Bedrock Newsletter

Friday, February 17th 2012

Another on-again off-again Greek story. Will they agree? If they agree will they implement? If they implement, will it resolve the issue? If the issue is resolved, what will be the next one? Complicated conundrum and the investor community appear to have given-up on following the saga. Monday is now the new Final Day for resolution. Let's watch…

Earlier this week in an interview with CNBC, the Saudi Prince Alwaleed (largest holder of Citi) said that Saudi Arabia will not let oil trade above $100. Well, it is trading now at $102.50/bbl. Perhaps not a mistake on his side, it's just those Iranians and Israelis rattling sabers with nuclear overtones which introduced some extra risk-premium to the black sludge. Energy prices may well be the next brake on the fragile economic recovery certain data are indicating.

A funny observation - garbage now claims to generate 50% of all renewable energy in America. A good commercial advertisement but hardly impressive if one considers the minute part of renewable energy in the total needs.

Then, many were caught short on a weak US Dollar on the back of relatively strong economic data. We remind our readers that economic wellbeing isn't positively correlated to currency moves! We argue that as the US economy awakes, so does demand for imports whilst exports are unaffected. This results in net US demand for foreign currencies or larger sales of the US$. That is the reality of currencies - when in doubt, look at the Japanese Yen. It continuously rose into a shrinking economy. The Euro? Well, whilst facing broad political and economic problems, it actually fared quite well as the Euro block as a whole does not have a trade deficit. Brazil recently swung from a net exporter to a deficit and its powerful currency reversed course. We reiterate here that the intuitive purchase of currency of relatively strong economies is not necessarily a good idea!

The "big miss" this year may have been the PIIGS' bonds! Other than the Greek ones, we see quite impressive yield declines for Spain, Italy and some for Ireland and Portuguese sovereign debt. Or has the real "miss" been the equity markets? Equity indices are all well up for the year but only small parts of portfolios had been allocated in this asset class. Trading volumes in these rising markets have been slow, so then, who was on this train?

Another "miss" maybe of a different type - There is a new Swimsuit-Miss on the cover of Sports Illustrated, and she is American. Stay with us here… U.S. stocks experience significantly better returns during years when an American model graces the cover of the Sports Illustrated swimsuit issue than during years when the magazine cover features a foreign model, history shows. The S&P 500 had an average return of 14.3 percent during the 17 years since 1978 that featured an American, with positive returns a whopping 88 percent of the time, according to the Bespoke Investment Group blog. That's about four percentage points above the average return during the years that featured a model from another country. Looking at models in tiny bikinis is therefore a valid activity for investors! Arguably buying the magazine is tax deductible!

Many investors seek the next "big change". The Industrial Revolution, the telephone, the microchip, computers, space travel, the one which will change the world and give us amazing returns. If only we had invested wisely into the change. What is the next one? We would argue that 3D printing may just be the next big one. It could change how we make things, watch out labor! On this thought and the sunshine outside, we wish you a wonderful weekend!

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Currencies

- The EURUSD pair gradually weakened as hopes faded for a “Greek Solution”. Moving from 1.32 to below the 1.30 handle. Only to rally almost back to 1.32 on the news yesterday that some agreements were in the pipeline and that a bond-swap might take place. We finish the week at 1.3170. We continue to believe that every rally should be sold.
- SNB’s Moser has made the headlines this week with his insightful comments that the “current EURCHF level is not ideal for the Swiss economy”... really?!? However EURCHF has been completely range bound this week, stuck at 1.2070. The USDCHF broke out in-line with the EURUSD weakness to trade to 0.93, but finishes the week at 0.9175.
- We saw the JPY weaken this week from 77.50 on Monday to above 79.00 as we write. With the BOJ pumping 10 Trillion Yen into an asset purchase program (128Bn USD of QE) and setting a target inflation rate of 1%. The EURJPY rallied from 103.00 to 104.00.
- GBPUSD had a mixed week. With the week starting in risk off mode, cable traded as low as 1.5640, only to see good consumer data cause a pop to 1.5850. 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 risk sentiment, how long will this last?
- Commodity currencies such as the AUD and the CAD had a mixed week finishing where they started at 1.0760 and 0.9950. Reflecting waning market sentiment.
- The Chinese closed the week at 6.2950, where it started. Asia saw the ADXY faithfully following the risk sentiment finishing the week exactly where it started at 117.30.
- Very little movement on USD vs. EM, trading in lock step with risk-on, risk-off. USDZAR is the only real mover trading to highs of 7.88 and finishing the week at 7.74 and BRL unmoved at 1.7160.

Fixed Income

- US Treasury 2 Year yields rebounded for a third week to finish at 0.2950%. The US 30-year slipped to a low of 3.06% only to bounce on the Greek news back to 3.16%. While the US 10-year followed the same pattern bottoming at 1.91% and climbing to 2.00%.
- On Tuesday the Italians issued the maximum debt of 6Bn EUR, with fund costs dropping for a fourth issuance in a row. With the yields ranging between 3.41% - 4.26%. With the 5 year finishing the week at 4.48% up 30 Bps from last week.
- French 10-year wobbled again this week, but finished up 3 Bps at 2.97%. In Spain we saw the yields slip in the same fashion to 5.29%. The strong performance of the Italian market issuance bodes well for the Spanish auctions.
- This week, EU HYs were the worst sector among global debt at -0.42%; the HY sector globally gave back some of its profits for the start of the year. Government debt outperformed corporates in the US, but corporates outperformed Government debt in EU. With the star of the show being EM debt putting in a +0.50% in 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.

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Equities

- Global equity markets were up for a seventh week with the MSCI World rising by 0.83% as of yesterday's close. While developed markets started the week amid mixed sentiment, strong US economic data supported stocks on Thursday, outweighing worries about a possible downgrade of global banks by Moody's and persistent fears of a chaotic Greek default.
- The EuroStoxx 50 rose by 1.43% this week. Starting the week, Greece was facing hurdles in its efforts to secure a bailout. However, government sources later said the country and its international lenders had agreed how to achieve budget cut worth 325 million Euros. Actually, Euro-area governments are considering cutting interest rates on emergency loans to Greece. Also using contributions from the European Central Bank to plug a new financing gap in the second bailout program for Athens.
- The S&P 500 rose by 1.15% as of yesterday's close. US stocks advanced following a two-day decline, as housing starts and manufacturing data topped forecasts while jobless claims slid to a four-year low, bolstering optimism in the world's largest economy.
- The Nikkei rallied 4.88% this week. Japanese stocks rose after the yen fell to a four-month low as major investment banks projected the currency will continue to slide, and on better US economic data, boosting the outlook for exporters.
- In terms of sectors, Information Technology and Energy stocks led the gains this week, while Materials, Utilities and Telecoms lagged. IT, Consumer Discretionary and Financials are the best performers so far this year. Outperformance of these sectors is 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 0.68% for the week as of yesterday's close, as measured by the MSCI EM index. This is worse than developed markets for the first time since the beginning of the year. However, Emerging Markets still outperform the Developed World by quite a distance for the year (14.50% vs 8.25%).
- The best performing region was Emerging Europe, up by 1.37% as measured by the corresponding MSCI index, followed by Latin America (1.02%) and Asia (0.71%).
- The Shanghai Composite rose only by 0.22% for the week, as positive data from the Western world were outweighed by concerns a jump in money-market rates will make it costly for small companies to borrow and as a state economist said, the government will set the lowest growth target in eight years.
- The Brazilian Bovespa gained 0.93% this week as of yesterday's close. The up move this week was supported by Brazil's biggest wireless carriers who pledged to keep up the pace of investment after posting their biggest operating profits ever in the fourth quarter, solidifying their positions in a booming mobile phone market. Brazil stocks rose 17% this year, almost

erasing last year's 18% decline. The gains came as central bank President Alexandre Tombini said on Feb. 2 that he may cut official rates further to spur the economy.

- 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 seem more attractive in the Emerging world with a PE ratio of 11.8 on average for the MSCI EM compared to 14.2 for the MSCI World. Therefore, we maintain our exposures to EM equities and EM corporate bonds, as well as our CNY positions.

Commodities

- Commodities rose by 0.73% 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 1.75%, while Industrial metals dropped by 6.13% as copper hit a three-week low on Thursday after signs of a delay to a bailout for Greece soured sentiment.
- Gold rose by 0.65%, currently trading around $1'732 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 4.22% this week, and is now trading at $102.50 a barrel, as signs of an improving US economy and final progress on a bailout for Greece bolstered the outlook for fuel demand.
- 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.

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