# Bedrock Newsletter

## Friday, February 18th 2011

It's been only a week but the fall of Egyptian's President Mubarak already seems a very long while away... As much as the situation has calmed down in Egypt and things look (temporarily?) to have calmed down, the situation has worsened in many other Arab Countries such as Libya, Yemen, and Bahrain. It seems that the Arab revolution is set to continue in a number of countries. The question is how are the governments in those countries going to respond to such mass rallies. We can already see that it is not going to be as peaceful as in Egypt...let's not forget here Iran where we have also witnessed some rallies this week that were met with a harsh response from the authorities.

Amid all these Middle East tensions, we find it quite astonishing that the equity markets continue to power ahead and where new highs since the summer of 2008 have occurred in the US indices. Although we keep our optimistic world economic scenario, we believe a correction could just be around the corner as markets have been really overextended as of late. Big issues in the US, Europe and Japan remain unresolved and inflation pressures in Emerging Countries also remain an unresolved issue.

Inflation was in the forefront of investors' concerns as higher CPI numbers rippled from Emerging Markets to advanced economies. This week saw higher inflation numbers in both the US and Europe following a pickup in Chinese prices.
But wasn't that what Bernanke sought with his QE program? We may have let the inflation ugly head reappear and we will be in no way able, at least in the Developed world, to raise interest rates to counter it. This should lead to an interesting set of reactions in the future....

Elsewhere, the Chinese Yuan appreciated to a new high this week, to stand at 6.5750 to the US$, a move that is welcome and that is set to continue. Commodities continued to power ahead, credit spread continued to tighten and the US$ weakened moderately.
All in all, a rather calm week.... let's hope it lasts!

Enjoy your week end (and your mountain break for some of you).

## Currencies

- The Dollar weakened this week against all other major currencies as "risk on" trades were put in again following the fall of Mubarak last Friday. The fall of the US$ was not even hampered by the excellent economic numbers that came out of the US this week.
- The Euro fell to a low of 1.3450 to the US$ on Wednesday before rebounding to 1.3600. We believe that EUR should not go much higher as Ireland and Portugal will come back soon in the headlines.
- The British Pound seesawed this week after a report from the Bank of England said that market participants were forecasting interest rate increases too rapidly. The Pound slid to below $1.60 but then rebounded to 1.6200. The Pound also seems expensive at these levels and should come down from here.
- Commodity Currencies such as AUD, Cad and NOK all rose strongly this week along higher commodity prices and good economic numbers in the US. Both the AUD and the CAD stand at multi month highs against the USD.
- The Japanese Yen continued to weaken this week hitting a low of 83.90 to the US$ before rebounding slightly. We remain of the view that the JPY should weaken quite significantly in the weeks and months ahead.
- The Swiss Franc strengthened again this week following reports that Iran was about to send 2 Warships through the Suez Canal. These news prompted comments from the Israeli minister of Foreign affairs to issue a stern warning which reminded everyone that the Middle East situation remains a highly volatile place and that tensions could flare up at any moment. The Swiss franc strengthened from USD 0.9775 to 0.9480 and from EUR 1.32 to 1.29 EUR.
- However, we remain of the view that the Swiss Franc should weaken from these much extended levels, but of course barring any major geopolitical event and/or renewed Debt issues within the EU.

## Fixed Income

- Government bonds gained this week, as many investors bought safe assets following reports that Iran is sending two warships through the Suez Canal and after initial claims for unemployment insurance in the US increased in the latest week, a sign that improvement in the US labour market will take time.
- The Yield on US 10 Year Treasuries declined this week from 3.63% at the beginning of the week to a low of 3.55%. It has since come back a little to 3.58% currently. European government bonds followed a similar path this week.
- Credit markets continued to be robust, with the Bar Cap Global Corporate index rising close to 1% this week, outperforming the High Yield index which is up around 0.5% for the week. However, the High Yield index is up 3.4% for the year while the investment grade index is flat.

- Despite lower performance for the week of junk bonds versus higher quality securities, the rally in junk bonds notched a new milestone this week with the average junk bond yield has fallen to 6.837%, according to Merrill Lynch's high yield index, slipping under the previous low of 6.863% in December 2004. However, spreads remain higher than historical average, indicating that there is still some room for tightening.
- 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.

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**Equities**

- Global stocks rose this week as improving corporate earnings and manufacturing data overshadowed inflationary concerns and the tensions in the Middle East.
- This week's gains brought various stock indices to a 32 month high, with the S&P 500 index reaching 1'340 and the Dow Jones Industrial Average index to 12'318, levels last seen in June 2008.
- Gains this week in European stock indices were more muted than in the US, with the Euro Stoxx 50 up 0.9% versus 1.4% for the S&P 500. European indices were slightly penalized as Sovereign-debt concerns re-emerged after a senior euro-zone official said late Thursday that Portugal is under pressure from fellow euro-zone members to follow in the footsteps of Greece and Ireland and seek a bailout from the European Union and the International Monetary Fund.
- Japan outperformed, with the Nikkei 225 up 2.2% benefiting from the improved global economic outlook, especially on better manufacturing data.
- This week saw the financial and energy sectors outperform. Financials benefited from improving economic data while energy related companies benefited from continued high prices in energy. Defensive sectors, such as telecoms and utilities, lagged this week.
- 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.

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**Emerging Markets**

- Emerging Markets' equities outperformed developed markets this week, with the MSCI EM up over 2% versus 1.7% for the developed index. However for the year these are far behind developed equities, with the MSCI EM down -4% versus the MSCI World index which is up 3.3% for the period.
- EM equities benefited this week from better economic data, especially on the manufacturing side and as slowing food inflation in India tempered inflationary concerns.
- India's Sensex index has rallied 6 percent from a seven- month low on Feb. 10 as concern eased that the central bank will stifle growth with interest-rate increases. Chinese stocks have also recovered well, with the Shanghai SE Composite up 2.5% this week.
- Brazilian equities also performed well, with the Bovespa up 4.8% this week. However, Brazilian stocks are down -3.2% for the year to date.

- Middle Eastern stocks however remained under pressure this week from the tension in the region, and should remain under pressure for some time until there is any sort of resolution.
- With the better sentiment on global growth and lower inflationary concerns, Asian currencies appreciated this week, bucking the trend from the previous two weeks.

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**Commodities**

- Commodities rose again his week, led by strong gains in soft commodities and in Precious Metals.
- Gold regained some ground, standing currently at $1388 an ounce, on the back of reports of Iranian warships due to transit through the Suez Canal.
- Silver prices exploded to the upside, to stand within a hair of $32 an ounce. This is a price increase of 17% in just 2 weeks!!
- Oil prices remained range bound, as tensions eased following the fall of Mubarak but then rose again with the Iran issue. Strong US economic numbers also served to put a floor under oil prices. Oil WTI currently stand at $86 a barrel.
- In agriculture, corn hit a high not seen since July 2008. These food price increases are especially worrisome in the Emerging Markets where food is between 60 to 70% of a consumer's monthly budget. Corn has more than doubled since June 2010!!
- We certainly expect a correction in the commodity sector soon, but we believe that the current environment will continue to be supportive for commodities as supply and demand fundamentals continue to be in focus.

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