Friday, July 25th 2014

News of this week has been anchored in the sky… After last week's tragic shooting of a passenger plane over Ukraine causing almost 300 casualties, another two Ukrainian fighter-jets were hit, then a passenger plane crashed in Taiwan (bad weather?) and yesterday yet another passenger-jet fell in Mali for unknown reasons. The headlines were shared with the escalation of violence in Gaza and left no space for information about Syria, Nigeria, Iraq, Libya or Iran… We doubt the problems and pains in these areas have been resolved. Through the sad headlines we have been watching the continued rise of equities with the S&P 500 breaking new highs on Wednesday and then again on Thursday, closing-in on 2'000 as the DJIA holds well in the 17'000 level and as the bonds show price rises and yields holding if not falling somewhat.

On the economic front we saw that new applications for unemployment benefits plunged last week, reaching an eight-and-a-half-year low and suggesting increasing strength in the labour market. Initial claims for jobless aid, a proxy for layoffs,fell by 19,000 to a seasonally adjusted 284,000 in the week ended July 19. That was the lowest level for first-time claims since February 2006 and below the 305,000 claims forecast by economists surveyed by The Wall Street Journal.
And we have been seeing a flurry of Q2 earning reports - "The general tone of earnings has been positive not just on the bottom line but also top-line, and we've seen inflation numbers that gave comfort to those who believe the market will be supported by the Fed," said Russ Koesterich, chief investment strategist at New York-based BlackRock Inc. Profits at S&P 500 members probably rose 6.2% in the second quarter, while sales gained 3.3%, according to analyst estimates compiled by Bloomberg.

U.S. house prices rose 5.5% in the 12 months through May as sales demand improved following a slowdown earlier in the year. U.S. consumer prices rose in June as the cost of gasoline surged, but the overall trend continued to point to a gradual build-up of inflationary pressures. Inflation is creeping up as the economy's recovery becomes more durable, a welcome development for some Federal Reserve officials who had worried that price pressures were too low. Economists polled by Reuters had expected consumer prices to gain 0.3% in June and rise 2.1% from a year-ago. Stripping out food and energy prices, the so-called core CPI rose 0.1%, slowing after May's 0.3% increase.

While recent measures of inflation — from producer prices and consumer prices to the PCE deflator (the Federal Reserve's preferred gauge of inflationary pressures) — have all approached a 2% year-over-year gain recently, it would appear that Janet Yellen's recent testimony will prove spot on. Inflationary pressures, particularly in food and energy costs, will likely prove "transitory." Agricultural commodity prices, excluding meats, have crashed. Corn, wheat and soybean prices have plummeted on expectations of bumper crops around the world — particularly in the United States. Heavy rains in the growing regions have altered the outlook for drought-stricken areas (except California) and have led to a major decline in prices. Even more telling, is the level of interest rate and the slope of the yield curve. As we write, the yield on the 10-year Treasury note is at 2.5%, as the yield curve is flattening. The message of the bond market is not suggesting in any way, shape, or form, that the Federal Reserve is "behind the curve" on battling phantom inflation. Indeed, even despite the "flight to quality" trade in Treasuries, which is pushing yields lower than they might otherwise be, is hardly the sole reason for declining interest rates. A flattening yield curve and tightening credit spreads are hardly screaming out that inflation is just around the corner. The velocity of money (the speed with which the money-supply turns over) is near zero. Velocity needs to accelerate markedly if one wishes to make the case that policy-inspired inflation is on the horizon. For years, and on all counts, inflation hawks have been, let's say, premature in calling for a rapid acceleration in inflation. But in an evidence-based economy and at a data-dependent Fed, their predictions are worth not a bitcoin.

The Federal Reserve may have scope to keep interest rates at zero for longer than investors anticipate as inflation stays muted and a 2014 slowdown prolongs the labour-market recovery, the International Monetary Fund said on Wednesday. The IMF cut its U.S. growth forecast for this year to 1.7% from 2% predicted in June, citing a first-quarter contraction, after a 1.9% advance last year. The fund left its 2015 forecast at 3%, the fastest expansion since 2005.

The International Monetary Fund also lowered its outlook for global growth this year as expansions weaken from China to the U.S. and military conflicts raise the risk of a surge in oil prices. The world economy will advance 3.4% in 2014, Next year growth will be 4%, compared with an April forecast for 3.9% the fund said. Growth in emerging markets is projected to be 4.6% this year, compared with an April forecast for 4.9% We find the outlooks from IMF and others together with Q2 results to be quite supportive of equities whilst not scaring us away from bonds as inflationary pressures are clearly absent.

We suggest we go into our weekend with a smile, as a smile is a curve that sets everything straight ☺

Market outlook

Core View: Our view is that the world's economies are mending from the fallout of the "Great Recession" if at a slower pace than hoped for. The economics are settling back into a reasonable growth pattern and stability with a positive bias 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 and Euro-zone at even less), the return of inflation appears to be in the distance and as such, 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. At the same time, the situations in Iraq and Syria are dangerous for the entire region and threaten oil supplies- we must not forget that Iraq borders on Saudi Arabia, which 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 is in a war-like situation with an unclear outcome. Clearly, political risks abound and are rising around us!

Arguably, if the S&P 500 can reach a new all-time high in the face of these political issues, the underlying economies must be running at a better clip than what the headlines announce!

- **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" it likely is the bond market which might be unreasonably expensive here.

- **Equities –**The Dow Jones is trading firmly above 17'000 and the S&P 500 breaking to new closing highs on Wednesday, a couple of points away from 2'000, we see P/E ratios around the globe at historically reasonable levels and rising (!) - with Q2 earnings showing fair growth rates on both top lines and bottom lines, we feel secure in owning equities. 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 allocating some fixed income exposure to convertible bonds for bond-oriented investors.

- **Alternatives -** With relative economic stability and a clearing horizon, fundamentals are returning to text-book norms of relative values. We expect this active management allocation to maintain, if not exceed, its relatively low recent results and possibly returning to past highs- with low correlation to any particular 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 and not as enhancement of returns!

- **Currencies/Commodities -** 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 $1.345 against the EUR and 0.9040 against the CHF. We maintain belief in the fundamental strength of the US$ and would not bet against it at this time. The ceiling level of $1.40 per EUR is likely to hold firm. The Japanese Yen has managed to surprize traders and Abe by holding firm at 101.50 against the US$ and Gold appears to have a fair value around $1'300 as the Iraq/Syria/Iran/Israel conflicts play out further. We do note that Oil has held surprisingly steady (WTI at +- $103) in the face of the turbulences in the Middle East and Nigeria!

This Week's Highlights:

- The FX markets have seen another ripple appear on an otherwise relatively calm sea. With escalating political issues around the globe and airway events in Taiwan, Mali and Malaysia the USD is ever so calmly coming back into vogue. EUR is down from 1.3550 to 1.3450; the Pound is starting to crack a bit and is now below 1.700 at 1.6960. The JPY remains almost at the same levels at 101.90 but we keep faith in a weaker JPY for the coming weeks and months. For now the USD is steady against most of its trading counterparts, with the USD index having moved another leg up from 80.50 to almost 81.00 this week.
- US Treasuries have bounced in a tight range during this week. The US 10Y yields have ranged from 2.45% to 2.50% and testing the 2.52% levels yesterday. The UK Gilt is trading at 2.60%, having moved up from the lowest 2.54% since Wednesday. The Bund yields tested again the lowest levels at 1.14% (yet again!) on Wednesday and then moving up to 1.19%, but still far away from this month higher 1.30% level. 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 have continued their downward move till yesterday with a low at 1.53% making this a new all time low for the yield. Shouldn't yields give a sense on risk premium? The spreads of peripheral Europe to the Bund have continued to narrow, Spanish spreads moved to 135Bps over the bund with Italy being marginally stronger to yield 155Bps over the Bund as well! Italy's 10 year is yielding 2.72% and Spain's 10 year is yielding at 2.55%.
- Global equities have seen a positive week – in spite of the awful war and airplane crashes that have been filling our TV screens during the week. Earning season continues to be positive pushing the S&P500 higher as it gained +1.50% this week, and with the Nasdaq climbing 2.5%. EM equities are so far the best performers since the beginning of the year- gaining this week another 1.65%, even with the Ukrainian situation which has driven the Russian RTS Index down by 1.5% this week. Europe also rose this week with the Eurostoxx50 up 1.7%. The best European equity markets remain the periphery countries, Spain (+3.5%) and Italy (+2.8%).

Bedrock Newsletter

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

24/07/2014

INDEX NAME	CCY	Last Price	1D	5D	MTD	1M	3M	6M	1Y	YTD	P/E
			PRICE CHANGE IN % (unless indicated)								
EQUITY MARKET INDICES - BY REGION											P/E
MSCI WORLD	USD	1,756.25	**0.12**	0.69	0.74	1.04	5.12	8.52	15.72	5.73	15.97
MSCI WORLD LOCAL	-	1,249.85	**0.19**	1.34	1.20	1.19	4.66	8.11	14.55	5.52	-
MSCI AC WORLD	USD	432.90	**0.14**	0.79	0.97	1.34	5.51	9.08	15.35	5.96	15.36
MSCI EM	USD	1,080.85	**0.29**	1.65	2.86	3.75	8.81	13.79	12.31	7.80	11.72
S&P 500 INDEX	USD	1,987.98	**0.05**	1.52	1.42	1.45	6.69	11.04	17.61	7.55	16.60
DOW JONES INDUS. AVG	USD	17,083.80	**-0.02**	0.63	1.53	1.28	4.41	7.59	9.82	3.06	15.11
NASDAQ COMPOSITE INDEX	USD	4,472.11	**-0.04**	2.49	1.45	2.11	9.73	8.33	24.05	7.08	19.25
RUSSELL 2000 INDEX	USD	1,156.26	**-0.16**	2.00	-3.08	-2.23	2.96	1.06	9.68	-0.63	19.24
EURO STOXX 50	EUR	3,210.58	**-0.29**	1.47	-0.55	-1.28	2.01	6.02	17.16	3.27	14.66
CAC 40 INDEX	EUR	4,383.85	**-0.61**	1.12	-0.88	-1.72	-1.35	5.34	10.81	2.05	15.28
DAX INDEX	EUR	9,759.97	**-0.35**	0.41	-0.74	-1.09	3.81	3.92	17.60	2.18	13.74
FTSE 100 INDEX	GBP	6,810.14	**-0.17**	0.90	0.98	1.14	1.86	2.20	3.37	0.90	-
SWISS MARKET INDEX	CHF	8,587.75	**-0.57**	0.90	0.39	0.07	2.55	4.71	9.18	4.69	16.78
NIKKEI 225	JPY	15,457.87	**1.13**	0.57	1.95	1.25	7.13	0.43	6.15	-5.12	17.34
HANG SENG INDEX	HKD	24,194.98	**0.22**	3.16	4.33	5.81	8.87	7.77	10.47	3.81	11.26
SHANGHAI SE COMPOSITE	CNY	2,126.61	**1.02**	3.28	3.82	4.99	4.42	3.52	5.22	0.50	8.35
S&P BSE SENSEX INDEX	INR	26,130.08	**-0.54**	1.91	2.82	3.22	15.17	23.64	31.94	23.43	16.77
RUSSIAN RTS INDEX $	USD	1,256.91	**-0.77**	-1.52	-7.99	-9.12	12.29	-7.86	-7.13	-12.88	5.07
BRAZIL IBOVESPA INDEX	BRL	57,977.56	**0.97**	4.21	9.05	8.52	12.80	21.32	18.16	12.56	12.09
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	309.63	**0.10**	1.55	-0.15	0.26	6.61	17.04	19.43	12.36	14.81
MSCI MATERIALS	USD	257.05	**-0.04**	0.86	1.91	2.37	4.85	10.41	16.92	7.11	16.98
MSCI INDUSTRIALS	USD	205.12	**-0.18**	0.10	-0.34	-0.14	2.16	5.16	15.16	1.56	16.38
MSCI CONS DISCRETIONARY	USD	182.43	**0.28**	0.29	0.16	0.80	4.45	4.22	11.89	0.37	16.83
MSCI CONS STAPLES	USD	199.42	**0.06**	-0.12	0.25	0.36	3.03	8.09	9.43	4.70	18.56
MSCI HEALTH CARE	USD	190.06	**-0.15**	0.76	0.82	0.80	6.74	10.07	20.78	10.60	17.63
MSCI FINANCIALS	USD	104.97	**0.46**	0.95	0.86	0.90	3.75	6.05	10.90	3.02	13.55
MSCI INFO TECH	USD	135.67	**0.10**	1.11	3.35	3.89	11.05	12.07	27.39	10.16	17.03
MSCI TELECOMS	USD	72.76	**-0.16**	0.12	0.53	0.99	4.21	3.85	14.47	1.07	15.78
MSCI UTILITY	USD	122.93	**0.38**	0.58	-1.95	-0.80	2.39	12.48	12.76	11.88	16.12
MSCI WORLD REAL ESTATE	USD	194.11	**-0.13**	0.33	1.63	2.11	7.14	11.94	8.03	10.93	23.69
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,245.87	**0.09**	0.21	-0.10	-0.17	1.04	1.32	3.92	1.66	
HFRX EQUAL WEIGHTED	USD	1,220.86	**0.08**	0.21	0.09	0.11	0.77	1.58	3.76	1.99	
HFRX GLOBAL EUR	EUR	1,152.86	**0.10**	0.20	-0.13	-0.20	0.99	1.18	3.64	1.51	

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			PRICE CHANGE IN % (unless indicated)							
FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.02	**0.00**	0.01	0.00	0.00	0.01	-0.03	0.01	-0.05
US 2 YEAR	USD	0.50	**0.00**	0.02	0.04	0.02	0.07	0.16	0.18	0.12
US 10 YEAR	USD	2.51	**0.01**	0.03	-0.02	-0.05	-0.15	-0.20	-0.06	-0.52
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	461.27	**-0.13**	-0.02	0.26	0.56	1.76	3.17	5.07	4.35
US GOVERNMENT TR	USD	2,032.01	**-0.20**	-0.13	-0.02	0.34	0.95	1.59	2.25	2.64
US CORPORATE TR	USD	2,547.71	**-0.25**	-0.17	0.13	0.48	1.78	4.34	6.89	5.81
US HIGH YIELD TR	USD	1,661.73	**0.04**	0.05	-0.41	-0.49	1.49	4.25	8.64	5.03
EU GOVERNMENT TR	EUR	228.23	**-0.11**	0.11	0.63	0.99	2.97	5.87	8.71	7.32
EU CORPORATE TR	USD	238.09	**-0.07**	0.03	0.31	0.46	2.15	4.02	6.77	5.09
EU HIGH YIELD TR	EUR	266.99	**0.04**	0.09	-0.14	-0.61	1.21	4.31	11.15	5.13
JACI GLOBAL	USD	261.39	**0.11**	-0.10	-1.66	-1.50	-0.71	1.33	10.12	3.17
GLOBAL EM TR (HEDGED)	USD	328.37	**0.06**	0.20	0.46	0.65	3.81	7.26	8.54	7.64
S&P/LSTA U.S. LEV LOAN	USD	98.77	**0.04**	-0.13	-0.18	-0.10	0.72	-0.06	0.44	0.54
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	4,906.60	**-0.49**	-0.45	-3.90	-5.14	-3.36	2.86	0.59	1.60
GSCI ENERGY TR	USD	1,139.75	**-0.65**	-0.39	-4.17	-5.56	-1.82	2.85	1.45	1.21
GSCI INDUSTRIAL METALS TR	USD	1,439.84	**1.19**	1.65	4.04	5.41	6.71	7.47	5.66	5.35
GSCI PRECIOUS METALS TR	USD	1,630.18	**-1.27**	-2.14	-2.41	-2.39	0.44	2.18	-1.93	7.02
GSCI AGRICULTURE TR	USD	564.87	**-0.12**	-1.91	-8.39	-11.13	-20.07	-5.25	-14.08	-6.88
GENERIC 1ST 'CL' FUTURE	USD	101.98	**-0.09**	0.87	-1.32	-2.38	4.03	9.67	-1.31	7.63
GOLD SPOT $/OZ	USD	1,293.10	**-0.05**	-1.37	-2.58	-1.98	-0.78	1.81	-3.06	7.25
CURRENCIES										
DOLLAR INDEX SPOT	USD	80.87	**-0.01**	0.42	1.37	0.80	1.40	0.51	-1.35	1.04
Euro Spot	EUR	1.35	**-0.01**	-0.46	-1.68	-1.23	-2.69	-1.54	1.39	-2.04
Japanese Yen Spot	JPY	101.83	**-0.01**	-0.48	-0.49	0.04	0.32	0.71	-2.49	3.42
British Pound Spot	GBP	1.70	**-0.05**	-0.64	-0.75	-0.03	1.04	2.37	10.32	2.54
Brazilian Real Spot	BRL	2.22	**-0.10**	1.64	-0.33	0.15	-0.35	7.91	1.30	6.32
China Renminbi Spot	CNY	6.19	**0.03**	0.25	0.17	0.68	0.97	-2.35	-0.93	-2.23
Singapore Dollar Spot	SGD	1.24	**-0.01**	0.01	0.43	0.68	1.24	2.85	1.85	1.75
Norwegian Krone Spot	NOK	6.21	**-0.09**	-0.31	-1.21	-1.24	-3.02	-0.96	-4.90	-2.21
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	11.84	**2.78**	-18.57	2.33	2.16	-15.79	-34.73	-8.71	-13.70
USD SWAP SPREAD SEMI 2YR		20.13	**0.65**	5.95	59.38	58.63	80.86	29.37	29.87	91.71
TED SPREAD		0.00	**0.47**	-3.89	2.09	0.70	-0.79	13.20	-11.97	-85.34

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