Bedrock Newsletter

Friday, January 27th 2012

This week, "Helicopter Ben" did it again! At its first meeting of the year 2012, and against all consensus expectations, Bernanke extended his pledge to keep rates at 0 to the end of 2014, or a year and a half more than previously announced! This announcement had the immediate effect of boosting equities and commodities (especially Gold) and also of trimming the value of the US currency against all other currencies, and lowering long term interest rates. In doing this, the Fed clearly wants to assure banks that they can enjoy the spread between short term interest rates and long term US Govt bonds, thus helping to rebuild their Capital.

Well, isn't this dose of liquidity injection going to be too much since we are already seeing the signs of a resurgence of the US economy? Isn't this going to create yet another bubble, which no one knows how it will end? One thing is clear however: short term rates in the US, but also in Europe, Japan, the UK and Switzerland are going to stay low for an extended period. This will for sure help to put a floor under equity prices and even lift them quite substantially. The same will be true for commodity prices. Gold? Definitely an asset to keep as all major countries are debasing their currencies and the cost of carrying the yellow metal is nil. Moreover, the fact that now the financial world has (finally!) understood that the EUR is not and will not be an alternative to the US Dollar as a reserve currency, will also help to underpin the price of Gold.

So what should we expect going forward? Maybe, after a little correction in the short term, due to the nice run-up that took place for a month now in all risky assets, equities and commodities should resume their uptrend and have a nice ride to the upside. US Govt Bond yields run a risk of not moving lower than they already are due to rising future inflation expectations and High Yield and corporate bond yields should compress further due to the search for yield and because of really sound corporate balance sheets. It should also be emphasized that the action from the ECB, which issued Long Term Refinancing for 3 years (LTRO), had a very positive effect in easy funding problems for the European banks. This alone has had a dramatic effect in the perceived risk environment.

In currencies, we should continue to see a lower Euro going forward, against the US Dollar but also against all other currencies (except for the Swiss Franc since it is floored). The issues facing Europe in the next few months continue to be huge and the economic outlook there remains negative. The French Socialist Holland, who is running against Sarkozy for the French presidential election in 3 months time, has said yesterday that the first thing he would do if elected, would be to renegotiate the agreement between Sarkozy and Merkel that finally gave some hope to the markets at the end of December!! The UK, Japan and Switzerland all want a lower currency in order to regain economic traction for the first one, and in order to fight deflation for the other 2. China will continue to allow a moderate pace of appreciation in its currency. This leaves us with the US, which in fact, has now regained the top spot for growth in the developed countries and which has a healthy corporate sector. We thus remain positive for the outlook of the US currency for 2012.

The big worry remains Iran as a showdown between the West and Iran continues to appear closer and closer. EU sanctions and Iranian reactions, war of words, Naval positioning all make us fear that a confrontation could happen sooner than we think. With this in mind, a good allocation to Oil remains warranted.

-Good week end to all-

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Currencies

- In light of all of the European problems seemingly evaporated due to the world economic leaders meeting in Davos and Greece CONTINUING to discuss how they will manage to get their next bailout without actually meeting their targets or agreeing to the write downs, the EUR has rallied against the USD. As mentioned above with USD rates capped at 0 till 2014 the USD weakened and almost without setback moved from 1.2885 to 1.3130 where we are now. However, we view this move up in the EUR as corrective and short term in nature. We remain structurally bearish on the EUR.
- It seems that the Hildebrand story has been forgotten and assigned to political assassination history, for the SNB have not been tested (as yet) by the market on the 1.20 floor, with EURCHF having stayed incredibly range bound between 1.2060 and 1.2090. However, in line with the EURUSD mounting the 1.30 handle the USDCHF has traded hand in hand with its partner and has retraced a little to finish the week just below 0.9190
- The Yen had finally started to weaken. For us this is the first sign that perhaps the exporters of Japan might see some respite in 2012. The JPY dropped to 78.20 at the lows but is finishing flat on the week at 77.00 as we write. The EURJPY pair has traded in line with risk on, at 101.15 as we write, 1% higher than last week. Perhaps this is the start of a weakening Yen? We believe it is.
- GBPUSD continued to trade up this week, even as confidence in the UK's economy still remains fragile and more QE should be in the pipeline (although none was announced this week, holding rates flat). We were, we are, and will remain bearish on the UK Pound and we feel this is only a temporary rally in Cable, which will probably continue in lock-step with the risk-on sentiment.
- Commodity currencies such as the AUD and the CAD were flat until the helicopter and his bazooka mounted the assault on Wednesday evening, rallying again this week to 1.0650 and parity respectively, the highs of the week and in line with the recent peaks we saw at the end of August and the end of October.
- With China on holiday for the whole week, riding the Dragons for the New Year, it has been relatively muted on the CNY. However Asia in general seems to be riding the USD weakness for now with the ADXY rallying very smartly up to 117.23 almost to the levels we saw at the end of October, but well below august highs. In general USD weakness was an EM theme this week with BRL rising to 1.7320, and ZAR rising to 7.75.

Fixed Income

- US Treasury short yields crumpled on Wednesday with the Bernanke and his extension of the 0 short rates till 2014. The US 30-year yield sunk by 14 bps to 3.03% only to rebound to exactly where it started at 3.15%, while the 10-year dropped by 15 bps to 1.90%, having been as high as 2.09% on Monday.
- On Wednesday we saw the Italians issue 5 Yr at 4.68%, only to see the bonds rally to a low of 4.48% and a massive reduction from December where the rates were at 7.6%. In total they raised 52.5Bn EUR, from 2016 to 2022, so perhaps they don't need the Chinese after all (since they were away...)? Italy followed up with another 20Bn EUR of short paper, which was oversubscribed!

- French 10-year rates were flat on the week only to drop a few Bps to finish at 3.06% and in Spain we saw a large rally in the bonds finishing the week down a massive 50Bps at 5.02%. In Italy we saw a drop from 6.25 to 5.92%, a 33 Bps drop.
- This week, EU HYs were the best sector among global debt leading by more than 0.8% to its nearest rival, US HY. Globally, European debt performed better than US debt, even outperforming on the corporate front, while Global EM was positive for the month.
- 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.

Equities

- Global equity markets were up last week with the MSCI World rising by 1.21% as of yesterday's close, on Fed comments that rates will remain low until late 2014 and that further QE measures may be on the cards.
- The EuroStoxx 50 also rose by 1.20% this week. European equities entered a bull market on Thursday, as private bondholders continued to discuss a debt swap with Greece's government. Also, GfK's announcement that German Consumer Sentiment index will increase in February bolstered investors' confidence. Within Europe, the DAX and the MIB were again the biggest gainers rising by over 2.2% and 2.4% respectively.
- Meanwhile, the S&P 500 rose by 0.23% as of yesterday's close. Early data this week showed the US economy ended the year with more momentum than previously thought. However, other reports on Thursday showed new claims for jobless benefits rose moderately, suggesting the labour market was healing only slowly, while new US single-family home sales unexpectedly fell in December.
- The Nikkei rose by 0.85% this week, as energy companies and trading houses gained on higher commodity prices.
- In terms of sectors, materials and financials kept leading the gains this week while healthcare and telecoms lagged. Materials are the best sector so far this year while Financials are also faring very 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 remains challenging and there are important risks should the Euro crisis deteriorate further. As such, we maintain our current equity allocations.

Emerging Markets

- Emerging Markets' equities are up 2% 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 continuing to respond with more drive to the encouraging news that came from US and Europe this week.
- The best performing region was Emerging Europe, up by 5.20% as measured by the corresponding MSCI index, followed by Latin America (2%) and Asia (1.4%). Emerging regions were globally boosted by the strong performance of materials stocks.

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- The Shanghai Composite was closed this week for the New Year holidays. China looks set to engineer a soft landing with economic growth slowing to about 8.5% this year from 9.2% in 2011, while reducing its inflation to about 3% from 4.5% last year...
- The Brazilian Bovespa gained over 1% last week as of yesterday's close extending an 8th day winning streak - the longest in 15 months - as mining companies MMX Mineracao & Metalicos SA and Vale SA followed higher metals prices.
- 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 close to 11% 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 0.78% 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.
- Precious metals were once again the biggest winners this week - up 5.25% - followed by quite some distance by industrial metals and agriculture - up 3.52% and 3.33% respectively.
- Gold reached a new high at $1'731 an ounce on Thursday, after the Federal Reserve said it planned to keep interest rates at rock bottom for some years and hinted at further monetary stimulus. Gold rose by 3.08% this week and currently stands at $1'718 an ounce.
- Crude Oil rose by 1.07% this week at $99.50 a barrel, on hopes of steady demand growth as positive data from the United States boosted expectations. Meanwhile, Crude got additional support as the supply threat escalated after Iran said it might stop exports to the European Union earlier than July when an EU ban on Iranian crude takes effect.
- 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.
