

Friday, July 11th 2014

If it is not one thing, it is always something.... We just can't have a calm, quiet week. Pathetic! Whilst we hadn't expected Assad to embrace his people or Malaki to become magnanimous towards Iraqi minorities, we didn't see the Palestinian rockets coming into Israel or the intensive reaction. The whole region is in conflict. And then, to top things off, we discover on Thursday a significant problem in Portugal's largest bank (Espirito Santo). Markets were rattled as the news dribbled-out from Lisbon, causing European equity markets to lose about 2%, followed by the US opening with serious cracks- DJIA falling 180 points... The feeling of "déjà vu" again... As the saying goes, there is never only one cockroach... But whilst commentators were riding the Espirito Santo story into the new demise of Europe, with equity indices at or close to all-time highs and bonds appearing to be very expensive, it doesn't take a big spark to spook investors- Periphery Europe got slammed, volatility spiked, gold rose and oils fluttered around a somewhat higher level. We noted, however, that the Euro was basically unchanged vs. the mighty Dollar and we looked carefully at the seams of Europe- French bonds remained calm implying that the Portuguese issue was only mildly serious. Based on these two observations, we chose not to panic quite yet... So far, so good, viewed from Friday morning...

Coming back to the mundane, we are in Q2 earnings' season! On Tuesday Alcoa reported a big beat on earnings and top-line, inducing a 3% pop in the stock price in after-hours trading, after a two day fall in the general market and the significant 10% rise in the VIX.

Alcoa's pleasant surprise was buried though by the big upset as Brazil was steamrolled by Germany that same evening, which became Wednesday's talk.

The stock market selloff comes as the Fed minutes showed the planned winding-down of its easing program is set to end in October; then it (the Fed) is seen turning its attention to rate hikes, generally expected sometime next year. Goldman Sachs now says mid-2015 is when the Fed could move, a time frame already expected by others. But Goldman economists had previously not been expecting a hike until early 2016. We view these predictions with our optimistic eyes- The Fed will only raise rates if and when the economy is back to cruising speed, i.e., much stronger than it is now. That would be good, n'est ce pas?

One legendary investor thinks the S&P 500 will continue to climb toward 2,100 by the end of 2014. Laszlo Birinyi, founder and president of Birinyi & Associates, said Monday on CNBC's "Halftime Report," that it wasn't too late for investors to get in. Bedrock's year-end 2013 prediction was for the S&P 500 to close 2014 at about 2'100 ☺. We sure hope Laszlo is right! Well, markets are a tug of war between opposing opinions- Jeffrey Saut, chief market strategist at Raymond James, believes a run higher that has been virtually unabated for the past two years now faces a major challenge. He joins a chorus of other market pros calling for a correction - predictions that all have been proven wrong. The market is up 27 percent since its last meaningful pullback in 2012. Wall Street expects S&P 500 earnings to rise 6.1% for the second quarter, based on the few companies that have reported and expectations for the many that have not, according to Thomson Reuters.

Strategists and traders have been predicting for months that 2014 was supposed to be the year of the dollar, where the Federal Reserve's tapering of quantitative easing and an improving economy would boost the greenback's value against other currencies. But they've been wrong. The U.S. Dollar Index ended the first half of the year weaker, though less than half a percent. At the same time, currencies like Brazil's real, New Zealand's dollar, Australia's dollar, the Japanese yen and the British pound strengthened 3 percent to 6 percent. Well, at the end of the day, yield differentials drive currency rates: If indeed the Fed is poised to consider US\$ rates' increases whilst both the ECB and BOJ are clearly pushing their own rates lower, the impetus for a rising Dollar is being cooked. Unless something else is lying in the currency fields ahead which no-one is seeing yet? We stay with the Green Back for now, whilst we do eye again the Chinese Yuan...but don't forget if everything seems to be going well, you have obviously overlooked something...

We will remind you that it is summer. Trading volumes are shrinking as many investors and traders are sunning themselves under palm trees on beaches around the globe. The resulting reduced liquidity induces an amplification of price movements- We suggest that if you are not on said beaches, you fasten your seatbelt and hold your sights on the horizon and your nerves in check. If you want the rainbow, you have got to put up with the rain.

Bedrock Newsletter

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.

The minutes of the Federal Reserve Committee state an intent to end QE3 by October this year; effectively ending the bond buying program by the Fed in maybe three months' time as long as the economy appear to be in good shape. Currently the Fed is buying bonds at the rate of \$35Bn/month. Nothing substantially new in the information.

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 has flared-up again into a war-like situation. 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/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 (coupons 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 which started this week with a big upwards surprise from Alcoa. 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, now trading again above \$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/Israel conflicts play out, bubbling higher on Middle East worries to almost 1,350.

Bedrock Newsletter

Weekly Highlights:

- The FX markets (normally the most sensitive to data and news flow) were remarkably unperturbed this week. EUR is almost unchanged, the Pound is resilient and after some fluctuations around the BOE minutes (with nothing new in the wording!), we are unsurprisingly unchanged! After all of PM Abe's blustering and the short term effects of the Tax reduction the JPY has trickled higher – not exactly what he had in mind – with USJPY at 101.30! For now the USD is steady against most of its trading counterparts. Considering there is so much belief in the markets for a USD that “has to rally”, it is not feeding through into the open markets just yet. Perhaps we should not be so fearful... well, in the short term at least.
- The US Treasuries and Gilts had a strong week, with the negative news flows being the main driver of their price performance. The US 10Y yields dropped from 2.66% to briefly touch 2.49% yesterday – still neatly inside the Bedrock trading band of 2.5% to 3%. The UK Gilt is trading at 2.62%, having moved down from 2.77% on Monday. The Bund yields moved lower (yet again!) to touch 1.16% only 4 bps away from the all-time lows of 1.12%. Some analysts consider France to be the highest risk to the bond market stability at the moment. The yields of the French OAT 10 year bonds are at 1.63%, having reached their lowest EVER yield yesterday of 1.60%... something is not right here! The spreads of the Periphery in Europe to the Bund are widening, Spanish spreads moved 20Bps wider to 160 over the bund with Italy being marginally stronger at only a widening of 17 Bps to 172Bps over the Bund! Italy's 10 year yields are at 2.92% and Spain unchanged at 2.80%. Unfortunately Portugal did not escape so lightly and the spreads widened by over 40Bps and their benchmark 10 yield yields are at 3.88% having touched 4% midweek!
- Global equities stumbled this week on Portuguese fears, a slew of old data and not much else other than waffle. The S&P500 dropped 1.0% this week, with the Dow performing a shade better at -0.90%. There were however, disparities in the Emerging Market with the Indian Sensex collapsing nearly 4%. Brazil took off Wednesday as a public holiday (or a day of mourning and atonement after the football result), which seems to be the only market so far that has escaped the rout and actually rallied 1.3% for the week so far (today the shares have not started trading yet).

Bedrock Newsletter

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

10/07/2014

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	1,734.48	-0.66	-1.64	-0.51	0.19	5.86	4.80	15.89	4.42	15.78
MSCI WORLD LOCAL	-	1,230.53	-0.62	-1.74	-0.37	-0.49	4.86	4.00	15.20	3.89	-
MSCI AC WORLD	USD	427.30	-0.57	-1.46	-0.34	0.23	5.73	5.29	15.55	4.59	15.16
MSCI EM	USD	1,062.37	0.14	0.00	1.10	0.60	4.62	9.51	12.67	5.95	11.49
S&P 500 INDEX	USD	1,964.68	-0.41	-0.50	0.23	1.07	8.21	6.64	17.29	6.29	16.52
DOW JONES INDUS. AVG	USD	16,915.07	-0.42	-0.36	0.53	0.42	5.54	2.91	9.41	2.04	15.09
NASDAQ COMPOSITE INDEX	USD	4,396.20	-0.52	-1.38	-0.27	1.48	9.91	5.31	22.86	5.26	19.01
RUSSELL 2000 INDEX	USD	1,161.86	-1.02	-3.14	-2.61	-0.42	4.54	-0.23	12.46	-0.15	19.36
EURO STOXX 50	EUR	3,169.30	0.59	-3.09	-1.83	-3.64	1.69	2.10	18.20	1.94	14.44
CAC 40 INDEX	EUR	4,321.60	0.47	-3.30	-2.29	-5.13	-1.01	1.67	11.70	0.60	15.11
DAX INDEX	EUR	9,703.82	0.46	-3.05	-1.31	-2.47	4.17	2.43	18.94	1.59	13.61
FTSE 100 INDEX	GBP	6,692.53	0.30	-2.53	-0.76	-2.14	1.99	-0.70	2.28	-0.84	-
SWISS MARKET INDEX	CHF	8,494.92	0.24	-2.11	-0.70	-2.49	2.36	1.55	6.37	3.56	16.56
NIKKEI 225	JPY	15,164.04	-0.34	-1.77	0.01	0.63	8.62	-4.70	4.78	-6.92	16.97
HANG SENG INDEX	HKD	23,210.47	-0.12	-1.43	0.09	-0.20	0.90	1.59	8.27	-0.41	10.81
SHANGHAI SE COMPOSITE	CNY	2,046.96	0.42	-0.80	-0.07	-0.39	-3.92	1.67	-1.26	-3.26	7.98
S&P BSE SENSEX INDEX	INR	25,114.21	-1.02	-3.27	-1.18	-1.41	10.98	20.98	27.64	18.63	16.09
RUSSIAN RTS INDEX \$	USD	1,378.99	-0.34	1.36	0.95	0.29	14.53	-1.21	4.25	-4.42	5.48
BRAZIL IBOVESPA INDEX	BRL	54,592.75	1.79	2.95	2.68	-0.92	5.25	9.85	17.09	5.99	11.23
EQUITY MARKET INDICES - BY SECTOR											
MSCI ENERGY	USD	305.38	-1.10	-1.86	-1.52	1.73	9.44	12.16	20.20	10.81	14.61
MSCI MATERIALS	USD	252.86	-0.98	-1.82	0.25	1.69	4.81	7.32	17.17	5.36	16.57
MSCI INDUSTRIALS	USD	203.54	-0.80	-2.08	-1.11	-1.85	3.56	1.43	15.54	0.78	16.21
MSCI CONS DISCRETIONARY	USD	181.38	-0.80	-1.94	-0.41	0.39	5.45	0.33	12.18	-0.21	16.66
MSCI CONS STAPLES	USD	199.36	-0.48	-0.84	0.22	0.20	4.81	6.45	9.44	4.67	18.47
MSCI HEALTH CARE	USD	188.72	-0.29	-1.59	0.11	1.67	9.20	7.82	21.98	9.82	17.53
MSCI FINANCIALS	USD	103.17	-0.79	-2.01	-0.87	-1.49	3.23	0.71	12.08	1.26	13.45
MSCI INFO TECH	USD	131.84	-0.41	-1.15	0.43	1.35	9.53	7.92	23.65	7.05	16.53
MSCI TELECOMS	USD	71.80	-0.33	-1.39	-0.80	-0.76	3.76	1.16	14.79	-0.26	15.48
MSCI UTILITY	USD	122.39	-0.21	-0.47	-2.38	1.38	3.85	11.72	13.87	11.39	15.97
MSCI WORLD REAL ESTATE	USD	191.59	0.35	0.42	0.31	1.30	7.24	9.12	5.83	9.49	23.49
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,244.54	-0.02	-0.49	-0.21	-0.05	0.76	1.37	4.44	1.55	-
HFRX EQUAL WEIGHTED	USD	1,219.02	-0.02	-0.30	-0.06	0.11	0.63	1.61	4.25	1.83	-
HFRX GLOBAL EUR	EUR	1,151.73	-0.03	-0.49	-0.23	-0.07	0.71	1.23	4.10	1.41	-

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)											
US 3 MONTH	USD	0.02	0.00	0.01	-0.01	-0.02	-0.02	-0.02	-0.02	-0.05	-
US 2 YEAR	USD	0.45	0.00	-0.05	0.00	0.02	0.10	0.08	0.12	0.07	-
US 10 YEAR	USD	2.54	0.00	-0.10	0.01	-0.10	-0.09	-0.32	-0.03	-0.49	-
FIXED INCOME INDICES - BY TYPE OF ISSUER											
GLOBAL AGG TR HEDGED	USD	460.12	0.04	0.34	0.01	0.59	1.49	3.47	5.34	4.09	-
US GOVERNMENT TR	USD	2,030.83	0.08	0.52	-0.08	0.52	0.71	2.01	2.65	2.58	-
US CORPORATE TR	USD	2,541.41	-0.03	0.67	-0.12	0.78	1.56	4.50	7.94	5.55	-
US HIGH YIELD TR	USD	1,666.03	-0.20	-0.19	-0.15	0.24	1.88	4.61	11.17	5.30	-
EU GOVERNMENT TR	EUR	226.82	-0.03	0.17	0.01	0.61	2.55	5.97	8.27	6.65	-
EU CORPORATE TR	USD	237.62	0.00	0.18	0.11	0.52	2.09	4.34	6.62	4.88	-
EU HIGH YIELD TR	EUR	266.42	-0.25	-0.47	-0.36	-0.62	1.23	4.20	12.11	4.90	-
JACI GLOBAL	USD	263.17	-0.33	-1.08	-0.99	-0.82	-0.12	3.52	13.68	3.87	-
GLOBAL EM TR (HEDGED)	USD	328.03	0.03	0.53	0.35	0.68	3.63	7.10	10.99	7.52	-
S&P/LSTA U.S. LEV LOAN	USD	98.98	-0.06	-0.12	0.03	0.14	0.76	0.20	1.13	0.75	-
COMMODITY INDICES - BY TYPE OF ISSUER											
GSCI INDEX TOTAL RETURN	USD	4,963.76	0.12	-1.99	-2.78	-0.92	-0.93	6.54	1.59	2.78	-
GSCI ENERGY TR	USD	1,155.33	0.49	-1.66	-2.86	-0.31	0.88	7.55	2.89	2.59	-
GSCI INDUSTRIAL METALS TR	USD	1,409.66	-0.19	-0.44	1.86	4.56	5.92	4.66	5.81	3.14	-
GSCI PRECIOUS METALS TR	USD	1,693.92	1.24	1.45	1.41	6.96	2.03	7.13	7.52	11.20	-
GSCI AGRICULTURE TR	USD	579.65	-1.24	-4.67	-6.00	-9.83	-16.64	-2.97	-15.24	-4.44	-
GENERIC 1ST 'CL' FUTURE	USD	102.54	-0.38	-1.46	-2.69	-1.38	-0.27	12.58	-2.16	5.95	-
GOLD SPOT \$/OZ	USD	1,336.10	0.03	1.18	0.66	5.95	1.34	7.02	3.88	10.82	-
CURRENCIES											
DOLLAR INDEX SPOT	USD	80.10	-0.03	-0.21	0.41	-0.85	0.82	-0.69	-3.20	0.08	-
Euro Spot	EUR	1.36	0.01	0.11	-0.60	0.58	-1.98	-0.45	3.92	-0.97	-
Japanese Yen Spot	JPY	101.37	-0.03	0.68	-0.04	0.69	0.25	1.61	-2.38	3.89	-
British Pound Spot	GBP	1.71	-0.04	-0.20	0.12	2.01	2.35	4.54	12.79	3.44	-
Brazilian Real Spot	BRL	2.22	-0.35	-0.45	-0.28	0.19	-0.62	6.21	1.96	6.37	-
China Renminbi Spot	CNY	6.21	-0.07	-0.02	-0.05	0.35	0.07	-2.61	-1.20	-2.45	-
Singapore Dollar Spot	SGD	1.24	-0.01	0.35	0.39	0.71	0.56	1.86	1.39	1.72	-
Norwegian Krone Spot	NOK	6.17	0.01	0.28	-0.64	-2.76	-3.87	-0.89	-1.77	-1.64	-
VOLATILITY / LIQUIDITY INDICES											
CBOE SPX VOLATILITY INDX	USD	12.59	8.07	16.36	8.82	8.53	-26.07	3.71	-10.14	-8.24	-
USD SWAP SPREAD SEMI 2YR		16.75	-0.36	26.42	32.62	15.68	25.85	42.43	-1.18	59.52	-
TED SPREAD		0.00	2.15	-3.79	3.80	9.25	14.38	5.94	-8.50	-85.10	-

All data is compiled from Bloomberg

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