Friday, July 22nd 2011

The European Union has agreed a $150 million package for Greece. The significance is not in the validity or quality of the package but rather in the fact that the Union has found agreement, with the support of the ECB. Now it is up to the USA to show that they too can step over political discords to resolve a serious issue. The market gave points to Europe in trading the Euro up against the US Dollar. 1.4418 and European stock markets extending their gains as we write. Churchill once said “You can always count on Americans to do the right thing - after they've tried everything else.” So they will reach an agreement and soon. Then we may expect a pop-up in US equities and in the US Dollar. It will happen, be certain of this and in the very near term. After? Well…

Corporate earnings are good, surprising analysts who were clearly too pessimistic. Google blowing away every evaluation matrix Microsoft beating handsomely, Apple reaching a new planet of performance to a point that some analysts claim now that Apple should be held in a sector all of its own. Morgan Stanley for the first time ever out-earned Goldman Sachs, the former surprising us on the up side whilst the latter disappointed. Clearly, the analysts are not on the ball… They make us think of paediatricians who tell an expecting mother that her child will not be of her hoped-for sex. If they are wrong, the mother will be so happy in getting the offspring she wanted and she will not remember the doctor’s prediction. If the child isn’t as she wanted, then the doctor was right. Analysts tell us to expect mediocre and when we get great, we make money and forget the analysts… This is hedging, by definition!
Overall, what with the diffusion of the European debt crisis and hopeful noises out of the USA, all backed by strong corporate earnings with good outlooks, the stage seems set for a powerful upside to equities with little downside to bonds as there still is little if any inflationary smoke in the air.
There is one nasty little cloud in the skies though. A semantic cloud: Is the Greek salvation an effective “default” or is it not a default? Some call it a partial default, rescheduling say some and others use some variation of words thereupon. Who cares you ask? Well, all holders and issuers of CDS’… if it is an event of default, well then significant monies must change hands… CDS’ are Credit Default Swaps so the semantics are critical here- is this or isn’t this an event of Default? We say, go long lawyers…

We note that volatilities are down- the VIX is falling as our implied volatilities in currency markets. Finance 101 teaches us that a stock is worth the present value of its future earnings. These are seen as rising beyond what we expected and then, the discounting factor is dropping as the price of risk is lowered. Base algebra suggests that overall, equities are cheap. Then bonds seem very expensive, even with a deflationary risk present in the back of our mind. We see value in corporate bonds as their ability to repay improves and then the low grade bonds are paying high yields whilst running at the lowest default rates ever. But who is buying ten year US Treasuries at 2.8%. Why? Think of this and enjoy your before-last weekend of July ☺

Currencies

- The major news of the week came Thursday, as EU leaders agreed to provide €109 billion in a new bailout package for Greece as well as laying the groundwork for stronger governance in the euro zone and enhancing the European Financial Stability Facility program.
- The decisions by the European Council went well beyond market expectations and are being widely perceived as a major step towards a resolution to the euro zone debt crisis and thus towards stabilizing markets. Consequently, the Euro saw hefty gains, rising on the back of the news from 1.4150 versus the US Dollar to over 1.4400 currently.
- The agreement boosted all "risk positive" assets and conversely, currencies perceived as "safe havens" declined. Indeed, the Swiss Franc and the Japanese Yen weakened as optimism over the EU sovereign debt crisis damped the demand for these "refuge" currencies.
- The Swiss Franc declined from a low for the week of 1.1375 versus the Euro to 1.18470 currently and from 0.8035 to 0.8220 currently versus the US Dollar. The Japanese Yen weakened from a low of 110.65 to 113.10 currently versus the Euro.
- Moreover, with a sense of resolution on the Greek situation, market concerns shifted to the debt showdown in the US. Indeed, on Thursday, the US Dollar weakened versus most of its major counterparts, with the US Dollar Index (which measures the Dollar versus a basket of major currencies) dropping by more than 1%.
- Meanwhile, the Australian and Canadian Dollar gained as both countries seem likely to raise interest rates over the next few months. The Canadian Dollar this week actually reached a three year high versus the US Dollar.
- We believe that the US will ultimately reach some sort of agreement over its debt situation, and therefore expect that the Dollar weakness / Euro strength of this week may be short lived.

Fixed Income

- Government bonds' prices declined this week as European Union leaders redoubled efforts to end the region's debt crisis, while US officials reported no progress on raising the federal debt limit and cutting the budget deficit.
- The yield on US 10 year notes rose by 8bps this week to 2.99% as Standards & Poor's, a credit rating agency, reiterated that it sees a 50% chance of downgrading the US credit rating within three months.
- The yield on German 10 year Bunds rose by 20 bps to 2.897% this week on the back of the agreement of the European Council. Short term other European government bonds also dropped sharply.
- Conversely, securities issued by the crisis countries advanced sharply. Greek 2 year note yields sank 403 bps to 29.8%, while yields on equivalent maturity Irish debt fell 442 bps to 14.7%. 10 year Greek yields dropped below 16% for the first time since early June.
- Credit markets responded positively to the agreement reached by the European Council on Thursday, with high yield bonds outperforming investment grade credits.

- We continue to favour lower quality securities within the credit spectrum given healthy corporate balance sheets and more attractive spreads and yields. We also like EM corporate bonds, also because of strong financial health, attractive spreads, as well as better growth prospects than their developed counterparts.

Equities

- Equity markets rose sharply this week, boosted by the deal reached by the European council on Thursday. The MSCI World is up 2.33% for the week as of yesterday's close.
- European bourses are leading the gains for the week, as these are benefiting more directly from the major breakthrough achieved on Thursday. The EuroStoxx 50 is up 4.4% for the week, the CAC 40 is up 3% while the Spanish IBEX 35 and Italian FTSE MIB are each up over 7% for the week! The best performing stock markets for the year to date are those lagging this week. Indeed the German Dax is only up 1.3% as we write this for the week.
- American stocks also gained as risk appetite came back this week. The S&P 500 is up 2.1% as of yesterday's close. Strong corporate earnings also boosted stock markets, with out of the 100 companies of the S&P 500 that have reported since July 11th, 86% exceeding the average analyst estimate.
- Financials were the best performers this week, as these benefited from the improvement in the Euro zone crisis as well as some of the major US banks reporting very strong results. Energy also did well on improved sentiment for global growth and higher energy prices.
- Conversely, defensive sectors such as healthcare and consumer staples were the weakest performers.

Emerging Markets

- Emerging markets were up this week, but by much less than their developed counterparts. Indeed, the MSCI EM is up only 0.7% for the week. EM equities continue to lag significantly for the year to date, with the EM index down -0.7% while the develop index is up nearly 5%!
- Chinese stocks were down this week, with the Shanghai SE composite down -1.75% on disappointing economic data. However, most other Asian stock markets were up, with these benefiting from the better global growth prospects following the positive developments in Europe.
- Meanwhile, the Brazilian Central Bank increased the "Selic rate" on Thursday by a quarter point to 12.5% In the accompanying statement, policy makers withdrew a commitment made in April and June to raise rates for a sufficiently long period, perhaps signalling that the fifth straight increase in borrowing costs may be enough to contain inflation running at a six-year high.
- Separately, Asian currencies continued to appreciate this week. South Korea's won climbed to its strongest level in almost three years after European leaders agreed on a package to contain the region's debt crisis, reigniting investor interest in emerging-market assets.

Commodities

- The S&P GSCI commodity index is up slightly for the week, with energy and industrial metals up while precious metals and agriculture are down.
- Oil is headed for a fourth week of gains as signs Europe and the US will contain their debt crises is easing speculation that demand for raw materials may falter. Crude oil is up 2.44% for the week, up to $99.61 a barrel currently.
- Gold is slightly down for the week, after having moved back and forth over the course of the week. Gold reached a high of $1610 an ounce this week, then tumbling to $1581, then bounced back up above $1600 and is now hovering around $1589.