Friday, September 16th 2011

It is Friday again. For reasons to be debated in future articles and textbooks, the markets' *tone* has changed. Panic has abated; gold is dropping, bond yields increasing slightly and equities have had a few days of pleasant "ups". Whatever the reasons, we welcome the outcome!

You, our reader, may have felt our ongoing dislike of Government actions and/or inactions. Our pseudo-anarchist or Adam Smithian "laissez faire" views have been vindicated! Belgium, an EU member, Euro anchored country, has just broken the World Record of number of days without a government having displaced Iraq from this throne (crossed 500 days earlier this week). We note with a smile that at the same time, left to its own devices, the Belgian GDP has been progressing faster than Germany's and actually, has the best economics of any European country.

Then, we listen to Boehner tell the world that President Obama's $447 billion Job Plan will not pass Congress- That Republicans will not approve extra taxes to pay the price of these jobs (a necessity for the budget-neutral promise). The same "leader" also implied that the Republicans will not allow any additional raising of the debt ceiling to pay this bill, just in case anyone wondered how they could block Obama… Let them just go away, all of them, just like the Belgians did and all will be well…

In regard to the apparent dysfunctional Europe, we believe that the markets have adopted an outlook which may be too dire, overlooking the true political conviction in the validity and importance of the European Union. We remind ourselves that the origins of the EU are planted in the leaders and peoples of Europe post World War II decision to end all wars. Yesterday, a Polish minister actually used the word WAR as a possible outcome to a breakup of the Union (within 10 to 20 years he said)! We believe that appearances and words notwithstanding, the political resolve to maintain and strengthen the Union is probably stronger and more valid than many realize. Yes, the uncertainty of how and when the eventual resolution will take form will continue to shake the daily trading. But afterwards, the pieces will fall into place and all will be better.

So how do we look at the world right now? We note that the Libyan situation is clearer if not resolved; Syria's leadership is under growing pressures to go join the other Arab dinosaurs. There is little inflation (not enough to our liking) so low interest rates are likely to remain and whilst Western employment remains in a sorry state with little hope for immediate remedies, corporate earnings are holding up if not improving.

We looked back at our projections for 2011 issued on December 17th of last year: "Equity indices: expected to rise into 2011, driven by corporate earnings. With the S&P 500 likely to earn about $90 per unit of the index, a P/E of 15X would suggest a **1'350 for end 2011** (up 8% or so from here)". It is interesting for us to note that our expected S&P earnings at $90 have been exceeded, running now at $91.45. Using a P/E ratio of 15X, then these earning suggest an index level of 1'370. We remain optimistic that by year-end our previous expectations might be ratified by the markets! The Index closed yesterday at 1'209 down 3.80% year-to-date, trading at a P/E of 13.22. In the (very) volatile interim, we remain cautious and hedged!

Bedrock Newsletter

May your weekend be as sunny as ours is expected to be!

Currencies

- The euro gained this week versus most major currencies, as Euro policy makers re-confirmed their commitment to keeping Greece afloat but more importantly as the ECB announced that it will coordinate with the Fed and other central banks to conduct three separate dollar liquidity operations to ensure lenders have enough of the currency through the end of the year.
- As such, the Euro advanced from a low of 1.3495 versus the Greenback early in the week to a high of 1.3935. The Euro gained versus practically all of its major counterparts. It remained in a band against the CHF, close to 1.20 “peg” level set by the Swiss National Bank.
- But the common currency has since lost some of its swagger and is trading at 1.3795 versus the US Dollar on concerns that policy makers will not come up with any credible long term solution to the euro zone sovereign debt problems.
- Euro-area finance ministers are meeting today in Poland to try to take decisive actions to halt of the debt crisis and show “unity of purpose”, but there is a lot of scepticism that any concrete solution will emerge from this meeting, and therefore we expect the Euro to remain under pressure.
- Meanwhile, the British Pound continued to weaken against the USD this week, edging close to an 8 month low, on speculation that the Bank of England will engage in some sort of quantitative easing program. Indeed this week saw UK retail sales fall and jobless claims rise even as inflation quickens.
- This week also saw higher yielding currencies such as the Australian and New Zealand Dollars weaken on concerns over global growth. The Aussie was particularly under pressure as speculation grows that the Reserve Bank of Australia will start cutting interest rates this year. The AUD lost 2.5% against the JPY this week.

Fixed Income

- US Treasury 10yr note yields rose the most in more than three weeks after having reached an all time low early in the week as the ECB said it will work with the Fed and other central banks to lend euro-area financial institutions dollars, damping demand for a refuge. The yield rose by 15bps to 2.07% currently. Yields on shorter term securities were marginally higher for the week, with the yield on the 2yr Treasury up 2bps to .185%.
- In Europe, yields on government bonds moved up in unison with their US counterparts. The yield on 10yr bunds rose by 13 bps to 1.9% and on 10yr French bonds, yields rose by 19bps to 2.65%.
- The UK 10yr Gilt rose by even more, gaining 24bps this week to 2.495% as inflation continues to advance in the UK.
- Meanwhile, yields on Italian and Spanish 10yr bonds continued to rise this week, despite the claims of euro zone leaders and today’s meeting of euro area finance ministers.
- Despite rising equity markets and a better sentiment overall, credit markets remained under pressure, especially in European high yield corporate bonds.

- Indeed, while US corporate investment grade and high yield bonds are roughly flat for the week, European IG corporate is down by 1% while HY bonds are down by more than 3%. This area of the fixed income spectrum continues to be roiled by a lack of liquidity and is being impacted by its proximity to the euro zone sovereign debt crisis.
- Again we reiterate our preference for high yield corporate bonds as well as Emerging Market Corporate bonds versus other types of issuers in the fixed income arena. The corporate sector is extremely healthy, has tons of cash on hand, and most companies will be able to withstand slowdown in global economy and the Euro zone's sovereign debt crisis.

Equities

- Global equity markets are up nicely for the week as the European Central Bank announced coordinated measures with the Federal Reserve to ensure banks have enough dollars and Germany and France assured investors that Greece will remain a member of the euro.
- The MSCI World as of yesterday's close is up 3% and European markets are up by around 1% as we write this. For the year to date, the MSCI World index is down 8.6%.
- European stock markets tanked on Monday as the euro zone crisis only seemed to intensify, with European financials experiencing large losses. For reference, the French CAC 40 index slid 4% on Monday. But then European bourses bounced back sharply on the back of encouraging statement from the region's policymakers. Now the Euro Stoxx 50 is up 4.5% for the week as we write this.
- American stocks did also very well, with the S&P 500 up 4.75% as of yesterday's close while Japanese stocks lagged, with the Nikkei 225 advancing only 1.45% for the week.
- Financials were extremely volatile this week, tanking in the beginning of the week on continued concerns over the euro zone sovereign debt crisis, almost reaching its low of 2008, but then bouncing back sharply. We expect financials to continue to recover as these have reached ridiculously low levels, but this will be a rocky ride and these are ridden with risks difficult to measure. Indeed, this week UBS announced that it had lost $2 billion from an unauthorized trade...
- In terms of sectors, information technology and consumer discretionary were the best performers this week while consumer staples and telecoms were the laggards given their defensive characteristics.
- We believe that equities do offer a lot of value, but for the near term we believe that markets will remain volatile given a much challenged macro backdrop and very inconsistent policy actions around the globe.

Emerging Markets

- Emerging markets equities underperformed their developed counterparts this week big time, with the MSCI EM index down by over 2% versus an increase of 3% for the developed index. For the year to date, the EM index is down 16.3% versus 8.6% for the developed index.
- EM stocks underperformed this week as growth forecasts were reduced across the different EM regions, while inflation remains a lingering concern. Asian bourses were largely flat, except for China which is down around 1% for the week while Latam is down by over 2% for the week.

- The best performing EM region was Eastern Europe, as Russia's stock index advanced by 1.5% benefiting from higher oil prices.
- EM stocks have been penalized by much more than their developed counterparts over late, and believe that ultimately the performance differential should reverse.
- Separately, the South African Rand plunged this week as the South African economy grew much slower than expected in Q2, putting to bed expectations for rate increases in 2011.
- Asian currencies also continued to weaken with the Bloomberg-JPMorgan Asia Dollar Index touched a five month low yesterday as global funds pulled more than $2 billion from equities in South Korea, Taiwan and Indonesia since the end of last week.

Commodities

- The S&P GSCI broad index is flat for the week, but again performance varied greatly by type of commodity.
- Energy prices continued to rise this week, with the GSCI Energy index up 1.5%. Crude oil is benefiting from supplies concerns and as global growth prospects seem slightly less dire than before, as well as ever rising geopolitical tensions in the Middle East (Turkey-Israel- Egypt...)
- Industrial metals were slightly negative for the week while agricultural commodities were down 3%, as measured by the GSCI corresponding indices.
- Precious metals were the major losers for the week, with the GSCI precious metals index down by more than 4%. Gold went from $1855.70 at the beginning of the week to $1777.3 an ounce currently. We continue to believe that gold is priced too richly and would not recommend buying gold at these levels.
