Friday, October 3rd 2014

It is Friday again. This one is special, being the first Friday of Q4 2014, the first Friday of 5'775 and the time to wish an *"Eid El Kebir"* ahead of Saturday's *Eid Al Adha*! To all our friends and readers we wish that our shared next year be better - starting with good Q3 results and a lucrative Q4!

However, we have another cloud in our optimistic skies - Street demonstrations in Hong Kong rattling the markets who remember Tiananmen Square. But to bring these upsetting scenes into context - there were more people last week in Jay-Z's concert in Central Park, NY, than on the streets of HK… More worrying though, were the whispers that Russia's central bank is evaluating the introduction of temporary capital controls if the flow of money out of the country intensifies, according to two officials. Later denied however as the Rouble continued to slide, falling to 39.75 vs. the US$.

We have had a seriously volatile week in the equity markets with a significantly negative slant. The Dollar rose more, oil traded down as did many other commodities. Geopolitics are being blamed, some are hailing the long awaited "correction" as if it were a Messiah of sorts. We believe that the true cause for fear lays elsewhere - Deflation, and a global one at that! Is the Japanese experience of the last 20 odd years to be a mould for the rest of the so-called "advanced" world? Well, the Eurozone can't seem to find its way out of downward drifting prices and poor economic growth, china is cooling... Oil prices continue to fall... The US Dollar is up and rising, reducing import prices to the States and acting indirectly as a tightening of interest rates, so making Janet Yellen's 2% inflation target more elusive than ever. What is the risk of lower inflation you may ask? A simple answer lies in the true cost of the debt - Inflation erodes the true cost of repayment, so clearly deflation must increase it. And when coupled with the fact that the indebtedness of the World in general (and the USA in particular) is at all-time highs both in nominal terms and in percentage of GDP terms- Yes, we want inflation! This may be the real storm clouds behind the horizon explaining the low bond yields... Is inflation falling because of technology? We need fewer workers at lower wages; we are ever more efficient in the use of a unit of commodities, etc., etc. Remembering that inflation is effectively a tax, used to repay debts, then deflation must be the opposite, raising debt. Can't be good… Christine Lagarde said this week that the Global economies – although recovering – had not grown as fast as the IMF had predicted and quipped, "There are some serious clouds on (the) horizon".

Or is the cause to be found in the Energy dynamic within the USA - importing less oil, reducing trade deficit, upwards pressure on the Dollar, an effective tightening... Even less US inflation... Will the Fed raise rates? Hardly possible! On Wednesday a new German Bund was issued under 1% for 10years! The US 10 year falls to 2.39%...

France is being pointed at as being the new sick man of Europe. Well, its debt to GDP has risen steadily... Now at 91.8% or so, but all of the Euro Zone is 92.6%, and the UK is right there as well, US at 101.5% and Japan over 227.2%; Horrible? Well, the French deficit is above the target of 3%, at 4.3% indeed naughty... but the UK is over 5%, the U.S. at 8% and we applaud the Dollar... What does it all mean? It is indeed a very complicated algorithm to formulate, even harder to solve. We must adopt a long-term vision and apply it day by day…

To add to our anxieties, we have the Brazilian elections this weekend. Markets, for their part, saw the release of second-quarter GDP figures as raising the chances of a victory by the opposition and are hopeful that a new president would implement a more responsible economic policy. This explains why investors have been so bullish; the Bovespa reached a 20-month high on August 29th. Ms Rousseff is no longer a shoe-in: polls suggest that she would lose in a second-round run-off to the Brazilian Social Party's Marina Silva. In the past week though, the BOVESPA is off 4.4% and 7.3% in $ terms…

Dr Doom, Nouriel Roubini, has been advocating his three Black Swan scenarios that could destabilise the global system. His worries are three fold, 1) A surprise terrorist attack that could unnerve global markets, 2) The conflict in Ukraine or Syria escalating, possibly having a destabilisation effect on the surrounding countries or lastly 3) Due to the interconnectedness of the world that any geopolitical or political tension is more likely to trigger a global contagion when they all happen at the same time...

For those of our readers who own equities and are feeling uncomfortable with the recent turmoil, do take comfort that one of the greatest investors, Warren Buffet said, "I bought stocks in Wednesday's big selloff". Buffett said he likes to buy stocks when they go down, not when they go up. "The more [the market] goes down, the more I like to buy." Well, the ECB will be buying debt instruments for at least two years says Draghi, so perhaps the clouds are still a little way off and looks like we have a safety net for a while yet. We believe that as Ralph Marston says, "What you do today, can improve all of your tomorrows." We can't predict the future, but we hope to be improving it today! Bon weekend ☺

Market outlook

Core View: We hold our long-standing base-view that the world's economies are mending from the fallout of the "Great Recession" if at a slower pace than hoped for. The economics are settling back into a reasonable growth pattern and with stability that creates a positive bias that is expected to continue. We maintain this "bullish" view, although European economies remain weak and we experienced a pullback in equities from September into October. We expect the ECB to add fuel to the European economies and act as a back-stop against economic declines, just as the Fed has done over the past several years. And now, the Bank of China is said to join the "party" supporting the rising Japanese support…

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 and as such, short term interest rates are unlikely to rise anytime soon. This in itself lightens the risk of significant changes to the yield-curves. Whilst this suggests that there is little "duration-risk" in the fixed-income sector, *there is little upside to holding bonds. Total-returns from fixed-income will not replicate the stellar returns of the past decade and are likely to remain in the very low single digit.*

The big unknown is the effects of the huge US$ rally - What dislocations will this cause? Prices of commodities in general (oil in particular) are rising for non-US Dollar economies, whilst falling for the USA. The US consumer sees a drop in import prices and a decline in petrol costs; a significant boost to their purchasing power. It adds downwards pressure on American inflation, whilst boosting inflation elsewhere. This is further confused by the effects of the US increased oil production, lowering its dependence on energy imports and an immediate effect on its balance of payments - with a drop in its trade deficit, it may further bolster the US$, but at the same time reduces the surpluses of oil-producing nations and therefore reducing the latters' appetite for buying US Treasuries. Complicated and difficult to assess. All this coupled with the Geopolitics, there is much fog covering our long-vision. In short we must keep vigilance on the following;

1. **Geopolitics in connection with the Islamic radicalisation in Iraq and Syria, accentuated by the risk of spill-over into Saudi Arabia, in-fighting in Libya, and the ongoing quarrels in the Sea of China.**
2. **Russia-Ukraine conflict - the risk of escalation remains severe despite the talks towards a definitive settlement.**
3. **The health-scare of Ebola spreading beyond West Africa - with risks of quarantines, reduced air-travel and eventual repercussions on economies.**
4. **Slide in oil prices and rise of the US Dollar.**

These risks don't produce predictable outcomes or effects in our markets.

- **Fixed Income -** As all Central Banks are seeking somewhat higher inflation than they have, it is hardly reasonable that they raise rates. Vigilance is important. Short maturities/low duration are, and remain, appropriate - virtually no upside exists in the sector and expected returns at the 3% level (coupons with eventual capital gains/losses) are insufficient to offset the underlying risks. We find that the reward for assuming credit-risk has become too small and we have been observing ongoing exits from the "High Yield" sub-sector.

- **Equities -** We feel secure in owning equities. We remain positive inspite of recent volatility and recommend exposures to be maintained or even increased - we say this even with indices at or near all-time highs! We suggest using global-diversified equity funds, some niche themes or allocating some fixed income holdings into convertible bonds for bond-oriented investors.

- **Alternatives -** With relative economic stability and a clearing horizon, fundamentals are returning to text-book norms of relative values. We expect this active management allocation to maintain, if not exceed, its relatively low recent results and possibly returning to past highs - with low correlation to any particular sector and significantly lower volatility than equities. We have seen the landscape improve for both the Macro and CTA Funds which has lead to improved performance after a tough H1 of 2014. We hold our view that a well-diversified Fund-of-Funds is the best way to express this allocation. We reiterate the role of hedge funds in a portfolio is to attenuate volatility and risks and not as an enhancement of returns!

- **Currencies/Commodities -** The markets' low volatility relative to the past 5 years may be changing with an uptick in option-volatility appearing. The USD is gaining versus almost all its major trading counterparts, now trading at about $1.2640 against the EUR and up to 0.9550 against the Swiss Franc. We maintain our belief in the fundamental strength of the US$ and would not bet against it at this time. The Japanese Yen has steadied at around 109.00 vs. the US$, having briefly crossed the 110 level! Gold has stabilized as the US$ continued its rise now around $1,206, we note that Oil has continued is downwards slide, whilst risks to its supply are rising. WTI had broken $90/BBl, reaching $88.00 and is now at $90.90.

This Week's Highlights:

- In the FX markets the EUR took a nasty tumble from 1.27 to hit 1.2570 after the EU Core CPI number disappointed the markets. As the dust settled and Mr Draghi spoke towards the end of the week holding the ship steady, the EUR move higher eventually hitting 1.27 yesterday evening. We are somewhat weaker today at 1.2650. Cable has now resumed its downward slow grind lower seeing the pound move gently from 1.6250 to 1.61 this morning. The Yen has not totally capitulated, with a little fight left in the currency it has moved from 110.10 to hit 108.00 yesterday only to rebound to 108.60 as we write. The USD index soared on Tuesday to reach 86.20, but as the days have rolled on it has given up some of its gains versus the basket of currencies that it is benchmarked against. Even the terribly beaten commodity currencies took a little respite from king dollar this week. The AUD moved from 0.8660 to 0.8820 in two sessions and is only marginally off its highs.
- US Government bonds strengthened this week and sent the yields lower again. The US 10Yr yields moved from 2.52% to briefly touch 2.38% mid-week, trading now at 2.42%. The UK Gilt traded well throughout the week, moving steadily from 2.47% to hit 2.32%! The Bund yields dropped even further from 0.98% to 0.89%. The yields on the French OAT 10 year bonds traded well this week, seeing the yield move from 1.33% to 1.24%. Overall, the bond markets globally have risen and would appear to be at near all-time highs in Europe, bringing yields closer to their recent, all-time lows. The trend of narrowing of the periphery yields continues and we are almost back to the lowest spreads in 4 years for Spain, Italy and France.
- Equity markets around the globe took a further tumble this week (except for Australia that was +0.1% on the week!). European markets were around 3% down for the week, with Italy and the Dax down the hardest at 3.4% a piece. The US escaped a little less painfully, although not totally unscathed, with the largest indices (S%P500 and DJIA) falling about 1% for the week (prior to the opening). Unfortunately the biggest loser this week has been Brazil with the domestic market falling 4.4% before today's open, which in USD terms means 7.3% in a week!

Data Flash:

As we are running a bit late today we are able to add the US Payrolls and Unemployment Figures that have just been released:

- Change in Non-Farm Payrolls was 248K, versus an expected level of 215K.
- Unemployment Rate is at 5.9%, versus an expected level of 6.1%.

The US$ has jumped significantly versus both the EUR and the GBP.

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

02/10/2014

INDEX NAME	CCY	Last Price	1D	5D	MTD	1M	3M	6M	1Y	YTD	
			PRICE CHANGE IN % (unless indicated)								
EQUITY MARKET INDICES - BY REGION											P/E
MSCI WORLD	USD	1,667.98	**-0.66**	-2.34	-1.79	-4.80	-5.45	-1.02	8.11	0.42	15.43
MSCI WORLD LOCAL	-	1,216.60	**-0.82**	-1.81	-1.88	-3.20	-2.31	1.23	10.61	2.71	-
MSCI AC WORLD	USD	409.62	**-0.64**	-2.41	-1.73	-5.37	-5.57	-1.00	7.05	0.26	14.85
MSCI EM	USD	992.53	**-0.43**	-3.06	-1.27	-9.85	-6.56	-0.76	-1.27	-1.01	11.30
S&P 500 INDEX	USD	1,946.17	**0.01**	-1.01	-1.32	-2.73	-1.98	3.04	15.94	5.29	16.11
DOW JONES INDUS. AVG	USD	16,801.05	**-0.01**	-0.85	-1.42	-1.62	-1.57	1.38	12.03	1.35	14.70
NASDAQ COMPOSITE INDEX	USD	4,430.20	**0.18**	-0.82	-1.41	-3.11	-1.24	4.54	17.38	6.07	18.50
RUSSELL 2000 INDEX	USD	1,096.38	**1.01**	-1.25	-0.48	-6.47	-9.25	-7.17	2.38	-5.78	18.04
EURO STOXX 50	EUR	3,106.42	**-2.77**	-3.51	-3.70	-3.49	-5.57	-3.13	7.04	-0.08	14.08
CAC 40 INDEX	EUR	4,242.67	**-2.81**	-3.46	-3.93	-4.05	-5.51	-4.64	2.78	-1.24	14.46
DAX INDEX	EUR	9,195.68	**-1.99**	-3.31	-2.94	-4.48	-8.31	-4.50	6.95	-3.73	12.80
FTSE 100 INDEX	GBP	6,446.39	**-1.69**	-3.05	-2.66	-6.21	-6.10	-3.05	-0.04	-4.49	13.35
SWISS MARKET INDEX	CHF	8,654.71	**-1.53**	-1.36	-2.04	-1.69	-0.46	1.56	8.97	5.51	16.70
NIKKEI 225	JPY	15,661.99	**-2.61**	-3.21	-2.87	-0.13	2.35	4.22	10.96	-3.58	17.29
HANG SENG INDEX	HKD	22,932.98	**-1.27**	-3.46	0.71	-6.69	-0.41	2.88	1.03	-0.91	10.61
SHANGHAI SE COMPOSITE	CNY	2,363.87	**0.26**	2.34	0.00	5.74	15.29	15.45	8.70	11.72	9.24
S&P BSE SENSEX INDEX	INR	26,567.99	**-0.23**	-0.66	-0.23	-1.67	2.81	17.81	36.13	25.49	17.08
RUSSIAN RTS INDEX $	USD	1,095.11	**-1.64**	-5.48	-2.75	-11.82	-21.42	-9.74	-23.46	-24.25	4.75
BRAZIL IBOVESPA INDEX	BRL	53,518.57	**1.25**	-4.37	-1.10	-13.45	-0.66	4.11	1.96	3.91	11.51
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	270.96	**-1.17**	-3.80	-2.89	-9.76	-12.94	-3.85	4.68	-1.68	13.33
MSCI MATERIALS	USD	228.24	**-0.82**	-3.68	-2.48	-8.67	-11.24	-6.50	-0.23	-4.90	15.39
MSCI INDUSTRIALS	USD	192.58	**-0.80**	-2.82	-2.33	-5.38	-7.32	-5.09	4.29	-4.64	15.81
MSCI CONS DISCRETIONARY	USD	172.65	**-0.42**	-2.49	-1.55	-5.03	-6.61	-3.85	2.63	-5.01	16.30
MSCI CONS STAPLES	USD	190.97	**-0.43**	-1.22	-1.22	-3.43	-5.06	0.40	6.51	0.26	18.36
MSCI HEALTH CARE	USD	191.50	**-0.65**	-1.85	-1.52	-1.71	-0.23	5.78	21.13	11.43	17.78
MSCI FINANCIALS	USD	100.18	**-0.77**	-2.39	-1.52	-5.11	-5.01	-2.67	5.08	-1.68	13.24
MSCI INFO TECH	USD	133.34	**-0.16**	-1.78	-1.76	-2.48	0.00	6.04	20.86	8.27	16.34
MSCI TELECOMS	USD	68.97	**-0.93**	-2.16	-1.74	-3.70	-5.35	-2.94	2.68	-4.20	15.61
MSCI UTILITY	USD	117.03	**-1.05**	-0.86	-1.17	-3.85	-5.05	-0.59	7.91	6.51	15.79
MSCI WORLD REAL ESTATE	USD	181.80	**-0.56**	-1.66	-0.68	-7.70	-4.83	1.46	2.35	3.90	22.47
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,233.22	**-0.55**	-0.97	-0.55	-1.31	-1.32	-0.67	2.70	0.63	
HFRX EQUAL WEIGHTED	USD	1,207.88	**-0.40**	-0.76	-0.40	-1.08	-1.13	-0.67	2.56	0.90	
HFRX GLOBAL EUR	EUR	1,139.63	**-0.57**	-1.02	-0.57	-1.40	-1.47	-0.86	2.35	0.34	

MARKET INDICES PERFORMANCE

02/10/2014

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.01	**0.00**	0.00	-0.01	-0.01	0.01	-0.01	-0.01	-0.06
US 2 YEAR	USD	0.53	**0.76**	-0.05	-0.04	0.01	0.02	0.07	0.22	0.15
US 10 YEAR	USD	2.43	**0.37**	-0.09	-0.05	0.04	-0.20	-0.36	-0.17	-0.59
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	466.46	**-0.06**	0.26	0.24	0.21	1.68	3.60	5.66	5.53
US GOVERNMENT TR	USD	2,046.05	**-0.13**	0.33	0.35	0.15	1.15	2.34	2.66	3.35
US CORPORATE TR	USD	2,555.47	**-0.19**	0.23	0.51	-0.45	1.13	3.49	7.22	6.14
US HIGH YIELD TR	USD	1,640.71	**0.03**	-0.06	0.20	-1.88	-1.70	0.60	7.22	3.70
EU GOVERNMENT TR	EUR	233.41	**-0.13**	0.29	0.14	0.53	3.15	6.18	10.74	9.75
EU CORPORATE TR	USD	241.91	**-0.05**	0.09	0.07	0.25	1.97	4.48	7.78	6.78
EU HIGH YIELD TR	EUR	266.45	**-0.11**	-0.46	-0.03	-0.67	-0.39	1.63	8.79	4.91
JACI GLOBAL	USD	248.94	**-0.41**	-1.50	-0.41	-3.79	-6.43	-5.93	1.27	-1.74
GLOBAL EM TR (HEDGED)	USD	325.51	**-0.04**	-0.60	0.06	-0.90	-0.29	3.73	8.04	6.70
S&P/LSTA U.S. LEV LOAN	USD	96.92	**-0.06**	-0.52	-0.04	-1.40	-2.19	-1.52	-0.59	-1.35
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	4,435.86	**-0.54**	-1.89	-0.75	-4.85	-12.58	-9.12	-9.14	-8.15
GSCI ENERGY TR	USD	1,019.39	**-0.77**	-2.87	-1.12	-4.67	-13.55	-7.95	-9.30	-9.48
GSCI INDUSTRIAL METALS TR	USD	1,318.15	**-1.18**	-2.32	-1.96	-7.92	-6.44	0.88	-3.23	-3.56
GSCI PRECIOUS METALS TR	USD	1,510.64	**-0.17**	-0.75	0.25	-4.78	-10.22	-7.15	-10.13	-0.83
GSCI AGRICULTURE TR	USD	502.02	**0.70**	1.05	0.79	-10.10	-17.64	-26.97	-23.03	-17.24
GENERIC 1ST 'CL' FUTURE	USD	91.01	**0.38**	-2.33	0.22	-3.72	-7.49	-2.88	-6.45	-0.13
GOLD SPOT $/OZ	USD	1,214.52	**-0.61**	-0.93	-0.09	-4.91	-8.52	-6.19	-8.33	0.12
CURRENCIES										
DOLLAR INDEX SPOT	USD	85.60	**0.25**	0.21	-0.14	3.56	6.99	6.64	7.61	7.22
Euro Spot	EUR	1.27	**-0.20**	-0.32	0.10	-3.85	-7.10	-7.84	-7.16	-8.00
Japanese Yen Spot	JPY	108.42	**-0.40**	0.40	0.74	-3.73	-6.12	-4.52	-10.64	-3.25
British Pound Spot	GBP	1.61	**-0.14**	-0.79	-0.56	-2.06	-6.02	-2.87	-0.21	-2.63
Brazilian Real Spot	BRL	2.49	**-0.55**	-2.69	-1.92	-10.07	-10.87	-9.06	-12.15	-5.32
China Renminbi Spot	CNY	6.14	**-0.02**	-0.20	0.00	0.04	1.20	1.18	-0.30	-1.38
Singapore Dollar Spot	SGD	1.27	**-0.09**	0.11	0.20	-1.70	-2.07	-0.79	-1.89	-0.80
Norwegian Krone Spot	NOK	6.45	**-0.13**	0.07	-0.42	-3.65	-4.09	-6.98	-7.73	-5.92
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	16.16	**-3.29**	3.32	-0.92	30.74	56.59	20.87	-8.55	17.78
USD SWAP SPREAD SEMI 2YR		26.94	**-0.71**	14.41	8.92	27.75	94.55	130.01	93.70	154.76
TED SPREAD		-	-	-2.63	1.18	2.11	-2.41	6.31	-7.00	-84.82

All data is compiled from Bloomberg

Disclaimer