Friday, September 23rd 2011

The big news of the week, the truly important one came from the CERN, the particle accelerator near Geneva- In one of their experiments some particle covered a known distance in a time that suggests it (the particle) travelled faster than the speed of light! This, if confirmed would suggest that much of our understanding (or lack thereof) of the universe has been and is fundamentally wrong.

Now let's discuss Ben Bernanke's "Twist"… The Fed announced on Wednesday that they will be buying $400Bn of longer dated securities and sell-down the shorter ones. They will not be adding capital here, just acting to flatten the yield curve and in so doing, reducing mortgage borrowing costs. This in itself was hardly overwhelming. The small print that followed said that the economy is in dire straits and the equity market took a severe dive. Perhaps Ben was responding to political criticism of the Fed? Preparing the ground for a huge QE3 sometime soon? We don't know and dare not guess here. Thursday, equities fell further and hard. Everything was being sold. Gold, other metals, all currencies other than the US$. Emerging currencies, the "darlings of investors" took huge smacks over the last few weeks. Banks in general and European ones in particular were punished for having met some Greek borrowers. Credit Agricole stock is down 60% in the past two months… Well, the markets are predicting with rising certitude that Greece will default. In reality, if this were to happen in an orderly manner it may well be the better of all evils.

A little question slipped into our thoughts here- The Greek debt per capita is about $54'000 which isn't that different than the $48'000 of debt per American capita… And the US capitas have significantly more personal debts… Just a thought as the US Dollar rises and Treasury yields plummet. Will CERN explain this phenomenon away?

The more we stare at the global markets as they reduce our capital and general wellbeing, the more we see ourselves sitting on Tatamis eating rice and raw fish. Zero rates (promised to last for a very long time), no growth, aging populations and declining asset prices… Many of us already drive Toyotas and eat Sushi. What next?

The more we stare, the less we believe that the yield curve manipulations are the solution. Some time ago we suggested that perhaps, just perhaps, a big rise in interest rates could help the economy! Say 5% for cash? The low rates don't help in an environment where potential borrowers do not qualify for loans and those who do, have no appetite to leverage themselves. Corporations? They have never been more cash-rich so they don't need or want to borrow. At the same time, a large and growing proportion of the population depends on its savings and retirement funds to live. No yield? They don't spend…

Last week UBS, the huge Swiss bank, reported that a "rogue trader" lost $2.3Bn. Yet another one… Remember Barings? Société Generale? We wonder what happens to rogue trades and traders who make money? Do they get the Chairmanship? Have a better weekend than your week was…

Currencies

- Yet another dramatic week with dramatic moves. The US Dollar shot up this week like a spaceship, the Japanese Yen was strong as well, the Euro dropped, the Swiss Franc dropped even more but seemed a little confused, the other Dollars (Canadian, Australian and New Zealand) took a beating as well while EM currencies collapsed.
- Markets in the beginning of the week traded like they had over the last few weeks, but the moves were accentuated sharply following the Fed's decision on Wednesday, as it cited "significant downside risks" to the Fed's outlook for the US economy. This prompted a flight to safety highly reminiscent of moves in 2008, with investors dumping everything and coming back to the USD.
- At the same time, the Euro crisis continued to worsen, with little on the policy front, and with Italy being downgraded by S&P and eight Greek banks downgraded by Moody's.
- As such, the Euro tumbled from 1.38 in the beginning of the week to a low of 1.3385 against the US Dollar. The common currency stumbled from 106 against the Japanese Yen to a low of 102.22, the lowest level since 2001...
- The British Pound was even weaker, falling from a high of 1.5764 against the US Dollar to a low of 1.5330, and also weakened against the Euro.
- The weakness in higher yielding currencies was even more pronounced. The Australian Dollar dropped from 1.04 against the USD to 0.97, the first time below parity since February of this year. The Canadian Dollar and New Zealand Dollars also traded in the same direction and magnitude...
- The Japanese Yen strengthened like the US Dollar, and even gained slightly against the Greenback for the week. The JPY is trading at 76.22 currently.
- The other major "safe haven" currency, the Swiss Franc, weakened this week, despite the flight to safety, against the US Dollar as well as against the Euro. Rumours floated this week that the SNB would move the "peg" against the Euro from 1.20 currently to 1.25. As such, the CHF dropped from 1.2085 against the Euro in the beginning of the week, to a low of 1.2345, but has since come back to 1.2205 currently as rumours have subsided.
- Today, currency markets reversed slightly following various statements from policy makers around the world, notably at the G20 meeting that they will do everything to support the banks. As such, the US Dollar has given back some of its strong gains and the Euro has recovered some. It is now trading at 1.35 after having gone below 1.34 versus the US Dollar. But in our opinion, this will be a short lived correction before further gains are seen for the USD.
- Despite today's price activity, we believe that currency markets will continue to trade as they have over the last few weeks as long as no concrete solution emerges for the Euro debt crisis. As such, we expect the US Dollar to remain strong and the Euro to remain weak. Given the volatility, and the very erratic and unconvincing policy, we would recommend against taking too much risk in currency markets at this moment.

Bedrock Newsletter

Fixed Income

- Moves were as dramatic in bond markets this week as well, with government bonds sharply up as stocks fell worldwide on concern the economy is sliding into recession.
- Long term US Treasuries moved sharply higher on concerns over the global growth outlook and following the Fed's announcement that it would buy $400 billion of longer-term debt while selling an equal amount of shorter maturities to cap borrowing costs.
- Consequently, the yield on 30yr US bonds dropped 50bps over the week, the largest move since 2008, to 2.814% currently. The yield on the 10yr benchmark security dropped 31bps this week and is now at 1.742%. The 2yr yield actually increased, moving higher by 3bps this week to .194%.
- Yields on German, French and UK government bonds moved lower as well, with the yield on 10yr UK Gilts lower by 16bps this week and by 18bps for 10yr German bunds.
- Meanwhile, yields on Italian bonds continued to rise this week as Italy was downgraded and as no solution seems to be coming for the European debt crisis. The yield on 2yr Greek bonds rose by 1130bps this week to 59%, and it seems almost certain that Greece will have to default.
- This week the banks, and especially the French ones continue to be in the eye of the storm as more and more policy makers now state that certain European Banks need to be recapitalized. Bank capital and hybrid securities are tanking as the outlook grows increasingly gloom for them...
- Credit markets continued to suffer this week, especially European High yield, which is down 1.5% for the week. US HY is doing less bad, down 1% for the week, while investment grade corporate bonds are up in the US but slightly down in Europe.
- 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 a slowdown in the global economy and the Euro zone's sovereign debt crisis. Valuations in high yield are reaching dramatic levels and we believe that this asset class offers one of the best risk/return proposition today.

Equities

- Global equity markets are down big time this week with the MSCI World index down 7.4% for the week, bringing performance for the year to date to -15%.
- Investors dumped everything this week, and most developed markets were down by around the same level. In a sign of the dramatic moves, the Vix index which measures the volatility on the S&P 500 jumped 33% this week and is at very high level...
- The S&P 500 declined by 7% as of yesterday's close. Markets reacted very badly to the statement by Bernanke on Wednesday, when he said that there were very high downside risks to the Fed's outlook for the US economy. And so while the "Operation Twist" managed to bring down long term yields, it clearly did not do anything to boost the confidence of equity investors...

- European stocks are down as we write this by close to 10% for the week. Markets opened higher today but have since reversed and are now down anywhere between 0.5-2% depending on the country. The Euro Stoxx 50 is down 9.4% and for the year to date is down almost 30%!!!! European markets are clearly in recession territory.
- The best performer this week: Japan, which is as we write this marginally positive for the week.
- In terms of sectors, cyclical sectors were the worst performers by far, with energy, materials and financials down over 10% as of yesterday's close (and probably much more now if US markets are to follow from Europe's lead). Conversely, more defensive sectors such as heal care and consumer staples were the "best" performers, only down 5% for the week.
- Banks continue to be under huge pressure. Bank of America saw its credit rating downgraded this week, and European banks are in the doldrums. We expect that financials will remain under strong pressure as long as the European crisis worsens and would not be surprised if sometime soon global policy makers finally come to the rescue.
- 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. We remain hedged.

Emerging Markets

- Emerging-market stocks tumbled this week, driving the benchmark index toward its biggest weekly loss since 2008, as a faltering global recovery boosted speculation developing nations will take measures to support markets.
- Indeed, the MSCI EM index is down nearly 10% for the week, and is now down 23.5% for the YTD, well into bear market territory...
- Again performance varied by region. The worst performing region was Eastern Europe, then Latin America and Asia. In Asia, the best performing country was China, down only 2% this week.
- EM government bonds as well as corporate bonds plunged this week, with yields sharply higher on government debt and the lower liquidity in EM credit hurting the asset class.
- This week also saw very significant outflows in all types of EM funds – government bonds, credit and equities.
- In currencies moves were also dramatic. The South African Rand went from 7.40 against the US Dollar to 8.6155 but has since recovered some and is at 8.3422. The Brazilian Real went from 1.70 against the US Dollar to a low of 1.95 (!!) and is now at 1.9055...
- Asian currencies also dropped sharply, with the biggest 5 day losses since 2008. These have bounced back some since South Korea's government said that it may step in to stem the declines.
- While moves have been dramatic, we believe that EM assets are being punished too severely given the better economic backdrop in the region and find EM corporate bonds attractive, while equities seem to offer a lot of value.

Bedrock Newsletter

Commodities

- All commodities tanked this week, with dramatic moves across the board. The S&P GSCI broad index is down 7% for the week as of yesterday's close, and things are not looking better today.
- Industrial metals were the biggest losers this week, with the GSCI Industrial metals index down almost 10% as of yesterday's close. Copper for delivery in three months fell to $7,115.75 per metric ton, the lowest price since August 2010, a loss of over 16% this week. Tin plunged by 14% and Zinc by 11% this week on recession fears.
- These moves are highly reminiscent of 2008, when industrial metals continued to do well even while equities and credit were down, and then moved sharply lower in a short timeframe...
- Energy prices dropped by more than 7% this week, as measured by the S&P GSCI Energy index. Crude oil dropped from $88.18 a barrel to 78.95 currently.
- Precious metals also tanked, despite their perceived "safe haven" status, with the GSCI corresponding index down 5%. Gold went from $1812 an ounce at the beginning of the week to $1706 currently. We still do not advise to buy Gold at these levels.
- Agricultural commodities were down roughly 7% as measured by the GSCI Agriculture index, with these declining as well on the flight to safety and concerns over global growth.
- These dramatic moves remind us of 2008 and do not give us much confidence for the short term outlook... As such, we would not recommend adding any risk in commodities at this stage.

Disclaimer

This document is for information purposes only and has been prepared by Bedrock SA, representing the opinions and investment views of Bedrock SA as applied in its investment advisory and management activities. It is a private publication intended for private circulation only. It does not constitute a company survey, a financial research, an offer, a solicitation or a personal recommendation to buy or sell specific products or securities. Bedrock SA disclaims all liability for any losses or damages of any kind relating to such information, which may be changed at any time without notice. The risks inherent in certain investments, particularly derivative products, may not be suitable for all investors. The contents of this publication may have been used for transactions by Bedrock SA prior to their communication. Distribution or dissemination of this document and/or the sale of certain products mention herein are subject to restrictions. Copyright 2011 All rights reserved. Approved for circulation in the UK to non-private customers only by Bedrock Asset Management (UK) Ltd which is authorized and regulated by the Financial Services Authority. This presentation is being made to you solely for your information and must not be copied, reproduced, further distributed to any other person or published, in whole or in part for any purpose.
© 2011 Bedrock S.A. 4, ch. Des Vergers, 1208 Geneva, Switzerland, T: +41 (0)22 592 5455 F: +41 (0)22 592 5459, www.bedrockgroup.ch