

Friday, July 11th 2014

Thursday started with the Obama administration and the European Union imposing further sanctions on Russian banks, energy companies and defence firms in the latest attempt to pressure the country to stop meddling in Ukraine. A little flutter of a baby Black Swan's wings from central Europe? Well, the bird grew bigger when, in the afternoon, a Malaysian passenger Boeing 777 plane was shot down over Ukraine's eastern border with Russia, killing 298 passengers and crew. Markets were roiled, only to be shaken a few moments later as Israel announced and commenced a ground-troop incursion into Gaza; The VIX shot-up 32% to 14.54 (but do note that this is just about its average level of the past year), the DJIA fell 160 and broke through its recently conquered 17'000, Gold rose \$20, ten year Treasury notes rallied bringing its yield down to 2.46% and WTI oil rose some to \$103.50. Wow... and through these market shaking events we all missed the news that the nuclear-talks with Iran broke down... Saudi Arabia said on Wednesday that it is deploying men and high-tech machinery to boost vigilance along its 800 kilometre northern border with Iraq, where it faces security threats from both sides in a deepening sectarian conflict. Some Sunni groups have criticized Saudi Arabia, a Sunni monarchy, for its ties with the U.S., whilst Shiites in Iraq have blamed it for supporting militants – Three rockets were fired at the border area on July 7, landing close to a housing complex for border guards near Arar. A few days before the rocket attack, Islamist militants killed four Saudi soldiers near the Yemen border, and two of the attackers blew themselves up in a suicide strike on a Saudi intelligence building, according to the Interior Ministry. This brewing situation is possibly the most significant topic of the week if clearly less headline-worthy than the tragedies in Ukraine and Gaza. What is truly going-on on our planet? Do we believe the Ukrainians that the Russians shot down the Boeing? Or the Russians who say it was the Ukrainians? Are the Israelis just reacting to Hamas provocations or are the Palestinians responding to Israeli blockades? Depends on which TV station you are watching to paint your views of reality - we recall an old quip from Trotsky - "Truth is the first victim of war..."

On a more mundane side of our world, we noted that on Tuesday Yellen said in her report to the Senate Banking Committee that, "a high degree of monetary policy accommodation remains appropriate." Then on Wednesday she added -"asset valuations aren't out of line with historical norms", after having said a day earlier that prices for some stocks were stretched.

Mario Draghi talked-down the Euro Speaking in front of the European Union Parliament's economic and monetary affairs committee in Strasbourg. The Euro has risen from a \$1.20 level in 2012 to its current \$1.35; Draghi has been urged to do more to tackle its rise although the ECB officially has no mandate to control the currency. With a slew of additional monetary policy tools detailed by Draghi at the ECB's June meeting, many currency experts now forecast the euro could start to drop lower. Draghi's remarks Monday build on the belief that the ECB will do more over the coming months to stimulate exports and thus economic growth in the region.

The Philadelphia Federal Reserve Bank said its business activity index rose to 23.9, its highest since March 2011, from 17.8 in June. That was sharply above expectations of 16.0, according to a Reuter's poll. It also beat the highest estimate of 21.0. Factory-activity in the U.S. mid-Atlantic region accelerated in July at its fastest pace in more than three years, handily beating expectations, a survey showed on Thursday. New orders soared to 34.2, the highest since July 2004, from 16.8. The employment component improved slightly, to 12.2 from 11.9. Pleasant reading which further supports the smiles acquired from the generally good Q2 results which are raining on us daily.

"In a world where real bond yields are lower for longer than normal, we think equity valuations are likely to remain at levels that feel uncomfortable to many investors, and could move higher still," said Dominic Wilson, a strategist at Goldman Sachs.

Beyond the now clearly visible and active political issues of Iran, Ukraine, Israel, Syria, Iraq, Nigeria and others in our stew, there is another little storm brewing on the American horizon- but this one may trigger the next leg-up of US equity prices, beyond current period earnings- Jack Lew, the US Treasury Secretary has started to talk of US Corporate Tax reform with a view to lowering taxes... to quote Jack, "We need to send a signal. I think we can get comprehensive business tax reform done." Maybe, just maybe... remaining long US equities through the turmoil of these days will be rewarded? Remember that the early bird may get the worm, but the second mouse gets the cheese!

We wish you a warm and pleasant weekend.

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 appears to be intensifying with increasing sanctions against Russia being imposed by the US and the EU and a passenger plane having been shot down in Ukrainian airspace. 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, which yesterday announced a reinforcement of its military presence on their 800Km long border with Iraq. Iran is sniffing around the periphery to position itself as the powerhouse of the region. The Israeli/Palestinian conflict has boiled-up 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 with eventual capital gains/losses) are insufficient to offset the underlying risks. If indeed there is an asset-price bubble, the "elephant in the room" isn't necessarily equities - it is the bond market which might be unreasonably expensive here.
- **Equities** - with the Dow Jones firmly above 17'000 we see 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 as the majority of reported earnings so far this month have beaten expectations. We remain positive and recommend exposures to be maintained using global diversified funds, or, for bond-oriented investors, 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 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 USD appears to have regained its footing versus its major trading counterparts, now trading steady around \$1.3530 against the EUR and 0.90 against the CHF. 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 further.

Weekly Highlights:

- The FX markets have seen a ripple appear on an otherwise relatively calm sea. With escalating political issues around the globe and events unfolding in Ukraine, Israel sending in ground troops to Gaza and Libya requesting UN help to protect its oilfields the USD is ever so calmly coming back into vogue. EUR is down from 1.3640 to 1.3520; the Pound is resilient and is almost unchanged at 1.71! After all of PM Abe's blustering and the short term effects of the Tax reduction the JPY has remained at about 101.30 – not exactly what he had in mind! For now the USD is steady against most of its trading counterparts, with the USD index having moved from 80.10 to 80.50 this week.
- The US Treasuries had a strong week, with the negative news flows being the main driver of their price performance. The US 10Y yields dropped from 2.56% to briefly touch 2.44% yesterday. The UK Gilt is trading at 2.58%, having moved down from 2.66% on Tuesday. The Bund yields moved lower (yet again!) to touch 1.14% only 2 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 1.58%, making this the lowest EVER yield... something is not right here! The spreads of the Periphery in Europe to the Bund have narrowed slightly, Spanish spreads moved to 150Bps over the bund with Italy being marginally stronger to yield 150Bps over the Bund as well! Italy's 10 year and Spain's 10 year are yielding at 2.63%.
- Global equities are almost unchanged on the week – in spite of the awful news that has been featuring on our TV screens during the week. The S&P500 is flat this week, with the Dow performing a shade better at +0.25%. EM equities are so far unchanged on the week but we await the markets to actually open to see if they will react at all. Europe however, seems to have been hit with the Ukrainian news and following up with the previous down move in the US, the markets are generally down about 0.5%.

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Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

17/07/2014

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	1,735.09	-0.94	-0.05	-0.48	-0.15	3.86	4.69	14.82	4.46	15.79
MSCI WORLD LOCAL	-	1,233.27	-0.91	0.22	-0.15	0.26	4.05	3.84	13.80	4.12	-
MSCI AC WORLD	USD	427.45	-0.88	0.00	-0.30	0.05	3.99	5.18	14.41	4.63	15.18
MSCI EM	USD	1,062.59	-0.40	0.37	1.12	1.73	5.01	9.29	10.98	5.97	11.52
S&P 500 INDEX	USD	1,958.12	-1.18	-0.33	-0.11	0.06	5.00	6.49	15.91	5.94	16.39
DOW JONES INDUS. AVG	USD	16,976.81	-0.94	0.36	0.89	0.42	3.46	3.15	9.19	2.41	15.04
NASDAQ COMPOSITE INDEX	USD	4,363.45	-1.41	-0.75	-1.01	0.01	6.54	3.95	20.83	4.47	18.89
RUSSELL 2000 INDEX	USD	1,133.60	-1.56	-2.43	-4.98	-4.19	-0.38	-2.98	7.93	-2.58	18.94
EURO STOXX 50	EUR	3,155.18	-0.08	-0.06	-2.26	-3.78	-0.02	0.03	16.09	1.49	14.40
CAC 40 INDEX	EUR	4,317.08	0.02	0.01	-2.39	-4.71	-2.59	-0.24	9.91	0.49	15.08
DAX INDEX	EUR	9,717.66	-0.37	0.53	-1.17	-2.14	3.27	-0.26	16.56	1.73	13.65
FTSE 100 INDEX	GBP	6,718.20	-0.30	0.42	-0.38	-0.89	1.40	-1.63	1.26	-0.46	-
SWISS MARKET INDEX	CHF	8,525.78	-0.26	0.68	-0.34	-1.52	1.80	0.55	7.53	3.94	16.61
NIKKEI 225	JPY	15,215.71	-1.01	0.34	0.35	0.66	4.82	-3.30	2.75	-6.60	17.06
HANG SENG INDEX	HKD	23,454.79	-0.28	0.95	1.14	1.18	3.05	1.39	9.88	0.64	10.92
SHANGHAI SE COMPOSITE	CNY	2,059.07	0.17	0.59	0.52	0.17	-1.84	2.70	1.76	-2.69	8.08
S&P BSE SENSEX INDEX	INR	25,620.45	0.23	2.38	0.81	1.48	13.22	21.63	27.29	21.02	16.36
RUSSIAN RTS INDEX \$	USD	1,277.66	-1.65	-7.63	-6.47	-6.26	6.45	-8.46	-7.24	-11.44	5.16
BRAZIL IBOVESPA INDEX	BRL	55,637.51	-0.14	1.91	4.64	0.79	6.77	13.13	16.75	8.02	11.52
EQUITY MARKET INDICES - BY SECTOR											
MSCI ENERGY	USD	304.08	-1.39	0.12	-1.94	-1.17	5.05	12.52	18.22	10.34	14.55
MSCI MATERIALS	USD	254.77	-0.48	0.68	1.00	2.04	4.13	5.87	16.90	6.16	16.77
MSCI INDUSTRIALS	USD	204.35	-0.99	0.11	-0.71	-0.99	1.58	1.42	15.09	1.18	16.28
MSCI CONS DISCRETIONARY	USD	181.29	-0.74	-0.17	-0.46	0.42	3.41	1.08	11.23	-0.26	16.68
MSCI CONS STAPLES	USD	198.72	-0.48	-0.45	-0.11	-0.35	2.93	6.63	8.86	4.33	18.45
MSCI HEALTH CARE	USD	186.78	-1.01	-1.21	-0.92	0.46	6.31	6.08	20.10	8.69	17.36
MSCI FINANCIALS	USD	103.53	-0.99	0.28	-0.53	-1.01	2.09	1.22	10.24	1.61	13.46
MSCI INFO TECH	USD	132.61	-1.08	0.26	1.02	1.35	7.87	7.48	23.73	7.67	16.62
MSCI TELECOMS	USD	72.48	-0.98	0.61	0.14	-0.17	2.68	1.37	15.95	0.68	15.69
MSCI UTILITY	USD	121.35	-1.09	-0.68	-3.21	-1.82	1.54	10.82	11.49	10.44	15.86
MSCI WORLD REAL ESTATE	USD	192.49	-0.47	0.57	0.78	2.19	6.04	9.31	6.46	10.01	23.56
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,243.25	0.10	-0.10	-0.31	0.14	1.25	1.00	3.96	1.45	-
HFRX EQUAL WEIGHTED	USD	1,218.36	0.06	-0.05	-0.12	0.24	0.93	1.34	3.87	1.78	-
HFRX GLOBAL EUR	EUR	1,150.52	0.11	-0.11	-0.34	0.11	1.19	0.86	3.66	1.30	-

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)											
US 3 MONTH	USD	0.01	0.00	-0.01	-0.01	-0.01	-0.01	-0.02	-0.02	-0.06	-
US 2 YEAR	USD	0.47	0.03	0.02	0.02	0.03	0.08	0.10	0.17	0.09	-
US 10 YEAR	USD	2.49	0.04	-0.03	-0.05	-0.10	-0.24	-0.33	-0.04	-0.54	-
FIXED INCOME INDICES - BY TYPE OF ISSUER											
GLOBAL AGG TR HEDGED	USD	461.37	0.20	0.27	0.28	0.90	1.87	3.49	4.95	4.38	-
US GOVERNMENT TR	USD	2,034.62	0.26	0.19	0.11	0.76	1.25	2.11	2.07	2.78	-
US CORPORATE TR	USD	2,552.00	0.34	0.40	0.30	1.20	2.32	4.74	6.95	5.99	-
US HIGH YIELD TR	USD	1,660.88	-0.19	-0.31	-0.46	-0.23	1.61	3.90	9.00	4.97	-
EU GOVERNMENT TR	EUR	227.99	0.17	0.52	0.53	1.32	2.85	5.92	8.57	7.20	-
EU CORPORATE TR	USD	238.01	0.08	0.16	0.28	0.68	2.20	4.15	6.53	5.05	-
EU HIGH YIELD TR	EUR	266.76	0.03	0.13	-0.23	-0.50	1.34	4.03	11.80	5.04	-
JACI GLOBAL	USD	261.65	0.06	-0.58	-1.56	-0.86	-0.09	1.81	11.19	3.27	-
GLOBAL EM TR (HEDGED)	USD	327.71	-0.01	-0.10	0.26	1.17	3.77	6.61	9.02	7.42	-
S&P/LSTA U.S. LEV LOAN	USD	98.90	0.00	-0.08	-0.05	0.06	0.71	0.00	0.65	0.67	-
COMMODITY INDICES - BY TYPE OF ISSUER											
GSCI INDEX TOTAL RETURN	USD	4,928.52	0.56	-0.71	-3.47	-3.95	-2.90	4.88	0.33	2.05	-
GSCI ENERGY TR	USD	1,144.17	0.58	-0.97	-3.79	-4.75	-1.65	5.58	0.93	1.60	-
GSCI INDUSTRIAL METALS TR	USD	1,416.51	0.14	0.49	2.36	5.75	6.29	2.98	6.40	3.64	-
GSCI PRECIOUS METALS TR	USD	1,665.79	1.37	-1.66	-0.28	3.95	2.45	4.95	3.43	9.35	-
GSCI AGRICULTURE TR	USD	575.85	0.51	-0.66	-6.61	-8.91	-18.18	-3.55	-14.53	-5.07	-
GENERIC 1ST 'CL' FUTURE	USD	103.69	0.48	2.84	-1.59	-1.75	0.30	11.82	-3.93	7.14	-
GOLD SPOT \$/OZ	USD	1,312.76	-0.49	-1.93	-1.10	2.75	1.43	4.68	2.22	8.88	-
CURRENCIES											
DOLLAR INDEX SPOT	USD	80.51	0.00	0.40	0.92	-0.09	0.85	-0.88	-2.80	0.59	-
Euro Spot	EUR	1.35	0.04	-0.57	-1.18	-0.47	-2.04	-0.16	3.22	-1.54	-
Japanese Yen Spot	JPY	101.38	-0.20	-0.08	-0.05	0.54	1.04	2.76	-0.94	3.88	-
British Pound Spot	GBP	1.71	0.04	-0.05	0.01	0.66	1.86	4.13	12.35	3.32	-
Brazilian Real Spot	BRL	2.26	-1.54	-1.67	-1.94	0.16	-0.95	3.73	-1.42	4.60	-
China Renminbi Spot	CNY	6.20	0.02	0.01	0.00	0.45	0.34	-2.42	-1.00	-2.40	-
Singapore Dollar Spot	SGD	1.24	0.19	-0.03	0.42	0.59	0.91	2.82	2.05	1.74	-
Norwegian Krone Spot	NOK	6.19	0.23	-0.20	-0.95	-2.95	-3.30	-0.24	-3.35	-1.95	-
VOLATILITY / LIQUIDITY INDICES											
CBOE SPX VOLATILITY INDX	USD	14.54	32.18	15.49	25.67	37.04	8.83	16.88	5.59	5.98	-
USD SWAP SPREAD SEMI 2YR		19.59	-0.81	16.96	55.11	22.13	32.81	45.11	12.59	86.57	-
TED SPREAD		0.00	2.34	2.34	6.23	11.42	8.73	8.39	-7.22	-84.75	-

All data is compiled from Bloomberg

Bedrock Newsletter

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