Bedrock Newsletter Friday, December 12th 2014

Equity markets have been roiled as the decline in oil prices continues into a collapse- The diplodocus dinosaur (much bigger than an elephant) in the room is clearly Oil!

Whilst the initial decline was viewed as a blessing for the global economy and considered to be equivalent to a tax cut for consumers, its further collapse through $60 a barrel of WTI is becoming a bane. From $105.50 on June 30th it has fallen by 44%. This is no longer a price drop, but a substantial dislocation! Year-to-date Coal prices have declined by 12% and these declines happen in the face of a global GDP growth of 3.5% which implies in itself an INCREASE in energy consumption. Where is the missing variable??? This equation doesn't compute!

Alternative energies have only their 'greenness credentials' left to sustain them; Windmills had trouble competing with $80 oil, fracking is cracking since $75 or so and now, talk of contagion is rising- Some are comparing this to the "Sub-Prime" loans of 2007, which were only a small fraction of US GDP, their collapse brought down the world. As frackers are heavily leveraged businesses, might they blow-up? Will regional banks operating in the fracked zones collapse? Growth in US jobs might stop or even reverse as the relatively new industry retrenches… Oi(l) Vey ! ☹

OPEC cut the forecast for how much crude oil it will need to provide in 2015 to the lowest in 12 years amid surging U.S. shale supplies and reduced estimates for global consumption. The Organization of Petroleum Exporting Countries lowered its projection for 2015 by about 300,000 barrels a day, to 28.9 million a day. That's about 1.15 million a day less than the group's 12 members pumped last month, and the 30-million barrel target they reaffirmed at a meeting in Vienna on Nov. 27. The impact of this year's price collapse on supply and demand remains unclear.

"The fundamentals outlined in the report look quite bearish," Abhishek Deshpande, oil markets analyst at London-based Natixis SA. "Fiscal balances are a huge problem for weaker OPEC members, so I won't be surprised if they call for an emergency meeting early next year."

Prices now are below what 10 out of OPEC's 12 members need for their annual budgets to break even, according to data compiled by Bloomberg. Kuwait and Qatar are the exceptions. Saudi Arabia, OPEC's biggest member, has $742.4 billion of reserve assets.

Morgan Stanley came with a bearish view "The risk of oil prices moving even lower into 2015 (as well as higher volatility) is now significantly elevated," bank analysts wrote in a research report. "By 2Q15, the market will be oversupplied and needs to find a mechanism to balance." Morgan Stanley said the price would need to fall as low as $35 or $40 a barrel to stop production and rebalance supply. Still, the bank noted that the price will likely rise eventually. "Oversupply is likely exaggerated and the market may be complacent about upside risks," the report said.

Russian government bonds slid, sending yields to a five-year high, on speculation the central bank will raise interest rates by as much as 2.5 percentage points this week as oil's retreat batters the Rouble- Now at 57.50 for a Dollar, down 40% since June 30th, tracking point-by-point the fall in the crude! At least $2.6 billion of currency interventions failed to end the currency rout.

Not only Russia is hurting here- We all know about Venezuela imploding from oil effects, but even Norway is being slammed- Norway is Europe's largest oil producer, the world's third-largest natural gas exporter, and an important supplier of both oil and natural gas to other European countries. The Norwegian Krone [NOK] is down 17% year-to-date against the US$.

Let's hope that oil prices find their footing soon and not too far from here so that stability returns. In contradiction to Mae West's old quip "Too much of something good is wonderful…", when too much is truly a lot, it can turn ugly! We all thought that the US becoming the largest oil producer was good for them and for us, well… the fall in prices hurts them more than anyone else!

Elsewhere in the news, Japan's elections loom over the weekend, with markets paying less attention than they should (perhaps) given the relative importance of the Japanese economy. Opinion polls predict a government victory. A two thirds majority may raise questions about whether constitutional or economic reform will take precedence.

Avoiding a government shutdown, the U.S. House of Representatives passed a federal spending bill on Thursday night. The House's $1.1 trillion spending bill posed a problem for many Democrats, who take issue with some of its stipulations. Among the attachments to the bill are a rollback of Dodd-Frank banking reforms and McCain-Feingold campaign finance regulation. The spending bill will keep most federal agencies funded through September 2015.

As we close-in on the Holiday season, we remind you of Johnny Carson's comment that you ought to mail your packages early, so the post office can lose them in time for Christmas… ☺

Market outlook

Core View: World economics are settling back into a reasonable growth pattern and with better and more predictable stability that creates a positive bias. We maintain our "bullish" view on equities inspite of recent turmoil emanating from the fast fall in oil prices. Whilst any rapid price movements cause uncertainty, looking forward we believe that lower energy costs are likely have positive effects on future earnings and sales in most sectors of the economy.

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 target level inflation appears to be far in the distance and as such, short-term interest rates are unlikely to rise anytime soon. The aforementioned fall in energy prices will further add downwards pressures on inflation. This further 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. Risks are mounting in the high-yield sector as a side effect of the fall in oil. The fall in oil prices could highten default risk for highly leveraged fracking operators and clearly also that of oil dependent Emerging economies (Venezuela and Russia in particular).

Our main concern lies with the effects of the US Dollar rally, in spite of its reversal these past few days - 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. However, the rout in oil prices now might affect the US in that it might create new dislocations within the American energy sector- Alternatives are losing quickly whatever shine they might still have had.

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. **The social unrest in the oil producing nations such as Venezuela, where their largest export has crash by 30% and therefore so have their revenues.**
4. **Continued slide in oil prices and rise of the US Dollar- changes in geo-political 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 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. We maintain our view that the essence of an equity portfolio should be US centric for now with the suggestion that 2015 may be the time when a shift towards European equities may be a reasonable shift.

- **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 $1.24350 against the EUR and down a little to 0.9650 against the Swiss Franc. We maintain our belief in the fundamental strength of the US$ and would not bet against it at this time. The Japanese Yen has continued its steep descent, trading at 118.30 vs. the US$. Gold's trading band has widened with a somewhat stronger tone, now trading at $1,220.

  We note that Oil has had an incredibly volatile week, WTI trading down to $59.30/Bbl.

This Week's Highlights:

- EURUSD moved from 1.2280 last week to hit nearly 1.25 on Wednesday. Regardless of the oil collapse and the USD strength, the EUR has found a small footing at these levels. USDCHF moved in a similar fashion dropping from 0.9800 to 0.9625 this morning. The JPY has regained a little ground this week as the election looms this weekend. For now there seems to be very little attention being paid to this, perhaps we should be taking more notice. With the JPY moving from 121.45 to 118.40 now. The Ruble is currently being decimated with the USD surging from 52.70 to hit 57.97 today… this is not a pretty picture, and the government intervention is not even touching the sides to plug the hole.
- The US 10Yr Treasury reversed its course rather rapidly… with the fear in the oil markets driving investors to buy up the 10Yr treasuries, seeing the yields plummet from 2.35% to 2.11% as we write. The German 10 Yr Bund mirrored the market reaction seeing a collapse in the yields to yet ANOTHER new low of 0.63%! The periphery in Europe was the main victim of the bad news, seeing the periphery bond yields rise and spreads rise between the Bund and the EU periphery. Japanese 10Yr yields moved in lock step and saw them fall to 0.39% hitting new lows again for their 10 year debt even through the 20 years of stagflation!
- Equities took a hit this week as fear and contagion ran amok with oil majors, to the refineries and right through to the distributors getting whacked. The S&P500 dropped from 2,071 to touch 2,020 and the futures set to open lower yet again. The Dax dropped by 3.5% so far, moving from 10,087 to 9,696, the CAC40 dropped 5.8% from 4,419 to 4,151 and Italy followed suit with 5.8% drop as well. Unlike China which had another stellar week seeing a rally of 9.8%. The Russian RTSI$ suffering a massive 11% drop on the week…

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

11/12/2014

INDEX NAME	CCY	Last Price	1D	5D	MTD	1M	3M	6M	1Y	YTD	P/E
			PRICE CHANGE IN % (unless indicated)								
EQUITY MARKET INDICES - BY REGION											P/E
MSCI WORLD	USD	1,699.05	0.06	-2.27	-2.33	-0.93	-1.76	-1.53	6.95	2.29	16.07
MSCI WORLD LOCAL	-	1,261.12	0.16	-1.99	-2.02	-0.39	0.28	2.30	10.70	6.47	-
MSCI AC WORLD	USD	414.33	-0.09	-2.45	-2.70	-1.37	-2.78	-2.51	5.65	1.41	15.48
MSCI EM	USD	946.04	-1.32	-4.02	-5.84	-5.02	-10.88	-10.31	-4.59	-5.65	11.70
S&P 500 INDEX	USD	2,035.33	0.48	-1.77	-1.56	-0.14	2.51	5.45	14.63	10.12	16.92
DOW JONES INDUS. AVG	USD	17,596.34	0.43	-1.70	-1.30	-0.09	3.58	5.15	11.80	6.15	15.51
NASDAQ COMPOSITE INDEX	USD	4,708.16	0.52	-1.28	-1.74	0.71	3.08	9.55	17.75	12.73	19.38
RUSSELL 2000 INDEX	USD	1,166.96	0.46	-0.52	-0.53	-1.64	0.55	0.65	5.77	0.29	19.28
EURO STOXX 50	EUR	3,159.11	0.26	-4.18	-3.40	3.06	-2.93	-4.38	7.25	1.01	14.40
CAC 40 INDEX	EUR	4,225.86	-0.05	-5.01	-4.38	0.44	-5.48	-7.82	3.17	-2.28	14.62
DAX INDEX	EUR	9,862.53	0.64	-3.01	-1.97	6.22	1.38	-1.56	8.51	2.43	13.72
FTSE 100 INDEX	GBP	6,461.70	-0.57	-4.61	-4.33	-2.71	-5.51	-6.01	-0.21	-4.70	13.69
SWISS MARKET INDEX	CHF	9,058.82	0.42	-2.10	-1.44	1.71	2.54	4.01	14.90	9.95	17.48
NIKKEI 225	JPY	17,257.40	-0.89	-3.06	-0.51	1.01	8.92	16.02	13.23	6.63	18.52
HANG SENG INDEX	HKD	23,312.54	-0.90	-3.14	-3.08	-2.88	-5.47	0.32	0.13	-0.25	10.94
SHANGHAI SE COMPOSITE	CNY	2,925.74	-0.49	0.02	9.52	17.79	26.00	43.21	33.38	38.86	11.93
S&P BSE SENSEX INDEX	INR	27,602.01	-0.82	-3.28	-4.07	-1.73	1.72	7.62	31.54	30.02	17.55
RUSSIAN RTS INDEX $	USD	824.01	-3.63	-12.18	-18.09	-23.64	-34.22	-41.96	-42.73	-44.68	4.41
BRAZIL IBOVESPA INDEX	BRL	49,861.81	0.63	-3.04	-8.88	-5.88	-12.41	-9.51	-0.52	-3.19	11.28
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	225.57	-0.20	-6.39	-6.30	-13.57	-21.58	-25.37	-14.43	-18.15	11.99
MSCI MATERIALS	USD	221.38	-0.77	-3.38	-2.95	-2.95	-8.88	-10.60	-2.47	-7.75	15.74
MSCI INDUSTRIALS	USD	196.46	-0.14	-2.66	-2.67	-2.05	-2.33	-4.66	2.68	-2.72	16.75
MSCI CONS DISCRETIONARY	USD	183.23	0.32	-1.96	-2.12	2.37	1.68	2.13	5.42	0.81	17.66
MSCI CONS STAPLES	USD	199.72	0.19	-1.33	-2.43	-0.03	2.11	0.72	7.95	4.86	19.71
MSCI HEALTH CARE	USD	204.21	0.31	-1.35	-0.50	2.09	5.34	10.43	23.42	18.83	19.04
MSCI FINANCIALS	USD	102.75	-0.17	-1.80	-1.54	-0.01	-1.45	-1.62	5.84	0.84	13.70
MSCI INFO TECH	USD	140.38	0.37	-1.91	-2.22	1.24	2.33	8.76	19.73	13.98	17.20
MSCI TELECOMS	USD	69.05	0.22	-2.69	-4.73	-2.71	-2.43	-4.65	-0.27	-4.08	15.94
MSCI UTILITY	USD	122.07	0.17	-0.91	-1.02	0.49	2.17	0.87	14.11	11.09	16.48
MSCI WORLD REAL ESTATE	USD	193.81	-0.29	-0.41	-1.37	0.00	2.43	2.74	13.88	10.76	24.11
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,206.76	-0.36	-1.28	-1.70	-1.11	-3.41	-3.11	-0.65	-1.53	
HFRX EQUAL WEIGHTED	USD	1,182.86	-0.25	-0.95	-1.23	-0.93	-3.12	-2.91	-0.49	-1.19	
HFRX GLOBAL EUR	EUR	1,113.97	-0.35	-1.29	-1.74	-1.16	-3.58	-3.38	-1.04	-1.92	

MARKET INDICES PERFORMANCE

11/12/2014

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			PRICE CHANGE IN % (unless indicated)							
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	-0.05	-0.05
US 2 YEAR	USD	0.58	-0.02	-0.06	0.12	0.05	0.02	0.15	0.26	0.20
US 10 YEAR	USD	2.14	-0.02	-0.17	-0.02	-0.23	-0.47	-0.45	-0.74	-0.89
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	473.14	-0.02	0.23	0.01	0.91	2.00	3.44	6.75	7.04
US GOVERNMENT TR	USD	2,074.16	-0.07	0.27	-0.01	0.86	1.91	2.64	4.23	4.77
US CORPORATE TR	USD	2,579.58	-0.12	0.25	-0.24	0.71	1.28	2.31	7.18	7.14
US HIGH YIELD TR	USD	1,604.31	-0.25	-1.61	-2.46	-3.06	-3.08	-3.48	1.70	1.40
EU GOVERNMENT TR	EUR	236.94	0.01	0.28	0.12	1.22	2.37	5.12	11.00	11.41
EU CORPORATE TR	EUR	244.41	0.00	0.22	0.07	0.32	1.26	3.33	7.85	7.88
EU HIGH YIELD TR	EUR	268.82	-0.14	-0.34	-0.19	0.06	0.27	0.30	6.39	5.85
JACI GLOBAL	USD	251.85	0.22	-0.42	-0.14	0.78	-2.33	-4.49	1.36	-0.59
GLOBAL EM TR (HEDGED)	USD	319.96	-0.28	-1.70	-2.47	-2.29	-2.40	-1.62	5.09	4.88
S&P/LSTA U.S. LEV LOAN	USD	95.53	-0.41	-1.13	-1.72	-1.74	-2.31	-3.35	-2.68	-2.76
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	3,511.66	-0.54	-5.38	-6.18	-14.79	-23.36	-29.95	-27.02	-27.29
GSCI ENERGY TR	USD	710.38	-1.03	-8.11	-9.45	-21.56	-32.67	-38.93	-36.23	-36.92
GSCI INDUSTRIAL METALS TR	USD	1,314.15	0.04	-1.75	-0.70	-3.38	-5.48	-1.71	-2.83	-3.85
GSCI PRECIOUS METALS TR	USD	1,521.40	-0.32	1.68	4.87	5.68	-1.99	-4.01	-4.54	-0.13
GSCI AGRICULTURE TR	USD	550.49	0.94	1.12	1.10	2.17	5.11	-13.58	-12.04	-9.25
GENERIC 1ST 'CL' FUTURE	USD	59.95	-1.25	-10.09	-10.51	-23.56	-35.35	-41.24	-34.79	-35.25
GOLD SPOT $/OZ	USD	1,227.55	-0.38	2.55	4.75	5.18	-0.56	-3.97	-0.22	1.43
CURRENCIES										
DOLLAR INDEX SPOT	USD	88.66	-0.16	-0.91	0.19	0.79	5.08	9.86	10.37	10.60
Euro Spot	EUR	1.24	0.09	1.13	-0.24	-0.13	-4.17	-8.34	-9.68	-9.61
Japanese Yen Spot	JPY	118.65	0.04	2.41	0.03	-2.62	-9.49	-14.25	-12.83	-11.21
British Pound Spot	GBP	1.57	-0.13	0.85	0.43	-0.42	-3.42	-7.19	-3.90	-5.10
Brazilian Real Spot	BRL	2.65	-1.35	-2.32	-3.28	-3.62	-13.37	-15.78	-11.69	-10.94
China Renminbi Spot	CNY	6.19	0.01	-0.58	-0.70	-1.00	-0.86	0.50	-1.89	-2.17
Singapore Dollar Spot	SGD	1.31	0.21	0.95	-0.44	-1.51	-3.60	-4.72	-4.14	-3.60
Norwegian Krone Spot	NOK	7.29	-0.29	-2.12	-3.85	-6.96	-12.98	-18.04	-15.24	-16.97
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	20.08	8.36	62.20	50.64	54.22	50.86	59.87	29.21	46.36
USD SWAP SPREAD SEMI 2YR		22.88	1.09	9.47	3.96	7.28	-2.61	54.41	131.30	120.29
TED SPREAD		22.03	2.66	0.05	-1.43	1.06	-1.65	13.38	23.76	22.25

All data is compiled from Bloomberg

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