Bedrock Newsletter

FLASH NEWS REPORT
Wednesday, August 10th 2011

After the Monday shock in the markets in reaction to the downgrade of the US, we started our Tuesday by halving our hedges on the S&P 500- we sold half our puts, reasoning that the spike in volatility and the huge fall in the markets should generate a reaction.
Then Ben Bernanke spoke. He said many things about the unsettling weakness of the American economy, the poor outlook for jobs and then he said that he would keep interest rates at zero or thereabouts until mid 2013. The markets went crazy! Bonds rallied as never before, gold spiked as did the Swiss Franc hitting parity with the Euro and its strongest level ever against the US$. Equities didn't know where to go. From a gain of 250pts on the Dow we saw a fall to negative 200pts only to zoom up to a gain of 430 at the close. Let us say that not all roller-coasters are fun… This one certainly isn't…
What Ben said was clear- economically we are not out of the woods. He redefined the meaning of "Extended Period of Time" to mean 22 months… Do note that he told us that the Fed will hold rates where they are for the duration of his term as Chairman AND through the US Presidential elections! De-politicizing the Fed?
What can be read between his lines is a message to the markets- "you are on your own now…" and we interpret further that any hopes for QE3 have been dashed.
Indirectly the Fed has converted US Treasury Notes into T.Bills- the yield on the two year note has fallen below the overnight Fed Funds target ceiling of 0.25% Will we go shopping with Treasury Notes instead of cash?

Where to now?

1. If you had any doubts about the inflation level (CPI as a measure), well, rest assured, it will remain very, very low as there clearly is no capacity constraints or any labour cost pressures. And as we can observe, even the commodity prices are falling. The risk remains however that in an import-reliant economy such as the US, the softness of its currency may "import" inflation. We do have a while ahead of us before this risk could bite…
2. For the near future (not fully two years forward) there will be little or no risk in owning US$ bonds. Probably commensurately low returns as well… We wonder if there will be a further compression of corporate spreads to treasuries, and tend to think there will be further tightening. Hold your bonds of all types for a little longer!
3. Equities after shaking us quite dramatically are looking more and more attractive. The Fed told us in no two ways that the applicable discounting factor for valuing equities is and will remain low, adding present-value to future earnings. Whilst Ben hinted that the US economy is likely to tread water for some time, it is likely that corporate earnings will remain as they are, i.e., strong. Growth? Maybe not so good. We hold what we own here.

4. Commodities? Probably stable here with some upside to oil as the risk is present that OPEC decides to cut production.
5. Currencies and Gold. Possibly a time to take an appetite for the US$... Clearly, the Swiss Franc is ridiculously high here as is Gold. The Euro is digesting its own issues and is basically impossible to predict. We suggest lightening positions in the escape currencies CHF, JPY and GLD. Buy some US$?
6. We expect general volatility to fall back substantially. If and when the VIX were to come in to the 20 level or so we will consider going long calls on equity indices.

The question remaining is if we have found the clear waters in the eye of the storm or have we passed the wall into truly calm waters? In due course we will know. We remain cautious and watchful for any believable signals. Do watch the riots in the UK… Are they an early symptom of social unrest which could spread?