Bedrock Newsletter

Friday, April 1st 2011

At last a quiet week! The Japanese reactors didn't melt-down although some fish are rumoured to glow in the dark, no new earthquakes and even the Arab Revolution has faded somewhat. Things are going on in Syria, Yemen and Libya. But all have been moved aside whilst our attention is now focussed on a new and exciting scandal- Did David Sokol (the rumoured successor) engage in financial shenanigans behind Warren's back?
Equity markets like stability and this week gave us a Q1 close on the upside. Bond markets seem to feel that they are coming-up to a moment of truth. The ECB is expected to commence raising rates soon and even the US Federal Reserve is emitting similar noises. It is the fear of inflation that is driving these concerns. But will higher short-term interest rates lower the price of oil? We say that indeed it is possible if not likely that central banks will raise rates slightly, just to mark their territory. It is highly unlikely that the Fed which has a dual mandate of inflation and employment will stray from the latter with unemployment at 9% or so. Yes, short rates may rise some, not by much if at all is our guess. Bond markets? Well they will clearly be rattled but then, is 3.5% a fair 10 year rate when inflation is at 2% or so? Seems about right so the fear of a big hit here is probably overblown. Perhaps we should seek returns away from the Bond markets? Confucius is rumoured to have said "Squirrel who runs up woman's leg will not find nuts…"

We are soon to see Q1 results and expect that these will show "better than expected" data. Equity markets are likely to pursue they upwardly grind and we would suggest to the Chinese squirrel to seek more of its rewards here rather than in bonds. We are comfortable suggesting a further portfolio re-allocation away from bonds towards equities.
The Japanese disaster will no doubt hurt the global GDP in early Q2 but then, the reconstruction of Japan may well return this loss with net overall growth contribution.
The Arab world turmoil clearly hasn't gone away and we can expect further volatility in the oil sector. This will be further affected with the political fallout from the nuclear scare we just experienced in Japan. If China were to back away from Nuclear energy, where will oil prices go? We are comfortable with the energy sector as there is little which could reverse the upwards pressures on oil prices.

Housing is still a wreck and shows no signs of coming back anytime soon. The effects are multiple- A major component of GDP is in a deep freeze, demand for mortgages is low (so some pressure off longer rates); Yet another reason to seek growth away from the main industrialized markets. Emerging markets are hardly emerging anymore and may disappoint in having somewhat slower growth into the foreseeable future. Maybe not perfect, but probably the best available!
Currencies remain stable.

Going into the first weekend of Q2, remember that Man who wants pretty nurse must be... patient…

Currencies

- The Euro gained this week versus the US Dollar, from 1.4090 at the beginning of the week to a high of 1.4230 after the euro-region's inflation unexpectedly accelerated in March, comforting the ECB's case to raise interest rates next week. The rise in the Euro occurred even as the sovereign debt problems continued to increase in Europe's periphery, and with the unravelling of the merger of four Spanish cajas (savings banks) adding to worries over hidden risks in Spain's financial systems and as it increasingly looks like Ireland will nationalize all of its banks.
- The sovereign debt issues put only some very very mild pressure on the Euro towards the end of the week. Separately, positive employment data and increasing rhetoric from certain Fed officials over the possibility of higher interest rates and/or a reduction in the reduction of the Fed's quantitative easing program added some swagger to the US Dollar. Consequently, the Euro has given back some of its earlier gains for the week and is now trading at 1.4150 versus the US Dollar.
- As risk is being put back on, the Euro is benefiting as the market looks forward to interest rate expectations. However, we find the strength in the Euro unsustainable given the many issues in the region and expect it to weaken against the US Dollar over the next few months.
- Meanwhile, the British Pound continued to drop against the Euro, dropping to 0.8830 currently from 0.8740 at the beginning of the week as UK banks reported an unexpected increase in mortgage defaults, increasing speculation that the Bank of England will delay a rate rise. Uk's just published March PMI was also on the soft side as it was the lowest print in 6 months.
- The Swiss Franc also continued to drop versus the Euro, and is now at 1.3055 from 1.2900 at the beginning of the week. It is however flat versus the US Dollar for the week, having traded back and forth.
- The Japanese Yen finally dropped this week versus all of its major counterparts, as signs that Japan has no other choice but to continue with very easy monetary policies. The Japanese Yen traded down to 83.85 currently from 81.35 at the beginning of the week against the US Dollar and to 118.60 from 114.60 versus the Euro.
- The Japanese Yen seems finally to be reflecting fundamentals, and we expect it to weaken further versus the US Dollar.
- Higher yielding currencies, such as the Australian and New Zealand Dollars, continued to advance this week on improving signs in the global economy. The Australian Dollar for example rose to 1.0345 versus the US Dollar, this week, an all time high since it was freely traded in 1983.

Fixed Income

- Government bonds are headed for a second consecutive weekly loss, on better global economic data around the world and a much improved investor sentiment.
- Yields on 2 yr US treasuries increased by 12 bps this week, to 0.85% and 10 yr notes yields rose by 4 bps to 3.48%. US government bonds were sold on better employment data but also as speculation increases that the Fed will end its bond buying program as scheduled in June, and thus the Fed will no longer be there as buyer of last resort for much longer.

- Yields on European government bonds also rose, with the yield on 10 year bunds rising by 11bps this week to 3.38%, on better manufacturing data and on growing speculation that the ECB will increase interest rates soon.
- Meanwhile, the European sovereign debt issues augmented with a failed merger in Spain between four savings banks adding to worries over Spain's financial system, growing concern that Portugal may need a bailout to avoid default, and Ireland increasingly seeming on track to nationalize its entire banking system. Yields on short term bonds for each of these countries rose to historical levels, and the cost of insuring against default also increased sharply…
- Credit markets were muted this week, with corporate investment grade bonds marginally negative while high yield securities were marginally positive. We remain positive on higher yielding securities given better risk/reward proposition and do not recommend investment grade securities as the headiest days of these securities more than two year run are long past.
- It is Interesting to note that subprime bonds have doubled from 30 cents on the dollar at the low point of the crisis to roughly 60 cents today, a sign that credit markets are healing.

Equities

- Global stock markets are headed for a second consecutive weekly gain, with the MSCI up 0.7% for the week, ending the first quarter of 2011 with a hefty 4.3% gain, on growing optimism that the recovery from the financial crisis has become self sustaining. However, given the dramatic events that occurred over the last three months, this performance is quite amazing…
- US stock markets outperformed European ones this week on the back of strong economic data, especially on employment. The S&P500 is up 1.2% for the week, versus the Euro Stoxx 50 index which us up 0.7% as we write this.
- US stock markets have also outperformed European ones for the quarter. The Dow Jones Industrial index was up 6.4% in Q1, its best first quarter in 12 years, despite the tumultuous period!
- Japanese stocks this week performed well, rising by 1.8% as the nuclear situation following the dramatic earthquake and tsunami is easing somewhat. Still, for the quarter Japanese stocks are the worst performers, with the Nikkei down by more than 5%, not surprisingly so.
- Cyclical sectors continued to perform well this week, with the materials, industrials and energy sectors outperforming broad markets. These sectors are benefiting from the improved global growth picture as well as from the probably re-building effort that will occur in Japan.
- The telecom sector was also a strong performer this week, as the whole sector was provided a boost following news that AT&T is planning to purchase T-Mobile, while healthcare also performed well this week.
- Consumer related sectors lagged however this week, while the worst performing sector was the financials. European financials are under pressure from growing sovereign debt issues in the region.
- Meanwhile, equity market volatility remained extremely low this week, with the Vix index well below the 20 level.
- We remain positive on equities overall, as better economic environment, reasonable valuations and strong M&A activity should continue to support equity prices.

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Emerging Markets

- Emerging markets equities outperformed developed markets this week and this month, with the MSCI EM Index up 2.35% for the week and 5.7% for the month (!!!) versus 0.7% and -1.24% for the MSCI World index respectively for these periods. However, the EM index is lagging for the year to date, being up 1.7% for Q1 versus 4.3% for its developed counterpart.
- Asian stock markets performed strongly as growth in China's manufacturing activity eased concern that monetary policy tightening will slow its economic expansion.
- The South Korean won appreciated against all of its 16 major counterparts as the improved outlook for the global economy boosted confidence in the country's assets.
- Bank of China Hong Kong Ltd. cut its interest rate for Chinese Yuan deposits in Hong Kong after money held in the accounts rose to a record in February, reflecting increased demand for trade and investment in the currency.
- The Chinese Yuan gained 4.2 percent in the past year and touched 6.5478 per dollar yesterday, the strongest level since the country unified official and market exchange rates in 1993.

Commodities

- Commodities appreciated this week with the GSCI broad commodity index up by 1.0% for the week.
- Energy commodities saw the biggest gains, with the GSCI energy index up 1.2%. WTI crude oil rose from $105.4 per barrel to $107.1 currently on continued unrest in the Middle East and growing demand from everywhere in the world.
- Precious metals were also strong performers this week, benefiting from the tensions in the Middle East, inflationary concerns and the relative unattractiveness of the US Dollar and of the Euro. Gold grinded higher to $1434.5 per ounce currently while silver advanced to $37.63 currently.
- Agricultural commodities were also up, with the GSCI agriculture index up around 0.8% for the week. The big gainers in soft commodities were wheat and corn, with both seeing sharp increases in price on supply concerns.
- Industrial metals were down on average for the week by 1.5%, on concerns that China will step up monetary tightening following its strong manufacturing data release this week. However, the decline in price in certain industrial materials may just reflect profit taking following a strong run over the last few weeks.

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