Friday, August 15th 2014

We start the close of this week with an optimistic outlook for the world in general and for equities in particular- The Earnings of the S&P 500 are at all-time highs, justifying an all-time high for the Index (we are a little below). Then with the 10 year Note yielding 2.39% implying an effective P/E ratio of 41X for said bond), it makes the equities seem really cheap! We are not alone here- Byron Wien still sees a 20% return in the S&P 500 for 2014, but the Blackstone Advisory vice chairman admits there are things that keep him up at night. Looking at the current market action, Wien thinks the correction can still go further because "sentiment is too positive." However, he thinks shares will end higher by year-end, *with the S&P likely hitting 2,300*! Well, towards the end of 2013 we wrote in your Newsletter "Here is the derived algebra for the S&P 500- Assuming the EPS of the index closes 2013 with an earnings' figure of $121, applying Nomura's 6% forecast (of EPS growth in 2014) we compute a $128.26 earnings' expectation for 2014. With a conservative P/E ratio of 15X we see the index reaching 1'924 whilst an increase in the multiple (which would be warranted with such growth rate) to 17X we find 2'180 as a fair expectation of the S&P index for next year". The S&P 500 closed yesterday at 1'955 and shows a trailing P/E ratio of 17.54! We prefer being approximately right to being precisely wrong… Recent downdrafts in equity prices were clearly driven by geopolitical knee-jerks. Stay the course! If you share our view that the World will continue to spin and pursue its voyage through infinity (for the foreseeable future), where would you invest your children's Trust-fund capital?
August is historically a not-so-good month for stocks with typically light volumes, but September is the worst month of the year for equities performance- The typical seasonal pattern is a top in July and August and then a selloff in September and a bottom in October. Everyone knows this, so why the drift higher? The way we're thinking about it, you basically have earnings on the bull side, geopolitics on the bear side and the Fed basically is the tie breaker. It explains the action perfectly. The Fed tilted ever so slightly to the hawkish side in the statement at the end of July, and the next day, the market started selling off. It couldn't just ignore Argentina, Russia, Iraq and Israel anymore.
Reinforcing our thinking, the U.S. budget deficit was $95 billion at the end of July, down 3% from the same period last year, according to data released by the Treasury Department on Tuesday. The fiscal year-to-date deficit at the end of July was $460 billion, the lowest level since the same period in fiscal year 2008, compared with a deficit of $607 billion for the same period in fiscal year 2013. The economy must be running better!
On Wednesday, Iran endorsed premier-designate Haidar al-Abadi to lead neighbouring Iraq, leaving current Prime Minister Nouri al-Maliki without his strongest international backer as he continued to defy calls to step down. *The move puts Shiite Iran in league with the U.S*. - its frequent nemesis - the European Union and the Arab League in pressing Maliki to step down to break a three-month political stalemate that has hampered efforts to combat the Sunni insurgents of the Islamic State. Maliki resigned on Thursday. Perhaps it is a step on the long route towards normalization between Iran and the US? Maybe an offset to the heating-up "cold-war" with Russia?
Stocks were on track after Thursday's gains for the best weekly performance since July 3rd. The bond market, meanwhile, showed yields at the bottom of the recent range after a $16 billion 30-year bond auction drew strong demand at low yields last seen at auction more than a year ago. We think that the market is saying awful news is OK because it gives us our juice (from the Fed) for longer. We note that revenue growth outside of financial companies is the best since 2012 at 4.6%, and earnings growth of 8.9%, without financial companies, is the best since 2011. Another factor that has been a double-edged sword for stocks is the dramatic decline in oil. While positive for airlines and other consumers of fuel, the energy stocks are under pressure and are down 2.2% in the last month, with some analysts reading this as an indicator for a slowing economy!? Well, maybe, given that in Europe, the French government abandoned its 2014 deficit targets after the economy unexpectedly failed to grow for a second straight quarter with gross domestic product stagnated in the three months through June, German GDP, shrank 0.1% and Italy is in recession, having recorded now two consecutive quarters of GDP declines. We recall with a smile George W Bush's explanation as to why the French are so bad in business- "it is because the French language doesn't even have a word for entrepreneur!".
But nothing can be perfect… Is a new problem brewing? Tens of thousands of Pakistanis joined opposition leader Imran Khan as he travelled from Lahore to the capital to oust Prime Minister Nawaz Sharif over fraud allegations in an election 15 months ago. And on Wednesday, Russia started military exercises in the remote far east of the country, prompting protests from neighbouring Japan at a time when its troops are also active in Eastern Europe and on the Ukrainian border.
We close the week with Yogi Berra's quip "The future ain't what it used to be.".

Market outlook

Core View: Our base-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 with stability that creates a positive bias that is expected to continue. We maintain this thought in the face of the disappointing data from Italy which has slipped into recession, France with zero growth in both Q1 and Q2 and the surprizing German negative GDP for Q2.
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 return of inflation appears to be in the distance and as such, short term interest rates are unlikely to rise anytime soon. This in itself lightens the risk of significant changes to the yield-curves- whilst this suggests that there is little "duration-risk" in the fixed-income sector, *there is little upside to holding bonds. Total-returns from fixed-income will not replicate the stellar returns of the past decade and are likely to remain in the very low single digit.*

1. **Geopolitics in connection with the Islamic radicalisation in Iraq and Syria accentuated by the risk of spill-over into Saudi Arabia, the Israel-Hamas war, Libya in-fighting, Nigeria and the ongoing quarrels in the Sea of China.**
2. **Russia-Ukraine conflict- With the collateral damage of economic sanctions from the EU and US against Russia, the risk of escalation is quite severe with Russia having riposted with its own sanctions against the West.**
3. **Economic slowdown in Europe as noted above combined dangerously low inflation.**
4. **The health scare of Ebola spreading beyond West Africa- with risks of quarantines, reduced air-travel and eventual repercussions on economies.**

These Geopolitical risks are hardly predictable as to how they may manifest themselves in our markets.

- **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 - 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. We find that the reward for assuming credit-risk has become too small and we observe exits from the "High Yield" sub-sector.

- **Equities-** The previous week scared us with declines induced by the geopolitical events into this August markets. As we see P/E ratios around the globe at historically reasonable levels and rising (!) - with Q2 earnings showing better than expected growth rates on both top lines and bottom lines, we feel secure in owning equities. We remain positive and recommend exposures to be maintained using global diversified funds, or allocating some fixed income holdings into 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 their role in a portfolio is to attenuate volatility and risks and not as an 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 through $1.34 against the EUR and at 0.91 against the Swiss Franc. We maintain our belief in the fundamental strength of the US$ and would not bet against it at this time. The Japanese Yen has traded steadily around 102.50 vs. the US$. Gold has been trading around the $1310 level, appearing to have found a fair value around here. We do note that Oil trading has been anaemic whilst risks to its supply are rising (WTI down to $97.50 or so).

This Week's Highlights:

- In the FX markets, with escalating political issues around the globe, the USD sees its Flight-to Quality status back in vogue and it has continued to appreciate. EUR is firmly below 1.34 at 1.3360; the Pound dropped like a stone from 1.6850 to almost touch 1.6650 after the Governor of the Bank of England reported that the economic slack had fallen and was focusing on weak wages. The JPY has finally awoken from its slumber, moving to 102.66 yesterday. For now the USD is softly higher against most of its trading counterparts, with the USD index (DXY) at 81.60. In spite of the increased political and economic tensions globally Gold has remained relatively stable at about 1310.
- Government bonds have had another strong week. The US 10Y yields remained below 2.50% for the week touching as low as 2.39% yesterday. The UK Gilt is trading at 2.42%, having moved to as low as 2.39% after the BOE statement on Wednesday. The Bund yields are trading at their lowest level <u>ever</u> and for the first time breached the 1% mark to touch 0.998%!! The yields on the French OAT 10 year bonds have continued their downward move with yet another new low at 1.38% - remarkable considering the dire state of their economy. Italy's 10 year is yielding 2.62% and Spain's 10 year is yielding 2.45%.
- Global equities had a positive week, rebounding from the slight hiccup around the media frenzy of world events. The S&P500 moved higher by 1.22%, with the Nasdaq up 1.88%. EM equities were mixed with the Bovespa having a bumpy ride and looking to be flat for the week. With the news coming on Wednesday that the Presidential Candidate Campos died in a plane crash, the markets reacted negatively and wiped out the gains that had been made. Europe seems to have fared better this week versus the US despite poor GDP data from France and Germany… AND Italy!

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

14/08/2014

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	1,715.71	**0.41**	1.49	0.08	-1.48	1.98	3.97	13.76	3.29	15.68
MSCI WORLD LOCAL	-	1,225.96	**0.40**	1.86	0.12	-1.12	1.82	4.35	12.06	3.50	-
MSCI AC WORLD	USD	423.63	**0.38**	1.61	0.14	-1.25	2.23	4.81	13.55	3.69	15.12
MSCI EM	USD	1,072.37	**0.14**	2.57	0.62	0.56	4.20	12.02	11.65	6.95	11.77
S&P 500 INDEX	USD	1,955.18	**0.43**	2.39	1.27	-0.92	4.51	6.34	17.69	5.78	16.32
DOW JONES INDUS. AVG	USD	16,713.58	**0.37**	2.11	0.91	-2.03	1.62	3.46	10.60	0.83	14.77
NASDAQ COMPOSITE INDEX	USD	4,453.00	**0.43**	2.72	1.90	0.83	9.43	4.92	23.48	6.62	19.00
RUSSELL 2000 INDEX	USD	1,143.34	**0.14**	2.11	2.08	-0.91	4.32	-0.51	11.26	-1.74	18.95
EURO STOXX 50	EUR	3,065.92	**0.25**	1.97	-1.59	-2.78	-3.08	-1.70	8.11	-1.39	14.16
CAC 40 INDEX	EUR	4,213.29	**0.19**	1.58	-0.77	-2.14	-5.21	-2.92	2.93	-1.92	15.09
DAX INDEX	EUR	9,249.70	**0.27**	2.67	-1.68	-4.83	-4.21	-4.27	10.43	-3.17	13.14
FTSE 100 INDEX	GBP	6,717.46	**0.48**	2.29	-0.19	0.10	-1.80	0.81	3.61	-0.47	-
SWISS MARKET INDEX	CHF	8,462.40	**0.38**	2.27	0.62	-1.31	-2.11	0.53	6.01	3.16	16.64
NIKKEI 225	JPY	15,318.34	**0.02**	3.65	-1.94	-0.50	7.13	7.02	11.38	-5.97	17.11
HANG SENG INDEX	HKD	24,983.62	**0.73**	2.68	0.92	6.49	9.91	12.04	10.84	7.20	11.56
SHANGHAI SE COMPOSITE	CNY	2,226.73	**0.92**	1.47	1.14	7.55	9.96	5.24	6.96	5.23	8.71
S&P BSE SENSEX INDEX	INR	26,103.23	**0.71**	2.01	0.80	3.47	9.19	28.17	34.78	23.30	16.72
RUSSIAN RTS INDEX $	USD	1,235.15	**0.26**	5.51	1.29	-8.65	-1.42	-8.04	-6.96	-14.39	5.08
BRAZIL IBOVESPA INDEX	BRL	55,780.41	**0.36**	-0.73	-0.09	-0.35	3.57	15.72	9.57	8.30	11.70
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	293.14	**-0.27**	-0.52	-1.48	-3.57	-0.13	9.45	15.80	6.37	14.22
MSCI MATERIALS	USD	250.02	**-0.09**	1.16	-0.31	-1.34	0.93	2.51	10.59	4.18	16.51
MSCI INDUSTRIALS	USD	200.15	**0.46**	1.92	0.61	-2.38	-0.73	1.36	12.44	-0.90	16.05
MSCI CONS DISCRETIONARY	USD	179.11	**0.63**	1.60	0.65	-1.53	3.10	0.51	10.88	-1.46	16.63
MSCI CONS STAPLES	USD	195.35	**0.56**	1.53	1.56	-2.03	-0.49	5.45	8.23	2.56	18.31
MSCI HEALTH CARE	USD	187.89	**0.99**	2.02	0.45	-0.47	3.79	4.38	21.01	9.33	17.32
MSCI FINANCIALS	USD	102.85	**0.40**	1.84	-0.42	-1.17	1.64	2.36	9.77	0.94	13.40
MSCI INFO TECH	USD	133.87	**0.22**	1.71	0.72	0.68	8.66	7.99	24.67	8.70	16.75
MSCI TELECOMS	USD	70.44	**0.28**	1.19	-2.73	-3.03	-2.67	2.13	11.51	-2.15	15.44
MSCI UTILITY	USD	118.89	**0.72**	1.46	-0.26	-2.51	-0.23	4.37	10.87	8.20	15.65
MSCI WORLD REAL ESTATE	USD	193.63	**0.12**	2.13	0.40	0.71	3.10	9.90	12.65	10.66	23.49
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,233.47	**0.16**	0.41	-0.22	-0.58	0.23	0.34	3.07	0.65	
HFRX EQUAL WEIGHTED	USD	1,211.59	**0.11**	0.31	-0.15	-0.39	0.30	0.64	3.09	1.21	
HFRX GLOBAL EUR	EUR	1,140.87	**0.16**	0.41	-0.25	-0.62	0.14	0.18	2.77	0.45	

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14/08/2014

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			PRICE CHANGE IN % (unless indicated)							
FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.03	**0.01**	0.01	0.01	0.02	0.01	0.02	-0.02	-0.04
US 2 YEAR	USD	0.42	**0.00**	-0.03	-0.11	-0.06	0.06	0.10	0.07	0.04
US 10 YEAR	USD	2.39	**-0.01**	-0.03	-0.17	-0.15	-0.10	-0.35	-0.37	-0.64
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	464.01	**0.14**	0.30	0.64	0.81	1.52	3.45	5.90	4.97
US GOVERNMENT TR	USD	2,045.33	**0.14**	0.19	0.80	0.77	0.85	2.08	3.23	3.32
US CORPORATE TR	USD	2,562.70	**0.23**	0.25	0.77	0.85	1.29	4.35	8.35	6.44
US HIGH YIELD TR	USD	1,661.35	**0.21**	0.95	0.91	-0.37	0.73	3.45	9.46	5.00
EU GOVERNMENT TR	EUR	230.41	**0.23**	0.61	0.73	1.49	2.85	6.08	9.72	8.34
EU CORPORATE TR	USD	239.58	**0.07**	0.25	0.44	0.79	1.63	4.17	7.21	5.75
EU HIGH YIELD TR	EUR	265.44	**0.17**	0.39	-0.45	-0.41	-0.20	2.92	9.48	4.52
JACI GLOBAL	USD	257.41	**0.10**	-0.03	-0.74	-1.69	-2.18	-0.78	7.49	1.60
GLOBAL EM TR (HEDGED)	USD	326.57	**0.24**	0.58	0.01	-0.43	1.75	6.32	8.87	7.05
S&P/LSTA U.S. LEV LOAN	USD	97.87	**-0.02**	-0.21	-0.53	-1.10	-0.84	-0.59	-0.10	-0.38
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	4,690.52	**-1.75**	-2.60	-2.99	-4.61	-6.98	-4.10	-4.53	-2.88
GSCI ENERGY TR	USD	1,083.47	**-2.41**	-2.80	-3.33	-5.13	-5.85	-4.54	-4.43	-3.79
GSCI INDUSTRIAL METALS TR	USD	1,388.33	**-0.87**	-2.19	-2.30	-1.77	2.05	4.34	-1.21	1.58
GSCI PRECIOUS METALS TR	USD	1,650.59	**0.12**	0.16	1.94	-0.09	0.61	-1.27	-2.58	8.36
GSCI AGRICULTURE TR	USD	559.35	**0.62**	-1.58	-0.60	-2.61	-19.92	-10.62	-13.08	-7.79
GENERIC 1ST 'CL' FUTURE	USD	95.47	**-0.12**	-2.23	-2.75	-2.51	-3.50	-1.22	-9.22	0.76
GOLD SPOT $/OZ	USD	1,313.12	**-0.03**	0.17	2.38	1.47	1.31	-0.42	-3.89	8.91
CURRENCIES										
DOLLAR INDEX SPOT	USD	81.57	**-0.03**	0.22	0.14	1.46	1.95	1.79	0.48	1.91
Euro Spot	EUR	1.34	**0.06**	-0.28	-0.13	-1.44	-2.46	-2.44	0.19	-2.69
Japanese Yen Spot	JPY	102.53	**-0.08**	-0.48	0.26	-0.83	-0.93	-0.59	-5.03	2.71
British Pound Spot	GBP	1.67	**-0.02**	-0.54	-1.21	-2.69	-0.64	-0.19	6.64	0.76
Brazilian Real Spot	BRL	2.27	**0.66**	1.26	-0.13	-2.40	-2.84	5.40	2.57	4.21
China Renminbi Spot	CNY	6.15	**0.05**	0.11	0.39	0.94	1.30	-1.40	-0.60	-1.55
Singapore Dollar Spot	SGD	1.24	**0.17**	0.63	0.27	-0.05	0.65	1.19	1.97	1.50
Norwegian Krone Spot	NOK	6.16	**0.01**	1.26	2.06	0.82	-3.38	-1.32	-4.06	-1.42
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	12.42	**-3.72**	-25.45	-26.73	3.85	-5.69	-8.47	-15.68	-9.48
USD SWAP SPREAD SEMI 2YR		22.38	**-1.10**	-2.44	12.24	24.33	57.05	72.15	26.08	113.14
TED SPREAD		0.00	**2.51**	-2.11	-4.80	-4.41	-2.39	-7.73	-4.27	-85.79

All data is compiled from Bloomberg

Disclaimer