

Bedrock Newsletter

Friday, June 20th 2014

We have been watching the news with much apprehension this week as radical Sunni militants violently wrest away control of much of Iraq; the country's ultimate fate is still open to debate. A paraphrased old nursery rhyme has been playing in our minds – 'Humpty Maliki sat on a Wall. Humpty Maliki Had a Great Fall. All the King's horses and all the King's men, couldn't put Maliki together again'... The United States spent more than a trillion dollars in Iraq, and has provided the Iraqi government with tens of billions of dollars in aid. If the country fails, it will be arguably one of the worst foreign policy disasters in history.

About one hundred years ago (Sykes-Picot Agreement of 1916) England and France designed Syria and Iraq out of the shambles of the Ottoman Empire, with the typically arrogant disregard for the ethnicities of the region. Well, maybe now that both Syria and Iraq are burning, the time has come to roll-back history and redefine the area as it had been? A likely outcome could be a tense three-state stalemate with the Shiites in the south and east, the Kurds in the north, and a Sunni caliphate from western Iraq to Syria. In this scenario the Shiite territory becomes so dependent on Iran for safety, that it would become a surrogate state of Tehran. "Experts" agree that international involvement in Iraq could only be a bad thing. Ted Carpenter, a Cato Institute senior fellow, said his worst-case outcome in Iraq involves the United States being dragged back into the "bloody, convoluted rivalries" of the country. Turkey, Russia and Iran are affected as they all control some of the historical territories and ethnic groups. Clearly, it is up to these countries to re-design Sykes-Picot and draw new boundaries by ethnicity. The USA clearly has no stomach to step back into the frying-pan a year after disengagement- But they might, just maybe, hopefully, take the unthinkable political step and befriend (again) the Islamic Republic of Iran and use them to settle the issues via their influence on the Shiite faction in the conflict. Well, Iran will gain respite from sanctions and possibly an "official" role in the area... possibly becomes the leader of the area? As America believes that it is on the road to energy independence, they will be less concerned about the effects on their relations with Saudi of such a 'rapprochement' with Iran. Wow! How elegant... And it would make all Iranian asset-prices explode and fuel global growth as demand from 80 million people suppressed for over a decade start buying... Well, lets' wake up now and look at reality;

Wednesday, the Federal Reserve said growth is bouncing back and the job market is improving as it continued to reduce the monthly pace of asset purchases. The FOMC trimmed bond-buying by \$10 billion for a fifth straight meeting, to \$35 billion, keeping it on pace to end the program late this year. Yellen and her fellow policy makers are debating how long to keep interest rates near zero as the U.S. labour market improves and inflation moves closer to the Fed's 2% goal. Updating their economic forecasts, Fed officials predicted their target interest rate will be 1.13% at the end of 2015 and 2.5% a year later, higher than previously forecast. They lowered their long-run estimated rate to 3.75% from 4%, reflecting slower long-term growth for the U.S. economy. Fed participants estimated long-term growth at 2.1% to 2.3%. At Bedrock we think this is a seriously dovish statement from the Federal Reserve and that the Fed is willing to accept inflation well above 2% - Goldilocks still has another bowl or two of Porridge to get through! Are equities expensive? Not so according to Janet- "The committee doesn't try to gauge what is the right level of equity prices," Yellen said. Rather, it looks to see if valuation levels "are outside of historical norms. I still don't see that broadly." The Chicago Board Options Exchange Volatility Index, a gauge of S&P 500 swings, fell to the lowest since early 2007. Foreign-exchange volatility also has slowed, falling to an almost seven-year low. Thursday, Gold rose the most since September as the dollar weakened after the Fed meeting. The S&P 500 is yet again in record territory, bond yields remain steady. Commodities rose to a nine-month high as crude advanced after a government report showed U.S. inventories shrank and amid concern that violence in Iraq will disrupt supplies.

Russia has cut off its gas supplies to Ukraine, after the two countries failed to agree on a payment scheme in talks. Although initial reports suggested that oil supplies were proceeding as normal, the Ukrainian minister told Reuters that its supplies had been halted. If Iraq's oil supply goes offline, crude prices could hit \$150-\$200 a barrel, T. Boone Pickens, founder of BP Capital Management, said last Friday. He added that long term, "there is plenty of oil around the world" and believes the U.S. can find the solution in a North American energy alliance with Canada and Mexico. The U.S. produces 8 million barrels of oil a day, but uses more than 18 million barrels a day.

Also in the news we read that China's holdings of U.S. Treasuries declined for the third straight month to \$1.26 trillion in U.S. debt as of April, down \$8.9 billion from the previous month. China is the largest foreign holder of Treasuries, followed by Japan. The Chinese currency has dropped 2.8 percent against the dollar this year. Whilst we expect more Yuan internationalization and liberalization measures to be steadily rolled out, this does not equal Yuan appreciation.

Tomorrow is the first day of summer, again - for those of us who are over one year of age ☺

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Core View: This week we saw the Federal Reserve take action- as expected they tapered another \$10Bn in their purchases- now down to \$35Bn per month but pleased the markets with a “dovish” statement- things are doing better but not as well as desired. Inflation, whilst rising slightly is NOT an issue at this time and interest rates will NOT be rising anytime soon. US stock markets rose nicely with the S&P500 trading at a new all-time high and Treasuries rallying in concert, with volatility as measured by the VIX dropping to a seven year low- now at 10.60! This, on the back of the ECB’s action of last week, reassures us of our view that 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 US is running at under 80% of 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. On the other hand, Iraq appears to be falling apart yet again and threatens oil supplies. Clearly, political risks are rising around us;

- **Fixed Income** - As all Central Banks are seeking somewhat higher inflation than they have, it is hardly reasonable that they raise rates! Vigilance is important, short maturities with low duration are and remain appropriate- whilst we are sanguine about short-term rates, we find little incentive in taking term duration risk or higher credit risk as markets have squeezed returns to a point where the risk/reward ratio in bonds is no longer interesting- virtually no upside exists in the sector and expected returns at the 3% level (coupon plus capital gains) are insufficient to offset the underlying risks.
- **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. As the P/E’s expand, the inherent value in the indices diminishes... we take note and will focus on watching the sector rotation and seeing whether the momentum stocks regain full 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** - 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 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. We reiterate our fundamental views on Alternatives, whereby their role in a portfolio is in attenuating volatility and risks, not as yield enhancement!
- **Currencies** - The market still has a very low volatility relative to the past 5 years. The Euro appears to have regained its footings versus the USD at 1.36+. 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. Gold appears range bound between \$1’250 and \$1’320.

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Weekly Highlights:

- The FX markets had a slow start to the week, with the major crosses sitting on their hands until the Fed Chair Yellen spoke. The EUR has bounced back off the lows as the USD weakened after the dovish tone to the commentary of the Press Conference after the announcement. The EUR moved from 1.3540 to 1.3640 and the Pound moved from 1.6940 to 1.7040. Carney's commentary from a week or so ago about the rates going up in the UK sooner than expected has driven the Pound above the 1.70 and we now wait to see if he follows through. The USD index moved lower this week despite the continued fears attached to the Iraq situation.
- The US Treasuries, Bunds and Gilts held relatively steady on the week, despite some large intraday moves around the Central Banks speaking. The US 10Y held steady at 2.62%, with an intraday move from 2.66% back to 2.60% after the FOMC conference. The Bund moved from 1.41% to hit 1.31% but moved back to 1.34% this morning. The UK Gilt is almost unchanged on the week at 2.75%. The spreads of the Periphery in Europe to the Bund widened this week and broke their narrowing course. Italy's 10 year yields moved dramatically higher from 2.75% to 2.94% this morning. Spain moved from 2.64% to hit 2.73% this morning.
- Global equities seem to have traded in lockstep for the week. The developed nations saw their major indices rise on average 1.0% on the week and with a very similar move for the Emerging markets, save for China that is down 0.5% on the week. The world cup is paying off already for Brazil as the equities are up 7.0% since the games began... we just hope that Brazil don't lose a match! The S&P 500 made new intraday highs of 1,959 and so too the DJIA a new intraday high of 16,923. So... we remain "comfortably" vigilant.

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Highlighted items are interesting data points for the week

All data is compiled from Bloomberg

MARKET INDICES PERFORMANCE

19/06/2014

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	1,748.41	0.61	1.23	1.94	4.20	5.69	7.48	22.79	5.26	15.96
MSCI WORLD LOCAL	-	1,241.40	0.41	1.11	1.76	3.73	5.41	7.27	18.41	4.80	-
MSCI AC WORLD	USD	429.80	0.60	1.10	1.96	3.95	6.29	7.35	21.99	5.20	15.30
MSCI EM	USD	1,049.94	0.51	0.08	2.17	1.94	11.61	6.24	15.57	4.71	11.41
S&P 500 INDEX	USD	1,959.48	0.13	1.52	1.87	4.63	4.67	7.76	23.38	6.01	16.55
DOW JONES INDUS. AVG	USD	16,921.46	0.09	1.12	1.22	3.34	3.62	4.32	14.66	2.08	15.12
NASDAQ COMPOSITE INDEX	USD	4,359.33	-0.08	1.44	2.75	6.41	0.93	6.20	29.56	4.38	18.96
RUSSELL 2000 INDEX	USD	1,184.03	0.08	2.12	4.37	7.85	-1.25	3.28	23.27	1.75	19.68
EURO STOXX 50	EUR	3,310.19	-0.14	0.83	2.02	4.62	7.16	8.55	27.98	6.47	14.85
CAC 40 INDEX	EUR	4,556.28	-0.15	0.29	0.81	2.33	5.28	8.64	23.18	6.06	15.44
DAX INDEX	EUR	9,998.65	-0.05	0.87	0.56	3.73	7.56	6.37	26.11	4.67	13.99
FTSE 100 INDEX	GBP	6,822.74	0.21	0.66	-0.32	0.30	4.28	3.27	10.77	1.09	-
SWISS MARKET INDEX	CHF	8,706.68	0.37	0.61	0.37	0.82	5.39	7.74	16.15	6.14	16.93
NIKKEI 225	JPY	15,349.42	-0.08	1.67	4.90	9.05	7.91	-3.28	17.94	-5.78	17.18
HANG SENG INDEX	HKD	23,214.47	0.20	-0.45	0.58	1.66	9.59	1.76	13.89	-0.39	10.73
SHANGHAI SE COMPOSITE	CNY	2,026.67	0.15	-2.13	-0.61	0.92	1.67	-2.79	-2.75	-4.22	7.88
S&P BSE SENSEX INDEX	INR	25,230.37	0.11	0.01	4.18	3.50	16.05	19.69	34.78	19.18	16.12
RUSSIAN RTS INDEX \$	USD	1,365.90	-0.41	-0.66	5.41	5.18	18.69	-4.48	9.86	-5.33	5.46
BRAZIL IBOVESPA INDEX	BRL	55,202.54	1.66	1.10	7.73	3.47	18.54	6.91	15.26	7.17	11.26
EQUITY MARKET INDICES - BY SECTOR											
MSCI ENERGY	USD	309.95	0.74	1.53	4.72	5.92	14.53	15.20	27.11	12.47	14.88
MSCI MATERIALS	USD	252.48	1.13	2.21	2.32	2.84	6.40	8.28	20.03	5.20	16.40
MSCI INDUSTRIALS	USD	208.03	0.79	0.94	1.66	4.05	5.60	5.41	24.38	3.01	16.64
MSCI CONS DISCRETIONARY	USD	181.35	0.45	1.27	1.17	4.47	2.27	2.09	20.80	-0.23	16.71
MSCI CONS STAPLES	USD	201.19	0.89	1.59	1.01	2.46	8.38	7.31	15.99	5.63	18.84
MSCI HEALTH CARE	USD	187.11	0.63	1.32	1.53	3.52	3.05	10.54	27.60	8.88	17.58
MSCI FINANCIALS	USD	105.14	0.53	0.82	1.87	4.37	4.43	5.31	20.49	3.19	13.64
MSCI INFO TECH	USD	130.87	0.02	0.82	2.07	5.47	4.50	8.71	27.37	6.26	16.57
MSCI TELECOMS	USD	73.08	0.66	0.68	0.30	2.12	4.25	3.90	22.13	1.51	15.69
MSCI UTILITY	USD	124.89	1.04	2.71	2.63	5.07	7.94	15.18	21.30	13.66	16.38
MSCI WORLD REAL ESTATE	USD	190.16	0.95	0.83	0.44	1.76	10.07	9.82	13.49	8.68	23.65
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,245.04	0.23	0.09	0.76	1.77	0.48	2.42	4.30	1.60	-
HFRX EQUAL WEIGHTED	USD	1,217.39	0.13	-0.03	0.56	1.26	0.47	2.29	3.96	1.70	-
HFRX GLOBAL EUR	EUR	1,152.54	0.24	0.09	0.74	1.78	0.44	2.30	3.98	1.48	-

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.02	0.01	-0.02	-0.02	-0.01	-0.04	-0.04	-0.03	-0.05
US 2 YEAR	USD	0.45	0.00	0.00	0.07	0.11	0.03	0.07	0.12	0.07
US 10 YEAR	USD	2.63	0.01	0.03	0.15	0.12	-0.14	-0.26	0.22	-0.40
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	458.14	0.09	0.06	-0.09	0.25	1.81	3.47	3.90	3.64
US GOVERNMENT TR	USD	2,022.03	0.00	-0.17	-0.64	-0.36	1.07	1.88	1.03	2.14
US CORPORATE TR	USD	2,526.15	-0.05	-0.18	-0.64	-0.15	2.72	4.81	5.80	4.92
US HIGH YIELD TR	USD	1,667.28	0.14	0.28	0.76	1.06	2.61	5.70	9.85	5.38
EU GOVERNMENT TR	EUR	225.79	0.29	0.27	0.58	1.06	2.96	5.95	7.24	6.17
EU CORPORATE TR	USD	237.08	0.20	0.18	0.44	0.62	2.40	4.56	6.16	4.64
EU HIGH YIELD TR	EUR	268.58	0.18	0.18	0.97	1.27	2.81	6.02	12.79	5.75
JACI GLOBAL	USD	263.92	0.09	-0.54	-0.10	1.13	0.41	5.81	12.27	4.17
GLOBAL EM TR (HEDGED)	USD	325.03	0.29	-0.09	0.18	1.14	4.88	6.54	7.27	6.54
S&P/LSTA U.S. LEV LOAN	USD	98.85	0.00	0.01	0.15	0.17	0.45	0.70	1.21	0.62
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	5,178.76	0.70	1.44	3.58	2.92	5.33	7.28	7.67	7.23
GSCI ENERGY TR	USD	1,209.35	0.47	1.38	4.90	4.92	8.71	7.43	11.73	7.39
GSCI INDUSTRIAL METALS TR	USD	1,348.13	0.36	2.26	-0.14	-0.32	5.30	0.36	-0.18	-1.37
GSCI PRECIOUS METALS TR	USD	1,658.05	3.39	3.46	6.07	2.16	-1.93	9.67	-4.76	8.85
GSCI AGRICULTURE TR	USD	644.17	1.15	1.37	-2.92	-5.77	-7.92	5.04	-10.76	6.20
GENERIC 1ST 'CL' FUTURE	USD	106.58	0.14	-0.31	3.77	4.15	8.30	8.63	11.65	9.64
GOLD SPOT \$/OZ	USD	1,310.44	-0.75	2.63	4.86	1.24	-1.31	8.90	1.98	8.69
CURRENCIES										
DOLLAR INDEX SPOT	USD	80.28	-0.04	-0.37	-0.11	0.30	0.11	-0.36	-1.99	0.31
Euro Spot	EUR	1.36	0.02	0.52	-0.18	-0.66	-1.22	-0.45	2.96	-0.96
Japanese Yen Spot	JPY	101.96	-0.02	0.08	-0.19	-0.62	0.42	2.10	-4.59	3.29
British Pound Spot	GBP	1.71	0.08	0.50	1.78	1.28	3.33	4.39	9.96	3.00
Brazilian Real Spot	BRL	2.23	1.54	0.27	0.62	-0.93	4.78	4.66	-2.07	6.04
China Renminbi Spot	CNY	6.23	-0.01	-0.31	0.28	0.13	-0.02	-2.56	-1.63	-2.82
Singapore Dollar Spot	SGD	1.25	-0.06	0.05	0.30	0.18	2.18	1.25	1.84	1.00
Norwegian Krone Spot	NOK	6.12	-0.03	-2.09	-2.42	-2.75	-0.88	0.65	-2.02	-0.82
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	10.62	0.09	-15.45	-6.84	-18.06	-26.86	-22.99	-48.17	-22.59
USD SWAP SPREAD SEMI 2YR		15.75	1.74	8.62	14.55	4.10	20.60	103.23	-12.50	50.00
TED SPREAD		0.00	1.71	12.51	11.42	8.23	17.22	14.00	-5.04	-85.02

All data is compiled from Bloomberg

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