Bedrock Newsletter Friday, October 31st 2014

It is Halloween! But the monsters, ghouls, goblins, witches, devils, ghosts and other scary things that go “bump in the markets” have already come-out during October (as has Tim Cook), so we are immunized and no longer scared nor worried! October is closing with a Japanese bang - The BOJ gave us its happy offering to close the month with a smile - a big stimulus which pushed the Nikkei up by 5% and knocked the Yen down by 2% or so. Just to put this in perspective; their additional stimulus package is approximately 47Bn USD of additional monthly purchases, across both the fixed income and (unlike the FED!) also directly into equity markets. So as the US removes 15Bn USD per month, the Japanese Central bank is in fact injecting twice what is being removed! Dare the ECB follow?!? As this came on the back of the US surprising us with a better than expected Q3 GDP growth at 3.50% - equity markets are on fire again! US futures greeted us with an indicated 1% rise for today and European markets are ticking-up at about 2% as we write. The “elephant in the markets” though is the US Dollar- rushing through 111.80 Yen and to 1.256 vs. the Euro. Yes, the elephant has a green-back ☺

On Wednesday night we had the FOMC minutes and press-conference - surprisingly, they were quite “hawkish” causing a fall in bond prices and a big jump in the US Dollar. Equities rose as the implicit message was that the economy is doing better. The “victims” of this news were gold, oil and US Treasuries. Gold now at $1’170/Oz is clearly out of favour; except for Alan Greenspan, the near-legendary Fed chairman whose every utterance used to be parsed by market watchers, as he spoke before the Council on Foreign Relations and advised listeners that under current conditions, gold is probably a good investment. Well, he is the “Ex-Chairman”… We look at it all and trace the effects to their cause - The rising King Dollar. And the King may yet be crowned Emperor if/when the ECB goes full-bore ahead with a massive QE of its own. Stay with the said green-backed-elephant!

With this currency outlook for the Dollar, it becomes even less likely that the Fed will raise interest-rates anytime soon, as this would further fuel the rise in the currency and further stymy inflation. And the US needs some inflation, if nothing else to deflate the national debt… Well, we know that the “tapering” process is over. For now... Perhaps we may want to worry about an eventual QE (IV) if the outlook becomes less rosy for the economy. We are all becoming like our mothers; we must worry about something… Well, Greenspan is clearly showing these symptoms, talking about QE at the same meeting mentioned above, saying that “(the program) hasn’t been a success on the demand side for one fundamental reason,” “What you’re basically seeing is an explosion of assets, an explosion of reserve balances, and that’s the only two statistics that are moving.” Hence his concern for the Dollar and fondness for Gold…

Oh well… Consumer confidence advanced in October as Americans enjoyed further price drops at the gas pump and the job market continued to improve. The Conference Board’s confidence index climbed to 94.5 this month, the highest since October 2007, from a September reading of 89 that was stronger than initially estimated. The gauge exceeded the most optimistic projection in a Bloomberg survey of economists. Things and perceptions are changing… It used to be that “Gentlemen preferred Bonds” and now they seem to favour Stocks (of any shade)…

Let’s not lose sight of last Sunday’s voting in Brazil and in Ukraine! Brazil’s President Dilma Rousseff won re-election and stretched her Workers’ Party’s rule to a record 16 years by convincing voters her opponent threatened social gains… which she had pledged to further expand in her second term. On the news, the Reais went down heavily as did the BOVESPA, only to close the week after as though nothing changed (which it didn’t)… Actually, the Reais is now up 3% versus last Friday’s close… In Ukraine, the parliamentary elections gave the country a stronger pro-west bias. And negotiations with Russia continue - the main issue is about bills… If we remember it right - “The advantage of a bad memory is that one enjoys several times the same good things for the first time.” (Friedrich Nietzsche).

We closed last year with a prediction of the S&P500 at 2’100 for year-end 2014 and a strong Dollar. Whilst at times during the year this dream took-on the flavour of a nightmare (on wall-street), it is now looking quite realistic - only 5% to go and the normally best months of the year about to start… Nietzsche said it well, “Hope in reality is the worst of all evils because it prolongs the torments of man.” May your weekend be as sunny as today’s markets no doubt will be!

Market outlook

<u>Core View</u>: 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. This view was confirmed by the FOMC's somewhat "hawkish" commentary rendered last night. We maintain our "bullish" view. We feel that the equity-markets have set a base for a rally as, overall, Q3 earnings are coming-in good and the stimulus from lower energy costs is yet to flow into earnings and sales.

A tough call as to which way we move forward from here though as commodities and the bond market still hint at deflation with the Equities seeing something very different. It may be the opportunity of a decade or the start of a big problem. We say we hold our positions of both some equities and some bonds and wait for further clarity to emerge.

As a group, most Central Banks are targeting an elusive 2% inflation rate. The industrialised economies are running with excess labour (less so in the USA as per Janet) 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- looking forward…

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 – finally exiting from QE3 yesterday evening. And let's not forget the Bank of China is said to join the "support party" together with the Bank of Japan.
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 increased oil production in the USA, lowering its dependence on energy imports and an immediate effect on its balance of payments from a drop in its trade deficit; it may further bolster the US$, but at the same time it reduces the surpluses of other oil-producing nations and therefore reducing the latters' appetite for buying US Treasuries. Complicated and difficult algorithm to assess. All this coupled with 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 settlement, especially in light of the Ukrainian vote in favour of steering to the West.**
3. **The health-scare of Ebola spreading beyond West Africa - with risks of quarantines, reduced air-travel and eventual repercussions on economies.**
4. **Continued 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 anytime soon. Vigilance is important! Short maturities/low duration are, and remain, appropriate - little upside exists in the sector and expected returns at the 3% level (coupons with eventual capital gains/losses) barely offset the underlying risks. We find that the reward for assuming credit-risk is too small.

- **Equities -** We feel secure in owning equities. We remain positive despite the recent large scale volatility and recommend exposures to be maintained or even increased. We suggest using global-diversified equity funds, some niche themes or allocating some fixed income holdings into convertible bonds for bond-oriented investors, especially as some pricing opportunities in the convertible space are appearing.

- **Alternatives -** With October hitting many managers hard, the CTA's having a strong performance to offset some of the equity managers low returns, we maintain 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 is clearly changing with a significant uptick in option-volatility. The USD has gained ground versus almost all its major trading counterparts, now trading at about $1.2570 against the EUR and up to 0.9600 against the Swiss Franc. We maintain our belief in the fundamental strength of the US$ and would not bet against it at this time. The Japanese Yen has dropped again, trading at 111.60 vs. the US$ after their surprise easing program was announced last night. Gold is really showing difficulties in holding its value and trades now around $1,172 (it is a soft metal after all!), we note that Oil has steadied with WTI trading around $80.50/BBl, having dipped to 79.350 on Monday.

This Week's Highlights:

- US Government bonds held their breath this week awaiting the closure of QE(III). When announced, the yields barely moved; having already priced the possible closure of quantitative easing the yield bumped around and we seem to be resting at or about 2.31% on the 10Yr Treasury. The UK 10Yr Gilt traded steadily throughout the week barely moving from 2.23%, more or less the same as last week's close. The Bund yields are going back to where they started last week at around 0.84% after having been as high as 0.91% on the slightly weaker than expected German GDP numbers. The yields on the French OAT 10Yr bonds have followed the Bunds lower to 1.17%.

- The USD soared again from 1.2750 at the FOMC meeting to hit 1.2540 this morning. The JPY took a battering twice this week, firstly from the FOMC moving it from 108.00 to 108.90 and then crashing from 109.30 to 111.85 as we write now on the news that the BOJ will unleash further QE on the markets. The CHF dropped as well seeing the pair move from 0.9450 to 0.96, Cable dropped as well moving from 1.6150 to 1.5950… in fact the USD rallied against nearly all of its major currency counterparts. The BRL in fact seems to be the stand out performer having moved from 2.54 on Monday morning (2.47 at last Friday's close) to 2.40 last night… +3% in 4 trading days, despite Dilma being re-elected. The CNY remains steady against the USD, as the only currency to wash over the recent turmoil.

- As the dust is settling once again, the media barons have not managed to find another case of Ebola and the Equity markets have been boosted by the firm economic numbers, the QE boosts from Japan and the better than expected Q3 earnings reports. The S&P500 rallied by 1.6% this week from 1,963 to close last night at 1,994 but with the futures indicating better than 1% up for today's open. The DJIA has moved up by 2.4% with another 1% expected on today's open. Europe took a boost as well, despite the poor German data yesterday morning that knocked the DAX down by 2.5%, only to end the week up 3.2%. With Dilma winning the Brazilian election, equities initially sold off by 6.25% however ended yesterday at +0.75% for the week so far!

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

30/10/2014

			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	1,689.22	0.18	1.28	-0.54	-0.54	-1.47	0.09	5.39	1.69	15.71
MSCI WORLD LOCAL	-	1,233.93	0.53	1.84	-0.48	-0.48	-0.71	3.07	7.99	4.17	-
MSCI AC WORLD	USD	414.94	0.19	1.40	-0.46	-0.46	-1.92	0.21	4.49	1.56	15.14
MSCI EM	USD	1,007.54	0.27	2.35	0.22	0.22	-5.46	1.23	-2.60	0.48	11.64
S&P 500 INDEX	USD	1,994.65	0.63	2.25	1.13	1.13	3.31	5.88	13.56	7.91	16.58
DOW JONES INDUS. AVG	USD	17,195.42	1.30	3.10	0.89	0.89	3.82	3.71	10.61	3.73	15.15
NASDAQ COMPOSITE INDEX	USD	4,566.14	0.38	2.55	1.62	1.62	4.49	10.98	16.49	9.33	18.99
RUSSELL 2000 INDEX	USD	1,155.77	0.82	3.52	4.91	4.91	3.19	2.57	5.06	-0.68	19.20
EURO STOXX 50	EUR	3,035.90	0.45	-0.28	-5.89	-5.89	-2.56	-5.08	-1.04	-2.35	13.91
CAC 40 INDEX	EUR	4,141.24	0.74	-0.40	-6.23	-6.23	-2.47	-7.71	-3.69	-3.60	14.29
DAX INDEX	EUR	9,114.84	0.35	0.75	-3.79	-3.79	-3.11	-5.09	0.90	-4.58	12.77
FTSE 100 INDEX	GBP	6,463.55	0.16	0.69	-2.40	-2.40	-3.96	-4.67	-3.98	-4.23	13.56
SWISS MARKET INDEX	CHF	8,719.03	0.75	2.02	-1.31	-1.31	3.67	2.86	5.89	6.29	16.98
NIKKEI 225	JPY	15,658.20	0.67	7.34	1.49	1.49	5.08	14.75	14.56	0.75	17.87
HANG SENG INDEX	HKD	23,702.04	-0.49	2.85	4.51	4.51	-3.19	8.28	3.28	2.83	11.06
SHANGHAI SE COMPOSITE	CNY	2,391.08	0.76	5.12	2.38	2.38	9.93	19.43	13.01	14.38	9.61
S&P BSE SENSEX INDEX	INR	27,346.33	0.92	3.28	4.14	4.14	7.10	23.71	31.03	31.00	17.88
RUSSIAN RTS INDEX $	USD	1,098.68	3.69	6.24	-1.99	-1.99	-9.68	-4.70	-25.60	-23.66	5.05
BRAZIL IBOVESPA INDEX	BRL	52,336.83	2.52	3.20	-3.29	-3.29	-6.26	1.38	-3.54	1.61	11.41
EQUITY MARKET INDICES - BY SECTOR											**P/E**
MSCI ENERGY	USD	260.86	-0.61	0.16	-6.51	-6.51	-12.33	-11.50	-3.16	-5.34	13.37
MSCI MATERIALS	USD	223.99	-0.86	-0.82	-4.30	-4.30	-10.69	-9.21	-5.02	-6.67	15.43
MSCI INDUSTRIALS	USD	196.40	0.00	1.46	-0.39	-0.39	-1.28	-2.69	2.31	-2.75	16.18
MSCI CONS DISCRETIONARY	USD	175.69	0.28	1.63	0.18	0.18	-1.28	0.31	0.86	-3.34	16.62
MSCI CONS STAPLES	USD	195.18	0.05	1.59	0.96	0.96	1.48	-0.19	3.52	2.47	18.87
MSCI HEALTH CARE	USD	198.17	1.33	1.88	1.91	1.91	5.95	9.46	20.70	15.32	18.34
MSCI FINANCIALS	USD	101.74	0.02	1.04	0.01	0.01	-1.49	-0.16	2.89	-0.15	13.40
MSCI INFO TECH	USD	134.69	0.28	1.55	-0.77	-0.77	1.34	8.50	17.80	9.36	16.46
MSCI TELECOMS	USD	69.88	-0.07	2.37	-0.44	-0.44	-3.51	-2.20	-0.77	-2.93	15.85
MSCI UTILITY	USD	122.22	0.96	1.99	3.21	3.21	2.53	1.24	9.26	11.23	16.47
MSCI WORLD REAL ESTATE	USD	191.80	0.48	1.30	4.78	4.78	-0.55	5.03	5.75	9.61	23.72
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,216.91	-0.12	0.30	-1.86	-2.00	-2.10	-1.06	0.39	-0.70	
HFRX EQUAL WEIGHTED	USD	1,196.48	0.01	0.31	-1.34	-1.47	-1.75	-1.00	0.81	-0.05	
HFRX GLOBAL EUR	EUR	1,124.25	-0.14	0.29	-1.91	-2.06	-2.25	-1.31	0.04	-1.01	

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30/10/2014

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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	-0.02	-0.02	-0.03	-0.06
US 2 YEAR	USD	0.48	0.01	0.10	-0.09	-0.09	-0.05	0.07	0.18	0.10
US 10 YEAR	USD	2.33	0.03	0.07	-0.16	-0.16	-0.22	-0.31	-0.22	-0.69
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	468.61	0.07	0.04	0.71	0.71	1.60	3.18	5.28	6.01
US GOVERNMENT TR	USD	2,060.95	0.09	-0.14	1.08	1.08	1.58	2.20	2.88	4.11
US CORPORATE TR	USD	2,573.25	0.07	-0.14	1.21	1.21	1.17	2.59	6.42	6.87
US HIGH YIELD TR	USD	1,655.05	-0.04	-0.01	1.08	1.08	-0.09	0.94	5.73	4.61
EU GOVERNMENT TR	EUR	233.20	0.17	0.30	0.05	0.05	1.90	4.90	9.62	9.65
EU CORPORATE TR	EUR	242.63	0.13	0.25	0.37	0.37	1.71	3.69	7.02	7.09
EU HIGH YIELD TR	EUR	266.39	-0.11	0.29	-0.05	-0.05	-0.31	0.78	6.75	4.89
JACI GLOBAL	USD	247.22	0.14	1.52	-1.10	-2.29	-5.42	-6.09	-1.19	-2.42
GLOBAL EM TR (HEDGED)	USD	328.69	0.04	0.47	1.03	1.03	0.44	3.81	6.87	7.74
S&P/LSTA U.S. LEV LOAN	USD	97.02	0.09	0.35	0.07	0.07	-1.39	-1.27	-0.95	-1.24
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	4,217.69	-0.94	-0.06	-5.63	-5.63	-13.53	-15.79	-12.34	-12.67
GSCI ENERGY TR	USD	935.17	-1.04	-0.35	-9.29	-9.29	-17.39	-17.71	-15.07	-16.96
GSCI INDUSTRIAL METALS TR	USD	1,366.58	-0.46	1.65	1.64	1.64	-4.73	3.82	-1.67	-0.02
GSCI PRECIOUS METALS TR	USD	1,486.24	-2.45	-2.68	-1.37	-1.37	-9.19	-8.46	-13.76	-2.43
GSCI AGRICULTURE TR	USD	541.60	-0.72	1.77	8.74	8.74	-3.63	-24.97	-15.19	-10.71
GENERIC 1ST 'CL' FUTURE	USD	81.12	-0.49	-0.36	-11.14	-11.14	-14.65	-13.74	-10.22	-11.45
GOLD SPOT $/OZ	USD	1,198.78	-2.13	-4.69	-2.89	-2.89	-8.53	-9.16	-11.33	-2.69
CURRENCIES										
DOLLAR INDEX SPOT	USD	86.15	0.60	1.09	0.85	0.85	6.40	9.05	8.07	8.29
Euro Spot	EUR	1.26	-0.39	-0.84	-0.53	-0.53	-6.17	-9.40	-7.51	-8.58
Japanese Yen Spot	JPY	109.21	-2.01	-2.95	-1.62	-1.62	-7.76	-8.26	-11.75	-5.51
British Pound Spot	GBP	1.60	-0.13	-0.68	-1.43	-1.43	-5.36	-5.29	-0.37	-3.48
Brazilian Real Spot	BRL	2.40	2.47	4.05	1.84	1.84	-6.53	-7.09	-8.83	-1.69
China Renminbi Spot	CNY	6.12	0.09	0.11	0.48	0.48	1.05	2.45	-0.26	-0.91
Singapore Dollar Spot	SGD	1.28	-0.43	-0.63	-0.59	-0.59	-2.78	-2.31	-3.24	-1.59
Norwegian Krone Spot	NOK	6.70	-0.01	-1.58	-4.14	-4.14	-6.24	-11.26	-11.36	-9.43
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	14.52	-4.16	-12.16	-10.97	-10.97	-14.34	8.28	5.60	5.83
USD SWAP SPREAD SEMI 2YR		21.56	0.88	-15.34	-11.44	-11.44	9.08	83.08	81.40	107.14
TED SPREAD		22.73	2.16	-0.53	3.37	3.37	8.65	14.74	7.47	26.14

All data is compiled from Bloomberg

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