Bedrock Newsletter

Friday, January 21st 2011

President Hu of China came to Washington to dine with President Obama. The Yuan [CNY] continued its pre-set slow rise vs. the US$, now at 6.584 and both leaders told us that they are aware of the global imbalances and the importance of cooperation. Clearly the markets didn't believe their intent or abilities, as all equity markets dropped for dessert. If we ever needed evidence of the importance of politics in understanding economics and finance, we got it for nothing yesterday; China agreed to order 200 new Boeing jets. This a week after an Indian low-cost carrier ordered 180 Airbus jets, putting Airbus ahead of Boeing in the sales' charts…
We remain long CNY and HKD as the trend here is set. Slowly, but steadily we are gaining here! Our limited imagination cannot see where we could get hurt here!?

The 'theme-of-the-week' was yet again, Inflation. Brazil raised rates to fend off this evil and China applied its version of garlic against the "iVampire" by raising reserve requirements yet again. In the UK though, the same blood-sucking inflation can be primarily attributed to a rise in VAT. Commodities caused this evil, as foodstuff prices have risen this year. We wonder if raising interest rates will help stop the flooding in Australia? We will give homage to Ronald Reagan and his "Supply Side" economics here…

Other points of attention can be found in the unravelling Q4 earnings; mostly ahead of expectations, with Apple and Google giving us blowout profits. But then, Citibank disappointed investors, then Steve Jobs is taking a leave of absence from Apple and it gives-up its earnings' gains. General Electric also beat expectations, better yet, in all its divisions, even finance!!! Its Chairman, Immelt, was just invited to join the President's Economic Advisors… Clearly, the falls this week in equities came primarily where investors have the most gains. Gold miners, commodities in general dragged indices down. We remain comfortable with the outlook for equities whilst aware that many are awaiting a "correction" after the huge run-up since last summer. We find it hard to time and hold our sights on an expectation of a higher close for 2011, S&P 500 above 1'350 ☺

Bond yields have been holding steady with 10 year Treasuries at 3.45% and other majors at steady spreads thereupon. Europe is still talking about its errant periphery and seems to have been successful in calming the markets hysterics, albeit at troubled levels. Prozac does hide symptoms but does not cure…
There is talk out of the Capitol of austerity, cutting the Federal budget like the Europeans are doing. The figure of a 5% cut has been rumoured to be bouncing among the elected. These must be the same guys and gals that order their Big Mac and double fries with a Diet Coke? It was Senatorial noises about the US obesity plague (indirectly) which guided Wall Mart's offer of low-sodium foodstuff on their shelves, in an attempt to combat this malady. Perversely, it may work though, as these low-sodium bites carry a better margin for the vendor and therefore more taxes for Uncle Sam. A follow-on thought for your weekend- If 'pro' is the opposite of 'con' what is the opposite of 'progress'?

Currencies

- After having hit a low at 1.2867 two weeks ago, The Euro continued to increase this week from 1.3390 to 1.3565 versus the US Dollar, from 1.29 to 1.3065 versus the Swiss Franc and from 110.90 to 112.25 versus the Japanese Yen.
- The Euro reached an eight-week high before being capped around 1.3570 versus the Greenback, with the strong German data (record level for the January IFO) supporting German yields.
- Separately the US Dollar further weakened this week versus most of its major counterparts, with the Dollar Index dropping by 0.8% this week. The greenback was still under pressure following last week's disappointing employment data which dampened the very bullish views on the US economy.
- We believe that the Euro will continue to depreciate as the sovereign debt crisis is far from over and believe that the US Dollar should move higher on the ground of better economic prospects.
- Overall, the yen appreciated against higher-yielding currencies on concern China's central bank will take more steps to tighten monetary policy, boosting demand for safer assets. The currency now stands at 82.72 versus the Greenback.
- We believe that the Japanese Yen should weaken from current levels and that the USDJPY pair will rise to 90 in coming months.
- The Swiss Franc further weakened versus the Euro this week reaching 1.3080 after having reached a record low three weeks ago at 1.2400. Fundamentally, the CHF should weaken more, but clearly, it will depend on the resolution of the ongoing EU story.

Fixed Income

- US Yields rose this week with equities selling off: the two year yield gained around 5 bps to 0,62%, the ten year yield jumped close to 10 bps to 3.42%, while the thirty year bond yield rose 5 bps to 4.56%.
- Demand for 30-year bonds versus the 2-year note widened to a record wide of close to 400 basis points, which some see as a reflection of concern over future inflation.
- 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 rising interest rates.
- The yield on 10yr German bunds jumped once again this week from 3.03% to 3.18% while 2yr bunds also rose by about 14 bps to 1.27%. French and UK government bonds took the same direction.
- Meanwhile, the cost of protecting against default of European government bonds continued to drop following last week's successful debt auctions of Portugal, Italy and Spain which helped in easing concerns over these countries' ability to fund themselves.
- However, while there was strong demand, the yields were still very high, probably on speculation a European pledge to strengthen the safety net for the area's most indebted nations will not end the region's fiscal crisis.

- 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.
- There continues to be massive inflows into high yield and convertible mutual funds as well as massive issuances.
- From a general standpoint, we remain keen on higher yielding securities than investment grade corporate bonds, and stay away from government and emerging markets bonds as we feel these have more risk now.

Equities

- Equity markets are down this week, with the MSCI World and the S&P 500 slightly declining by over 1% 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 remained penalized by last week's disappointing employment data.
- The Euro Stoxx 50 index is up over 5.4% for the month while the S&P 500 and MSCI World are up about 1.2% and 1.8% respectively.
- Gains in Europe were once again led by the "crisis" countries (Spain, Italy, Greece and Portugal), with their stock markets up sharply on the back of the successful debt auctions and better outlook.
- The Nikkei 225 was down this week dropping bout -2.2% on continued strength in the Japanese Yen, hurting Japanese exporters.
- Almost every sector indices were down between 0.5% and 2% this month with defensive sectors such as Health Care and Consumer Staples faring much better than Energy and Materials which suffered from the drop in commodity prices this week.
- Surprisingly, Utility was the only positive sector up over 1.7% for the week while Financials and Technology remain the top-performing sectors for the month (3.2% and 2.9% respectively).
- 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 Market equities slightly underperformed their developed counterparts this week, although both were negative.
- The MSCI EM index was down 0.7% as of yesterday's close versus 1.2% for the MSCI World index.
- Following last week's news that China raised banks' reserve requirements and concerns over an accelerated inflation in India, the Shanghai Composite incurred sharp losses this week down by over 5% while the BSE Sensex underwent modest losses around 0.7%.

- 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.
- Also, China's latest growth figures on Thursday fuelled concerns that its economy is overheating, showing that GDP grew faster than expected in late 2010 as inflation remained above target.
- Latin America in general did not fare much better, mainly driven down by poor performance on the Bovespa this week at -1.5%.
- While slightly negative this week, the best performer remains the Russian RTS Index which is currently up about 5.4% for the month.
- Separately, China's central bank set the Yuan's reference rate against the Dollar at a new high. The Chinese Renminbi is now at 6.5870 versus the US Dollar.
- Meanwhile the Brazilian central bank efforts to stem the rise of the Real by offering to buy as much as $1 Billion in the currency futures markets did not have the expected impact as the Brazilian Real continued to appreciate versus the Dollar and is currently at 1.6740.

Commodities

- Commodities declined overall this week led by sharp losses in precious metals.
- Crude oil prices dropped this week from a high at $92.57 a barrel to $89.25 heading for a third weekly decline in the month as China's inflation fanned speculation the world's biggest energy consumer will take steps to cool its economy and U.S. crude supplies unexpectedly rose.
- Within this difficult environment, agricultural commodities were modestly positive as concerns over tight global food supplies still remain.
- Signs that inventories will be lower than expected in the US as well as floods in Brazil and in Australia are adding to the supply concerns and should keep prices under upward pressure.
- Spot gold – trading near a two-month low – also headed for a third weekly drop amid speculation China will raise interest rates, curbing demand for commodities, and as exchange-traded product holdings fell to the lowest since August.
- Gold is negative for the month despite the lower US Dollar and despite growing inflationary concerns, two factors considered as bullish for gold prices.
- We believe that commodities, and especially precious metals will continue the recent correction and we recommend lightening up on these for now.
- Still, on the long term, supply and demand fundamentals should push commodity prices higher in general.

Disclaimer

This document is for information purposes only and has been prepared by Bedrock SA, representing the opinions and investment views of Bedrock SA as applied in its investment advisory and management activities. It is a private publication intended for private circulation only. It does not constitute a company survey, a financial research, an offer, a solicitation or a personal recommendation to buy or sell specific products or securities. Bedrock SA disclaims all liability for any losses or damages of any kind relating to such information, which may be changed at any time without notice. The risks inherent in certain investments, particularly derivative products, may not be suitable for all investors. The contents of this publication may have been used for transactions by Bedrock SA prior to their communication. Distribution or dissemination of this document and/or the sale of certain products mention herein are subject to restrictions. Copyright 2009 All rights reserved. Approved for circulation in the UK to non-private customers only by Bedrock Asset Management (UK) Ltd which is authorized and regulated by the Financial Services Authority. This

presentation is being made to you solely for your information and must not be copied, reproduced, further distributed to any other person or published, in whole or in part for any purpose.

© 2009 Bedrock S.A. 4, ch. Des Vergers, 1208 Geneva, Switzerland, T: +41 (0)22 592 5455 F: +41 (0)22 592 5459, www.bedrockgroup.ch