Bedrock Newsletter

Friday, March 16th 2012

It is Friday again. The weather (at least here) is wonderful, sunshine every day, temperatures rising and our screens have locked-on to green. The S&P 500 index trading over 1'400 for the first time since June 8th 2008, the DJIA solidly over 13'000 and the NASDAQ comfortably over 3'000 – we are back to pre-crisis levels! After four years of fears and pains, we find ourselves back where we were. Well, not truly unchanged as these years have been taxing and we all have more grey to show…

On Tuesday the VIX (volatility index) traded below 14, the first time since early 2007. Clearly, the fear of risk has abated dramatically. This week the Fed released the results of its latest "stress-test" on major banks. The test was draconian, assuming unemployment at 13%, equities falling by 50% and other "nasties". Most passed (Citi failed and said that they misunderstood the questions….) and simultaneously JPM announced a 20% increase in dividend augmented by a $15Bn stock buy-back, authorized by the Fed! All the major bank stocks soared by 5% or so… Many participants revisited their equity-market textbooks and rediscovered an old truth- Financials lead the market out of slumps; heavy trading ensued with indices showing continued strength.

This intellectual-driven response found support in economic data- US jobless claims at a 4 year low, unemployment steady at 8.3% whilst new job creation appears to be rising (as are Obama's reelection odds), the Federal Reserve is holding its rates and we didn't even flinch when we realized that there is no new QE in the wings- we don't need it… Some hints of inflation are creeping into the system. We don't really care, as the economy could benefit from some inflation which erodes debts and raises values of real assets (condos and other brick & mortar stuff).

Gold traders didn't like this at all! Some inflation and they forgot their mantra of "Gold is an inflation hedge" and sold heavily. Rightly so, as historically, gold was acquired as a hedge and when inflation arrived, interest rates rose and gold collapsed. Every time. Some older investors remembered this and recalled that in reality, the asset class which best protected against inflation effects were equities… These movements were less arbitrary than we have come to expect these past few years: As gold fell, copper and other industrial commodities actually rose. Perhaps we are seeing return to normal correlation? Equity markets rising imply economic growth to come, higher demand for copper so we buy ahead. Interest-rates may rise soon, so the carry-cost of gold may rise, let's sell…

Oh, Apple traded through $600 this week. The talk we hear has changed- last week the rise above $500 was unsustainable, a one-stock bubble etc. Now we hear that actually, it may go to $1'000 with reason… It is the tone that intrigues here, not AAPL in itself. More and more skeptic investors and analysts are becoming believers in the economic turnaround, optimism overcoming concerns and fears! Iran came off the first page, Syria has been forgotten as well as Greece, oil is expensive but Obama may release some strategic reserves, so no worries…

All the above was underlined by significant moves in the bond markets. US 10 year Notes traded to 2.30% as the entire curve rose. We are hearing the bond investor herd running to the exits… is this the next bubble to go 'poooof'? We lightened-up ahead of the crowd. Whilst we don't expect a crash in Treasury bond prices we sense that some damage may occur and it might spill to other fixed-income sub-sectors. And then China showed a $4.2 billion trade deficit!!! The Yuan faltered a little, Japan announced a $10Bn purchase of Chinese bonds. Are we seeing a rebalancing of global flows? This is good news and we retain our long Yuan vs. US$ as we think there is a distance still to go here.

Let us all join hands and welcome the return of boring, predictable markets! Have a nice St. Patrick's day (it is Green!) and a fine, sunny weekend!

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Currencies

- Monday saw EURUSD open at 1.31, we have seen it move in a 50 point range either side only venturing South briefly to 1.30 on Thursday morning as the USD rallied across the board. Some stability and a chance to breathe, the quiet before the storm?
- The CHF weakened again against the USD, while it maintained its floor level against the EUR with a short two day move above the 1.21 figure only to settle back at 1.2075. With the USDCHF mirroring the CHF weakening and the EURUSD slow descent to finish higher at 0.9275.
- The JPY weakened again this week, starting around 82.50 to reach 84.00 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. The strength of the USD in all broad based currency pairs has helped to weaken the JPY.
- Meanwhile, GBPUSD did not really move that far from 1.5680, not breaching 1.56 to the downside, nor 1.5750 to the upside. A quiet week for the majors all round.
- The general USD bid tone meant that the EM currencies did weaken this week, with the BRL losing ground from 1.77 to a low of 1.83 to finish at the mid-point of 1.80. Something the local government will be very glad to see.
- The commodity currencies however are almost unchanged on the week having weakened on Wednesday, only to rally back to close flat on the week.

Fixed Income

- US Treasuries were the place to be (or not to be in this case) as treasury yields jumped across the board, with a broad based rising of the US Treasury curve; can we sense a change in the air? +28 bps for US 30-year yield to 3.45%, +34 bps for the 10-year yield to 2.33%!!! and +4 bps for US 2-year yield to 0.36% (having reached 0.4% on Thursday).
- On the European front, Italian government bond yields held their low levels and Spanish yields bounced a little after the euphoria of the last week. The Italian 10-year yield dropped 2 basis points this week to 4.82%, after losing some of its ground last week when it reached 4.69%, while the Spanish 10-year yield lost some ground before bouncing back by 9 bps to 5.16%. We are at some of the lowest levels of spreads over the German Bund in over a year.
- Greece's successful debt restructuring brought some relief to Italian and Spanish bonds, but poor euro zone growth prospects and fears Portugal may also impose losses on creditors is still likely to limit the fall in yields, with the Portuguese 10 Year Bond remaining at 13.57% this week, well above its Mediterranean European counterparts.
- This week, EM Debt was the best performing sector among global bonds rising by 1.19%, while other strong performing sectors included US High Yield at +0.27%, along with EM and Leveage Loans, both achieving +0.25% or more on the week. Otherwise, the corporates and Government bonds suffered this week with the US dropping over 1% each and in Europe the corporates were more or less flat, but the Government bonds dropped (-0.50%).

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Equities

- Developed equity markets rose this week, with the MSCI World advancing by 1.75% amid strong corporate earnings and better-than-estimated economic reports that bolstered optimism around the world.
- European equities rose strongly over the week, with the EuroStoxx 50 advancing by 3.17% on a better risk picture for the Eurozone after the successful Greek debt restructuring and on strong economic data from the US.
- The S&P 500 rose by 2.69% this week as of yesterday's close managing to breach the 1,400 level, as manufacturing in the New York region expanded in March at the fastest pace since June 2010, indicating factories are still driving the expansion. Also, claims for jobless benefits dropped, matching the lowest level in four years, more evidence the labour market is improving.
- Earlier in the week, the S&P had snapped a five-day rally on Wednesday amid concern that stock gains have outpaced economic prospects as the index capped the best start to a year since 1991, approaching the median 2012 projection of strategists surveyed by Bloomberg.
- Meanwhile, Japanese shares extended gains to an eight-month high with the Nikkei rising by 2.02% over the week, as the yen's drop to an 11-month low against the dollar buoyed earnings prospects for exporters.
- In terms of sectors, Information Technology and Financials stocks led the gains this week, while Energy and Materials lagged. IT, Consumer Discretionary and Financials are the best performers so far this year. Outperformance of these sectors is due to investors keeping a risk-on approach and therefore favouring high beta segments. We however advise caution on these stocks as the incredible run they experienced since the beginning of the year could fade anytime soon.
- We find equity valuations attractive as the corporate world looks quite healthy. However, the macro backdrop remains challenging as global issues are far from over. We therefore tend to favour high dividend-paying defensive stocks to growth names.

Emerging Markets

- Emerging Markets' equities were positive this week, up 0.51% as of yesterday's close - as measured by the MSCI EM Index – underperforming their developed counterparts as China weighed on the weekly performance. However, Emerging Markets still outperform the Developed World by quite a distance on a year-to-date basis (16.27% vs. 11.15%).
- The best performing region was Emerging Europe, up by 2.78% as measured by the corresponding MSCI index, followed by Asia (+0.51%) and Latin America (+0.16%).
- The Shanghai Composite lost 1.42% this week, as China's property stocks extended declines after Premier Wen Jiabao said the country's home prices are far from a reasonable level, denting hopes real estate curbs will be eased.
- Meanwhile, the Brazilian Bovespa rose by 1.57%. The index started the week by posting the World's biggest gain on Tuesday, rising by over 3% on the back of the metals rally that followed better-than-expected German investor confidence and US retail sales. However, the Index dropped since then, as Brazilian policy makers signalled they will not cut borrowing costs as much as traders had wagered. Dimming the outlook for companies selling in the local

market. The Bovespa has advanced close to 20% this year, buoyed by Brazil's interest-rate cuts, signs of growth in the US and renewed optimism Europe may be closer to solving its debt crisis.

- 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 12.1 on average for the MSCI EM compared to 14.8 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 dropped by 0.47% 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.
- Precious Metals took the biggest hit this week down by 2.70%, while Industrial Metals and Agriculture surged by 2.35% and 3.53% respectively on signs of stronger global demand.
- Gold dropped by 3.39%, currently trading around $1'656 an ounce. Gold dropped as much as 4% earlier in the week, as growing investor optimism on the outlook for the US economy boosted the dollar and riskier assets. Meanwhile, Silver dipped by over 5%!
- Crude Oil lost 1.78% this week, currently trading at $105.35 a barrel. Oil slipped on speculation that higher retail prices will lower demand and after a report that President Barack Obama and Prime Minister David Cameron discussed a release of oil from reserves to try and stem increases at the pump.
- We remain constructive on oil given supply/demand dynamics as well as Middle East tensions, and on gold, which should continue to find support on the medium to long term as global central banks provide liquidity to markets.

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