Friday, May 16th 2014

We started the week with a bang! On Monday the DJIA raced to a record close, then Tuesday the DJIA, S&P 500 and the Dow Transport index (a leading indicator for the economy and the broad markets) all at record highs. Felt good… And then the week's follow-up didn't quite extinguish the excitement- The U.S. posted a smaller budget surplus in April than economists projected, as spending increased at more than twice the pace of tax receipts. Revenue exceeded spending by $106.9 billion last month, compared with a $112.9 billion surplus a year before, as per the Treasury Department. The median estimate in a Bloomberg survey of 24 economists was for a $114 billion surplus. So far this fiscal year, which began Oct. 1, the country is running a budget shortfall that's about 37 percent smaller than it was a year earlier and was the narrowest at the seven-month mark since 2008. Still, the economy nearly stalled in the January-March quarter, while outlays rose last month on defence and entitlement programs. The nation's budget gap will narrow to $492 billion in the 12 months to Sept. 30, compared with $680 billion in 2013 and about a third of its 2009 record level of $1.4 trillion, the Congressional Budget Office said on April 14. Next year, the shortfall will decline further, to $469 billion, the nonpartisan agency said. The 2014 deficit will be 2.8% of GDP, according to CBO, compared with 4.1 percent of GDP in 2013 and lower than the 3.1 percent average of the past 40 years. *Well, if these projections will be realized, the US could qualify for joining the Euro…*

Global bond yields are in a deep slide taking the 10-year U.S. Treasury to a level not seen since October, well before the Fed began winding down its easy money program. The common themes are accommodating central bankers and concerns about growth. In the U.S. a short position in Treasuries continues to support the market as investors are forced to cover with each notch higher in price and lower in yield. Yields were lower across the curve, but the 10-year yield broke below a range that it has held since the end of October, breaking through 2.50% on Thursday. On Tuesday, Irish 10 year bond traded to yield 2.61%, an all-time low, similar to the US Notes and below UK Gilts. Go-figure!? It came from 15% at its worst... Who buys this? And why? Will someone stand-up and explain?
U.S. producer prices ("PPI") posted their largest increase in 1-1/2 years in April as the cost of food and trade services surged, hinting at some inflation pressures at the factory gate. The Labour Department said on Wednesday its seasonally adjusted producer price index for final demand rose 0.6 percent, the biggest gain since September 2012. Producer prices increased 0.5 percent in March. In the 12 months through April, core PPI for final demand rose 1.9 percent after increasing 1.4 percent in March.
On Thursday we got some good news on the employment front in the US - The fewest Americans in seven years filed applications for unemployment benefits and consumer prices rose by the most in 10 months, adding to signs the economy gaining momentum. Jobless claims dropped by 24,000 to 297,000 in the week ended May 10, less than any economist projected in a Bloomberg survey and the least since May 2007, figures from the Labour Department showed. But then, the consumer price index ("CPI") increased 0.3 percent in April, the biggest advance since June, after rising 0.2 percent the prior month.

Slow and steady wins the race. That lesson from the Aesop's fable about "The Tortoise and the Hare" can also apply to the stock market. That's the way stock picker Oscar Schafer sees it. "I don't think a low-growth economy necessarily means a bad stock market," he told CNBC on Tuesday. "Greece had a terrible year last year, and the market was up. China has been growing fast, and the market has been terrible," the Rivulet Capital chairman observed in an interview on CNBC. Making his case, Schafer also said that a rise in price-earnings ratios is not a reason to worry in a low-inflation environment. "Any time when the CPI was less than 3 percent for the last 47 years, multiples have averaged 18 times."
We add here our December 2013 thoughts- Expecting the S&P 500 to earn say $126 for 2014 (up 4% on 2013, similar to the IMF expected world GDP growth), then at "just" 17X we find a level of 2'140 for year end- up 14% from here! Think of this basic algebra through the volatility…

Just in-case you are confused with your tax forms (it is THAT season), we try to console you with thought from Albert Einstein "The hardest thing to understand in the world is the income tax".

Core View: 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 imminently 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 in the distance - short term interest rates are unlikely to rise anytime soon. Other risks are brewing on the horizon - whilst the Ukrainian debacle has moved off the front page, it is clearly unresolved and might yet grow to be a serious problem. Syria is still burning and other political conflicts are still simmering in different parts of the globe. We have taken note of increased armaments sales, much of which was procured by South-East Asian countries. Some have clearly taken note of the thinness of the paper used for mutual-defence agreements; Ukraine had given-up its nuclear arms in exchange for promises, Obama's chemical red-line in the sand was crossed and nothing happened. Political risks are rising around us; let's keep this in mind whilst watching new record highs in both equity indices and bond prices globally.

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

- **Fixed Income -** The Fixed Income world is dealing with yet lower 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 dramatic easing at next month's meeting, it is very likely that Europe will embark on large scale QE, a la BOE and FOMC – The size of that intervention may well be lessened as the explicit threat has seen the EUR drop, and in so doing has cheapened the export market, hopefully allowing for support to flow through to the domestic European businesses and driving up global competitiveness. 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 when inflation rears its head. No immediate threat though.
- **Equities –** With P/E ratios around the globe at historically reasonable levels (+-15X) and relatively strong Q1 earnings, 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 P/Es 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 relative 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 significantly lower volatility than equities. We maintain our recommendation for about a 20% allocation 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 has slipped from its elevated perch to weaken rather dramatically versus the USD. We maintain belief in the fundamental strength of the US$ and would not bet against it at this time. The ceiling level of 1.40 USD per EUR seems to have held firm for now. The rhetoric from Mr Draghi seems to be maintaining the downward pressure that he required. Perhaps we have seen that action (or at least the imminent threat of action) speaks louder than empty words.

Weekly Highlights:

- The FX markets maintained their frothy movements. The USD reigned supreme this week against the major crosses; EUR dropped to as low as 1.3650 but has regained a little ground to be at 1.3715, the GBP slipped to 1.6730 and is still below 1.68 for now, the Yen moved around but is only a touch lower from when we last wrote at 101.60 and the CHF touched 0.8960 but subsequently fell back to 0.8910. BRL is unchanged at 2.2190, TRY slipped on unrest in the country following a mine collapse seeing it touch 2.1066, replacing the centre stage news of the Ukraine. The Ukraine story has slipped off the headlines and as such the RUB has appreciated again, seeing the USDRUB slip from 35.30 to 34.60 on Wednesday. The next big news will be… how much with the ECB buy, what will they buy and is it too little, too late?
- The US Treasuries, Bunds and Gilts soared this week. As Equity markets turned lower, the threat of actions from the ECB has sunk in, the Treasury markets are nervous and the yields dropped. The US 10 year dropped from 2.65% to the bottom of our range 2.50%, the Bund and the Gilt followed suit, dropping to 1.3% and 2.5% respectively. This is not the actions of an exuberant market seeking economic recovery. As the US employment data and PPI was encouraging and shows that the QE from Big Ben (remember him?!) may well have had the desired effects, but as they are beginning Tapering is the bond market saying this is too much, too soon? We do not envy the Central Bankers task in life, they are definitely underpaid for the amount of grey hairs they have… poor Janet Yellen has only been in the job less than a few months!! As if to bolster the fear factor that we have mentioned, the trade that we have been talking about for months – periphery narrowing to the Bund – made a very sharp about-turn. Italy's yields ran up to 3.10% and Spain to 3.05%... the spreads moved out to 1.8% and 1.75% respectively, a 21 Bps widening in 2 days!
- Global equities had a steady week so far based solely on the close versus when we wrote the letter last week. This does not really give the whole story though, the S&P 500 soared to a new high of 1,902, the DJIA a new high of 16,735, but those gains have been given up for now to remain steady on the week. Indian equities have taken the election results as very positive, with the Sensex index up 10% on the open this morning and settling at +5% on the week. Last week we mentioned that European equities should perform well based on the flood of new capital that will be coming to market; perhaps we should have been more specific, we believe that the core European markets shall continue to rise, the periphery should be sifted through very carefully and on an individual basis as they all have their own issues to deal with… Italy lost 4.5% this week alone as its GDP fell on the Quarter! As the Bond markets rally and equities have halted their grind higher for the moment, we take stock for now and keep our eyes open…

Bedrock Newsletter

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

15/05/2014

INDEX NAME	CCY	Last Price	PRICE CHANGE IN % (unless indicated) 1D	5D	MTD	1M	3M	6M	1Y	YTD	
EQUITY MARKET INDICES - BY REGION											P/E
MSCI WORLD	USD	1,682.34	-0.74	-0.06	-0.32	1.05	1.95	3.75	11.56	1.28	15.32
MSCI WORLD LOCAL	-	1,194.83	-0.77	0.04	-0.19	2.24	1.70	3.25	9.54	0.87	-
MSCI AC WORLD	USD	414.38	-0.69	0.18	0.07	1.22	2.52	3.61	9.99	1.43	14.70
MSCI EM	USD	1,029.10	-0.30	2.20	3.40	2.65	7.50	2.38	-1.65	2.63	11.01
S&P 500 INDEX	USD	1,870.85	-0.94	-0.25	-0.70	0.46	1.75	4.04	13.35	1.22	15.83
DOW JONES INDUS. AVG	USD	16,446.81	-1.01	-0.63	-0.81	0.13	1.81	3.04	7.97	-0.78	14.72
NASDAQ COMPOSITE INDEX	USD	4,069.29	-0.76	0.44	-1.10	-0.41	-4.12	2.09	17.43	-2.57	17.77
RUSSELL 2000 INDEX	USD	1,095.99	-0.65	-0.13	-2.74	-3.16	-4.63	-1.81	11.23	-5.81	18.24
EURO STOXX 50	EUR	3,159.40	-0.12	-0.78	-1.22	0.64	1.29	3.43	12.57	1.62	14.16
CAC 40 INDEX	EUR	4,446.97	0.05	-0.68	-0.90	0.94	2.46	3.61	11.76	3.52	14.95
DAX INDEX	EUR	9,649.50	-0.07	0.71	0.48	3.56	-0.13	5.24	15.29	1.02	13.43
FTSE 100 INDEX	GBP	6,845.03	0.06	0.45	0.96	3.96	2.72	2.26	2.35	1.42	-
SWISS MARKET INDEX	CHF	8,641.44	-0.04	1.54	1.94	3.83	2.66	3.77	4.67	5.35	16.63
NIKKEI 225	JPY	14,096.59	-1.41	-0.73	-1.45	-2.23	-1.51	-7.05	-6.26	-13.47	15.93
HANG SENG INDEX	HKD	22,660.48	-0.31	3.65	2.38	-0.16	1.62	-1.61	-1.83	-2.77	10.39
SHANGHAI SE COMPOSITE	CNY	2,026.50	0.08	0.76	0.01	-3.73	-4.22	-5.12	-10.01	-4.23	7.89
S&P BSE SENSEX INDEX	INR	24,727.11	3.44	7.54	10.30	11.00	21.41	21.21	22.13	16.80	15.66
RUSSIAN RTS INDEX $	USD	1,252.36	-0.05	1.59	8.36	8.49	-6.76	-13.29	-9.29	-13.20	3.01
BRAZIL IBOVESPA INDEX	BRL	53,855.54	-1.02	0.81	4.32	5.19	11.73	0.76	-1.67	4.56	11.02
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	293.52	-0.99	-0.41	-0.42	2.22	9.59	8.02	15.49	6.51	14.14
MSCI MATERIALS	USD	247.71	-0.86	0.93	0.40	1.54	1.56	4.14	9.31	3.22	15.85
MSCI INDUSTRIALS	USD	201.62	-0.94	0.20	-0.10	1.02	2.10	3.63	15.25	-0.17	16.08
MSCI CONS DISCRETIONARY	USD	173.73	-0.63	-0.37	-0.81	-0.49	-2.51	-1.38	10.45	-4.42	15.85
MSCI CONS STAPLES	USD	196.32	-0.24	-0.02	0.39	1.74	5.97	2.96	5.12	3.07	18.29
MSCI HEALTH CARE	USD	181.03	-0.60	0.42	-0.01	3.22	0.57	7.97	17.49	5.34	16.95
MSCI FINANCIALS	USD	101.19	-0.92	-0.44	-0.70	0.21	0.71	1.63	7.82	-0.69	13.11
MSCI INFO TECH	USD	123.20	-0.78	0.21	-0.76	0.14	-0.62	5.47	15.90	0.03	15.71
MSCI TELECOMS	USD	72.37	-0.32	-0.41	1.29	3.15	4.93	2.86	11.13	0.53	15.26
MSCI UTILITY	USD	119.17	-0.50	-0.60	-1.28	-0.78	4.62	6.76	6.57	8.45	15.60
MSCI WORLD REAL ESTATE	USD	187.81	0.12	1.15	2.84	3.59	6.60	4.40	-4.12	7.33	23.40
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,228.80	-0.15	0.12	-0.11	0.36	-0.11	1.42	2.06	0.27	
HFRX EQUAL WEIGHTED	USD	1,205.99	-0.17	-0.04	-0.23	0.15	0.10	1.60	2.67	0.75	
HFRX GLOBAL EUR	EUR	1,137.50	-0.15	0.12	-0.13	0.34	-0.18	1.28	1.71	0.16	

MARKET INDICES PERFORMANCE

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INDEX NAME	CCY	Last Price	PRICE CHANGE IN % (unless indicated) 1D	5D	MTD	1M	3M	6M	1Y	YTD
FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.02	0.00	0.00	-0.01	-0.01	0.01	-0.05	-0.01	-0.05
US 2 YEAR	USD	0.35	0.00	-0.03	-0.06	-0.01	0.04	0.06	0.13	-0.03
US 10 YEAR	USD	2.50	0.01	-0.12	-0.14	-0.13	-0.24	-0.20	0.62	-0.53
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	457.56	0.11	0.38	0.75	0.83	2.02	3.05	2.52	3.51
US GOVERNMENT TR	USD	2,031.20	0.15	0.42	0.72	0.72	1.37	1.75	0.12	2.60
US CORPORATE TR	USD	2,535.78	0.22	0.62	1.10	1.24	3.26	5.58	3.04	5.32
US HIGH YIELD TR	USD	1,648.56	-0.05	0.23	0.54	0.86	2.66	5.46	6.37	4.19
EU GOVERNMENT TR	EUR	223.86	-0.07	0.26	0.70	0.87	3.06	4.89	5.36	5.26
EU CORPORATE TR	USD	235.99	0.11	0.48	0.85	1.17	2.61	3.89	4.61	4.16
EU HIGH YIELD TR	EUR	265.63	-0.13	0.15	0.50	0.90	3.00	5.93	10.07	4.59
JACI GLOBAL	USD	262.77	-0.15	-0.12	-0.12	0.90	1.14	5.35	11.68	3.72
GLOBAL EM TR (HEDGED)	USD	321.43	0.15	0.66	1.52	1.68	4.65	5.88	1.48	5.36
S&P/LSTA U.S. LEV LOAN	USD	98.70	-0.02	0.17	0.44	0.51	0.26	0.48	-0.15	0.47
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	5,018.12	-0.49	0.52	0.19	-0.71	2.59	6.46	7.13	3.91
GSCI ENERGY TR	USD	1,148.23	-0.22	1.33	1.04	-0.76	1.16	5.95	9.49	1.96
GSCI INDUSTRIAL METALS TR	USD	1,337.16	-1.71	1.05	1.59	1.67	0.49	1.10	-3.11	-2.17
GSCI PRECIOUS METALS TR	USD	1,624.13	-1.01	0.62	0.03	-0.48	-2.85	-0.50	-8.61	6.62
GSCI AGRICULTURE TR	USD	691.03	-1.07	-3.49	-4.27	-2.17	10.42	11.15	-1.37	13.92
GENERIC 1ST 'CL' FUTURE	USD	101.78	0.28	1.79	2.05	-1.55	2.58	8.82	6.74	4.58
GOLD SPOT $/OZ	USD	1,293.65	-0.19	0.38	0.16	-0.68	-1.90	0.27	-6.66	7.30
CURRENCIES										
DOLLAR INDEX SPOT	USD	80.02	0.02	0.15	0.69	0.28	-0.14	-1.02	-4.26	-0.01
Euro Spot	EUR	1.37	0.07	-0.28	-1.06	-0.69	0.09	1.58	6.51	-0.17
Japanese Yen Spot	JPY	101.57	0.01	0.29	0.66	0.65	0.34	-1.56	0.68	3.68
British Pound Spot	GBP	1.68	0.03	-0.33	-0.46	-0.01	0.48	4.26	9.99	1.44
Brazilian Real Spot	BRL	2.22	-0.78	-0.21	0.57	0.59	7.65	4.27	-8.86	6.42
China Renminbi Spot	CNY	6.23	-0.06	-0.09	0.42	-0.18	-2.72	-2.27	-1.35	-2.87
Singapore Dollar Spot	SGD	1.25	-0.07	-0.36	0.03	-0.21	0.46	-0.55	-0.06	0.77
Norwegian Krone Spot	NOK	5.95	0.03	-0.63	0.00	0.40	2.15	2.95	-1.92	2.05
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	13.17	8.22	-1.94	-1.79	-7.12	-2.95	8.04	0.77	-4.01
USD SWAP SPREAD SEMI 2YR		14.88	4.42	11.21	25.25	0.88	14.46	38.42	4.42	41.71
TED SPREAD		0.00	0.24	3.79	3.79	4.90	-8.95	19.37	-13.85	-85.98

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