Bedrock Newsletter

Friday, February 8th 2013

Another rather mundane week has come and gone. No great events, no shattering news items and no dramatic moves but quite unnerving as equities bounced up to new highs and fell after, only to come back, bonds went through 2% and Europe found new scandals. After a big selloff on Monday, Tuesday rebounded and we saw the Dow Transports hit another all-time high, up much more than the DJIA at +11% vs. +6.5%. We remind ourselves that this sub-index has been a powerful predictor of the markets as a whole! And we were told that Equity Funds had big inflows, $27bn higher than the previous record in 2000. Will these record inflows push markets to new records?

Is the World economy coming back from the abyss? Well maybe just so! German December trade data shows record exports. And record imports... and this in the face of a strong Euro... Germany had a surplus for December of over Euro 17BN. And then China; last year's fear of its economy grinding to a halt was clearly misplaced- they just told us that their exports grew at 28% as imports rose 25% for a trade surplus of $25Bn… Clearly, the economy there at least is turbo-charged. We await the US trade deficit which is expected at $45Bn. They must be making money somehow, somewhere, to afford this much buying… And yes, the DJIA traded through 14'000 with the S&P 500 comfortably over 1'500. Let's not forget that the markets are a discounting mechanism of the future- Clearly, the value of said future is rising! On Thursday, Jim Rogers said he is shorting Government bonds and buying Russian bonds, equities and the currency [RUB]. He is also a buyer of Japanese equities as he finds them cheap at 75% off their highs, and this, versus US equities at their highs...

With these observations of the recent past we plugged fresh batteries into our own crystal-ball and took a peek at the future. Our focus is now set on the currencies of the World. We have an un-scientific observation to share here- Over the years, markets show rising and ebbing volatilities in various sectors. We rarely have seen periods where all sectors are volatile- it is as if the investor world needs a certain amount of volatility and this need has been satisfied with the accentuated price movements of a sector- At times, equities bounce around whilst bonds and currencies are calm. Then equities calm down and bonds start jumping all over the place, or commodities or currencies. As the equities have calmed down these past months, the VIX (the volatility index) has traded lower into rising prices, we had been expecting (together with many market participants) that the volatility will shift to bonds and furthermore, expecting this to occur into lowering prices, i.e. rising yields. Our freshly re-energized crystal-ball is now telling us that we were wrong… the volatility has indeed shifted away from stock but it found its offset in currencies, not bonds! Talk of currency wars is rising across the globe. The Euro which had risen sharply against the world has been slapped this week. The Yen is melting before us and the Swiss refuge has been battered. The almighty Yuan changed course suddenly into 2013, giving back some of its continuous rise. We now note that China has been less vocal than other major economies in recent weeks in voicing discontent about a sharp slide in the yen, which means stronger currencies elsewhere. Yet, Beijing is taking action of its own to head off unwanted pressure on the Yuan to appreciate. The Chinese Yuan, also known as the Renminbi, fell on Thursday to its weakest level since late December. In fact, the Yuan has been creeping down since January 14, when it hit a record high against the U.S. dollar at about 6.21, as China's central bank steps up its intervention in the foreign exchange markets to curb Yuan appreciation. The Yen has tumbled against all major currencies since the start of the year, falling roughly 10 percent against the dollar and the euro, amid growing expectations of aggressive monetary policy from Japan, now on a concerted bid to revive a weak economy and end years of deflation.

Yes, equities look set to continue rising, bonds are likely to trade in rather narrow bands and we will find our dose of excitement in the FX world! So says our crystal-ball… But before believing our "ball", remember Nietzsche's observation that, "faith is not wanting to know what is true…"

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Currencies

- Our patience has paid off; EURUSD finally tried to gasp for breath in the upper atmosphere and tumbled with the lack of oxygen. This week has seen one directional flows, out of the EUR, into the USD. Starting at 1.3650 on Monday and maintaining yesterday's low throughout the night at 1.3380 level. The initial sell off was trading and positioning related ahead of the ECB meeting. Draghi's words at the ECB meeting on Thursday moved the EUR from 1.3580 to 1.3371 in the space of an hour or so. The ECB may not have a central bank target for the exchange rate, but they can still mention the effects it has. Hollande, however, in his ever left of left of left stance, has decided in his great wisdom that the ECB should have a target for the EUR… we suspect he would venture for somewhere near parity!

- The CHF was relatively unchanged against the dollar for the majority of the week; with little news drivers it remained between 0.9080 and 0.9100. Draghi moved the USD up from 0.9080 to 0.92, in line with the EURUSD move. EURCHF started the week at the highs of 1.24 and was not able to escape the repositioning of the EUR ahead of the ECB speech and saw it move to as low as 1.2260 and we are currently trading at 1.2290. With no great news flows ahead we expect to see a little more consolidation and for the EURCHF to head back on the tracks towards 1.30.

- After we went to print last week the USDJPY continued its ascent and closed at 92.35. With a few stories the ride was a little bumpy, but it peaked on Wednesday at 94.06 and maintained its highs until today where the long awaiting retracement has started we believe. The big moves that we have seen in USDJPY (-1.9% on the week) have been even larger in EURJPY (-3% on the week), slumping from a high of 127.70 to 123.50. With the news this morning that the new BOJ governor may not be as "Abe-Inflation-Target" accommodative as was originally hoped, it looks like we may see a period of JPY strength for a couple of weeks. As we said before, a small retracement in the longer term depreciation of the JPY is expected and we wait patiently on the sidelines for now.

- It would appear that this week has paid the patient market participants. The long awaited AUD weakness has been brought to bear. With weakening domestic economic figures, even the positive Chinese data could not rescue the AUD (although it did cause a little bounce from 1.0256 to 1.0310!) The AUD has slipped from 1.0450 to as low as 1.0256 this morning. If the Risk sentiment slips further and the negative news flows take centre stage again, the AUD will likely lose ground rapidly ignoring the higher yield status that has kept it elevated. Economic data can only be ignored for so long…

- The British Pound has had a tough week. With positioning ahead of the MPC meeting (which remained unchanged) causing some fluctuations from 1.57 to as high as 1.58 only to settle at 1.5650 awaiting Carney's speech on Thursday. The much hyped and much awaited first words of the new BOE chairman-to-be saw the pound move from 1.5670 to 1.5770 in a vertical line. He seemed less intent on the Nominal GDP target and favoured explicit policy guidance and very much in favour of credit easing policy to stimulate the economy. Unfortunately words alone will not buy the pound and so we await this limited bullish mode to subside and for the pound to weaken further.

- The ZAR is trading wildly again and saw the USD slump to as low as 8.83 from 9.00 in one day. The ZAR has settled more or less unchanged on the week at 8.92. BRL continued to trade positively and moved from 1.99 on Monday to 1.9625 yesterday.

- As a general point we have seen the risk environment slip for the majors this week, the EUR, CAD, GBP, AUD and when they all fall in lock step we should pay attention. Risk-off to follow!

Fixed Income

- Treasury yields on the 10-year were bought on Monday and continued throughout the week seeing the yields slide a little lower from 2.06% to as low as 1.93%. With poorer jobless figures on Thursday and higher continuing claims the yields moved lower. The 30-year bonds have followed the same pattern as the 10 Year moving to as low as 3.14% on Thursday, after the Jobless Claims.
- The German 10-year Bund was bought aggressively on Monday seeing the yield collapse from 1.72% to 1.60%. Bouncing only for Tuesday and awaiting the ECB meeting. We are currently trading at 1.58% on the Bunds and feel there could be further upside on the bonds in the short term. The return of the Bund-Periphery spread expansion trade will return.
- Spanish yields are struggling again. With Rajoy embroiled in a political debate over past “discrepancies” and a growing fear that Spain has other issues in the economy… Shock horror that we never saw it coming…! The yields moved from 5.20% to 5.50%. The Spanish Corporates have slowed their issuance and for now we re-iterate, Spain cannot refinance itself in the open market as the banks’ balance sheets are almost at bursting point and at some point they will have to come hat-in-hand for a bailout.
- The Italian 10 Year debt sold off as well this week moving the 10Yr yield from 4.33% to 4.62%. As we have mentioned in the past, we feel that the direction will be downwards for the bonds and should continue to do so. With the Monte de Paschi scandal still rolling on the newswires, the banking scandal should apply pressure to the Italian markets for a while yet. Yields to continue to climb.
- With little to separate the sectors the general trend of Corporate outperformance over HY is evident, roughly +0.25% for Corp, versus -0.25% for HY.

Equities

- Developed equities fell for the week, with the MSCI world falling 1.05%, as of yesterday’s close. Shares mostly lost as Europe’s debt concern returned to the spotlight, overshadowing a week of strong corporate earnings.
- The EuroStoxx slumped by as much as 3.78% for the week. The index fell the most this year on Monday (-3.15%) amid renewed concern over Europe’s debt crisis. Spanish premier Mariano Rajoy faced opposition calls to resign due to contested reports about illegal payments, and Silvio Berlusconi narrowed the front runner’s lead before the Italian elections this month, and by so increased the political uncertainty in the block. In addition, ECB’s Mario Draghi warned on Thursday that the EUR’s strength might hamper the recovery, causing further equity selloffs.
- US stocks as well were affected by headwinds from Europe, causing some profit taking, with the S&P dropping 0.25% for the week (as of yesterday’s close). Internally, economic reports were relatively mixed with better than expected housing figures, but lower than expected factory orders and a rise in Jobless claims. In addition, corporate earnings were strong during the week, causing US equities to outperform their European counterparts.
- Japanese equities were volatile during the week, initially rising on the back of last week’s positive US and Chinese figures, only to give back gains soon-after on EU worries. On Wednesday the Nikkei gained as much as 3.8%, as the Yen slid to a three year low, causing several Japanese exporters to raise their FY13 guidance. The Nikkei gave back its gains at

the latter part of the week, as Sony fell 10% following reports of a quarterly loss and on further uncertainty in Europe, with the Index ending the week down 0.35%.

- In terms of sectors, Telecoms and Material were the worst performers (dropping 1.47% and 1.46% respectively), while IT and Healthcare fared better (-0.36% and -0.46% respectively).

Emerging Markets

- Emerging Market equities fell 1.24% as of yesterday's close, as measured by the MSCI EM Index. In terms of regions, Latin America and EM Europe were the worst performers (-1.08% and -0.90% respectively), while EM Asia fared better (-0.43%), on the back of positive Chinese outlook.
- The Shanghai Composite posted an additional week of gains, with the index rising 0.55%. Chinese economic reports continue indicate an improving state of affairs, with rising Non-manufacturing and Services PMI figures. In addition, the Chinese government announced a plan to tackle the wealth gap and increase minimum wages, signalling that the country is working towards achieving a steadier growth environment. On Wednesday, the Chinese navy aimed weapons at a Japanese warship, taking the Islands' dispute step further, raising worries for the trade relationship between the second and third largest economies.
- Brazilian equities suffered for the week, with the Bovespa falling 3.28%, as of yesterday's close. Brazilian shares dropped on the back of poor corporate earnings, as well as speculation that policy makers may raise borrowing costs to curb inflation, driving companies linked to domestic demand lower.

Commodities

- Commodities dropped by 0.81% for the week with Agriculture and Industrial Metals weighing the most on the GSCI broad commodity index (-2.05% and -1.36% respectively), while Precious Metals and Energy fared better (-0.21 and -0.49% respectively).
- Agriculture sharply dropped this week, as corn posted the longest slump in almost eight weeks on speculation that rain will boost yields in Argentina and Brazil, easing global supply concerns. In general, grain market was put under bearish pressures this week due to a higher Dollar and risk-averse investor selling.
- Gold oscillated between gains and losses over the week amid volatile trading, after comments by European Central Bank's Mario Draghi on Thursday ignited renewed economic fears over the euro zone. The metal fell in tandem with US equities and industrial commodities on recession worries after Draghi's comments triggered a nearly 1% drop in the euro against the dollar.
- Gold dropped to $1'664 an ounce on Thursday before rebounding to about $1'671 currently, as bargain hunting and firmer equities helped lift prices up although thin trade ahead of the Lunar New Year exaggerated movements, with investors also factoring in China's better-than-expected trade data for January.

- Oil dropped by 1.84% over the week on a higher Dollar and is currently trading at $96 a barrel. Starting the week, Crude prices have been under pressure from reduced near-term demand from refiners amid a heavy period of seasonal maintenance at plants. Also, Crude Oil futures sharply dropped on Thursday – erasing earlier modest gains – after equities prices turned lower.

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