

Bedrock Newsletter

Friday, April 25th 2014

It is the end of the Easter week. It should have been quiet, with many participants chasing eggs and rabbits. Mostly it was, but the big issue facing us all is the Russia-Ukraine conflict. It is likely to drive events for the near future- As the worst standoff between the West and Russia, since the Cold War, escalates, the crisis is increasingly unnerving investors who are unsure of what will happen next. Hopes of a resolution were dashed when Ukraine declared an end to the so-called Easter truce earlier this week. "In the short term, the most likely outcome of the Ukraine crisis is more of the same," as per David Dalton. Nicholas Spiro, of Spiro Sovereign Strategy, agreed that a continuation of the current state of affairs was what most investors were pricing in – but he warned that this was a risky strategy. As Ukraine boosts its offensive against pro-Moscow separatists and Russia begins military drills on the border, fears of a Russian invasion have heightened. Spiro called this the "nightmare scenario," which would be the "straw that breaks the camel's back, as far as east-west relations are concerned." It would certainly hit markets hard. If the situation were to tip over to war, this would trigger another bout of capital flight and currency weakening, as investors anticipated both further economic-deterioration and the imposition of stronger Western sanctions. A cut in gas supplies to the EU across Ukraine—either by Russia, or by Ukraine—would deliver a supply shock to many Western firms, but would also do significant damage to Russia's budget inflows. Serious worries here! Are they priced-in?

This week Nuriel Roubini spoke in Geneva and we summarize his views;

- The Global Recovery is accelerating, and global tail risks have receded. Tail risk of EU breakup has receded, although EU structural problems such as unemployment and high debt remain.
- In Europe, P/E ratios are significantly below LT averages, contrary to the US, which should help underpin EU equities.
- US deficits are down massively from 2008/2009 levels, which is a further tailwind for the US recovery and benign scenario
- Debt Crisis risk in Japan has also receded due to Abenomics
- Lower risk of war between Israel and Iran due to the interim accord. Fear premium in oil prices are also down.

All the points above tend to give comfort to a good view on the global economy going forward.

In Geopolitics, the biggest worry remains China-Japan issue.

- US\$ will gradually strengthen against all currencies. Specifically against EUR and JPY; the USD will rally as monetary policy and growth diverge between them. US\$ will also strengthen against some EM currencies such as ZAR and TRY, and also versus commodity currencies such as CAD and AUD as those will suffer from China Deceleration. On Gold, the question is what share of overweight/underweight you should be at and not if you should not have some at all! Roubini recommends either neutral or slight underweight

By Wednesday, published Q1 results pushed the ratio at which Standard & Poor's 500 earnings beat projections so far to 75% this season, with almost three-quarters of companies having yet to report. The industrial sector has exceeded estimates at an 88% pace. Clearly, the Analysts have not improved... The renewed uptick of euro area PMI data Wednesday may grant the European Central Bank additional time to delay decisions on a possible next easing move, but weak price pressures will keep policymakers alert and the door to further easing measures in June wide open. ECB policymakers in recent days have continued their verbal campaign against the strength of the common currency. While their warnings have become increasingly aggressive, they have failed to sustainably keep a lid on the euro, which on Wednesday rose back to 1.3854 against the dollar. And the Euro strength is particularly bewildering as we all know that the Ukraine issue presents greater risks to Europe than to either the USA or Japan...

How language manipulates ideas- today we heard a bond portfolio manager saying that people need income, so that drives investors to buy bonds. Well, people need Cash Flow, not revenues; Hold a portfolio of whatever, Need money? Sell something... Even Dennis Gartman is back to buying stocks and is "pleasantly long" on the market after bailing out in early April. Well, let's hope that the pleasure we find in being "long" isn't just as Oscar Wilde once said, "Illusion is the first of all pleasures"...

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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 Fixed Income world is still struggling with low yields and still struggling with low inflation. As all (!) Central Banks are seeking somewhat higher inflation than they have, it is hardly reasonable that they raise rates! With the extreme example of Japan showing exactly what is possible when stagnation occurs. With the ECB's talk of further easing it is likely that Europe will embark on large scale easing in the not too distant future, a la BOE and FOMC – especially in light of the commentary from Draghi about the worrying strength of the EUR. No need to worry in the short term about rising rates, then... but do keep an eye on the horizon as it will eventually show signs of rising rates.
- **Equities** – After the dust settles on the showdown at the OK(etski)-corral in the Black Sea the markets are more or less unchanged. With low PE ratios around the globe and earnings (mostly) coming in positive (so far, 75% of the reporting S&P 500 have beaten expectations of Q1 earnings!), we feel that the corporate world is still floating. Consumption around the globe is still expanding (albeit slowly) which should mean a positive environment for cash flow growth... so at low PEs and positive cash flow growth, equities would seem like a sensible choice for the year ahead.
- **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 still has very low realized volatility and the Euro is still very strong (and strengthening) versus the USD. We maintain belief in the fundamental strength of the US\$ and would not bet against it at this time.

Weekly Highlights:

- The FX markets were fairly muted all week. The major crosses are finishing the week roughly where they started – only a few blips around data flows and low liquidity caused short lived spikes. EUR is trading at about 1.3830, GBP at 1.6800, CHF at 0.8810 and the JPY at 102.30. AUD however, had a pretty tough week.... Slumping from 0.9380 to 0.9260 as CPI heavily missed the expectations. The USD is stable on the week.
- The US bond market sold off very hard after our newsletter from last week. The yields surged from 2.63% to close on Friday night at 2.72%. With the Easter weekend that followed, the bonds were subdued and combined with stable equity performance saw the yields slightly abate and are trading at about 2.67%. But we reiterate that this is still in our 2.5%-3.00% trading band. The Bunds were relatively similar in the direction and timing of their moves by the amplitude of oscillation was much smaller. The Bund is trading exactly where it closed before Easter at 1.51%.
- Global equities had a steady upward performance this week, the S&P 500 rallying from 1,865 to briefly hit 1,885 and the futures are signalling a very slightly weaker cash opening – but still a good week for stocks. With such a large number of companies beating expectations the markets seem to have settled into a comfortable position at the highs. As earnings grow, the PE expansion should mean that equities will continue higher... we believe they will! Roll on 2014.

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MARKET INDICES PERFORMANCE

24/04/2014

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	1,681.16	0.11	0.63	0.44	1.54	3.88	4.55	15.21	1.21	15.29
MSCI WORLD LOCAL	-	1,194.16	0.11	0.75	0.28	1.83	3.30	5.00	14.71	0.82	-
MSCI AC WORLD	USD	413.05	0.11	0.49	0.49	1.87	4.07	3.80	13.11	1.10	14.64
MSCI EM	USD	1,004.46	0.07	-0.73	0.99	4.80	5.74	-2.22	-2.22	0.18	10.74
S&P 500 INDEX	USD	1,878.61	0.17	0.88	0.33	0.70	4.93	6.75	18.51	1.64	15.97
DOW JONES INDUS. AVG	USD	16,501.65	0.00	0.47	0.27	0.82	3.92	5.98	12.25	-0.45	14.83
NASDAQ COMPOSITE INDEX	USD	4,148.34	0.52	1.52	-1.21	-2.03	0.49	5.20	26.09	-0.68	18.17
RUSSELL 2000 INDEX	USD	1,144.35	-0.24	1.11	-2.45	-2.86	0.02	2.33	21.70	-1.66	18.92
EURO STOXX 50	EUR	3,171.02	-0.59	1.01	0.30	2.40	4.72	4.50	17.25	1.99	13.72
CAC 40 INDEX	EUR	4,463.06	-0.37	1.30	1.63	2.74	7.25	4.46	16.21	3.89	14.13
DAX INDEX	EUR	9,478.27	-0.74	1.72	-0.81	1.50	0.92	5.48	21.01	-0.77	13.29
FTSE 100 INDEX	GBP	6,681.97	-0.31	1.49	1.27	1.17	0.27	-0.59	3.72	-0.99	-
SWISS MARKET INDEX	CHF	8,376.56	-0.39	0.65	-0.91	0.93	2.13	1.54	6.02	2.12	16.06
NIKKEI 225	JPY	14,429.26	0.17	-0.60	-2.69	0.04	-6.25	2.42	3.61	-11.43	16.22
HANG SENG INDEX	HKD	22,254.46	-1.37	-1.95	0.47	2.40	-0.87	-1.96	-0.66	-4.51	10.28
SHANGHAI SE COMPOSITE	CNY	2,036.52	-1.00	-2.92	0.16	-1.49	-0.87	-4.52	-7.40	-3.76	7.84
S&P BSE SENSEX INDEX	INR	22,853.28	-0.10	2.59	2.09	3.62	8.14	10.27	19.16	7.95	14.52
RUSSIAN RTS INDEX \$	USD	1,126.74	-1.65	-6.12	-8.10	-3.71	-17.40	-24.49	-18.82	-21.90	4.57
BRAZIL IBOVESPA INDEX	BRL	51,817.45	0.48	2.70	2.78	7.55	8.43	-4.31	-5.72	0.60	10.29
EQUITY MARKET INDICES - BY SECTOR											
MSCI ENERGY	USD	291.31	0.12	0.64	4.47	6.56	10.12	8.10	17.86	5.71	14.03
MSCI MATERIALS	USD	245.81	-0.02	0.47	1.25	2.53	5.58	2.93	10.21	2.43	15.63
MSCI INDUSTRIALS	USD	201.91	-0.02	0.37	0.61	1.84	3.52	4.68	20.28	-0.02	16.03
MSCI CONS DISCRETIONARY	USD	176.60	0.12	0.73	-0.37	0.72	0.89	1.37	18.16	-2.84	16.07
MSCI CONS STAPLES	USD	193.37	0.10	0.16	1.54	3.02	4.81	2.75	5.51	1.52	17.94
MSCI HEALTH CARE	USD	179.01	-0.19	1.89	-0.93	0.03	3.67	8.91	16.55	4.17	16.81
MSCI FINANCIALS	USD	101.98	0.12	0.56	-0.02	1.08	3.03	2.17	12.44	0.09	13.17
MSCI INFO TECH	USD	123.77	0.76	0.68	-0.98	-1.11	2.24	8.37	23.56	0.50	15.89
MSCI TELECOMS	USD	70.16	-0.55	-0.61	-1.04	0.17	0.14	0.00	9.59	-2.54	14.72
MSCI UTILITY	USD	119.71	0.20	0.17	0.96	2.62	9.53	6.22	6.72	8.95	15.62
MSCI WORLD REAL ESTATE	USD	182.00	0.24	0.26	2.58	4.17	4.96	-1.66	-7.03	4.01	22.93
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,233.06	-0.06	0.42	-0.49	-0.30	0.28	1.85	3.93	0.62	-
HFRX EQUAL WEIGHTED	USD	1,211.50	-0.03	0.37	-0.24	0.09	0.80	2.14	4.50	1.21	-
HFRX GLOBAL EUR	EUR	1,141.56	-0.07	0.40	-0.51	-0.33	0.19	1.71	3.58	0.51	-

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.01	98.04	-50.25	-66.78	-77.85	-77.85	-66.78	-80.08	-84.67
US 2 YEAR	USD	0.43	-1.78	8.81	2.80	1.18	28.17	43.86	91.20	13.19
US 10 YEAR	USD	2.67	-0.34	-1.84	-1.71	-2.79	-1.61	6.48	56.41	-11.78
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	453.29	-0.01	0.09	0.50	0.64	1.38	1.99	0.93	2.55
US GOVERNMENT TR	USD	2,012.92	0.00	0.17	0.36	0.50	0.63	0.51	-1.54	1.68
US CORPORATE TR	USD	2,503.11	0.03	0.36	0.99	1.27	2.51	3.61	0.78	3.96
US HIGH YIELD TR	USD	1,637.39	0.05	0.17	0.49	0.74	2.73	4.88	6.88	3.49
EU GOVERNMENT TR	EUR	221.65	-0.07	-0.01	0.60	1.00	2.82	4.44	3.99	4.22
EU CORPORATE TR	USD	233.07	0.01	0.08	0.52	0.67	1.83	3.19	3.78	2.87
EU HIGH YIELD TR	EUR	263.81	0.05	0.22	0.75	0.92	3.06	6.03	10.64	3.87
JACI GLOBAL	USD	263.26	0.14	0.53	-0.08	-0.04	2.05	5.22	14.60	3.91
GLOBAL EM TR (HEDGED)	USD	316.31	-0.05	0.16	0.96	1.99	3.33	2.84	0.04	3.68
S&P/LSTA U.S. LEV LOAN	USD	98.06	-0.02	-0.15	-0.34	-0.36	-0.78	0.15	-0.45	-0.19
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	5,077.30	0.61	0.03	2.13	3.30	6.44	6.27	10.14	5.13
GSCI ENERGY TR	USD	1,160.90	0.68	-0.22	2.58	3.87	4.76	6.78	12.88	3.09
GSCI INDUSTRIAL METALS TR	USD	1,349.26	0.67	1.25	4.29	6.52	0.71	-1.37	-3.34	-1.28
GSCI PRECIOUS METALS TR	USD	1,623.09	0.56	-0.17	0.42	-1.60	1.73	-5.79	-10.32	6.55
GSCI AGRICULTURE TR	USD	706.72	0.42	0.41	0.51	1.77	18.54	7.86	3.74	16.51
GENERIC 1ST 'CL' FUTURE	USD	101.53	-0.40	-2.30	0.33	2.75	6.25	4.09	8.21	4.33
GOLD SPOT \$/OZ	USD	1,292.53	-0.06	-0.14	0.66	-1.42	1.77	-4.31	-11.95	7.21
CURRENCIES										
DOLLAR INDEX SPOT	USD	79.76	-0.04	-0.08	-0.42	-0.23	-0.86	0.72	-3.60	-0.34
Euro Spot	EUR	1.38	0.02	0.15	0.47	0.06	1.18	0.23	6.33	0.66
Japanese Yen Spot	JPY	102.27	0.05	0.16	0.94	-0.01	0.27	-4.74	-2.94	2.97
British Pound Spot	GBP	1.68	0.01	0.05	0.85	1.66	1.31	3.95	8.87	1.49
Brazilian Real Spot	BRL	2.21	0.36	1.03	2.62	4.92	8.29	-0.48	-9.20	6.69
China Renminbi Spot	CNY	6.25	-0.01	-0.43	-0.54	-0.80	-3.26	-2.68	-1.29	-3.15
Singapore Dollar Spot	SGD	1.26	-0.03	-0.46	-0.08	0.76	1.45	-1.81	-1.57	0.36
Norwegian Krone Spot	NOK	6.00	0.04	-0.18	-0.17	0.49	2.50	-1.75	-2.12	1.22
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	13.32	0.38	-6.06	-4.03	-4.99	-26.57	1.76	-2.20	-2.92
USD SWAP SPREAD SEMI 2YR		11.25	7.14	-23.73	-10.64	-21.38	-27.70	-14.32	-17.34	7.14
TED SPREAD		0.00	4.31	8.37	11.26	18.01	17.39	7.90	-0.96	-84.80

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