Bedrock Newsletter

Friday, September 2nd 2011

Jobs, Jobs, Jobs!

This remains the most important issue for Governments and Central Banks around the world (maybe excluding the ECB…!)

Today, we eagerly await the unemployment numbers coming out of America. The market expects a positive number of +70'000 increase and a steady rate of unemployment around 9.1%. Anything worse than that will add to the market turmoil, which we do not expect to be over yet.

The equity markets, after rallying smartly from their lows of August 9th, may have hit a peak again. It seems that we should see one more move to the downside, and this will probably be caused by the increasing angst over Europe. Mohamed El-Erian, the CEO of PIMCO has said that the ECB made a mistake to raise rates in June and that they will probably cut interest rates as the chance of a recession in the Eurozone has risen to 50%... Greece is bankrupt and the default is a question of when, not if. Then, there is the problem of contagion within Europe that no one knows how it will evolve... and of course, there is Germany that will vote soon on the acceptance of this bailout package. In fact, there are a lot of disturbing macro issues at hand and we have decided to once again protect the portfolios by buying more puts on equity indices.

The Euro seems to have hit a wall at 1.4500 versus its American counterpart, after many attempts to clear that level proved too difficult. We are now at 1.4200 and it seems that the level of 1.4000 will break soon. Actually, the USD seems to have found a (temporary?) floor as it is strengthening against all currencies, save for the CHF (which had dropped 15% versus the USD and the EUR in the past 3 weeks…).

Precious Metals continue to rise, but until when? Bond Yields continue to fall, but then, how much money can you expect to make when yields are so low? Equity markets remain the best bet for the next 2 years as companies have deleveraged and have a lot of cash at hand. Moreover, the Emerging world is still growing at a nice pace and corporate earnings are on the rise. So, we must find a balance between the macro risks, which are undoubtedly there, and the compelling reasons that make us believe that equity markets offer good value here.

After an Arab Spring, a Japanese devastating earthquake, a Libyan war and a Syrian brutal repression and oppression, a Global Sovereign Debt crisis, a US credit rating downgrade, a hurricane reaching New York City, we are left to wonder and ponder on to what is still in store for us all for the remainder 4 months of the year (2 of which have a reputation for being nasty months…)

Have a restful and serene week end!

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Currencies

- The Euro dropped this week versus most major currencies as macro data continues to deteriorate. This week saw a contraction in European manufacturing and plunging business and consumer confidence. To make matters worse, some European banks are struggling to access medium and long term funding, clearly showing that the sovereign debt crisis is contagious…
- The Euro's weakness was compounded by better macro data in the US (finally), with the ISM August manufacturing index topping expectations, coming in at 50.6, a level indicating growth. So the Euro dropped from 1.45 at the beginning of the week to a low of 1.4210 against the USD and is now trading at 1.4245.
- We believe that the Euro will weaken further, as downside pressures are building. Uncertainty regarding the EFSF ratification process is likely to intensify, as the political debate regarding bailouts heats up in Germany. The German Constitutional Court is also set to rule on the Greek aid package, which could complicate matters further
- The US Dollar strengthened this week, with the Dollar Index up 1.2%, on the back of the better manufacturing data. The major boost for the Dollar was not the better macro data in itself, but rather that on the back of it the Fed would not increase the supply of Dollars by embarking on another round of QE3.
- Meanwhile, the JPY and CHF continued to strengthen this week as the global growth picture remains very bleak. The Swiss Franc went from 0.8060 versus the USD to 0.7800 currently and from 1.1690 at the beginning of the week to 1.1100 currently against the Euro.
- The Japanese Yen went from 11.17 against the Euro to 109.35 currently but is roughly flat against the Dollar for the week, currently trading at 76.82. However the moves in the JPY were quite volatile against the USD this week.
- The Swiss Franc especially continues to benefit from the "safe haven" bid, as markets anticipate that this afternoon's job release in the US will disappoint. We continue to find the strength in the CHF unsustainable, and expect Swiss authorities to intervene to weaken its currency, but as long as data disappoints, the CHF may remain strong for some time.
- Higher yielding currencies, such as the AUD and CAD were strong this week, benefiting from the better manufacturing data in the US. The Canadian Dollar is trading near its four week high against the Greenback, while the Aussie Dollar is headed for its third week of gains versus the USD and the JPY as investors pared bets the Reserve Bank will cut interest rates.

Fixed Income

- US Treasuries are headed for a weekly gain before reports forecast to show US companies created fewer jobs in August, adding to signs of economic slowdown.
- Yields on 10 year US securities are down 5bps to 2.135% currently, while yields on 2 year and 30 year were largely unchanged over the week. The 2 year yield is .184%, 6 points below the upper range of the Fed's target rate…
- German government bonds traded in line with American ones, but other euro zone bonds actually declined, as the euro zone sovereign debt crisis continues to linger on. Yields on Spanish and Italian bonds rose this week, as a key Spanish bond sale attracted lacklustre demand on Thursday.

- Interestingly, the Czech Republic's funding costs this week fell below higher rated Belgium, as investors put more confidence in the Czech's fiscal and monetary policies than those of some of their Western European neighbours…
- Meanwhile credit markets improved this week, with high yield and investment grade corporate bonds up roughly 0.5% over the week. This follows a very tough August, especially for high yield bonds. Indeed, this August was the slowest month for high yield issuance since 1995! And also was the first month with no euro-denominated, investment-grade corporate bond sales since the European common currency was introduced in 1999.
- While we have suffered with high yield bonds, we believe that these are even more attractive today as credit spreads that are much too wide given economic realities and the strong health of the private sector overall.

Equities

- Global equity markets rose sharply this week with the MSCI World index up 3.45% as of yesterday's close. However, the gains are likely to be much more muted, as European markets today and US stock futures are down significantly this morning before this afternoon's US job reports which is likely to show that the US continue to struggle.
- News flow was nothing particularly great this week, and the market moves seem to have been more driven by participants snapping up stocks that have lost tones of value since spring of this year. The only real positive news was the US ISM manufacturing release, which surprised to the upside. However data in the EU continued to paint a very troubling picture for economic growth.
- Some of the higher appetite for risk may have come from growing expectations for more stimulus from the Fed, however the ISM data put these expectations to rest for now.
- European bourses, which suffered the most in August, saw the sharpest gains this week, despite no major development or improvement in the euro zone. The Euro Stoxx 600 index is up 4.2% for the week, including today's 1.3% decline. In August it was down by more than 10%, and is negative for the year.
- Conversely, US markets were up by less than their European counterparts for the week, but did much better in August and are roughly flat for the year. The S&P 500 index is up 2.35% as of yesterday's close, after having declined by 5.7% in August. For the year it is marginally negative.
- In terms of sectors, industrials, financials and materials were the best performers as these benefited from the return of risk appetite. Conversely, consumer staples, utilities and telecoms lagged given their defensive nature.
- We believe that equities do offer a lot of value, but for the near term we believe that markets will remain volatile given a very challenged macro backdrop and very inconsistent policy actions around the globe.

Emerging Markets

- Emerging markets equities outperformed their developed counterparts this week, with the MSCI EM Index up only 6.4% versus the MSCI World up 3.5%. EM equities underperformed developed equities in August, and are still lagging for the year to date. However, the

performance differential is declining. The MSCI EM index is down 2% for the year to date, versus -0.3% for the developed index.

- Latin American stock markets were the best performers this week, with the MSCI Latam index up 8% for the week. This is largely attributable to Brazil, following a surprise interest rate cut which boosted the country's stock market.
- The Brazilian central bank's rate cut was unexpected, and is clearly a sign that policy makers there are now shifting from fighting inflation to boosting growth. Equity markets have reacted very positively, with the Bovespa Index up nearly 20% since its low on August 8th.
- Following the announcement, the BRL dropped sharply, from 1.5820 against the USD on Wednesday to 1.6197 currently.
- Eastern Europe also did well this week, thanks to higher commodity prices while Asia EM was up around 5% for the week.
- The only major negative market this week was China, with the Shanghai Composite index down 3% for the week. Recently this market has traded completely against world markets, so this week's performance is in line with recent activity.

Commodities

- Commodities gained this week, with the S&P GSCI broad index up 1.9%. As is often the case, performance varied by major type of commodity quite significantly.
- Energy continued to rise with the GSCI Energy index up 3.2% for the week. Today some of the gains have been given back as markets anticipate weak jobs figure in the US. WT Crude oil is trading around $100 a barrel, from last week's close at $98.40.
- Industrial metals were also up this week, around 1.7% as EM growth remains robust. However agriculture was down.
- Meanwhile, precious metals dropped in the beginning of the week but then have risen in the second part of the week as concerns over growth come back. Gold began the week at $1819.55 an ounce then dropped to $1776.00 and is now at $1852.6.
- 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.

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