Friday, June 13th 2014

It is Friday the 13th… Scary, for some, especially as it is full moon as well… The last full moon on Friday the 13th occurred in October 2000 as the Dotcom bubble was exploding (the next one won't happen until 2049, lucky for us). For today, let's hold on tight to our rabbit's foot, just in-case…

Whilst we have had a period which felt like the distilled essence of boredom, now we are awakening into a shifting world again! We became believers in the extinction of Black Swans as a species, only to find them alive and screaming in Iraq!

As the Iraq situation is beginning to spill out we are seeing a little bit of a flight to safety. You're seeing it in gold. You're seeing it in Treasury bonds. People are beginning to wake up… Wall Street knows all too well that not one, but two bear markets were brought on by Iraq; Saddam's invasion of Kuwait in 1990 and the 2003 US invasion of Iraq itself caused tremendous weakness in markets. It's only prudent to at least consider the possibility that markets may be in for some rough sledding.

Crude oil is surging on the Iraq news but the spike might not even be close to over, according to Oppenheimer senior energy analyst Fadel Gheit- "Iraq is responsible for 3 million barrels a day of crude oil supply and if Iraq stops exporting oil… add that to the disruption in Libya, the situation in Nigeria, you'll have a total of more than 4 million barrels of lower supply worldwide. And that could push oil prices to a much higher level—maybe 10, 15 dollars higher from here." With crude oil settling at about $107.00 per barrel on Thursday, already a nine-month high, it could mean crude oil above $120. And lest investors consider that impossible, Gheit is quick to remind that "we've experienced $150 oil five years ago—and we did not have disruption of 4 million barrels." Oil prices were also supported by a 2.6 million bpd drop in US inventories, which came just as the summer driving season gets underway.

The Washington-based World Bank, a United Nations agency which provides loans to developing countries, has downgraded its global growth estimates for this year to 2.8%, from a January forecast of 3.2%. "Growth rates in the developing world remain far too modest to create the kind of jobs we need to improve the lives of the poorest 40%," President Jim Yong Kim said. "Countries need to move faster and invest more in domestic structural reforms to get broad-based economic growth to levels needed to end extreme poverty in our generation." One other risk in the medium term, also highlighted by the World Bank, is the potential of financial turmoil in emerging markets once the U.S. Federal Reserve raises its interest rates. "This could see a pullback in liquidity in global markets however this is likely to be an issue in 2015 rather than 2014."

Then the IMF added its own warnings on the state of the economy, looking at housing- The world must act to contain the risk of another devastating housing crash. The IMF published new data showing house prices are well above their historical average in many countries. The warning shows how the acceleration in global house prices from already high levels has emerged as one of the major threats to economic stability. The IMF's new global house price index shows a fresh acceleration, with prices up by 3.1% on a year ago. House prices are rising fastest in emerging markets, with prices up more than 10% on a year ago in the Philippines, 9% in China and 7% in Brazil. "In some cases house prices are recovering from a sharp correction during the Great Recession," Mr Zhu said. "In other cases, house prices have continued an upward march with only a bit of moderation during the Great Recession." In the US, house prices are rising fast but not overvalued, coming in at 13.4% below their long-run average relative to incomes and 2.6% above their long-run average relative to rents. The world's cheapest housing market is Japan, where housing is 41% below its long-run average relative to incomes and 38% relative to rents. Germany and Estonia also appear cheap, with prices in both more than 10 per cent below their long-run average compared with incomes and rents.

Stocks aren't the only things that have gone quiet. Anticipated and actual volatility in many heavily traded commodities have also plunged over the course of this year. The CBOE Volatility Index touched the lowest level since 2007 this month, but it's not just S&P 500 volatility that traders are refusing to pay for. The indices measuring implied volatility of gold and oil have also plunged this year. And this doesn't just reflect complacency. These plunges in implied volatility come as realized volatility has collapsed. Stocks, gold and crude oil have all done precious little over the past few months—Thursday's macro-related oil spike aside. Of course, the decline in volatility is not bad for everyone. Actually, the calm in the markets makes it relatively more attractive to be long-term oriented. But then, never forget that any long-term investment is a series of short-term decisions… Volatility can change fast and dramatically at that.

This weekend Bedrock is celebrating its tenth anniversary! We hope you enjoy our weekly thoughts and observations which we try to differentiate from the telephone book which is full of facts but doesn't contain a single idea...

<u>Core View</u>: The ECB took action last week. Nothing much happened except some volatility; the Euro fell then rose only to close a week later slightly lower than before the "Show". A weaker Euro clearly can help the ECB to bring-in some inflation. Overall, we read this as stimulus to the Euro-economies. We hold our views whereby 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 a group, most Central Banks are targeting an elusive 2% inflation rate. As the industrialized economies are running with excess labour and industrial capacity, the return of inflation appears to be in the distance - short term interest rates are unlikely to rise anytime soon.

Some other and less predictable risks are brewing on the horizon - The Ukrainian elections and Russian-debacle have moved off the front page, it is clearly unresolved and might yet grow to be a serious problem. Iraq appears to be falling apart again and threatens oil supplies. Clearly, 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 -** As all Central Banks are seeking somewhat higher inflation than they have, it is hardly reasonable that they raise rates! We see no need to worry in the short term about rising rates. We don't yet know how large the budget is for the ECB repurchases, but we know it is not unlimited like the Fed. So do maintain a watch on the horizon, as rates will eventually start pointing towards the sky when inflation rears its head. Vigilance is important, short maturities with low duration are and remain appropriate.

- **Equities –** With P/E ratios around the globe at historically reasonable levels and rising (!) - And earnings are still maintaining fair growth rates (3.5%), we feel secure in owning equities. We have noted that the P/E ratios are slowly creeping higher. As the P/E's expand, the value in the indices diminishes… we take note and will focus on watching the sector rotation and seeing whether the momentum stocks regain any traction. We remain positive and recommend exposures to be maintained using global diversified funds, or by allocating some fixed income exposure to convertible bonds- owning the security of fixed income with an exposure to equities.

- **Alternatives - I**n 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 historical 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 are struggling to find trading ideas and to capitalise on them; whilst the Multi-Strategy, Distressed and Event Driven funds are 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 a very low volatility relative to the last 5 years and the Euro continues to weaken 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 per EUR is likely to hold firm. The rhetoric from Mr Draghi seems to be maintaining the downward pressure. The Pound seems to be the only resilient currency for now as the BOE Governor, Mr Carney, frets 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, the down trend we thought might occur has not re-emerged. Gold is relatively unchanged at 1,265

Weekly Highlights:

- The FX markets have been busy this week. The EUR has continued to slip dropping to as low as 1.3520 yesterday. Carney has pushed the Pound higher saying that rates hikes will be necessary and that they may come before the market expects them. The comments saw Cable reach 1.6992 and almost touch the 1.70 barrier that the market believes should act as a strong resistance level. BRL gained some ground moving from 2.27 to almost 2.22. The USD index moved higher this week on fears of Iraqi news that insurgents are trying to take over some of the cities.

- The US Treasuries, Bunds and Gilts slipped a little on the week. The US 10Y moved back to 2.66% only to drop a little lower to 2.60% on the Iraqi headlines. The UK Gilt weakened further by moving from 2.66% to 2.80% as Carney's discussion topics caused the Gilt market to drop. The Periphery in Europe maintained its narrowing course. Italy's 10 year yields oscillated around 2.77% and have moved a little higher to 2.80% this morning. Spain moved from 2.55% to hit 2.70% this morning.

- Global equities had are a mixed bag for the week. The developed nations saw their major indices drop on average 1.5% on the week but in stark contrast the EM equities have performed remarkably well, ranging from +1% to +6.3% for the Bovespa – maybe the world cup is paying off already! The S&P 500 made new highs of 1,955, the DJIA a new high of 16,910; Europeans followed suit with the DAX touching 10,033. All of the major indices though have come off their highs for now and we look for the rally to push ahead once the dark clouds have passed. We do 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! Don't forget that Iraqi troubles have been the touch-paper that has lit the warning flare for many an international crisis.

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

All data is compiled from Bloomberg

12/06/2014

INDEX NAME	CCY	Last Price	PRICE CHANGE IN % (unless indicated) 1D	5D	MTD	1M	3M	6M	1Y	YTD	
EQUITY MARKET INDICES - BY REGION											P/E
MSCI WORLD	USD	1,725.49	-0.33	-0.52	0.60	1.62	4.47	8.68	17.84	3.88	15.76
MSCI WORLD LOCAL	-	1,227.76	-0.41	-0.09	0.64	2.04	3.64	8.34	18.31	3.65	-
MSCI AC WORLD	USD	424.99	-0.31	-0.36	0.82	1.79	5.22	8.45	17.17	4.02	15.13
MSCI EM	USD	1,054.74	-0.12	0.94	2.63	3.16	11.83	6.49	11.78	5.19	11.40
S&P 500 INDEX	USD	1,930.11	-0.71	-0.53	0.34	1.72	4.54	8.72	17.95	4.42	16.30
DOW JONES INDUS. AVG	USD	16,734.19	-0.65	-0.61	0.10	0.11	3.88	6.21	10.27	0.95	14.95
NASDAQ COMPOSITE INDEX	USD	4,297.63	-0.79	0.03	1.30	4.05	0.87	7.41	24.74	2.90	18.74
RUSSELL 2000 INDEX	USD	1,159.40	-0.63	0.47	2.19	3.41	-1.47	4.73	17.15	-0.36	19.25
EURO STOXX 50	EUR	3,274.41	-0.30	-0.60	0.92	1.95	8.44	12.06	23.02	5.32	14.67
CAC 40 INDEX	EUR	4,542.07	-0.27	-0.85	0.50	0.82	6.86	11.88	19.59	5.73	15.34
DAX INDEX	EUR	9,888.46	-0.51	-0.99	-0.55	1.37	9.66	9.79	22.15	3.52	13.81
FTSE 100 INDEX	GBP	6,816.28	-0.39	-0.61	-0.41	-0.83	4.01	5.84	8.12	1.00	-
SWISS MARKET INDEX	CHF	8,643.80	-0.31	0.01	-0.35	1.17	5.34	10.41	13.32	5.37	16.73
NIKKEI 225	JPY	15,097.84	0.83	0.14	3.18	4.66	1.90	-1.98	21.31	-7.33	16.88
HANG SENG INDEX	HKD	23,307.05	0.57	1.55	0.98	4.27	7.13	0.26	11.59	0.00	10.79
SHANGHAI SE COMPOSITE	CNY	2,070.72	0.93	2.01	1.54	0.97	2.56	-5.71	-3.61	-2.14	8.06
S&P BSE SENSEX INDEX	INR	25,387.49	-0.74	-0.04	4.83	6.35	16.59	22.55	34.85	19.92	16.17
RUSSIAN RTS INDEX $	USD	1,374.94	0.45	3.08	6.11	11.39	24.98	-1.34	8.81	-4.70	5.47
BRAZIL IBOVESPA INDEX	BRL	55,102.44	0.91	6.31	7.54	1.94	20.15	9.94	12.04	6.98	11.27
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	302.27	0.69	0.90	2.13	1.90	12.28	15.14	20.37	9.69	14.53
MSCI MATERIALS	USD	247.63	-0.41	-0.79	0.35	-0.63	3.19	8.81	13.24	3.18	16.00
MSCI INDUSTRIALS	USD	206.07	-0.63	-1.17	0.70	0.90	4.51	7.55	20.71	2.04	16.48
MSCI CONS DISCRETIONARY	USD	179.41	-0.70	-0.99	0.09	2.05	0.79	3.00	16.98	-1.29	16.55
MSCI CONS STAPLES	USD	198.30	-0.34	-0.15	-0.44	0.58	6.35	7.58	10.58	4.11	18.61
MSCI HEALTH CARE	USD	184.92	-0.38	-0.33	0.34	1.70	2.46	11.84	21.93	7.61	17.37
MSCI FINANCIALS	USD	104.44	-0.28	-0.61	1.19	1.97	3.82	7.51	16.06	2.50	13.57
MSCI INFO TECH	USD	129.07	-0.78	-0.56	0.66	3.46	4.47	10.26	23.24	4.80	16.40
MSCI TELECOMS	USD	72.42	0.10	-0.70	-0.60	0.12	4.40	5.15	17.64	0.60	15.61
MSCI UTILITY	USD	121.02	0.25	-1.11	-0.55	1.26	3.94	13.42	14.04	10.14	15.89
MSCI WORLD REAL ESTATE	USD	188.65	-0.26	-1.45	-0.36	1.17	6.84	10.67	8.00	7.81	23.51
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,243.87	-0.13	0.51	0.66	1.50	0.23	2.61	4.47	1.50	
HFRX EQUAL WEIGHTED	USD	1,217.75	-0.05	0.49	0.59	1.11	0.30	2.54	4.13	1.73	
HFRX GLOBAL EUR	EUR	1,151.50	-0.13	0.52	0.65	1.51	0.20	2.49	4.14	1.39	

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.04	0.00	0.01	0.01	0.02	-0.01	-0.03	-0.01	-0.03
US 2 YEAR	USD	0.45	0.01	0.05	0.08	0.07	0.11	0.13	0.17	0.07
US 10 YEAR	USD	2.60	0.00	0.01	0.12	-0.01	-0.05	-0.27	0.45	-0.43
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	457.88	0.10	0.14	-0.14	0.61	1.73	3.40	3.91	3.59
US GOVERNMENT TR	USD	2,025.41	0.23	-0.02	-0.48	0.34	0.99	1.92	0.97	2.31
US CORPORATE TR	USD	2,530.82	0.37	0.23	-0.46	0.72	2.75	5.31	5.49	5.11
US HIGH YIELD TR	USD	1,662.64	0.03	0.36	0.48	0.96	2.56	5.47	9.97	5.08
EU GOVERNMENT TR	EUR	225.18	-0.09	0.34	0.31	1.00	2.81	5.65	7.38	5.88
EU CORPORATE TR	EUR	236.66	0.05	0.29	0.26	0.69	2.20	4.51	6.14	4.46
EU HIGH YIELD TR	EUR	268.11	0.04	0.56	0.79	0.91	2.66	6.10	12.90	5.57
JACI GLOBAL	USD	264.48	-0.13	0.30	0.11	1.01	-0.01	6.00	12.56	4.39
GLOBAL EM TR (HEDGED)	USD	325.32	0.03	0.39	0.27	1.78	5.14	6.88	7.65	6.64
S&P/LSTA U.S. LEV LOAN	USD	98.84	0.00	0.07	0.14	0.15	0.41	0.69	1.04	0.61
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	5,105.25	1.84	2.59	2.11	2.26	3.96	6.71	8.42	5.71
GSCI ENERGY TR	USD	1,192.85	2.55	3.73	3.47	5.10	6.93	7.64	13.12	5.93
GSCI INDUSTRIAL METALS TR	USD	1,318.32	-1.40	-2.09	-2.35	-2.72	3.45	-2.07	-4.28	-3.55
GSCI PRECIOUS METALS TR	USD	1,602.62	1.12	1.74	2.52	-1.50	-7.27	3.45	-9.08	5.21
GSCI AGRICULTURE TR	USD	635.48	-0.24	-1.44	-4.23	-9.45	-8.05	2.44	-9.48	4.76
GENERIC 1ST 'CL' FUTURE	USD	107.33	0.75	4.55	4.50	5.65	10.44	12.20	10.94	10.41
GOLD SPOT $/OZ	USD	1,273.71	0.02	1.63	1.92	-1.54	-7.04	2.82	-8.10	5.65
CURRENCIES										
DOLLAR INDEX SPOT	USD	80.50	-0.10	0.11	0.16	0.44	1.10	0.35	-0.31	0.58
Euro Spot	EUR	1.36	0.12	-0.55	-0.49	-0.99	-2.16	-1.27	1.44	-1.27
Japanese Yen Spot	JPY	101.90	-0.20	0.57	-0.13	0.35	-0.06	1.29	-6.41	3.35
British Pound Spot	GBP	1.70	0.28	1.04	1.33	0.90	2.12	4.15	8.00	2.54
Brazilian Real Spot	BRL	2.23	0.11	1.38	0.46	-0.75	5.57	4.59	-3.35	5.87
China Renminbi Spot	CNY	6.21	0.21	0.72	0.66	0.36	-1.11	-2.17	-1.15	-2.45
Singapore Dollar Spot	SGD	1.25	0.01	0.30	0.48	0.35	1.49	0.56	0.03	1.19
Norwegian Krone Spot	NOK	5.99	0.09	-0.70	-0.24	-1.09	-0.29	3.19	-4.12	1.40
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	12.56	8.28	7.53	10.18	3.54	-22.56	-20.30	-23.46	-8.45
USD SWAP SPREAD SEMI 2YR		14.88	-0.67	7.20	8.22	6.29	3.77	48.80	-7.29	41.71
TED SPREAD		0.00	0.41	-2.55	-0.96	-4.15	3.09	6.58	-14.30	-86.69

All data is compiled from Bloomberg

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