Bedrock Newsletter

Friday, August 12th 2011

What a week! We lived through history in the making… Last Friday evening Standard & Poor's downgraded the US to AA+ (first time ever), then Bernanke announced that the Federal Reserve will hold interest rates at zero or thereabouts for two years (a first), Gold rushed through $1'800 (a first, albeit on an inflation adjusted basis a real high would be around $2'400) and the Swiss Franc traded to parity with the Euro (a first) as bond yield collapsed to unbelievable levels. And to top the list, for the first time ever the Dow Jones had four consecutive 400 point days: two up and two down. And as a result, Bedrock felt compelled to issue two "flash news" letters. We sincerely hope that this was a first and a last…

We are puzzled as to what is really going on. Thin summer volumes would usually be blamed for high volatilities, but not viable this time around as we had near-record trading. Then, the Fed's actions and words actually reduced risk, as we all know that we have a clear stretch of steady and low interest rates. Less risk, prices should rise. Lower and fixed rates should generate reduced discounting factors, so again, prices should rise. Lower credit ratings on the US should push yields upwards, but they fell. The Fed's lower growth forecast should pull prices down. Well, it would seem that the data processing capabilities of the players in the markets are quite limited- they can focus on and trade one set of information at a time, sequentially… When will be getting parallel processing? All data in one conclusion out? No such luck this week.

With the benefit of a few days (sleepless) we can focus a little more on the realities: On the equity dips there was much insider buying of stock. Even Donald Trump revealed to CNBC that he who never buys stocks has invested in a select list of US blue chips… We are not sure if this information is of any value? Then we note that Gold spiked through $1'800 and fell back, the almighty Swiss Franc fell back 8% against both the Euro and the Dollar from what were frankly "silly levels". But this just brings us back to early August. Oil rebounded from a steep fall from $100 to $80, now trading at $85. The truly terrible fact hiding in all this is that we just wasted two weeks of our lives- back to where we started the month. Go figure…

Yes, we are all reacting to bits of data/news, some of which dramatic and others simply incomprehensible. In trying to look through all the noise, all the proverbial trees and the fog of our minds, we believe that all we have experienced since 2008 can be assigned to the huge shift in the global economics- the centre of gravity which has been shifting fast from the West to the East. We are experiencing the realignment shocks. Indeed, it is the fault of China. Let's not be ostriches- the power shift is far from being over. China has evolved in a decade from being the purveyor of cheap consumer goods to becoming the banker to the West. Do add to your Yuan holdings, even now, at the 6.39 all time high.

A thought for the weekend- It is better to be an optimist proven wrong than being a pessimist proven right. Same outcome, but the route is better as an optimist…

Currencies

- Wow and wow! The CHF experienced twice this week one day moves against the EUR that used to be seen in the space of an entire year!! On Tuesday, the CHF rocketed higher from 1.09 to a historic high of 1.0070 (an 8% move!) before falling yesterday by more than 6% on rumours that the SNB (Swiss National Bank) would impose a tax on CHF deposits and maybe peg the CHF to the EUR for a limited period of time. What is sure is that apart from market rumours or speculation, the level of the CHF is just ridiculously expensive and out synch with fundamentals. It is also very clear that this level is unsustainable as a Swiss can buy across the border a Swiss product 35% cheaper than at home! We certainly believe that one has to be bold and sell some CHF here, both against the EUR and the USD. The SNB has been trying to influence the market in the past week by flooding it with liquidity and driving interest rates lower. One is now paid to short the CHF!!

- The EUR itself was under pressure after strong rumours about French banks, and particularly on Société Générale. The EUR dipped from 1.43 to 1.41 against the US Dollar, but of course its move lower was much more impressive versus the CHF. The EUR remains at a level against the USD where we see more downside than upside.

- The Japanese Yen, the other major safe haven currency, stayed fairly stable amid the global chaos and remained centered around 77 to the US$ but made a 5 month high against the EUR on the back of the ongoing Euro Zone debt crisis at 108.75, where it currently stands. The BOJ has been on the wires stating that the level of the Japanese Currency was threatening the recovery post the earthquake and that it was monitoring the exchange rate closely. We also believe that the level of the Yen is not sustainable going forward and that it shall weaken once the global turmoil fades away...

- The GBP was hit by lower economic figures and declined to 1.6150 against the USD. But it was the UK riots that took centre stage and that could add to the UK economic woes that actually helped to foster the Sterling decline. We also believe that the GBP is probably faced with more weakening ahead.

- The Chinese Yuan strengthened beyond 6.4 per dollar for the first time in 17 years, supported by the Federal Reserve’s pledge to keep interest rates at a record low and signs China will use currency gains to help rein in inflation. The strong rebound in the trade surplus, together with less willingness to accumulate more foreign-exchange reserves given the structural weakness of the U.S. dollar, are likely behind the recent rapid pace of Yuan appreciation. Chinese officials are allowing the currency to appreciate as slowing growth and gyrations in global currencies and stock markets threaten to spark a new recession. Besides countering inflation and accelerating China’s shift to domestic-driven growth, a stronger Yuan may also signal a willingness to help shore up slumping confidence in the global economy. We continue to foresee a strengthening of the Yuan against the USD and a faster appreciation.

- Commodity currencies (AUD, NOK, and CAD) all weakened this week on the back of softening global growth and market turmoil. As long as the markets will stay on the defensive, we think that these currencies could actually weaken further.

Fixed Income

- Government bonds are headed for sharp gains for the week despite S&P’s decision to cut the US credit rating. Bond markets were extremely volatile, with massive daily moves.

- The yield on ten year US treasuries went from 2.56% in the beginning of the week to an all time low of 2.0346% on August 9th, as the Fed vowed to keep interest rates near zero through at least mid-2013, but since then it has moved back up and is now at 2.256%.
- Yields came back up on Thursday on higher appetite for risk, but as well because of a poorly received auction of 30 year US bonds, with the worst bid-to-cover ratio (which measures the demand at the auction) since February 2008. However, earlier bond sales were very well received and actually, this week's $72 billion sale of notes and bonds have been issued at the lowest average yield for a refunding on record, saving US taxpayers almost $650 million in interest payments during the life of the securities! So much for S&P's Downgrade!
- Yields are lower across all maturities. The US 2 year yield slid to 0.157%, the least ever. The rate is about three basis points more than yields on same maturity securities in Japan, the smallest spread since 1992.
- The US yield curve has flattened, with the yield spread between the 2 year and 10 year notes moving from 2.59% in late July to as low as 1.91% on Wednesday. This indicates that markets are now much more negative on economic growth.
- UK and German bonds traded similarly, with very large moves as well.
- Japan government bonds however are set for a weekly loss, with yields on the 10 year JGB higher by 4bps to 1.04% for the week. This may be because Moody's Investor Service, the ratings agency, is likely to cut the credit rating of Japan. However, it may be simply because Japan bonds offer the lowest yields of any other nation and that 95% of Japanese government securities are held by domestic investors…
- Credit markets suffered this week, with investment grade corporate bonds down around 1% for the week while high yield corporate suffered even more, down by more than 3.5%. These were sold on lower appetite for risk as a batch of economic indicators around the world point to a much challenged global economy. We remain however very keen on high yield securities due to the big coupon protection they offer and that the corporate space is in very good financial health.
- Separately, the cost to protect against defaults by European financial companies reached a record, and a swaps index that gauges the perceived risk of owning junk bonds, which falls as sentiment deteriorates, is at about the lowest level in more than a year…
- Meanwhile, to take advantage of the very low cost of borrowing, both Mexico and the University of Southern California each sought buyers this week for bonds that mature in 100 years!

Equities

- Global equity markets are headed for a decline for the week, in what has been one of the most volatile streaks in history for stocks. The MSCI World is down 2.3% for the week as of yesterday's close. European markets are higher by around 1.5% today, so it looks like the loss for the week should be even lower.
- While the loss for the week may seem moderate, the daily moves were ridiculous. For example, the S&P 500 dropped 6.66% on Monday, gained 4.74% on Tuesday, dropped 4.42% on Wednesday and gained 4.63% on Thursday! The Dow Jones Industrial average has moved by more than 400 points for four consecutive days, the first time in the index's 115 year history. Intraday volatility and swings were also very, very large.

- Volumes were unusually large for August. The average daily volume on the NY stock exchange for the past seven sessions has been almost twice the 2011 average. The volume on Monday was the fourth biggest trading day on record for the NYSE!
- All major equity indices saw these types of moves, and the intraday swings were also extremely violent. This is reminiscent of the crisis in 2008. Back then it was the financial system that was creating the tensions. Now market participants are worried that governments will be unable to deal with a possible double-dip in the US and the debt crisis in Europe.
- In terms of regions, European markets are down by more than American ones. European bourses have been dragged lower especially by financial stocks, as the sovereign debt crisis only deteriorates further, and rumours grow that some banks may be on the verge of collapse.
- To contain these swings, officials in Belgium, France, Italy and Spain imposed new bans prohibiting naked short sales. However, history suggests that these bans have limited impact. Still, markets are up this morning, with most European indices up between 1-2%, with banks leading the gains.
- For the week, the Euro Stoxx 600 index is down 3.5% versus -2.2% for the S&P 500. Japan is down 3.6%. Interestingly, the Canadian S&P/TSX composite index is the only developed market positive for the week. The index is up 3.1%!
- In terms of sectors, financial saw the largest losses, followed by industrials and consumer discretionary. Conversely, the information technology, utility and consumer staples sectors outperformed.
- The Basic Material sector was the best performer for the week, as industrial metal prices did not decline that much and as precious metals soared.
- We believe that equities offer a lot of value today and better risk/reward proposition than other asset classes. However, given the very uncertain environment we would recommend only to the most daring to increase exposure at this stage.

Emerging Markets

- Emerging markets equities were also extremely volatile this week and are down by even more than their developed counterparts. The MSCI EM index is down 4.9% for the week as of yesterday’s close, as EM equity funds posted the third largest weekly outflows on record according to a report from Citigroup.
- Performance varied by region as is often the case. Eastern Europe was the poorest performing region, as countries within this region are more impacted by the troubles in Western Europe. Russia also suffered as energy prices dropped sharply.
- Asia was mixed, with China and India down roughly 2% for the week. However, South Korea is one of the worst performing markets, down 10% for the week. South Korea imposed a short selling ban on Monday and market participants did not perceive this ban as positive!
- The best performing region was Latin America, with Brazil’s Bovespa index up 1% for the week. The Bovespa saw its biggest three day gain in more than two years this week after reports showed Brazil’s retail sales slowed less than forecast in June. However, Brazil for the year to date is one of the worst performing market…
- EM credit was down sharply this week on global growth prospects and the uncertainty in Europe and US.

Commodities

- Commodities were also extremely volatile this week, but overall losses for the week are lower than for other “risk positive” types of assets. The S&P GSCI index is down 0.5% for the week. Again, performance varied by type of commodity.
- Precious metals saw sharp gains this week, with the corresponding GSCI index up 5.3%. Gold went from $1663 an ounce in the beginning of the week to an all time high of $1814.95 on Thursday. It has since come down and is now at around $1750. Silver, the other major precious metal, had wild swings this week, but overall is largely unchanged for the week at $38.35.
- Agriculture commodities overall are up for the week, with the corresponding GSCI index up around 1%. These were boosted as the US lowered the supply outlook for corn, soy and wheat.
- Energy commodities are down 1% for the week, as measured by the S&P GSCI Energy index. These had a rough ride this week, tracking the equity market moves. Crude oil sold off big time in the beginning of the week, going from $86.88 a barrel to a low of $75.71, but has since bounced back and is now at $85.21.
- Industrial metals were also down and volatile, with the corresponding GSCI index down 1.1% for the week. These also largely moved in a similar way as equity markets.

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