Bedrock Newsletter

Friday, February 10th 2012

It must be Equity Season! Another week of rises, little ones, but persistent. The NASDAQ is up 12% YTD, but 25% of this due to Apple alone. The DJIA whilst up somewhat less can also thank Caterpillar which gave 25% of the rise. Not exactly broad-based… The NASDAQ is a new 11-year high so should we be excited? Well, the pessimists argue that this is terrible, as we backpedaled for a decade and then some. It is a point, but then, even the ultimate bear, Nouriel Rubini has changed his tone- now becoming bullish on equities, supported by Warren Buffet who stated this week that equities will outperform bonds, gold and all other asset classes.

At Bedrock, we checked on our past predictions and outlooks. In December 2010 we had said that we saw the S&P 500 reaching 1’350 for year-end 2011. We were wrong; it happened on February 8th Thirty nine days late…Now we venture that 2012 may well reach 1’500 on this same index or another 10-11% rise from here. Our reasoning follows the same logic as applied in 2010- Equities would be fairly priced at 15 times earnings, which we expect to be about $100 for the components of the S&P index so with the same multiple of 15X you find our computed prediction. This remains conservative, as it is likely that the fall in volatilities and the general abatement of risk perceptions, the multiple itself may rise as well.

Last week we were a little more cautious as we didn’t find support for the equity move in bond yields which were falling. This week however, the latter have rejoined the view expressed by their equity-siblings: Yields on Treasuries are rising; 10 year Treasury Notes crossing above 2% suggesting that the views of a better than previously though economy is broader-based now.

And yet, many issues remain unresolved: From Syria’s unnamed civil war and its eventual repercussions (it does border on Turkey and Iraq and is under Iranian influence), to ongoing Iranian noises and the on again, off again Greek debacle. As we write, Greece is not resolved. This said, even if all the powers to be sign a document of one nature or another, we must apply some cynic sauce to the actual outcome… But Greece did distract investors from Spain, Portugal and Italy which together and individually are the proverbial elephant in the Greek Parthenon…

We observe some other unsettling political issues- The imminent French Presidential elections could define Mr. Holland as the eventual leader which doesn’t augur well for markets, in the US, Mitt Romney’s GOP nomination chances were rattled some this week which might be upsetting to Wall Street. Then the incumbent administration has agreed to some $20Bn in re-financings and write-down on non-performing mortgages. This is a morality trap as Bank analyst Dick Bove said. "Those people lucky or smart enough to stop making payments on their homes may get their loan balances reduced," he said. "Other beneficiaries of the agreement may be homeowners who have seen the value of their houses drop below the size of their mortgages. They get a freebie that other homeowners who have paid their mortgages down will not get." Some have recommended to “good” borrowers to cease payments… Could this become a new and effective movement of “occupy Wall Street”, default-to-gain… Would this be analogous to the Greece debacle?

US winter-weather has been unusually mild. Europe in a record freeze. Makes sense, no?

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Currencies

- The EURUSD pair remained firm as hopes that the Greek situation will quickly be resolved (...) Butt as we write this, new problems have emerged and hence, the EUR immediately dropped from a high of 1.3325 to 1.3190. We continue to believe that every rally should be sold as large problems loom for Europe.
- SNB's Jordan released another statement leaving no room for doubt that the 1.20 level will be maintained as a floor for EURCHF. On the news, the pair rallied from 1.2050 to above 1.21. The status quo is maintained. The USDCHF was also range bound between 0.9120 and 0.9220 – decidedly similar to last week.
- We saw the JPY weaken this week from 76.20 on Monday to 77.70 as we write in a gentle incline throughout the week. The EURJPY fell back into its usual pattern of tracking "risk-off risk-on", rallying from 100.00 to 103.00 again throughout the week gaining on a daily basis.
- GBPUSD continued to trade up this week from 1.5790 to 1.5920, as the BOE held rates flat and expanded by £50Bn the QE. As we have been writing weekly, "We were, we are, and will remain bearish on the UK Pound" and cable continues to trade in lock-step with the risk-on sentiment, how long will this last?
- Commodity currencies such as the AUD and the CAD rallied again this week to 1.0840 and 0.9920. However they trailed off in line with the weakening equity markets from Thursday afternoon and finished flat on the week at 1.068 and 1.00.
- The Chinese continue to slowly strengthen their currency and we saw the first week since January where we maintained the 6.30 level. We close the week at 6.2950. Asia saw the ADXY stable on the week however finishing the week slightly lower at 117.30.
- Very little movement on USD vs. EM, except today where the USD has started to strengthen. USDZAR is trading at the highs of the week at 7.70 and BRL although unmoved (as market is closed as we write) will likely follow suit when the market opens.

Fixed Income

- US Treasury 2 Year yields rebounded again this week to finish at 0.26%. The US 30-year yield bounced again by 11 bps to 3.22% only to drop to 3.15% as we write, while the 10-year rebounded by 15 bps to 2.07% to soften a little at 2.0%.
- On Thursday the Italians issued 10Bn for 2014 - 2017 ranging between 3.41% - 4.10% (both of which were lows on the yields since last June). With the 5 year finishing the week at 4.15%, a level not seen since last June and the 10 year at 5.49, also not seen since September 2011.
- French 10-year wobbled a little this week finishing up 10 Bps at 2.94% and in Spain we saw the yields slip from 5.00% to 2.27% at the end of the week. With both the French and the Portuguese having auctions for 82Bn EUR and 2Bn EUR respectively, and the Portuguese postponing the other two small short term notes, perhaps the market was a little less than receptive after a large week of issuance?

- This week, EU HYs were the best sector among global debt; In fact aside from EM debt and EUR corporates they were the only sectors to have positive performance. Globally, European debt performed better than US debt. With US Gvt performing the worst at -0.78%
- 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. Especially when some corporates can boast cash balances of 30Bn USD (Petrobras)!!

Equities

- Global equity markets were up for a sixth week with the MSCI World rising by 0.82% as of yesterday's close. The Euro zone edged closer towards securing a €130bn bail-out package for Greece, which was finally dismissed, as Eurozone finance ministers set a fresh set of austerity demands from Greece of €325mn in additional cuts.
- The EuroStoxx 50 rose by 0.33% this week, reaching an 8 month high. The index pared gains of as much as 1.70% earlier this week, due to the ECB willing to exchange their Greek government bond holdings at a price below face value. This would reduce Greece's debt by up to €11bn, but would only be implemented on a positive outcome of the restructuring talks.
- The S&P 500 rose by 1.99% as of yesterday's close. This week the MSCI World index has surpassed the level of a 20% gain since October's lows, and therefore, has officially entered a Bull market. This week's jobless claims maintained the low rate of the preceding weeks, justifying the 8.3% unemployment rate figure which was released last Friday.
- The Nikkei rallied 1.30% this week, on the back of strong carmaker earnings, showing signs of recovery from last years' disasters. The index gave back some its gains at the latter part of the week, as Japanese machinery orders came in substantially lower than expected.
- In terms of sectors, IT and Consumer Discretionary stocks led the gains this week, while Materials and Healthcare lagged. Outperformance of IT was due to investors switching to a risk-on approach, and using high beta stocks to do so. We however advise caution on Financials, especially on European institutions given sovereign concerns and stricter regulation.
- 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 1.27% for the week as of yesterday's close, as measured by the MSCI EM index. This is better than developed markets, as EM stock valuations still appear more attractive.
- The best performing region was Asia, up by 1.81% as measured by the corresponding MSCI index, followed by Latin America (0.94%) and Emerging Europe (0.03%).
- The Shanghai Composite rose only 0.93% for the week, where data showed that Chinese inflation has increased in January, breaking a streak of five monthly declines. However, the index was weighed down by lower than expected holiday sales figures earlier this week, as well as reporting of the first trade contraction in two years.

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- The Brazilian Bovespa gained 1.45% this week as of yesterday's close. Rally this week was strongly supported by Itau Unibanco who offered to buy minority shareholdings in Redecard SA, further proving the attractiveness of current stock prices in the region.
- 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. Valuations, as well, seem more attractive in the Emerging world with a price to earnings ratio of 12.12 on the MSCI EM compared to 14.07 on the MSCI World. Therefore, we maintain our exposures to EM equities and EM corporate bonds, as well as our CNY positions.

Commodities

- Commodities rallied 3.20% this week as of yesterday's close as measured by the S&P GSCI broad commodity index. However, performance varied strongly by type of commodity.
- Energy indices were the biggest winners this week, up 4.37%, while Precious metals and Agriculture were the only negative contributors (-0.99% and -0.60% respectively).
- Gold had flat performance for the week, as of yesterday's close. Yet, it is now trading -0.50% lower at around $1'720 an ounce. Gold is expected to continue to have a bullish bias, as investors will continue to seek diversification away from European instability.
- Crude Oil rose 1.55% this week, and is now trading at $99.00 a barrel. API reporting a shortfall of 4.53mn barrels in last week's inventories offset an earlier selloff caused by a supposable softened stance from Iran on cutting oil supplies to Europe.
- We remain constructive on oil given supply/demand dynamics as well as Middle East tensions, and on gold, which should continue to find support as global central banks provide liquidity to markets.
