Friday, December 9th 2011

What is a world coming to? Where is Santa Claus? For a moment it seemed that Mario Draghi (new ECB Chairman) brought us some relief announcing a modest rate cut but then, he counteracted the gift with a negative outlook and no plan to support markets. Markets tanked again… Italian bond yields which had been rallying to about 6% yield fell over again, closing-in on the scary 7% level yet again. Yesterday, whilst the European Management (for lack of a better term) was debating their options, equity markets lost several percentage points in value. When we heard that the UK and Hungary sort-of broke away and refused to play with the others, some saw the breakup of the union. This morning we woke-up to a sad looking environment. But then the markets came back and are up as we write. Just reconsidering the meaning of it all? Brings back an old observation whereby it is better to make money by mistake than to lose it with reason…

Ask Corzine, CEO of MF Global who actually lost $1.2 billion- He said it himself at his Senate hearings- The money disappeared and he didn't know where it is!! This is the old-fashioned meaning of loss, not GAAP or Non-GAAP accounting stuff, but lost like your car keys do sometimes…

On a more serious note, we observe with deep concern the developments surrounding the Russian elections. Is this the beginnings of an Arab Spring for Russians' Christmas? It is potentially explosive. These guys know how to revolt! Just ask the Romanovs…

The press and television have turned amazingly quiet about Syria where the killings are still going on. We have absolutely no news on the previous disaster-in-the-making of Libya, not even a flash about Yemen and even Egypt earned just some talk earlier in the week. Where did the news disappear to?

One week ago we heard an amazing story, out of the Twilight Zone: The USDA makes mortgage loans! We thought they controlled meat quality!? Believe it or not, they actually offer 100% financing on residential properties located in so-called rural areas. Pulte Homes, a real estate developer, advertized in Florida homes for sale with no down payment and USDA financing… This is now!?! It isn't funny anymore…

Whilst we watch the world trying to redefine itself we offer you these three old, yet pertinent definitions;

1. BULL MARKET -- A random market movement causing an investor to mistake himself for a financial genius.
2. BEAR MARKET -- A 6 to 18 month period when the kids get no allowance and the wife gets no jewelry.
3. VALUE INVESTING -- The art of buying low and selling lower.

Wishing you a better understanding of next week, enjoy the weekend!

Bedrock Newsletter

Currencies

- This week was all about the build up to the EU summit which is happening as we write this. Throughout the week, FX markets traded back and forth on various bits and pieces of news. Yesterday and early today there was a big risk off move, but now risk is back one. Best way to explain is to go day by day. So here we go:
- Monday, Sarkozy and Merkel present the plan that they will present at the EU summit at the end of the week to deal with the EU crisis. Modestly positive reaction. The Euro rises from 1.3390 on Monday to 1.3485.
- But then S&P announce that they are putting all of the EU countries on credit watch negative. EUR drops to 1.3340 on Tuesday.
- More positive tone on Wednesday on speculation surrounding ECB meeting and EU summit. Euro rises to 1.3450 on Wednesday, and positive tone continues on Thursday as the ECB announce various measures to support the financial system. The Euro rises to 1.3460 on Thursday.
- But later on Thursday, the Euro dropped sharply, to a low of 1.3290, as the first major news from the EU summit was that the 27 EU countries had failed to agree to change the EU's treaties in order to implement tighter fiscal rules, one of the proposals which Merkel and Sarkozy were pushing for.
- While markets reacted very negatively initially, now the mood is much more positive as markets digest the news flow out of the EU summit. The major positives are a larger role played by the IMF and while a 27-member fiscal pact now seems unachievable, the 17 euro zone members have agreed something close to Draghi's 'fiscal compact'. And so the Euro is rallying. It went today from a low of 1.3280 to 1.3420 currently!
- Overall, the Euro dropped versus most major currencies, but is now moving higher. The US Dollar gained up to today, but is now declining with the risk on move. Same with the Japanese Yen. Conversely, risk positive currencies such as the AUD and CAD were weak throughout the week but are now rallying.
- There is a lot of news coming out and there could well be more twist and turns, but cautiously, what is coming out as we write this seems to be positive for the European Union. If the "fiscal compact" is agreed, then it is likely that the ECB will be much more active in providing supportive measures. While short term this is positive for the Euro, if the ECB does embark in some sort of QE, this may actually make for a lower Euro.
- While markets are being driven by the news flow out of the EU summit, the macro backdrop seems to be deteriorating. And so we remain cautious in adding currency risk at this very uncertain stage.

Fixed Income

- US Treasuries advanced this week. Yields on 10year US securities are lower by 2bps week over week, to 2.01% currently. The yield touched a low of 1.96% on Thursday as markets grew nervy over the potential outcome of the EU summit, but are now back up to 2.01 as the news flow is now more positive.
- European government bonds also advanced this week. And moves were very volatile, not surprising given the dramatic events that occurred throughout the week.

- The yield on German 10 year bunds initially rose from 2.15% to 2.25% as S&P put all EU countries on credit watch. But then, the yield went down to below 2% as the ECB cuts its benchmark rate by 25bps. The yield is now higher, at 2.07% as appetite for risk is coming back.
- Italian and Spanish bonds were very volatile this week. 10 year Italian bonds are yielding 6.51% currently, a 14bps drop for the week, while Spanish 10 year bonds are yielding 5.83%, a 24bps increase for the week.
- Credit markets overall were strong this week, especially European lower quality bonds, as these responded very positively to the measures announced by the ECB to support financial markets. European HY index is up 1.8% for the week, while the US HY index is up 0.8%.
- We remain keen on corporate bonds in general, and find that the ECB measures will provide a boost to credit markets in general. While the macro backdrop is very difficult, the corporate world is extremely healthy, defaults should remain at very low levels, and therefore, corporate bonds, especially higher yielding ones seem very attractive.

Equities

- Global equity markets had a volatile week! On Monday up, then down on Tuesday, then up slightly on Wednesday and on Thursday markets tanked on concerns that the EU summit would come up to nothing. Today European markets are rallying as it seems that EU leaders are finally getting around the crisis.
- As we write this, European markets are up between 1.5% and 2% for the day, bringing the losses for the week to around -0.5%. US futures are also up.
- As of yesterday's close, the S&P 500 was down 0.8% for the week and the Dow Jones Industrial Index down only 0.2%.
- In terms of sectors, cyclicals underperformed while defensives outperformed. However, this is reversing today. As of yesterday's close, Energy, materials and industrials are down between 1.6 and 2% for the week, while consumer staples and healthcare are just very slightly negative.
- Financials are down as of yesterday's close by 1.10% for the week but in Europe, financials are rallying big time today (up 3.2% as we write this).
- We continue to find equity valuations extremely attractive, despite lower growth prospects. Moreover, it seems that the EU is getting a handle on things. Maybe a Santa Claus rally in the making...

Emerging Markets

- Emerging Markets equities traded in line with their developed counterparts this week, really driven by the news flow coming out of Europe. The MSCI EM is down 1.4% as of yesterday's close, but given the positive sentiment surrounding the EU summit today, EM stocks are doing well today.
- Performance varied by region this week as is often the case. The worst performing region as of yesterday was Europe EM, given the proximity to the euro zone, but also because of problems in Hungary. MSCI Europe EM is down 4.8% as of yesterday's close.

- Latin America was down 1.25% as of yesterday's close, while Asia EM outperformed, down 0.8% for the week. Here the positive this week came from China, where inflation came in lower than expected, which makes Chinese policy makers more comfortable should they want to provide stimulus if global growth continues to deteriorate.
- EM currencies dropped in the first part of the week on risk aversion but are now rising as the EU summit may well bring some concrete measures to deal with the EU sovereign debt crisis. The BRL for example dropped from 1.7910 against the USD to a low of 1.8300 but is now at 1.8050.
- Our view on EM assets is unchanged. 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 down 1.9% for the week as of yesterday's close measured by the S&P GSCI broad commodity index. However, these are rallying today as some risk appetite comes back.
- Energy and industrial metals were both down by roughly 2.1% for the week, on global growth concerns. Crude oil was steady early in the week, trading around $101.00 a barrel, but then dropped sharply to $97.55 on the initial bad reaction to the EU summit on Thursday, but has now recovered some and is trading at $98.55 a barrel.
- Precious metals were down 2.3% this week as measured by the corresponding GSCI index. Gold was very volatile this week and traded more like a risk positive asset than a safe haven. Indeed, gold went from $1746.75 at the beginning of the week to a low of $1702.15 on Tuesday. It moved back higher to a high for the week on Thursday of $1755.90 but then tanked later during the session to $1705. It is now slightly higher at around $1720.
- The best performing type of commodity this week was agriculture, down 0.5% for the week. These also suffered given lower global growth prospects, but supply pressures limited the drop.
- We remain constructive on oil given supply/demand dynamics and on gold, which should continue to find support as global central banks provide liquidity to markets.
