# Bedrock Newsletter

## Friday, February 11th 2011

We are watching the events as they unfold in Egypt, wondering who will be sitting on top of this Egyptian Pyramid...As of this morning, things do not look pretty as the Egyptian Population has been enraged by last night's speech from Mubarak. They expected nothing less than a resignation and it is not what they got. We wonder if things will not get out of hand today. We also saw yesterday that "risk on" was back when rumours about Mubarak's resignation first surfaced with equity markets rallying, along with commodity prices and a lower USD. As it became clear that Mubarak was staying and that uncertainty would prevail, equity markets went south again and the USD strengthened. We are not sure we agree with this type of "rationale", but this is what happened.
In terms of Economic news, we got a very good piece of news coming from America with the weekly jobless claims dropping 400'000 at 383'000, the lowest level since July 2008. This bodes well for the confirmation of a continuation of Job creation along growth which is gaining pace. Of course, yields of US treasuries rose, as one would expect, and the USD strengthened. Equity markets were holding their ground in the US but were wobbly in the Emerging Markets as outflows continued out of Emerging Market equity Funds. This rotation (out of the EM and into the Developed Markets, particularly the US) is the result, in our view, of 2 things. One, the Egyptian situation is driving a fear of contagion, pushing people to cash in some gains before they disappear, and second, the confirmation of stronger growth in the US and Germany.
As we have often repeated during the last few weeks, we are projecting better growth in the US, a continued good environment in the EM world, and continued pressure for higher commodity prices in general. However, we also repeated that big risks remain for 2011, primarily debt concerns in Europe, in America and in Japan, as well as big geopolitical risks.

On the subject of debt, we would like to reproduce here a speech last Tuesday made by Richard Fisher, the President of the Dallas Regional Fed. His speech was on the subject of debt and of fiscal consolidation. Sometimes, it is worth repeating things that are so evident. Here is the excerpt:

"But here is the essential fact I want to emphasize and have you think about today: The Fed could not monetize the debt if the debt were not being created by Congress in the first place.
The Fed does not create government debt; Congress does. Deficits and the unfunded liabilities of Medicare and Social Security are not created by the Federal Reserve; they are the legacy of Congress. The Fed does not earmark taxpayer money for pet projects in local communities that taxpayers themselves would never countenance; only the Congress does that. The Congress and administration play the dominant role in creating the regulatory environment that incentivizes or discourages job creation.
It seems to me that those lawmakers who advocate "Ending the Fed" might better turn their considerable talents toward ending the fiscal debacle that has for too long run amuck within their own house.
A look within the United States makes clear the overriding influence of fiscal and regulatory policy. Monetary policy is uniform across the 50 states; the base rate of interest paid on a business or consumer loan or a mortgage in Michigan, California, Ohio or New York is the same as that paid in Texas. Yet there is a reason that Michigan and California each lost more than 600,000 jobs over the past decade while Texas added more than 700,000 over the same period.

There is a reason that the population of Ohio grew by only 183,000 residents over the past 10 years, while Texas grows by that number every five and a half months. There is a reason that with each passing census, the state of New York has been losing congressional seats and Texas has been adding them; a reason that, in the recent census, California failed to gain any while Texas gained four. There is a reason that, as documented in the Jan. 12 issue of the Wall Street Journal, college graduates—the best and brightest of the successor generation—are leaving New York and Cleveland and Detroit and moving to Austin, Texas. There is a reason no state in the union houses more Fortune 500 headquarters than Texas. There is a reason for the disparate employment growth that has taken place in the 12 Federal Reserve districts over the past two decades, data that are documented in the graph at your place setting.

That reason has nothing to do with monetary policy. It has everything to do with the taxation and fiscal and regulatory policies of the states. The cost of capital does not explain the different economic performances of the states; the cost of doing business has everything to do with those differences. However well-meaning tax and regulatory initiatives in the laggard states may have been when they were conceived and levied, they have had unintended consequences that have led to economic underperformance and job destruction.

Similarly, the key to correcting the underperformance of the American economy and American job creation does not presently rest with the Federal Reserve. It is in the hands of those who make fiscal and regulatory policy...

...We shall see if the new Congress will prove worthy of the power the American people have “loaned” them, and, together with the president, actually draw the spirits of fiscal reform and sanity from the “vastly deep” to at long last implement meaningful fiscal and regulatory policy that incentivizes private-sector job creation here at home while arresting the haemorrhaging of our Treasury. If they do, then more Americans will find work and be better off, better paid and freer to make their own decisions about the economy.

If they don’t, then woe to our children, their children and the American Dream.”

Insightful, isn’t it? Enjoy your (bright) week end.

## Currencies

- The Dollar rose against all other major currencies as turmoil in Egypt worsens and economic numbers coming out of the US continue to surprise in a good way. We believe this trend is set to continue.
- The Euro declined this week from a high of 1.3735 on Wednesday to 1.3525 currently, after the Euro Zone witnessed the re-emergence of debt concerns. The Euro was also under pressure from speculation that Axel Weber's exit from the race to succeed Jean-Claude Trichet as head of the European Central Bank will delay an interest-rate increase. We believe that the Euro will slide further in the weeks ahead.
- The British Pound declined this week versus the Greenback this week from a high of 1.6185 to 1.5975 currently on concern that this year's gains were overdone after the Bank of England held interest rates steady yesterday, dimming speculation about increases later this year.
- After having surged last week following increase in growth and inflation forecasts, the Australian Dollar weakened and slid below parity with the Greenback (.9970) as Reserve Bank Governor Glenn Stevens said policy makers judged it was "sensible" to keep interest rates on hold.
- The Japanese Yen has been depreciating this week against most of its currency rivals due to a variety of forces. Among these influences is a recent move into riskier assets, as well as an unwinding of JPY long positions. The yen fell to a 1-month low against the US dollar, reaching 83.65 in today's session. We continue to foresee a further weakening of the JPY in the weeks and months ahead.
- The Swiss Franc weakened this week versus the Dollar from .9555 to .9750 and dropped significantly versus the Euro, from 1.2975 to 1.3175 currently as inflation unexpectedly weakened in January. We see the Swiss Franc continuing to depreciate barring a major geopolitical event and /or a renewed acute crisis in the EU.

---

## Fixed Income

- US government bonds are roughly flat this week, but yields moved sharply over the course of the week. Yields on 10yr US treasuries rose from 3.63% to 3.76% in the middle of the week on continued market optimism but these sharply reversed as inflation concerns in Asia, the re-emergence of the Euro zone sovereign debt crisis and the Egypt situation lowered appetite for risk. Yields on 10yr US treasuries are now at 3.66%.
- European government bonds followed a similar path as US ones.
- Elsewhere in credit markets, the extra yield investors demand to own company bonds worldwide instead of similar-maturity government debt fell 1 basis point to 152 basis points, the lowest since May according to the Bank of America Merrill Lynch Global Broad Market Corporate Index.
- 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 were about flat this week, with the MSCI World down about -0.1% while the S&P 500 was up about 0.2%.
- Within the Euro Stoxx, strong gains made by the DAX (1.5%) and CAC 40 (2%) over the week were offset by losses on some "crisis" countries (Greece, Spain and Ireland were down -1.3%, -1.2% and -2.5% respectively for the week).
- The Nikkei 225 was about flat this week up about 0.15%, amid caution before the release of important Japanese and Chinese economic data next week.
- Consumer Discretionary and Industrials led the gains this week while Energy and Consumer Staples fared less well.
- Financials and Technology were also among the most positive sectors this week after having been the top-performing ones 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 the Middle East situation, inflation concerns and Europe's debt crisis which is far from resolved.

**Emerging Markets**

- Emerging Markets' equities strongly underperformed their developed counterparts this week, mainly due to the evolving negative situation in Egypt and increasing concerns over rising inflation.
- The Egyptian situation worsened this week as Mubarak defied calls for his immediate resignation – this is a significant concern for the region and for the rest of the world.
- The MSCI EM index was down about -3.5% as of yesterday's close versus roughly -0.1% for the MSCI World.
- The MSCI Latin America fared a bit better, losing -1.8% this week while the MSCI Asia lost -4.3%. Most Asian EM countries are experiencing higher inflation and this is a significant concern, especially since they do not seem to be doing much to address this issue.
- 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.
- Surprisingly, the Shanghai Composite was the best performer among Emerging Markets this week and gained 2.5%.
- Separately, the Chinese Yuan weakened versus the US Dollar from 6.5840 to 6.5930 after China's central bank set the reference rate at a new high last month.

**Commodities**

- Commodities rose overall this week, led by strong gains in soft commodities.

- Gold gained some ground this week standing currently at $1362 an ounce, after having declined during January for the first month since July, dropping 6.2%.
- After having hit a high at $92.2 a barrel two weeks ago, oil lost some ground until $86.7 and is now up again, currently standing at $87.6. Oil rose on concern supplies may be disrupted amid further unrest after Egyptian President Hosni Mubarak defied calls for his resignation, agreeing only to delegate some authority to his deputy.
- Within this positive environment for commodities prices, agriculturals also gained as concerns over tight global food supplies remain.
- 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.
- Wheat climbed to the highest level in more than two years this week on concern drought in China may curb output, boosting competition for dwindling global supplies.
- The jump in food costs has spurred some nations including South Korea and Bolivia to warn there may be a food crisis.
- 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.

---

**Disclaimer**

This document is for information purposes only and has been prepared by Bedrock SA, representing the opinions and investment views of Bedrock SA as applied in its investment advisory and management activities. It is a private publication intended for private circulation only. It does not constitute a company survey, a financial research, an offer, a solicitation or a personal recommendation to buy or sell specific products or securities. Bedrock SA disclaims all liability for any losses or damages of any kind relating to such information, which may be changed at any time without notice. The risks inherent in certain investments, particularly derivative products, may not be suitable for all investors. The contents of this publication may have been used for transactions by Bedrock SA prior to their communication. Distribution or dissemination of this document and/or the sale of certain products mention herein are subject to restrictions. Copyright 2009 All rights reserved. Approved for circulation in the UK to non-private customers only by Bedrock Asset Management (UK) Ltd which is authorized and regulated by the Financial Services Authority. This presentation is being made to you solely for your information and must not be copied, reproduced, further distributed to any other person or published, in whole or in part for any purpose.

© 2009 Bedrock S.A. 4, ch. Des Vergers, 1208 Geneva, Switzerland, T: +41 (0)22 592 5455 F: +41 (0)22 592 5459, www.bedrockgroup.ch