Bedrock Newsletter

Friday, February 4th 2011

Watching the events unfolding in Egypt and the return of the use of "contagion" in news commentaries reminds us that wishing "interesting times" is considered a curse in some cultures… We recite here a broadly followed money manager who wrote "*The world is changing before our eyes, and these changes may either result in the greatest unleashing of freedom, democracy and free markets in history and may usher in a new era of global trade unlike anything seen heretofore, or this may end in utter and complete chaos*".
This is the definition of risk! Without attempting to assign probabilities to either outcome, we can say that it will be either good or very bad. We can hope that the odds for the good outcome are higher. Interesting times indeed!

As some analysts lay the blame for this situation at the rising prices of food-stuff we think it may be interesting to linger a little on the subject; We note that in many emerging markets (notably in Egypt) inflation is high and rising, at least as measured by the local Consumer Price Index. Many revolution were triggered by the price of bread (remember Marie Antoinette and her thoughts on Brioches for the people?). We in the West are worried that the rising food prices might cause our CPI to rise beyond our Central Bankers' tolerance and that rates will rise and etc., etc. We are less concerned than the headlines here- In the West, food accounts for a relatively small weight in the CPI basket whilst in places like Egypt and India it accounts for 80%. As such, a 10% rise in food costs give India 8% increase in CPI and for us, maybe 0.8%, the latter largely offset by the decline in wages…[1]

Then, we all "know" that governments manipulate the CPI for their political ends. Well, maybe less than we thought we "know". The Economist magazine analyzed this, using their very own "Big Mac Index" which compares the cost of the burger in various countries, establishing a cost-of-living comparative table. Using their data, they tested the change in prices of said burger over a ten year period in many countries. This gave an indication as to the 10 year inflation rate in these countries. Amazingly, in most countries the official CPI change over the period closely reflected the Big Mac inflation! Notable exceptions do emerge though, implying that Venezuela understates its CPI rise by 10% or so… But broadly speaking, we can have faith in the data.

So yes, there is inflation in many emerging economies and much of it arises from food cost rises. Locally, they raise interest rates which likely will not make corn or wheat cheaper. Our central bankers see less effect from the same phenomena and we trust that they will not be fooled into raising rates. We believe that the small rises in longer term interest rates that are occurring are fully explainable by credit concerns, not inflation fears.
The equity markets are watching Egypt with one eye whilst focusing on corporate earnings and economic data. We sense a strong positive bias to the markets. The proof is in the pudding, as the Egypt events hardly dented the upturn. Unemployment is the elephant in the room! Just imagine what will happen to US consumption if employment were to rise by 5%... An upside reserve?

[1] This data and calculations are rough estimates and meant for demonstration purposes only.

Currencies

- The Euro strengthened in the first part of the week, rising from 1.36 to a high for the week of 1.386 versus the Dollar, only to fall back down close to levels where it started the week as market participants pared bets for interest-rate increases in Europe after the region's central bank President Jean-Claude Trichet said inflation risks are "broadly balanced." The Euro was also under pressure as Germany and France are at odds over what strategies to take to strengthen the safety net for debt-strapped countries.
- The Dollar continued to weaken versus most major counterparts in the beginning of the week, but then reversed course following strong manufacturing data release and is holding on to its recent gains before this afternoon's US payrolls report that economists expect will show employers added the most jobs in three months in January.
- The British Pound gained this week versus most of its counterparts this week, on inflationary concerns and as various recent economic data release suggest that UK's unexpected 0.5% contraction in Q4 may have been a temporary setback. Strong housing data further added to that view, and the British Pound rose from .8660 in the beginning of the week to .8440 currently versus the Euro and from 1.586 to 1.615 currently versus the US Dollar.
- The best performer this week however was the Australian Dollar, which surged after the Reserve Bank of Australia increased its growth and inflation forecasts. The Aussie Dollar almost reached 1.02 versus the Greenback and went from 1.38 to 1.34 versus the Euro.
- The Japanese Yen remained strong this week, rising against the US Dollar, Euro and Swiss Franc but declining versus the British Pound. The Swiss Franc also remained firm versus the Euro and US Dollar.
- Fundamentally, the CHF should weaken in the following weeks, but clearly, it will depend on the resolution of the ongoing EU story and the evolving political turmoil in Egypt.

Fixed Income

- Government bonds are headed for a weekly decline as investor sentiment continues to improve and as economic data, especially in the US, remains strong.
- US 10 year Treasury yields rose by 22bps to 3.54% this week, the highest levels since May 2010, as investors sought higher returns in stocks and corporate bonds as the US recovery gains traction. The yield on 2 year bonds rose by 17 bps to 0.71%.
- Long term French and German government bonds moved in line with their US counterparts, but yields were flat for shorter term securities. UK short term government bonds however jumped this week on higher inflation expectations, with the yield on 2year gilts jumping by 18bps to 1.43%.
- The Euro zone sovereign debt crisis eased further this week, especially in Spanish and Italian debt, after Spain's economy grew faster than forecast.
- Credit markets were robust overall, with high yield bonds outperforming higher quality credits, on signs of an improving global economy and easing of the European sovereign debt crisis.
- We remain keen on higher yielding bonds, and remain away from government and emerging markets sovereign bonds as we think that the absolute levels of returns are too low.

Equities

- Most developed equity markets are up this week, with the MSCI World and the S&P 500 gaining over 1.6%, supported by strong manufacturing data from the US and Europe.
- European stock markets were also up this week with the Euro Stoxx 50 gaining 1.4%, sustained by the easing in its sovereign debt crisis.
- Gains in Europe were once again led by some “crisis” countries (Greece, Ireland and Italy were up 5.1%, 3% and 1.8% respectively for the week), on the back of January’s successful debt auctions and better outlook in general.
- The Nikkei 225 was up about 1.9% this week after a planned merger of two steel firms lifted hopes for restructuring in corporate Japan as well as better-than-expected results or annual guidance on some majors (Sony, Hitachi and Softbank).
- Energy and Materials led the gains this week while Industrials and defensive sectors such as Health Care and Consumer Staples/Discretionary fared less well.
- Financials and Technology were also positive this week after having been the top-performing sectors last month.
- Our view on equities remain constructive in general for the year given improving economic growth, attractive valuations and strong corporate health combined with the relative unattractiveness of fixed income securities.
- However, we do anticipate a tactical pullback soon given the significant run-up in asset prices and sovereign risks that remain.
- Materials and financials led the gainers, while utilities and consumer staples lagged.

Emerging Markets

- Emerging Markets’ equities slightly underperformed their developed counterparts this week, mainly due to the evolving situation regarding Egypt.
- The MSCI EM index was about 1.25% as of yesterday’s close versus roughly 1.7% for the MSCI World.
- Concerns over accelerating inflation in India seem to have mitigated as the BSE Sensex was up close to 0.7% this week, after having been the largest detractor to the MSCI EM during January, down -10.3%.
- The Shanghai Composite was up about 0.3% this week while the FTSE JSE Africa gained over 6%.
- We expect Asia EM to underperform other regions over the upcoming weeks as heightening concern that Asian central banks will curb growth with higher borrowing costs will keep indices under downward pressures.
- Latin America in general fared much better than Asia, gaining 2.5% this week.
- The Russian RTS was up again this week (2.1%) after having been the best performer among Emerging Markets last month.
- Separately, the Chinese Renminbi stood still versus the US Dollar at 6.5850 after China’s central bank set the reference rate at a new high two weeks ago.

Commodities

- Commodities rose overall this week, led by gains in oil and gold.
- Gold gained some ground this week standing currently at $1349 an ounce, after having declined during January for the first month since July, dropping 6.2%.
- Bullion fluctuated between gains and losses over January as investors weighed escalating tensions in Egypt against signs of improving economic growth.
- Gold may advance as this year's drop boosts physical purchases and political tensions in the Middle East spur demand.
- Oil rose as tensions and antigovernment protests in Egypt prompted concern that protests may spread to crude-producing parts of the Middle East and disrupt supplies, extending Crude's biggest gain in 16 months.
- Futures climbed to a high at 92.2 on Monday after tens of thousands of protesters defied a curfew in Cairo, demonstrating against Egyptian President Hosni Mubarak for another day.
- Also, continuing protests in Egypt increased concern among investors that shipments through the Suez Canal will be disrupted.
- In a lesser extent, economic data bolstered optimism fuel demand will increase in the US, the world's biggest crude-consuming nation.
- Within this positive environment for commodities prices, agriculturals also gained as concerns over tight global food supplies remain.
- Grains rallied this week on speculation that demand will climb in the Middle East and North Africa after soaring food costs helped spark riots and protests.
- Corn and soybeans jumped this week on optimism demand from China, the largest buyer of the commodities, will continue to expand while wheat also increased.
- China's corn imports may reach a record 9 million metric tons in 2011 after the government sold stockpiles to slow inflation.
- While we expect some correction on the mid-term, we believe that the current environment will continue to be supportive for commodities as supply and demand fundamentals should push prices higher in general.