Bedrock Newsletter

Friday, September 9th 2011

Weeks come and go, and yet, nothing really changes. Every day we get "ground-breaking" declarations and new plans and with each, we are reminded of the following:

> *"The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed lest Rome become bankrupt. People must again learn to work, instead of living on public assistance" Cicero, 55 BC*

Yesterday, Barak Obama announced to Congress a $447 Billion package to create jobs. We wonder if he decided on $447Bn and not say $500Bn to make the number more credible (in that it isn't round)? How will this help businesses to hire if the package is to be "budget neutral", being funded by new corporate taxes? Well, political logic escapes us, being an oxymoron in itself…

It gets better. The US is suing banks for the sub-prime fiasco. The number we heard is $30Bn. Yes, banks should be punished for doing what the government had imposed on them to do, back before things went silly. But let's take this "justice" one step further: At a time when banks are blamed for not lending, fining them $30Bn will reduce their ability to lend by about $350Bn using Basel III leverage. This isn't clever, even if it appears to serve some altruistic justice, it will not help the economy to create jobs if capital is being withdrawn… Irrational, but it does feed the crowds. No wonder the markets are nervous… What will come next?

Other Governments are no better… Europe can't get out of its own way. Greece might have to default, possibly triggering its expulsion from the Euro. It would clearly be cheaper for the European economy to just write off all the Greek debt, but that would be a difficult "sell" for the Political leaders.

The markets seem to lean the US way here, making the US$ rise against the Euro.

It seems to us that the world is being managed by the Central Banks-

The Swiss one managed to salvage the Swiss economy with bold action of setting a ceiling on the Swiss/Euro exchange rate. Yes, it is early days here, but so far, the market has been trading the CHF at weaker levels that the 1.20 level set by the SNB.

J-C Trichet who is about to hand over the leadership of the ECB is self congratulating on the price stability he has maintained. He did actually as Euro inflation has been held at the target 2% since its beginning. Now his Italian replacement will have to cut rates to revive the economy though…

So we are looking to Obi Wan Bernanke's wisdom to reign-in the US elected class.

Let's not lose sight that both optimists and pessimists contribute to our society. The former invent the airplane, the others, design parachutes.

We remain optimists (whilst wearing parachutes…). Matters must get better, so they will!

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Currencies

- The euro is set for the biggest weekly drop versus the dollar in four months on speculation the European Central Bank will lead its counterparts in coordinated monetary easing after cutting the region’s growth forecast. The Euro declined from 1.42 in the beginning of the week to 1.3800 currently versus the Greenback.
- The Euro weakened versus almost all major currencies this week and we expect the Euro to continue to be under pressure. There are too many problems in Europe that will drag on growth, and the diverse governments, different fiscal policies and all the troubles that come with it will take a toll on the euro in the near term.
- The US Dollar strengthened this week against the Euro, Japanese Yen and all other major currencies as the US trade deficit narrowed more than forecast in July as exports climbed to a record, offering a bright spot for an economy at risk of a bigger slowdown.
- The other major news this week was the announcement by the Swiss National Bank that it will not tolerate an exchange rate below 1.20 for the CHF against the Euro, and the Swiss Franc almost instantaneously dropped from 1.10 to the 1.20 level. The CHF is currently trading at 1.2160 against the Euro.
- While the SNB did not mention the USD, the CHF also immediately dropped from 0.78 to 0.86 against the US Dollar, and is currently trading at 0.88. We believe that the SNB will stick to its word and will not allow the EUR to drop below the 1.20 level against the CHF, and that the CHF will hover around that level as long as the Euro area problems remain.
- Higher yielding currencies, such as the AUD and NZD were strong this week, as lower than expected inflation in china decreased speculation that the Chinese will take more actions to cool their economy.

Fixed Income

- US Treasuries are roughly flat for the week, having risen in the beginning of the week on lower appetite for risk but then dropping back to the level at the close of last week. US 10yr is yielding 1.99% currently, the 2yr is at .189% and the 30yr is at 3.32%.
- In Europe, yields on German 10yr and 2yr bunds dropped to record lows amid concerns global growth is slowing, and as the ECB signalled it may take further steps to fend off the region’s worsening debt crisis.
- The German 10 year yield dropped from 19bps this week to 1.818% currently, while the 10yr French bond shed 22bps to 2.53% as we write this.
- Meanwhile the sovereign crisis only intensified this week, with the yield on 10 year Italian bonds up 7bps to 5.317%, while the 2yr Greek bond declined, pushing the yield up to 55.77%, after having reached a record high of 55.84%.
- It increasingly looks like Greece will default, and really it is a matter of when rather of if. CDS prices now indicate that the changes of a default are 91%...
- Corporate bonds performed ok this week, with investment grade corporate up almost 1% for the week. However, higher yielding securities underperformed, with US high yield bonds up marginally for the week while European high yield corporate down by more than 1% for the period.

- European credit markets are suffering more than other regions because of the regions sovereign debt issues. Certain European banks are struggling for their funding needs, and this is reducing the appeal of high yield corporate bonds.
- A positive sign nevertheless is that this week saw the highest issuance of corporate bonds since May, as measured by Bloomberg.
- Again we reiterate our preference for high yield corporate bonds as well as Emerging Market Corporate bonds versus other types of issuers in the fixed income arena. The corporate sector is extremely healthy, has tons of cash on hand, and most companies will be able to withstand slowdown in global economy and the Euro zone's sovereign debt crisis.

Equities

- Global equity markets are down for the week. The MSCI World as of yesterday's close is down 0.5%, and European markets are down by over 1% as we write this. For the year to date, the MSCI World index is down 8.6%.
- European stock markets underperformed significantly this week, with the Euro Stoxx 600 down 2% while the S&P 500 index is up 1% as of yesterday's close. This is also the case for the year to date, with the European market down 17% while the S&P 500 is down 5.7%...
- Financials continue to weigh sharply on European bourses, as the risk of contagion grows. The Euro Stoxx 600 is down 21% from its highs reached on February 17th, and is trading at 9.5% of its estimated earnings of its companies, near the lowest valuation since 2009.
- Indeed, some valuations are getting quite ridiculous, with Air France trading at a level below the value of its airplanes fleet and Accor at lower levels than the value of its hotels…
- Corporate news was tilted to the negative as Volkswagen abandoned its planned merger with Porsche, Yahoo's CEO was fired and BofA shuffled around its management team, while Zynga and Groupon pulled back from going public this month.
- In the US, stock markets did slightly better but were not inspired by Obama's Thursday speech on jobs, as the markets dropped following the speech. It looks like markets are waiting for concrete actions to move higher.
- In terms of sectors, energy and information technology were the best performers while financials continued to underperform.
- We believe that equities do offer a lot of value, but for the near term we believe that markets will remain volatile given a very challenged macro backdrop and very inconsistent policy actions around the globe.

Emerging Markets

- Emerging markets equities underperformed their developed counterparts this week, with the MSCI EM index down 0.8% versus 0.4% for the developed index as of yesterday's close. For the year to date, the EM index is down 12% versus 8.6% for the developed index.
- Emerging market stocks suffered from concerns over a global slowdown. In terms of region, Asia EM was the worst performer, with the MSCI Asia EM down 1.3%, then Latam down 0.3, then Europe EM up slightly for the week.

- While Latam stocks overall also declined on concerns over global growth, Brazilian stocks rose nicely, with the Bovespa up 1.93% for the week, bringing the gains for the Brazilian index to 20% since its lows for the year reached on August 8th.
- Separately, the BRL continued to weaken, from 1.59 versus the USD at the close of last week to 1.66 currently.
- Asian currencies also dropped, with the ADXY index, which measures a basket of Asian currencies against the USD, dropping from 119.60 to 118.65 currently.

Commodities

- Commodities gained this week, with the S&P GSCI broad index up 1.3%. Once again performance varied significantly depending on the type of commodity.
- Energy continued to rise with the GSCI Energy index up 2.3% for the week. The positives for oil continue to be mostly supply driven, with this week's storm in the Gulf of Mexico adding to concerns over supply, but Obama's jobs speech also may herald some increase in demand.
- Gold moved big time this week, starting at $1880 an ounce, moving to a high for the week of $1921, then moving sharply lower to $1793 only to come back to $1880 and falling back down to $1837 currently! We believe that gold is priced too richly and would not recommend buying gold at these levels.
- Finally industrial metals were up slightly for the week while agricultural commodities were down slightly.
