Bedrock Newsletter

Friday, May 9th 2014

We are Friday again. An agitated week- Putin backing-down somewhat on Ukraine, stock markets still punishing recent darlings (High tech, internet and biotech), bond markets surprizing everyone with high prices (low yields) and interesting gyrations in the currency markets. Here are some observations- The European Central Bank says capital flight from Russia since the Ukraine crisis erupted may be four times higher than admitted by the Kremlin, a clear sign that sanctions pressure is inflicting serious damage on the Russian economy. Mario Draghi said that the outflows from Russia have been large enough to push up the euro exchange rate, complicating monetary policy for the ECB. “We had very significant outflows that have been estimated by some to be in the order of €160bn out of Russia”. This capital flight may well explain Putin’s about-face on Ukraine… Then we saw a classic compression-of-time effect- Mario Draghi has primed investors for action next month. With the threat of deflation still stalking euro-area economies that are barely out of recession, the European Central Bank president all but committed himself to providing further stimulus at June’s monetary policy meeting. After keeping rates at record lows today, Draghi told reporters that the 24-member Governing Council is “comfortable with acting next time.” He underscored that position with comments showing a heightened concern that a rising euro will depress prices and derail the recovery. “The strengthening of the exchange rate in the context of low inflation is cause for serious concern.” Just believing that the ECB will reduce rates, the Euro fell from a 2 1/2 year high, dropping to as low as $1.3849 from $1.3993 and today the Euro dropped further against the US$ to 1.3811. The power of the spoken word in this connected world is amazing…

Other economic data flowed inexorably all week- government data showed on Thursday that China's exports and imports rose in April from the year-ago period, defying expectations for a dip in both figures. Exports climbed 0.9 percent on the year in April, much better than the 1.7 percent dip a Reuters poll had predicted and versus March's 6.6 percent fall. This brought the trade surplus for the month to $18.5 billion, more than double the $7.7 billion in March.
On Monday the ISM (USA) said that its index of national factory activity rose to 54.9 in April, up from 53.7 in March. It was the best reading since December. The report beat analyst expectations although the index remains below November's recent peak of 57, which was the highest since April 2011. On Tuesday, the OECD cut its global growth expectations from its November outlook from 3.6 percent to 3.4 percent for 2014- however it kept its forecast for 2015 at 3.9 percent. It expects growth across its 34 member countries to come in at 2.2 percent in 2014 and 2.8 percent the following year. Then France's finance minister called for a debate about the strength of the euro, as the currency neared a seven-week peak against the U.S. dollar on Tuesday. The euro zone currency hit $1.3944 on Tuesday, a smidgen off its year-peak of $1.3965, reached in March. Since the start of the year, the euro has risen 1.37 percent against the dollar, and it is 5.67 percent higher versus the greenback since the start of 2013. We at Bedrock had expected for some time now that the threshold for ECB action is situated at 1.40. We missed- Draghi spoke at 1.3993, ‘And The Rest Is History’ as they say…
2014 was supposed to be the year of the dollar, a breakout for the currency. It was a no-brainer—the U.S economy was outperforming developed markets like Europe and even emerging markets like China and India. The Federal Reserve was finally starting the "taper", or scaling back the massive, unprecedented amount of easy money that diluted the dollar's value. At the same time, central banks in Japan and Europe are looking to ease further. For all of these reasons, strategists from JPMorgan Chase to Morgan Stanley to UBS predicted 2014 would kick off with a stronger dollar. But so far, the trade has gone in the opposite direction. The dollar index—a measure of the currency against a basket of its global competitors—is trading below the critical 80 mark, the lowest level since last October. The euro soared to a seven-week high, and the British pound is hovering at the highest point since August 2009. Why? One factor is the surprisingly low Treasury yields; the dollar tends to track yields, especially the dollar-Japanese yen trade. Another reason that traders cite is a strong demand for European assets, particularly debt of euro zone periphery nations including Spain and Italy.

We would like to close our News with a peek at the Scriptures- The S&P 500 was up in 15 of the last 17 Tuesdays of 2014. Tuesday is the “Doubly Blessed Day”, as per the story of Creation… Believe this if you so wish, but remember that “A casual stroll through the lunatic asylum shows that faith does not prove anything”. Friedrich Nietzsche

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<u>Core View</u>: The world's economies are mending from the fallout of the "Great Recession". The economics are settling back into a reasonable growth pattern and stability is expected to continue. As the Federal Reserve is slowly reducing its stimulus (QE), the Bank of Japan is increasing its own; the European Central Bank is expected to press on the accelerator. As a group, most Central banks are targeting an elusive 2% inflation rate. As the industrialized economies are running with excess labor and industrial capacity, the return of inflation appears to be distant- Short term interest rates are unlikely to rise anytime soon.

Volatility as a measure of risk is low in bonds, FX and equities.

- **Fixed Income -** The Fixed Income world is dealing with low yields and investors are struggling with accepting low inflation. As all Central Banks are seeking somewhat higher inflation than they have, it is hardly reasonable that they raise rates! With the ECB's talk of further easing it is likely that Europe will embark on large scale QE in the not too distant future, a la BOE and FOMC – The strong Euro contributes to low inflation in the zone and the ECB wants inflation to rise somewhat!? In conclusion, we see no need to worry in the short term about rising rates. But do keep an eye on the horizon as rates will eventually start pointing towards the sky, if and when inflation rears its head. No immediate threat though- In Japan, the BOJ has not succeeded in over 20 years!

- **Equities –** With PE ratios around the globe at historically reasonable levels (+-15X) and Q1 earnings having come in mostly ahead of expectations, we feel secure in owning equities. The caveat here being that the markets appear to have lost some of their enthusiasm for tech, internet and biotech companies, switching their focus to the large cap industrials and energy related businesses. Consumption around the globe is still expanding (albeit slowly) which should mean a positive environment for cash-flow growth… so at sensible PEs and positive cash flow growth, equities would seem like a fair choice for the year ahead. We remain positive and recommend exposures to be maintained or raised using global, diversified funds.

- **Alternatives -** In a normalizing financial-world, with new-found economic stability and a clearing horizon, fundamentals are returning to base text-book relative values allowing traders and investors to take views and positions. We expect this active management allocation to maintain if not exceed its recent results- similar to equity returns but with low correlation to any sector, with about 10% per annum, albeit with significantly lower volatility than equities. We maintain our recommendation for about 20% allocations to this asset-class whilst acknowledging the disappointing results YTD.

- **Currencies -** The market still has very low volatility relative to the last 5 years and the Euro is still very strong (and strengthening) versus the USD. We maintain belief in the fundamental strength of the US$ and would not bet against it at this time. This said, we do see a short-term level of 1.40 US$/Euro as a short-term ceiling to the Euro move. This level has in fact been reached (1.3993!) during the ECB minutes on the 8th May… Draghi is now talking down the Euro and the market is following. As we said, we would be EUR sellers at 1.40.

Weekly Highlights:

- The FX markets have regained a little vigour! Finally something to write about, however, the levels are almost unchanged since we last wrote the letter… just with some exciting moves during the week. Some of those moves during the week were around PMI's and also Draghi's commentary. EUR is 1.3820, Cable is 1.6930, CHF is 0.8810 and JPY at 101.70. On Tuesday the GBP soared to almost touch 1.70 as PMI jumped dramatically, yet we have given most of the move back up as the USD strengthened. The EUR came within a cat's whisker of 1.40 and then tumbled as Draghi performed a rather delicately balanced ballet of veiled rhetoric to infer that the ECB ***<u>may</u>*** cut rates in June and ***<u>might</u>*** allow negative deposit rates! The EUR should continue to drop, especially if we close tonight below 1.3771... watch out!

- The US bond market held steady this week as the focus was on European data rather than the US. The Yields stayed roughly within the 2.58% to 2.62% band and seemed to take the ECB meeting within its stride. But we say again that this is still in our 2.5%-3.00% trading band. The Bunds have in fact had quite a choppy few trading sessions. Last Friday, after our letter had been published, the Bund yields soared to 1.50% on US jobs data, only to reverse course just as quickly as Russian/Ukrainian news flows stirred the fear emotion in the markets and finished the week at 1.44%. The yields moved from 1.49% yesterday prior to the conference to as low as 1.44% again this morning… So again, lots of movement but not really going anywhere! If inflation is at about 1.7%, the bunds are yielding 1.44%... the deposit rate should therefore be at -0.25% for the value of money to just maintain the status quo… Go Draghi!

- Global equities had a steady week, the S&P 500 closing last night at 1875, the DAX trading at 9,570. As there have been very few macro surprises and we are out of silly season with US earnings coming in thick and fast, we believe that the longer term outlook for Equities is strong. As earnings grow, the PE expansion should mean that equities will continue higher… we believe they will, and feel comfortable remaining in Equities. If the deposit rate on the Euro is eventually set as negative then the European Equities should continue to catch a bid as the cost of borrowing could effectively be IN YOUR FAVOUR (If you are a national bank that is..)!

MARKET INDICES PERFORMANCE 08/05/2014

			PRICE CHANGE IN % (unless indicated)								
INDEX NAME	**CCY**	**Last Price**	**1D**	**5D**	**MTD**	**1M**	**3M**	**6M**	**1Y**	**YTD**	
EQUITY MARKET INDICES - BY REGION											**P/E**
MSCI WORLD	USD	1,686.79	**0.16**	-0.13	-0.06	0.68	4.65	5.67	12.77	1.55	15.33
MSCI WORLD LOCAL	-	1,194.32	**0.20**	-0.38	-0.24	1.09	3.70	4.74	11.34	0.83	-
MSCI AC WORLD	USD	414.48	**0.19**	-0.06	0.09	0.55	4.96	5.20	10.63	1.45	14.68
MSCI EM	USD	1,008.85	**0.43**	0.54	1.36	-0.59	7.63	1.36	-4.88	0.61	10.81
S&P 500 INDEX	USD	1,875.63	**-0.14**	-0.43	-0.44	0.18	4.37	5.93	15.30	1.48	15.88
DOW JONES INDUS. AVG	USD	16,550.97	**0.20**	-0.05	-0.18	0.69	4.79	5.01	9.74	-0.15	14.82
NASDAQ COMPOSITE INDEX	USD	4,051.50	**-0.40**	-1.84	-1.53	-3.16	-1.80	3.37	18.84	-3.00	17.73
RUSSELL 2000 INDEX	USD	1,097.43	**-1.00**	-2.54	-2.61	-5.39	-1.71	-0.23	13.57	-5.69	18.25
EURO STOXX 50	EUR	3,192.86	**-0.36**	0.47	-0.17	0.32	5.08	5.20	15.13	2.70	14.30
CAC 40 INDEX	EUR	4,489.09	**-0.40**	0.69	0.04	1.04	6.17	5.37	14.27	4.50	15.12
DAX INDEX	EUR	9,589.70	**-0.18**	0.35	-0.14	0.88	3.09	5.63	16.06	0.39	13.35
FTSE 100 INDEX	GBP	6,824.65	**-0.21**	0.23	0.66	2.85	3.85	1.73	3.52	1.12	-
SWISS MARKET INDEX	CHF	8,459.95	**-0.07**	0.20	-0.20	0.58	1.70	2.66	4.53	3.13	16.35
NIKKEI 225	JPY	14,199.59	**0.25**	-0.73	-0.73	-0.70	-1.82	0.80	0.06	-12.84	15.99
HANG SENG INDEX	HKD	21,826.21	**-0.05**	-1.39	-1.39	-4.45	0.88	-4.04	-5.97	-6.35	10.13
SHANGHAI SE COMPOSITE	CNY	2,011.14	**-0.21**	-0.75	-0.75	-4.47	-1.63	-4.51	-9.93	-4.95	7.79
S&P BSE SENSEX INDEX	INR	22,807.63	**2.07**	1.80	1.74	0.46	11.93	10.36	14.39	7.73	14.45
RUSSIAN RTS INDEX $	USD	1,232.78	**0.41**	6.67	6.67	3.58	-8.10	-14.10	-15.11	-14.55	5.02
BRAZIL IBOVESPA INDEX	BRL	53,422.37	**-1.17**	3.48	3.48	4.37	11.13	2.25	-3.65	3.72	10.86
EQUITY MARKET INDICES - BY SECTOR											**P/E**
MSCI ENERGY	USD	296.34	**-0.73**	0.39	0.53	4.83	13.52	10.57	15.71	7.53	14.34
MSCI MATERIALS	USD	246.56	**0.20**	-0.04	-0.06	0.28	4.81	4.84	6.79	2.74	15.70
MSCI INDUSTRIALS	USD	201.51	**0.27**	-0.11	-0.16	0.42	3.77	5.05	16.35	-0.22	16.01
MSCI CONS DISCRETIONARY	USD	174.00	**0.13**	-1.26	-0.65	-1.62	-0.29	1.00	13.15	-4.27	15.83
MSCI CONS STAPLES	USD	196.27	**0.27**	0.75	0.36	2.12	8.01	4.49	6.28	3.05	18.22
MSCI HEALTH CARE	USD	180.03	**-0.13**	-0.34	-0.56	0.71	3.40	9.54	18.68	4.76	16.84
MSCI FINANCIALS	USD	102.19	**0.63**	-0.03	0.28	0.20	3.68	4.04	9.53	0.29	13.21
MSCI INFO TECH	USD	122.86	**0.10**	-0.96	-1.03	-1.47	1.81	6.99	17.24	-0.24	15.67
MSCI TELECOMS	USD	72.96	**0.84**	1.23	2.11	3.87	7.34	5.19	13.06	1.35	15.27
MSCI UTILITY	USD	121.00	**-0.15**	1.08	0.23	1.80	9.46	9.11	8.62	10.12	15.74
MSCI WORLD REAL ESTATE	USD	185.51	**0.25**	0.89	1.58	2.95	6.97	4.92	-5.68	6.02	23.20
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,227.30	**-0.16**	-0.23	-0.23	-0.51	0.31	1.60	2.39	0.15	
HFRX EQUAL WEIGHTED	USD	1,206.44	**-0.14**	-0.20	-0.20	-0.43	0.54	1.75	3.17	0.78	
HFRX GLOBAL EUR	EUR	1,136.13	**-0.16**	-0.25	-0.25	-0.53	0.24	1.47	2.06	0.04	

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			PRICE CHANGE IN % (unless indicated)							
FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.02	-0.01	0.01	-0.01	-0.01	-0.06	-0.03	-0.02	-0.05
US 2 YEAR	USD	0.39	0.00	-0.04	-0.02	0.02	0.08	0.08	0.17	0.01
US 10 YEAR	USD	2.60	-0.01	0.02	-0.04	-0.09	-0.08	-0.14	0.79	-0.42
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	455.83	0.12	0.26	0.37	0.80	1.57	2.89	1.39	3.12
US GOVERNMENT TR	USD	2,022.75	0.07	0.13	0.30	0.63	0.80	1.61	-0.83	2.18
US CORPORATE TR	USD	2,520.24	0.07	0.15	0.48	1.17	2.69	5.49	1.57	4.67
US HIGH YIELD TR	USD	1,644.79	0.09	0.27	0.31	0.71	2.99	5.37	5.63	3.96
EU GOVERNMENT TR	EUR	223.29	0.28	0.43	0.44	1.18	2.74	4.90	4.22	4.99
EU CORPORATE TR	USD	234.87	0.23	0.37	0.38	1.12	2.18	3.51	3.87	3.67
EU HIGH YIELD TR	EUR	265.23	0.14	0.33	0.34	0.92	3.33	5.80	9.72	4.43
JACI GLOBAL	USD	263.09	-0.37	0.00	0.00	0.24	2.80	6.64	12.16	3.84
GLOBAL EM TR (HEDGED)	USD	319.33	0.27	0.72	0.85	1.29	4.19	5.00	0.22	4.67
S&P/LSTA U.S. LEV LOAN	USD	98.53	0.02	0.16	0.27	0.18	0.00	0.22	-0.35	0.30
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	4,992.12	-0.23	0.27	-0.33	0.05	2.94	6.87	5.20	3.37
GSCI ENERGY TR	USD	1,133.22	-0.44	0.18	-0.28	-0.50	0.49	6.32	6.66	0.63
GSCI INDUSTRIAL METALS TR	USD	1,323.24	0.99	0.94	0.53	1.01	0.09	-1.73	-7.38	-3.19
GSCI PRECIOUS METALS TR	USD	1,614.20	-0.21	0.36	-0.58	-2.01	1.18	-1.29	-13.95	5.97
GSCI AGRICULTURE TR	USD	716.04	0.25	1.07	-0.80	1.93	15.90	13.80	2.40	18.05
GENERIC 1ST 'CL' FUTURE	USD	100.58	0.32	0.82	0.84	-2.56	1.80	6.67	4.14	3.35
GOLD SPOT $/OZ	USD	1,290.66	0.11	-0.69	-0.07	-1.61	1.85	0.16	-11.49	7.05
CURRENCIES										
DOLLAR INDEX SPOT	USD	79.48	0.15	-0.04	0.01	0.00	-1.50	-2.24	-4.00	-0.69
Euro Spot	EUR	1.38	-0.05	-0.26	-0.25	-0.16	1.37	3.18	6.06	0.65
Japanese Yen Spot	JPY	101.72	-0.06	0.47	0.51	0.28	0.53	-2.52	-1.11	3.53
British Pound Spot	GBP	1.69	-0.05	0.32	0.30	0.78	3.18	5.85	9.55	2.22
Brazilian Real Spot	BRL	2.22	0.08	0.78	0.78	-0.61	8.80	4.44	-9.46	6.64
China Renminbi Spot	CNY	6.23	-0.04	0.47	0.47	-0.48	-2.73	-2.23	-1.59	-2.82
Singapore Dollar Spot	SGD	1.25	-0.02	0.42	0.47	-0.09	1.84	0.09	-1.14	1.22
Norwegian Krone Spot	NOK	5.89	0.15	0.77	0.99	0.78	4.04	4.33	-1.88	3.06
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	13.43	0.22	1.36	0.15	-2.82	-12.16	4.11	2.28	-2.11
USD SWAP SPREAD SEMI 2YR		13.81	6.23	3.99	16.25	4.70	14.51	17.53	1.17	31.52
TED SPREAD		0.00	-0.30	-2.22	0.00	-1.96	29.66	4.95	-15.54	-86.49

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