Bedrock Newsletter

Friday, April 8th 2011

We just lived a week in the shadow of the never-ending US Budget saga which might cause a shutdown of Government. More debacles around Portugal's finances, some Spanish sauce as well, we almost let the BOE get away with unchanged interest rates and all appeared indifferent to the ECB's dramatic raising in short term interest rates by 0.25% to 1.25%
And then we were surprised by another large seism in Japan.

And yet again, nothing happened to the markets. Are we all complacent or just tired of being shaken around? Neither is probably the correct answer here- the resilience of markets are simply the manifestation of their power under recovery scenarios.

We are expecting Q1 results to come and spice-up our weeks to come and believe that these will confirm the markets' apparent optimism, probably to fuel yet another upwardly stretch.

US 10 year Notes whilst faced with possible budget showdown and other nastiness are holding around the 3.50% yield. Will the Fed follow Trichet and raise rates? Highly unlikely as unlike the ECB, the Fed has a dual mandate of Inflation AND employment. At this time, the burning problem remains employment, not inflation!
Oil? Well, with growth appearing to be well launched, the Arab revolution still simmering around our oil sources, the Japanese nuclear problem which may redirect demand away from hot-rods of radioactive metals, where else will oil go but up? $111/Bbl and rising… Some say $130 is coming soon to a gas station next to you, others say the same thing when prophesying Gold at 1'500. The true unease beneath the surface is the outlook for the US Dollar. The Budget debacle? This is the easy one; they are posturing around the 2011 budget, already six months into it… Democrats and Republicans are arguing more about where to cut rather than how much to cut. The true battle will emerge in the opening rounds of the 2012 budget… The Dollar is looking fragile here, as the US issues start to dwarf the European PIGS… Do take another look at the CNY (Chinese Yuan)! Whilst no-one was looking, it has strengthened to 6.53 to the US$, whilst not dramatic, just another 2% for this year. We would venture that the steady if slow appreciation is set to continue. This and the slow grind-up of equities make us think of sailing into the wind. It is slow, the line is jagged but the direction of progress is maintained.

It is sunny outside, trees are in bloom and our sentiment is positive.

Currencies

- This week in currency markets was all about interest rate expectations, with currencies of countries expected to raise rates soon strong and those of countries expected to keep rates low weak.
- The Euro continued to strengthen this week versus the US Dollar and the Japanese Yen on speculation that the European Central Bank will raise interest rates further after Thursday's increase. The Euro went from 1.4235 at the beginning of the week to 1.4410 currently versus the US Dollar and from 119.65 to 122.80 currently versus the Yen.
- Europe's currency has rallied 7.5% against the dollar so far this year as inflationary concerns lead to expectations of rate hikes by the ECB. The Euro's strength has so far been resilient to the euro-area's sovereign debt crisis, as Portugal is set to become the third European country to seek EU aid, having begun talks to hammer out a bailout package that is expected to be around 75 billion EUR.
- The British Pound also advanced against the US Dollar and Japanese Yen this week on expectations of higher interest rates, and was slightly higher versus the Euro. The Sterling advanced from 1.6110 to 1.63935 currently.
- The Japanese Yen weakened versus most of its major counterparts as appetite for risk improves. The Bank of Japan is unlikely to raise rates anytime soon and is likely to provide liquidity as the country aims to recover from the dramatic earthquake and Tsunami of early March.
- Higher yielding currencies, such as the Australian and New Zealand Dollars, continued to advance this week on improving signs in the global economy and higher appetite for risk. The Australian Dollar continued to reach new highs versus the US Dollar, reaching 1.0540 this week.
- The Canadian Dollar also saw sharp gains against the US Dollar, rising to almost the strongest level in over three years as crude oil traded at a 30 month high this week.

Fixed Income

- Government bonds are headed for a third consecutive weekly loss, on higher inflation and policy rates expectations.
- Indeed, over the last few weeks markets have been increasingly pricing in higher inflation, as shown by the difference between yields on 10 year US notes and Treasury Inflation Protected Securities of the same maturity which has widened to 2.61%, the most in 32 months.
- The yield on 10 year US Treasuries rose by 15bps this week to 3.596% while yields on shorter term bonds were largely flat this week. This is partly driven by the fact that longer term bonds are more sensitive to inflation but also because of supply and demand factors. Indeed, the supply of shorter term bonds declined this week as the US Treasury cut the amount of bills it sells as the US approaches its federal debt limit…
- Yields on long term European government bonds also rose this week as the ECB became the first major central bank to raise its benchmark rate this week.
- Meanwhile, Portugal this week became the third country to seek a bailout from the EU. Instead of the domino effect that one may have anticipated, there is some growing optimism

that the worst of Europe's sovereign debt crisis is over and that it will not reach Spain nor Italy. Indeed, Spain was able this week to sell roughly 4 billion EUR of bonds and its borrowing costs fell.

- High yield bonds performed well this week on higher appetite for risk. The iBoxx liquid high yield index is up roughly 0.7% for the week and 4.6% for the YTD. However, investment grade corporate bonds were slightly negative this week, as these are more impacted by moves in interest rates and inflation expectations.
- We remain constructive on higher yielding fixed income securities on valuations and as these will continue to see inflows but stay away from high quality corporate and government bonds as these will be under pressure from higher inflation.

Equities

- Global stock markets are headed for another consecutive positive week. The MSCI World as of yesterday's close is up 0.3% for the week, and over 5% since the beginning of the year.
- Equity markets were fairly calm this week, with no major daily moves. The S&P 500 is marginally up for the week while the Dow Jones Industrial average is up 0.25%. European and Japanese markets as of writing this are up on average 0.8% for the week.
- Markets were roiled at one stage as Japan experienced another large earthquake. However the impact was much lower than the one in March and markets went back up.
- Financials and materials were the best performing sectors this week. Basic materials related companies benefited from higher metal prices and a busy week in M&A activity. Financials benefited on optimism over some sort of resolution to the European debt crisis as well as M&A activity, especially in the exchanges.
- Consumer related stocks were also strong performers this week on the back of positive retail sales data in the US. Conversely, industrials and energy related stocks lagged overall markets.
- This week saw a number of deal announcements and we expect corporate activity to remain very strong as companies look to put their large cash balance to work.
- We remain positive on equities overall, as better economic environment, reasonable valuations and strong M&A activity should continue to support equity prices.

Emerging Markets

- Emerging markets equities again this week outperformed developed markets, with the MSCI EM Index up 1.45% for the week versus 0.3% for the MSCI World index. The EM index is close to catching up its developed counterpart for the year to date, having been far behind only a few weeks ago.
- Asian stocks were strong performers this week as the crisis in Japan eases, and many Asian companies are set to benefit as Japan rebuilds its affected areas. Europe EM also did well this week as these regions benefited from the easing in the European sovereign debt crisis.
- Chinese stocks are back in demand, having lagged significantly last year. The Shanghai Index is up 8.8% for the year, compared to 4.6% for the Brazil Bovespa index. There is growing

confidence that China will be able to curb its high inflation rate, which is leading many investors to come back to China.

- Meanwhile, the Brazilian Real strengthened beyond 1.60 per dollar for the first time since August 2008 this week after its Finance Minister said long-term appreciation is to some extent “inevitable”. He nevertheless broadened the scope of a 6% tax on foreign borrowings to include loans of up to two years from one year, the third attempt in two weeks to curb the Real’s strength.
- The other major EM currencies gained as well against the US Dollar, on better growth prospects in the EM region and higher appetite for risk.
- We are positive overall on EM equities and other assets and believe these should show strong performance on better growth prospects and as they make up for the lower performance versus their developed counterparts since the beginning of the year.

Commodities

- Commodities appreciated this week with the GSCI broad commodity index up by 1.8% for the week. All of the major commodity sectors were positive this week.
- Industrial metals were up the most this week, with the GSCI industrial metals up close to 2.8% on better global growth prospects, inflation expectations and a weaker dollar.
- Precious metals also did well, with gold up by nearly 3% for the week and silver up over 6%! Gold is near its all time high as we write this of $1473.07 on inflationary concerns and the weaker dollar.
- Energy prices continued to move higher, with brent crude oil up 4.6% for the week to $124.65 a barrel currently, a level last seen 30 months ago… Oil prices are increasing on global growth and the weaker dollar, but also because of continuing trouble in the Middle East leading to concerns over supply.
- Agricultural commodities were also up, with the GSCI agriculture index up around 1.7% for the week.
- We remain positive on commodities, especially energy and industrial metals on growth prospects and supply and demand pressures.
