Bedrock Newsletter

Friday, May 13th 2011

We are Friday 13th… Many cultures believe this is a bad date. But here at least, it is a lovely sunny day and we received some encouraging data; French GDP growth beats expectations at 1% month on month and the Germans, showing 1.50% are growing at Emerging Markets' clip of almost 5% annualized clip. The latter driven by exports (as usual) and surprise, a huge jump in domestic demand! The Euro-zone Q1 GDP is now up 2.50% year on year. This includes the PIGS… When looking at Germany we can observe that whilst unemployment is quite high, employment is back above pre-crisis levels. So perhaps, just maybe our world is truly back on track? At least from an economics' point of view?
Maybe the ECB wasn't wrong to raise its rates? It may help in rationalizing allocation of capital, as the inflation-fighting excuse is a little pale.

Commodities are experiencing aftershocks of last week's knocks. Silver, Gold, Oil and other "real assets" were clobbered and are fluctuating around lower levels than the lofty levels which they had all attained before the spanking. The weak US Dollar was reanimated by the exit from commodities and may have found a new, if temporary, floor. We may indeed have entered a period of Dollar strength. We think that it is prudent to commence rebuilding Dollar exposure and lightening-up on some of the "escape-currencies" such as the Swiss Franc and Australian Dollar which have risen to un-explainable levels.

Equities should have rallied into the declines in input costs as commodities crashed. This "should have rallied" is supported by good corporate earnings and generally optimistic outlooks for top-line revenue growth. But there may be a lag here. We remain comfortable with the equity markets globally, as something akin to the Goldilocks scenario is in place- Low inflation, low interest rates, no wage pressures and accelerating global growth. We advocate building up global equity exposures.

Looking through all these gyrations, we believe that there are two primary trends around which there are and will be many short-term fluctuations-
The first being a long-term rise in the price of oil, driven by real demand from the conversion of the emerging masses towards middle class living (cars, heat, A/C, travel and electricity).
Then, there is the continued downwards drift of the US Dollar; this from the erosion of the relative economic power of the USA, which after reaching 60% of world GDP in the 1950's is now hovering around 23% and loosing relative ground whilst growing to larger absolute levels than ever before!

This weekend we will be pondering Johann Wolfgang von Goethe's observation; "Ignorant men raise questions that wise men answered a thousand years ago."

Currencies

- The Dollar had a very good week, for once. The Greenback strengthened against all major currencies with the exception of the Japanese Yen. It had a particularly strong performance against the Euro as the common currency fell from 1.4940 to 1.4140 in one week, a 5% move! When things turn, they do so in a very violent way, especially when the market was so one sided... it should then be no surprise to anyone as the US Dollar fall was way overextended. The question is: has the US Dollar downtrend ended? We would venture that at least the relentless fall has stopped and we should see quite higher levels for the greenback around the summer.
- Greek worries have surfaced again and this is why we have had a massive move down on the EUR. The EUR fell hard against the Swiss Franc as well as it revisited the end of December levels around 1.2500.
- The UK Pound rallied in the middle of the week due to the inflation report submitted by the Bank of England. They are seeing a 5% rise in inflation in 2011, which sparked worries that the BOE would need to raise rates, which is why the value of the Pound was driven up. However, manufacturing figures came out weak and knocked the Pound down again. We now stand at 1.6250 against the greenback versus 1.6520 2 days ago. We also see lower Pound values ahead.
- The Australian Dollar weakened on the back of sharply lower than expected job figures. Where the market expected a rise of 30’000 jobs, the figure was a loss of 22’000, with full time employment jobs being the hardest hit. The AUD weakened from a high of 1.10 at the beginning of May to a low of 1.0560 yesterday before bouncing a bit. It should be noted that the commodity rout has not helped the currency either. We expect the AUD to weaken further.

Fixed Income

- Government debt prices kept rising this week following lower commodity prices, and especially in energy and food prices. The inflation fears are indeed abating, hence the plunge in 10 Year US T Note yield to 3.15% yesterday. It has since bounced a little to 3.22%.
- It should be noted that the spread between the US and the German 10 Year yields have again gone into the US favour, to stand at 9 Basis points. Last week, this spread was in Germany’s favour. This has also helped the USD recover against the EUR.
- Greek Yields continue to rise as the 10 Year yield stands at 15.30% this morning, on fears that there will be no escape for a Greek debt restructuring.
- Norway yesterday hiked its benchmark deposit rate by 0.25% to 2.25%, which was expected.
- China again hiked the Reserve Requirement Ratio yesterday by another 0.50% as fears are mounting in the government circles that hikes are more than needed in order to slow inflation.
- Germany released its first quarter GDP figures this morning, and they were surprisingly strong. They came in at +1.5% quarter on quarter and +4.9% year on year.

Equities

- Global stock markets were slightly down this week as commodities kept losing some ground amid a strengthening dollar and concerns that accelerating global inflation may curb economic growth. The MSCI World as of yesterday's close is down -0.6% for the week, -2.7% for the month and up close to 5.55% since the beginning of the year.
- US stocks are up over 1% as of yesterday's close, erasing the second straight decline for the S&P 500 Index, as the dollar lost some ground and commodities slightly rebounded from an early slump triggered by China's efforts to curb lending.
- In Europe, stocks slightly fell amid sovereign debt fears mainly driven this week by the sentiment that Greece cannot escape default. The Euro Stoxx slid -1.1% and is down -2.8% for the month.
- MSCI Sectors Indices were broadly down last week, with Consumer related sectors Healthcare and Technology being the only one in positive territory. Energy and Materials were the worst performing sectors while Healthcare was the best performing one. Healthcare remains the best performing sector for the year along with Consumer Staples while Materials and Utility remains the worst performing ones.

Emerging Markets

- Emerging markets equities underperformed developed markets this week, with the MSCI EM Index down -1.4% versus -0.6% for the MSCI World. Last month, the MSCI EM was close to catching up its developed counterpart for the year-to-date, but is now quite far from it (-0.33% vs 5.6%).
- All Asian marketplaces were slightly up overall this week with the Shanghai Composite about flat while the Kospi Index was the only one to be negative sliding close to 3% while Thailand gained over 3%. The Indian BSE Sensex gained about 1% this week but is still one of the worst performers among EM countries for the year down over -9%. During last week, the Index lost over -4% after investors cut their exposure to Indian equities on tightening fears.
- For the year, South Korea (3.4%), Indonesia (3.5%) and Thailand (4.9%) are the best Asian performers. Within Asian frontier markets, we can note a spectacular performance in the Mongolia's MSE Top 20 Index which is up over 38% for 2011 so far.
- Latin America was up overall last week with Columbia, Peru and Argentina performing strongly while Brazil was up about 1% and Mexico slightly down. Brazil is still in negative territory year-to-date and is down over -3% this month still on concern about the strengthening Real and mounting inflation that could lead policymakers to tighten monetary policy more than investors originally thought.
- Russia and Eastern Europe did poorly this week with the Russian RTS Index losing over 2%. However, a lot of Eastern Europe countries remain among the world's best performing markets for the year, including Bulgaria (22%), Serbia (15.5%) and Hungary (9.5%).

Commodities

- Commodities were slightly down this week with the GSCI Index down by about -0.4%. Commodities dropped the most in almost two years last week, losing over 10% paring this year's gains to about 8%, on speculation of slowing economic growth as governments raise interest rates to contain inflation.
- After having lost over 15% last week falling to about $97 a barrel mainly on US slowdown fears, Crude Oil gained about 3% last week rebounding slightly above $100. Gasoline recovered from the biggest slide in two years on concern floods moving south along the Mississippi River toward refineries and the Gulf of Mexico will curtail production.
- Agriculture was the worst performing sectors this week, down -1.6% while Precious Metals were the only positive sector, up about 0.75%.
- After having experienced an historic correction sliding over 30% in less than a week, Silver was slightly up this week close to $36 an ounce while Gold gained about 1%. Gold and silver advanced as Europe's sovereign-debt crisis showed no signs of abating and global inflation accelerated, spurring demand for precious metals as a store of value.
- We believe that for the moment, it is better to lighten up in commodities as we believe that the decline that stared this week is not over and that we will see lower prices ahead.