Bedrock Newsletter

Friday, January 20th 2012

There is an old adage whereby as goes January so goes the year. Let's hope that January continues on its trajectory. So far, the S&P 500 is up about 4.50%, the MSCI World at 4.26% and the emerging markets as measured by the MSCI EM index are up over 8%. Headwinds? What headwinds? We did get a breeze from Standard & Poor's who downgraded France and other Europeans. The storm around Iran seems to have left the weather forecasts and the Arab Spring whilst still raging at least in Syria has ceased shaking our trees. The Winter Storms of Europe seem to be confined to weather as even the discussions of the inevitability of Greek default are suggesting an orderly event "if and when". Will Greece and the other PIIGS leave the Euro? The question seems to have little impact. Some even believe that should this happen then the Euro should rise as its weaker components are trimmed away. Indeed, the Euro has bounced up nicely this week, moving up from 1.26 to over 1.29 vs. the US$.

In America, it seems that GOP is getting closer to naming Mitt Romney as their candidate. Then, the White House strangely chose to oppose an oil pipeline from Canada tar sands to Texas refineries. This is the same Obama who advocated energy independence, shooting-down a project which could have redirected the said dependence from Venezuela and the Middle East to a friendly neighbour. The GOP will have a field day with this, improving Mitt's odds for November. Is the market rallying into the rising odds that the GOP will reclaim the big villa in Washington?

We were pleasantly amazed that the credit downgrades in Europe had a similar effect as the earlier downgrade of the US had had- Affected Sovereign debt had rallied. France and Spain had very good reception at their auctions of debt this week. Is this the effect of risk being removed, prices rise?
With all the attention on the downgrade of the Western industrialized economies, we miss the fine print showing the general upgrade of the emerging world. Even Indonesia is now "Investment Grade"…
China has a slowing growth rate of its economic growth. Let's not lose sight of the fact that it now is a huge economy which is still growing at over 8% with a backdrop of Europe slowing to a flat-line or even a shallow recession. The Chinese are doing something right as they have managed to slow their inflation rate, probably via the strengthening of the Yuan.
Well, Japan for one has gone into trade-deficit mode: for the first time in half a century has its trade balance not been in surplus! Will it take 50 years for China to follow this example?
Strangely, with no particularly good news hitting, there is a general feeling that things are stabilizing. We are into the thick of earnings season. Overall seeing good results: Yesterday's news from Intel, IBM, Microsoft and American Express were good enough to generate good after-hour price rises whilst Google disappointed and lost 10% in afterhours… Banks may have bottomed… Do join us into the weekend with a smile!

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Currencies

- With a quiet Monday due to Martin Luther King Day, the EURUSD pair started at the lows of 1.2629 (a new 15 month low) before rebounding to nearly 1.2975 on good auctions results from Spain and France on Thursday. Market fears were again alleviated as both short and long term yields in these 2 countries went down versus previous prints. 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.
- Last week we noted that we touched the lows for EUR against both JPY and the AUD. In line with the broad-based EUR rebound we are now off the lows, but only marginally.
- After Hildebrand's resignation the market started the week in EURCHF at 1.2070 drifting slightly higher mid-week with some fat-finger trading causing a momentary spike to 1.2130 and we end where we started.
- The Yen has continued its strength as it rose to 76.55 against the USD, not quite reaching the lows of last October of 75.82, only to reverse back above 77 at the end of the week. As already stated the EURJPY pair has traded in line with risk on and we see it printing 100.00 as we write. We believe that this JPY strength is still way overdone and we cannot see how this strength will continue.
- GBPUSD pared its losses from the previous week to finish at the highs for this week around 1.55. 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 and we feel this is only a temporary rally in Cable.
- Commodity currencies such as the AUD and the CAD rallied again this week on the back of a better risk taking environment as equities around the world rebounded to multi-month highs.
- Emerging market currencies such as the ZAR and the BRL had a very decent week, with both currencies posting gains of 2.5% and 1% 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. The CNY fixing for the majority of the week at approximately 6.3150.

Fixed Income

- US Treasury yields slightly jumped on Thursday. The US 30-year yield moving by 10 bps to 3.05% currently while the 10-year moved by 10 bps to 1.98%, having been as low as 1.8323% on Wednesday.
- The now infamous rating agency S&P, downgraded several Euro zone members ratings including France with the knock-on effect that the EFSF rating was also downgraded as it is measured by the amount of AAA guarantees in the fund – it was either a downgrade or the fund dropping to 260Mn EUR and being ineffective. The effect of the rating drop would normally have led to an increase in market funding costs, in the case of France however that has not happened, leading the market in a show of force against the rating agency.
- On Thursday both Spain and France sold a variety of debt ranging from 2014 to 2040. Not only did they manage to sell the debt at lower rates but they managed to increase the issuance by a total of 15Bn EUR. With the French dropping the BTAN short rates from 1.52 to 1.08, a substantial reduction of funding cost in light of the downgrade!

- This having been said the 10-year rates in fact rallied on the week by 12 bps in France to 3.12% and 34 bps in Spain to 5.52%, but slid by 25 bps in Italy to 6.37%.
- This week, EU HYs were the best sector among global debt leading by more than 1% to its nearest rival. Globally European debt performed better than US debt, even outperforming on the corporate front, while Global EM was net positive for the month USD terms.
- 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 still seem very attractive.
- As a house we have however cut our exposure to the convertible bond space to focus on the HY sector and to reflect our worries over the equity sector where we feel they could be hurt if we see an equity setback.

Equities

- Global equity markets were up for the third week of the year. The MSCI World index rose by 2.65% as of yesterday’s close, with investor sentiment riding high on encouraging results from US banks, while near-term concerns over Europe eased after solid demand at debt auctions.
- The EuroStoxx 50 rose by 3.60% this week, as strong demand and falling yields at Spanish and French debt sales soothed worries over the euro zone debt crisis and triggered sector rotation out of defensives and into banks. Within Europe, the DAX and the MIB were the biggest gainers rising by over 3.8% and 3.7% respectively.
- Meanwhile, the S&P 500 rose by 1.70% as of yesterday’s close hitting a fresh five-month high, sparked by results from Bank of America and Morgan Stanley. Also, data showed the number of Americans filing for new jobless benefits dropped to nearly a four-year low. However, reports after the bell were mixed as Google fell short of Wall Street's expectations and dropped by 10%.
- Japanese stocks hit a five-week closing high on Thursday as the euro climbed on news that the International Monetary Fund is seeking to bolster its funds to stem the euro zone sovereign debt crisis. The Nikkei increased by 3.13% this week.
- In terms of sectors, industrials, financials and consumer discretionary led the gains this week while consumer staples, telecom and utilities 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 sovereign concerns.
- 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 deteriorate further. As such, we maintain our current equity allocations.

Emerging Markets

- Emerging Markets’ equities are up 4.04% 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 drive to the encouraging news that came from Europe this week.

- The best performing region was Emerging Europe, up over 4.5% as measured by the corresponding MSCI index, followed by Asia (4.4%) and Latin America (3.7%). Emerging regions were globally boosted by the strong performance of energy and materials stocks.
- The Shanghai Composite rose by 3.32% for the week continuing a 3.8% rally last week, supported by optimism that the government would usher in market-boosting steps after next week's Lunar New Year holiday.
- The Brazilian Bovespa gained 3.35% last week as speculation China will ease its monetary policy sparked a rally on industrial metals, boosting the outlook for Brazilian raw material producers.
- Our view on EM assets is unchanged. While EM economies will undoubtedly be affected by a slowdown in Europe and in the US, these economies overall are in a much healthier state than developed economies. Asset prices just begin to reflect that reality as EM equities are up over 8% since the start of 2012. As such, we maintain our exposures to EM equities and EM corporate bonds, as well as our CNY positions.

Commodities

- Commodities rose by 0.63% 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 once again the biggest winners this week - up 3.95% - followed by quite some distance by agriculture and precious metals - up 0.60% and 0.52% respectively.
- Gold started the week with sustained gains until Wednesday - hitting a high at $1’660 an ounce - before greater it fell to $1’648 an ounce currently, up 0.2% for the week.
- Crude Oil kept steady around $100 a barrel, as investors bet oil demand will grow as Europe's funding worries ease. Meanwhile, supply concerns over Iran's tensions with the West remain the main issue.
- 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.
