Bedrock Newsletter

Friday, August 5th 2011

We experienced an absolutely horrible day yesterday, with indications that today, Friday, could be more of the same, should the US employment report show less than expected (+85K) job creations. Ouch. Let's step back a little and look at the situation through a broader lens: Look at the S&P 500 index since January 1st 2009…
We have come from 903 to close at 1'200 yesterday. Up 33% even after the mini-crash of yesterday not bad, overall, at first reflection, no?
But let's look at this data with different eyes- Golden and Swiss ones. On January 1st 2009 we could have bought the S&P index for 1.03 ounces of Gold. At close of business yesterday the equity index was worth only 0.73 ounces of the shiny metal, a 29% loss. A similar view can be had when looking at the stock index with Swiss eyes- The index would have cost a Swiss-Franc investor 963 Francs and when sold yesterday it was worth 919 Francs, off 5% or so. Lets see what happened to our friends at OPEC. They invested the proceeds from sale of 19 barrels of oil on January 2009 and sold their equities yesterday, buying back 14 barrels. So they "gave" America 5 barrels of oil over these 2 years…
How should we measure performance then? A wonderful 33% return could be seen as a severe loss. What is the problem here? We would venture that we can interpret this issue as a demonstration of the fundamental problem of the US$, which is clearly and continually being debased. The US lures foreign capital with high returns but then taxes them heavily upon repatriation. Didn't the naughty Russians do that in a less "elegant" way in 1998- lured in foreign capital with 80% yields in Rouble on their GKO's, then taxed them maturing notes at 100% via a default.
Oil is down heavily for August, off 12% or so. An indication of weakening demand, i.e., soft economies? Or is it because of margin calls due to the general market falls?
US 1 month T.Bills rose so much in price on Thursday that the yield has turned negative. This implies that investors rather lose money for certain with the security of the Treasury than hold a deposit at a bank. Hardly logical, or do "they" see something we don't?
A thought to consider- We all rejoiced when the Americans agreed on their debt ceiling increase. A partial agreement, but they did defuse the risk of imminent default. They didn't raise taxes, which is broadly viewed as good for the economy. But they agreed to cut expenses. This will surely shave some off the GDP, reduce employment. Similarly, unemployment benefits are about to run-out in the US of A. Within a couple of months the unemployed will reach the limit of the 99 month benefits. It is unlikely Congress will extend this limit again, so consumption will drop further. The trigger for this shakeout was the appearances of discords within the ECB and the Euro-politics. Clearly, there isn't a clear path here. But this isn't new. We saw similar fog in the US debt debates. The Swiss are desperate- the Central Bank had lost billions in fighting the rise of the Franc last year and now chose to drop rates to zero, causing the CHF to fall 3% vs. the US$ and the Euro. For two hours… now again at all time highs against both.
Lets hope for a good employment figure later today or we will face a sad weekend, hoping for QE(III) to be announced on Monday …

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Currencies

- Markets took a turn for the worst big time this week as the euro zone's debt crisis, which only two weeks ago seemed to have reached some sort of resolution, intensified sharply while the global growth picture continues to deteriorate.
- The US Dollar was one of the major beneficiaries of the risk off move as market participants flocked to the world's reserve currency, despite all the major problems facing the US economy. The Dollar Index, which tracks the greenback versus a trade weighted basket of major currencies, jumped by 1.7% this week.
- The Swiss Franc continued to strengthen to stratospheric levels, despite this week's unexpected cut in interest rates by the Swiss National Bank and its pledge to boost the supply of the Franc over the next few months. The Swiss Franc went from .7855 to 0.7681 currently versus the US Dollar and from 1.13 at the beginning of the week to 1.08730 currently versus the Euro…. Both ratios being all-time highs!
- The Japanese Yen, the other major safe haven currency, actually declined this week versus the US Dollar and is roughly flat against the Euro over the period, as the Japanese government intervened directly in currency markets to try to stem it's appreciation. Meanwhile, this week the Bank of Japan announced that it was expanding its asset-purchase fund, doubling the purchases of domestic bonds to 4 trillion yen ($51 billion) and it kept its benchmark interest rate near zero.
- Meanwhile, the Euro declined versus most major currencies, as yields on Italian and Spanish bonds soared, threatening the ability of the EU's third and fourth biggest economies to borrow. The Euro dropped from 1.44 at the close of last week to 1.4165 currently versus the Dollar.
- The rout in Italy and Spain came despite the ECB resuming bond purchases and the announcement by its president that the central bank will offer banks more cash to stop the region's sovereign debt crisis from engulfing Spain and Italy. In the announcement, Trichet said that "downside risks may have intensified". We agree with him.
- However, the Euro was not the biggest loser at all this week. Indeed, currencies that tend to be correlated global growth prospects, such as the Australian, Canadian, and New Zealand Dollars, as well as most Asian and other EM currencies dropped big time.
- Indeed the Canadian and Australian Dollars dropped sharply versus the US Dollar and are even lower against the Euro for the week on troubling global growth prospects and much lower commodity prices.
- Our view has not changed since the last few weeks. Currency markets are extremely shaky and uncertain, and we do not recommend taking any currency risk for the moment. The Governor of the Swiss National Bank said today that the Swiss Franc is "ridiculously overvalued" and yet, we would not dare sell it short here!

Fixed Income

- US Treasuries rallied this week, pushing down yields to the lowest in almost a year, as concern that the global economic recovery is faltering stoked demand for the safest assets. The yield on the 10 year US treasury dropped 41bps this week to 2.386 currently. Amazingly, the yield on 1 month Treasury Bills went to a negative value!!! The US TIPS, the inflation adjusted bonds fell, their implied inflation collapsing.

- As it stands currently, US Treasuries are actually heading for the biggest weekly advance since 2008, when the Fed cut interest rates!
- UK and German 10 year bonds also saw sharp gains, with yields dropping by more than 20bps over the week.
- With the euro zone crisis intensifying sharply, Italian, Spanish and Belgian bonds tanked, driving yields on the securities relative to German bunds to the most since before the euro was introduced in 1999…
- Meanwhile, the TED spread, the difference between what lenders and the US government pay to borrow for three months, widened to 25.9 basis points, the most in a year. However this is far away from the levels seen during the financial crisis in 2008.
- The stress was also highly visible in credit markets. High yield bonds dropped over 1.5% for the week. Investment grade corporate bonds were however resilient, and are actually up by over 1% for the week.

Equities

- Global equity markets tanked this week. The MSCI world dropped 7.5% this week, and there was no place to hide. With this week's move, all major markets are now well in the red for the year to date. The MSCI World Index is now down -5.6% for the year…
- The moves were extremely violent, with most stock markets on Thursday experiencing the largest daily losses since February 2009. The VIX index, which measures the volatility on the S&P 500, jumped by 35% on Thursday, which shows how panicky markets have been (its absolute level though is far from its peaks).
- European equity markets experienced the sharpest losses in the developed markets, as the sovereign crisis seems set to cause even more pain for the region. The Euro Stoxx 600 index declined by more than 11% this week and is down almost 15% for the year to date.
- American bourses did slightly better, but are still down as of yesterday's close by more than 7%. The S&P index is now down -4.6% for the year.
- With very grim global growth prospects, cyclical sectors were the worst performers this week. The energy, materials and consumer discretionary sectors are all nearly down 10% for the week, as shown by the corresponding MSCI indices. Financials were also poor performers, as these, especially European banks, saw sharp losses on the back of the deterioration in the euro zone.
- Conversely, defensive sectors such as consumer staples, utilities and telecoms "outperformed" this week, with these down by "only" 5%. The only sectors that remain in positive territory for the year to date are healthcare and consumer staples…

Emerging Markets

- Emerging markets equities also tanked this week, but by a little less than their developed counterparts. The MSCI EM index as of yesterday's close is down 5.7% for the week vs. -7.5% for the developed index. The MSCI EM index is now down 6.8% for the year.

- Performance across EM regions was negative overall, but the worst hit markets were those with high commodity exposure. The Brazilian Bovespa is down 10% for the week, bringing the losses for the year to nearly 24%, while the Russian RTS index is down 9% for the week.
- The Brazilian Real also tanked, going from a high for the week of 1.5445 against the US Dollar to 1.5880 currently.
- Chinese stocks were the best performers, with the Shanghai SE composite down by 2.8% for the period.
- Meanwhile, all of Asia's 10 most-used currencies excluding the yen weakened versus the dollar, led by a 0.7 percent slide in Malaysia's ringgit, and the cost of insuring Asian corporate and sovereign debt from default surged to a one-year high.

Commodities

- Commodities dropped big time this week, with the S&P GSCI commodity index down 6% for the period. As is often the case, performance varied significantly by type of commodity.
- Energy commodities were the largest losers, on concerns over global growth. The GSCI energy index dropped over 8% for the week, and this index is now negative for the year.
- Brent crude oil futures declined almost 10% this week, from $116.7 a barrel at the close of last week to $105.1 currently.
- Industrial metals were also down, with the corresponding GSCI index down 5.3% for the week.
- Precious metals were higher as these benefit from the turmoil in currency markets and in all "growth" related assets. Gold went from $1628 an ounce at the beginning of the week to $1667.85 currently. It had reached an all-time high of $1681.7 earlier in the week.
- Agriculture commodities were flat for the period. However these are the worst performing commodity sector for the year to date by some distance.
