Bedrock Newsletter

Friday, July 8th 2011

What a turnaround… Equity markets have just had one of their best weeks in decades! The NASDAQ is now at the level it had in November 2007 just before the crash. Is this an expensive moment to buy? Well, arguably it is cheap; If the earnings were the same as they are today, why then, given today's lower interest rates (discounting factor) we are cheap. If we adjust for inflation, there too we would conclude that today's prices are low. Then if we consider the expansion of the World in terms of number of economically active people why then it all does seem cheap…

Yesterday the ECB raised interest rates by 0.25% to 1.50%. This whilst the Greek problem still in full force, Portugal coming back into the headlines and Italy and Spain reappearing in the texts. This rise should reassure us that the bigger economies are doing fine and need throttling back some. The USA gave us a pleasant surprise yesterday with an ADP jobs report showing private sector job creation at 157K, way ahead of expectations and consequently raising the expected figures for today's Non Farm Payroll data. Switzerland today advised us that the unemployment rate is at 3%, golden currency notwithstanding. China is tightening further in its ongoing effort to reign-in inflation. It's not all gloomy… Well, the US has 8 million or so unemployed. If they create 100K jobs per month, that means about 6.5 years to absorb the existing unemployed, but then, our American friends produce about 100K of new job seekers every month. Perhaps we should expect high unemployment to become part of the "New Normal"?

Equity and bond markets do not look at the NOW but at the future. They are telling us that the global economy is healing. Let's listen to the Dollar Weighted opinions here!
We are optimistic about the future but remain concerned about short-term disruptions to the recovery process. Other than the Swiss situation, Europe and the US have a serious problem with unemployment. It hinders growth, is expensive especially in times of austerity and could lead to social unrest. Then, the effective zero cost money (Dollar, Euro, Swiss Franc and Yen) can and will cause distortions in the efficient deployment of capital (see the price Microsoft paid for Skype???) with the long-term economic costs which come later.

Oil prices have come back to the discomfort zone, wiping out the gains from the release of Strategic Reserves. Let's not forget that these are likely to be rebuilt in the near future… Iran is still out there, the Arab Spring is still killing people, the US government can't get out of its own way in resolving the simple debt ceiling issue not to mention the serious cause- their deficit and ballooning debt. No, it isn't clear sailing into a sunrise…
It is a difficult environment from which to extract value in a reasoned manner. Many great investors of the past are struggling. See hedge fund performances, even Berkshire Hathaway stock is exactly flat over the past 12 months. We think that the time for heroics is not here yet.
Maybe after the Summer… ☺

Currencies

- The Euro declined this week versus most of its major counterparts, on concerns that despite the improvements in Greece, the sovereign debt crisis would undoubtedly spread towards other periphery countries and would hurt the whole Euro zone area. The Euro dropped from 1.4525 to a low of 1.4220 versus the US Dollar and from 1.2350 to 1.1965 against the Swiss Franc.
- However, the Euro's weakness was curbed by the ECB's decision to raise benchmark rates by 25 points to 1.50% and strong statements by Trichet (the ECB president) signalling more increases in the coming months. As such, the Euro strengthened slightly and is now at 1.425 versus the US Dollar and at 1.2145 against the Swiss Franc. The Euro was also provided a boost by better than expected export data from Germany.
- Meanwhile, the US Dollar benefited from better economic data, with yesterday's ADP employer service release showing that US companies added more than double the number of workers forecasted.
- This afternoon's (for us Europeans) payrolls report from the US Labor Department will hopefully confirm the recent trend of better economic data. In any case for sure that the payrolls number will have a huge impact for currencies and all markets for the summer months…
- With better US jobs data and a more positive tone in markets generally, risk positive currencies such as the Canadian Dollar and Australian Dollar performed well. Conversely, the Japanese Yen, considered as the safe haven currency of choice, weakened.
- The Swiss Franc, another safe haven currency, was strong against the US Dollar in the beginning of the week but weakened sharply after the employment data released on Thursday. It went from 0.845 at the beginning of the week to a high of 0.8365 and has now come back to 0.85…

Fixed Income

- Government bonds seem headed for a slight gain for the week. Economic data in the US and in certain pockets of Europe have improved and the ECB did raise rates this week, indicating more to come, but this week's gains probably just result from the dramatic losses of the previous week.
- Yields on 10yr US treasuries are down 3bps for the week to 3.15% and are flat for the week for 2yr securities, with the benchmark at .473%.
- In Europe, yields on 10 year UK and German bonds dropped by 10 basis points for the week, while yields on 10 year French bonds rose by 6 basis points during the week.
- Meanwhile, Italian bonds fell for a fifth straight day, pushing yields to a nine-year high amid concern Greece may be headed for a default that would send repercussions across the region's most indebted nations and their banks. Moreover, the cost of insuring against default on Portuguese and Irish government debt rose to records leading a gauge of the region's sovereign risk to an all-time high.
- With the more positive sentiment, credit markets were buoyant this week, with higher yielding securities outperforming investment grade credit.

Equities

- Equity markets seem headed for a gain for the week, with the MSCI World up 0.6% as of yesterday's close. The world index is now up 5.65% for the year.
- With appetite for risk higher, small cap stocks outperformed blue chip names this week, with the Russell 2000 up 2% compared to 1% for the Dow Jones Industrial average.
- There were also strong differences in performance by region, with the US outperforming Europe, and Japanese stocks advancing the most of the developed world for the week. Indeed, the Nikkei 225 was up 2.7% this week, and is back to its highest level since the March 11 earthquake, as a recovery in demand boosted advertisers and real estate developers.
- US stock markets did well, with the improving employment data and better tone in the market. However, European markets were mixed, with the UK and Germany up around 1% while bourses of countries caught in the sovereign debt crisis down. Spanish and Italian stocks are down around -3% for the week.
- The VIX index, which measures volatility and is considered as a fear gauge, was stable this week, staying at levels that are very low compared to the past…
- In terms of sectors, the best performers this week were cyclical sectors such as energy, basic materials, consumer discretionary and information technology while consumer staples, utilities and healthcare lagged.
- The financial sector was the worst performer, as this sector continues to be pressured by the credit crisis in Europe.

Emerging Markets

- EM equities are ahead of developed stocks for the week, with the MSCI EM index up nearly 1% versus 0.6% for the developed one as of yesterday's close. Asian stocks outperformed other regions this week, with these responding well to the better employment data and retail sales out of the US.
- Latin American bourses meanwhile were soft compared to other regions. Brazil continues to lag, as expectations for higher interest rates pulled down Brazilian banks and retailers, offsetting gains in commodity prices that boosted some producers
- Conversely, Russia did particularly well, benefiting from higher prices in commodities.
- Asian currencies rose for a second week, led by Thailand's baht, on speculation the world's fastest economic growth and rising interest rates will spur more fund inflows from abroad.
- Separately, China's finance ministry failed to sell all of the debt offered at an auction for the third time this year as a cash crunch damped demand from banks.

Commodities

- Commodities performed very well for a second consecutive week, with the S&P GSCI broad index up 4%. All major types of commodities were up sharply this week.
- The best performing sector was energy, with oil prices up sharply on shrinking stockpiles and signs of economic recovery in the US.
- Precious metals also saw big gains this week, with gold up 2.65% and silver up by 6.75% for the week. Gold is at $1526 an ounce currently, edging close to its all time high.
- Industrial metals are up 3.10% for the week while agriculture is up 2.85%.