# Bedrock Newsletter

## Friday, January 14th 2011

Another interesting week... Europe was disintegrating on Monday and Tuesday until the Portuguese Italians and Spanish managed to issue new debt at better than expected yields, albeit high ones. The Euro fell to $1.2850 only to close the week at about 1.3400 We dare postulate that the ECB together with the Chinese and Japanese orchestrated this wonderful result. Well, at least that kicked the proverbial can-of-worms further down the road… Adam Smith said “All money is a matter of belief”. European equity markets are clearly religious… rising to new multi-year highs! Let’s be a little agnostic here and try to understand the said rise of indices with a glance across the pond: The DJIA is about 17% off its all time peak on October 9th, 2007 and seems to be climbing too. But what does this mean? Being a widely followed measure of equity performance, let’s take a closer look and see if we can find some insight;
After reaching its high, the editors of the Wall Street Journal (who “manage” the index!?) decided to add Bank of America (“BAC”) on February 19th 2008, since which date BAC is off 60% and the DJIA is down about 5%. Had these wise Index Managers chosen to include Apple Computer (“AAPL”) instead of BAC with the same weighting, the Index would have been up about 2% helped by AAPL rising 183%
We often say, not all that is written and followed makes sense…

It is quite amazing how religions and beliefs turn! Milton Friedman, who besides having a Nobel Prize helped guide the US economy, had said “I am favour of cutting taxes under any circumstances and for any excuse, for any reason, whenever it's possible”. And now, the legislature of the State of Illinois voted (with a tiny majority) to raise taxes by a whopping 67%!!! Silly enough a legislative act for the Governor of neighbouring Indiana to congratulate the decision, clearly anticipating a major exodus of businesses his way. Some commentators anticipated that within 2 years, the Illinois total tax collection will decline by 10% whilst its neighbours will have a significant hike in tax revenues without raising rates!

The real issue that is rising above all others is inflation. Whilst statistics are coming through of rising costs (PPI) we all see the major rises in food commodities from corn to wheat, oil and non-precious metals. What with QEII and the pegging of interest rates at the lowest possible figure, the Inflation genie is slipping-out of its bottle? Well, Inflation is taxation without legislation, so perhaps Bernanke is playing in the Fiscal arena too? Bond prices rose this week lowering yields to 3.30% on the US Treasury 10 year Note. What/who/why to believe? We stay with the bonds, a Dollar weighted opinion of all the players. So we do not fear imminent inflation, but still shy away from long-dated government bonds.

Have a fine and hopefully warm weekend!

## Currencies

- After slumping to a 4 month low versus the US Dollar and Japanese Yen early in the week, the Euro bounced back with a vengeance following a slew of positive events/news. These included successful debt auctions from Portugal, Italy and Spain (although investors pushed for higher yields…), hawkish talk on inflation from the ECB president, a sharp rise in inflation in Germany and growing speculation that European finance ministers will increase the size of aid reserves and lower rates on bailout loans at a meeting next week.
- The Euro jumped from a low of 1.2867 to 1.3450 versus the US Dollar, from 1.2434 to 1.2950 versus the Swiss Franc and from 106.83 to 110.90 versus the Japanese Yen.
- Separately the US Dollar weakened this week versus most of its major counterparts, with the Dollar Index (which tracks the value of the USD versus a basket of six major currencies) dropping by 2.8% this week. The greenback was under pressure following disappointing employment data which dampened the very bullish views on the US economy.
- The Australian Dollar, strongly tied to global growth expectations, traded in unison with the US Dollar on the back of the disappointing US employment data, as well as on the downward adjustment on GDP due to the massive flooding in Queensland State.
- Despite this week's activity, we believe that the Euro's strength will be short lived as the sovereign debt crisis is far from over and believe that the US Dollar should move higher on better economic prospects.
- We also believe that the Japanese Yen should weaken from today's levels and that the USDJPY pair will rise to 90 in coming months.
- The Swiss Franc weakened sharply versus the Euro this week following last week's record high at 1.2400. Fundamentally, the CHF should weaken more, but clearly, it will depend on the resolution of the ongoing EU saga.

## Fixed Income

- 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 17bps to 3.03% and on 2yr bunds rose by 27bps to 1.13%. French and UK government bonds moved the same way.
- Meanwhile, the cost of protecting against default of European government bonds dropped following the successful debt auctions this week of Portugal, Italy and Spain. This helped in easing concerns over the "crisis" countries' ability to fund themselves. However, while there was strong demand, the yields were still very high…
- US government bonds were flat this week, with yields moving back and forth on disappointing employment data and expectations of higher inflation data. The yield on 10yr US bonds is at 3.30% and on 2yr bonds at .59%.
- Credit markets were robust, 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 mutual funds and massive issuance as well.
- Within the fixed income arena, we remain keen on higher yielding securities than investment grade corporate bonds, and stay away from government bonds.

**Equities**

- Equity markets continued to push higher this week, with the MSCI world index up by well over 1% for the week as we write this.
- European stock markets outperformed US ones by some distance this week, with Europe being boosted by the easing in its sovereign debt crisis while the US was hampered by disappointing employment data. The Euro Stoxx 50 index is up over 3.5% for the week while the S&P 500 is up by 0.8%.
- Gains in Europe were led by the “crisis” countries, with their stock markets up sharply on the back of the successful debt auctions. Spain’s Ibex is up close to 8% for the week, while the Italian, Greek and Portuguese stock indices are up well over 3%.
- Japanese stocks are slightly down for the week on continued strength in the Japanese Yen, hurting Japanese exporters. The Nikkei 225 is down -0.23%.
- Cyclical sectors outperformed more defensive ones this week, with these boosted by the easing of the Euro Zone debt crisis. Financials outperformed this week, as well as Energy and Materials with these boosted by higher energy and industrial metals prices.
- On the flipside, Consumer Staples, Healthcare and Telecoms underperformed this week given their defensive nature.
- We remain optimistic on equities 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 will put a note of caution at these levels as it seems a correction could unfold shortly.

**Emerging Markets**

- Emerging Market equities underperformed their developed counterparts this week, with the MSCI EM index up 0.7% as of yesterday’s close versus 1.7% for the MSCI World index.
- Asia EM underperformed other regions this week as China raised banks’ reserve requirements again today and India said inflation accelerated, heightening concern that Asian central banks will curb growth with higher borrowing costs. India’s Sensex index is down by more than 4% for the week while China’s Shanghai composite is down -1.6%.
- Latin America in general fared slightly better, with commodity-related stocks doing well. The best performing region was Eastern Europe, with Russia’s RTS index rising 6.3%, boosted by the easing in the sovereign debt crisis and higher energy prices.
- Separately, China’s central bank set the Yuan’s reference rate against the Dollar at a new high and the Chinese government launched a program to allow domestic companies take Chinese currency overseas to make investments, another step in its effort to make the Yuan a global currency. The Chinese Renminbi is now at 6.59 versus the US Dollar.
- Meanwhile the Brazilian central bank stepped up its efforts to stem the rise of the Brazilian Real by offering to buy as much as $1 Billion in the currency futures markets. Nevertheless the Brazilian Real continues to appreciate versus the Dollar and is currently at 1.6850.

**Commodities**

- Commodities rose this week, with sharp gains in energy and agricultural commodities.
- Crude oil prices jumped this week from a low of $88.03 a barrel to a high of $92.39 on optimism over the global economic recovery. However, prices have come down since following the disappointing US jobless claims figures. Crude oil is currently at $90.99.
- Agricultural commodities also performed well on concern over tight global food supplies. Corn for example is set for its biggest weekly gain in three months on signs inventories will be lower than expected in the US. Floods in Brazil and in Australia are adding to the supply concerns.
- Gold is flat for the week, although it was a rocky ride, with the precious metal moving from a low of $1365.75 to a high of $1393.30 but then back down to $1365 currently. Gold is flat for the week 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 could undergo a good correction here 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.