Friday, August 22nd 2014

It is Friday yet again! Well, what can we say? The long awaited, inevitable, scary and heavily debated "market correction" that finally struck our markets and wiped-out the year's gains, went away with a whimper… Yesterday the S&P 500 added 0.3% to reach a new high, for a fourth day of gains - its longest streak since June. The S&P 500 has rebounded more than 4% from a three-month low on Aug. 7 as investors speculated central banks will keep interest rates low even as the economies show signs of recovery. Ten-year Treasury yields retreated for the first time in four days as Gold dropped to a two-month low, whilst the dollar erased (some) gains and oil climbed (a little). The market seems to be in a sweet-spot for equities! The expectation for later today is that Yellen in Jackson's Hole is not going to say anything that's going to be dramatically different from what she has said before.

All told, if you're selling stocks because of the Fed, or because you think earnings weren't strong enough to keep stocks buoyant, Jim Cramer says "think again"- There are legitimate reasons to sell, such as events in Russia, but declines triggered by the Fed or earnings aren't among them. In fact, the related weaknesses have turned out to be opportunities to buy, with other catalysts in the market generating points of strong resistance. "That's been the pattern for all of 2014. And I am beginning to believe it will be the pattern from now until this year's conclusion," said Jim Cramer on CNBC.
Some data to support our optimism in spite of the atrocities of ISIS and the renewed hostilities around Gaza; U.S. housing starts and building permits rebounded strongly in July, suggesting the housing market recovery was back on track after stalling recently. Hidden in the government's report we found a reason to believe the housing market will likely continue to strengthen- both US Home ownership rate and the rental vacancy rate hit 19-year lows in the second quarter!
Then, U.S. consumer prices barely rose in July as declining energy costs partially offset increases in food and rents, which could give the Federal Reserve ammunition to keep interest rates low for a while to come. The Labour Department said on Tuesday its Consumer Price Index edged up 0.1% last month, after increasing 0.3% in June. In the 12 months through July, the CPI increased 2.0% after advancing 2.1% in June (exactly on the Fed's target!).
Unlike the European economic scene where manufacturing activity slowed as rising political tensions threaten to weaken trade and dampen the outlook for the global economy. A preliminary Purchasing Managers Index for the manufacturing industry in the Euro area fell to 50.8 from 51.8 in July, as per London-based Markit Economics. That's the lowest level in 13 months and less than the 51.3 median estimate in a Bloomberg News survey. In China, a similar gauge from HSBC and Markit dropped to 50.3 from 51.7, trailing all forecasts in a separate survey. (Readings above 50 indicate expansion).
But then, Moeller-Maersk A/S raised its full-year profit forecast after the company's container-shipping line, the world's largest, said earnings are rising because of higher freight volumes and lower costs. Can we read further improvement in the economy through shipping? Our natural optimism wants to believe this…

The price action on Crude Oil in recent weeks is leading us to believe that there is a danger of a bigger move lower than we originally expected– If correct this could turn out to be a strong "fiscal stimulus"/ "shot in the arm" for the US economy, just as it is gaining some self-sustaining traction. Clearly a lower price for energy is a form of stimulus for industrialized economies, but it could spell trouble for Russia and the Rouble! Oil being about 32% of the Russian exports, falling prices will most certainly hurt the local economy and damage its currency! Putin is planning to let the Rouble float freely towards year-end… Perhaps he has another issue to re-think besides Ukraine?

The latest bull-run in bonds has defied expectations of those traders and investors who had bet on U.S. interest rates rising this year as the U.S. jobs picture improved and the Federal Reserve paved the way to tighten policy in 2015. Bond yields could decline further.
Bond analysts and managers interviewed by Reuters on Friday said the 10-year yield could fall another 10-15 basis points. They didn't rule out it reaching the 2% level in the current rally. Still, they warned that if global political tensions ease, the safe-haven demand for U.S. bonds will subside. Then, the 10-year yield could snap back to 2.60-2.70%! Do note that Italy's 10 year rates are at 2.57%, France's at 1.37% and Spain at the same level as the US at 2.38%! Unbelievable but true!

Let's keep our face to the sunshine and all shadows disappear, let's just enjoy what is left of our summer ☺

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 remains 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 these risks may manifest 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 markets' low volatility relative to the past 5 years may be changing as we write. The USD is gaining versus almost all its major trading counterparts, now trading through $1.33 against the EUR (a full point since last week) and at 0.91 against the Swiss Franc. We maintain our belief in the fundamental strength of the US$ and would not bet against it at this time. The Japanese Yen has traded down as well through 103.20 vs. the US$. Gold has been trading down and is at around $1280, we do note that Oil trading has been anaemic whilst risks to its supply are rising (WTI down to $93.00 or so).

This Week's Highlights:

- In the FX markets, what else is there to say this week other than… King Dollar. EUR is firmly below 1.33 at 1.3290; the Pound continued to drop to 1.6590, the CHF dropped to 0.9110. The JPY has continued to slip rather dramatically to 103.75 at the moment, nearly touching 104.00 yesterday. For now the USD is higher against most of its trading counterparts, with the USD index (DXY) at 82.10. In spite of the increased political and economic tensions globally, Gold and oil were not able to escape the USD strength, seeing Gold tumble to 1273.00 yesterday and oil dropping off a cliff from 96.50 on Wednesday to be at 92.50 by mid-morning Thursday!
- Government bonds have had another strong week. The US 10Y yields remained well below 2.50% for the week touching as low as 2.34% and trading at 2.39% as we write. The UK Gilt is trading at 2.36%, having moved to as low as 2.32% after the BOE statement on Wednesday. The Bund yields are trading at their lowest level ever and after breaching 1% have continued to strengthen to 0.95%!! The yields on the French OAT 10 year bonds are now trading at 1.37% having touched 1.33% - we truly are speechless! Italy's 10 year is yielding 2.57% and Spain's 10 year is yielding 2.38%!!! (Just to put this in context… that is the SAME as the United States of America!)
- Global equities had a positive week, gently melting upwards as the media have been relatively silent this week – perhaps they are on holiday (what a blessing!). The US markets all moved in lockstep and gently moved up about 2% for the week. Europe followed suit and moved about 1.75% higher. EM equities were mostly positive with the Bovespa sailing up 5.75%! It looks like the poor European GDP figures have been consigned to history and that the world is rosy again… perhaps the tinted sunglasses help.

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

21/08/2014

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	1,741.88	0.35	1.61	1.61	-0.51	2.93	4.94	16.30	4.86	15.91
MSCI WORLD LOCAL	-	1,248.39	0.41	1.83	1.95	0.94	4.12	5.52	17.15	5.39	-
MSCI AC WORLD	USD	429.79	0.28	1.51	1.60	-0.38	3.04	5.76	16.42	5.20	15.34
MSCI EM	USD	1,081.93	-0.29	0.69	1.52	0.69	3.91	12.79	17.31	7.90	11.89
S&P 500 INDEX	USD	1,992.37	0.29	1.90	3.20	0.45	5.28	8.50	20.24	7.79	16.69
DOW JONES INDUS. AVG	USD	17,039.49	0.36	1.95	2.87	-0.43	3.00	5.81	13.87	2.79	15.06
NASDAQ COMPOSITE INDEX	USD	4,532.10	0.12	1.78	3.71	1.71	9.09	6.30	24.55	8.51	19.35
RUSSELL 2000 INDEX	USD	1,160.03	0.22	1.46	3.57	0.34	4.14	-0.40	11.95	-0.31	19.28
EURO STOXX 50	EUR	3,126.22	0.05	3.06	0.34	-1.98	-1.93	-0.17	11.16	0.55	14.18
CAC 40 INDEX	EUR	4,290.56	-0.06	2.78	1.05	-1.81	-4.19	-2.07	5.70	-0.13	14.80
DAX INDEX	EUR	9,408.57	0.07	3.48	0.01	-3.35	-3.21	-2.57	12.03	-1.50	13.32
FTSE 100 INDEX	GBP	6,782.21	0.07	1.39	0.77	-0.19	-0.56	-0.82	5.20	0.49	-
SWISS MARKET INDEX	CHF	8,572.91	0.03	2.46	1.93	-0.25	-1.39	1.67	7.31	4.51	16.78
NIKKEI 225	JPY	15,539.19	-0.30	1.44	-0.52	1.28	8.38	4.53	16.27	-4.62	17.33
HANG SENG INDEX	HKD	25,101.80	0.43	0.59	1.39	5.55	9.36	11.23	14.64	7.70	11.58
SHANGHAI SE COMPOSITE	CNY	2,240.81	0.46	0.63	1.78	7.97	10.86	6.01	8.40	5.90	8.74
S&P BSE SENSEX INDEX	INR	26,426.86	0.25	1.24	2.05	1.54	8.42	27.66	44.31	24.83	16.88
RUSSIAN RTS INDEX $	USD	1,269.90	-0.45	3.05	4.14	0.24	-3.28	-3.47	-4.45	-11.98	5.24
BRAZIL IBOVESPA INDEX	BRL	58,992.11	0.19	5.76	5.66	1.74	11.71	24.51	14.78	14.53	12.45
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	298.35	0.11	1.40	0.27	-3.01	1.18	10.23	18.68	8.26	14.51
MSCI MATERIALS	USD	251.16	-0.23	0.52	0.14	-1.87	1.73	2.03	12.52	4.65	16.60
MSCI INDUSTRIALS	USD	203.80	0.25	2.05	2.44	-0.98	1.16	2.92	14.93	0.91	16.37
MSCI CONS DISCRETIONARY	USD	181.54	0.11	1.59	2.01	-0.20	3.08	1.58	12.74	-0.12	16.84
MSCI CONS STAPLES	USD	197.08	0.10	0.78	2.46	-1.09	-0.05	5.85	10.61	3.47	18.56
MSCI HEALTH CARE	USD	191.26	0.31	1.97	2.26	0.89	4.69	4.90	22.95	11.29	17.65
MSCI FINANCIALS	USD	104.43	0.86	1.85	1.11	0.24	2.81	3.76	12.73	2.49	13.52
MSCI INFO TECH	USD	136.75	0.50	2.11	2.89	1.06	9.16	10.27	27.29	11.03	17.12
MSCI TELECOMS	USD	70.91	0.48	0.82	-2.09	-2.76	-1.38	0.51	14.28	-1.50	15.59
MSCI UTILITY	USD	120.77	0.32	1.34	1.32	-1.56	1.07	4.43	14.52	9.91	15.93
MSCI WORLD REAL ESTATE	USD	196.69	0.20	1.41	1.99	1.50	5.55	10.57	16.76	12.41	23.92
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,242.86	0.01	0.76	0.54	0.02	1.69	0.81	4.39	1.42	
HFRX EQUAL WEIGHTED	USD	1,216.96	-0.01	0.44	0.29	-0.08	1.23	0.81	3.98	1.66	
HFRX GLOBAL EUR	EUR	1,149.55	0.00	0.76	0.51	-0.05	1.61	0.66	4.07	1.22	

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.01	0.00	-0.02	-0.01	-0.01	-0.02	-0.03	-0.01	-0.06
US 2 YEAR	USD	0.47	0.00	0.06	-0.06	0.00	0.12	0.15	0.08	0.09
US 10 YEAR	USD	2.40	-0.01	0.06	-0.16	-0.06	-0.15	-0.33	-0.48	-0.63
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	464.36	0.04	0.08	0.71	0.60	1.69	3.45	6.54	5.05
US GOVERNMENT TR	USD	2,043.11	0.08	-0.11	0.69	0.44	0.69	1.93	3.68	3.20
US CORPORATE TR	USD	2,563.72	0.20	0.04	0.81	0.49	1.46	4.23	9.60	6.48
US HIGH YIELD TR	USD	1,669.49	0.04	0.49	1.41	0.72	1.19	3.41	10.72	5.52
EU GOVERNMENT TR	EUR	231.22	0.03	0.35	1.08	1.25	3.76	6.26	10.74	8.72
EU CORPORATE TR	USD	240.18	0.00	0.25	0.69	0.87	2.11	4.24	7.87	6.01
EU HIGH YIELD TR	EUR	267.06	0.09	0.61	0.16	0.18	0.87	3.14	10.59	5.15
JACI GLOBAL	USD	258.72	0.09	0.51	-0.24	-0.88	-1.05	-1.00	7.88	2.12
GLOBAL EM TR (HEDGED)	USD	327.95	0.01	0.42	0.43	0.20	2.05	6.43	11.05	7.50
S&P/LSTA U.S. LEV LOAN	USD	98.03	0.10	0.16	-0.37	-0.74	-0.63	-0.39	0.36	-0.21
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	4,699.67	0.40	0.20	-2.80	-4.58	-7.24	-5.52	-4.14	-2.69
GSCI ENERGY TR	USD	1,086.46	0.52	0.28	-3.06	-5.19	-6.85	-5.83	-3.70	-3.52
GSCI INDUSTRIAL METALS TR	USD	1,426.91	-0.31	2.78	0.42	0.53	6.81	6.65	2.27	4.40
GSCI PRECIOUS METALS TR	USD	1,601.30	-1.40	-2.99	-1.11	-3.61	-0.94	-4.74	-8.32	5.12
GSCI AGRICULTURE TR	USD	558.18	0.57	-0.21	-0.81	-1.32	-17.98	-13.36	-14.29	-7.98
GENERIC 1ST 'CL' FUTURE	USD	93.62	-0.36	-1.17	-2.02	-6.16	-5.11	-2.58	-6.48	1.62
GOLD SPOT $/OZ	USD	1,279.61	0.22	-1.93	-0.23	-2.05	-1.11	-3.37	-7.02	6.13
CURRENCIES										
DOLLAR INDEX SPOT	USD	82.15	0.00	0.89	0.85	1.69	2.36	2.38	0.81	2.64
Euro Spot	EUR	1.33	0.02	-0.87	-0.79	-1.35	-2.72	-3.28	-0.54	-3.34
Japanese Yen Spot	JPY	103.76	0.09	-1.35	-0.93	-2.22	-1.95	-1.20	-4.86	1.49
British Pound Spot	GBP	1.66	0.05	-0.63	-1.76	-2.80	-1.67	-0.41	6.42	0.19
Brazilian Real Spot	BRL	2.27	-0.30	-0.09	-0.22	-2.10	-2.70	3.39	8.18	4.12
China Renminbi Spot	CNY	6.15	-0.03	-0.11	0.32	0.81	1.32	-0.92	-0.53	-1.62
Singapore Dollar Spot	SGD	1.25	0.13	-0.20	-0.02	-0.63	0.28	1.19	2.80	1.20
Norwegian Krone Spot	NOK	6.14	0.09	-0.09	2.35	0.81	-3.13	-1.72	-0.55	-1.14
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	11.76	-0.17	-5.31	-30.62	-3.92	-2.24	-19.89	-20.33	-14.29
USD SWAP SPREAD SEMI 2YR		22.38	1.13	0.86	12.24	10.52	42.10	65.04	16.99	113.14
TED SPREAD		0.00	4.75	9.23	2.74	5.89	12.99	12.77	-2.98	-84.66

All data is compiled from Bloomberg

Disclaimer