Bedrock Newsletter

Friday, August 19th 2011

Global equity markets are bleeding heavily. Everyone is seeking explanations- some say it is the economics and politics of Europe, others point fingers at the American debasing of their currency. In truth, there probably isn't a truth here… Equity investors' sentiment has turned and may force a recession and prove their fears founded. Whilst the media is focussing our sights on the rather dramatic fall in equity markets, let's not lose sight of the bond markets which have soared! Every dark cloud has a silver lining- With US ten year Notes rallying to break 2% yields, Swiss Franc bonds of same maturity yielding 0.80% someone is making money on some of their portfolio, given the capital gains from the yields falling.
The economic data we saw this week gave some serious support to the view that the "P" in the markets' P/E ratio might be overly optimistic with a slowdown happening all around, even if it isn't quite a recession, yet…
The truly scary part is indeed in the bond markets. The US yield curve is as low as it has ever been, the Fed promising us that it will not rise for years to come. Europe? Well, problems everywhere, governance is non-existent (with all due respect to Merkel and Sarkozy) and yet, yields on core European bonds are holding steady at extremely low levels.
Somehow, with all its structural issues, the lack of Fiscal unity and a central Treasury, the Euro is holding up quite well trading now at 1.43 to the US$, it is exactly where it was in January 2010. Against the US$ that is, so we can surmise that in effect the Euro is falling against the World, in line with the US$. When we hear the badmouthing of the Euro, let's remember the old adage that says "Money talks and BS walks"…
As bond prices climb and equity prices drop we are receiving a consistent message for a change- Both are telling us that the economic situation is not good. Equities are saying that earnings will decline or simply not grow, bonds are saying that there is no risk of inflation and are setting total return expectations lower. The currencies are telling us that the US and the EU are together here, suffering in the contest with the developing world. Let's not be mislead by the fall in the equities in the emerging markets in general and the BRIC's in particular- most of the market capitalization there comes from capital belonging to the rich economies. As the western markets fall, westerners sell out of risk and reduce EM holdings and force those markets down. This in a global economy where the slowing west is the client of the booming EM… Complicated, isn't it? Let's try and remain positive here! With oil falling to $80/bbl and other commodities falling in step, the costs to the economies are receding and this could help revive some activities. Much like a tax cut…

What can we hope for? We would like to see the EU creating a Euro-Treasury and therefore a funding vehicle. The Chinese would then diversify their reserves into such Euro Bonds and Europe will be able to fund its own "TARP" equivalent and same the PIIGS and its banks… Then, to complete the Global solution, the US should impose a Wealth tax and a gasoline tax, close the deficit and all will be well. Let's hope together…

Currencies

- The CHF continues to be at the centre stage of the currency markets. The CHF depreciated on the first part of the week on rumours the SNB would announce a peg to the EUR on Tuesday. The CHF weakened to 1.1550 (from 1.0070 the week ago!) And to 0.80 against the USD (from 0.7150 a week ago) before retreating a bit after there was no such announcement. However, the SNB opted for more liquidity measures as it expanded sight deposits from 120 Bio to 200 Bio and pushed interest rates deeper in the negative camp. It should also be noted that the 10 Year Swiss Confederation Bond now yields even less than the Japanese Gvt Bond! (0.8% versus 1.00%)
- The CHF remained weaker yesterday, even after a global equity rout of more than 4%. This is a first and may show us that the worst of the CHF overvaluation is over. The USDCHF and EURCHF pairs have remained above last week's closing levels, which is a good sign.
- The EUR itself rose just above 1.4500 on Wednesday as there was hope that the Sarkozy-Merkel meeting would produce a real plan to deal with the Euro Zone debt plan. When the announced pan proved to be another disappointment, the EUR fell again versus the USD to below 1.4300. The EUR at this level remains a mystery to many market participants, including ourselves. We do not see how the weak Euro zone countries will be able to survive if their currency is not allowed to depreciate. The EURUSD pair also reacts hand in hand with equity market movements. When markets are jittery, the EUR comes down, and when markets rise, the EUR rises in tandem. This does not make sense and hopefully will stop one day.
- The British Pound was surprisingly strong this week reaching levels above 1.6500 to the USD, even as the BOE released an even more dovish statement and as weaker economic figures were released.
- The Chinese Yuan remained below 6.4 per dollar, thus holding its last week's gains. Chinese officials are becoming more and more pressured to let their currency appreciate in order to reduce global imbalances and to counter domestic inflation pressures. The visit by US Vice President Biden to China this week underscored the importance of US-China economic cooperation, as the Chinese said that both countries shared a joint responsibility to reduce macro imbalances in the world.
- Commodity currencies (AUD, NOK, and CAD) remained on the soft side this week as global equity markets remain volatile and weak and as commodities tumble. As long as the markets will stay on the defensive, we think that these currencies could actually weaken further.

Fixed Income

- Government bonds continued their march higher this week, extending last week's gains and even driving yields to record lows, as slowing economic growth and weaker economic numbers were published. 10 Year US treasuries now stand at 2.0a% after briefly dipping below the 2% mark. 2 Year treasuries stand at 0.19%.
- The yield on ten year Bunds also dipped to a record low of 2.05%. As already stated above, the Yield on the 10 Year Swiss Government bond now stands at 0.8% and the Japanese is at 1%. These yields are so low that it is difficult to envision more gains to the bond markets unless we really sink into another panic or an economic depression.
- Weak Euro Zone countries 10 Year yields remained elevated as Greek bonds offer now 15.8% yields, Ireland is at 9.6% and Portugal at 1.4%. Spain and Italy remain around 5%.

- Fitch, one of the other 3 big rating agencies, reaffirmed this week the AAA rating of the US, saying that the key Pillars of US exceptional creditworthiness remains intact, in a move that contradicts the S&P downgrade.

- There were outflows this week from both investment grade and high yield space. Both markets underperformed steeply the Governments space. Disappointment that proposal from the highly anticipated meeting between Germany's and France's leaders would not offer any immediate support led to a rapid fall in the high-yield market.
- Default insurance costs for European banks rose above their all-time record closing level Friday, as combined worries revolving around slower economic growth and the sovereign-debt crisis heaped pressure on financial institutions in Europe's core countries.
- The iTraxx Europe Senior Financials index, which investors can use to buy or sell protection on 25 banks and insurers, had widened above its all-time wide closing level of 240 basis points hit on Aug. 12.
- The visible shift from proceeding months was that banks in Europe's financially stronger, "core" countries, as opposed those in the weaker "periphery" countries, were hardest hit.
- There remains a continued focus on funding concerns surrounding European banks, perhaps missing the point that the weakness in the banking sector more pointedly reflects a lack of confidence in the euro zone as a whole and continued political inaction.
- Separately, the cost to protect against defaults by European financial companies reached a record, and a swaps index that gauges the perceived risk of owning junk bonds, which falls as sentiment deteriorates, is at about the lowest level in more than a year…

Equities

- Developed equity markets plummeted this week, with the MSCI World down by -2.8% as of yesterday’s close. The Index lost over -12% month-to-date, with Europe being again the major laggard. The MSCI is now down over -10% for the year. World stocks tumbled on weak US economic data and renewed concerns about the Eurozone debt crisis.
- The S&P 500 lost about -2.7% as a grim mix of economic data and fresh concerns about Europe's banks reinforced investors’ fears on the US faltering recovery and Europe’s debt crisis contagion risk.
- European stocks sank during the week, dragging the Euro Stoxx Index to the biggest two-day drop since November 2008, amid growing concern the global economy is slowing. The European Index is losing close to -7% for the week as we write this with the DAX being the major detractor, down about -9.5%!
- The Nikkei declined by 2.7% this week, on deepening concern the global economy is slowing and Europe’s debt crisis will damage the banking system.
- MSCI Sectors Indices were all in negative territory last week, with Information Technology and Industrials being the biggest laggards, while defensive sectors such as Consumer Staples, Telecom and Utility pulled through the week relatively well. Consumer Staples remain the best performing sector for the year along with Healthcare and Telecom while Financials, Industrials and Materials remain the worst performing ones.

Bedrock Newsletter

Emerging Markets

- Emerging markets equities outperformed their developed counterparts this week, with the MSCI EM Index up by 0.6% while the MSCI World was down by -2.8% as of yesterday's close. For the year, the MSCI EM continues to lag, down about -13.5% while the MSCI World index is down about -10.3%.
- Performance across EM regions was negative overall, setting the EM Index on course for its longest streak of weekly losses since May, as signs the global economy is slowing drove investor outflows from riskier assets.
- Amid this turmoil, Latin America pulled through relatively well. While the Bovespa lost about -0.4% and Mexico -1%, Colombia was about flat and Chile and Venezuela gained about 1.3% and 4.6% respectively.
- Brazil remains however the worst performing markets year-to-date, down over -23.3%. Brazil became the first among the largest emerging economies to fall into a bear market this year as the government adopted new measures to stem currency gains and inflation quickened.
- Nearly all Asian marketplaces were negative this week. Chinese stocks lost about -3.5% for the week following four consecutive negative days, after some major investment banks cut their economic growth forecasts for the Asian country on concern a slowdown in the US and Europe will reduce exports.
- India was the worst performer among Asian markets this week, losing about -5.2% on worries that higher interest rates will restrict corporate profit growth. Commercial banks have raised lending rates over the past few days after the Reserve Bank of India (RBI) late last month raised its key lending rate by a steeper-than-expected 50 basis points at a policy review.
- Meanwhile, Asian currencies stood still as shown through the Bloomberg JP Morgan Asia Dollar Index, although many of the component currencies experience higher inflation rates and as interest rates go higher.

Commodities

- Commodities were again extremely volatile this week, as we had massive moves in precious metals, energy.
- Precious metals saw sharp gains this week, with Gold rising to a new record at $1'868, as markets are getting more and more concerned about European debt woes and as very low interest rates make it very cheap to own gold. Silver also rose for the week to stand at $41.25, but remains still 20% below its April peak.
- Agriculture commodities were more or less sideways up for the week, as bigger than expected food imports from China surprised market participants thereby putting a floor under agricultural prices.
- Energy prices retreated sharply this week amid a very volatile week. WTI opened the week at $85, before rising 5% to 89$ Wednesday as markets were calmer. However today, oil prices stand below $80, a 10% down move in 48 hours, as fears are mounting that the world is entering a sharp economic slowdown.
- In general, we remain on the defensive in the commodities sector and will wait to have a clearer picture on where the world economy is really headed before raising exposure

Bedrock Newsletter

Disclaimer
This document is for information purposes only and has been prepared by Bedrock SA, representing the opinions and investment views of Bedrock SA as applied in its investment advisory and management activities. It is a private publication intended for private circulation only. It does not constitute a company survey, a financial research, an offer, a solicitation or a personal recommendation to buy or sell specific products or securities. Bedrock SA disclaims all liability for any losses or damages of any kind relating to such information, which may be changed at any time without notice. The risks inherent in certain investments, particularly derivative products, may not be suitable for all investors. The contents of this publication may have been used for transactions by Bedrock SA prior to their communication. Distribution or dissemination of this document and/or the sale of certain products mention herein are subject to restrictions. Copyright 2011 All rights reserved. Approved for circulation in the UK to non-private customers only by Bedrock Asset Management (UK) Ltd which is authorized and regulated by the Financial Services Authority. This presentation is being made to you solely for your information and must not be copied, reproduced, further distributed to any other person or published, in whole or in part for any purpose.
© 2011 Bedrock S.A. 4, ch. Des Vergers, 1208 Geneva, Switzerland, T: +41 (0)22 592 5455 F: +41 (0)22 592 5459, www.bedrockgroup.ch