Friday, May 23rd 2014

It is Friday again. Amazing, it repeats every week. We decided to reinvigorate the future in our small way by cancelling next Friday (well, just the Newsletter).

This week we will focus on perspective; to illustrate, we paraphrase a known cynic, David Zevros- "It is amazing what passes for amazing these days!" The US fixed income markets have been mesmerized by a 50bps move in the 10yr notes. Yes, it appears somehow that a 50bps drop, from 3.00% to 2.50%, over the first 5 months of 2014 is somehow worthy of great excitement!!! To put this move in context, last year we moved from 1.60% to over 3.00% in less than 4 months - now that was something to get the juices flowing. Similarly, the rally of 2011, the sell-off of 2009, the rally of 2008, the sell-off of 2003, or the big kahuna - the sell-off of 1994, were all 150bps+ moves over a 3 to 4 month period. Now these were the REAL deal! This 50bps dribble-fest is about as exciting as reading another Charlie Plosser speech which warns that rates might need to rise faster than the market thinks . Typically in an improving economy, yields rise. But that's not happening, right now. The price action in the bond market has left money managers scratching their heads. To them, it makes no conventional sense. Therefore a growing percentage of these "specialists" believe the rate drop is a harbinger of something bigger. That is, they think the bond market is telegraphing a serious crisis looming on the horizon. Arguably, the declines in yield are largely benign; having more to do with a permanent change in the national psyche and a lower tolerance for risk.

On Tuesday the Fed's Dudley said that an expected pickup in growth will gradually lift the Fed's inflation benchmark closer to its 2 percent target, and that the pace of eventual interest-rate increases "will probably be relatively slow," depending on the economy's progress and how financial markets react. Then, independently of Dudley's words, we saw a quick move higher in yields of Europe's weakest sovereigns and we think that the hunt for yields may have peaked- we decided to lighten on some of our exposures to high-yield bonds after the huge rally we enjoyed so far this year. *Just in case*.

Wednesday we read the FOMC minutes. We noted that several members offered various reasons for the decline in longer-term bond yields, though none of them involved an economic slowdown. They instead attributed the move to "portfolio reallocation by large institutional investors, the trading strategies pursued by some investors, and safe-haven flows." Nothing significant was revealed, no new news. Well, even the word NEWS is highly overrated in our minds- actually, it was pointed-out to us that "News" isn't a word but an acronym, North, East, West, South- N.E.W.S. a bit of everything pointing any which way you choose…

Furthermore, away from the rationality of bonds, "Correction" is the call du jour in the stock market these days, and it's getting more and more converts. A bevy of high-profile names have warned lately that the market is on the doorstep of a major move lower. From long-term market bulls such as Piper Jaffray to short-term traders such as Dennis Gartman, expectations are high that the major averages are poised for a big dip, with calls varying from 10% or so, all the way up to 25%. And, of course, there's the perpetually bearish Marc Faber, who warned recently that the economy is in for a worse financial crisis than the panic of 2008. N.E.W.S. we say… choose your direction ☺

The "bomb" of the week might be found in oil. Shale oil… Those hoping for a "black gold" rush in California better not wait with bated breath. Federal energy authorities are now echoing the doubts many industry officials have held for years—we could end up recovering only a tiny fraction of the shale oil in California's sprawling Monterey deposit, according to the Los Angeles Times. The new estimate from the U.S. Energy Information Administration, says drillers are likely to extract only about 600 Million barrels of oil from the reserve that extends across much of central California. That's 96 percent less than the 13.7 Billion barrels previously predicted—which was expected to bring in almost 2.8 million jobs and more than $24 billion in tax revenue, the newspaper said. Now, Occidental Petroleum and others are quickly moving their resources out of the area, as everyone in the industry reprints their marketing and investor material. Maybe these re-sized estimates will push back over the horizon the American Energy Independence dream? Possibly explaining the rise in crude now to about $104/Bbl?

Well, if you don't think every day is a good day, just try missing one. Enjoy your weekend!

<u>Core View</u>: 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. As the Federal Reserve is slowly reducing its stimulus (QE), the Bank of Japan is increasing its own; the European Central Bank is expected to imminently press on the accelerator. As a group, most Central banks are targeting an elusive 2% inflation rate. As the industrialized economies are running with excess labor and industrial capacity, the return of inflation appears to be in the distance - short term interest rates are unlikely to rise anytime soon. Other risks are brewing on the horizon - whilst the Ukrainian debacle has moved off the front page, it is clearly unresolved and might yet grow to be a serious problem. Russia has turned its focus on China for the next few weeks. Syria is still burning and other political conflicts are still simmering in different parts of the globe. We have taken note of increased armaments sales, much of which was procured by South-East Asian countries. Some have clearly taken note of the thinness of the paper used for mutual-defence agreements; Ukraine had given-up its nuclear arms in exchange for promises, Obama's chemical red-line in the sand was crossed and nothing happened. Political risks are rising around us; let's keep this in mind whilst watching new record highs in both equity indices and bond prices globally.

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

- **Fixed Income -** The Fixed Income world is dealing with yet further lower yields and investors are struggling with accepting low inflation. As all Central Banks are seeking somewhat higher inflation than they have, it is hardly reasonable that they raise rates! The ECB's is very likely to embark on large scale QE – The size of that intervention may be lessened as the EUR dropped against most of its major exporting partners, and in so doing has cheapened the export market, hopefully allowing for support to flow through to the domestic European businesses and driving up global competitiveness. In conclusion, we see no need to worry in the short term about rising rates. Although, as we have been watching the horizon, there may be the first glimmer of change (or maybe it's a mirage!) as we have seen a very sharp widening of the European Periphery spreads over the Bund… could this be the first signs of change? The answer is simple; it depends how big the ECB's budget is for asset repurchases. There seems to be no rising rates (yet) for the core Euro states (Germany…), so do maintain a watch on the horizon, as rates will eventually start pointing towards the sky when inflation rears its head.

- **Equities –** With P/E ratios around the globe at historically reasonable levels (+-15X for the MSCI AW) and earnings still maintaining string levels, we feel secure in owning equities. The caveat here being that the markets appear to have lost some of their enthusiasm for tech, internet and biotech companies, switching their focus to the large cap industrials and energy related businesses. Consumption around the globe is still expanding (albeit slowly) which should mean a positive environment for cash-flow growth. We have noted that the P/E ratios are slowly creeping higher. The S&P has moved above 16, the Russell is at 18.50 and the Sensex is now at 15.4. As the P/Es expand the value in the indices diminishes… we take note and will focus on watching the sector rotation and seeing whether the momentum stocks gain any traction. No great worries for now, we remain positive and recommend exposures to be maintained using global diversified funds.

- **Alternatives -** In a normalizing financial-world, with relative economic stability and a clearing horizon, fundamentals are returning to base text-book relative values allowing traders and 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 significantly lower volatility than equities. We maintain our recommendation for about a 20% allocation to this asset-class whilst acknowledging the disappointing results YTD. The Macro Funds that were so successful in the past, are struggling to find trading ideas and to capitalise on them, the Multi-Strat, Distressed and Event Driven funds managing to capture some performance. The CTAs that perform so well in crises or downward trending environments are obviously struggling in this sideways trading marketplace. We stick with our view that a well-diversified Fund of Fund is the best investment for now.

- **Currencies -** The market still has even lower volatility relative to the last 5 years and the Euro has slipped from its elevated perch to weaken rather dramatically versus the USD. We maintain belief in the fundamental strength of the US$ and would not bet against it at this time. The ceiling level of 1.40 USD per EUR seems to have held firm for now. The rhetoric from Mr Draghi seems to be maintaining the downward pressure that he required. The Pound seems to be the only resilient currency for now as the BOE Governor, Mr Carney, fretted about the housing market bubble (contained to about 3 streets in London, the rest of the UK is down about 20% from the 2008 peak!). We are watching the Aussie Dollar very carefully for now as it would appear that the down trend is rearing its head again.

Weekly Highlights:

- The FX markets were a little more stable this week with little hard data and a few speeches. The USD reigned strengthened this week against the major crosses but slid against the EM currencies; EUR dropped to as low as 1.3615, the GBP gained ground back to 1.6865, the Yen moved around quite a bit, briefly dropping to as low as 100.85 has moved higher to 101.81 this morning and the CHF touched 0.8950 this morning. BRL rallied and touched 2.20, TRY gave up the news on the mineshaft and rallied to a low of 2.08. The Ukraine story has slipped off the headlines completely now as Russia focuses on China talks; as such the RUB has appreciated again, seeing the USDRUB slip from 34.80 to 34.20. We are still in the holding pattern to hear how much, what and when will the ECB buy and is it too little, too late? With the “non”-military-coup in Thailand, that is definitely not a coup, but simply martial law instigated by the Army having ousted the ruling parties… which is clearly not a military coup… the Thai Baht is almost unchanged. Maybe it really isn’t a Coup! Lastly, we have mentioned a few times that the AUD looks to be breaking down again, well this week saw it drop from 0.9360 to 0.9210… maybe it is beginning, and we are now on high alert looking for the break.

- The US Treasuries, Bunds and Gilts did not give back much this week after last week’s dramatic rally in Bonds. As Equity recovered their lost-step the bonds stayed relatively steady and more or less held their ground. The US 10 year moved from 2.50% at the bottom of our range to 2.54% this morning, the Bund and the Gilt followed suit but with slightly stronger moves, moving to 1.40% and 2.64% respectively. These are not the actions of an exuberant market of economic recovery. As the US employment data and PPI has been encouraging and implies that the QE from Big Ben (remember him?!) may well have had the desired effects, as they are beginning Tapering, is the bond market saying this is too much, too soon? We do not envy the Central Bankers task in life, they are definitely underpaid for the amount of grey hairs they have… poor Janet Yellen has only been in the job less than a few months!! The Periphery in Europe continued its widening of spreads over the Bund this week and did not revert back to its course that had been pre-set for many months. Italy’s yields ran up to 3.35% and Spain to 3.15%, the spreads moved to 1.95% and 1.75% respectively at the highs

- Global equities had a steady week so far, up about 1% more this week than last week. The S&P 500 rallied back to a high of 1,896, the DJIA a high of 16,565, Europeans followed suit with the DAX up 1% as well at 9,720. Indian equities have continued their rally after the Modi election win, on the expectation that corporate earnings will be boosted and many of the infrastructure projects that were mired in a backlog of paperwork will now be released. We want to re-iterate that European equities are likely to perform well based on the flood of new capital that may be coming to market; however, we believe that the core European markets shall continue to rise, but the periphery should be sifted through very carefully as it is not one-size-fits-all … Italy lost another 1.1% this week. We remain vigilant on the short term equity situation, as we see there may be the first cracks appearing round the edges… Let’s hope this is just “settling in to the new environment” and not precursor to a subsidence event!

Highlighted items are interesting data points for the week

All data is compiled from Bloomberg

MARKET INDICES PERFORMANCE

22/05/2014

INDEX NAME	CCY	Last Price	1D	5D	MTD	1M	3M	6M	1Y	YTD	
			PRICE CHANGE IN % (unless indicated)								
EQUITY MARKET INDICES - BY REGION											P/E
MSCI WORLD	USD	1,692.36	**0.35**	0.51	0.27	0.78	1.96	4.26	13.32	1.88	15.43
MSCI WORLD LOCAL	-	1,203.25	**0.36**	0.71	0.51	0.69	1.70	3.83	9.74	1.58	-
MSCI AC WORLD	USD	417.11	**0.41**	0.56	0.73	1.09	2.64	4.15	11.93	2.10	14.81
MSCI EM	USD	1,041.19	**0.92**	0.90	4.61	3.73	8.54	3.17	1.49	3.84	11.12
S&P 500 INDEX	USD	1,892.49	**0.24**	1.16	0.45	0.91	3.06	4.86	14.66	2.39	16.02
DOW JONES INDUS. AVG	USD	16,543.08	**0.06**	0.59	-0.23	0.25	2.73	2.98	8.16	-0.20	14.81
NASDAQ COMPOSITE INDEX	USD	4,154.34	**0.55**	2.09	0.97	0.66	-2.56	4.08	20.09	-0.53	18.18
RUSSELL 2000 INDEX	USD	1,113.87	**0.93**	1.63	-1.15	-2.90	-4.36	-0.98	13.17	-4.28	18.50
EURO STOXX 50	EUR	3,183.38	**-0.13**	0.34	-0.47	0.23	1.65	4.17	14.64	2.39	14.33
CAC 40 INDEX	EUR	4,474.24	**-0.09**	0.40	-0.29	0.52	2.13	4.57	12.78	4.15	15.10
DAX INDEX	EUR	9,719.15	**-0.02**	0.94	1.21	1.83	0.64	5.42	16.37	1.75	13.49
FTSE 100 INDEX	GBP	6,807.19	**-0.20**	-0.71	0.40	1.98	-0.45	1.99	1.65	0.86	-
SWISS MARKET INDEX	CHF	8,688.77	**-0.06**	0.06	2.50	2.91	3.05	5.31	6.37	5.92	16.77
NIKKEI 225	JPY	14,462.17	**0.87**	2.59	1.10	-0.58	-2.71	-5.98	-0.15	-11.23	16.32
HANG SENG INDEX	HKD	22,970.00	**0.07**	1.13	3.78	2.05	1.78	-3.06	1.32	-1.44	10.66
SHANGHAI SE COMPOSITE	CNY	2,034.57	**0.66**	0.40	0.41	-1.59	-3.74	-7.37	-10.59	-3.85	7.92
S&P BSE SENSEX INDEX	INR	24,566.52	**0.79**	1.84	9.58	7.39	18.67	21.51	24.87	16.04	15.54
RUSSIAN RTS INDEX $	USD	1,309.10	**-0.29**	3.73	13.27	11.70	-0.49	-9.40	-6.55	-9.26	5.23
BRAZIL IBOVESPA INDEX	BRL	52,806.22	**1.15**	-1.95	2.28	2.40	11.45	0.01	-6.29	2.52	10.65
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	294.87	**-0.21**	0.54	0.03	1.34	8.94	8.17	15.19	7.00	14.17
MSCI MATERIALS	USD	246.89	**0.59**	0.13	0.07	0.41	0.30	5.26	9.52	2.88	15.84
MSCI INDUSTRIALS	USD	201.47	**0.39**	0.19	-0.18	-0.24	1.75	3.37	15.57	-0.24	16.10
MSCI CONS DISCRETIONARY	USD	176.11	**0.72**	1.33	0.55	-0.16	-1.46	-0.14	12.71	-3.11	16.13
MSCI CONS STAPLES	USD	197.18	**0.07**	-0.19	0.83	2.08	5.91	3.78	7.65	3.52	18.42
MSCI HEALTH CARE	USD	182.69	**0.39**	0.62	0.91	1.86	0.20	7.67	18.65	6.31	17.12
MSCI FINANCIALS	USD	101.58	**0.46**	0.46	-0.31	-0.27	0.92	1.51	10.49	-0.30	13.20
MSCI INFO TECH	USD	125.27	**0.25**	1.27	0.91	1.98	1.02	7.79	18.63	1.71	15.95
MSCI TELECOMS	USD	71.90	**0.48**	-0.72	0.63	1.91	1.91	2.32	13.59	-0.13	15.30
MSCI UTILITY	USD	119.49	**0.29**	0.01	-1.02	0.02	3.32	7.84	8.86	8.75	15.67
MSCI WORLD REAL ESTATE	USD	186.35	**0.10**	-0.98	2.04	2.64	4.76	5.88	-1.23	6.50	23.26
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,224.84	**0.22**	-0.32	-0.43	-0.45	-0.76	1.07	1.50	-0.05	
HFRX EQUAL WEIGHTED	USD	1,204.16	**0.17**	-0.15	-0.38	-0.43	-0.31	1.50	2.34	0.59	
HFRX GLOBAL EUR	EUR	1,133.78	**0.22**	-0.33	-0.46	-0.47	-0.83	0.93	1.16	-0.17	

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.03	**-0.01**	0.01	0.00	0.01	-0.01	-0.05	-0.02	-0.04
US 2 YEAR	USD	0.34	**0.00**	-0.02	-0.07	-0.10	0.03	0.06	0.10	-0.04
US 10 YEAR	USD	2.54	**-0.01**	0.02	-0.10	-0.16	-0.19	-0.20	0.53	-0.49
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	456.50	**-0.03**	-0.23	0.52	0.82	1.70	2.87	2.36	3.27
US GOVERNMENT TR	USD	2,027.21	**-0.09**	-0.20	0.52	0.88	1.14	1.62	0.17	2.40
US CORPORATE TR	USD	2,524.13	**-0.11**	-0.46	0.63	1.13	2.62	4.95	2.91	4.83
US HIGH YIELD TR	USD	1,649.52	**-0.02**	0.06	0.60	0.83	2.18	5.22	6.28	4.26
EU GOVERNMENT TR	EUR	222.97	**0.05**	-0.40	0.30	0.62	2.47	4.45	4.55	4.84
EU CORPORATE TR	EUR	235.43	**0.09**	-0.24	0.62	1.12	2.17	3.79	4.11	3.92
EU HIGH YIELD TR	EUR	264.85	**0.04**	-0.29	0.20	0.52	2.28	5.38	9.26	4.28
JACI GLOBAL	USD	261.50	**0.01**	-0.49	-0.60	-0.35	0.00	5.03	10.54	3.21
GLOBAL EM TR (HEDGED)	USD	321.49	**0.04**	0.02	1.54	1.65	4.33	5.73	1.71	5.38
S&P/LSTA U.S. LEV LOAN	USD	98.65	**-0.01**	-0.05	0.39	0.58	0.24	0.46	-0.11	0.42
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	5,057.63	**-0.18**	0.79	0.98	0.17	1.68	6.02	7.79	4.72
GSCI ENERGY TR	USD	1,163.19	**-0.27**	1.30	2.36	0.63	0.82	5.42	11.01	3.29
GSCI INDUSTRIAL METALS TR	USD	1,348.97	**0.98**	0.88	2.48	0.31	0.83	1.60	-5.27	-1.30
GSCI PRECIOUS METALS TR	USD	1,625.93	**0.58**	0.11	0.14	1.03	-3.27	3.21	-6.71	6.74
GSCI AGRICULTURE TR	USD	679.96	**-0.08**	-1.60	-5.80	-2.80	5.54	8.89	-3.39	12.10
GENERIC 1ST 'CL' FUTURE	USD	103.73	**-0.01**	1.79	4.12	2.37	2.52	10.47	9.99	6.71
GOLD SPOT $/OZ	USD	1,294.79	**0.06**	0.10	0.25	0.85	-2.23	4.11	-6.92	7.39
CURRENCIES										
DOLLAR INDEX SPOT	USD	80.26	**0.01**	0.27	0.99	0.51	0.03	-0.56	-4.22	0.28
Euro Spot	EUR	1.36	**-0.06**	-0.34	-1.58	-1.22	-0.63	0.97	5.52	-0.69
Japanese Yen Spot	JPY	101.67	**0.07**	-0.17	0.56	0.86	0.83	0.00	0.34	3.58
British Pound Spot	GBP	1.69	**-0.08**	0.27	-0.10	0.44	1.20	4.34	11.58	1.81
Brazilian Real Spot	BRL	2.22	**-0.39**	0.16	0.74	0.98	5.65	2.86	-7.51	6.59
China Renminbi Spot	CNY	6.24	**-0.04**	-0.07	0.34	0.00	-2.25	-2.32	-1.66	-2.94
Singapore Dollar Spot	SGD	1.25	**-0.10**	-0.10	0.08	0.28	0.81	-0.18	0.87	0.82
Norwegian Krone Spot	NOK	5.96	**-0.15**	-0.40	-0.15	0.62	1.30	2.45	-2.15	1.90
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	12.03	**1.01**	-8.66	-10.29	-9.34	-18.05	-1.88	-14.50	-12.32
USD SWAP SPREAD SEMI 2YR		16.00	**1.59**	8.47	34.68	68.42	17.99	60.97	6.31	52.38
TED SPREAD		0.00	**-0.10**	-4.28	-0.66	-3.22	-1.30	18.81	-17.42	-86.58

All data is compiled from Bloomberg

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