

Bedrock Newsletter

Friday, April 11th 2014

Last Friday we saw yields on the Spanish 5 year bonds fall to match the US 5 year Treasury yield at 1.70%. Then, on Thursday this week Greece issued a five year bond which was gobbled-up by investors. The European crisis may be over! This seems to be confirmed by the strength of the Euro, which in the face of the Ukrainian crisis continues to rise against the US\$- Now at 1.39. We can breathe easier now...

Or can we? As we see the US equity markets questioning their valuations- A powerful selloff on Monday followed last week's Thursday and Friday declines- starting in the NASDAQ Biotech and Technology sectors eventually spreading to all sectors and markets. Then Tuesday and Wednesday gave us huge rallies which offset the Monday rout. But then, Thursday we saw good news on the US employment front with fewer Americans filing applications for unemployment benefits than at any time since before the last recession; indicating bigger gains in hiring will soon follow. A drop in firings signals that employers are optimistic that sales will pick up following a weather-related slowdown at the start of the year, which will pave the way for bigger increases in employment as demand rebounds. More jobs and growing incomes would help lift confidence and provide a spark for consumer spending, which makes up the largest part of the economy. Reading this news, equity futures were rising into the US open, extending the previous two days' uptrend.

As the cash-markets opened, talk of "Dead Cat Bounce" spread into what became the worst day in equity markets in years- The NASDAQ falling over 3% Wow...Scary stuff, but then, if we step back a little and look at the charts we see that the S&P 500 was at 1'847 at the close of 2013 and closed Thursday at 1'833.08 or virtually unchanged...

On Tuesday we saw European inflation expectations rising as the ECB looks to accelerate price rises to its 2% target. Well, the rise of the Euro seems to offset the ECB's desires... And, whilst we see oil trading higher (reaching \$103.50 for WTI), we wonder if this is just a currency effect, what with the US\$ falling to a 5 month low? Some say that oil is about to fall, as there is a record amount of "oil on the water", i.e. fully loaded oil tankers anchored around the oceans will bring prices down. Should we really be worried about inflation returning? And consequently, should we truly worry about short term interest rates rising? Maybe we should, but we don't, for now at least...

Later on Tuesday we got Alcoa's Q1 results and they beat handsomely on earnings whilst coming in a little shy on revenues. The stock gained 4% thereafter. The minutes of the FOMC published on Wednesday triggered an equity and bond market rally, softening gold and the Dollar. In effect, the Federal Reserve played down forecasts by some of its own policy makers that interest rates might rise faster than they previously predicted.

The big question we are facing is whether or not we are on the brink of a market collapse? All 25% falls commenced with a 3% fall, and then, most 3% drops were followed by rebounds. We can't be certain either way, but when the situation is analyzed objectively, we see the following- We just started Q1 earnings' season and so far, it is satisfactory. Interest rates are low and the bond market is very firm. The Fed sounds supportive of the economy, the ECB has some powerful arms up its sleeves, the BOJ is in concert and there isn't a cloud in the sky over Geneva. The volatility is low, very low even- The VIX, in spite of the equity market drops, is still low at 15 or so, FX volatility is as insignificant as the bonds' price movements; the market players are sanguine. On the political front we have the Ukrainian debacle and the usual conflicts in Syria, Sudan, Libya and some other, local issues around the globe. The most unclear piece is the FX market and the US\$ weakness- Perhaps this is reassuring, as usually when things go bad, the US\$ rises.

It brings to mind an exchange between Einstein and Chaplin- "what I admire most in your art", said Einstein, "is your universality. You don't utter a word, yet...the whole world understands". "It's true", retorts Chaplin. "But your glory is bigger still: the whole world admires you, whilst no one understands you."

Well, we choose not to panic, not quite yet anyway... Have a nice weekend ☺

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Core View: 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. Volatility as a measure of risk is low in bonds, FX and equities.

- **Fixed Income-** The low to non-existent inflation is expected to continue for the foreseeable future. This will drive Central Banks to maintain low short-term interest rates. Whilst the Fed may taper further, other central banks are likely to embark on easing. The fixed income world will likely remain stable at current levels- A well-diversified portfolio is expected to generate current income at about 3.5% in US\$ terms with little if any capital gains or losses. It is a fair real return so long as inflation remains subdued under 2% per annum.
- **Equities-** Although most indices are at or close to all-time highs, they are not expensive on historic P/E measures and frankly cheap when compared to bonds. The effective P/E of a US 10 year Note is at about 37X and the S&P 500 is at 16X. With global economies growing at a slow but steady rate (world GDP expected at about 3.5%) we see limited fundamental downside risks. A well-diversified global equity portfolio can be expected to grow at 8-10% per annum.
- **Alternatives-** In a normalising world, with new-found financial stability and a clearing horizon, economics are returning to base text-book relative values allowing clever 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 about 10% per annum, but lower volatility than equities.
- **Currencies-** The market has very low volatility and the Euro is showing unexpected strength. We maintain belief in the fundamental strength of the US\$ and would not bet against it at this time.

Weekly Highlights:

- Generally the USD had a poor trading week with the USD index [DXY] slipping from 80.40 to 79.40 by this morning. This was a broad based weakening with the major currency pairs rallying. EUR rallied from 1.37 to reach 1.39, the CHF from 0.8930 to 0.8750, the JPY from 103.50 to 101.50, AUD from 0.9250 to 0.9390. The GBP also took strength from the much better than expected Industrial numbers and saw the pair move from 1.6550 to 1.6800.
- The US bond market rallied in light of the very poor equity moves that we saw yesterday and the yields dropped from 2.74% to as low as 2.62%, the Bund dropped from 1.58% to 1.515% and peripheral spreads closed in again; Italy is now 165Bps over the Bund at 3.18% and Spain is also 165Bps over at 3.18%. Looks like we are back to the periphery trading in lockstep again!
- Global equities that seemed resilient for the first half of the week took a very large and aggressive tumble yesterday. The Nasdaq being down 4.3% since last week... effectively a 300Bn USD loss! Whereas EM markets seem to have been more resilient dropping only 0.25% - 1.0% on the day and more or less flat on the week. The weakness would seem to be continuing into today's trading session as well with the US markets looking to be down 0.5% or so when it opens.

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MARKET INDICES PERFORMANCE

09/04/2014

INDEX NAME	CCY	Last Price	PRICE CHANGE IN % (unless indicated)							P/E	
			1D	5D	MTD	1M	3M	6M	1Y		YTD
EQUITY MARKET INDICES - BY REGION											
MSCI WORLD	USD	1,675.32	0.69	-0.58	0.09	-0.07	1.22	8.37	15.35	0.86	15.24
MSCI WORLD LOCAL	-	1,188.69	0.62	-1.09	-0.18	-0.59	0.80	9.98	16.01	0.35	-
MSCI AC WORLD	USD	412.22	0.66	-0.37	0.29	0.57	1.57	7.43	13.38	0.90	14.54
MSCI EM	USD	1,014.83	0.33	1.47	2.03	6.26	4.61	0.08	-0.94	1.21	10.51
S&P 500 INDEX	USD	1,872.18	1.09	-0.99	-0.01	-0.27	1.62	10.61	17.92	1.29	15.94
DOW JONES INDUS. AVG	USD	16,437.18	1.11	-0.82	-0.12	0.11	0.00	8.67	11.05	-0.84	14.84
NASDAQ COMPOSITE INDEX	USD	4,183.90	1.72	-2.16	-0.36	-3.47	0.22	11.25	26.89	0.18	18.54
RUSSELL 2000 INDEX	USD	1,159.96	1.37	-2.75	-1.11	-3.38	-0.39	8.46	22.61	-0.32	19.19
EURO STOXX 50	EUR	3,187.11	0.14	-0.61	0.81	3.05	2.67	7.33	19.74	2.51	13.71
CAC 40 INDEX	EUR	4,453.89	0.25	0.10	1.42	1.90	4.78	5.59	18.97	3.68	14.00
DAX INDEX	EUR	9,549.91	0.46	-0.82	-0.06	3.07	0.81	9.95	22.27	-0.02	13.40
FTSE 100 INDEX	GBP	6,665.25	0.45	0.24	1.01	-0.36	-1.11	3.65	4.35	-1.24	-
SWISS MARKET INDEX	CHF	8,450.18	0.46	-0.84	-0.04	0.99	1.02	7.63	8.73	3.01	16.12
NIKKEI 225	JPY	14,300.12	0.00	-5.12	-3.56	-5.42	-10.13	0.74	7.62	-12.22	16.03
HANG SENG INDEX	HKD	23,096.44	1.11	2.35	4.27	3.73	1.10	0.63	4.82	-0.90	10.62
SHANGHAI SE COMPOSITE	CNY	2,134.30	1.38	3.66	4.97	6.76	6.01	-2.58	-4.12	0.87	8.16
S&P BSE SENSEX INDEX	INR	22,749.56	0.21	0.88	1.62	3.71	9.59	12.22	23.54	7.46	14.42
RUSSIAN RTS INDEX \$	USD	1,206.21	1.35	-0.37	-1.62	4.09	-13.59	-18.76	-17.03	-16.39	4.94
BRAZIL IBOVESPA INDEX	BRL	51,185.40	-0.86	-1.00	1.53	12.41	3.00	-3.42	-8.90	-0.62	10.00
EQUITY MARKET INDICES - BY SECTOR											
MSCI ENERGY	USD	262.68	0.56	0.31	1.37	3.20	3.82	9.12	13.06	2.58	13.58
MSCI MATERIALS	USD	245.86	0.48	0.71	1.27	1.09	4.35	8.44	8.25	2.45	15.51
MSCI INDUSTRIALS	USD	200.67	0.63	-1.10	-0.01	-0.27	0.00	8.19	18.89	-0.64	15.92
MSCI CONS DISCRETIONARY	USD	176.86	0.76	-1.50	-0.22	-2.33	-2.17	5.53	20.81	-2.70	16.05
MSCI CONS STAPLES	USD	192.19	0.36	1.05	0.92	1.72	2.62	6.94	5.62	0.90	17.83
MSCI HEALTH CARE	USD	178.76	1.46	-1.25	-1.07	-2.54	2.13	13.47	20.05	4.02	16.98
MSCI FINANCIALS	USD	101.99	0.39	-0.91	-0.01	-0.08	-0.44	5.95	13.92	0.10	13.18
MSCI INFO TECH	USD	124.69	1.30	-0.84	-0.25	-0.62	2.07	13.10	22.65	1.24	16.04
MSCI TELECOMS	USD	70.24	0.20	-1.15	-0.93	0.21	-1.04	4.32	12.76	-2.43	14.70
MSCI UTILITY	USD	118.86	-0.01	0.97	0.24	3.15	8.50	7.72	8.28	8.17	15.60
MSCI WORLD REAL ESTATE	USD	180.20	-0.32	0.57	1.56	1.59	2.63	0.83	-5.88	2.98	22.81
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,231.93	-0.13	-0.78	-0.58	-0.97	0.35	2.97	4.40	0.53	
HFRX EQUAL WEIGHTED	USD	1,210.49	-0.09	-0.46	-0.33	-0.48	0.95	2.92	5.08	1.12	
HFRX GLOBAL EUR	EUR	1,142.15	-0.49	-0.46	-0.46	-0.86	0.67	2.71	4.29	0.57	

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)											
US 3 MONTH	USD	0.03	0.00	100.00	0.00	-14.37	-14.37	-33.33	-53.87	-53.87	
US 2 YEAR	USD	0.36	-2.20	-21.78	-15.11	-2.85	-4.00	3.95	54.32	-6.53	
US 10 YEAR	USD	2.67	-0.74	-4.55	-1.77	-3.86	-6.58	-0.43	48.05	-11.83	
FIXED INCOME INDICES - BY TYPE OF ISSUER											
GLOBAL AGG TR HEDGED	USD	452.24	0.01	0.45	0.27	0.64	2.02	2.47	0.94	2.31	
US GOVERNMENT TR	USD	2,011.12	0.05	0.60	0.28	0.55	1.48	1.02	-1.44	1.59	
US CORPORATE TR	USD	2,491.59	0.02	0.90	0.53	1.45	3.06	4.51	0.84	3.48	
US HIGH YIELD TR	USD	1,633.92	0.05	0.19	0.28	0.72	2.71	6.39	7.53	3.27	
EU GOVERNMENT TR	EUR	220.62	-0.03	0.36	0.13	0.87	3.22	4.74	4.34	3.74	
EU CORPORATE TR	EUR	232.18	-0.03	0.28	0.14	0.46	2.15	3.42	4.14	2.48	
EU HIGH YIELD TR	EUR	262.94	0.05	0.29	0.42	0.71	2.86	6.82	11.50	3.53	
JACI GLOBAL	USD	262.46	0.00	-0.38	-0.38	-0.93	3.37	6.87	14.96	3.59	
GLOBAL EM TR (HEDGED)	USD	315.70	0.14	0.61	0.77	1.71	3.25	4.44	0.00	3.48	
S&P/LSTA U.S. LEV LOAN	USD	98.36	-0.01	-0.03	-0.04	-0.06	-0.43	0.89	-0.01	0.12	
COMMODITY INDICES - BY TYPE OF ISSUER											
GSCI INDEX TOTAL RETURN	USD	5,017.04	0.55	2.79	0.92	0.43	8.46	3.31	4.97	3.88	
GSCI ENERGY TR	USD	1,147.62	0.76	3.63	1.41	0.36	7.57	2.82	7.48	1.91	
GSCI INDUSTRIAL METALS TR	USD	1,316.18	0.47	0.73	1.74	0.79	-1.00	-2.35	-10.02	-3.70	
GSCI PRECIOUS METALS TR	USD	1,640.88	-0.39	0.86	1.53	-2.81	5.43	-1.50	-19.61	7.72	
GSCI AGRICULTURE TR	USD	698.53	-0.56	1.62	-0.65	1.32	17.81	6.65	0.48	15.16	
GENERIC 1ST 'CL' FUTURE	USD	103.56	-0.04	3.26	1.95	2.95	12.57	-0.02	8.28	6.00	
GOLD SPOT \$/OZ	USD	1,321.17	0.72	2.67	2.89	-1.38	5.82	2.61	-15.23	9.58	
CURRENCIES											
DOLLAR INDEX SPOT	USD	79.49	0.01	-1.22	-0.76	-0.34	-1.44	-1.15	-3.68	-0.68	
Euro Spot	EUR	1.39	0.03	1.01	0.65	-0.13	1.38	2.51	6.04	0.84	
Japanese Yen Spot	JPY	101.73	0.27	2.16	1.47	1.51	2.41	-3.51	-1.92	3.52	
British Pound Spot	GBP	1.68	-0.08	1.09	0.70	0.81	1.80	5.08	9.43	1.34	
Brazilian Real Spot	BRL	2.19	0.67	3.74	3.88	7.48	9.31	0.93	-9.41	8.01	
China Renminbi Spot	CNY	6.21	-0.10	0.09	0.18	-1.06	-2.48	-1.45	-0.20	-2.44	
Singapore Dollar Spot	SGD	1.25	-0.10	1.23	0.77	1.67	1.30	0.02	-0.79	1.21	
Norwegian Krone Spot	NOK	5.95	-0.30	0.82	0.57	0.01	3.19	1.43	-3.57	1.96	
VOLATILITY / LIQUIDITY INDICES											
CBOE SPX VOLATILITY INDX	USD	13.82	-7.19	5.58	-0.43	-2.68	13.84	-16.14	11.81	0.73	
USD SWAP SPREAD SEMI 2YR		13.56	2.81	16.60	7.70	-2.31	14.14	1.35	-5.96	29.14	
TED SPREAD		0.00	-2.40	-8.26	-1.52	-0.85	-4.37	4.98	-9.27	-86.55	

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