Bedrock Newsletter

Friday, December 23rd 2011

It is Friday again. This will be our last Newsletter of the year and will start with our best wishes for Christmas, for the New Year and your vacations!

It has been a long and difficult year. We were affected by the Arab Spring, the European Debacles, the Iranian threat, the American discombobulated governance, the Blackberry blackout, the unusual weather and market volatility. Oh yes, North Korea lost its leader and appears unstable. Will they merge with the South? Will this be good for the Korean markets?

2011 was a year in which *bears* looked good in *shorts*… Or did they? Hedge Funds didn't perform so well after all…

The ECB which had been *Draghing* its feet, finally gave us a sign of life: they auctioned a huge amount of 3 year money to the banks, at 1% interest. This was taken up in larger than expected amounts and initially markets rallied- only to fall back when the question arose "why did they need so much money?"… Then, Mario Draghi, the new ECB Chairman did a "no show" at a press conference yesterday. We still don't know why. Was it Indigestion?

This week we were given some more encouraging data on the American economy with jobless claims falling further, mortgage rates falling to new lows, housing starts suggesting some revival in activity if not in prices. The final American Q3 GDP was 1.80%, revised slightly downwards from the last revision. Slow but not recessionary - Consumer sentiment is rising some, supported by reasonably good holiday sales. Maybe the closing days of 2011 will suggest easier sailing for 2012?

European bond yields have been declining and as the markets' focus appears to be shifting away from the Old Continent toward China, we may well find relief as media attention wanes. The Chinese economy appears to be faced with a Shakespearian question: To be Hard Or To Be Soft (landing)? Well, from where we stand (and read) it appears that the Chinese MUST maintain a fast growth rate in order to maintain social stability. Some economists peg this need at the 8% level so we would venture that given their reserves and control, this will be achieved, at least over the foreseeable future.

Indeed, looking into our crystal ball we see 2012 as the year of social turmoil. Will Iran fall into its own Arab Spring (without being Arabs)? Will Russia revolt again (it has been 20 years since the last revolution)? Will Europeans agree to ongoing austerity and resulting slow growth, high unemployment and taxes? Will North Koreans run North to China or South to "our" Korea?

And we must add that we see in the corner of our ball the US Presidential elections and the French ones. We postulate here that the lack of reassuring choices may frustrate voters even further.

The markets appear tired and may just grind upwards slowly into the closing of 2011 and then, into the New Year. Let us hope together that stability returns to our world and that fundamental economics return to rule. We would hate to think that our education and years of experience have gone down the drains of turmoil.

Have a Merry Christmas and wonderful holidays. May your next year be a ***Bedrocking*** year!

Currencies

- The Euro was well bid on Tuesday as investors priced in an improvement in the economic outlook and looked forward to a big take up by banks of the ECB's first-ever offer of three-year loans. Moreover, an improvement in Germany's business climate in December as measured by the Munich-based IFO, as well as a sharp drop in Spanish short-term borrowing costs boosted riskier assets.
- But on Thursday, the Euro pared its gains against the Greenback in choppy year-end conditions with ongoing concerns that the Euro zone debt crisis could intensify next year driving investors to sell into any rebounds in the single currency.
- As a result, the common currency stood still against the Dollar and the CHF at 1.3070 and 1.2215 respectively but depreciated against some major counterparts, declining by about 0.75% against the GBP to 0.8325, -1.65% against the CAD to 1.3325, -1.50% against the AUD at 1.2865, but rose by 0.60% against the JPY at 102.
- Meanwhile the Dollar appreciated against some counterparts, rising by 0.40% against the JPY to 78.05, 1% against the GBP to 1.5695, 1.80% against the AUD to 1.0160 but declining against the CAD by -1.80% to 1.0195 and against the SGD by 1% to 1.2915.
- The CHF stood relatively still this week, even after the SNB’s decision to hold the franc cap at 1.20 per Euro despite renewed weakening calls from Swiss parliamentarians. The CHF currently stands at 0.9350 against the USD and at 1.2215 against the Euro.
- The JPY globally weakened this week after the Bank of Japan lowered its assessment of the economy on Wednesday for the second straight month due to concerns over the European debt crisis and the Yen's persistent strength, but refrained from taking additional easing steps.
- While markets are being driven by the news flow out of the Euro zone, the macro backdrop improved in the US as jobless claims kept drifting lower this week, hitting their lowest level since March 2008.

Fixed Income

- US Treasury notes declined this week as 10 and 30-year yields rose by 11 and 14 basis points respectively. Meanwhile, almost every short- to mid-term European Government yields decreased with the stunning case of Spain.
- The major news this week was the ECB’s decision to offer banks Euros 489 billion of low-cost three-year funds, which many hope will encourage buying of high-yielding Spanish and Italian bonds, helping ease the crisis in the euro bloc.
- German government bonds edged lower ahead of the ECB operation but in very low volumes as the holiday season approaches.
- Apparently, more than 10 Italian banks including major lenders, had already applied for the ECB loans by using state-guaranteed bonds as collateral.
- But it is also likely that some banks would use the funds to repay their own debts as they strive to get rid of bad assets and improve their balance sheets amid strong regulatory pressures to beef up their core capital.

- Italian and Spanish government 10-year bond yields fell to around 6.79% and 5.29% respectively, moving further away from the levels above 7% that were widely seen as unsustainable.
- Consequently, European Government debt outperformed by far US Treasuries and high yield debt surged.
- We remain keen on corporate bonds in general, and find that the ECB measures will provide a boost to credit markets. While the macro backdrop is very difficult, the corporate world is healthy, defaults should remain at very low levels, and therefore corporate bonds, especially higher yielding ones seem very attractive.

Equities

- Global equity markets rose this week with the MSCI World up by 2.35% as of yesterday's close. Stocks started an end of year rally on Tuesday when German data encouraged hopes Europe's largest economy would avoid a recession. This was followed by better-than-expected US housing data and new Federal Reserve capital proposals for banks, which turned out to be less onerous than some had feared.
- As a result, US stocks rallied by nearly 3% on Tuesday as investors bought surging banks, homebuilders and networking companies, though low volume was seen as amplifying the market's move. On Thursday, US markets edged even higher on lower jobless claims – that already hit a 3-1/2 year low last week – bolstering views the economy was gaining momentum, the only downbeat being Q3 growth revised down. The S&P 500 rose by 2.8% as of yesterday's close.
- Europe also rose this week with the Euro STOXX 50 gaining over 2% on a better outlook and a successful Spanish bond sale. While positive murmurings are audible, no one wants to put too bright a view on the outlook, as expectations are that the euro zone will slide into recession in the first quarter of next year, making it even harder for struggling countries to get their finances in order.
- MSCI Sector Indices were all in positive territory this week, with Energy, Materials and Industrials rising the most, while defensive sectors such as Consumer Staples and Healthcare followed the upturn more gently. These sectors are still the only ones to be positive for the year while Financials and Materials remain the most affected sectors, both down close to 21% for the year.
- We continue to find equity valuations attractive, with corporations keeping on posting pleasant earnings' surprises.

Emerging Markets

- Emerging Markets' equities slightly underperformed their developed counterparts this week. The MSCI EM index is up 1.71% as of yesterday's close, reducing its year-to-date's decline to about 20.1% versus a decline of 8.3% for the developed index.
- Performance across regions was quite homogeneous. Latam was the best performer up by 2.30%, followed by EM Europe up 2% and EM Asia up 1.40%.
- China shares traded on the low this week, with the Shanghai Composite Index briefly touching the lowest intraday level in 33 months on Thursday amid a weak turnover that amplified price movements. A key drag mainland China is currently suffering is tight short-term money supply

in the financial system which might persist until January. As a result, the Shanghai Composite lost 0.90% this week while the Hang Seng rose by 1.88%.

- The Bovespa advanced by 2.23% this week on better jobless rate figures in Brazil. The Index recovered some of last week's losses, and now shows a loss of 17.25% for the year.
- 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 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 rose by 4.34% this week as of yesterday's close as measured by the S&P GSCI broad commodity index, driven by Energy and Agriculture which gained 4.60% and 5.04% respectively.
- Crude Oil rose by close to 7% this week currently holding around $100 a barrel, supported by fresh signs of a strengthening US economy and concern of potential supply disruptions in Iran and Iraq. In addition, futures jumped on Wednesday after a government report showed a huge decline in US oil stockpiles.
- Gold advanced by about 0.8% after last week's correction. The precious metal oscillated between down and up moves; with important gains made on Tuesday and Thursday taking cues from higher equities after upbeat US economic data encouraged investors, while the persistent gloom hanging over the Euro zone generally weighed on sentiment. Gold currently trades around $1'607 an ounce.
- 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.

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