Bedrock Newsletter

Friday, February 24th 2012

It is Friday again…Equity markets remained on their upwards trajectory set in January. The Dow Jones Industrial Average traded briefly through the mythic 13'000 level on Tuesday and has been gyrating just below since. In 2007 the DJIA crossed through this level and then in 2008 broke through in the other direction. Are we like 2007? Treasury yields are steady with ten year notes hovering around the 2% yield whilst lower grade bonds are tightening-in generating pleasant capital-valuation gains.

The word "Goldilocks" has resurfaced in the lingo of articles and talk shows. A Goldilocks economy with no inflation, low interest rates and a reasonable if unexciting growth rate. Others are saying that for the same reasons it is a Goldilocks market, as there is a wall of liquidity seeking a home. Well, when we think back to the fairy tale, we remember that there were four bears at the table with the little blond…

Then, there is the European situation which whilst not resolved seems to have stabilized-The Euro is leading the way, rising to 1.34 vs. the US$, or is it the US$ which is losing ground (as it should if the US economy is reviving)? See Gold and Oil rising, in US$ terms.

The loudest noises in the media are no longer Greek or in other European dialects. The noises are in Iranian and Hebrew. Two ancient and hardly understandable languages and we must rely on translations of the words emanating from either Netanyahu or Ahmanadinejad. Quite ominous as they are centred on nuclear arms, missiles and other nastiness. That much we and the oil markets have understood. Oil has risen beyond $108/Bbl in response to increased risks of supply disruptions and in spite of last week's assurances from a Saudi Prince that the said Barrel will not trade through $100!? Will oil prices be the next brake on economic growth? Let's hold-on to our long oil positions as a hedge, just in-case…

Strangely, the VIX index (viewed as a measure of risk perception) is falling, now trading below 17. Perhaps the money-weighted interpretation of the Iranian conundrum is less severe than that of news-people? Maybe the "truth" behind the rise of oil prices emanates from the simple, Keynesian equations of supply and demand? The latter, clearly rising…

Then we have been graced with conflicting views on the state of the US housing markets. Some say the bottom has been reached and that prices may well soar from here whilst others show analysis whereby the stocks will weigh down prices for another generation. Some show housing affordability to be at a high level, others showing a significant rise in rental activity and interest. Perhaps the US legislators should consider imposing in the US the concept of "recourse", whereby borrowers are personally liable for any collateral shortfall? In most modern societies, it is the norm. It is difficult to stick the lenders with our failed bets…

We will leave you with a thought about the voting for austerity in many countries, the political talk about raising taxes, delaying retirement… Remember that Turkeys don't vote for Christmas… Enjoy your sunny weekend!

Currencies

- The EURUSD pair stayed in a very narrow range for the first 3 days of the week, between 1.3200 and 1.3300 before breaking to the upside and reach 1.3380. Even though the Greeks were awarded a second bailout and a "lifeline", we fail to see how this Greek tragedy will end in a happy way. We believe that the deal only bought the Greeks and the world some time before we will witness again the same kind of events and news that we have seen for the past 2 years. And if Greece is now staying in the Euro as are the other peripheral countries, the only way back to prosperity will then be by a lower EUR and not a higher one. So we view this move up as temporary in nature and we continue to believe that every rally should be sold.
- The other big mover of the week was the JPY. Finally, patience was rewarded as the Japanese currency continued to weaken sharply, reaching a low of 80.65 against the USD and 107.85 against the EUR. Since the beginning of February, the Yen has lost 6% against the USD and 9% against the EUR! Of course, we believe that this move is far from over, although in the short term, it will need to pause. The BOJ finally appears to want to tackle the strength of the JPY seriously and seems eager to take action to weaken it more. The first reaction is that Japanese equities have shot up as the Nikkei Index is up by 15% since the low point reached in mid January.
- Although the mood was more "risk on" following the Greek deal, we saw the Swiss Franc strengthening both against the USD and the EUR. We believe that the Swiss do have the same problems as the Japanese and that they will do whatever it takes to defend the EURCHF floor at 1.2000. We also think that the Swiss economic figures do warrant a weaker currency. As such, we remain bearish on the CHF.
- GBPUSD started the week on a strong note, rising to 1.5880 against the USD, before the minutes of the MPC (Monetary Policy Committee) that were released on Wednesday showed that two members of the committee wanted more QE than the £50 billion increase that were agreed. The GBP plunged to 1.5650 before rebounding a bit today above 1.57.
- The CAD had a good week due to higher oil and gold prices, but the AUD had rather a weaker tone due to the resignation of Ken Rudd as foreign minister and a potential political fight as well as a mixed message concerning monetary policy from the Reserve bank of Australia.

Fixed Income

- US Treasuries activity was very quiet this week, with the only significant move being the US 2 Year yields slightly rising for the fourth consecutive week to finish at 0.301% (+1 bps). Otherwise, the US 30-year and the US 10-year stood still, standing at 2.003% and 3.144% respectively.
- On the European front, the biggest yields' drop were observed in Spain (-18 bps at 5.022%), and in Italy (-8 bps at 5.457%), stimulated by a better economic outlook and keeping on a positive momentum after the success encountered by both countries debt issuances last week.
- UK rates also dropped quite significantly over the week (-10 bps at 2.085%), as the Bank of England expanded its asset-buying program by 50 billion pound and kept its benchmark rate at a record low 0.5% this month after the economy contracted in the fourth quarter.
- Meanwhile, Portugal saw the biggest yield's increase among the Euro zone (+60 bps at 11.973%) a week after the country disclosed record unemployment figures at 14%.

- This week, EU High Yields were the best sector among global debt rising by 1.65%, while other strong performing sectors included EM Debt (+0.98%) and US High Yields (+0.76%). Otherwise, EU Corporates (+0.48%) slightly outperformed US Corporates (+0.52%), while EU Sovereigns (+0.36%) outperformed by far US Government debt (+0.08%).

Equities

- Global equity markets have increased for the week, with the MSCI World rising by 0.49% as of yesterday's close. Markets have rallied rather modestly, as the Euro zone's PMI composite figures showing signs of contraction outweighed bullish indicators on German business confidence and what seems to be a sustainable lower rate of Jobless claims in the US.
- The EuroStoxx 50 rose by 0.25% this week, shrugging-off news of Euro zone finance ministers securing a second bailout for Greece. Investors seem to view the current package as just another can-kick and are awaiting news of a more sustainable solution for the EU debt crisis.
- The S&P 500 rallied 1.51% as of yesterday's close. US shares have rallied due to stronger employment and confidence data, while a strong rise in Existing home sales was offset by an equal downward revision of the preceding month. Uncertainty still remains a dominant factor in the US, as volume in the markets have reached record lows and only 20% of the companies who have reported earnings, have issued guidance for 2012,
- The Nikkei rallied 2.80% this week reaching a 6 months high. The continued weakening of the Yen has provided strong support for Japanese equities with hopes that the depreciation will finally stop diluting company earnings. The Nikkei has rallied close to 16% since mid January.
- In terms of sectors, Material and Energy stocks led the gains this week, while Real-Estate, Utilities and Financials lagged. Financials in the EU are showing a strong sign of contraction with reports of HSBC withdrawing from Consumer Banking in Japan and from several EM countries, as well as weak earnings reported for Credit Agricole and Lloyds.
- Although we remain keen on equities for the year 2012, we feel that the rally has been quite sharp in a very short time span, and as such, we feel there might be a correction coming soon.

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Emerging Markets

- Emerging Markets' equities are down 0.30% for the week as of yesterday's close, as measured by the MSCI EM index. EM equities have been underperforming for the month but still leading against their developed counterparts for the year (+15.59% vs. +9.45% respectively).
- The best performing region was Latin America, down by 0.03% as measured by the corresponding MSCI index, followed by Asia (-0.49%) and Emerging Europe (-1.07%).
- The Shanghai Composite rose 3.50% for the week, as China's central bank cut the reserve requirement ratio by 50 basis points which is expected to free up to Rmb400bn for new lending. The central bank move has been done to combat the slowdown of the Chinese economy. According to Chinese manufacturing data released this week, the Manufacturing

sector has contracted in February for the fourth straight month, with a sharp drop in new export orders.

- The Brazilian Bovespa gained 1.20% this week as of yesterday's close. Slower Brazilian inflation boosted the outlook for sellers in the local market, and higher commodity prices supported producers.
- Our view on EM assets is unchanged. While EM economies will undoubtedly be affected by a slowdown in Europe and in the US, these economies overall are in a much healthier state than developed economies. Valuations seem more attractive in the Emerging world with a PE ratio of 12.15 on average for the MSCI EM compared to 14.32 for the MSCI World. Therefore, we maintain our exposures to EM equities and EM corporate bonds, as well as our CNY and SGD positions.

Commodities

- Commodities rose by 3.11% this week as of yesterday's close as measured by the S&P GSCI broad commodity index. All segments of the index have had positive returns for the week.
- Crude oil was the biggest winners this week, up 6.12%(!), while Agriculture increased by 0.74%
- Gold rose by 3.15%, currently trading around $1'780 an ounce. PM traders are the most bullish in two months on speculation on strengthening worldwide demand, and reports on metals stockpiles being at a 2.5 year low. Gold is expected to continue to have a bullish bias, as investors will continue to seek diversification away from European instability.
- Crude Oil rose this week, and is now trading at $108.30 a barrel, as events surrounding Iran deteriorate further. Iran has declared that it shall cut oil supplies to France and the UK. Also, the US has reached a basic agreement with Japan, and is in current talks with India, on agreeing on an alternative line of supply, which will dramatically isolate the Iranian regime economically.
- We remain constructive on oil given supply/demand dynamics as well as Middle East tensions, and on gold, which should continue to find support as global central banks provide liquidity to markets.
