Bedrock Newsletter

Friday, October 19th 2012

We are closing yet another week. In the greater scheme of things, a relatively insignificant week, full of insignificant events. We started the week with American CPI rising 0.1% after 0.6% in August. QE3 and the previous ones clearly non-inflationary, or, as we see it and applaud it, a great medicine against the risk of deflation!

We also received data showing that China's decline is only in the second derivative of its growth formula- the rate of change in growth has slowed, but by less than markets had been anticipating, running at 7.4% which is its slowest rate since 2009. But it is a huge number in actual dollar figures! Well, the Yuan (CNY) has resumed its ascent vs. the US$, logging daily record highs, now at 6.25 Are they fending off both Obama's and Romney's campaigning rhetoric? Or is it true demand for the Chinese currency? Whatever the motor here, we stay with our long CNY exposure.

On Monday Citibank published very strong Q3 earnings and then announced the immediate departure of their CEO, Pandit, with little to no explanation. Disagreements in the Board Room? Salary or Strategy? Or as the rumor-mills had it, some new uncovered scandal? Or is it just a continuation of Wall Street's purging of the past? Only Dimon of JP Morgan and Blankfein of Goldman are still at the helm of their banks…

Then on Wednesday we had the wizards of Moody's re-affirming Spain's credit rating at investment grade, sparking rallies in their bonds and equity markets and indirectly helping the Euro trade up through $1.31

The good-feeling was reinforced all week through Wednesday with 67% of Q3 reports coming in ahead of expectations, further fuelling the melt-up in equity markets. Gold declined to $1'725 but then, when valued in Swiss Francs, it has actually tumbled to 1'603 from 1'671 at the end of September. Oil has bounced around all this month, only to trade at its opening price of $92/Bbl of WTI. No new noises from Iran, even Netanyahu held his tongue. We remain concerned here and continue to worry about the skirmishes between Turkey and Syria as these could escalate and ignite a broader Middle Eastern conflict of Sunni vs. Shiite Muslims. We remain long oil as a hedge.

The Ying and Yang of markets came back Thursday- After the good feelings, a rush of earnings' misses from the behemoths of the tech sector- IBM, Intel, Microsoft and then Google- All disappointing from a little to "big-time", on EPS and/or top-line revenues. A sudden cold shower on an otherwise warm and cuddly week… On top of the data itself being disappointing, GOOG had a serious glitch in its delivery- Report was expected after the close but was released by their agent at noon. A 10% fall ignited a 2 hour long trading halt, after which a small rebound did occur… We await the law suits as stop-loss orders were triggered and losses incurred. Perhaps a non-event in itself, but it is yet another straw falling on the backs of already uncomfortable investors- Is the system fair? Is it manipulated? Is it a place for our important retirement funds?

For all of you who have been harboring doubts as to the future of the Euro zone and of the Euro itself, we draw your attention to a small event this week- Panama would like to introduce the euro as legal tender alongside the U.S. dollar, President Ricardo Martinelli told German Chancellor Angela Merkel on Monday during a visit to Europe. Martinelli provided no details about the switch but he expressed "full confidence" in the German and European economies and said he expected the euro zone debt crisis would soon pass.

You worry about equities? Well, a monthly survey by Bank of America/Merrill Lynch showed 24 percent of fund managers are overweight equities — the highest in six months — rising from 15 percent in September. The survey of 200 managers, who oversee a combined $561 billion, was conducted over Oct. 5-11. When asked how further exposure to riskier assets would be funded, the majority of respondents or 37% said they would sell government bonds to do so. Fund managers, however, were much less willing to let go of their corporate bond holdings to buy up higher beta plays, according to the survey.

We heard the second debate between Obama and Romney (a draw it is said) and we remind both as they go into the third round (isn't that the Amateur Boxing number? Pros go 10) that you cannot legislate the poor into prosperity by legislating the wealthy out of prosperity.

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Currencies

- Monday saw positive data out of China, boosting the Risk on momentum. Followed by the EU summit that was set to resolve all EUR issues… next year though. All the positivity in the market drove the EUR higher from a low of 1.29 to a high of 1.3140 on Wednesday. With weaker than expected jobs data (after last week's anomaly) the EUR is down a little but relatively unaffected by the US data. Spain still has not requested a bailout and the Italian's stated that their share of any possible bailout would amount to 1.5% of the Italian GDP; however, Schaueble assures the market that he does not believe that Spain needs a bailout and also that Greece has met its targets and will receive its next funding tranche. Debt to repay debt, as long as the Greeks don't control the money… off the highs at the moment at 1.3050

- EURCHF is back to trading a range – a little wider than the recent months but still a range between 1.2080 and 1.2115. We need the EURUSD pair to break significantly up before the EURCHF pair sees any further movement out of the range to the upside. The USDCHF pair inversely tracked the EUR and moved from 0.9370 to 0.9260, having been as low as 0.9220 on Wednesday.

- Finally the Yen broke out of its trading pattern and saw the Yen weaken against the dollar breaking above 79.00 for the first time since mid-august. From a technical perspective the longer down trend resistance has been breached and the JPY could be starting the depreciation that the BOJ has long been searching for. To be watched carefully how the week ends.

- With the good news out of China on Monday and the general Risk-On sentiment we saw the AUD rallying from 1.0200 through to just above 1.0400; however we are currently off a little at 1.0350. The Aussie may be trading with the Risk-On sentiment for now, but the positioning is still short and when the market turns we believe that the AUD may suffer the most.

- Cable had an interesting week, starting and ending at the moment exactly where it started at 1.6040. In the interim though, the British Pound rallied with the positive sentiment up to as high as 1.6180 on Wednesday, slipping heavily last night on Philly Fed and leading indicators surprising the market with more positive data than expected.

- CNY continued its appreciation in the cash markets moving from 6.2650 to 6.2450. The BOC rhetoric and political wrangling seem to have satiated the US election campaign's need to pressure the Chinese to appreciate their currency at a faster rate as it is no longer in their speeches (for now).

- The BRL currency maintained its range bound trading with a weekly drop of the USDBRL from 2.0420 to 2.0270. However, there is much room on the upside for the USD here and could see the pair trade as high as 2.40 before the situation is under control.

Fixed Income

- This week saw the rates go up in the US market right from the short to the long dated paper. Short term rates moved from 0.258% to 0.30%. Treasury yields on the 10-year soared from 1.65% to 1.8340% as of the close yesterday, but the bonds rallied a little today causing the yield to drop to 1.7975 as we write. The 30-year traded in a similar fashion moving from 2.82% right up to 3.02% only to print lower as we are writing at 2.96%

- With the Spanish rating being maintained by Moody's as Investment Grade, the bond yields have dropped significantly from as high as 5.84% to 5.26%. The fact that the Germans continue to state that the Spanish do not need a bailout and that the Greeks managed to do enough to receive their next cash injection, we feel that this is as good as it will get and we do not forecast too much further spread compression from these levels. **Spain** also managed to raise more than expected at the beginning of the week in short term paper at the lowest yields seen in a long time.
- The Italian bond market was relatively stable all week, seeing good interest in their bonds translating into yields coming down from 4.99% to 4.7% today. Although no one is trying to think about actually bailing out Spain and politically no one would consider it, the Italians did pass comment that their share alone would amount to 1.5% of their Domestic GDP, of course only if the Spanish ever decided they needed help… that is a lot of olive oil taxes.
- This week European high yields were again the outstanding performers at +1.36%, with the only bonds who actually lost this week being the US Treasuries… short the Treasury to buy the equity…?

Equities

- Equity markets rose this week, with the MSCI World up 2.57% (as of yesterday's close), supported by brighter prospects for resolving Spain's debt woes, while better-than-expected housing data and gains among financials lifted equity markets.
- European stocks jumped over the week by 2.30%, as US and German government debt prices fell after Spain avoided a damaging ratings downgrade from Moody's and positive data in the US pointed to an improving economy. On Friday, Spanish and Italian bond yields hit their lowest levels in over half a year after the Eurozone firmed up plans for a single bank watchdog, providing further support to European shares.
- US equities rose for the third consecutive day on Wednesday lifted by financials' strong earnings and housing starts that hit a four-year high, pushing the S&P 500 higher by 2.01% as of yesterday's close. The index was however slightly dragged down on Thursday as technology stocks were hit hard after Google's surprisingly weak earnings – released prematurely during the trading day – disappointed investors.
- Japanese stocks surged this week, with the Nikkei up 5.49%, on track for its biggest weekly gain this year as robust risk appetite kept the yen soft, helping exporters, while China-related stocks extended gains after data on Thursday hinted the country's slowdown is bottoming out.
- In terms of sectors, Materials and Financials stocks posted the biggest gains (3.99% and 3.63% respectively), while Information Technology and Consumer Staples had a disappointing week (0.49% and 0.81% respectively).

Emerging Markets

- Emerging Markets rose by 1.67% this week (as of yesterday's close), as measured by the MSCI EM, underperforming its developed counterpart. The best performing region was EM Europe (2.25%), followed by Latin America (1.75%) and Asia (1.61%).
- The Shanghai Composite advanced by 1.38% over the week, strongly rising on Thursday after data showed China's economic slowdown has been stabilizing and may start to pick up in the

fourth quarter. As stimulus policies start to take effect, investors seem confident that China's GDP is likely to rebound to 8% by the end of the year.

- The Brazilian Bovespa rose by 0.97% for the week (as of yesterday's close). The index rose until Wednesday on upbeat economic figures and earnings from the US just before tracking declines abroad brought on by discouraging US jobs data.

Commodities

- Commodities were about flat this week as of yesterday's close, as measured by the S&P GSCI broad commodity index. Agriculture and Industrial Metals led the gains (1.37% and 1.01% respectively), while Precious Metals and Energy suffered (-1.07% and -0.51% respectively).
- Agricultural commodities rose this week, driven up by wheat, corn and soybeans, as a bullish export report from the US Department of Agriculture provided support to trading. In addition, South American weather issues prompted speculation about demand.
- Meanwhile, Gold dropped by 1.10% and is now trading around $1'734 per troy ounce. Gold is heading for a second weekly decline as improving economic data from the US to China dampened speculation of more government stimulus, reducing demand for the metal as a safe haven. On Friday, Gold prices dropped further as some disappointment over US jobless claims drove gains for the US dollar.
- Crude Oil stood still this week, currently trading around $92 a barrel, as lingering worry about the global economy overshadowed relief that Spain avoided a ratings downgrade and optimism prompted by strong US corporate results. Investors were reluctant to buy into oil as concern about the demand outlook remained in focus, and crude stayed towards the lower side of its trading range. On the other hand, oil was supported by supply concerns, as the European Union slapped fresh sanctions on Iran.
