Bedrock Newsletter

Friday, February 28th 2014

Time flies as we already are 2 months into 2014. Well, events in the financial markets certainly did not resemble the events of the last months of 2013. World equity markets fell down hard in January, followed by a rebound in February, but still leaving the Japanese Stock market down 9% YTD, and the EM index down 4%. The USD showed a lot of strength versus the Emerging Market currencies, while remaining stable versus the European currencies and dropping 3% versus the Japanese Yen. Ukraine has come to the news forefront and the situation is getting more difficult by the day with the Country on the brink of default and needing immediate financial assistance. Russia flexes its muscles as it doesn't want and will not let Ukraine slipping off its sphere of influence. Ukraine could become a catalyst for more trouble in the markets.

In China, the Central Bank reversed course on the Yuan and engineered a steep drop, as it wants to widen the currency's trading band, allowing greater volatility at a time when growth is slowing in the world's second-largest economy. The Yuan plunged as much as 0.85 percent to a 10-month low of 6.1808 per dollar in Shanghai, the biggest intra-day drop in China Foreign Exchange Trade System prices going back to 2007.The People's Bank of China is expected to double the Yuan's trading band by the end of June, according to the majority of 29 analysts surveyed by Bloomberg, as policy makers loosen exchange-rate controls and promote greater usage of the currency in global trade and finance.. The PBOC included an "orderly" broadening of the Yuan's band among its 2014 policy goals in a Feb. 19 statement, while the State Administration of Foreign Exchange said on Feb. 26 that two-way moves in the exchange rate will be the norm and that the market shouldn't read too much into the recent decline.

In Japan, industrial production grew the most since 2011, indicating the economy is strengthening as a looming sales-tax bump stimulates demand, while inflation matched the highest level in more than five years. Output rose 4 percent in January from the previous month, the trade ministry said today in Tokyo, more than a 2.8 percent median estimate in a Bloomberg News survey of 33 economists. Consumer prices excluding fresh food climbed 1.3 percent from a year earlier. Economic growth is set to surge this quarter as consumers and businesses splurge ahead of the April tax increase. The test for Abenomics and the Bank of Japan will be steering the nation through the aftermath, with the economy set to contract for a quarter and analysts projecting that Governor Kuroda will be forced to add to already unprecedented easing. The Topix stock index fell 0.7 percent, headed for its second monthly loss after a 52 percent rise last year.

One odd thing seems to gain traction in the markets: the fear of a "Black Swan event". With the market rebounding off the January selloff despite weakening economic signals and geopolitical turmoil, traders have been taking precautions against a return of the dreaded black swan.

The CBOE SKEW Index, which uses out-of-the-money—lower than the market price—options to discern fear of an unusual event hitting the market, has been pushed to levels indicative that something may be at hand.

Over the past few months, the black swan index, as it is nicknamed, has been trading above its normal area and is drawing attention on trading floors.

"People are buying cheap protection. There are some people that think with the market sitting here we're ignoring too many risks, either from (Federal Reserve) tapering or emerging market instability from geopolitics," said Dave Lutz, managing director of trading at Stifel Nicolaus. "But that's trying to guess what a black swan event is, which by definition you can't do."

In order to ponder all these thoughts this week end, we leave you with some basic instinct about investing from Warren Buffet. In his annual letter to Berkshire Hathaway shareholders to be released Saturday, he writes about how nonprofessional investors shouldn't get distracted by constantly changing stock prices and instead buy stocks of companies that will be profitable over the long run.After warning against entering the market "at a time of extreme exuberance and then (becoming) disillusioned when paper losses occur," Buffett quotes the late Wall Street money manager Barton Biggs: "'A bull market is like sex. It feels best just before it ends.'"

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Currencies

- EURUSD is set to end the week higher , around the 1.38 mark as inflation in the Euro Zone came in a tad higher than expected (0.8% vs. 0.7%!!...) This is obviously not bound to last as the EURUSD rate needs to come down , as voiced by the French this week…On Wednesday the Dollar fell as the Fed's Yellen said that recent economic weakness is attributed to the abnormally cold weather, and accommodative monetary policy will be in place for some time.
- The CHF gained for the week against both the EUR and the USD. EURCHF initially rose at the start of the week (from 1.2191 to 1.2216) as a rise in risk taking caused a drop in the safe haven currency. However, the CHF was soon to regain its strength (to an almost 10 month high of 1.2157) as concerns over Ukraine prompted the return of risk aversion. USDCHF is set to end the week lower around the 0.88 level.
- USDJPY lost ground this week, falling from 102.48 at the start of the week to 101.60 The pair started its selloff already early in the week as investors rushed to the safe haven currency as Asian stocks suffered sharp falls. We said and maintained that the level of 100.50 to 101.50 should be a good buying opportunity for the medium term as more monetary easing by the BOJ will come in the 2nd quarter.
- The Aussie fell modestly for the week (down from 0.8980 at the start of the week to 0.8960 currently) following a volatile week. The pair initially rose to 0.9050 on a USD selloff as investors continued to weigh the potential weather drag on recent economic data. The AUD has since sold off on weak Iron Ore prices and disappointment over weaker than expected capital expenditure numbers for Q4 – sending the pair to 0.8904. Finally the pair recovered to current levels on USD weakness.
- Cable gained for the week, gradually rising from 1.6628 at the start of the week to 1.6700 currently. With little news coming out of the UK, the rise in Cable was attributed to broad selloff in the USD on weak US data and following the Fed's comments.
- The Chinese Yuan received much attention this week as the currency reached its lowest level against the USD (6.1450) in 8 months. The PBOC guided the currency lower in a move viewed as the Central bank wanting to end the currency's steady appreciation to curb currency speculation and to prevent further inflows of hot money.
- Some EM currencies continued their descent against the USD, with the TRY falling from 2.1783 to 2.2163, and the RUB from 35.53 to 36.13. The BRL stood out as it rallied from 2.3678 to 2.3192 on signs of an improving economy and a change of sentiment towards Brazil.

Fixed Income

- US treasuries rallied for the week, with the 10yr yield falling from 2.731% on Monday to 2.662% currently. Treasuries headed for their biggest weekly advance in a month on signs of slower growth in the US.
- Spanish yields fell to the lowest level since 2006 (the 10yr currently at 3.497%) as the prospects of extended ECB stimulus drove yield-hungry investors to Peripheral European bonds, completely overlooking warnings by the EU that the country's deficit is on route to further widening under the current austerity measures in place.

- Italy's 10Yr yields moved in similar fashion to an 8 month low of 3.450%, with the bond rally attributed to the newly appointed prime minister which pledged an ambitious reform plan, consisting of cuts in corporate and labour taxes and higher unemployment benefits.

Equities

- Developed equities rallied 0.51% for the week – as of yesterday's close – as measured by the MSCI World index. Equities gained on the back of positive economic data, as well as supportive comments by the Fed.
- The EuroStoxx is set to end the week down 0.44%. European stocks gained at the start of the week as German business confidence figures bear expectations. Shares reversed their gains later in the week as tension escalated in the Ukraine. The gauge is set to end the month of February up 3.67%.
- The S&P 500 rose 0.98% for the week, as of yesterday's close. Shares gained on increased M&A activity, and on positive housing data, overshadowing a fall in Consumer Confidence. Finally, gains on Thursday were attributed to Yellen's speech which said that the central bank may change its strategy on asset purchases should the economy weaken. The S&P 500 is set to end the month up 4.02%.
- The Nikkei shed 0.17% for the week. Japanese shares gained early in the week, on the back of positive corporate earnings. Shares gave back their gains due to the strengthening of the Yen on geopolitical concerns. The gauge concluded February down 0.43%.
- In terms of sectors, Consumer Discretionary and IT stocks were the best performers (+1.19% and +1.06% respectively), while Utilities and Material stocks lagged (-0.46% and -0.43% respectively).

Emerging Markets

- Emerging Market equities rose by 0.41% for the week – as of yesterday's close – as measured by the MSCI EM index. EM Asian stocks rose the most (+0.87%), while EM European stocks slumped by 3.34% and Latin America was about flat.
- The Shanghai Composite declined by 2.72% for the week, sending the benchmark to its biggest retreat in five months, amid speculation a weaker property market and falling currency will curb corporate earnings. The Yuan sank the most since 2010.
- The Bovespa lost ground during the week as shares of Brazilian state-run energy firm Petrobras tumbled to an eight-year low as management failed to convince investors of an impending turnaround after the company's fourth-quarter earnings fell and debt soared. However, the index strongly bounced back on Thursday on the back of Fed's Janet Yellen positive talk regarding the US economy.

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Commodities

- Commodities dropped by 0.59% over the week, as measured by the S&P GSCI Total Return index. Energy and Industrial Metals lost the most (-1.04% and -0.84% respectively), while Agriculture and Precious Metals rose by 0.44% and 0.27% respectively.
- Gold rose by 0.47% for the week, and is currently trading around $1'330 per troy ounce. Gold lost ground on Wednesday, after striking a near four-month high the day before, as a strong dollar and upbeat US housing data dented bullion's safe-haven appeal.
- Meanwhile, crude oil was about flat and is currently trading around $102.30 a barrel. US oil swung between gains and losses as positive US economic data were outweighed by rumours that some refineries had suffered unplanned outages, which would reduce demand for crude.
