Bedrock Newsletter

Friday, October 28th 2011

Equity markets roared in this often scary month of October. Less than a month ago the markets “knew” that the Euro Zone was crumbling and that it was likely to break-up and were convinced in the “fact” of the US Recession. Viewed from today’s stand-point, this knowledge and this fact have become heresy! The US enjoyed a Q3 GDP growth of 2.50%, the Europeans have concocted and funded a new acronym to resolve the Greek issue and the Euro is soaring now almost at $1.42.

We can find some more facts with which to chide the heretics- Housing starts were reasonable, commodities are rising again, corporate earnings continue to come in ahead of expectations (71% have beaten so far) and volatility as measured by the VIX is falling- down to a 25 level from the high 40 now close to historic averages around 22.

We see retail sales rising in the face of consumer sentiment surveys showing morose outlooks. Which is wrong? The survey or the measure of sales? Are we under the influence of some Economic Hopium?

The equities rally is powerful. But then, the “other” market, the bond world has stumbled. Yields are up, as investors shift from the security of bonds to risk-assets. Ten year US Treasuries now yield 2.39% representing a 10% drop in price from mid August highs. Quite ugly for the most secure of investments…

And then, as the risk-on trades gain favor, we observe Gold rising again- climbing from $1’600 to $1’750 in only 3 weeks. Wow, you may think, but in reality, it was a drop in the US$ that pushed Gold prices upwards- In Swiss Francs, Gold remains flat for the month and down to 1’500 from its recent high of 1’650 in mid September.

Is oil rising? Well, at $93 per barrel, it is up 22% from its recent low of $76 definitively a real rise, in any measurement currency.

And then, the Chinese currency continues its slow but steady rise against the Greenback. But then, the Euro block is a bigger export market for China and here, the Yuan is depreciating… Well, European politicians are not screaming as they are hoping for Chinese funding of the aforementioned “Greek Solution”…

Ah, the politics of the World… Let’s see what other aberrations these leaders of ours are serving-up… Remember the talk of US dependency on Oil imports? A powerful agenda item which has already given the US the ethanol debacle, using food to feed cars, Solar energy subsidies and busts… Wait, the real issue is the US dependency on Savings’ imports! The US isn’t saving so it depends on capital inflows from the savings of Japan, China, Brazil and others to fund its existence and future growth. What language will they use here? In an economy that is 70% driven by consumption, can they truly encourage savings? Well, not really, so this dependency must be ok, at least for now…

And then, our European leaders are not much better… they agree to a 50% “haircut” on Greek bonds, but this is not, is NOT a default! This way, those poor investors who hedged their holdings with Credit Default Swaps do not get paid, as there isn’t an

event of Default. When all else fails, change the language! Oh, we almost forgot that Gaddafi died. Another Arab Spring story completed…

May your weekend be as good as your equities!

Currencies

- Finally a plan! Indeed, several measures were agreed this week at the Eurogroup summit to stymie the ongoing European sovereign debt crisis, the major steps being: 1) an agreement to pursue a 50% write-down in the notional value of Greek bonds; 2) a plan to recapitalise banks based on a requirement of a minimum 9% core tier 1 ratio in mid 2012 plus plans to re-establish government guaranteed bank issuance at a pan European level; 3) plans to leverage the assets of the EFSF by structuring a first-loss guarantee scheme for new debt issues from selected countries and a special purpose vehicle to buy bonds.
- While the precise mechanics of these measures are not entirely clear, markets reacted very positively to the fact that some sort of plan was finally taking shape. The other major news this week was the US Q3 GDP, which was positive overall. As such, this week was definitely risk on. While the Euro obviously benefited, the major mover this week was the US Dollar, which declined broadly.
- Indeed, the Dollar Index, which measures the greenback against a basket of its major counterparts, dropped almost 2% for the week. The US Dollar was further under pressure on growing speculation of further stimulus measures from the Fed.
- Meanwhile, the Euro jumped against the US Dollar, British Pound and Japanese Yen on the news. The Euro jumped from a low of for the week of 1.3800 against the USD to 1.4175 currently, having gone as high as 1.4245. It went from 0.8715 to 0.8805 currently against the GBP and from 105.95 at the beginning of the week to 107.55 currently against the JPY.
- Nevertheless, the Euro is slightly lower against the CHF for the week and declined against more “risk positive assets” such as the AUD, NOK and EM currencies.
- Indeed, the AUD was one of the best performers this week, as easing concern about Europe’s debt crisis and signs of US growth supported demand for high-yielding assets.
- Despite the risk on move, the Swiss Franc was strong this week, slightly higher against the Euro at 1.2230 currently and much higher on the week against the Dollar, from .8825 to .8630 currently.
- Finally, the Japanese Yen strengthened against the US Dollar, reaching a post WWII high of 75.66 on Thursday as speculation Japan will intervene to weaken its currency faded.
- While we are relieved that European policy makers are finally moving, in our view the measures announced this week can be considered as offering some assistance without representing a lasting solution. Furthermore, the Euro has gained dramatically this month (from a low of 1.3176 to a high of 1.4189!!!!). Therefore, while the Euro may be supported in the very short term, we think that it should give back some of its recent gains.

Fixed Income

- Government bonds declined this week amid optimism over the global economic outlook after European leaders agreed on a plan to stem the region’s debt crisis and as the US Q3 GDP release was overall positive.

- US 10 yr yields rose by 17bps this week to 2.3930% currently, having reached a high of 2.4175%. Yields on 2 year US securities rose by 3bps for the week to .293% currently and by 20bps to 3.468% on 30 yr bonds.
- Yields on 10 yr US bonds have risen by 49 bps this month, the biggest increase in 2011.
- German and UK bonds also dropped this week. The yield on 10 yr bunds rose by 12bps this week to 2.22% currently. The yield on French bonds conversely declined this week, a good sign as the spread between French and German bonds tightened. Yields on 10yr French bonds declined by 4bps to 3.192% currently and on 2yr French bonds yields declined by 17bps to 1.147%.
- Meanwhile, CDS on the periphery European countries declined significantly this week on the back of the Eurogroup meeting while yields on Spanish bonds declined sharply. The yield on 10 yr Spanish bonds dropped by 6bps and on 2yr bonds by 25bps this week!
- Credit markets responded very well to the positive developments in Europe. Indeed, benchmark gauges of credit risk plunged globally this week while corporate bond indices saw strong gains.
- Lower quality bonds outperformed investment grade corporate bonds this week. European HY indices gained 3% this week while US HY indices rose by 2%. Investment grade corporate bonds meanwhile increased by roughly 0.5% for the 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.
- Furthermore, high yield bonds have suffered disproportionately given fundamentals and valuations are very attractive. As such we believe that this asset class offers one of the best risk/return proposition today.

Equities

- Developed equity jumped this week on the positive development in European and better than expected US GDP data. Overall robust corporate results in Europe and in the US also provided some welcome good news to what has been a very negative last few months...
- The MSCI World as of yesterday is up 4.7% for the week and by 13.3% for the month of October. As of now, this is the best monthly performance for the MSCI World Index since the 80's!!!!
- European markets slightly outperformed US ones this week, as these reacted with more swagger to the positive developments in the region. The EuroStoxx 50 is up 6.8% for the week as we write this and the EuroStoxx 600 up by 5%. The S&P 500 for the week is up 3.75% and the Dow Jones Industrial is up by 3.4%.
- The big laggard for the week and for the month is Japan, up 4.3% for the week but only 4% for the month.
- However for the month American and European major bourses are all up around 13%. For many this is the best monthly performance in a very very long time.
- Small cap stocks outperformed large caps this week and for the month. The Russell 2000 index, which is an index of small cap US stocks is up 7.4% for the week and 18.8% for the month, its best monthly performance ever!!!

- This just shows how dramatic markets have been so far this year. Indeed, US small cap stocks, which typically are less exposed to Europe than larger US stocks have suffered much more in 2011 than US large caps, and now have rebounded by even more as market sentiment improved.
- Another good positive indicator this week is the VIX index, which measures the implied volatility on the S&P 500 index. It declined by 20% this week and by 40% in October.
- The dramatic upturn this week and for the month now bring developed markets close to or slightly positive for the year. The MSCI World Index is down 2.3% YTD, while the S&P 500 index is up 2.1% for the year. European bourses however are still negative for the year despite this month's jump. The EuroStoxx 600 is down 9% YTD as we write this.
- In terms of sectors, cyclical outperformed by far defensive sectors as the positive developments in Europe and better macro data out of the US, coupled with overall robust corporate results encouraged risk taking. Energy, materials, industrials and financials are all up around 8% for the week and between 15-20% for the month.
- Conversely, utilities, health care and consumer staples lagged, with these sectors up on average 2% for the week and up roughly 7% for the month. Still, these sectors are positive for the ytd while most cyclical sectors are still negative for the year.
- The re-rating of stock markets this month has been dramatic. However, this has come from extremely depressed levels and against a very pessimistic mood. We believe that markets have adjusted somewhat from levels that were just too low. While we do not expect markets to continue to rise as they have over this month, we believe that equities will continue to appreciate at least to the end of the year, and therefore are sticking with our current equity exposures.

Emerging Markets

- EM equity markets roared ahead this week, with the MSCI EM up 8% on the improvements in Europe and better growth data in the US. This is the best weekly performance for the MSCI EM index since May 2009.
- Still for the month, the MSCI EM index is trailing its developed counterpart (12.9% vs 13.3% for the MSCI World Index) and is far behind for the year to date, down 13.7% versus a decline of 2.3% for the developed index.
- For the week, Latam was the best performing region, with Brazil's Bovespa index up 14.2% (!!!). Then Europe EM also was ahead of the MSCI EM index as this region benefited with more "umph" from the developments in the Euro zone, as well as higher oil prices. EM Asia was up "only" 7% on average, slightly trailing the MSCI EM index for the week.
- EM currencies also strengthened sharply this week. Asian currencies jumped by the most since 2009 this week, with the Asian – Dollar index (which measures a basked of Asian currencies vs the Dollar), up 2%, led by gains in the Korean Won.
- The Brazilian Real saw dramatic gains, going from 1.7755 against the USD to 1.7055 currently. The South African Rand also strengthened sharply, going from 8.04 to 7.73 against the USD, its biggest weekly increase in over 20 months.
- Meanwhile EM corporate bonds did well, as investors came back to EM assets with the second week in a row of monthly inflows into EM funds.

- We remain keen on EM assets in general given the better macro backdrop in EM economies and as EM assets have suffered more than DM assets, despite arguably better fundamentals. As such, we maintain our exposures in EM equities and EM corporate bonds, as well as our CNY exposures.

Commodities

- Commodities appreciated this week, boosted by the US growth data and improvements in the Euro zone. The S&P GSCI broad commodity index advanced by 4.2% this week and by 11.3% for the month. For the year the index is just flat now.
- The best performing type of commodity this week was industrial metals, which gained 9.8% as measured by the corresponding GSCI index. However these for the month lag (up 10%) and is the worst performing commodity type for the year so far, down 15%.
- Then precious metals were the second best commodity sector for the week, up 7.6% as measured by the S&P GSCI Precious Metals index. For the month these are up 8.9% and for the year up 20%, the best performing commodity type.
- Gold had a very strong week, moving up from $1642.4 an ounce in the beginning of the week to a high of $1752.8. It has come down a little since and is now at $1737.0.
- Gold typically has been considered as a safe haven and so it is interesting to see that it has performed in the recent weeks in line with risky assets. Really we find this week's move more a USD move than a gold move. We find gold prices hefty at these levels and would not recommend adding any.
- Meanwhile, energy commodities jumped this week by 4.5% as measured by the corresponding GSCI index. This brings the performance for the month to 13.6% and for the year energy commodities are up 5%.
- WTI rose from $87.4 a barrel to a high of $94.65 then dropped slightly and then moved back higher and is now around $92.15. We believe oil prices should remain supported as the demand pictures proves to be holding if not growing.
- Finally, agriculture commodities lagged other commodity types this week, up by only 1.5% for the week. This brings the performance for October to 6.4% and for the year, a decline of 10.9% as measured by the S&P GSCI Agriculture index.

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