Bedrock Newsletter

Friday, November 11th 2011

Clearly our week was dominated by Italian risks and events. Everyone wanted Berlusconi to leave office and on Tuesday markets rose as rumour had it that indeed he is leaving office, only to collapse on Wednesday as the question arose "and now what?". This question was triggered by an increase in margin requirements on Italian bonds by clearing houses; these collapsed in price in response, driving yields on ten year Italian bonds through 7% to a high of 7.45%, clearly an unsustainable level. Amazingly, the Italian yield curve inverted (short yields higher than long ones) and is now above another if earlier "desastre du jour", Spain. This is severe, as Italy is bigger than India, in GDP terms…
We almost forgot about Greece which continues to irritate us with its inability (until Thursday) to find its way to new governance and tighter austerity. We have been so centered on Italy that we almost missed a reminder from the ECB that it isn't a lender of last resort to banks. This role is daintily left to the National Central Banks; remember the Bundesbank? Banque de France?
Some transatlantic news did come through all the pasta- A county in Alabama filed for bankruptcy with $3.14 billion of debt, the largest ever municipal debt default. This and all other "Muni" type bonds are held by American investors only, as they have tax exemptions and are not yield attractive to non-US investors. And FNMA the quasi-government agency which funds mortgage lending in the States is in difficulties and asked for $7.80 billion in additional government funding. Isn't it wonderful when one can print as much of one's own currency?

This week also gave us the IAEA report on Iranian nuclear activities, a nasty report which all but stated that they indeed are building a Bomb. This was followed by debates and articles about the possibility, probability and capabilities of the Israelis to act in a pre-emptive manner. Can they, will they and what this might engender? Hard to opine here, except on the likely effects on Oil prices should the rhetoric get louder and the news concentrating on the risks therewith. We have seen a big upwards move in oil prices already, with West Texas Intermediate ("WTI") trading over $98, $20 over its October lows! The black sludge is back in the news as analytical paper after paper hit our desks and screens. Citi uses impressive charts and other crystal-balls to demonstrate the strength of this upwards swing, asking a rhetorical question "Crude over 200 by 2013" as a conclusion… We are impressed with the logic and when combining this with the implicit effects from the Iranian situation, acquiring oil makes a lot of sense here, best via long-dated Call Options. Just in case…
Gold has been edging back up the chart for most of November, continuing the line of November, albeit retracing a little these last few days as the US$ gains against the Euro and JPY. Oil makes more sense as the Black Gold here.
This week we were treated to a debate amongst the current crop of Republican candidates to face President Obama in next year's elections. It is sad that of 320 million Americans, this is the field…
For your weekend, here is an observation made by an anonymous philosopher "Alcohol does not solve any problems, but then again, neither does milk"

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Currencies

- This week clearly marked the end to the "eu(ro)phoria" of October with dramatic news flow out of the euro area and with global policy makers voicing extreme concerns on the EU crisis and its impact on the rest of the world. IMF's Lagarde warned of the risk of a "lost decade", while Bernanke, Geithner and Mark Carney, the head of the Financial Stability Board, all spoke about the massive risks from the euro zone...
- Politics in Europe were a complete fiasco this week with twists and turns as Greece searched for a new PM (it now seems to have one) and in Italy, where Berlusconi finally announced his intentions to step down once the government approves emergency austerity measures as Italian yields crossed the 7% mark. Still the situation is chaotic and very much unclear.
- Meanwhile, France announced a second round of austerity measures to keep its AAA credit rating, while reports emerged that Germany and France have been discussing a smaller, more balanced euro area while it seems that Merkel's political party may be drafting some sort of guidelines for countries to voluntarily exit the euro zone. Separately, the idea of increasing the size of the EFSF now looks much less likely. In summary, it is a complete mess.
- On top of all this, global economic data releases have been in general quite negative. As such this week was clearly "risk off", and the major gainers were the US Dollar, which gained nearly 1% for the period as measured by the Dollar Index, and the Japanese Yen, which gained even against the USD, from 78.24 at the beginning of the week to 77.41 currently, the strongest level since Japan's government intervened last month to weaken its currency...
- The Euro was obviously under severe pressure this week. It dropped from 1.3860 against the USD to a low of 1.3485 but has gone back a little to 1.3650 currently as the euro zone situation has calmed slightly. Against the JPY it went from 107.88 to 105.63 currently (having gone as low as 104.73).
- The Euro has recently bounced back a little after Italy drew double the bids for the amount on offer at a bill sale, damping bets the nation will face a challenge funding itself. Nevertheless, we expect the Euro to continue to be under pressure and to weaken from what are still elevated levels. It is likely that the ECB will need to be much more active in saving the euro zone, and this should put pressure on the common currency.
- The CHF was also under pressure this week, down from 1.2200 to 1.23655 currently against the Euro and from 0.8847 to 0.9055 currently against the USD. The move was driven by signs of declining consumer prices in Switzerland and rumours that the SNB may move its floor against the Euro from 1.2 to 1.3...
- With the risk off move, higher yielding currencies, such as the AUD and NOK, declined. Asian currencies also declined.
- The environment is extremely troubling and we expect the Euro to remain under pressure while the USD should benefit from the very negative market sentiment.

Fixed Income

- US Treasuries are largely unchanged week over week, but experienced big daily moves. US 10 yr yields dropped to a low of 1.9274% for the week on Wednesday, but then went back up to 2.05% currently, roughly the same level as last week's close, as a 30yr bond sale was met with weak demand, and as tensions eased after it emerged that France's credit downgrade was actually a mistake...
- In Europe, government bonds are down for the week, and moves were dramatic! German 10 yr bunds advanced, with the yield down 3bps for the week at 1.787% currently, near an all time record low. French bonds dropped, with the yield on 10 yr bonds up 34bps for the week to 3.373% currently,
- Yields on Italian bonds soared this week. 10 yr Italian yields rose from 6.35% at the beginning of the week to a high of 7.458% (!!!). But after a successful debt sale, these have come down now and are at 6.58% currently.
- Yields on other periphery EU countries also rose this week and this is clearly very problematic. At these levels, the debt servicing cost is extremely high and unsustainable. The path is now clearly binary: either the situation keeps on deteriorating and we see the end to the Euro as we know it, or the ECB steps in massively and yields come down. We hope for the second...
- Credit markets suffered this week on the very bad news flow out of Europe. High yield and investment grade corporate bonds are down roughly 1% for the week.
- Despite the negative sentiment and troubling situation in the euro zone, we remain keen on corporate bonds globally, especially higher yielding ones on valuations and very healthy corporate balance sheets.

Equities

- Global equity markets are down 2% this week, as measured by the MSCI World index. This week's loss comes almost entirely from a big drop in Wednesday, when Italian yields reached their record high at nearly 7.5%, marking a severe intensification of the Euro zone crisis.
- Since then markets have calmed down slightly as Italian yields have declined and as the political debacle in Greece and Italy have eased somewhat. European markets are up roughly 50bps today, and US futures are following Europe's lead as we write this.
- Given the turmoil in the euro zone, it is of no surprise that European bourses underperformed American ones this week. For the week, the Euro Stoxx 600 is down 1.84% as we write this, while the S&P 500 is down 1.1% as of yesterday's close.
- US stock markets were also helped by some positive macro data on the employment front.
- Japan underperformed this week, suffering from the Europe crisis as well but also from growth concerns in the Asia region and as the Japanese Yen's strength put intense pressure on Japanese exporters. The Nikkei 225 is down 3.3% for the week and 16.8% for the year.
- For the year, American stock markets are slightly negative. The S&P 500 is down 1.4% YTD, the NASDAQ is down 1% but the Dow Jones Industrial is up 2.7%. European indices however are well in the red with the Euro Stoxx 600 is down 14.7% YTD...

- Looking at sectors, cyclicals underperformed this week given the risk off environment. Materials were down 3% for the period, industrials down 2.5% and consumer discretionary down 2.2%. Financials were the worst performers, down 3.6% as measured by the MSCI World Finance index, on the back of the intensification in the Euro zone crisis and on concerns on global economic activity.
- Conversely, defensive sectors such as healthcare, telecoms, utilities and consumer staples outperformed, with these down by less than 1% for the week. Defensive sectors are well ahead of cyclical ones for the year. Consumer staples for example are up 2.6% YTD while financials are down 20.3%...
- We continue to find equity valuations extremely attractive, despite lower growth prospects. However, given the massive risks from the euro crisis, we do not recommend adding any risk at this stage. The situation is binary, and while we do not expect a collapse, such a possibility is now large enough to warrant caution.

Emerging Markets

- Emerging Markets equities tanked this week, underperforming developed ones. The MSCI EM index is down 3.6% as of yesterday’s close, versus a decline of 2% for the MSCI World index. YTD the EM index continues to lag significantly its developed counterpart, down 17.1% vs. 7.9% for the developed index.
- EM stocks suffered from the intensifying euro zone crisis, but this was made worse by bad macro data in various EM countries. Chinese exports data surprised to the downside (although imports surprised to the upside), India’s industrial production came in also worse than expected, while preliminary reports indicate that Hong Kong’s GDP declined in Q3... One positive though is that inflation pressures are now much lower, as shown from inflation data in China and in Indonesia.
- Given the negative data out of Asia, Asia EM stocks underperformed, down 4.8% for the week. EM Europe and Latin America are down roughly 2% each.
- Meanwhile, EM currencies declined broadly. Asian currencies, as measured by the Asian Dollar Index, are down 0.65% for the week. The Brazilian Real went from 1.7375 at the beginning of the week against the USD to a low of 1.7820 but is now at 1.7615.
- EM equities continue to lag developed ones, and we continue to expect this underperformance to reverse! While EM economies will undoubtedly be affected by the slowdown in Europe and in the US, these economies overall are in a much healthier state than going in 2008, and in much better shape than developed economies. Asset prices are not reflecting that but we believe these ultimately will. As such, we maintain our exposures to EM equities and EM corporate bonds, as well as our CNY positions.

Commodities

- Commodities are up 1% this week as measured by the S&P GSCI broad commodity index. Again, performance varied by type of commodity.
- Energy commodities were the best performers this week, up 2.4%. Here, the Iran situation is driving oil prices higher, as speculation increases that some sort of clash (and possibly much worse) will happen with Israel...

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- Crude oil prices are now at $98.14 a barrel, from $94.26 at the beginning of the week. We continue to expect oil prices to increase as we do not see the turmoil in the Middle East ending any time soon...
- We continue to believe that higher prices lie ahead for oil prices.
- Precious metals are slightly positive for the week, up 0.2% as measured by the S&P GSCI precious metals index. Gold continued to go up in the beginning of the week as the European crisis intensified. It went from $1754.65 an ounce to a high for the week of $1802.93, but then went back down as low as $1736.75 but is now back up at $1764.95.
- We have recently changed our view on gold as our base case for a positive resolution to the euro zone crisis is now much more challenged. We have recently added gold to our portfolios, as we now find that only the ECB has the ability to save the euro zone, and will have to engage in some sort of QE to do so. With all of the major central banks printing money in some form, gold should continue to be supported and should be a good hedge should the situation deteriorate much further.
- Industrial metals were the worst performers, down 3.2% for the week, as these tanked on lower global growth prospects. Agriculture commodities are down 1.9% for the week, on growth concerns as well.

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