Bedrock Newsletter

Friday, July 27th 2012

This is quite definitively *SUPER MARIO* week! For some time now we have argued that the state-of-the-world is no longer based on economics or finance but rather on politics. In Europe, the latter appear to be in complete disarray making the lack of leadership an insurmountable obstacle to much needed clarity of vision. Yesterday, Mario Draghi (Chairman of the ECB) stepped-up to the task! In one phrase managing to reverse trends of declining stock markets and floundering peripheral-Europe bonds as well as a sinking Euro. In response to his laconic and un-explained statement that the ECB will not permit the collapse of the Union or its currency, the Euro rose sharply to well above $1.23, collapsing Spanish bonds rose to shed over 0.50% in yield, oil rose over $1.00 per barrel and the Dow Jones gained over 200 points by the close!
The power of the word strikes again! The ECB may have firepower much as the Federal Reserve has, leveraging its own balance sheet, but does the ECB have such a mandate? We believe that the markets responded to the emergence of leadership rather than some particular action. Arguably, Mario has had a chat with Ben and they plan to take synchronized actions- we do now expect Ben to at least mention QE3…
Well, if anyone had a doubt as to what are the powers running our destinies… We are living in democracies lead by appointed technocrats… In times of stress, this seems to be a better "technology"…

It was a messy week leading up to Mario's surprising proclamation. We saw Moody's placing Germany (!) on credit watch, US Treasuries rallied further into improbable grounds with the ten year Note yield dropping to an all-time low of 1.39% on Tuesday as the equity indices shed about 1.5%

We are in the midst of reporting season for Q2 earnings. Arguably, these have been generally ahead of (admittedly reduced) expectations. Apple disappointed on both bottom-line and more worryingly on top line as well. This is the second quarter in a row that AAPL misses and we all miss Steve Jobs! The stock fell accordingly.
The persistent theme has been a clear disappointing "top-line" performance across most all industries. The economies are clearly slowing. Yesterday we saw this again with Amazon, Starbucks and Facebook. The latter, issuing its first report since its messy IPO disappointed and the stock fell quite dramatically (10%) in after hours.

Nouriel Roubini, the oracle of doom, issued a paper this week in which he predicts further and deeper gloom ahead. He believes the US economy will slow further this year and into 2013. He worries about the election and of the political stalemate in DC which only accentuates the risks of the so-called "Fiscal Cliff" in January.
It sure seems as though the USA is on a collision-course with time… They really should hurry and resolve to at least delay the date by some distance? Ben Bernanke in a rare departure from his own pastures did venture into this dangerous zone. Will he too, like Mario, take decisive words to shake-up his own bosses?
We have been wondering about the German leadership or apparent lack thereof. Why have they been procrastinating so dramatically? One explanation can be found in the drop of the Euro. The uncertainty about its future reduces its value and that in turn helps the European economies in general and the German in particular, being a major exporter. Are the Germans engineering devaluation here? A weak Euro can help Europe stay together and Germany to rise farther on top of all…

Let's all go off for a warm summer weekend with Super Mario watching over us all!

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Currencies

- EURUSD was having a very normal boring week until Super Mario stepped in with what Bernanke would call a "communication tool" to temper the markets. And with a few simple words, "The EURO is irreversible… and the ECB is ready to do whatever it takes", we saw EUR jump from 1.2110 to over 1.23. We have come off a little from the highs, probably after the stops have been cleaned out, but we feel this is a short term turning point in the market that could see 2-6 weeks of rebound in thin summer markets to the 1.26/1.28 region in EURUSD.
- The talk on the street was clearly European focused this week, Bernanke had already spoken a lot over the past few weeks and the market needed someone else's dulcet tones to trade around… step in the Italian Stallion, Super Mario D of the ECB. For now, however, we remain slightly sceptical as there is really very little definitive information about whether the ESM will be converted into a bank and what debt or ABS will be purchased, however, with a positive note in the air we will not play scrooge (just yet) and wait for the update next Thursday.
- USDCHF again was inversely aligned with EURUSD. KOF, however, came in much stronger this week at 1.42 and the previous month's result was revised up. With the respite in the EURUSD pair, obviously the CHF strengthened against the USD, but not until we had peaked for the year so far at 0.9972, we are currently at 0.98 and will see what happens with Draghi before we feel there is a long term change in the CHF weakness.
- With the PBOC stating on Sunday that the growth in China may "slow" to 7.4% in Q3, Monday saw the risk tone continue in a decidedly negative manner seeing the JPY bid and as a result saw the pair drop to 77.94 by Monday morning, other than this, it was a particularly lacklustre week for the USDJPY pair. Traded about 78.15 for the majority of the week and is currently there now.
- AUD slid for the first half of the week on negative tones in the market, slipping from 1.0350 to 1.0175 by Wednesday morning. However, totally reversing course and post MD's comments we see the AUD trading at 1.0410 at the moment. The Aussie economy simply does not warrant a currency this high, with the commodity prices slipping and the rate forecasts to drop, we do not foresee it remaining this elevated for long…
- GBP traded negatively on the weak sentiment for Monday, slipping from 1.5625 to 1.5470. However, with the risk-on sentiment from the Draghi-Effect we saw it soar to 1.57, where we have then traded sideways. EURGBP started the week at 0.7760 and has subsequently managed to claw back to 0.7840, however, this cannot last as the EUR is structurally weaker than the UK, but if Mario gets his way, perhaps this could change! As we have stated before, there is no real rationale for the British pound to stay as strong versus the Greenback…
- BRL followed the same pattern that is becoming familiar, trade up to 2.05, back to 2.02. The BRL tracks the Risk sentiment quite well at the moment and as long as we have sudden news to trade around, this is how the BRL will react. Although ZAR was almost unchanged on the week we did see it drop like a stone for the first half of the week, moving from 8.27 to 8.55, only for it to rally with the risk-on sentiment to 8.22. We are currently unchanged on the week at 8.2640.

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Fixed Income

- US yields dropped significantly this week across the curve from when we wrote the letter last week, but less of an impact from the start of the week. The 30Yr rallied, seeing a move from 2.54% to 2.44% only to stage a weakening after SM comments to 2.50% as we write, the 10Yr mirrored the picture moving from 1.44% to 1.38% but back to unchanged at 1.44%, however the 2Yr moved to the lows at 0.195% to then trickle back up to 0.23%. We repeat the thoughts from last week: Where can the US rates go from here? We would venture to say this looks likely to be where we remain for a while, with no QE3 or intervention elsewhere (YET!! But as we say, this may change) we don't see the situation changing, especially in the doldrums summer months.
- The French although holding onto the relative European safe haven status have seen the reversal that we mentioned last week, moving from 2.01% back to 2.28% and only dropping back after Mario's words to about 2.18% as we write.
- Germany's 10Yr Bund turned the corner this week, selling of the all-time lows from 1.172% up to 1.31%. The market last week was telling us that negative yields were here to stay, this week the world just got a little less sick and returns back to 0% real yield… watch this space.
- Well Spain should have been the biggest winner this week with the ESM rumours abounding that the world would be saved by Super Mario... as we have mentioned for the last few weeks the straws have been piling on. Wednesday saw the Spanish 10Y peak at 7.62%, unfortunately all Mario did was lift off a few straws and we are currently back where we started the week at a shade under 7%. Let's hope Super Mario has plenty of sticky-back plastic, Blutack and UHU glue, and remembers building straw bridges as a child, because Spain needs all the help it can get at the moment… perhaps Mario even has a little magic glitter to make the proposal look good as well?
- The market in no uncertain terms thought the Italians were in trouble forcing the 10Y yields right out to 6.49% (where Spain was a week and a half ago!). Luckily the ECB Chairman is Italian and nepotism is nothing, if not fair to La Famiglia! However we are only back to the week starting yields of 6.07% and Much like Spain these levels are not sustainable. The major difference is that Italy could reduce its deficit if it actually had any tax receipts!!! Perhaps now is the time to start collecting some taxes to reduce their deficit!
- The outperformers of the week were US corporates and US treasuries in at 0.42% a piece. All other sectors were weak and dropped with the worst performer being EU HY at -0.83%, however YTD it still outstrips the pack with +12.6%

Equities

- Developed equity markets slid this week until Wednesday on ongoing worries about the Euro zone, before bouncing back on Thursday after ECB's Mario Draghi vowed to save the Euro as surging yields in Spain and Italy threaten the existence of the 17-nation currency bloc. As a result the MSCI World only dropped by 0.29%.
- The EuroStoxx 50 started on a negative tone this week, on deepening worries about Euro zone's debt crisis as countries such as Spain and Italy struggle to fund themselves and evidence grows of a region-wide economic slowdown. However, as the ECB reaffirmed its determination to consider new measures to tackle these issues, European stock strongly rebounded and the benchmark ended the week slightly positive (+0.58%).

- The S&P 500 slightly declined this week (-0.19%), as of yesterday's close. The index fell until Wednesday for a fourth straight day as disappointing results at Apple and an unexpected decline in new home sales overshadowed a rally in banks and industrial shares. Then, US stocks bounced back on Thursday after remarks by Europe's central bank chief about protecting the Euro zone from collapse helped reassure a market already expecting the Fed to step up stimulus efforts. Moreover, better than expected jobless claims figures supported the uptrend.
- Meanwhile, Japan's Nikkei wrestled back almost 1% on Thursday and 1.5% as of today, lifting off a seven-week low as investors picked up stocks on better-than-expected earnings, but this rebound is seen as limited because of concerns over global demand. The Nikkei lost 1.19% over the week.
- In terms of sectors, Materials and Information Technology were the worst performers this week (-1.30% and -1.25% respectively) while Consumer Staples and Telecoms fared much better (+0.43% and +0.74% respectively). Materials are still the most negative sector year-to-date (-5.31%) while Healthcare is leading the way (+7.83%).
- We remain constructive on equities on a medium/long-term timeframe, as we expect further quantitative easing from policy makers to support growth. In addition, equity valuations are cheap (average P/E of 13.75 on the S&P) and companies continue to report strong earnings, with large cash reserves at their disposal.

Emerging Markets

- Emerging Markets lost 2.18% for the week as measured by the MSCI EM. The best performing region was Latin America followed by EM Europe (-0.76% and -1.16% respectively), while Asia lost over 3%.
- The Shanghai Composite declined for the week (-1.92%). Chinese stocks extended their losing streak into Thursday as Europe's prolonged financial woes and the anaemic domestic economy continued to press on investors.
- The Brazilian Bovespa dropped 2.26% this week, as of yesterday's close. The index dropped three days in a row as weak housing data in the US and lingering concern over Europe's debt troubles weighed on the outlook for global growth.
- We are bullish on EM equities in the medium/long term as valuations are very attractive (P/E of 10.86 on the MSCI EM and 8.74 on the MSCI BRIC index). However, in the short term these are the most vulnerable to growth slowdown signs.

Commodities

- After last week's rally, Commodities dropped by 2.95% over the week as of yesterday's close, as measured by the S&P GSCI broad commodity index. The benchmark was pulled down by Industrial Metals and Agriculture which dropped by 3.41% and 4.24% respectively, while Precious Metals rose by 2.02%.
- Agricultural commodities sharply fell this week after five straight weeks of rally. However, drought in the US is expected to drive up food prices again. If these record high crop prices are sustained, inflationary worries are likely to arise. Current drought conditions in the Midwest are the worst since the 1980s.

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- Gold started the week on a negative note on Monday before rising three days in a row pushing prices to three-week highs above $1’620 an ounce on Thursday after ECB’s Mario Draghi said the central bank was ready to do whatever it takes to preserve the euro, boosting the single currency versus the dollar. Gold is currently trading around $1’621 an ounce.
- Crude Oil dropped by about 3.60% on Monday as sentiment took a hit after the Energy Information Administration reported an unexpected build in US petroleum stockpiles. However, Oil rebounded the three following days as the euro rallied to a two-week high against the dollar on Draghi's comments, encouraging investors to buy dollar-denominated commodities, erasing some of the losses incurred earlier in the week.
- We remain constructive on gold and oil in the medium/long term as we believe global growth will pick up during the H2 of the year due to the likelihood of China further adding stimulus and other CB’s continued easy monetary policy, as was evident with Draghi’s comments.

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