Bedrock Newsletter

Friday, September 30th 2011

Another week is ending as is a quarter; the worst quarter for global equities since 2008. And it was the end of the year 5771 so we wish you all a “Shana Tova” and hope that this blessing for a good year comes to be!

Let’s hope that Q3 earnings which are imminent prove the expectations right- These are now at around $100 for the S&P 500, and if confirmed, make the P/E of the index 11.60X which is very low on an historic basis, having averaged closer to 15X.

And then, commodity prices are down in general and oil in particular, perhaps this cost-reduction will assist the re-booting of the western economies? And the cost of money remains at historic lows, almost everywhere. There are some reasons for guarded optimism. Some more optimistic thoughts for consideration; Certain Emerging Economies such as China and Brazil are experiencing inflationary pressures. These are basically demand driven as they are bumping against supply bottlenecks- these economies are short on qualified labor. Maybe our unemployed should travel south from the USA and east from Europe? Then, let’s not lose sight of the going-on in China: They have urbanized about 400 million farmers, creating a huge building boom. When we hear analysts warning the investor-world that China is slowing and that the world will hurt from this, we remind those analysts that China needs to urbanize yet another 400 million people. So Iron Ore demand will not abate and then energy demand will increase. Yes, the motor remains revving, albeit no longer in acceleration mode.

This week we had Germany’s legislature approve the funding of the European “rescue fund”. They had to and they did. Markets rallied then stalled as Slovakia is hesitating, will they contribute their share?

At the end-of-the-day, all members will approve the requisite measures. Most remember the reason behind European Unity- “No More Wars”. The alternative is hugely more expensive.

Think of this- If anyone complains about aging, ask them if it’s not better than the alternative?

We believe that the obvious solution for the European woes can be found in the weakening of the Euro. This implies inflating. Here, Germany with its genetic fear of inflation is the problem. No Euro Bond, no printing, no return to Weimar… This may be a “tougher sale” than more Euros for Greece. Until then, we best get used to volatility…

Overall though, even as we can reason for some optimism we are very concerned about the state of the economy. The mains driver of economic activities lies in sentiment and all we see and hear is fear, concern and apprehension. When people are gloomy about the future, the present turns sour. We remain cautious but wish you a Shana Tova again. Maybe it will bring more serenity for all of us this time around?

Currencies

- The US Dollar continued to strengthen and the Euro continued to weaken early in the week, as it seemed that no consensus had emerged over the weekend as to how to deal with the euro zone sovereign debt crisis. The Euro dropped to a low of 1.3365 against the USD.
- But then hopes grew that some resolution was coming, and the Euro bounced back, reaching a high for the week of 1.3690 vs. the USD. Since then, the Euro has traded range bound, despite the positive news that the German parliament has ratified the expansion of the euro zone's bail-out fund. The Euro is currently trading at 1.3500 versus the US Dollar, roughly the same level at the beginning of the week. We continue to expect more downside in the Euro in the coming weeks.
- Market participants are now expecting the ECB to lower rates over the next twelve months, while early in August the expectations was for further rate increases.
- The British Pound gained this week versus the US Dollar and versus the Euro, as a report this week showed that UK consumer confidence rose for the first time in four months. The GBP went from 1.5450 vs. the USD to a high of 1.5715 and is now at 1.5580. Against the Euro it went from a low of 1.1400 to 1.1520 currently.
- Separately, the Australian Dollar and especially the New Zealand Dollar continued to be under pressure, with the NZD falling to its weakest level in 6 months against the USD after both S&P and Fitch cut the country's credit rating. Another negative for these currencies was a private report which showed contraction in Chinese manufacturing.
- Looking back since the end of July, when market turmoil really began to hit hard, we have seen a dramatic appreciation of the US Dollar versus practically all currencies. Indeed, the Dollar Index has gained 6% since July, with larger gains in September than in August. Conversely, since then, the Euro has dropped 6% against the US Dollar.
- The flip side of this strengthening is a large sell-off across currencies against the USD (and in Europe against EUR). Since end-July, the hardest hit currencies have been BRL, which has weakened 15.4% against USD, followed by ZAR (down 14.9% against USD), MXN (12.6% down against USD), NZD (11% down against USD), and AUD (down 10.4% against USD).
- In non-Japan Asia, the hardest hit currencies have been KRW (down 10.2% against USD) and India (down 9.8%), followed at a distance by SGD, MYR, TWD, and IDR (down 6.9%, 6.6%, 5.1%, and 4.0% against USD, respectively). To put the dramatic FX sell-off in perspective, Asian currencies are set for their biggest monthly loss in over a decade...
- The FX moves over the last two months have been dramatic, and may well offer opportunities both on an outright basis against the USD and on a relative value basis. Nevertheless, we believe that markets currently are waiting to see whether the European crisis morphs into something similar that we experienced in 2008 or not. If it does turn into something even more severe, then the USD will strengthen sharply. If not then we may see some reversal of the current strength. As long as there is no clarity over the European situation, we remain cautious over taking significant risks in currencies.

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Fixed Income

- Yields on government bonds moved higher this week following last week's dramatic drop. Yields on 10 year US treasuries moved higher by 13bps to 1.967%, on 30 yr securities by 10bps to 3.004% and on 2 year Treasuries by 5bps to .263%.
- Yields on German 10 year bunds rose by 22bps this week, to 1.955%, the biggest weekly gain since May 2009. Yields on 10 year French and UK bonds also rose by roughly 10bps for the week.
- The weekly decline in government bonds this week stopped on Thursday, following weak German retail sales and a report showing a contraction in Chinese manufacturing.
- In Q3, US government securities are up 5.66%, the largest gain for a quarter since Q4 2008. European government bonds are up 3.4% in Q3 as measured by the Bar Cap Euro Agg Government bond index.
- Separately, with the better news over the euro zone crisis this week, yields on Spanish and Italian bonds declined this week. The yield on 10 yr Italian bonds is down 12bps to 5.49% and on 10yr Spanish bonds down by 15bps to 5.03%.
- Despite rising equity markets and some tentative signs of appetite for risk, credit markets were soft this week, with investment grade and high yield corporate bonds marginally down for the week.
- A sign of the weak credit markets: corporate bond offerings worldwide plunged in the third quarter to the lowest level since Q4 2008 as Europe's sovereign debt crisis caused investors to shun all but the safest securities...
- 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 up big time this week as European as policy makers increased efforts to contain the region's debt crisis and US employment and growth data exceeded forecasts. The MSCI World index is up 3.2% for the week as of yesterday's close. However, European markets are down 1% as we write this following weak German retail sales and poor manufacturing data out of China.
- Markets were extremely volatile over the quarter and are headed for the biggest quarterly decline since Q4 2008. The MSCI World index is down 15.1% for the quarter and 11.7% for the year to date.
- To show the market turmoil over the period, the VIX index (which measures the volatility on the S&P 500 index) jumped by 135% over the quarter. At its highest this year, the VIX hit 48, a level last seen in May 2010. However, the VIX has remained at much higher levels over this quarter than in Q2 2010...

- Another sign of the negative environment over Q3, companies cancelled or postponed $8.9 billion in initial public offerings in the quarter, putting the market on pace to set a record for pulled deals.
- European equity markets this week were up by much more than US ones. The Euro Stoxx 600 is up 5% and the Euro Stoxx 50 (heavier weighting in financials) is up over 8%, with today's 1% decline. The S&P 500 is up only 2% for the week. Japanese stocks meanwhile are up only 1.6%, as measured by the Nikkei 225 index.
- However, performance for the quarter and for the year to date is in sharp contrast with this week's activity. Indeed, for the quarter, the S&P 500 is down 12% and the Nikkei 225 down by 11.3% versus declines of 16.7% for the Euro Stoxx 600 and of 22.9% for the Euro Stoxx 50. Year to date, European markets are down around 20% while the US S&P 500 is down 7.7% and the blue chip Dow Jones Industrial index is down only 3.6%.
- Interestingly, there were significant differences in performance per country in Europe over the quarter, and especially in September. The French CAC 40 index and the German DAX index are each down 24% in Q3, while the Spanish IBEX 35 index is down 17%. The Swiss SMI index is down in Q3 only 10 %...(thanks to the SNB's Intervention on the CHF).
- Clearly, the European sovereign crisis has roiled European markets this quarter and for the year to date. In some ways, market activity over Q3 11 was almost as bad as in 2008. Indeed, the DAX Q3 performance is even worse than over 08, and is the worst quarterly performance since 2002...
- With hopes over some sort of resolution for the European sovereign debt crisis, financials were the best performers this week by far. The MSCI Finance index is up 6%, far ahead of any other sector.
- Energy and Industrials also did well this week while healthcare and consumer staples underperformed broader markets, as cyclicals outperformed defensives.
- For the quarter however, defensive sectors such as utilities, consumer staples and healthcare outperformed significantly cyclical sectors. These were down by mid single digits, while materials, energy and industrials were down around 20% over the period.
- Financials were the worst performing sector for the quarter, especially European financials. Indeed, the Stoxx 600 Banks index declined by 28% in Q3, coming close to the lows reached in early 2009....
- 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. As long as the euro zone situation remains uncertain, we do not expect much and therefore, we remain hedged.

Emerging Markets

- Emerging-market stocks are up this week by 3.8% as measured by the MSCI EM index on some improvement in sentiment over the global economy and over the euro zone debt crisis.
- However, EM stocks did very badly over September (-13.4%) and over Q3 (-22%), underperforming sharply developed stock markets.
- For the quarter, the largest losses came from Eastern Europe (-27.8%), followed by Latin America (-23.2%) and then Asia (-21%). These regions suffered on concerns over the slowdown in global growth, and concerns over policy activity in these different regions.

- China's benchmark index fell to its lowest close since April 2009 this quarter, on signs growth is slowing as the government maintains measures to curb inflation and overseas demand for exports falters. Another negative for Chinese stocks this quarter was concern over accounting practices as a few high profile companies seem to have had fraudulent practices in how they reported their numbers.
- This quarter also saw very significant outflows in all types of EM funds – government bonds, credit and equities.
- As mentioned in the section on currencies, EM currencies sold off sharply against the US Dollar and also against the Euro over the quarter. As an example, the BRL reached a high of 1.55 against the USD in late July, only to drop to a low for the year of 1.95. The Brazilian currency is trading now at 1.84.
- EM bonds, both government and corporate bonds did much better than EM equities. The Bar Cap Global EM index declined only 2.9% over the quarter, versus a decline of over 20% for equities.
- 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. Again however, until some clarity emerges as to the European situation, we remain cautious as to adding risk for the moment.

Commodities

- Commodities appreciated this week with the S&P GSCI broad commodity index up 1.25% for the week. Commodities had a volatile quarter, up in July, then down slightly in August and down 9% in September. Separately, performance varied dramatically by commodity type over the quarter and performed differently over the last three months.
- Energy is up 1.4% for the week, down 8.4% in September, down 10.8% for the quarter leading to a -5.2% for the year to date. Crude oil is trading at $97.73 a barrel, having reached a high for the quarter of $102.37 on August 2nd, then falling as low as $90.92 on August 9th, only to come back to around $100 level.
- Energy has been moving back and forth, lower given uncertainty over global growth and therefore global demand, and higher given concerns over supply. We expect oil to continue to trade around the $100 level until some sort of clarity emerges over the European situation.
- Industrial metals were the biggest losers for the quarter, with the S&P GSCI down 19.6% in Q3, with the bulk of the losses in September. Here the driver was concern over growth, and as industrial metals had reached very high prices over the year.
- Agriculture was also down big time in September (-15%), but not that bad over Q3 (-3.9%).
- Finally, precious metals are down slightly for the week and for September down 14%. However, in Q3 precious metals are up 4.2% as measured by the S&P GSCI precious metals index.
- Gold had dramatic moves over the quarter. It began Q3 at $1535 an ounce, and rose to a high of $1920 in early September, only to tumble back down to a low of $1532 on September 26th, and is now back at $1621. While gold prices are not as elevated as they were a few weeks ago, we still do not recommend adding gold at these levels as we believe that the precious metal will remain under pressure for some time.

- Commodities have declined broadly and do seem to offer some opportunities. But again given the uncertain environment, we do not recommend adding any risk in commodities at this stage.

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