Friday, June 6th 2014

Fridays are back on! We lived this week under the expectation of the ECB announcing its rate cuts and stimulus package. Nail biting as many shorted the Euro into this expectation, bought gold, sold equities etc., etc., and then Super Mario gave us the decisions. Rates down, negative rates on deposits, a sort-of QE in the making and lo and behold, the Euro fell a point, equities rose only to reverse a little later in the day- Euro ending up on the day and equities up, but less than their intra-day peaks. Surprisingly for some, the US markets rose by as much as the European ones. Well, many an investor had forgotten their first lessons in physics- Pascal's law of communicating vases- Add water in one tube and it will rise in another- Here, a big and powerful central bank adds liquidity and capital into one market and we get the effects in all the other ones too.
This week we want to re-visit a previously debated question- Should we read the news and then try to forecast the markets, or conversely, should we read the markets and predict the ensuing news? We are firm believers in the predictive powers of the markets and remain staunch sceptics in regard to analysts' capabilities… Yesterday's ECB "event" being a fine case-study; The Central Bank wants to usher-in inflation and to do so, wants to weaken the Euro. So they cut rates… Strongly confident in their power and intent, the Market believes that they will be successful in improving the Euro-zone economies; lo and behold, the Euro rises, equities rally and benchmark Bund yields fell to 1.36%
What are the markets saying to us? Equities clearly are saying that future corporate earnings are to rise, hence all-time highs on many indices, the bond markets are telling us that there is little to no inflation risk hence low and even falling long-term yields, credit spreads at all-time lows imply that economies will strengthen (lower default risks) and even commodities are trading into expected rising demand. A concerted opinion emerges across all markets- The global economy is doing better, no inflation. The currency markets are telling us that the recently imminent break-up of the Euro has gone the way of the dinosaurs and then, these markets are telling us that the European economies are about to come back from the dead… We may read about this in next period's newspapers…
In the throes of the financial crisis some five years ago, bond fund manager Mohamed El-Erian said the U.S. economy would find itself in a "new normal" period of slow growth and lower returns on stocks. To some market observers, though, the "new normal" is finally over. Everybody is still more concerned about protecting against the downside than about accentuating the upside and we think you've never had a market top where people have been more worried about protecting against the downside. A lot of smart people have been calling for a market correction for an awfully long time. And all of them have been dead wrong. Rather than make the expected sharp move lower, markets instead have inched their way to record highs. Stock gains have been unspectacular but they indeed have been steady, defying a plethora of predictions for drops of 10 percent— or worse. For all the reasons why the market should correct—or drop more than 10 percent, according to the traditional Wall Street definition—there are just as many reasons why it shouldn't. And while earnings are nothing to brag about, S&P 500 companies did collectively increase profits by 3.35 percent in Q1—again, nothing great, but at least positive. It's a hard point to argue: That 3.35 percent earnings gain compares to a 3.9 percent increase on the S&P 500. Yet the correction calls have continued, and they've not been from just the usual suspects. It is in fact the crowded correction trade that has helped prevent it from coming true!
Well, if these Bears keep crying Wolf, it is likely that one day they will be right. But then, in the interim they have been and are very, and we mean… very expensively wrong.
New orders for U.S. factory goods rose for a third straight month in April, pointing to strength in manufacturing and the broader economy. The Commerce Department said on Tuesday new orders for manufactured goods increased 0.7 percent. March's orders were revised to show a 1.5 percent increase instead of the previously reported 0.9 percent rise. The U.S. trade deficit widened to its highest level in two years in April as imports hit a record high, suggesting trade could be a drag on second-quarter growth. On Wednesday the trade gap increased 6.9 percent to $47.2 billion. That was the largest since April 2012 and followed March's revised $44.2 billion gap. This data should weigh on the Dollar and check its recent rally, whilst at the same time, this data suggests that the US economy is growing, driving up imports. There was little sign that wage inflation was igniting. Unit labour costs rose by a revised 1.2 percent compared to the first quarter of 2013. They had previously been reported to have increased at a 0.9 percent rate. Economic growth increased in all 12 Federal Reserve districts as per a relatively upbeat Fed Beige Book on Wednesday. The pace of growth was described as "moderate" to "modest," according to the release, which details economic projections from the central bank's members.
Let's not forget that as sure as spring will follow winter, prosperity and economic growth will follow recession…

<u>Core View</u>: The ECB took action- lowering interest rates and reaching negative 0.10% level to be paid on bank deposits with the ECB. In addition, the ECB reiterated the downside risks for the Euro-zone economies and a monetary bolstering via a QE program. Clearly, there is no inflation around, not now or in the near term. The Euro fell a point vs. the US$ and bounced back all of the way. A weaker Euro clearly can help the ECB to usher-in some inflation. Overall, we read this as stimulus to the Euro-economies, already measurable in the responses in the European exchanges. On a broader outlook we consider the ECB's measures as offsetting the slowing in the American stimulus and we hold our views whereby 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 a group, most Central banks are targeting an elusive 2% inflation rate. As the industrialized economies are running with excess labour 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. 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 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 (Draghi proved this point only yesterday)! In conclusion, we see no need to worry in the short term about rising rates. Although, as we have been watching the horizon, there may have been the first glimmer of change (or maybe it was a mirage!) as we briefly saw a very sharp widening of the European Periphery spreads over the Bund… was this be the first signs of change? The answer is simple; we don't know how large the budget is for the ECB repurchases, but we know it is not unlimited like the Fed. So do maintain a watch on the horizon, as rates will eventually start pointing towards the sky when inflation rears its head.

- **Equities –** With P/E ratios around the globe at historically reasonable levels (+-15X for the MSCI AW) and earnings still maintaining strong levels, we feel secure in owning equities. Consumption around the globe is still expanding (albeit slowly) which should mean a positive environment for cash-flow growth. We have noted that the P/E ratios are slowly creeping higher. The S&P has moved to 16.3, the Russell is at 18.80 and the Sensex is now at 15.8. As the P/E's expand the value in the indices diminishes… we take note and will focus on watching the sector rotation and seeing whether the momentum stocks gain any traction. We remain positive and recommend exposures to be maintained using global diversified funds, or by allocating some fixed-income exposure to Convertible bonds- owning the security of fixed income with an exposure to equities. With QE being continued by one CB or another, there really is not much change in the cash pumping mechanism for now.

- **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. The Macro Funds that were so successful in the past, are struggling to find trading ideas and to capitalise on them; whilst the Multi-Strat, Distressed and Event Driven funds are managing to capture some performance. The CTAs that perform so well in crises or downward trending environments are obviously struggling in this sideways trading marketplace. We stick with our view that a well-diversified Fund of Fund is the best investment for now.

- **Currencies -** The market still has a very low volatility relative to the last 5 years. 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 has held firm for now. The ECB decision from Mr Draghi seems to be maintaining the downward pressure that he required, or at least halting the EUR strength. The Pound seems to be the only resilient currency for now as the BOE Governor, Mr Carney, continues to fret about the housing market bubble (contained to about 3 streets in London, the rest of the UK is down about 20% from the 2008 peak!). We are watching the Aussie Dollar very carefully for now as it would appear that the down trend is rearing its head again. Gold has drifted lower and held through the ECB announcements at about $1'250.

Weekly Highlights:

- The FX markets (if you only look on the week) seem to have been relatively quiet. With the JPY weakening, EUR almost unchanged (believe it or not!), GBP slightly stronger and the BRL having dropped quite significantly from 2.23 to 2.29 by Wednesday. INR maintained its relative strength staying at a shade over 59.20 for the majority of the week. The AUD has not broken downwards just yet although the highs from 4 weeks ago have not been seen. In light of little Asian data and not much Aussie data we feel that some of the positioning is just taking place now and as such we will wait for moves to manifest themselves before taking a view.

- The US Treasuries, Bunds and Gilts slipped a little on the week as the fear of Mr Draghi's actions receded and returned to their "new normal" trading ranges. The US 10Y moved back into the range having briefly had a foray into the 2.40's%, now at 2.56% it remains firmly in the range of 2.50%/3.00% as we have said it would do for some time now. The UK Gilt weakened further by moving from 2.57% to 2.72% only to strengthen to 2.66% this morning. The Periphery in Europe has fully reversed its course and has narrowed to the tightest spreads over the Bund since May 2011 – on a 10 year basis we are at the mean spread, on a three year basis we are 2 standard deviations <u>below</u> the mean. Italy's 10 year yields dropped to 2.78% and Spain to 2.63%, the spreads to Bunds moved to 1.42% and 1.30% respectively. Perhaps a longer set of binoculars will remind you that the spread used to trade at 4Bps and a move to 30Bps was big news! Sometimes the trees do obscure the forest.

- Global equities had a steady week so far, up more than 1% this week. The S&P 500 made new highs of 1,942, the DJIA a new high of 16,845; Europeans followed suit with the DAX breaking 10,000 for the first time ever. Indian equities have continued their rally after the Modi election win, on the expectation that corporate earnings will be boosted and many of the infrastructure projects that were mired in a backlog of paperwork will now be released. We want to re-iterate that European equities are likely to perform well based on the flood of new investment-capital that is expected to flow into Europe; As such, we believe that the core European markets shall continue to rise, but the periphery should be sifted through very carefully as it is not one-size-fits-all … We remain vigilant on the short term equity situation, as we see there may be the first cracks appearing round the edges… Let's hope this is just "settling in to the new environment" and not precursor to a subsidence event!

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

All data is compiled from Bloomberg 05/06/2014

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	1,715.18	**-0.08**	0.57	0.04	1.59	2.26	6.92	16.45	3.30	15.66
MSCI WORLD LOCAL	-	1,222.29	**-0.06**	0.56	0.19	2.02	3.80	6.17	15.40	3.19	-
MSCI AC WORLD	USD	421.53	**-0.01**	0.48	0.12	1.77	2.88	6.61	14.89	3.30	15.02
MSCI EM	USD	1,035.95	**0.63**	-0.22	0.80	3.24	8.34	4.04	3.18	3.32	11.16
S&P 500 INDEX	USD	1,923.57	**-0.04**	0.64	0.03	2.29	2.69	7.33	17.95	4.11	16.26
DOW JONES INDUS. AVG	USD	16,722.34	**-0.13**	0.28	0.03	1.27	1.99	5.24	10.18	0.88	14.95
NASDAQ COMPOSITE INDEX	USD	4,234.08	**-0.07**	-0.07	-0.20	2.67	-2.71	4.86	22.90	1.38	18.54
RUSSELL 2000 INDEX	USD	1,126.15	**-0.24**	-1.41	-0.74	-0.24	-6.83	0.43	14.68	-3.22	18.77
EURO STOXX 50	EUR	3,235.65	**-0.17**	-0.33	-0.28	1.82	3.17	8.15	17.42	4.07	14.53
CAC 40 INDEX	EUR	4,496.89	**-0.15**	-0.77	-0.50	0.87	2.30	8.40	14.55	4.68	15.20
DAX INDEX	EUR	9,904.47	**-0.15**	-0.35	-0.39	3.65	3.29	8.36	19.39	3.69	13.78
FTSE 100 INDEX	GBP	6,824.66	**-0.17**	-0.39	-0.29	0.03	0.01	4.83	4.06	1.12	-
SWISS MARKET INDEX	CHF	8,662.19	**0.01**	-0.55	-0.14	2.60	2.57	7.66	9.99	5.60	16.74
NIKKEI 225	JPY	15,067.96	**0.22**	2.71	2.98	4.22	2.35	-2.21	11.34	-7.51	16.89
HANG SENG INDEX	HKD	23,141.45	**-0.64**	0.86	0.26	3.96	2.14	-2.47	3.84	-0.71	10.75
SHANGHAI SE COMPOSITE	CNY	2,025.10	**-0.65**	-0.47	-0.69	-0.06	-2.24	-10.07	-10.88	-4.29	7.88
S&P BSE SENSEX INDEX	INR	24,865.39	**0.03**	1.26	2.68	10.99	17.24	20.07	27.22	17.45	15.78
RUSSIAN RTS INDEX $	USD	1,317.98	**-0.46**	1.35	1.72	14.71	11.30	-3.41	-0.33	-8.65	5.28
BRAZIL IBOVESPA INDEX	BRL	52,032.38	**0.83**	-0.27	1.55	-1.79	10.49	3.62	-3.68	1.02	10.69
EQUITY MARKET INDICES - BY SECTOR											**P/E**
MSCI ENERGY	USD	296.58	**0.24**	0.73	0.21	0.47	8.24	11.47	17.48	7.62	14.26
MSCI MATERIALS	USD	246.66	**-0.29**	-0.25	-0.04	0.00	0.23	7.34	9.81	2.78	15.88
MSCI INDUSTRIALS	USD	205.08	**-0.15**	0.51	0.22	1.66	2.11	6.98	19.21	1.54	16.40
MSCI CONS DISCRETIONARY	USD	179.35	**-0.20**	0.60	0.06	1.78	-1.25	2.36	16.58	-1.33	16.51
MSCI CONS STAPLES	USD	198.25	**-0.23**	0.78	-0.46	1.77	4.81	5.91	10.26	4.08	18.58
MSCI HEALTH CARE	USD	184.78	**0.02**	1.00	0.27	2.29	-0.19	10.17	22.98	7.52	17.39
MSCI FINANCIALS	USD	103.38	**-0.03**	0.45	0.16	1.13	2.17	4.86	13.26	1.46	13.44
MSCI INFO TECH	USD	128.04	**-0.04**	0.49	-0.14	3.22	1.82	8.43	21.33	3.96	16.29
MSCI TELECOMS	USD	72.56	**-0.53**	0.19	-0.41	0.68	3.20	4.64	18.50	0.79	15.42
MSCI UTILITY	USD	121.81	**-0.01**	0.86	0.10	1.75	5.26	12.34	14.46	10.86	16.06
MSCI WORLD REAL ESTATE	USD	189.99	**0.01**	0.99	0.35	3.32	6.02	9.73	5.98	8.58	23.73
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,236.74	**0.09**	0.56	0.09	0.37	-0.42	1.54	3.01	0.92	
HFRX EQUAL WEIGHTED	USD	1,210.85	**0.02**	0.29	0.02	0.05	-0.26	1.69	2.98	1.15	
HFRX GLOBAL EUR	EUR	1,144.71	**0.06**	0.55	0.06	0.36	-0.48	1.40	2.68	0.79	

MARKET INDICES PERFORMANCE

05/06/2014

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.03	**0.00**	0.00	0.00	0.02	-0.02	-0.02	-0.01	-0.04
US 2 YEAR	USD	0.39	**-0.01**	0.03	0.02	-0.03	0.06	0.10	0.09	0.01
US 10 YEAR	USD	2.57	**-0.03**	0.13	0.10	-0.01	-0.12	-0.26	0.43	-0.45
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	457.00	**-0.17**	-0.12	-0.33	0.44	1.23	2.98	2.96	3.39
US GOVERNMENT TR	USD	2,024.63	**-0.22**	-0.32	-0.51	0.21	0.47	1.48	0.46	2.27
US CORPORATE TR	USD	2,522.81	**-0.34**	-0.44	-0.77	0.11	1.61	4.73	3.79	4.78
US HIGH YIELD TR	USD	1,655.25	**-0.03**	0.24	0.03	0.87	1.87	5.15	8.32	4.62
EU GOVERNMENT TR	EUR	224.06	**-0.20**	-0.04	-0.19	0.62	2.32	4.79	6.04	5.36
EU CORPORATE TR	USD	235.69	**-0.14**	-0.08	-0.15	0.57	1.87	3.64	4.93	4.03
EU HIGH YIELD TR	EUR	266.12	**0.01**	0.15	0.05	0.60	2.29	5.37	10.83	4.78
JACI GLOBAL	USD	263.85	**-0.13**	0.34	-0.13	0.00	0.02	5.75	12.67	4.14
GLOBAL EM TR (HEDGED)	USD	323.83	**-0.13**	0.40	-0.19	2.03	4.39	6.74	4.72	6.15
S&P/LSTA U.S. LEV LOAN	USD	98.70	**0.00**	0.08	0.00	0.30	0.37	0.58	0.55	0.47
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	4,984.02	**-0.13**	-1.20	-0.31	-0.25	-1.22	3.57	6.80	3.20
GSCI ENERGY TR	USD	1,149.23	**-0.03**	-1.34	-0.32	1.13	-1.47	2.79	10.92	2.05
GSCI INDUSTRIAL METALS TR	USD	1,357.21	**-0.43**	-0.27	0.53	2.91	3.49	4.50	-5.11	-0.70
GSCI PRECIOUS METALS TR	USD	1,562.37	**0.05**	-1.67	-0.06	-4.45	-8.48	1.40	-12.90	2.57
GSCI AGRICULTURE TR	USD	654.21	**-0.99**	-1.82	-1.40	-7.60	-2.08	4.27	-7.81	7.85
GENERIC 1ST 'CL' FUTURE	USD	102.83	**0.17**	0.11	0.12	3.19	0.51	6.83	10.13	5.78
GOLD SPOT $/OZ	USD	1,245.67	**0.06**	-0.99	-0.32	-4.15	-6.65	0.15	-10.99	3.32
CURRENCIES										
DOLLAR INDEX SPOT	USD	80.67	**0.14**	0.12	0.37	1.45	0.62	0.06	-2.54	0.79
Euro Spot	EUR	1.36	**-0.15**	0.13	-0.20	-1.92	-0.98	0.11	4.03	-0.98
Japanese Yen Spot	JPY	102.67	**-0.16**	-0.80	-0.88	-0.52	-0.45	-0.30	-2.57	2.57
British Pound Spot	GBP	1.67	**-0.23**	0.00	-0.26	-0.92	0.28	2.00	9.14	0.93
Brazilian Real Spot	BRL	2.28	**-0.17**	-1.88	-1.71	-1.60	2.79	3.86	-6.86	3.57
China Renminbi Spot	CNY	6.25	**0.06**	0.08	-0.05	-0.10	-1.72	-2.55	-1.95	-3.14
Singapore Dollar Spot	SGD	1.26	**-0.10**	-0.14	-0.29	-0.60	0.91	-0.27	-0.45	0.41
Norwegian Krone Spot	NOK	6.01	**-0.11**	-0.57	-0.60	-0.85	0.04	2.42	-3.32	1.03
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	11.87	**2.50**	3.13	4.12	-8.06	-15.82	-19.25	-27.04	-13.48
USD SWAP SPREAD SEMI 2YR		14.00	**3.70**	14.38	1.82	1.08	4.63	47.37	-15.66	33.33
TED SPREAD		0.00	**0.55**	1.65	1.62	-2.13	5.34	8.19	-16.22	-86.34

All data is compiled from Bloomberg

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