Friday, October 7th 2011

We are closing the first week of the fourth quarter. Equities started with a nasty continuation of a horrible Q3 only to stabilize and reverse course into a rise with a substantial fall in volatility. What happened? J-C Trichet had his last press conference as Chairman of the ECB. Some think he was a disaster, some think he did a great job. In truth, he did very well managing a lousy mandate. Yes, the Euro zone had the targeted 2% inflation since the inception of the Euro. Much else has gone to the wind though… Maybe now the ECB will be engaging in real QE, the Bank of England did say it would do so in the UK and maybe Helicopter Ben will do the same in the US.

There was a show of European resolve and immediate action as Dexia (a large Franco/Belgian bank) appeared to be falling off a cliff. They agreed strong support by both governments, offering assurances to depositors, etc.

Wow, it was swift. Let’s be a little cynical here and remind you that the same Dexia had passed the Stress Test only a couple of months ago. Then, only a week ago, Goldman Sachs had down-graded the bank from a “buy” to a “hold”. Well, its stock is off 35% since…

We are getting closer to November, a time when the Super Committee in the US is to decide on deficit reduction. We know already that they are unlikely to agree on a plan. Our concern is focused on the small chance that they do agree and reduce significantly government expenditures. What will this do to an economy which arguably is facing another recession? Maybe not agreeing is the right outcome?

And sadly, the world lost a great innovator, Steve Jobs. Apple stock lost 1.5% in an up market.

This week showed us falling yields on Treasuries, with the US 10 year Note falling to 1.77% then rising back to 1.99% as equities rose. Gold has been straddling $1’650 all week, as the US Dollar traded in a narrow band against all the majors. All emerging market currencies found a bid into the end of the week. Overall, the general “feel” of the markets is one of a newfound calm. Is this the calm in the eye of the storm or is it real? Let’s watch for a while yet…

The talk of the street is about recession. Are we facing one? Are we in one? Or are we just bumping along the flat-line? Analysts and consultants seem to be leaning to the recessionary view whilst amazingly, corporate managers are saying that things are ok and the outlooks offered are fair. True, no-one is promising jobs, President Obama aside…

For those pushing for more QE and further state borrowing to stimulate the economies, here is a quote they may want to read: ***“To combat the depression by a forced credit expansion is to attempt to cure the evil by the very means which brought it about; because we are suffering from a misdirection of production, we want to create further misdirection—a procedure that can only lead to a much more severe crisis as soon as the credit expansion comes to an end.”*** Friedrich August von Hayek (Nobel Prize Laureate in Economics) in a speech in June 1932…

What should we hope for? Let’s agree on a nice, restful weekend? ☺

Bedrock Newsletter

Currencies

- The Euro continued on its weak footing in the beginning of the week but then strengthened versus most major currencies on hopes that policy makers would finally provide some sort of measures to stem the euro zone crisis.
- And on Thursday, these hopes were partially answered as the ECB announced that it will reintroduce yearlong loans, giving banks access to unlimited cash through January 2013, and that it will resume purchases of covered bonds to encourage lending. Meanwhile, it seems that the European Commission is pushing for a coordinated capital injection into banks...
- So the Euro went from 1.3340 at the beginning of the week against the USD to a low of 1.3145 but then rose sharply and is now at 1.3445. Against the Japanese Yen, the common currency went from 103.10 at the beginning of the week to a low of 100.75 and is now back at around 103.10.
- The other major central bank in the news this week was the Bank of England, which announced that it will boost its quantitative easing program by £75 billion, more than what economists had forecasted. The British Pound as a result fell sharply against most all its major peers, but has since recovered some.
- The GBP went from 1.5585 against the USD at the beginning of the week to a low of 1.5275, but is now back at 1.5545. Against the Euro it began the week at 1.1640, then fell to a low of 1.1460, and is now at 1.1565.
- The Swiss Franc was the other major loser this week as the SNB said its foreign currency holdings increased to a record last month and inflation accelerated more than economists forecast in September. The CHF went from 0.9080 against the USD to 0.9205 currently (having reached a low of 0.9315) and from 1.2165 to 1.23675 currently against the Euro.
- The sense that EU policy makers are finally getting a handle on the underlying issues helped spur some appetite for risk, and as such higher yielding currencies such as the Australian Dollar and New Zealand appreciated. Both currencies increased by roughly 1% for the week.
- However appetite for risk was still modest as the better news flow out of Europe was somewhat offset by concerns over the US economy. Indeed, today's US jobs report is expected to show that unemployment failed to decline in September, supporting demand for "refuge" currencies. As such, the US Dollar is only moderately lower for the week, as measured by the Dollar Index.
- The ECB's move is a very positive for the euro zone and will provide support for the Euro. However, we now need to see the European Union step up to shore up its banking system, and EU policy makers over the past two years have consistently disappointed so it is far from certain that any clear plan will come into being in the near future. We believe that the US Dollar will remain strong.

Fixed Income

- Yields on government bonds moved higher this week, on positive news flow regarding the euro zone debt crisis and as US car sales and manufacturing data surprised to the upside, cooling fears of a double dip recession in the US.
- The yield on 10yr US treasuries went from 1.915% in the beginning of the week to a low of 1.715% (!!!) but then jumped back higher and is now hovering around 2%.

- Week over week, the yield on 2yr US securities moved higher by 2bps and on 30yr securities by 3bps to 2.944%.
- French and German government bonds traded in line with US securities. The yield on German 10 year bund rose by 6bps to 1.941% and on 10yr French bonds by 11bps to 2.705%.
- Meanwhile, yields on Italian and on Spanish declined this week following the moves by the ECB and various announcements from EU policy makers. This despite Italy's credit rating being downgraded and as Dexia seems set to be the first victim of the current crisis in Europe.
- Despite the improvements in Europe, some positive US economic data, and rising equity markets, credit markets were soft this week. Investment grade and high yield corporate bond indices in both the US and in Europe are down week over week.
- 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 tanked early in the week but have but have since bounced back and are headed for a weekly gain. The MSCI World index is up 1.8% for the week.
- European markets dropped sharply on Monday and on Tuesday, as the Eurozone crisis intensified with Italy being downgraded and Dexia becoming the first bank to be bailed out in the current crisis.
- However, sentiment improved in the US following better macro data (car sales and manufacturing). The announcements by the ECB and by the BOE improved sentiment further, and as such equity markets rose sharply.
- The S&P 500 is up 3% for the week as of yesterday's close, and the Russell 2000 (small cap index) is up 4.6%.
- Volatility remained very high in the early part of the week, with the VIX index closing at 45 on Monday. But it has come down and is now at 36, a 15% decline.
- The Euro Stoxx 600 is up 2.4% for the week while the Euro Stoxx 50 is up 3.5%.
- Japan underperformed this week, with the Nikkei down 1% as Asian markets suffered more in the early parts of the week than the US and Europe.
- In terms of sectors, cyclical outperformed this week given the improvement in sentiment. The MSCI Energy index is up 3.35% and the Materials Index is up 4.1% for the week as of yesterday's close. These sectors however were some of the worst performing sectors in September.
- Conversely, defensives such as healthcare and consumer staples lagged this week.
- We believe that equities do offer a lot of value and that the risk/reward is increasingly favourable. It seems that Europe is making progress on the debt crisis, and this is a major positive for equities. However, the situation is still uncertain and there are still significant risks

of policy mistakes. As such, we are not adding risk at the moment, but the time to put risk back on may be coming soon!

Emerging Markets

- Emerging-market stocks are down 1.86% for the week as measured by the MSCI EM index, a big underperformance compared to developed markets (+1.8%). For the year to date, the MSCI EM index is down 25% while the developed index is down 12.2%...
- EM stocks suffered more in the early part of the week on deepening concerns that the euro zone's debt crisis will dampen global growth. But then these bounced back sharply as optimism grew Europe will step up measures to contain its debt crisis.
- Asian stocks were extremely volatile, with large losses on Monday, especially in Korea, after a report showed that manufacturing data in Korea had contracted. The Kospi tumbled 5%, hitting a one year low.
- But following the positive news from the US and Europe, Asian markets then rose, posting the biggest two day gain since 2009.
- Separately, EM currencies also weakened in the beginning of the week, only to bounce back sharply from Tuesday. The BRL for example went from 1.84 against the USD to a low of 1.92 but is now at 1.7815!
- EM assets, in particular equities, have underperformed significantly DM assets during the recent sell-off. While EM markets tend to react with more magnitude to sharp swing in sentiments, we believe that these have been punished too severely given the better economic backdrop in the region and expect that ultimately, EM asset prices will catch up DM ones.

Commodities

- Commodities are up this week as sentiment improved on the ECB stimulus plans. The S&P GSCI index, which measures the performance of a diversified basket of all type of commodities, is up 2.6% for the week as of yesterday's close.
- Energy commodities are up 3.25% for the week as measured by the GSCI corresponding index. Crude Oil dropped initially to a 12 month on Tuesday of $75.67 per barrel, but then rose sharply reaching $83 and is now trading around $82.25.
- Energy has been moving back and forth, lower given uncertainty over global growth and therefore global demand, and higher given concerns over supply. This week was positive for global demand and therefore energy moved higher.
- Industrial metals traded in a similar way as energy commodities and the GSCI Industrial Metals index is up 2.85% for the week while agriculture underperformed with the S&P GSCI Agriculture index up only marginally for the period.
- Finally, precious metals are up for the week by 2.5% as measured by the S&P GSCI precious metals index. Gold continued to be volatile, going from $1624 an ounce at the beginning of the week to a high of $1678 on Tuesday, only to fall back to $1596 and is now at $1654!
- Gold traded more like a "risk positive" security this week, while it has been considered as a "safe haven" asset historically. We notice that market commentators find any reason to explain

gold moves. We find that gold is a pure speculative play at this moment driven by nothing in particular and do not recommend adding at these levels.

- 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.
