## Friday, November 18th 2011

The weeks pass. Much is happening everywhere and yet, these passing weeks resemble each other. Every day is volatile; every sector of the markets is volatile and most instruments therein are moving in broad swings. And yet, the whole seems to be trading in a rather narrow band; US 10 year Treasury Notes are yielding 2.00%, the S&P 500 is at 1'216 or barely 3% off its level at the end of 2010. The US$ is at 1.354 vs. the Euro, within a fraction of where we started the year. Gold and Oil are clearly up, so should we expect these two to "revert to the mean" and drift down?

We are submerged with data; The US Producer Price Index was negative 0.3% for October wit Industrial Production edging up 0.70%, then the CPI was down. Germany tells us that they have some inflation, the US measures employment and suggests that the worst may be over on this front. We have our doubts about the validity of all this data; We are still awaiting an explanation of Germany's windfall discovery of Euros 55 billion of debt disappearance, where are the 600 million of MF Global's cash shortfall? How can the CPI decline when we see prices rise? Oil traded through $100/Bbl this week, will the next CPI data show a rise? We recall the Greek deception of the world in connection with their National Accounts, just like Enron some years back. Last week's Economist gave us an interesting question to ponder- The Global Trade imbalances don't add-up! When all the reports are added up, we must be exporting to Mars or some other extraterrestrial destination, as the World has a Trade Surplus. Believe it if you wish, or become cynical like us and question the official data reported. We are not suggesting that we are being lied-to intentionally, nor do we suggest some conspiracy to trick the people. It is likely poor controls over information. Then, why do we wonder when the markets swing one way or another as data is published?

Oh, yesterday the House of Representatives passed a funding bill which assures continued funding of the Government until December 16th. Let's not get excited quite yet, the Senate must ratify…

On our side of the puddle we have Mario Monti, a non-politician trying to resolve Italian politics. We have another Mario now running the ECB and perhaps with Italian technocrats running the show some order will come back into our world. Almost an oxymoron, or is it?

The true motor of this week's turbulence have been interest rates on European Sovreign debt- Spanish ten year yield reaching the mythical 7% level like the Italians, then French yields edging upwards to new all time wide spreads to the German Bund at 200bp. Maybe last week's S&P's slip on a French downgrade wasn't a "slip"?

We must end this letter with a quote from Albert Einstein who said "*We can't solve problems by using the same kind of thinking we used when we created them.*" Have a fine weekend!

# Bedrock Newsletter

---

### Currencies

- Yet another eventful week in Europe. On the political front, Greek PM Lucas Papademos won a confidence vote in Parliament, as expected, and new Italian PM Mario Monti unveiled his cabinet and outlined the government's ambitious programme. However, early hopes that new political leaders in both Italy and Greece could help implement the necessary reforms to end the region's debt crisis were overshadowed by fears that the euro zone was sliding back into recession. More importantly, tension in the sovereign debt market took on a new dimension as non-German AAA-rated sovereign bond spreads widened notably.
- Consequently, the Euro tanked this week, and the USD and JPY gained. The common currency dropped from 106.10 against the JPY to 103.95 currently. Against the USD it dropped from 1.3750 to a low of 1.3422 but has since gained back a little as speculation that the US Fed will come up with more stimulus measures grow. The EUR is now at 1.3540 against the USD.
- The Euro is slightly lower for the week against the GBP, at 0.85470 currently and is roughly at the same level week over week against the CHF, at 1.2360 currently.
- The CHF, which essentially is pegged against the Euro, is now trading in sync with the common currency. It dropped against the USD from 0.8995 at the beginning of the week to 0.9134 currently and from 85.72 against the JPY to 83.97 currently.
- The USD gained roughly 1.5% this week, as measured by the Dollar Index, with the greenback benefiting from the "risk off" environment. The Japanese Yen was also a major gainer this week, even rising against the USD. The JPY went from 77.20 at the beginning of the week to 76.65 against the USD.
- With the risk off move, higher yielding currencies, such as the AUD and NOK, declined. Asian currencies also declined.
- Our view is unchanged. The environment is extremely troubling and we expect the Euro to remain under pressure while the USD should benefit from the very negative market sentiment. At this stage we do not recommend adding currency risk.

---

### Fixed Income

- US Treasuries are set for another weekly gain as the drama unfolding in Europe increase the demand for the safety of US government bonds. Yields on US 30-year bonds dropped 11bps to 3.020% currently and on 10-year securities, yields dropped by 7bps to 1.991% currently.
- In Europe, the sovereign debt crisis intensified further. The yield on Spanish 10-year bonds surged this week, crossing the 7% mark at one stage after the Spanish Treasury issued €3.6bn of 10-year bonds at an average yield of 6.975 per cent, their highest level since 1997 and one regarded as unsustainable.
- Separately, the premium demanded by investors for 10-year French debt over German Bunds – a measure of perceived risk – exceeded 200bp, another new Euro record…
- But since the lowest point on Thursday, yields have come back down to less dramatic levels as heavy buying by the ECB has eased tensions somewhat. Yields on Italian 10-year bonds are at 6.674% and on 10-year Spanish bonds at 6.694%.

- Meanwhile French 10 year bonds are yielding 3.50%, a premium of roughly 170bp over German bunds.
- The sovereign debt problems are clearly spreading into credit markets now. The 5 year US Swap spread has widened to 47 bps, while the cost to insure eurozone debt against default has soared to record highs for most of the leading economies. The jump in credit default swap prices has come as the extra cost to swap euros for dollars has jumped to highs last seen in December 2008 when many markets had seized up in the wake of the collapse of Lehman Brothers....
- Given the tensions clearly spreading to credit markets, corporate bonds declined this week. Investment grade bonds are down 0.3% for the week while higher yielding ones are down 0.5% as measured by the BarCap global bond indices.
- Meanwhile, indices of credit default swaps on corporate both in the US and in Europe are rising...
- Still our view is unchanged. The corporate world is extremely healthy, defaults are expected to remain at very low levels, and therefore, with the decline in value, corporate bonds, especially higher yielding ones seem very attractive.

---

**Equities**

- Global equity markets are down big time this week. The MSCI World is down 3-55% as of yesterday’s close, with declines in all of the 4 days of this week, and European markets down as we write this. The culprit is clearly the European crisis, which overshadowed some moderately good macro data this week.
- American markets and European ones are down largely the same this week. The S&P500 is down 3.8% as of yesterday’s close, while the German Dax and British FTSE are down 3.8% and 3.5% respectively as we write this. French stocks took a bigger hit, the CAC down 4.5% as the yield on France debt rose to troubling levels.
- The Nikkei 225 is among the best developed markets this week, down 1.6%, after Japan’s Q3 GDP came in at 1.5%, an annualized 6% growth rate. But this is really more an adjustment after the disruptions caused from the earthquake and tsunami in march of this year.
- YTD markets are well in the red. The MSCI World index is down 9.2%. The S&P 500 is down 3.3% while European bourses are down 15%, as measured by the Euro Stoxx 600 index. The only major index in the green for the YTD is the Dow Jones Industrial average which is up 1.7%.
- Looking at sectors, cyclical continued to underperform this week. Materials and financials are down by more than 5% for the week as measured by the corresponding MSCI indices. Energy, consumer discretionary are down nearly 4% in the period.
- Conversely, defensive sectors continue to outperform. Consumer staples and healthcare are down “only” 2% for the week, with these sectors the only ones in the green for the YTD.
- We continue to find equity valuations extremely attractive, despite lower growth prospects. However, given the massive risks from the euro crisis, we do not recommend adding any risk at this stage. The situation is binary, and while we do not expect a collapse, such a possibility is now large enough to warrant caution.

## Emerging Markets

- Emerging Markets equities declined this week, but for once in a long time, by less than their developed counterparts! The MSCI EM index is down 2% vs a decline of 3.55% for the developed index. Still YTD, EM stocks are down 17.3% vs a decline of 9.2% for the developed index.
- Performance varied by region this week. As we write this, the Bovespa is down 1.6% for the week, the Shanghai Composite down 2.7%, India's Sensex is down 7%, while Russia's Micex is down 3.4%.
- Here the moves were driven by the lower appetite for risk and on risks of a global slowdown from the EU crisis.
- In China, banks led the decline after new home prices fell last month in some cities including Shanghai and a person with knowledge of the matter said China's banking regulator warned lenders that some projects backed by local governments may run out of funds.
- Meanwhile, EM currencies continued to drop versus the US Dollar. Asian currencies are down nearly 1% against the USD, as measured by the Asia Dollar Index. The Brazilian Real dropped from 1.7616 at the beginning of the week to 1.7740 currently, while the South African Rand went from 7.9365 to 8.2135 currently against the Greenback.
- EM bonds declined as well this week on the lower appetite for risk. This despite Brazil being upgraded by S&P this week, the third major credit rating agency to upgrade Brazil, given the country's strong finances and prospects. And so now, Brazil's 9 year bond yields around 10bp less than does the French 10 year benchmark....
- Our view on EM assets are unchanged. While EM economies will undoubtedly be affected by the slowdown in Europe and in the US, these economies overall are in a much healthier state than going in 2008, and in much better shape than developed economies. Asset prices are not reflecting that but we believe these ultimately will. As such, we maintain our exposures to EM equities and EM corporate bonds, as well as our CNY positions.

## Commodities

- Commodities are down 1.85% as measured by the S&P GSCI broad commodity index this week. All commodity sectors are down this week, but by different magnitudes.
- Industrial metals are down the least (-1.5%) for the week, followed by energy (-1.67%). Both of these declined on concerns over global growth, but the drops were partially offset by supply concerns, especially in oil.
- Agriculture is down 3.26% for the week.
- The biggest loser was precious metals, down 4.5% for the week. Gold dropped from $1788.67 an ounce at the beginning of the week to $1728.13 currently.
- We remain constructive on oil given supply/demand dynamics and on gold, which should continue to find support as global central banks provide liquidity to markets.

# Bedrock Newsletter

**Disclaimer**