Bedrock Newsletter

Friday, June 3rd 2011

A red week. Economic data was in the red (growth slowing down), consequently equity markets show red (down), the US Dollar has turned a reddish shade of green (weak against its major counterparts). We are all awaiting today US employment report which is expected to be lower than expected. It reads silly, doesn't it? And yet, silly or not, markets are pointing red… Well, we all remember Picasso having a Blue Period and magnificent as it was, it ended. So we do have some hope yet… The month of May which ended this week did little to dispel the "Sell in May and Go Away" expression having been expensive for holders of most classes of investments; Real estate in the USA down everywhere, equities down most everywhere and general sentiment having the doldrums.

The bond market which is rumored to harbor the better thinking and thinkers of the financial markets brought yields down. The 10 year Treasury Note yielded less than 3% as did the German Bund. Last week we looked at these low yields as indicators of low inflation expectations. Now, might we interpret them as indicating anticipation of economic slowdown? Actually, if the latter view is the truth, then indeed inflation should remain subdued, at least in the Western and industrialized economies.

The Greek misery remained in the headlines. Some bad days, "less badder" days but overall, it seems as though the EU, the IMF and the Greek Government have concocted some semblance of a solution. So the Euro found reason to rise some against the US$ In reality, the proverbial can of Greek worms has only been kicked some way further down the road. The people of Greece are demonstrating in the streets, in disapproval of the whole deal…

The Chairman of the ECB, J-C Trichet suggested this week that what the EU needs now is a European Treasury. To complement monetary management (Central Bank) with Fiscal policy and tools. Soon we will have European Bonds and a structural solution for member states' problems. The offset might become US style problems - Centralization of the debt and then, debt ceiling debates…

In the US, the debt ceiling impasse has brought the rating agencies (Moody's and S&P) to place the US on a credit watch. The bond markets were utterly unfazed by these declarations. It is clearly political posturing which inexorably will be resolved with an increase of the debt ceiling and a continuation of US Government spending. The soft data is of greater concern - Words of double-dip are floating into many analysts' discussions, talk of QE(III) is rising. Some are pointing fingers at the slowdown in China and India. But let's clarify the language here: The Chinese economy is not slowing. It is decelerating, i.e., its rate of increase is lesser than it had been. How can one say that an economy growing at 9% is slowing? Yes, the growth had been running at 10%, so the growth-rate has slowed (by 10% or so), but it's hardly slowing, at 9%...

The real issue we are facing and not seeing is the move to low and falling real returns on capital. We must all adjust our expectations, maybe a globalization of the ol' Japanese conundrum?

As we go into our first weekend of this June, we smile and keep in mind Mark Twain's observation "apparently, there is nothing that cannot happen today."

Currencies

- The Euro strengthened against most of its major counterparts this week as international officials prepare a second bailout for Greece. The European currency reached an all-time low against the Swiss Franc during the week at 1.2065 but rebounded to 1.2205 currently. The Euro continued to appreciate versus the Greenback at $1.45 currently, heading for the longest stretch of weekly gains since March.
- The Japanese Yen slightly appreciated this week, as Asian stocks declined after a measure of Chinese corporate activity fell in May, boosting demand for safer assets. However, the JPY slid versus the Euro this week back to levels around 116.88, while it strengthened versus the Greenback at $80.10 currently.
- The Dollar broadly fell this week amid speculation that further signs of economic slowdown will prompt the Federal Reserve to expand quantitative easing, debasing the currency. The Greenback depreciated against most of its major counterparts, breaking another record low against the Swiss Franc at 0.8350 currently.
- The British Pound fell against all it major counterparts this week, sliding the most against the Euro and the Swiss Franc. The Pound should stay under pressure as the UK picture remains very bearish and interest rate expectations have come off massively.
- Meanwhile, currencies of commodity exporters broadly depreciated versus the Greenback, with the Australian, Canadian and New Zealand Dollars losing some ground while the Swedish and Norwegian Krone appreciated slightly.

Fixed Income

- Treasuries rose, pushing yields toward the lowest level this year, on concern around Europe's debt crisis following Greece downgrade and the US economy slowdown. Yields on most US maturities kept dropping during this week, the US 10yr bond losing 7 bps at 3.00% currently while the 2yr note lost 2 bps, currently yielding .46%.
- Yields on long term European bonds also dropped, with the yields on UK 10 year Gilts, on French 10 year OATs and Italy 10 year bonds down 4, 3 and 10 bps respectively, while German 10 year yields were among the only ones to be positive, up 3 bps. On the troubled side, Spain 10 year yields lost 6 bps while Greece and Ireland 10 year bonds lost 27 and 15 bps respectively. Meanwhile, Portugal 10 year yields gained 18 bps.
- It seems now almost certain that the Mediterranean nation will be forced to reorganize its debt. The most likely outcome for Greece consists of additional loans with conditions from the IMF and EFSF in 2012, coupled with a voluntary restructuring of its existing bailout and other sovereign debt. This approach would give Greece more time to meet loan conditions and to complete asset sales and would delay the effect on the European banking sector.
- Overall, despite the European sovereign crisis and disappointing US economic data, credit markets were relatively robust this week, as investors look for yield. This week again, investment grade securities outperformed high yield bonds while convertibles remained the highest performers among credit.

Equities

- Developed equity markets are slightly negative for the week, with the MSCI World down by close to 1% as of yesterday's close. The Index lost over 2% this month, with Europe being again the major laggard. The Euro Stoxx is now slightly negative year-to-date for the first time since the beginning of 2011.
- US and Europe declined relatively in line this week, as investors grew more concerned that Greece will default on its debt as Moody's raised to 50% Greece's risk of default. The rating agency downgraded Greece to Caa1 from B1, putting it on par with Cuba...
- Japanese stocks fell, sending the Nikkei to a fourth straight weekly decline, as investors awaited a US jobs report expected to show hiring as well as growth pace slowed in the world's biggest economy, reducing the earnings outlook for Japanese exporters.
- MSCI Sectors Indices were all in negative territory last week, with Energy, Materials and Financials being the biggest laggards, while defensive sectors such as Consumer Staples and Healthcare pulled through the week relatively well. Healthcare remains the best performing sector for the year along with Consumer Staples and Energy while Materials and Utility remains the worst performing ones.

Emerging Markets

- Emerging markets equities outperformed their developed counterparts this week, with the MSCI EM Index up about 1% while the MSCI World was down about 1% as of yesterday's close.
- For the YTD, the MSCI EM continues to lag, up about 0.7% while the MSCI World index is up about 3.5%.
- Performance across EM regions was mixed this week. Latin America was slightly positive overall with Argentina being again the largest detractor this week. Brazil gained about 3% recovering some of the losses incurred during the month. The Bovespa was slightly positive for the week and is now down 7% year-to-date.
- Nearly all Asian marketplaces were positive this week, as Chinese stocks rebounded as investors speculated inflation may ease in coming months. However, the Hang Seng did not benefit from this regain of interest and was negative this week.
- Meanwhile, Asian currencies continued to gain, as shown through the Bloomberg JP Morgan Asia Dollar Index, as many of the component currencies experience higher inflation rates and as interest rates go higher.

Commodities

- After a deeply negative month of May – losing close to 7% – broad commodity indices began June in further negative territory.
- Industrial metals and Energy were the most negative sectors, with Crude oil (WTI) tumbling over 3% since the 1st of June at $99.66 a barrel currently, while Agriculture was the only sector to be positive. Precious metals are about flat for the week, with Gold being slightly negative while Silver is down over 7% since the 1st of June back to levels around $35-36 an ounce.
- For the year, commodities remain very positive with the GSCI Index up over 10%, with Precious metals and Energy remaining the top performers while Industrial metals is the only detractor, down over 4% year-to-date.
- We have mixed views on commodities – over the long term, energy, certain industrial metals and agricultural commodities should continue to experience supply/demand pressures and therefore should appreciate. However, in the short term, we remain cautious given the fact that these have come a long, long way…

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