Bedrock Newsletter

Friday, January 28th 2011

We are at the end of the annual “Davos Week” of the World Economic Forum. As usual, World leaders and persons of power discussed the state of the world and postulated the future. Interestingly they actually said that they all, jointly missed the 2008 collapse. Perhaps we best spare you their new outlook which is “worried”?
We would rather put forth that which we consider truly important points of this week- Without doubt it is the lightning-fast revolution in Tunisia and its broader repercussions, followed by the downgrade of the Japanese credit standing. Firstly Tunisia; we could be ostriches and say that this will not affect our investment portfolios and we would rather vacation in the South of France anyway. We could further reason that the market support our indifference, as they didn’t even wobble as Ben Ali ran away. We worry about the spillover of the concept, whereby between Facebook, Twitter CNN and SMS the “people” have uncovered their true power. This is great in itself, but there are huge risks associated with this. The people of Egypt have picked up the flame and are seriously shaking the stability there. Still not worried? Markets are reasonably stable, still. Sure, the Egyptian Government have already blocked these tools of the people, just the local market fell Thursday by 11% But let’s expand our view of the map here… Let’s ask ourselves what if this discontent spills down to Sudan, then across the Red Sea to Saudi Arabia? Beyond the obvious discomfort in Israel, do we really believe that oil supplies and consequently prices shall remain stable? Yes, oil prices are up today 25¢… Can the US find the strength to intervene here as well (if needed)? Is the Black Swan lurking behind these events eyeing China? If it can happen in Tunisia what makes us think that the Chinese will not repeat what Mao had done, not so long ago and without Twitter… Vodafone has just reported that they and all other mobile operators were instructed to suspend services in Egypt.

All this is wonderful from a view point of morality, true democracy and the like but for our own money? Possibly troublesome! Our year-end outlook for the future did include social unrest as one of the major risks for 2011 but we definitively didn’t expect it to hit in the second week of January. But as we all like to believe, every black cloud (swan?) has a silver lining! Maybe, just maybe this Internet revolution will spill into Iran?
Now the other “big news”- Japan’s credit ratings have been cut by Standard and Poor from the highest “AAA” to “AA-“ a big cut, two notches. Yes, Japan has huge debts, a big deficit and troubling demographics. Nothing new, and the Yen wobbled on the news but not by much. Arguably the market knew that the previous rating was wrong… Then the Nikkei fell by 1% also, hardly significant. But like the Tunisian event, perhaps we should step back and take a wide-angle view and wonder if Moody’s will not show their alertness and revisit the credit of the USA?

Q4 earnings coming-in, good figures and broadly better than expectations. Augmented with positive outlooks from big players, YES, we remain positive on equities and we remain comfortable on OECD interest rates holding here and if not for Tunisia, would have become even more bullish with our portfolios… But we rather err on the side of caution, so piano piano… Enjoy the weekend!

Currencies

- After having hit a low at 1.2867 in the beginning of the month, the Euro surprisingly stood still this week at 1.370 versus the US Dollar, at 1.2970 versus the Swiss Franc, and even strengthened from 112.50 last week to 113.40 versus the Japanese Yen. Perhaps the markets started to believe that the political wills at work will overcome the Union's troubles?
- This unexpected strength is probably due to this month's successful debt auctions of Portugal, Italy and Spain which helped in easing concerns over these countries' ability to fund themselves and reassured investors.
- Separately, the US Dollar weakened this week versus most of its major counterparts, with the Dollar Index dropping by 0.5% this week. The greenback was still under pressure following disappointing employment data released two weeks ago which dampened the very bullish views on the US economy.
- The yen depreciated slightly versus the Greenback and more against the other main currencies following Standard and Poor's Japan's credit rating downgrade. The limited impact is due to the fact that market participants had anticipated this decision as inevitable, given the country's heavy debt.
- While some believe this downgrade could bring about fiscal reform, which could be positive for the debt market, we think that the Japanese Yen should weaken from current levels and that the USDJPY pair will rise towards 90 in coming months.
- The Swiss Franc held steady versus the Euro and Greenback trading at 1.2930 and 0.9430 respectively. Fundamentally, the CHF should weaken in the following weeks, but clearly, it will depend on the resolution of the ongoing EU story and the evolving political turmoil in Egypt.

Fixed Income

- The US Treasury 2-year yield dropped about 3 bps to 0.59%, the 10-year yield stood still at about 3.40 after a 10 bps jump last week, while the 30-year bond yield rose 3 bps to 4.59%.
- Thirty-year yields approached the highest level in eight months as analysts said the world may be entering an expansion that will lift all economies and accelerate inflation.
- The spread between 30-year bonds versus the 2-year note widened to a record, hitting 400 basis points, primarily driven by inflation concerns.
- The cost to protect against losses on US Treasuries using Credit Default Swaps rose during the week, as Japan's ratings were lowered and Moody's Investors Service saying that its time frame for possibly placing a negative outlook on U.S. Treasury bonds is shortening…
- Yields on most European government bonds jumped this week as Germany's inflation accelerated to the highest level in 2 years, sparking bets that the ECB may start raising interest rates.
- The yield on 10yr German bunds continued to rise this week from 3.18% to 3.20% while 2yr bunds also rose by about 10 bps to 1.39%. French government bonds took the same direction while yields on UK 10-year Gilts slightly dropped.
- Credit markets were robust overall, with high yield bonds outperforming higher quality credits, on signs of an improving global economy and easing of the European sovereign debt crisis.

- We remain keen on higher yielding bonds, and remain away from government and emerging markets sovereign bonds as we think that the absolute levels of returns are too low.

Equities

- Most developed equity markets are up this week, with the MSCI World and the S&P 500 gaining over 1.3% as we write this.
- European stock markets sustained last week's gains and outperformed other developed countries, being boosted by the easing in its sovereign debt crisis while the US equities were driven by a surprise in December new home sales.
- The Euro Stoxx 50 index is up over 6.5% for the month while the S&P 500 and MSCI World are up about 3.3% and 3.5% respectively.
- Gains in Europe were once again led by the "crisis" countries (Spain, Italy and Greece are up 9.8%, 10.6% and 10.3% respectively for the month), on the back of this month's successful debt auctions and better outlook.
- The Nikkei 225 is up about 2% this week bringing the month to close to 2.5% on a weaker Japanese Yen, benefiting Japanese exporters.
- Every sector indices were up this week with Energy, Materials and Industrials leading the gains while defensive sectors such as Health Care and Consumer Staples fared less well.
- Financials and Technology (5.1% and 5.3% respectively) remain the top-performing sectors with Energy and Industrials following closely.
- Our view on equities remain constructive in general for the year given improving economic growth, attractive valuations and strong corporate health combined with the relative unattractiveness of fixed income securities.
- However, we do anticipate a tactical pullback soon given the significant run-up in asset prices and sovereign risks that remain.

Emerging Markets

- Emerging Markets' equities underperformed again their developed counterparts this week.
- The MSCI EM index was about 0.5% as of yesterday's close versus 1.4% for the MSCI World.
- Concerns over accelerating inflation in India are still pressuring down the BSE Sensex, the index lost 1.7% this week bringing performance for the month to -10.3%, the largest loss among EM countries.
- The Shanghai Composite was up about 1.25% this week but still negative for the month after having incurred sharp losses last week following latest growth figures that fuelled concerns that China's economy was overheating.
- We expect Asia EM to underperform other regions for the month as heightening concern that Asian central banks will curb growth with higher borrowing costs will keep indices under downward pressures.
- Latin America in general did not fare much better at -2.3% for the month.

- The Russian RTS which was up again this week remains the best performer among Emerging Markets up close to 8% for the month.
- Separately, the Chinese Renminbi stood still versus the US Dollar at 6.5815 after China's central bank set the reference rate at a new high last week.

Commodities

- Commodities declined overall this week, led by losses in oil and gold
- Once again, China's inflation fanned speculation the world's biggest energy consumer will take steps to cool its economy by raising interest rates, curbing growth and demand.
- Crude oil prices dropped this week from a high at $89.10 a barrel to $85.80 heading for its biggest weekly decline since August amid speculation that prices are too high and on signs that the OPEC is starting to increase output to cap prices.
- Within this difficult environment, agricultural commodities were modestly positive as concerns over tight global food supplies remain.
- Gold dropped to the lowest price in almost four months at $1315 an ounce, heading for a fourth weekly decline, as the recovering global economy, higher stock prices and increasing corporate profits eroded demand for safe-haven investments.
- We believe that commodities, and especially precious metals will continue the recent correction and we recommend remaining "light" for now whilst we believe that in the longer term, supply and demand fundamentals should push commodity prices higher in general.
