Friday, December 19th 2008

Bedrock Offices will be closed on Friday 26th and Friday 2nd making this our last newsletter for 2008.

This has been absolutely the worst year in financial history. There is little about 2008 we could say which you, our reader, is not already well aware of. As such, we will spare you “The Wake of ’08” speech and try and glimpse into the future!

We are in a global recession. As bad as it may feel at the moment, recessions tend to eventually end. This one will do the same, however different from past recessions it may be proclaimed to be. The most obvious difference this time is in the concerted and reasonably coordinated global effort to manage the issue.
In an unprecedented set of moves we find interest rates globally at zero or thereabout, we hear of huge monies being shoved into the system country after country. Scary, but likely to work and stall the fall from becoming a true systemic collapse. Sure, we expect the economic data to keep coming in as bad and worsening for the next few months or even quarters. We expect the world to emerge from the decline having lost several percentage points of GDP growth, possibly seeing as bad as 5% declines in the USA and possibly Europe. Then we will all climb back, albeit rather slowly.
This process will be painful as more people will be losing their employment. Many others will be shocked by year-end financial statements from their financial advisers and the catastrophic results of their pension plans, 401K’s and IRA’s. We can expect to be surrounded by long faces and gloomy moods for the next few months, maybe a little longer. But then, the Sun always comes out after the darkest hours… And yes, we do expect the global economies to find their footings sometime toward the end of Q2 ‘2009

The equity markets tend to predict the economics of the so-called real economy about six months ahead. So we may expect the markets to have found their bottom in the near term and to restart a long-term recovery from here. This view can be supported by the level of interest rates which both raise the present value of future corporate earnings whilst also increasing said expected earnings as debt carry-cost is reduced.
What about interest rates? Well, Central Banks have just about completed their cuts, ECB excepted. The developed world will be in a zero rate environment for some times to come, and the yield curves of government bonds will probably flatten further, i.e., expect somewhat lower long dated yields. This will be achieved with the help of Central Banks buying their own governments’ outstanding securities lowering market rates and providing cash to the system.
Eventually the lack of return on these securities will divert investors monies towards the corporate financings and the system will restart.

Commodities? Well, we expect these to track the “real economy” and therefore find their new base within the next several months. This is a broad paintbrush view, encompassing copper to grains through oil and pork bellies.
Currencies? There is a long standing misnomer in the marketplace which tends to expect a currency to track the relative strength of its issuing economy. Well, it doesn’t really work: As the American economy weakens, its trade deficit shrinks, the Dollar can rise. At the bottom of the Japanese recession its currency hit its all time high… So now what? Well, with historic relative carry-costs becoming irrelevant, one can only consider the effects of inflationary effects in the various currency blocks. We would venture herewith that the greatest debasing is occurring in the USA, so our best guess would be for a resumption of the gradual decline of the US$. Which will do best? Hard to say viewed through today’s volatility screens. We would have a preference to the higher yielding emerging currencies as little can beat a “positive carry” in the long run. *We like the idea of a basket of emerging currencies held against US$ for one year- Earn Emerging rates, pay the low US$ carry and be long the currencies most damaged this year against one that gained. If we are right, capital will be flowing back to these countries strengthening them whilst their interest rates will be cut towards the G7 levels.*

Our biggest fears for 2009? A popping of the Treasury Bonds’ bubble and the risk of a severe realignment of currencies (Dollar down).

Wishing you a Merry Christmas and a Happy and lucrative New Year,

The Bedrock Team

Currencies

- The US$ plunged against most currencies following the Fed's dramatic new near-zero interest rate policy. The Dollar suffered its biggest one day loss against the Euro ever and hit a 13 year low versus the Japanese Yen in yet another extremely volatile week, only to recover some of its losses in Friday's trading.
- The British Pound took a further beating, creeping closer and closer to parity with the Euro! The Pound was dragged lower by speculation of further easing from the BOE and by signs of even further deterioration in the British labour market.
- The Swiss Franc rose sharply this week and the Japanese Yen continued to be extremely strong.
- The currency markets were extremely volatile, with prices moving in dramatic intraday swings!

Fixed Income

- Following the Fed's move on Wednesday, government bond yields in the US and in Europe dropped to multi-decade and historic lows! Yields on long term 10 year and 30 year US government bonds fell by close to 50 bps in a week!
- With this dramatic move, the Fed has officially indicated that it will do anything to get the US economy back on track.
- Yields on 10 year US treasuries are now hovering around 2%. The yield on shorter term US treasuries were actually negative this week!
- Even with the Fed's moves and its "unorthodox" tool box, credit markets remain under pressure, as the economy quickly deteriorates. The debacle over the auto industry continues to weigh on these markets. With the Standards & Poor's rating agency announcing that GE's pristine credit rating may be at risk, credit markets remained strained…
- Interest rates across the world, short term and long term are going down to historic lows as central banks around the world try to restart business activity and confidence.

Equities

- Equity markets are largely flat week over week, with European and Japanese markets slightly up and US markets slightly down.
- Equity markets were buoyant in the beginning of the week, but optimism over government actions was sharply offset by the deteriorating state of the global economy and disappointing results from many companies.
- The financial sector was under pressure this week as both Morgan Stanley and Goldman Sachs reported sharp losses for Q3, and things do not look better for Q4… The energy sector was the other laggard, as energy-equities are being dumped with the fall in oil prices. Industrial stocks were also under pressure on concerns over the state of auto companies and on the back of a gloomy outlook from GE.
- Nevertheless, volatility as measured by the VIX index continues to fall.
- While few expect an improvement in the state of the economy in early 2009, investors are sitting on possibly the largest pile of cash since our last recession...

Emerging Markets

- Yields on EM government bonds fell sharply this week. The yield on 10 year Brazilian government fell by nearly 100 bps!!!
- Following big moves last week, EM currencies were largely unchanged for the week although intraday moves were volatile.
- EM equities gained slightly on the week, as some investors re-enter these “risky” markets following their massive YTD declines.

Commodities

- Crude oil price continued to tumble and is now trading below $35 a barrel. Careful though- One month longer dated oil is almost 15% higher… Since its summer high, crude oil has slid by close to 75%!!!!! This decline continued even after OPEC announced a record cut in production.
- Gold bounced above $880 an ounce following the Fed’s rate cut, but came back down to around $835, slightly higher than a week ago. Gold remains a safe haven investment…
- Agricultural commodities picked up this week, with wheat appreciating by 10%.