moved higher on the continued fighting in Libya and growing unrest in other countries in the Middle East.

- Despite all that is going on in the world and in the Middle East, the move on Brent crude oil futures during the week was one of the tightest weekly ranges since 2006!
- Precious metals were also strong performers this week, benefiting from the growing tensions in the Middle East. Gold reached a record high of $1447.8 per ounce, but then came down to $1433.7 currently. Silver is hovering around its 31 year high…
- Industrial metals were up by around 2.25% this week, as measured by the corresponding GSCI index, as these are likely to see higher demand as Japan begins rebuilding parts of the country impacted by the earthquake and tsunami.
- Agricultural commodities were mixed, with the GSCI agriculture index up around 1.5% for the week. The big gainer in soft commodities was wheat, which advanced sharply on unexpected demand for US exports from China and on concern that the dry weather in the US Great Plains may hurt crops.
- 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.
