Bedrock Newsletter

Friday, August 26th 2011

QEIII or not QEIII?
To say or not to say?
The week is ending on a Shakespearean note, culminating in an expected Bernanke speech at Jackson Hole; will he or won't he announce further measures to resuscitate the US economy? If he does, what will it/they be? These concerns knocked some value off equity markets on Thursday, 170 points off the DJIA. Some of this drop can be attributed to Apple which fell 2.50% on the resignation of its CEO Steve Jobs. As Apple is such a huge market-cap company, its fall had a big impact on the indexes.
At the same time, Warren Buffet announced a huge ($5BN) investment into Bank of America. Who is right here? The Oracle or the general market worries?
Yesterday, yields on 2 year Greek debt reached the hardly comprehensible level of 44% Does this mean that they will default? Who knows… It just brought back memories of a great banker, Edmond Safra, who once said to us that if a client is willing to borrow at say 10% over the Prime Rate, it can only mean that he doesn't intend to repay you…
Other players in the financial game seem to have passed over this observation as they traded the Euro upwards, now at 1.4430 vs. the US$ (or simply never had the honor of discussing matters with Safra).

The Chinese currency (CNY) appreciated some more, now at 6.3880 to the Dollar. Is it because Sarkozy is paying them a visit? More likely it can be attributed to the markets' belief in the Chinese intent to allow the appreciation rate to accelerate? We hold our long Yuan…

Currencies are strange animals. They are hard to understand or predict. Look at Japan which is stuck in a rut of deflation, slow growth, and aging population. Their market, the Nikkei, is worth ¼ of its peak of some 20 years ago, and the Yen is at an all time high, up over three fold. These past two weeks showed us just how dangerous the FX can be- The Swiss Franc which had rallied to a stratospheric 1.00 to one Euro and 0.70 to the US$, collapsed by 15% to the Euro and similarly to the US$ in the matter of two days. This made us take a hard look at Gold as it soared though $1'900.00 Can this new bastion of safety take a smack too? We went as far as pricing 6 months Put Options on Gold, strike 1'500. This would have cost us 3.3% and as we discussed the merits thereof, Gold fell to 1'750… Yes, we did nothing, for now. But it could fall hard and fast if Ben Bernanke chooses to support markets tonight…

Oh yes, do note that US Treasury yields have edged up off historic lows…

Not much else to say here as the truth will be divulged to all later today.
The Israelites had similar feelings when Moses came down the mountain… Monday may be a new world…

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Currencies

- Currency markets traded sideways this week on low volumes, with little clear direction. The positive was that FX markets were much less volatile than they have been over the last few weeks.
- Currencies initially traded in slightly “risk on” mode as equity markets gained, but then moved back and forth on mixed economic news. Recently most pairs have traded in a very tight band, as participants eagerly await today’s Bernanke speech at Jackson Hole, Wyoming, which will likely set the tone for markets for the next few weeks to come.
- The EUR/USD is the best example of this week’s choppy price action. The Euro initially strengthened, from 1.44 to a high of 1.45, as Sarkozy pledged support to the common currency, and as many European governments undertook more fiscal consolidation measures, but then declined on concerns over the global economy to a low for the week of 1.4330. It is now trading higher against the greenback and is around 1.4450.
- The “clearest” move this week was a lower British Pound, as speculation rise that the Bank of England will undertake another round of quantitative easing to stimulate the British economy. The GBP declined from 1.6465 to 1.6325 currently against the USD and from 1.1435 to 1.1300 currently against the Euro.
- Meanwhile, the Japanese Yen and the Swiss Franc weakened moderatly, as the Swiss and Japanese governments continue to try to lower the value of their currencies. The CHF went from .7850 versus the USD to 0.7910 currently, having hit a low of 0.7990, and from 1.1300 at the beginning of the week to 1.1435 currently versus the Euro, having reached a low for the week of 1.1518 versus the common currency.
- The Japanese government this week took fresh steps to weaken the yen, including the creation of an unusual government-backed fund that aims to aid exporters whose profits are being squeezed by a rising currency. The Japanese Yen moved from 76.55 to a low of 77.70 versus the USD, and is now at around 77.00 and went from 110.20 to 111.10 currently against the Euro.
- Commodity currencies strengthened slightly this week as appetite for risk tentatively resurfaced. The AUD was higher as speculation of a rate cut tempered and the Norwegian Krone also gained as energy prices rose this week.
- Clearly, everyone is waiting for today’s Bernanke speech, which will indicate what the Fed will do (or not do) given the challenging growth backdrop. It increasingly seems unlikely that the Fed will engage in QE3 given a still growing economy and some small signs of inflation creeping up in the system, and it is very unclear how markets will react to whatever is said during this speech!

Fixed Income

- Government bonds are headed for their steepest weekly loss in almost two months, on speculation that developed economies will not fall back into recession. All eyes are set on today’s Bernanke speech, and most now believe that the Fed chairman will not announce a third round of quantitative easing.
- US Treasuries declined, with the yield on 10 year securities higher by 16bps to 2.22% and higher by 31bps to 3.6% on 30 year maturities. Shorter term securities were flat for the week.

- Separately, traders added to inflation bets, damping expectations for so-called QE3. The difference between yields on 10-year notes and Treasury Inflation Protected Securities, a gauge of inflation expectations, widened to 2.08% from 2.02% a week ago. The average for the past decade is 2.11%.
- Yields on German, UK and French 10 year government bonds increased by roughly 10bps for the week, moving in line with US securities.
- Meanwhile, the ECB continued to buy government bonds to try to stop the contagion of the debt crisis, and Spanish and Italian 10 year yields have remained around 5%, despite continued trouble in Greece.
- Indeed, Greek 2 year bonds collapsed this week, with the yield rising from 36% to 44% currently amid concern Finland's demands for loan collateral jeopardize a second bailout package for the nation and may trigger a default. The Greek situation is truly a disaster and clearly now the euro-zone's policymakers strategy is to try to limit contagion to other areas.
- This week also saw Moody's Investor Services lowering Japan's credit rating one notch to Aa3. Markets did not react too much as everyone is well aware of the difficult situation Japan finds itself in.
- Credit markets continued to suffer this week, with high yield corporate bonds lower around 1% this week, while investment grade credits were also lower for the week. This is in sharp contrast to equity markets which gained this week.
- The market for junk bonds is enduring its worst rout since the depths of the financial crisis. Indeed, demand for high-yield bonds has nearly dried up, new offerings in August are at their lowest level since December 2008 and investors have been withdrawing record amounts from high-yield funds. So far high yield bonds are down 5.1% in the US and 7.1% in Europe, the worst monthly performance since November 2008…
- Bonds issued by financial companies have suffered significantly of late. Indeed, spreads on dollar-denominated bonds sold by financial institutions have hit their widest levels in nearly two years amid growing concerns about the impact on the sector of European sovereign risk and US economic weakness.
- While we have suffered with high yield bonds, we believe that these are even more attractive today, given healthy balance sheets, and spreads that are much too wide given economic realities.

Equities

- Global equity markets seem headed for the first weekly gain in August, although European markets are trading lower today and US futures are lower, trimming the gains for the period. As of yesterday's close, the MSCI Index is up 3.26% for the week, bringing the loss for the month of August to -10.5%.
- Markets moved up the first three sessions on low volumes and not much positive news, with some participants viewing the recent declines as overextended. Also many equity investors were looking forward to today's speech by Bernanke, hoping that a new round of QE would be announced.
- Since Thursday markets reversed, following big declines in European equity markets, on concerns that the ban on short selling could be extended. The other big news for the week was the retirement of Steve Jobs, Apple's emblematic CEO, and Warren Buffet's $5bn

investment in Bank of America, with the share price jumping by nearly 20% since the news (after having declined sharply over the previous sessions).

- So US markets as of yesterday are up nearly 4%, lowering the losses for the month to -9.7% for the S&P 500 and -7.7% for the Dow Jones Industrial. European bourses did not perform that well, and are up around 2% for the week as we write this.
- In Europe, the major negative was that French, Italian and Spanish financial regulators extended temporary bans introduced this month in a bid to stem market volatility. This however has not prevented an 8% drop in European bank stocks since the ban was imposed on Aug. 12 after shares of lenders hit their lowest levels since 2008.
- In terms of sectors, energy, industrials, consumer discretionary and information technology outperformed this week as cyclical sectors benefited from the less dire sentiment on the global economy. Conversely, consumer staples lagged given the defensive status of this sector.
- Financials also underperformed, despite the Buffet investment in Bank of America, with the sector under pressure from the sovereign debt crisis in Europe, and lower earnings prospects in the US. Goldman Sachs was a clear underperformer this week (down -1.7% for the week while the financial sector is up over 2%) as news emerged that its CEO has hired a high profile lawyer, reigniting concerns that the bank's legal headaches may return.
- We find equities in general cheap, especially given our base case scenario that the world will continue to grow, albeit at a low pace. However, the risk of a double dip is real and has risen over the last few weeks, and we therefore expect markets to remain volatile until some clarity emerges. As such, we are not increasing exposure for the moment…

Emerging Markets

- Emerging markets equities underperformed their developed counterparts this week, with the MSCI EM Index up only 0.8% versus the MSCI World up by 3.2%. EM equities are now down 14% in August, versus -10.5% for their developed counterparts.
- Performance varied significantly by region, as is often the case. The best performing region was Asia, with Chinese markets the best performers, up over 3% for the week. Chinese stocks were boosted by a better than expected PMI index early in the week, and strong earnings from banks. Indian stocks underperformed with the BSE Sensex index down 1.8% for the week, while Taiwan was up 1.4% and the Kospi index nearly 2% for the week.
- Russian markets were up by 2%, with these benefiting from higher oil prices. Latin American stocks however underperformed, with the Bovespa index down slightly for the week. The Bovespa traded sideways this week as it is very unclear whether or not the Brazilian central bank will lower interest rates to spur growth.
- Meanwhile, EM currencies were mixed for the week, with little direction.

Commodities

- Commodities gained this week, with the S&P GSCI broad index up 1.8%. However, performance varied big time by type of commodity.
- The big story this week was the massive drop in gold prices on Thursday. Gold continued to rise early in the week, reaching an all time high of $1913.5 an ounce on Tuesday, but then,

over the next two day it dropped to a low of $1704 – a 10% drop! It has recovered some and is now trading at $1785.

- Gold's sharp drop came as some began to think that gold's price had risen too much (our view), but also following CME's (the operator of New York's Comex exchange) announcement late on Wednesday, that it will increase gold margin requirements by 27%. This followed a 22% increase two weeks ago.
- We continue to believe that gold is too high, and believe that we could see further sharp downward moves in the not so distant future.
- All other commodities were higher for the week. Industrial and agricultural commodities were up by 1.4% and 1.1% respectively as calculated by the GSCI indices.
- The largest gainer for the week was energy, with the corresponding GSCI index up 2.6% for the week. Here supply concerns are boosting oil prices, with hurricanes in the States and unrest in the Middle East big concerns.
