# Bedrock Newsletter

## Friday, January 6th 2012

The year 2012 started well for the markets as all equity and commodity markets rallied quite strongly at the start of the year, thereby continuing a move that started in the last 10 days of December. What was unusual is that the USD rallied also, even with higher equity markets, which may finally show that a break of the silly correlation (higher equities = lower USD) might be on the cards. And it should! The economic figures coming out of the US keep on surprising on the upside (yesterday ADP report was a perfect example) and China’s figures came out better than feared (Chinese PMI came out above the 50 mark). Oil rallied, flirting with the 104$ on the WTI, on ever rising tensions between the West and Iran and Gold roared up by a 100$ in the space of 5 days.

So where does this leave us for 2012? Well, on a first macro note, we are pleased to see that our long held view of the rising Emerging Countries economic power has been proven right as it has just been published that Brazil passed now in front of the UK in terms of GDP, thereby climbing to the 6th place... not bad for a country which was in the worst of conditions only 10 years ago... we now have China as the number 2 and Brazil as number 6th in terms of GDP weight. This proves us that growth in those countries will continue and that we should stick with investments in those places. Then, the US is clearly recovering and finally growing more than just at a lacklustre pace. We should continue to favour US equities and the US dollar.

Europe? Definitely a place to avoid as the risk of a big erosion of the value of the EUR is big, and that the debt woes will continue to weigh heavily for the European economies. Switzerland should continue to see a weakening of its currency as deflation is clearly happening and that the economy is on a downward path.

Commodities should shine this year with Gold benefiting from money printing in all major developed countries as well as further easing in monetary policy in emerging countries, and Oil continuing to price further tensions with Iran as well as supply disruptions

Fixed income might be a challenging place this year, with US long term yields potentially reversing to the upside if the US economy gains traction and if expectations of an abrupt change of monetary policy by the Fed takes place... in Europe, if the governments and the ECB finally deliver on QE, we might see lower interest rates in Sovereign European countries and lower spreads. High Yield spreads should contract, thus producing very decent returns for 2012.

What is sure is that we should again brace for volatility and continue to favour a broad diversification among asset classes

Have a very good year 2012 and a restful week end

## Currencies

- Market activity in the first week of 2012 was very similar to what happened over the course of last year. Some modestly positive macro data in certain pockets of the world and an improvement in the US employment picture were trumped by the continued deterioration in the euro zone crisis.
- The two major gainers this week were the Japanese Yen and the US Dollar, the two traditional safe haven currencies. The Dollar Index, which measures the performance of the USD versus a basket of its major counterparts, gained 0.8% for the week.
- The Euro dropped sharply this week as the European sovereign debt crisis deteriorated further. Italian, Spanish and French yields rose this week while Investors worried over the ability of European banks to raise much-needed equity after UniCredit suffered a steep share price fall this week, rattling the group's planned €7.5bn rights.
- And so, the Euro went from a high for the week of 1.3077 against the USD to a 15 month low of 1.2764. The common currency dropped to an 11 year low against the Japanese Yen to 98.48.
- Meanwhile, the British Pound gained against the Euro, reaching a 15 month high of .8240, as data showed overseas investors boosted their UK government bond holdings by the most in three years in November. The GBP however was slightly down for the week against the USD, from 1.5540 to 1.5505 currently, and is flat against the Japanese Yen trading currently at 119.50.
- The Swiss Franc was stable against the Euro at 1.2180, as it is essentially pegged against the common currency, but declined against the US Dollar from 0.9380 at the beginning of the week to 0.9550 currently. While no major economic news emerged this week, the central bank head is currently facing calls to resign following dubious currency trades by his wife.
- Higher yielding currencies, such as the AUD, CAD and NOK are roughly flat for the week against the USD. These rose in the first part of the week on better manufacturing data out of China and India, and optimism on the US economy, but then reversed in the second part of the week as the Euro crisis trumped the better economic releases.
- Not surprisingly the Euro crisis continues to drive currency markets. Our view is that the Euro will head lower. Either policy makers are too slow and we see a very nasty situation, or significant easing occurs which will weaken the Euro. As such, we recommend reducing Euro exposure and favour the USD in these times of crisis.

## Fixed Income

- US government bonds declined this week on speculation the US economy continue to add jobs, damping demand for the safest assets. Yields on US 10 year bonds rose by 12bps this week to 1.995% currently and on 30 year securities yields rose by 17bps to 3.067%.
- In Europe, the sovereign debt crisis deteriorated further with borrowing costs for France, Spain and Italy rising sharply as large government bond sales loom. Yields on French 10 year bonds rose by 25bps and on Italian 10 year bonds by 13bps this week, back above the 7% mark... However the yield for 2 year Italian securities dropped by 10bps to 4.878% this week.
- Spain was the worst hit this week after the new government signalled that the budget deficit in 2011 would be higher than previously estimated and as it expects its banks to set aside up to

€50bn in further provisions on their bad property assets as part of a new round of reforms for the country's financial sector. Spanish 10 year yields rose by 63bps this week to 5.617% currently and by 59bps to 3.612% currently for 2 year bonds.

- German government bonds also declined this week as European consumer confidence fell and as retail sales fell in Germany. The yield on 10 year bunds rose by 5bps this week to 1.875%.
- Despite the continued deterioration in European sovereign bonds, credit markets gained this week on better macro data in the US and Asia and possibly as valuations attract investors. US High Yield bonds are up 0.7% for the week while European HY is up 1.3%.
- Elsewhere in the fixed income arena, the US mortgage market was roiled by speculation that the Fed may boost efforts to aid the housing market. Consequently, Fannie Mae and Freddie Mac mortgage bonds that guide home-loan rates gained while those backed by high-cost debt declined.
- We remain keen on corporate bonds in general. While the macro backdrop is very difficult, the corporate world is healthy, defaults should remain at very low levels, and therefore corporate bonds, especially higher yielding ones seem very attractive.

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**Equities**

- Global equity markets are up for the first week of the year. The MSCI World index is up 1.2% as of yesterday's close. The positive performance comes mostly from a sharp rally in global equities on Tuesday, following better macro data from China. Since then markets have moved lower as investors focus more on the deteriorating European crisis.
- European and American bourses are up roughly 1.7% as we write this. The S&P 500 is up 1.9% as of yesterday's close and the EuroStoxx 50 is up 1.7% currently for the week. Japan however is down -0.8% as measured by the Nikkei 225 index.
- Within Europe, there are already sharp differences in performance by country. The German DAX index is up 4% for the week, but Spain's Ibex 35 is down 2% and Italy's FTSE MIB index is down 1.6%....
- In terms of sectors, Materials and Technology are outperforming broad markets so far this week while consumer staples, utilities and health care are lagging. But really this is mostly due to the sharp rally on Tuesday, where higher beta sectors saw sharp gains. But these are already reversing...
- Financials were higher early in the week but have started to fall. We advise caution on financials, especially on European financials given the sovereign debt crisis.
- We find equity valuations attractive and the corporate world is quite healthy. However, the macro backdrop is extremely challenging, and there are very fat tails should the Euro crisis turn into something even worse than it already is. As such, we maintain our current equity allocations, but we are buying some put options in order to protect against an adverse decline.

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**Emerging Markets**

- Emerging Markets' equities are up 1.75% for the week as of yesterday's close, as measured by the MSCI EM index. This is better than developed markets, and likely due to EM equities responding with more juice to the better macro data out of China and India this week.

- The best performing region was Latin America, up nearly 3% as measured by the corresponding MSCI index. Here equity markets were boosted by the strong performance of materials stocks, and also boosted by news that Brazil has become the $6^{th}$ largest economy in the world, bypassing the UK.
- Meanwhile, Asia was up roughly 1.7% for the week, while EM Europe was up 1.5% as a whole. However, performance varied by country. Russia was up 4%, thanks partly to higher oil prices. However, Hungary was a clear underperformer given the turmoil happening in the country.
- EM bonds were positive overall and EM currencies gained versus the USD slightly this week. Asian currencies on the whole were flat against the USD, but the BRL gained, from 1.8635 at the close of 2011 to 1.8430 currently.
- Our view on EM assets is 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 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.

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**Commodities**

- Commodities rose by 2.5% this week as of yesterday's close as measured by the S&P GSCI broad commodity index. As is often the case, performance varied strongly by type of commodity.
- Energy was the biggest winner this week, up 3.7% as measured by the GSCI corresponding index. Crude oil gained 5.7% this week, from $95.2 a barrel at the close of 2011 to $101.8 currently. Here, better manufacturing data out of China and employment data out of the US helped on the demand side while concerns over the Middle East and especially Iran led to concerns over supply...
- Precious metals were also very strong this week. The GSCI Precious Metals index is up 3.6% as of yesterday's close. Gold gained 3.85% and silver is up 5.75% for the week.
- Meanwhile, industrial metals are flat for the week while agricultural commodities are down 1% for the week.
- 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.

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