Friday, July 1st 2011

QE(II) ended last night! Amazingly, the Sun rose this morning anyway… Alan Greenspan came out of his mothballs last night critically questioning whether or not it worked (the stimulus). We will probably never know what would have happened had Bernanke not embarked on this process. As he says it (Ben), it was a totally unacceptable risk not to do it, a view we applaud; The US economy and consequently the World economy could have collapsed and that, would definitively been beyond our means.
Then we have the Greek debacle appearing to have been handled. The EU and IMF have come up with a plan and the Greek government (if not the people) has accepted. Again, debates will rage now for a very long time whether or not this is better than letting Greece default and leave the Euro. The money-weighted opinion of today appears to believe this is a good outcome as seen by the rise of the Euro and equity markets around the globe. Maybe this was supported by the Japanese data suggesting they have found the route to growth again? Whatever, the results are promising!
Ten year US Treasuries which just a few days ago had rallied to yield 2.80% have fallen back to yield 3.10% It is as if nothing happened… As usual, all huge problems have one thing in common- let it be a nuclear meltdown in Japan, a Greek collapse, a global recession and even wars, all eventually go away and the World keeps spinning. Yes, the Sun is shining brightly today!
Last week we were impressed with the concept of printing oil embarked upon by 28 nations, all agreeing to release Strategic Reserves with the thought that relaxed oil prices, stimulate the economy. Well, oil did drop for a moment, now back to where it had been. We calculate that releasing 30 million barrels represents about 8 hours of global consumption. What were they thinking???
Whilst we maintain our optimistic outlook as regards the future, we recognize that several major risks are still in the shadows around us. We decided to take advantage of the recent rally and reduction in volatility to acquire some relatively cheap portfolio protection. We bought put options on the Standard and Poor 500 index. If the US will fail to resolve their debt ceiling issues, we might have a hit on the markets. We covered some of this risk whilst remaining invested in support of our core view that the markets are more likely to rise than decline. Like Ben Bernanke, we realize that we must protect against the unacceptable… Let’s all hope that we were over cautious! This is a little like renewing our auto insurance although we had no claims last year ☺
But all is not “honkey dory” out there. The absolute level of US debt is huge and growing, China has successfully applied its growth-brakes, Greece is not alone in being a disaster zone etc., etc. Oh yes, DSK might not be as evil as suggested but his career is shot anyway (no job at the IMF, Presidential candidate?) but life isn’t fair…
A supporting thought- Isn't it a shame that future generations can't be here to see all the wonderful things we're doing with their money?
Overall, a pleasant start for the summer vacations… ENJOY!

Currencies

- This week saw some resolution to the Greek debacle as Greece's government approved the austerity plan needed to keep aid flowing. With the lower "event risk", currency markets came back to being driven by the risk on vs risk off trade and by expected interest rate differentials, with currencies of countries expected to keep rates low weak and those expected to increase strong.
- Consequently, the Euro was one of the strongest currencies, benefiting from the improvement in the Greece situation as as Trichet, the ECB president, reiterated that policy makers are in a state of "strong vigilance" against inflation, leading to increased speculation that the ECB will increase rates next week. The Euro jumped from 1.42 at the beginning of the week to 1.45 currently against the US Dollar.
- Conversely, the British Pound was especially weak against the Euro, as deteriorating economic data makes it unlikely that the Bank of England will raise rates soon, while the ECB seems likely to do so next week. The British Pound dropped from 1.125 in the beginning of the week to 1.1040 versus the Euro.
- The Dollar was also weak against most of its major counterparts as economic data continues to disappoint. With the end of QE2 and the US economy growing at a sluggish pace, the Fed is likely to keep rates near zero for a very long time, whilst most other central banks have begun tightening.
- As appetite for risk re-emerged, the Swiss Franc declined across the board, and especially against the Euro. The Swiss Franc went from 1.18 in the beginning of the week to 1.23 currently against the Euro.
- Currency markets in Q2 felt like a merry go round, as markets went from optimism on global growth to strong concerns about a renewed slowdown and yet another flare-up of the European debt crisis. As such, currencies were very volatile, with no clear direction over the period.
- While this week saw some improvements on the euro zone crisis, it has not been resolved and remains highly uncertain. Meanwhile, global growth is very mixed and with risks to the downside in the developed world, and inflation risks in the emerging world. As such, we expect currency markets to remain volatile and do not see any clear trend emerging over the summer months.

Fixed Income

- Government bonds are headed for their steepest weekly loss in five months after Greece staved off defaulting on its debt, bolstering expectations that economic growth will pick up and boosting demand for riskier assets.
- Yields on US Treasuries shot up big time this week, with the yield on 10yr up by 31 basis points to 3.17% and on 2yr up by 13 basis points to 0.462%. Meanwhile, the difference between yields on 10yr notes and Treasury Inflation Protected Securities, a gauge of inflation expectation, widened to 2.39% from this year's low of 2.14% set last month.
- German, British and French government securities also dropped sharply, with the yield on German 10yr bunds up 19 basis points to 3.022%.

- With the improvements in Greece, securities from the euro region's most indebted countries jumped, with the 2yr Greek bond leading the gains.
- Credit markets were also strong, with credit-default swap indexes linked to everything from high-yield corporate bonds to commercial-mortgage securities, which deteriorated to the worst levels since October earlier this month, rebounding sharply.
- Higher quality credit securities however declined this week, with the move in rates more than offsetting the improvement in credit.

Equities

- Equity markets are up big time for the week, with the MSCI world up 4.4% as of yesterday's close, paring back the losses for the month of June to -1.75%. The MSCI World was down 0.3% in Q2 and is up 4% for the year!
- All developed markets are up sharply for the week, with European bourses leading the way as these benefit the most from the improvements in Greece. This week's rally in the Euro Stoxx 600 is the largest in over 10 months.
- American stocks also appreciated sharply, with the S&P 500 up 4.1% for the week. Japanese markets were up by less, with the Nikkei 225 appreciating by 2%. However, Japanese stocks outperformed over the month of June, and the major Japanese indices are well in the black for the month.
- The VIX index, which measures volatility and is considered as a fear gauge, dropped sharply this week to 16.5. This is a very low level historically…
- In terms of sectors, the best performers this week were those that had suffered the most since market sentiment turned negative. As such, energy, materials and financials saw the strongest gains for the week, but are still down the most for the month of June.
- Conversely, healthcare and consumer staples, considered as defensive sectors, underperformed broader markets for the week.
- Q2 was a rollercoaster for all asset classes, and equities were not spared. Risk on vs. risk off drove equities, with these responding primarily to macro data and events. Despite the sharp moves, developed markets are overall slightly negative for the period, with US stocks marginally positive and European stocks down 1% as measured by the Euro Stoxx 600.

Emerging Markets

- EM equities are also headed for a weekly gain, with these boosted by the positive news over Greece. However, the MSCI EM is up by less than the MSCI World for the week, (2.7% vs 4.4%), and is down -2.1% in Q2, versus -0.3% for the MSCI World index.
- Asia EM lagged this week, with Chinese stocks the worst performers, up only 0.5% for the week. Asian markets were tempered by rising concerns over inflation. Latin American stocks and Europe EM are up by around 2.8% for the week.
- Asian currencies were up sharply this week against the US Dollar, on interest rate differentials.
- EM credit was mixed.

Commodities

- Commodities were up this week, with the S&P GSCI broad index up 3.7% for the week. As is often the case, performance varied sharply by type of commodity.
- Energy was the best performer, with the S&P GSCI Energy index up 5.7% for the week. Brent Crude Oil rose by nearly 6% for the week, recouping all of the losses since the 23rd of June when the IEA announced that members would tap emergency reserves.
- Industrial metals are up 3.45% for the week while agriculture is down -1.85% in the period and precious metals marginally down for the week.
- Commodities were all over the place in Q2, with energy prices declining sharply after having reached prices last seen in mid 2008. Agricultural commodities were actually the worst performers for the quarter, down by more than 12% as measured by the corresponding S&P GSCI index.