Friday, October 14th 2011

Two weeks into Q4 and equity markets are handsomely up. Main US indices are closing on flat ytd performance, whilst Europeans are still lagging heavily. Somehow Greece has faded away, off the financial headlines. The general sense is that some rational is being formulated with the European Governments and that some form of reasonable outcome is being put in place. We note that the Euro is up against the US$ on a year-to-date basis. Bond yield? Well, the US 10 year Treasury now yields 2.16% down for the year (up in price) but way away from two weeks ago when it had traded at 1.70% Safe haven? Its price is down over 3% since… Strangely, Gold is creeping back up as the risk-on trades are coming back into the markets.

Google gave us an earnings' jolt yesterday, beating by huge margins all expectations. The reporting US banks have shown down results, but ahead of expectations. Alcoa disappointed. Overall, as usual, analysts are missing the marks.

Attention remains focused on China. Is it, can it, will it continue growing at this breakneck rate? We are reminded of the Dot Com era when extrapolated growth rates on Cisco, AOL, Intel and the like implied that each would grow to exceed the worlds GDP… Clearly, a growth rate of 8% or so can be maintained so long as the base isn't huge. Well, now China has become huge (GDP terms) and it would be normal that its growth rate decline. But let's look at China on a GDP per capita base- they are about at rank 125 in the world and need to double on this count to pass Gabon… There are over 50 million Chinese earning under $100/year. There is much to be done, much growth still to be found there! And the Yuan is pursuing its slow appreciation. We hold our exposures here!

Oh, let's not forget India here. India's exports are growing, now about 25% of GDP. Actually, they are catching up with China's 32% of GDP. Good for them, but perhaps we in the West should shudder? Were we hoping to regain jobs? Somehow, Europe with its strong Euro (we emphasize this!) managed to show strong growth in industrial production now up 3.30% year-on-year. We note that the world had, as of end Q2, official foreign currency reserves of $9.70 trillion, of which 6.50T held by the emerging countries. It stands to reason that the "rich" world will let their currencies decline…

A couple of bits of information running in the small-print part of the news attracted our attention:

There are growing tensions between Iran and Saudi Arabia. The former reputed to have made some further and serious strides towards a nuclear capability. We are concerned and added to our holdings of long-dated call options on oil.

The other little info relates to the evolution of the "Arab Spring" revolution. Libya seems to be completing their specific issues, Egypt is slipping backwards into military style government, and Syria keeps on slaughtering its own people whilst issuing threats to Turkey and Israel. The new game though may be the "American Fall"- the siege on Wall Street… Spreading to other cities in the USA, and now, even across the puddle to London…

Bedrock Newsletter

May the markets remain with us!

Currencies

- The Euro strengthened big time this week as Sarkozy and Merkel confirmed their intension to recapitalize the regions banks and later in the week on hopes that the G-20 finance ministers meeting today and tomorrow in Paris will come up with some positive measures to tackle Europe's debt crisis. Apparently, EM countries are working on ways to contribute money rapidly to expand the effective firepower of the IMF, with the aim of increasing its role in combating the euro zone sovereign debt crisis.
- And so the Euro jumped, despite Spain's credit rating being downgraded, producing its biggest weekly gain since January against the US Dollar. It went from 1.338 at the beginning of the week to a high of 1.3834, and is now trading at 1.3785. The Euro gained against the Japanese Yen, from 102.66 to 106.2 currently, and against the Sterling from 0.86 to 0.8745 currently.
- Meanwhile, the US Dollar and Japanese Yen both weakened in what has been a "risk-on" backdrop this week. The Dollar Index, which measures the USD against a diversified basket of its major counterparts, dropped 2.25% this week.
- The Swiss Franc appreciated against the JPY and against the USD, going from 0.9270 in the beginning of the week against the Dollar to 0.8985 currently. Against the Euro, the CHF was quite choppy, moving back and forth but is a little stronger than it was at the beginning of the week, and is currently at 1.2380 against the common currency.
- Given the better new from Europe and optimism that some sort of resolution is in the making, "risk positive" assets and currencies, such as the Aussie Dollar, New Zealand Dollar and EM currencies all appreciated against the USD.
- Both the Kiwi and the Aussie are up roughly 3% for the week against the US Dollar, while the Asian Dollar Index (which measures a basket of Asian currencies vs. the USD) is up 0.5% for the week.
- While we expect better some more coherent and thus positive policy activity in the near term, the problems of the euro zone are extremely significant and therefore believe that the Euro's recent strength will be limited and expect the US Dollar to recover and to remain strong in the near to midterm.

Fixed Income

- US Treasuries fell this week, their third weekly loss in a row, before US reports forecast to show retail sales rose and consumer confidence improved, easing concern the nation is headed for a recession. The yield on 10 year bonds rose 13bps to 2.208% currently and on 30 year bonds yields rose by 16bps to 3.177%. Yields were flat for the week on 2 year securities.
- European government bonds also fell this week. The yield on 10 year German bunds increased by 16bps to 2.157% currently on optimism that global policy makers will finally get some sort of grip on the crisis.
- However, news flow and market action was not all positive. The yield on 10yr French bonds rose 34bps this week to 3.083%, and the premium over 10yr benchmark bunds is now as much as 91.3 bps, the most since the euro started in 1999. Yields on Belgium bonds also rose

sharply amid speculation the region's nations will need to provide funding to backstop their banks, creating an additional burden on state finances...

- Yields also rose 30bps on 10 yr Italian and Spanish securities as Spain's credit rating was downgraded for the third time this year by S&P.
- Credit markets nevertheless were strong this week, following the lead of equity markets higher, on optimism that some sort of solution is in the making. Investment grade corporate bonds are up roughly 0.5% for the week while high yield corporate are up over 2% for the week.
- European high yield bonds outperformed US ones this week, (2.6% vs. 2%). European high yield securities have underperformed significantly their US counterparts this year, with the move accelerating in Q3 as the euro zone debt crisis intensified. We believe that this move is overextended and given the strength of the corporate sector, in the US as well as in Europe, we believe that EU securities will catch up their US counterparts.
- 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.

Equities

- Global equity markets are headed for another good week. The MSCI World index is up 3.8% as of yesterday's close, and European markets are up slightly today while US futures are also positive for the day.
- Markets began the week on a very positive tone, boosted by the pledge over the weekend by Sarkozy and Merkel to deal with the regions banks, and then the optimism over the European situation continued throughout the week. The more positive mood took a small hit on Thursday, on weak trade data from China, confirming the slowdown in global trade and concerns over China's growth prospects.
- Meanwhile, earnings season began this week, with overall fairly positive results. Alcoa produced worse than expected results, but Google beat expectations by a long shot, while JP Morgan was slightly better than expected.
- So for the week, equity markets are well into positive territory. The S&P 500 is up 4.2% and the Nasdaq up 5.7% as of yesterday's close. The Euro Stoxx 50 is up 3.4% and the Euro Stoxx 600 is up 2.7% as we write this. The worst performing developed market was Japan, with the Nikkei 225 up 1.65%.
- In terms of sectors, cyclical continued to outperform this week. The energy, materials and industrial sectors are all up over 4% for the week. Financials are also up by over 4%, with these still in the eye of the storm given the uncertainties in the European region. But the best performing sector was technology, up over 5%, as the whole sector got a boost by the much better results from Google.
- Conversely, defensive sectors lagged. Consumer staples and health care are up between 1-2% for the week while utilities are only flat. Still for the year to date these sectors are the best performers.
- Our view is unchanged and we are not adding risk just yet. 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. Still, the time to put risk back on may be coming sooner than later!

Emerging Markets

- Emerging-market stocks are up 5.3% for the week as measured by the MSCI EM index, finally outperforming the developed index (up 3.8%). For the year to date the MSCI EM is down 19.2% while the MSCI World is down 8.7%...
- All EM regions are up between 5-6% this week. All were boosted by the better news flow and sentiment out of Europe, and from the mostly positive start to earning season.
- Asian stock markets were provided a boost as the US ratified a trade treaty with Korea but then disappointing Chinese trade data tempered the more optimistic tone.
- Meanwhile, Latin America also did well, with the Bovespa up 7% for the week, as investors now believe that Brazilian policy makers will be in easing mode vs. tightening mode.
- Separately, EM currencies also advanced this week as optimism over the European crisis lead to higher appetite for risk globally. The Brazilian Real advanced from 1.78 against the USD at the beginning of the week to 1.74 currently.
- We continue to believe that EM assets, which have suffered more than DM assets during the sell-off 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 on optimism over the euro zone debt crisis and higher appetite for risk. The S&P GSCI broad commodity index is up 2.8% as we write this. As is often the case, performance varied by type of commodity.
- Energy commodities as measured by the GSCI index are up 2.9% for the week. Crude oil (WTI) went from $82.98 a barrel early in the week to $85.94 currently. Energy, as well as other growth related commodities, are also benefiting from the softer tone in US macro data, as recession fears somewhat dissipate.
- While markets were much more optimistic this week and growth fears have cooled down, industrial metals were nevertheless slightly negative. The GSCI industrial metals index is down 0.6% for the week.
- Agriculture commodities were the best performers this week, with the GSCI corresponding index up nearly 5% for the week. Here supply concerns are driving prices higher.
- Finally precious metals are up 2% for the week as measured by the corresponding GSCI index. Gold went $1637.85 an ounce to $1680.00 currently, but again price movements were quite volatile.
- Interesting to note that this week's gain in gold (+2.25%) mirrors the performance of the Dollar index (-2.25%)...

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