Friday, June 24th 2011

Strange week… The debacle of Greece was noisy in the background with bounces in the value of currencies and equities in reaction to words from leaders and scenes of upset people in Athens. Then, the US gave us its share of frights with political brinkmanship in connection with the Federal Debt Ceiling (serious this, as no one wants the US to default on its obligations), then we got some disappointing economic data from just about everywhere. The economic rebound we thought we were enjoying appears to be less pleasurable than we all thought. Bonds rallied again into the Fed's "Meet The Press II" and Bernanke's official downward revision of 2011 and 2012 GDP growth expectations. The markets didn't like this outlook and were disappointed that Ben didn't follow through with an appeasement with a hint of QE (III). Our disappointment was fuelled with the data showing that the Housing crisis in the USA is now worst than the one in the Great Depression, the Misery Index which was our lantern in the days of Paul Volker is now the highest it has been since 1983- this measure being the sum of the inflation and the unemployment rate. We reached Thursday totally depressed. The DJIA concurred with a 240 point drop in early trading. Oil kept on its downwards course, the Euro was shaky and then, a rumour hit the screens that the Greeks had reached a 5 year deal with the IMF and the European Union. The Euro popped up, the DJIA started to regain some of its losses. Abbey Joseph Cohen told us that she fully expects the S&P 500 index to close the year at 1'450 (she must have finally read Bedrock's Newsletter of Year end 2010) which would be up about 13% from here. Our grimace faded somewhat and then, the IEA's Mr. Tanaka (this is the International Energy Agency) announced that there will be a release of Strategic Oil Reserves by the USA, Japan and others, meant to alleviate the shortfall of production due to the Libyan unrest. For once the authorities acted like seasoned traders- They played into the market trend, not against it, getting a huge bang for their barrels… Oil dropped, the DJIA cut immediately most of its losses and the NASDAQ turned positive. Energy stocks did get rattled some as airlines and other transporters rose happily…

Perhaps, just perhaps, the powers-to-be decided on a different type of QE by boosting the economy through reducing costs of energy. The Fed had printed Dollars, now the Department of Energy has turned to printing oil… Another innovative initiative from the authorities. Who said that Government can't manage the economy?

We see acts of courage and resolve from officials. We are speechless here with a great verbal follow-on from a member of the ECB this morning saying "Banks MUST participate voluntarily in the Greek bailout…" We tried to understand and are stuck. It isn't a bailout, and then, if they must, how could it be voluntary? Well, we can't quite understand how the other guys can print oil, but it seems to work any way…

Innovation is rarely understood when it is first introduced. One hundred years on, do we really understand how an airplane stays up in the air? ☺

Currencies

- The Euro seems set for a third weekly decline against the US Dollar, the longest streak in four months. It was a bumpy ride, with the Euro tumbling to a low for the week of 1.4125 against the Greenback on Thursday amid growing worries about the health of the global economy, but it pared its losses later in the day after reports that Greece had reached an agreement with EU officials on its austerity plans. It is now trading at 1.4220, but markets seem quite edgy…
- The British Pound also weakened this week, hitting record lows against the Swiss franc and New Zealand dollar, and falling below $1.60 for the first time in almost three months as traders continued to pull back their expectations for a UK interest-rate rise.
- The US Dollar on the flipside was strong this week versus most of its major counterparts, despite disappointing economic data and quite a gloomy outlook from the Fed. Bernanke announced this week, as was expected, that the Fed would end QE2 as initially planned by the end of June. They however left the door open to further stimulus measures should the economic rebound fail to materialize. Was this a hint on the Oil QE?
- Higher yielding currencies were mixed this week. The Aussie Dollar rebounded from a one-month low against the USD as the news flow over Greece improved somewhat. However, the Canadian Dollar dropped as oil prices tanked.
- Meanwhile, the Swiss Franc remained very strong, hovering below 1.2 versus the Euro and is currently at 0.8370 versus the US Dollar. The Franc has appreciated 14% versus the Euro and 32% versus the Dollar over the last 12 months!
- Currency markets are behaving in a very nervy manner and we do not expect any change over the summer months! The Euro is being driven by news flow over the Greek situation, and there are many events coming in the next few weeks, starting with next week’s Greek vote on the 78 billion Euro package, that will undoubtedly cause a lot of volatility.

Fixed Income

- Government bonds seem headed for another weekly gain as investors turn to the safest assets following the Fed’s gloomy outlook for the US economy and as the Euro-zone’s sovereign debt crisis seems to be deteriorating.
- Yields on US Treasuries dropped slightly this week, with the 10yr currently yielding 2.91% and the 2yr yielding 0.34%. The Fed announced this week that it will end its bond buying program as planned by the end of June and expects to keep rates near zero for a long time (meaning 2-3 FOMC meetings hence).
- Yields on German and French bonds dropped more than their US counterparts this week, with the yield on the 10yr bund dropping by 6bps to 2.89% and on the 2yr by 10bps to 1.40%. Yesterday’s announcement that Greece had agreed to the terms for the aid package from its EU partners calmed market participants to some extent.
- Meanwhile Japan’s 10-year yields touched the lowest level this year, at 1.105%
- Despite yesterday’s positive news over Greece, the sovereign debt crisis is spreading, with yields on all periphery European countries rising again this week. This week saw the Irish 10yr government bond yield rise above 12% for the first time ever…

- Credit markets also suffered this week as sentiment continues to be negative. High yield securities performed poorly while investment grade credit was down slightly.

Equities

- Equity markets seem headed for a weekly gain – finally! European equity markets are up around 1.5% for the day as we write this, responding to the news that Greece had come to an agreement with its European partners over its aid package. This brings most European bourses well into the black for the week, as they are for the year (not Switzerland's SMI which is suffering from its strong host currency)!
- US markets as of yesterday were marginally up for the week and are likely to follow European markets higher today. US markets had a rocky week, up nicely in the beginning of the week, but then tumbled following an increase in jobless claims and un-supportive Fed Talk.
- Meanwhile, Japanese stocks are up big time for the week, with the Nikkei 225 up 3.5%. This comes from a combination of the better news in Europe, lower oil prices and optimism on China's inflationary data. Attractive valuations undoubtedly help…
- A sign of the improvement can also be shown through the VIX index (which measures the volatility on the S&P 500), considered by many as a "fear gauge", declining by 11% this week.
- In terms of sectors, energy and financials were the worst performers this week. Energy did poorly given a big weekly drop in oil prices, while financials continue to be under pressure because of ongoing credit concerns in Europe because of the sovereign debt crisis, and in the US worries over housing are coming back...
- Conversely, the best performing sectors were consumer discretionary and technology.
- Despite the uncertain outlook, this week saw its fair share of corporate activity, with a pick up in M&A announcement. This should not come as surprise given the huge piles of cash on companies' balance sheets.

Emerging Markets

- EM equities are also headed for a weekly gain, with these boosted by the positive news over Greece at the end of the week. Chinese Premier Wen Jiabao's announcement that efforts to stem inflation have worked and a drop in oil prices also helped.
- Asia EM was the best performing region, with the Shanghai SE composite up 3.9% for the week, and the BSE Sensex up 2%. Latin America also did well, but Brazil continued to underperform, with the Bovespa down -0.6% for the week. Finally, Russia suffered this week given the drop in oil prices.
- While EM equities rose, EM credit was under pressure with yields rising and credit spreads widening.

Commodities

- Commodities declined this week, with the S&P GSCI broad index down -3% for the week. Again, there were wide divergences in performance across the different types of commodities.

- Energy was the worst performer, with oil tumbling this week, erasing its gains for the year, after the International Energy Agency said its members would release crude from strategic reserves. Brent crude oil dropped on the news from $113 a barrel to $106. It is now hovering slightly above the $106 level.
- Agricultural commodities also performed poorly, with these down by -2.3% for the week as measured by the S&P GSCI Agriculture index. These continue to be impacted by larger than expected supply, therefore driving prices down.
- Precious metals were also down for the week. Gold declined by -1% and silver by -2% Some explain that precious metals have been going down recently because of lower inflationary concerns, but we would argue that probably more because of US$ strength!
- Finally, industrial metals dropped by -0.5% as measured by the S&P GSCI Industrial index. Within this group copper rose given strong demand from China.
