Friday, March 2nd 2012

Another busy week, February is over as well… the first two months of the year produced one of the best year-opening in recorded history… The DJIA traded over 13'000 for a day and even closed one day above. Only to have Ben Bernanke disappoint the market the next day… The NASDAQ composite is also flirting with a big round number of 3'000, nice, but let's not forget it had been above 5'000 in 1999…

Then we heard that the US growth rate in Q4 was 3% revised from the previously stated 2.80% and inverted to the expected downwards revision. It reminds us of John Kenneth Galbraith who said "*The only function of economic forecasting is to make astrology look respectable*" ☺

Whilst the Fed disappointed the markets in remaining mute about a QE (III), the ECB gave us LTRO (II) with a 529 billion Euro funding auction to banks. It had a larger take-up than the previous LTRO.
Is this an institutional Ponzi scheme? The ECB lends money to banks to buy securities which said banks then place as collateral with the ECB… Either way, it clearly adds funds to the system and should "motorize" economic activity. A wave for markets to ride? The Euro which had been roaring early in the week, trading through 1.3450 petered-out and slipped back down to the 1.32 handle.

An interesting relic of the Greek saga we have been enduring for many months now; The ISDA (the governing entity for Swaps and other derivative contracts) ruled that Greece didn't default and as such, obligations under Credit Default Swaps are not triggered. Some $3.50 billion of such swaps (or insurance policies) have not been triggered. This is an interesting precedent… A designated Committee decides if an event has occurred or not…

Oil has slipped a little from its recent highs. Some of its price can and probably should be attributed to geopolitical risks (Iran, Nigeria, other Arab springs etc.) Some of the price rise should be assigned to actual growing demand into stagnating production. In the distant future, Brazil will become a big new producer, but from here to there, spare capacity is hardly significant. All such spare capacity is assigned to Saudi Arabia but then no one can say what Saudi produces, what are their reserves and their ability to extract. Perhaps these are wishful thinking… if so, oil has one way to go, for the foreseeable future. Let's stay with the play.

Gold gave us a scare on Wednesday, dropping over $90/ounce in minutes as Bernanke was speaking. Granted, from rather lofty levels, but the fall was unpleasant to watch. A small rebound on Thursday was well received. On the good side of market moves we saw significant declines in Italian government bond yield, with the 10 year now under 5% (it had been above 7%!).

A thought about Apples; One apple eaten by Eve got us all kicked out of Heaven. Another apple hit Newton and inflicted us with Gravity. Now Apple iPads… Believe it, even with Apple stock above $520…

Bedrock Newsletter

Currencies

- The EURUSD pair stayed in a 100 point range for the first 3 days of the week, between 1.3400 and 1.3480 before breaking to the downside to print 1.3240 this morning. It seems that the market is slowly seeing last week's bailout in the correct light and the EUR is weakening. This is the correct response and in line with our view that the only solution to the European crisis is for the EUR to weaken and to continue to do so if the periphery do indeed remain in the Euro zone.
- As we thought last week, the assault on the JPY did indeed take a small breather this week only to be remounted after Bernanke spoke on Wednesday. We started the week at 80.00, sailing to 81.60 within a day, only to give back the ground on the following trading day, ending the week at the USD highs/JPY lows of 81.70 post Bernanke's comments on growth and the "unthinkable implied merest possibility" he might take away some of the stimulus at some point – shock-horror! Bernanke's comments were USD positive across the board and caused an almost unanimous Bid in the market for the Greenback.
- EURCHF maintained its floor level, trading at or around 1.2050. This price action keeps the USDCHF pair as the inverse twin of EURUSD, and as the EUR slipped, the USD surged with the pair printed 0.9100 this morning having rallied from a Pre-Bernanke low of 0.8930.
- GBPUSD has defied the USD bid tone and has continued its ascent from 1.5720 to 1.5920. It seems the markets have shrugged off the dissenting votes for more stimuli last week and the British pound is flirting with the 1.60 level. We do not believe that this is sustainable and look to see it weaken over the coming weeks.
- The CAD had another good week due to higher oil and gold prices, and the AUD recouped some of the weakness shown last week.

Fixed Income

- US Treasury 2 Year yields declined this week, finishing at 0.2860%. The US 10-year fell, sending yields to 2.023% due investor appetite for riskier assets and comments by Fed Chairman dampening hopes for further economic stimulus. The US 30-year followed, ending the week at 3.137%.
- The ECB have allotted EUR 530BN in cheap 3 year loans, slightly exceeding expectations. EU Sovereigns rallied across the board. Italian 10 year rallied strongly sending yields to below 5% for the first time since August. The only exception has been Portugal which fell as default fears are continuously growing.
- UK 10 years had a negative week, sending the yields to the highest since November, as PMI have shown slower growth than expected and BOE signalling a reduction in likelihood of further stimulus.
- The S&P have downgraded Greece further, now in selective default. Yields have spiked to an all time high of 37.75%. However, the ISDA have confirmed that Greek CDS will not be triggered for the moment.
- This week EU High Yields were the best performing sector (+1.61%), followed by EU Sovereigns and EU Corporates (+1.17% and +0.78% respectively). Other notable performers were US High Yields (+0.78%) and EM bonds (+0.75%). US Sovereigns were the worst performing sector falling by 0.14%.

- We remain constructive on Corporate bonds in general, with an emphasis on higher yields. In spite of the Macro environment, we expect low corporate default rates. However, we still advise regional diversification.

Equities

- Global equity markets were up this week with the MSCI World rising by 1.28% as of yesterday's close, as borrowing costs fell for Spain and France and US jobless claims matched a four-year low.
- The EuroStoxx 50 rose by over 1% this week. Spanish and French bonds auctions were successful helping both countries to raise 12.5 billion Euros as the European Central Bank's long-term refinancing operation helped spurring demand. It seems that market is happy with this renewed LTRO allocation, which signals easing of monetary conditions.
- Also, the International Swaps & Derivatives Association's decision that $3.25 billion in default insurance on Greek debt will not be paid out – after it was asked to rule whether part of the nation's $170 billion bailout was a credit event – gave some more support to markets, although it is quite a bad news for a lot of financial players.
- The S&P 500 rose by 0.61% as of yesterday's close. US stocks gained more ground this week, following the longest monthly advance for the S&P 500 in a year, as financial stocks rallied on the back of strong demand encountered by European auctions and as jobless claims reached a new low - more evidence the labour market is healing - outweighing concerns that the US factory activity grew less than forecast according to the ISM Index. However, uncertainty still remains a dominant factor in the US, as volumes in the markets have reached record lows.
- Otherwise, the Nikkei rose by 1.34% this week as the yen dropped to a nine-month low and better economic data from western developed regions boosted earnings prospects for export-dependent companies.
- In terms of sectors, Information Technology and Financials stocks led the gains this week, while Energy and Materials 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, or tensions with Iran gather steam.

Emerging Markets

- Emerging Markets' equities are up 1.31% for the week as of yesterday's close - as measured by the MSCI EM Index - in line with their developed counterparts. However, Emerging Markets still outperform the Developed World by quite a distance for the year (17.46% vs. 10.31%).
- The best performing region was Emerging Europe, up by 3.07% as measured by the corresponding MSCI index, followed by Latin America (+1.66%) and Asia (+0.31%).

- The Shanghai Composite rose by 0.86% for the week, as better data from China and the Western world as well as signs Europe's leaders will speed up the timetable for setting up a bailout fund strengthening defences against the debt crisis bolstered optimism.
- The Brazilian Bovespa gained 1.50% this week as of yesterday's close. The index rose to a 10-month high as bets for lower Brazilian borrowing costs lifted consumer stocks and raw material-producers followed commodities higher after a report showed manufacturing expanded in China. Brazil stocks rose by over 18% this year, almost erasing last year's 18% decline. The gains came as central bank President Alexandre Tombini said on Feb. 2nd 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 12.1 on average for the MSCI EM compared to 14.5 for the MSCI World. Therefore, we maintain our exposures to EM equities and EM corporate bonds, as well as our CNY and SGD positions.

Commodities

- Commodities rose by 0.77% this week as of yesterday's close as measured by the S&P GSCI broad commodity index. As usual, performance varied strongly by type of commodity.
- Precious metals were the biggest laggards this week down by 3.05%, on the back of Gold's weakness, while Industrial metals were the biggest winners, rising by 2.33% as Copper recovered from lows reached few weeks ago, on better economic data.
- Gold dropped by 3.3%, currently trading around $1'714 an ounce. Gold headed for its worst weekly decline this year as the dollar's advance damped demand for alternative investments even as exchange-traded product holdings expanded to a record. However, Gold is expected to continue to have a bullish bias, as investors will continue to seek diversification away from the instability induced by Europe.
- But the biggest action was on Silver, which dropped by 10% (!!) at one point on Wednesday following Bernanke's speech. It has since regained some ground to stand at 35.20 an Ounce. It should also be noted that we are at the same levels reached only 2 weeks ago.
- Crude Oil dipped from a 43-month high - dropping by about 1.4% this week - and is now trading at $108.10 a barrel. Oil experienced a short term setback after its recent sharp run and was also penalized by the stronger dollar. We however expect Crude Oil to rise significantly in the upcoming weeks as tensions surrounding Iran's nuclear plans and regional unrest are far from being resolved.
- 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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