Friday, July 4th 2014

Isn't it lucky that we are not superstitious and we held on to our rabbit's foot; we didn't sell in May and go away! The S&P 500 having rallied 4% since the beginning of May and up 7% for the year at the end of June. Our thoughts turn to the summer months ahead and look to July – obviously to the beach and sunshine, but our focus is also on the markets – a month that has historically been a positive producer of performance. In the past 20 years, the Dow Jones Industrial Average has posted average gains of 1.1% in July, and been up 65% of the time… But its monthly performance has been falling in recent decades in the race for best performing month of the year. In the past 100 years, July has ranked number two with an average gain of 1.4%, however, in the last 50 and 20 year periods it has dropped to the sixth best month out of the twelve! History may not repeat itself… but refreshing to know that the statistics are on your side. And you know how much we believe in statistics! So, it is lucky that we have the REAL data to support our optimistic outlook for Equities. Coming into Earning Season (again) the Unemployment Rate in the US has dropped dramatically to 6.1% - to give you a feeling of what that means, this is the same rate as in August 2008! With renewed strength in the Nonfarm Payrolls and the trade deficit shrinking, we see no reason to stand in the way of the equity bulls. If earnings season is strong again, then the second half of 2014 will see a strong performance in global equities.

So what could possibly upset this positive outlook…? The dreaded "I" word perhaps… Inflation?!? Well, maybe we can see some signs of inflation through commodities. The drought in California has played a large part in boosting prices as yields have dropped in the farming community. The dreaded price inflation should then be creating inflation in the consumer market, right? Well why are we not seeing it… because there is none. None in the prices and none (just yet) in the labour force… inflation is not here (yet). The manufacturers are so sensitive to price competition that the short term cost spike is not being passed on to the end user, so inflation never makes to the end market. With the perceived rate rise in the media we see that, in and of itself, a rate rise does not bring the rainy season it just creates a short term storm. Localised markets can see inflationary aspects, causing short term trading aberrations, but the general market carries on its course taking this in its stride. As the Fed Chief Janet Yellen put it, "the inflation data is noisy"; we agree. A lot of noise and not much actually said.

Although Inflation does not exist in the current global market, the fact that there exist short-term spikes should perhaps be the first signal we should take note of. Some of the largest global investors are shying away from the riskier fixed-income asset subclasses with the US High Yield corporates being one of their positions to be reduced. "Valuations are getting stretched," said Jack Flaherty, investment manager at GAM with more than $120Bn in assets. "You'd rather be early in getting out because when it does turn, it could be more violent than expected." The next question is… where does that money flow to? Have we reached the proverbial tipping point of an equity rally fuelled by bond bearishness? Maybe… just maybe!

So let's take a look at one of the existential questions we raised last week; Risk. What are the risks that we see ahead for the second half of 2014 and could be the trigger event to destabilise the markets. Well, we find ourselves in fascinating (and scary) times politically. We come back to the Ukrainian and Russian stand-off. We see the Iranian power play that is emerging. We see Syrian atrocities on the television. We see Iraq struggling under fire from insurgents. All of which at first glance should be USD positive – not even mentioning the rhetoric that Draghi has been pushing, very openly now, that the strength of the EUR currency is an issue. So why is the USD stable or weakening? Once we delve into the political decisions we see that Russia has been forced to reduce its USD holdings. The sanctions take out their ability to settle through the normal Dollar channels, therefore they need another international currency thereby selling their USD and purchasing A.N.other settlement currency and keeping the USD weak. Yet another supporting factor why rates won't need to rise any time soon as the Political impact is keeping the USD weak (for now at least).

Let's now look at Syria and Iraq (note we did not try to say explain!): ISIS is being bombed by the same Syrian regime that has slaughtered millions of its own people and that members of Congress want the U.S. to help overthrow. It's also being attacked by Shia-dominated Iran – nobody's idea of a U.S. ally – which is backing the Shia-dominated Maliki regime. A regime which, by the way, was already widely detested by huge portions of the country before ISIS even turned up. And don't forget Iraq's autonomous Kurdish region, which is pushing back against ISIS, but shows zero interest in cooperating with the Maliki regime in Baghdad. And now there will be US attack helicopters flying over Baghdad again! So to try to summarise: Syria is against ISIS, the US is against Syria, but also against ISIS, Iran is against ISIS, the Kurds are against ISIS but also against the Maliki regime…Those who think the perfect seasoning for that toxic stew is a sprinkling of U.S. bombs, might just do us all a favour this time around by thinking twice…

We leave you with hope that there is a peaceful solution, however hard it may be. As John F. Kennedy said, "The best road to progress is freedom's road". On that note, Happy Independence Day!

Core View: Our view is 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 remain on our radar screens - The Ukrainian/Russian debacle is yet to be settled and might yet grow to be a serious problem. At the same time, the situation in Iraq is dangerous for the entire region and threatens oil supplies. We must not forget that Iraq borders on Saudi Arabia. Iran is sniffing around the periphery to position itself as the powerhouse of the region. The Israeli/Palestinian conflict is heating up. Clearly, political risks abound and 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. If indeed there is an asset-price bubble, the "elephant in the room" isn't necessarily in equities- it is the bond market which might be unreasonably expensive here.

- **Equities –** With P/E ratios around the globe at historically reasonable levels and rising (!) - With earnings having maintained fair growth rates (3.5%), we feel secure in owning equities into Q2 reports due to commence as we write. 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 stick with our view that a well-diversified Fund-of-Funds is the best way to express this allocation. We reiterate our fundamental views on Alternatives, whereby their role in a portfolio is to attenuate volatility and risks, not as enhancement of returns!

- **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 to have maintained a hold above $1'300 as the Iraq/Syria/Iran debacles plays out.

Weekly Highlights:

- The FX markets have been mixed; with various Central Bankers speaking this week the moves have been surrounding data and speeches. As Draghi mentioned again the fact that the currency strength was an issue for the Economic growth of the EU, the EUR saw weakness and dropped to 1.3585 this morning. Cable saw another strong performance as the race to be the first central banker to raise rates heats up between Carney and Yellen; the Pound reaching a recent high of 1.7180. With the historically normalised level of the Pound at about 1.60 and the likelihood of a rate rise being soon, we feel that the risk is already priced into the exchange rate; we don't see much upside from here for the Pound. The JPY has moved back into its trading range and reached as high as 102.27 yesterday. The USD index moved higher this week jumping on very strong payrolls numbers, a sustained drop in the Unemployment Rate and stable Initial Jobless figures.

- The US Treasuries and Gilts had a poor week, with the supportive data that the markets were desperate to see to ratify their hopes of a recovery, the Bonds sold off. The US 10Y yields rose from 2.51% to 2.63% and the UK Gilt is trading at 2.75%, having moved up from 2.64% on Monday. The Bund is unchanged on the week at 1.25%. The spreads of the Periphery in Europe to the Bund are steady at the same levels as last week. Italy's 10 year yields slightly stronger at 2.81% (down from 2.84%) and Spain unchanged at 2.65%.

- Global equities soared this week as the US economic data truly supports the Equity rally. Non-Farm Payrolls were much stronger than expected and the Unemployment rate dropped to 6.1%. The S&P500 rallied 1.6% this week and closing at both a Monthly all-time high and then a weekly all-time high. As we mentioned last week in our Bedrock questions, all-time highs do not mean you have to sell. We think the rally is here to stay, especially as Bonds sold off as well. There was a very similar move for the Emerging markets and for Europe, both up about 2%. The S&P 500 made new highs of 1,985 and so too the DJIA a new high of 17,075. So… we remain "comfortably" vigilant.

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

03/07/2014

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	1,764.12	0.41	1.34	1.19	2.70	5.24	7.17	21.81	6.20	16.04
MSCI WORLD LOCAL	-	1,252.33	0.56	1.50	1.40	2.46	4.22	6.43	20.35	5.73	-
MSCI AC WORLD	USD	433.79	0.38	1.36	1.18	2.73	5.32	7.31	21.08	6.18	15.39
MSCI EM	USD	1,062.18	0.15	1.53	1.08	3.01	6.00	8.44	15.19	5.93	11.49
S&P 500 INDEX	USD	1,985.44	0.55	1.44	1.29	2.99	6.45	8.41	22.91	7.42	16.71
DOW JONES INDUS. AVG	USD	17,068.26	0.54	1.32	1.44	1.98	3.99	3.63	13.88	2.97	15.22
NASDAQ COMPOSITE INDEX	USD	4,485.93	0.63	2.44	1.76	5.51	8.68	8.57	30.27	7.41	19.37
RUSSELL 2000 INDEX	USD	1,208.15	0.72	2.32	1.27	6.80	4.75	4.50	21.90	3.83	20.02
EURO STOXX 50	EUR	3,282.92	-0.21	1.71	1.69	1.39	1.63	6.78	24.05	5.59	14.93
CAC 40 INDEX	EUR	4,485.20	-0.10	1.09	1.41	-0.35	0.01	5.59	17.74	4.41	15.57
DAX INDEX	EUR	10,022.22	-0.07	2.11	1.92	0.96	3.37	6.22	25.37	4.92	14.07
FTSE 100 INDEX	GBP	6,860.71	-0.07	1.52	1.73	0.62	2.47	1.93	6.84	1.65	-
SWISS MARKET INDEX	CHF	8,682.65	-0.13	1.41	1.50	0.25	2.11	4.98	10.87	5.85	16.89
NIKKEI 225	JPY	15,437.13	0.58	2.27	1.81	2.45	2.48	-5.24	10.12	-5.24	17.30
HANG SENG INDEX	HKD	23,546.36	0.06	1.50	1.53	1.70	4.60	3.20	15.04	1.03	10.95
SHANGHAI SE COMPOSITE	CNY	2,059.38	-0.19	1.12	0.54	1.71	0.03	-1.14	2.66	-2.68	7.99
S&P BSE SENSEX INDEX	INR	25,785.71	-0.15	2.73	1.46	3.95	15.32	23.66	32.84	21.80	16.49
RUSSIAN RTS INDEX $	USD	1,387.43	-0.24	0.56	1.56	4.72	12.44	-3.83	8.34	-3.83	5.52
BRAZIL IBOVESPA INDEX	BRL	53,874.58	1.59	0.69	1.33	3.94	5.47	5.68	17.72	4.60	11.04
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	311.22	0.09	0.57	0.36	5.26	10.36	14.61	26.81	12.93	14.92
MSCI MATERIALS	USD	257.14	0.68	2.39	1.94	4.03	4.92	7.84	23.67	7.15	16.82
MSCI INDUSTRIALS	USD	207.78	0.55	1.00	0.95	1.24	2.80	3.78	22.90	2.88	16.52
MSCI CONS DISCRETIONARY	USD	184.87	0.45	1.75	1.50	2.88	3.93	2.38	18.49	1.71	16.97
MSCI CONS STAPLES	USD	201.14	0.50	1.39	1.11	1.36	5.84	6.88	13.71	5.60	18.61
MSCI HEALTH CARE	USD	191.94	0.40	1.75	1.81	3.62	7.18	12.25	28.19	11.69	17.89
MSCI FINANCIALS	USD	105.46	0.48	1.35	1.33	1.82	2.63	4.10	18.27	3.50	13.71
MSCI INFO TECH	USD	133.34	0.49	1.82	1.58	3.87	8.14	9.76	28.94	8.27	16.71
MSCI TELECOMS	USD	72.87	0.28	0.51	0.68	0.34	2.76	2.37	18.12	1.22	15.72
MSCI UTILITY	USD	123.26	-0.61	-1.15	-1.69	1.53	4.32	13.96	18.43	12.18	16.08
MSCI WORLD REAL ESTATE	USD	191.02	-0.35	0.01	0.01	0.70	5.97	9.27	8.66	9.17	23.36
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,250.70	0.08	0.43	0.28	1.13	0.65	2.23	5.41	2.06	
HFRX EQUAL WEIGHTED	USD	1,222.64	0.08	0.39	0.23	0.97	0.46	2.29	4.88	2.14	
HFRX GLOBAL EUR	EUR	1,157.43	0.07	0.41	0.26	1.11	0.60	2.09	5.08	1.91	

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			PRICE CHANGE IN % (unless indicated)							
FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.01	0.00	-0.02	-0.02	-0.03	-0.02	-0.06	-0.04	-0.06
US 2 YEAR	USD	0.51	0.00	0.05	0.05	0.12	0.10	0.11	0.14	0.13
US 10 YEAR	USD	2.64	0.00	0.10	0.11	0.04	-0.08	-0.36	0.14	-0.39
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	458.57	-0.04	-0.31	-0.33	0.34	1.78	3.65	4.79	3.74
US GOVERNMENT TR	USD	2,020.42	-0.11	-0.53	-0.59	-0.21	1.01	2.01	1.54	2.06
US CORPORATE TR	USD	2,524.55	-0.10	-0.80	-0.78	0.07	2.06	4.63	6.67	4.85
US HIGH YIELD TR	USD	1,669.13	0.00	0.04	0.03	0.84	2.31	5.32	11.58	5.49
EU GOVERNMENT TR	EUR	226.44	0.07	-0.19	-0.15	1.06	2.85	6.15	8.37	6.47
EU CORPORATE TR	USD	237.20	-0.02	-0.12	-0.06	0.64	2.35	4.64	6.93	4.70
EU HIGH YIELD TR	EUR	267.69	0.07	-0.25	0.12	0.59	2.05	5.16	13.73	5.40
JACI GLOBAL	USD	266.05	0.01	0.41	0.10	0.83	0.41	5.39	14.99	5.01
GLOBAL EM TR (HEDGED)	USD	326.30	-0.05	-0.21	-0.17	0.76	4.02	6.92	9.54	6.96
S&P/LSTA U.S. LEV LOAN	USD	99.09	-0.01	0.21	0.14	0.34	0.69	0.62	1.68	0.86
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	5,064.60	-0.19	-1.63	-0.80	1.62	2.87	7.92	6.37	4.87
GSCI ENERGY TR	USD	1,174.82	-0.36	-1.82	-1.22	2.23	4.94	8.53	8.11	4.32
GSCI INDUSTRIAL METALS TR	USD	1,415.94	0.51	2.83	2.32	4.33	8.41	4.70	5.13	3.60
GSCI PRECIOUS METALS TR	USD	1,669.66	-0.77	0.23	-0.04	6.87	3.22	6.23	5.29	9.61
GSCI AGRICULTURE TR	USD	608.02	-0.25	-4.99	-1.39	-7.06	-12.25	0.67	-9.09	0.24
GENERIC 1ST 'CL' FUTURE	USD	104.07	0.01	-1.58	-1.23	1.82	3.84	12.73	2.91	7.53
GOLD SPOT $/OZ	USD	1,322.06	0.19	0.45	-0.40	6.28	1.41	6.88	5.77	9.66
CURRENCIES										
DOLLAR INDEX SPOT	USD	80.28	0.09	0.30	0.64	-0.47	-0.17	-0.63	-3.54	0.31
Euro Spot	EUR	1.36	-0.15	-0.44	-0.75	-0.07	-0.85	-0.29	5.23	-1.12
Japanese Yen Spot	JPY	102.03	0.16	-0.60	-0.69	0.71	1.23	2.15	-1.95	3.21
British Pound Spot	GBP	1.71	-0.04	0.67	0.25	2.46	3.46	4.53	13.78	3.58
Brazilian Real Spot	BRL	2.21	0.59	-0.62	0.17	3.17	3.12	7.50	2.63	6.85
China Renminbi Spot	CNY	6.20	0.15	0.23	-0.01	0.75	0.14	-2.44	-1.26	-2.41
Singapore Dollar Spot	SGD	1.25	0.01	0.23	-0.01	0.91	0.97	1.70	2.16	1.31
Norwegian Krone Spot	NOK	6.22	-0.42	-1.42	-1.33	-3.39	-3.47	-0.72	-1.73	-2.32
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	10.32	-4.62	-11.26	-10.80	-14.57	-26.07	-25.00	-36.30	-24.78
USD SWAP SPREAD SEMI 2YR		13.50	-1.82	6.22	6.89	-1.39	6.89	26.29	-25.00	28.57
TED SPREAD		0.00	3.46	8.72	7.89	15.23	8.46	30.50	-2.70	-84.51

All data is compiled from Bloomberg

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