Bedrock Newsletter

Friday, March 9th 2012

It is Friday again. An interesting week in which we had a fright with the DJIA falling over 200 points on Tuesday amid renewed Greek matters, Fed Governor Fisher saying that the market has a QE fetish (he is no longer a voting member of the FOMC so perhaps saying the truth?) or was it the Chinese saying they had cut their growth target from 8% to 7.50% But then, given its size, 7.50% growth remains a huge number… Everything fell on Tuesday, Gold, oil, equities. Is this the correction many analysts have been expecting and warning about? We went to sleep on Tuesday saying to ourselves “maybe…”

Wednesday we learned that “Super Tuesday” gave Mitt Romney a further advantage in the race for GOP nomination albeit less than his supporters may have hoped for. Then the ADP jobs report was better than expected. Productivity reports showed a better than expected improvement combined with a rising labor cost component. Markets regained their footings and held as Greece is still cooking our lunch… it might yet trigger a default in Credit Default Swaps’ terms… Then Abby Joseph Cohen (Goldman Sachs Guru) said that equity markets are pricing a 7% earnings decline annually for the next 5 years. Highly improbable she says... Maybe a big rally lies ahead? So we went into Thursday to find a nice rally which together with Wednesday basically cleared the Tuesday “correction”. Whenever we are tempted to predict the future we hesitate, recalling Bill Gates in 1981 who said "640K ought to be enough for anybody."

Thursday night Greece tallied the responses to its debt restructuring proposal. €172bn was tendered which represent 85.something% acceptance level or 95.7% with “CAC” included. Well, ISDA will determine today (again) if default occurred to trigger CDS based on the CAC… Sounds like military jargon… We uncovered the code: The CAC is Collective Action Clause and basically says that if enough holders agree, the others, non-consenting investors are forced to accept. So ISDA, the governing entity of the CDS (Credit Default Swaps) can decree if there was or wasn’t a default event. Or deciding if default insurance should be paid... Whatever…

Today’s markets are stable ahead of the employment report from the U.S. The sentiment appears to be that the Greek issue has been removed from page one. We are far from convinced, as a precedent is being defined here which could in itself trigger decisions elsewhere within the EU/Euro block.

We much enjoyed listening to Jim Grant who had the audacity to suggest that perhaps, just perhaps, we should consider moving towards a capitalist market economy to resolve our current situation. Crazy thought with some merit! We have all forgotten about the unresolved bloodshed in Syria and listened to Obama and Netanyahu’s views on Iran and the nuclear risks. We can only conclude that we will have this issue overhanging our lives for quite some time to come.

Our immediate future though will be set by the data to be released today. We will leave you with an observation that Statistics are like a bikini, what they reveal is interesting. But what they hide is vital.... Enjoy your weekend!

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Currencies

- The EURUSD pair rose over the week on optimism over the Greek debt swap deal from about 1.3200 to a high at 1.3275 reached yesterday. The Euro then slid against most of its major counterparts after Greece said the participation rate in its swap of government debt for new securities will reach 95.7% with the activation of so-called collective action clauses. This response 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. The EURUSD currently stands at 1.3215.
- The CHF weakened against the USD, while it maintained its floor level against the EUR, trading at or around 1.2050. This price action keeps the USDCHF pair as the inverse twin of EURUSD, and as the EUR slipped over the week, the USD rallied to 0.9125 this morning.
- The JPY weakened a bit further this week, starting around 81.30 to reach 81.90 against the US$, reaching a nine-month low as speculation of further easing by the Bank of Japan and gains in Asian shares curbed demand for the currency.
- Meanwhile, the GBPUSD did not defy the USD bid tone and slid – as we predicted last week – from 1.5865 to reach a low at 1.5720 on Tuesday, after reports showed retail sales and house prices fell last month, stoking concern the nation’s economic recovery is faltering. We do believe in further weakening on the British Pound over the coming weeks.

Fixed Income

- US Treasuries activity was very quiet this week, even if claims for jobless benefits were up for the third straight week. However, this report did not inspire a rush into the safety of Treasuries and it seems that investors prefer to save their energy for the US payrolls report, which is due out today. Treasuries stood still until Thursday before the yields all rose on Greece's looming bond-swap deal result: +8 bps for US 30-year yield to 3.179%, +5 bps for the 10-year yield to 2.019% and +4 bps for US 2-year yield to 0.314%.
- On the European front, Italian government bond yields fell to their lowest levels since mid-2011 and Spanish yields declined sharply in early trading Thursday on growing optimism that Greece will pull off a successful debt restructuring. The Italian 10-year yield sank 19 basis points this week to 4.69%, its lowest since June last year, while the Spanish 10-year yield lost some ground before bouncing back by 8 bps to 4.95%.
- On Thursday, holders of more than half of Greek bonds eligible for a debt restructuring had pledged to participate in the government's debt exchange offer that would see the value of their holdings more than halved, putting the country on the verge of the biggest sovereign restructuring in history.
- On Friday, Greece confirmed it averted the immediate risk of an uncontrolled default, winning strong acceptance from its private creditors for its bond swap deal. The finance ministry said creditors had tendered 85.8% of the 177 billion Euros in bonds regulated under Greek law. This would reach 95.7% of all privately-held Greek debt with the use of "collective action clauses" to enforce the deal on creditors who refused to take part voluntarily. This result should clear the way for the European Union and International Monetary Fund to release a 130 billion Euro bailout package agreed with Greece last month. As a result, Greek 10-year yield fell by 83 basis points, to 29.48%.

- Greece's successful debt restructuring brought some relief to Italian and Spanish bonds on Friday, but poor euro zone growth prospects and fears Portugal may also impose losses on creditors was likely to limit the fall in yields.
- This week, EM Debt was the best performing sector among global bonds rising by 0.51%, while other strong performing sectors included EU Corporates (+0.47%) and EU Sovereigns (+0.50%). Otherwise, higher yielding debt suffered with Convertibles being the worst performer (-0.91%) followed by US Corporates (-0.43%) and US High Yield (-0.37%).

Equities

- Global equity markets decreased for the week, with the MSCI World falling by 0.63% as of yesterday's close. Markets started the week with a sharp selloff, as China lowered its growth target to 7.5% (down from an 8% target maintained over the last 7 years), signalling further slowdown in global growth. Risk appetite returned at the second half of the week with positive economic figures from the US and Germany, as well as a successful outcome in the largest debt restructuring in history.
- The EuroStoxx 50 fell 1.14% this week. The index fell as much 4% earlier in the week, as German Industrial orders fell sharply by 2.7% for January. Much of the losses were recovered with German better than expected Industrial production, and especially, a Greek debt swap support of close to 95% by bond holders taking a 75% haircut on their holdings.
- The S&P 500 declined by 0.60% as of yesterday's close. ADP National Employment report showed an increase in the pace of hiring for February signalling further recovery in the US economy.
- The Nikkei rose by 1.56% this week as Japan's economy has shrunk less than the Government estimated (-0.7% vs. -2.3%) and the Yen resumed its weakening trend.
- In terms of sectors, Consumer Staples and Health Care were the best performers this week (+0.61% and +0.09% respectively), while Materials and Financials lagged (-2.76% and -1.3% respectively). Materials sold off on the back of lower Chinese growth prospects. Financials (especially EU) are showing worrying signals with heavy borrowing from the ECB lending program. Deutche Bank is reported to have borrowed as much as €10Bn last week!
- We find equity valuations attractive as the corporate world is quite healthy. However, as global issues are far from over, we favour high dividend-paying defensive stocks to growth stocks.

Emerging Markets

- Emerging Markets' equities are down 2.52% for the week as of yesterday's close - as measured by the MSCI EM Index. This is worse than their developed counterparts, as negative sentiment from China weighed heavier on these economies.
- The worst performing region was Latin America, down 3.26% as measured by the corresponding MSCI index, followed by EM Asia (-2.45%) and EM Europe (-2.12%).
- The Shanghai Composite declined by 0.86% for the week. Premier Wen Jiabao lowered growth forecasts with efforts to achieve a higher quality of development going forward, expressed in lower exports and higher consumption.

- The Brazilian Bovespa gained 0.15% this week as of yesterday’s close. Brazil grew 2.7% last year, now surpassing the UK to become the sixth biggest economy worldwide. The index rallied as the Central bank accelerated the pace of interest-rate cut (the BCB cut by 0.75% to 9.75% on Wednesday), supporting homebuilders and retailers.
- The BRL weakened sharply this week on mounting actions from the Central Bank and the Government to resist the appreciation of the currency. The Real weakened from 1.70 to 1.77.
- 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 11.87 on average for the MSCI EM compared to 14.46 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 0.11% 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.
- Industrial Metals took a hit this week down by 4.28%. Agriculture and Precious Metals also lost ground this week (-2.59% and -1.94% respectively) Brent Crude was the biggest winner, rising by 1.21%.
- Gold dropped by 0.56%, currently trading around $1’699 an ounce. Gold dropped as much as 3% earlier this week. Drop this week is viewed as merely a short time correction following its strong rally this year (up 8.9% YTD).
- Crude Oil gained 0.25% this week - and is now trading at $106.90 a barrel. Oil lost some of its strong momentum as US and 5 other world powers agreed to reopen talks with Iran on its nuclear programs. This is likely to be a final attempt for negotiations in order to hold back an Israeli airstrike on Iranian nuclear facilities.
- 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.
