Bedrock Newsletter

Friday, January 13th 2012

We are in 2012 and it has commenced nicely. Equities around the globe have been drifting upwards slowly but overall, quite a big move- it has accumulated to a better than 3% rise in the S&P index! At the same time, prime quality bond yields have held steady or even drifted lower - US ten year note auction resulted in a lowest-ever auction yield of 1.90% Italy and Spain also sold bonds at auctions and we were all pleasantly surprised at the demand and falling yields. Was it the ECB bidding? Whatever, the yields are down. The Euro itself rose over 1% on this alone!

Not everything is rosy though. Iranian risk is back in the headlines. Oil spiked through $100 on embargo on Iranian oil talk, only to fall back to $99 when Europe suggested they would defer the application by six months or so. Gold has resumed an upwards drift, comfortably over the $1'600 level. We are pleased with Chinese inflation data showing a cooling with some apprehension as to a possible slowing of their growth rate. In Europe we are observing more talks, much travel of leaders and somehow, less panic and hysteria of Euro and/or Union breakdown. The US seems to be finding a consensus on a Republican candidate to challenge President Obama. Mitt Romney may well be The Man. Is this good? Time will tell…

We do note that trading volumes are very subdued and the uptrend is supported by lack of selling rather than by enthusiastic buying. Volatilities have fallen quite dramatically with the VIX index at 20 or so, way below its recent forays into the 30's zone and its spikes over 45 of September. Fear is abating, clearly. The US government deficit broadened to over $85Bn in December, way above the year earlier figures. No surprise here, attenuated with a very strong employment report showing a powerful job creation. Perhaps, just perhaps we have seen the bottom? Some big Private Equity groups have commenced buying US real estate for renting. Is this bottom fishing or truly the formation of a floor? And now, we are facing Q4 earnings' reports. Will these sustain the newfound sentiment that the worst is behind us? We don't know but do hold the view that earnings are likely to exceed expectations. The latter have been deflated by fears of a European recession but the effects of this are substantially overblown - Europe exports represent a very small part of the US GDP and a slowdown here will affect only marginally the overall US economics. Let's not forget the huge mountain of money being thrown at the markets by the Fed, the ECB and other Central Banks. They have a purpose in removing all returns from the "riskless" asset class, pushing and forcing us all to assume risk elsewhere. This process is nowhere near ending! It will work, and soon…

Do remember the old adage that when the Sun will rise tomorrow, it will shine favourably on the optimists of today…

After four miserable years, the time has come for some optimism! Let's start by enjoying this weekend!

When the Sun will rise tomorrow it will shine favourably on the optimists of today.

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Currencies

- The US Dollar reigned supreme during the first few days of the week, before giving back some gains. The EURUSD pair dipped to a low of 1.2670 (a 15 month low) before rebounding to nearly 1.29 on good auctions results from Spain and Italy on Thursday. Market fears were alleviated as long term yields in these 2 countries went down to a one month low. However, we view this move up in the EUR as corrective and short term in nature. We keep a bearish view on the currency for the weeks and months ahead.
- It is also important to note that the EUR has hit record lows against both the Japanese Yen and the Australian Dollar this week.
- The other big story of the week was of course the resignation of the Swiss national bank President Philip Hildebrand. This has provoked a small strengthening of the Swiss Franc (!!...) as market participants were questioning the resolve of the SNB to maintain the floor on the EURCHF pair at 1.20. Of course, the SNB has maintained its policy and reiterated its commitment to sell unlimited quantities of the CHF should they need to. It should also be noted that Switzerland has officially entered deflation, which makes this defence of the Floor even more likely. Nonetheless, the EURCHF pair drifted down to the 1.21 level.
- The Yen has continued being very strong as it rose to 76.65 to the USD and hit a record high against the EUR at 97.30 before weakening a little to 98.70 currently. We believe that this JPY strength is way overdone and we can't see how this strength will continue.
- The British Pound weakened quite a lot this week against the USD, and hit a one year low at 1.5280, before rebounding a little. Confidence in the UK's economy remains fragile and more QE should be in the making in the months ahead. We were, and remain bearish on the UK Pound.
- Commodity currencies such as the AUD and the CAD rallied this week on the back of stronger oil and Gold prices, but also on a better risk taking environment as equities around the world rebounded to a month high.
- Emerging market currencies such as the South African rand and the Brazilian Real had a very decent week, with both currencies posting gains of 2 and 4% respectively. We see that with every move up in Equities, EM currencies restart to rally. We remain also confident on Asian currencies, particularly on the Chinese Yuan and on the Singapore Dollar.

Fixed Income

- US Treasury yield slightly slipped on Thursday. The US 30-year yield dropped by 7 bps to 2.95% currently while the 10-year dropped by 6 bps to 1.90%.
- On Friday, Italy sold its November 2014 three-year benchmark bond at an average rate of 4.83%, raising the maximum planned amount of 4.75 billion Euros at the sale but failing to match interest of the Spanish auction where Madrid sold 10 billion Euros of bonds - twice the planned amount on Thursday. This success was clearly helped by domestic demand fuelled by cheap European Central Bank funds.
- As a result, European yields globally slid with 10-year rates dropping by 35 bps in France to 2.99%, 52 bps in Italy to 6.55% and 50 bps in Spain to 5.13%.

- This week, EU Sovereigns were the best sector among global debt, followed by EU High Yield. Globally European debt performed better than US debt, except on the corporate front, while Global EM was flat.
- We remain keen on corporate bonds in general. 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 were up for the second week of the year. The MSCI World index rose by 1.22% as of yesterday's close. The positive performance came mostly from strong European debt sales that boosted confidence.
- European equities outperformed US stocks this week. The S&P 500 is up by 1.13% as of yesterday's close and the EuroStoxx 50 rose by 3%. Japan however is about flat (0.13%) as measured by the Nikkei 225 index.
- The lag on US equities this week was due to a mix of poor data, as US retail sales rose at the weakest pace in seven months in December and first-time claims for jobless benefits moved surprisingly higher last week.
- Within Europe, Italy posted the biggest weekly gain rising by 4.60% while Spain is up by 2.90% and Greece is flat. Meanwhile, the CAC 40 and the DAX are gaining 3.20% and 2.50%.
- In terms of sectors, Materials and Financials outperformed broad markets this week while Consumer staples, Utilities and Energy lagged. Materials are the best sector so far this year while Financials are also faring quite well. We however advise caution on Financials, especially on European institutions given the sovereign debt crisis.
- We find equity valuations attractive as the corporate world is quite healthy. However, the macro backdrop is extremely challenging, and there are very fat tails should the Euro crisis turn into something worse. As such, we maintain our current equity allocations.

Emerging Markets

- Emerging Markets' equities are up 2.85% for the week as of yesterday's close, as measured by the MSCI EM index. This is better than developed markets, and likely due to EM equities responding with more juice to the encouraging news that came from Europe this week.
- The best performing region was Latin America, up over 3% as measured by the corresponding MSCI index. Equity markets were boosted by the strong performance of materials stocks. Meanwhile, Asia was up over 2% for the week, with China leading the gains.
- While China is up 3.75% for the week as we write this, Chinese shares were lower on Friday after data showed that China recorded declines in forex reserves in November and December, the first consecutive fall since the first quarter of 2009, as a narrowing trade surplus and an outflow of speculative funds reversed the accumulation of dollars.
- 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.

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Commodities

- Commodities declined by 1.06% this week as of yesterday's close as measured by the S&P GSCI broad commodity index. As is often the case, performance varied strongly by type of commodity.
- Industrial Metals were the biggest winners this week, up 5.89% followed by Precious Metals up 1.86%. Greater appetite for risk this week weighed on Gold, pushing it down 0.5% to near $1'642 an ounce after it hit a one-month high on Thursday at $1'655.
- Meanwhile Agriculture was the worst commodity sector this week, down 1.95% after a USDA report showed higher forecasts on crop supplies.
- Energy was also negative this week, down about 1.70%, as Oil experienced a sell-off on Wednesday and Thursday on a report that a proposed European Union embargo on Iranian crude imports would be delayed. Oil dropped from $101.5 a barrel last week to $99.5 currently.
- 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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