Bedrock Newsletter Friday, December 5th 2014

We can hear a faint sound of Christmas bells tolling in the background… Thanksgiving came and went in a whimper with disappointing Black Friday sales and yet, both the S&P 500 and the DJIA continued their relentless striking of new highs. The stock market has heated up mightily after a swift October rout, with the S&P 500 6% higher in a month. And history suggests that it could soon get even better for the bulls. In the 20 times when the S&P 500 has enjoyed moderate gains (between 0 and 15%) in the year to Thanksgiving, the S&P has added to those gains 18 of 20 times, according to Jason Goepfert of SentimenTrader.

Clearly the three big issues of 2014 are and have been the rise of the US Dollar against all its major trading partners (except the Chinese Yuan), the fall in commodities' prices in general and the fall of oil in particular, and then, the unexpected drop of longer-term bond yields. We had the Federal Reserve end its QE(III) in October and the "TARP" has been repaid, the Bank of Japan stepped in with its own huge QE and the ECB has talked a lot about a huge QE of its own. Clearly, Central Banks are still holding the reigns. Meanwhile, US inflation readings have been benign, with the consumer price index showing inflation of 1.7% over the past year, which is below the Fed's stated 2% target. Inflation expectations are critical to longer-term yields, since investors need to be adequately compensated for the risk that the value of money will drop over the decades that they hold those bonds.

An interesting observation here - Since January 1st the 10 year US Treasury yields have fallen from 3.01% to 2.26%, the 2 year yields have risen from 0.38% to 0.55% - Clearly a "flattening" of the yield curve which is usually associated with a slowing economy.

Well, let's try looking forward a little - With inflation in the OECD countries holding below the 2% targets of most central banks, and then the effects of cheaper energy further reducing inflationary expectations - it is likely that even the Fed will hold-back on its tightening thoughts. One sector of the fixed-income market has been behaving strangely since October - High Yield has been falling in price as seen in the iShares iBoxx ETF - Since October the S&P is up about 3% and this ETF is off 4%. How can prices for high-yield bonds be falling and prices for stocks rising, when they've so reliably traded in tandem in the past? Prices for high-yield bonds are a great coincident—and sometimes leading—indicator for stocks because they are just above equities on the risk scale. When investors feel less comfortable about the world, they cut junk bonds from their portfolio first and then stocks second. The 64'000 Dollar question is, "Are HY bonds cheap now, or are equities expensive?".

Well, as we continue to believe that equities are not particularly expensive at this time, we must conclude that HY bonds are cheap here. The S&P 500 is trading at an all-time high and yet, its P/E is at 17.21X which isn't historically high in times of economic recoveries. Some noted market gurus have reiterated views of the DJIA continuing its rally through 18'000- And this with the heavy chains of the fall of the entire oil sector. But then, in fact, the International Energy Agency estimates that the demand for energy is going to increase by 50% in the next 25 years thanks to emerging markets, and it will take $37 trillion of capital spending to meet that demand - Should be good for investors!

As a side-bar to the oil story, whilst we are amazed at the rapid fall in oil prices, we must not forget that in fact, Oil had climbed from $12 in 1999 to $140 in 2008. For a better perspective of the situation, the average price per barrel of WTI since 2000 has been $64.88, about where we are at today!

In fact, the energy sector has borrowed $90 billion in the high-yield market since 2008, making energy producers a large component of the high-yield market itself- The fall in oil prices endangers these borrowers, so perhaps the market is correct in hitting the said ETF?

In the meanwhile, Investors shrugged off Moody's downgrade of Japan's sovereign debt rating, maintaining their bullish outlook on the market despite headwinds facing the world's third-largest economy. The Japanese currency has dropped 21% since the BOJ unveiled unprecedented easing in April last year, and is down 7.2% since Oct. 30, the day before Kuroda led a divided policy to add more stimuli.

The Russian situation is concerning - A plummeting currency, rising inflation and sagging oil prices — that's the stuff Vladimir Putin's nightmares are probably made of. As the Kremlin now lords over Ukraine and stares down the West, Putin's nationalist gambit is finally being felt on the home front, threatening the central notion that's helped keep him in power so long. Are we facing a risk that Russia implodes? And if this unthinkable Black "Oily" Swan were to appear, what would it mean? Colder winters in Europe for one… Who knows what else?

Well, whilst both Ebola and ISIS horrors have faded to back-page status, we know that they are clearly still there. And if Putin's nightmares are yet to hit headline status, we are aware that they could easily come to the fore with the other two horrors…

Well, we must remain optimistic and will enjoy cheaper gasoline for now. But perhaps we should hope for it to rise? As said Oscar Wilde "this suspense is terrible. I hope it will last…"

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 and is expected to continue. We maintain our "bullish" view on equities as Q3 earnings have come-in on average ahead of expectations and looking forward we believe that lower energy costs are to flow into future earnings and sales.

As a group, most Central Banks are targeting an elusive 2% inflation rate. The industrialized economies are running with excess labour (less so in the USA as per Janet) and substantial excess of industrial capacity, the return of inflation appears to be far 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…

Our main concern lies with the effects of the US$ rally - What dislocations is this causing? And then, the ongoing drop in prices of commodities in general and oil in particular. These phenomena add downward 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. This re-emergence of the USA as a major energy producer has and will have significant geo-political side-effects, further complicating an already difficult algorithm to assess.

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 and in-fighting in Libya.**
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. **Risk of Russian internal turmoil in reaction to the economic pains from the combination of oil-price drop and international sanctions.**
4. **The social unrest in the oil producing nations such as Venezuela, where their largest export has crash by 30% and therefore so has their revenue.**
5. **Continued slide in oil prices and rise of the US Dollar- changes in alliances might emerge here!**

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 changes (now abated) in 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 -** October hit many managers hard. November saw the Macro funds rebound, CTA's perform well and Multi-Strat mixed. 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 <u>to attenuate</u> volatility and risks <u>and not</u> as an enhancement of returns!*

- **Currencies/Commodities –** The USD is now trading at about $1.2320 against the EUR and up to 0.9775 against the Swiss Franc. We maintain our belief in the fundamental strength of the US$ and would not bet against it at this time. The Japanese Yen has continued its steep descent, trading at 119.90 vs. the US$. Gold is in a holding pattern at $1,201, we note that Oil has had an incredibly volatile week, WTI trading down to $63.72/Bbl, only to rebound now to $67.75/Bbl being down 8% since the close last Friday.

This Week's Highlights:

- EURUSD slipped this week from 1.2480 to touch 1.2280 prior to Draghi's speech. However, on the news that Draghi was continuing to look at options the EUR spiked back to 1.2460, only to realise that he had said nothing and it is trading at 1.2350 now. With the USD index stronger after Draghi and the oil move, most majors are lower on the week against the US Dollar. The CHF has weakened as the Dollar regained some ground, trading at 0.9732 now having been as high as 0.9796 on Monday. The JPY traded from 118 this week to 120.40 today, it looks like Abe and the BOJ may be getting their way. Cable is almost unchanged on the week at 1.5670. The Brazilian Real is still under pressure from the USD dollar move and oil drop. Russia, struggled, even as Putin tried to reassure his people and the world that there was no need to worry about the Ruble, but even with a 1.5% increase in the interest rate the flows do not seem to be stemming. As long as crude oil remains under pressure there is likely to be continued pressure on the Russian currency.

- The US 10Yr Treasury reversed its course after the Thanksgiving holiday and the yields rose, seeing the bonds sell off and the yield move from 2.15% to touch 2.30% by Wednesday. The UK's 10Yr Gilt moved in a similar fashion to that of the US 10Yr Treasuries, seeing the yield cross back over the 2% barrier and touched 2.01% this morning. The bunds traded to their lowest <u>ever</u> yields this week. With the Bunds touching 0.69% we smell a faint whiff of similarity to Japan… Let's just hope that Draghi can steer the ship though these troubled waters or follow Simon and Garfunkel's advice and build a bridge!

- Equities had another relatively quiet week in the US with the markets almost unchanged on the week, despite the large allocations to oil related stocks in both the Indices. The S&P500 and the Dow moved to make new all-time highs this week – a phrase we are suddenly seeing a lot. The core European markets were almost unchanged with the exception of Italy being – down 1.25% on the week. With little real news flows and little talk of Ebola, the Ukraine and Russia or Syrian issues, there were very few drivers for the market to change direction. As a result, this has been a quiet week for the developed markets… EM had a slightly differing view with Russia's RTS Index dropping another 5%, Brazil dropping 6%. China however was the standout performer as the new cross exchange between domestic and offshore shares caused the Shanghai Composite to fly by nearly 10%.

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

04/12/2014

			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	1,736.63	-0.17	-0.16	-0.16	1.77	-0.80	0.64	8.62	4.55	16.39
MSCI WORLD LOCAL	-	1,286.77	-0.31	-0.18	-0.03	3.19	2.10	5.15	12.20	8.63	-
MSCI AC WORLD	USD	424.39	-0.15	-0.34	-0.34	1.45	-1.85	0.06	7.52	3.88	15.81
MSCI EM	USD	986.91	0.11	-1.77	-1.77	-1.15	-10.02	-4.64	-1.16	-1.57	12.05
S&P 500 INDEX	USD	2,071.92	-0.11	-0.04	0.21	2.39	3.20	6.77	16.07	12.10	17.21
DOW JONES INDUS. AVG	USD	17,900.10	-0.07	0.41	0.40	2.38	4.45	6.32	13.14	7.98	15.74
NASDAQ COMPOSITE INDEX	USD	4,769.44	-0.10	-0.37	-0.46	3.22	4.07	11.01	18.26	14.19	19.68
RUSSELL 2000 INDEX	USD	1,173.01	-0.50	-1.48	-0.02	0.51	0.25	1.65	4.50	0.81	19.40
EURO STOXX 50	EUR	3,191.25	-1.74	-0.56	-0.56	4.57	-1.30	-1.05	9.47	3.98	14.78
CAC 40 INDEX	EUR	4,323.89	-1.55	-0.44	-0.44	3.86	-2.58	-3.91	6.60	1.74	15.17
DAX INDEX	EUR	9,851.35	-1.21	-0.13	-0.13	7.00	2.27	0.20	9.72	4.35	13.96
FTSE 100 INDEX	GBP	6,679.37	-0.54	0.06	0.06	2.86	-1.88	-1.28	3.51	-0.34	14.20
SWISS MARKET INDEX	CHF	9,118.17	-0.55	0.04	0.04	3.52	4.16	5.91	14.07	11.60	17.73
NIKKEI 225	JPY	17,887.21	0.94	2.64	2.64	5.80	14.37	18.84	18.07	10.00	19.16
HANG SENG INDEX	HKD	23,832.56	1.72	0.06	0.06	1.30	-4.90	3.86	1.22	2.99	11.14
SHANGHAI SE COMPOSITE	CNY	2,899.46	4.31	9.50	9.50	21.43	26.27	43.94	30.73	38.83	11.91
S&P BSE SENSEX INDEX	INR	28,562.82	0.42	-0.51	-0.51	2.27	5.63	14.11	36.22	34.85	18.19
RUSSIAN RTS INDEX $	USD	918.65	-3.16	-4.93	-4.93	-12.16	-26.33	-30.56	-32.02	-35.80	4.92
BRAZIL IBOVESPA INDEX	BRL	51,426.87	-1.71	-6.02	-6.03	-4.23	-15.25	-0.26	1.26	-0.16	11.57
EQUITY MARKET INDICES - BY SECTOR											**P/E**
MSCI ENERGY	USD	243.78	-1.16	1.27	1.27	-5.63	-18.13	-17.97	-8.02	-11.54	12.83
MSCI MATERIALS	USD	230.12	0.04	0.88	0.88	2.87	-7.26	-7.31	0.48	-4.11	16.23
MSCI INDUSTRIALS	USD	201.69	-0.25	-0.08	-0.08	1.53	-0.78	-2.45	5.46	-0.13	17.18
MSCI CONS DISCRETIONARY	USD	186.58	0.10	-0.33	-0.33	5.44	2.29	3.41	6.67	2.65	18.00
MSCI CONS STAPLES	USD	202.12	-0.06	-1.26	-1.26	1.96	1.97	1.72	8.51	6.12	19.88
MSCI HEALTH CARE	USD	205.96	-0.11	0.36	0.36	3.39	6.13	11.08	22.84	19.85	19.21
MSCI FINANCIALS	USD	103.97	-0.28	-0.37	-0.37	0.70	-1.42	-0.14	6.25	2.04	13.85
MSCI INFO TECH	USD	143.31	0.15	-0.18	-0.18	3.91	4.40	10.85	21.60	16.36	17.60
MSCI TELECOMS	USD	70.79	-0.14	-2.33	-2.33	0.75	-0.87	-2.65	2.33	-1.67	16.25
MSCI UTILITY	USD	123.38	-0.17	0.04	0.04	-0.43	0.62	0.92	14.43	12.29	16.65
MSCI WORLD REAL ESTATE	USD	195.55	-0.23	-0.48	-0.48	0.59	-0.68	2.29	13.15	11.76	24.21
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,222.36	0.15	-0.46	-0.43	-0.04	-2.31	-1.12	0.58	-0.26	
HFRX EQUAL WEIGHTED	USD	1,194.21	0.15	-0.31	-0.29	-0.43	-2.27	-1.36	0.46	-0.24	
HFRX GLOBAL EUR	EUR	1,128.48	0.15	-0.49	-0.46	-0.08	-2.47	-1.38	0.19	-0.64	

MARKET INDICES PERFORMANCE

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.02	0.00	0.01	0.01	-0.01	-0.01	-0.02	-0.04	-0.05
US 2 YEAR	USD	0.55	0.01	0.08	0.08	0.03	0.04	0.17	0.25	0.17
US 10 YEAR	USD	2.26	0.02	0.09	0.09	-0.09	-0.20	-0.33	-0.61	-0.77
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	472.05	0.02	-0.11	-0.22	0.62	1.47	3.37	6.63	6.79
US GOVERNMENT TR	USD	2,068.58	0.14	-0.08	-0.28	0.52	1.38	2.21	3.94	4.49
US CORPORATE TR	USD	2,573.22	0.20	-0.32	-0.49	0.29	0.49	2.05	7.27	6.87
US HIGH YIELD TR	USD	1,630.57	0.02	-1.04	-0.87	-1.37	-2.27	-1.50	3.65	3.06
EU GOVERNMENT TR	EUR	236.28	-0.13	-0.07	-0.16	1.07	1.68	5.57	10.90	11.10
EU CORPORATE TR	EUR	243.88	-0.05	-0.15	-0.15	0.26	1.00	3.54	7.56	7.64
EU HIGH YIELD TR	EUR	269.73	0.08	0.22	0.14	1.01	0.62	1.31	6.86	6.21
JACI GLOBAL	USD	252.20	-0.28	0.61	1.01	0.81	-2.67	-4.23	0.72	-0.46
GLOBAL EM TR (HEDGED)	USD	325.50	-0.01	-0.73	-0.78	-0.85	-1.05	0.60	7.45	6.70
S&P/LSTA U.S. LEV LOAN	USD	96.62	-0.10	-0.62	-0.59	-0.63	-1.54	-2.17	-1.53	-1.65
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	3,711.46	-0.41	-7.16	-0.84	-9.53	-20.97	-25.35	-23.12	-23.15
GSCI ENERGY TR	USD	773.07	-1.01	-10.25	-1.46	-14.42	-28.68	-32.59	-30.99	-31.35
GSCI INDUSTRIAL METALS TR	USD	1,337.62	1.40	-1.70	1.07	-1.31	-6.72	-0.52	1.19	-2.13
GSCI PRECIOUS METALS TR	USD	1,496.34	0.03	0.74	3.14	3.37	-5.77	-4.23	-5.15	-1.77
GSCI AGRICULTURE TR	USD	544.41	0.85	-0.60	-0.01	2.58	1.07	-16.61	-13.25	-10.25
GENERIC 1ST 'CL' FUTURE	USD	66.81	-0.78	0.21	0.21	-16.04	-28.40	-31.45	-26.88	-27.50
GOLD SPOT $/OZ	USD	1,205.30	-0.18	3.06	3.06	5.48	-5.18	-4.03	-1.80	-0.21
CURRENCIES										
DOLLAR INDEX SPOT	USD	88.70	0.08	0.48	0.48	1.53	6.02	10.46	10.65	10.93
Euro Spot	EUR	1.24	-0.08	-0.67	-0.67	-0.94	-4.49	-9.45	-9.50	-10.00
Japanese Yen Spot	JPY	119.78	-0.40	-1.36	-1.36	-4.67	-12.61	-14.84	-15.36	-12.43
British Pound Spot	GBP	1.57	-0.19	-0.01	-0.01	-2.08	-4.18	-6.99	-4.22	-5.51
Brazilian Real Spot	BRL	2.59	-1.45	-2.30	-0.98	-3.67	-13.43	-12.01	-7.76	-8.83
China Renminbi Spot	CNY	6.15	0.04	-0.12	-0.12	-0.61	-0.18	1.66	-0.99	-1.59
Singapore Dollar Spot	SGD	1.31	-0.35	-0.93	-0.93	-1.75	-4.76	-4.88	-4.82	-4.08
Norwegian Krone Spot	NOK	7.06	-0.63	-0.99	-0.99	-3.85	-11.54	-15.71	-13.34	-14.50
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	12.38	-0.72	2.57	-7.13	-12.63	2.40	5.99	-17.90	-9.77
USD SWAP SPREAD SEMI 2YR		21.00	-0.57	-6.16	-6.16	-2.34	-0.57	48.51	138.63	98.86
TED SPREAD		22.02	-4.18	-3.63	-1.48	4.06	3.48	10.60	12.18	22.20

All data is compiled from Bloomberg

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