Friday, September 5th 2014

Super-Mario strikes again! The European Central Bank spoke yesterday. Mario Draghi reduced all three of its main interest rates by 10 basis points. The benchmark rate is now 0.05% and the deposit rate is now minus 0.2%. And then he announced that the ECB would purchase asset-backed securities (ABS) and covered bonds to boost the economy and boost inflation. Under such a program, euro zone banks would sell the ECB their loans and other types of credit that have been packaged. The aim being to strengthen the euro-zone's financial system and increase lending in the real economy, by boosting and liquefying banks' balance sheets. His budget is set at €700Bn (a trillion US$! or so)… That is a huge number in itself, but to have some perspective - The ECB's balance sheet is currently €2Tn and this would raise its size to €2.7Tn – back to where it had been in early 2012, whilst the Fed's balance sheet is now at US$ 4.5Tn when the US and the Euro zone economies are similar in size! Euro denominated bonds rallied hugely, stock markets in Europe rose as did American ones initially at least (only to fall back into small losses by the close). The BIG moves were in the FX markets where the Euro tumbled severely, as much as 2% against the Greenback! That is what Draghi wanted - Effectively "importing" inflation via the weakness of the currency. Elegant!

Last week Goldman Sachs reduced its forecasts for the Euro, saying the recent slump against the Dollar is the beginning of a long-term trend that will result in parity by the end of 2017 and expect a level of 1.20 in a year's time. However, this is the third time they have lowered their forecasts… running behind a little maybe?

The next potentially big market-moving data is expected today, with the release of the US August employment report. It is expected to be strong and fuel the next Fed decisions. Were there any doubts as to what drives markets?

An interesting titbit of information here – Beyond the unemployment rate, the number of persons employed in the US is now at the same level as it had been just prior to "The Great Recession" and since that time, about 16 million new job seekers joined the economy.

More ancillary data around the big event - German industrial output grew more than forecast in July, signalling that Europe's largest economy is headed for a third-quarter rebound. Production, adjusted for seasonal swings, rose 1.9% from June, when it expanded a revised 0.4%. Then, the trade deficit in the U.S. unexpectedly narrowed in July to the lowest level in six months as exports climbed to a record. The gap shrank 0.6% to $40.5 billion, the smallest since January, another impetus for a stronger US$ and then a strange piece of advice came out of China - their state-run media are trying to do something the securities industry has failed to accomplish for much of the past three years: get the world's biggest population to buy more stocks. The official Xinhua News Agency published at least eight articles this week advocating equity investing after similar stories appeared in the People's Daily newspaper and on state-run television last month, clearly, an increased government push to bolster the market. Authorities have also cut trading fees, and made it cheaper to open new accounts and then, organized investor presentations by the biggest listed banks in the past two weeks. Imagine the effects of a billion new equity buyers… This came on the back of information that China's service industries strengthened in August, contrasting with declining manufacturing gauges and suggesting a transition away from factory-led growth. As China moves from intensive manufacturing towards services, the USA is adding to its industrial activities- Manufacturing expanded in August at the fastest pace in three years as orders grew by the most in a decade, showing U.S. factories will help power the economy into the third quarter - the Institute for Supply Management's [ISM] index unexpectedly climbed to 59, the highest level since March 2011… Is this the beginnings of economic normalization?

With all this going on, we can better understand Morgan Stanley's Adam Parker when he said on Tuesday "Forget S&P500 at 2'000 - There's a slow and steady path for the stock index to hit 3,000 in 2020"

And then, Ukraine is talking with Russia with a view to a permanent cease-fire whilst the Europeans are adding sanctions and NATO is reassuring its eastern members with words of support. The Israeli-Hamas conflict appears to have settled back into a quiet truce, leaving Syria and Iraq to deal with ISIS under US airplanes.

With all the above, we can't help being optimistic into September- In support of our optimism- We quote the late Joan Rivers "I succeeded by saying what everyone else is thinking"… Perhaps the Euro is interesting at this level?

Market outlook

Core View: We hold our long-standing base-view 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 "bullish" view although European economies remain weak. We expect the ECB to add fuel to these economies and act as a back-stop against declines, just as the Fed has done over the past several years.
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 (now calmed to a stand-still), in-fighting in Libya, and the ongoing quarrels in the Sea of China.**
2. **Russia-Ukraine conflict - the risk of escalation remains severe inspite of announced (and non-respected) cease-fire and talks towards a definitive settlement.**
3. **Economic slowdown in Europe as noted above combined with 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 risks engender hardly predictable outcomes and effects 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 have been observing ongoing exits from the "High Yield" sub-sector.

- **Equities -** We feel secure in owning equities. We remain positive and recommend exposures to be maintained or even increased- we say this even with indices at or near all-time highs! We suggest using global-diversified equity 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 and significantly lower volatility than equities. We hold our view that a well-diversified Fund-of-Funds is the best way to express this allocation. We reiterate the role of hedge funds 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 $1.295 against the EUR (two full points since last week) and up to 0.93 against the Swiss Franc. We maintain our belief in the fundamental strength of the US$ and would not bet against it at this time. The Japanese Yen has fallen further trading through 105.00 vs. the US$. Gold has been drifting down as the US$ rises, now around $1,264, we do note that Oil trading has been anaemic whilst risks to its supply are rising. WTI has ticked-up somewhat to $95.00 or so).

This Week's Highlights:

- In the FX markets, it would appear the markets were all holding their breath to see what Super Mario had to say. Well he did NOT disappoint. He cut rates across the board by 10Bps, the benchmark rate is now 0.05% (essentially 0%!) and the deposit rate is now negative 0.20%. Although he said that we were now at the lower bound of rates, he flashed a wry smile and went on to say that the asset purchase program would now include MBS and ABS… Does anyone else recognise this story… join in when you know the words! We guess the new acronym might be called PRADA II – **P**rogramme de **R**achat d'**A**ctifs en **D**ifficulté **A** la 2!! His dulcet tones sent the EUR tumbling, USD soaring and European equity markets flying high again. EUR/USD dropped off another cliff moving from 1.3150 to eventually stop moving at 1.2920! USD/CHF soared from 0.9180 to 0.9320 and even USD/JPY moved from 104.80 to hit 105.70 by this morning. The US Dollar Index (DXY) flew from 82.85 to 84.00! What an impact. Maybe there is room in Big Ben's helicopter, now Janet's, for Super Mario as well… we look forward to his next "bazooka" strike!
- US Government bonds weakened and sent the yields higher. The US 10Yr yields moved from their slumber of Labour Day levels at 2.34% to peak at 2.46% this morning. The UK Gilt is trading at 2.49%, having moved off the lows on Monday of 2.36% (some Scottish tremors here?). The Bund yields have finally reversed their course from 0.80% at the beginning of the week and are trading at 0.96% having hit 0.98% yesterday after Mario's speech. The yields on the French OAT 10 year bonds are now trading at 1.27% having dropped to 1.23% after the "show" – These absolute levels hardly make sense to us! Italy's 10 year is yielding 2.27% - the lowest ever; Spain's 10 year is yielding 2.09%. So the Spanish, Italians, Germans now trade at a premium to US. The spreads over the Bund are now tighter again… we re-iterate, please don't get caught running for the exit unless you can run faster than Usain Bolt! As a small note, today the Irish 2 year paper now yields 0%. This is the first time this has happened since the €150Bn bailout package that took place as recently as September 2008.
- Global equities had a positive week so far. The US markets all moved in lockstep and have oscillated around the level we closed at last week – the S&P500 and the DJIA put in new intraday highs, let's see if we get a weekly close at an all-time high. Europe lead the way with an average of about +3% in the wake of the new quantitative easing that will be flooding the markets in the coming months. EM equities were mostly positive with the Bovespa moving up another 0.8%. The markets don't seem to be worried and so for now, we shall remain quietly confident of our long term view, despite a short term spike in the VIX to 13.0 yesterday.

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

04/09/2014

INDEX NAME	CCY	Last Price	1D	5D	MTD	1M	3M	6M	1Y	YTD	
			PRICE CHANGE IN % (unless indicated)								
EQUITY MARKET INDICES - BY REGION											P/E
MSCI WORLD	USD	1,748.59	-0.19	0.00	0.00	2.97	1.33	4.14	16.76	5.27	16.06
MSCI WORLD LOCAL	-	1,260.35	0.04	0.72	0.48	3.24	2.99	5.46	17.28	6.40	-
MSCI AC WORLD	USD	432.08	-0.17	0.13	0.13	3.03	1.87	5.23	16.71	5.76	15.50
MSCI EM	USD	1,100.23	-0.04	1.14	1.14	3.49	6.30	14.71	16.10	9.73	12.17
S&P 500 INDEX	USD	1,997.65	-0.15	-0.12	-0.29	4.03	2.95	6.61	20.70	8.08	16.66
DOW JONES INDUS. AVG	USD	17,069.58	-0.05	-0.31	-0.17	3.90	1.39	4.34	14.27	2.97	15.10
NASDAQ COMPOSITE INDEX	USD	4,562.29	-0.22	-0.16	-0.39	4.81	6.19	4.69	24.69	9.23	19.47
RUSSELL 2000 INDEX	USD	1,167.21	-0.42	-0.47	-0.61	4.07	1.15	-3.21	13.47	0.31	19.36
EURO STOXX 50	EUR	3,277.25	1.81	3.26	3.26	6.63	0.27	4.46	18.08	5.37	14.82
CAC 40 INDEX	EUR	4,494.94	1.65	2.61	2.61	6.21	-1.17	2.38	12.20	4.65	15.43
DAX INDEX	EUR	9,724.26	1.02	2.93	2.93	6.08	-2.01	2.16	18.37	2.05	13.79
FTSE 100 INDEX	GBP	6,877.97	0.06	0.64	0.64	2.71	0.73	1.30	5.06	1.69	-
SWISS MARKET INDEX	CHF	8,834.75	0.35	1.74	1.74	5.60	1.92	4.14	11.06	7.39	17.09
NIKKEI 225	JPY	15,676.18	-0.33	1.58	1.58	2.27	3.91	5.18	11.40	-3.82	17.30
HANG SENG INDEX	HKD	25,297.92	0.03	2.01	2.01	2.40	9.22	11.78	11.69	8.30	11.61
SHANGHAI SE COMPOSITE	CNY	2,306.86	0.80	4.93	4.93	4.80	13.99	13.31	9.61	9.95	9.10
S&P BSE SENSEX INDEX	INR	27,085.93	-0.20	1.52	1.52	4.38	8.08	27.10	42.48	27.73	17.28
RUSSIAN RTS INDEX $	USD	1,241.51	0.19	4.42	4.42	4.32	-6.82	5.14	-7.24	-13.86	5.20
BRAZIL IBOVESPA INDEX	BRL	60,800.02	-1.68	0.84	-0.80	8.18	17.92	30.50	16.14	18.04	12.92
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	296.90	-1.11	-1.71	-1.71	0.90	-0.10	9.12	15.72	7.74	14.46
MSCI MATERIALS	USD	248.80	-0.44	-0.56	-0.56	0.34	0.22	0.97	11.43	3.67	16.52
MSCI INDUSTRIALS	USD	203.22	-0.16	0.32	0.32	3.20	-1.71	1.05	14.64	0.62	16.49
MSCI CONS DISCRETIONARY	USD	182.07	0.15	0.40	0.40	2.97	0.91	0.09	12.92	0.17	17.01
MSCI CONS STAPLES	USD	198.18	0.21	0.39	0.39	3.07	-0.26	4.92	12.75	4.05	18.79
MSCI HEALTH CARE	USD	193.73	-0.56	-0.05	-0.05	4.08	4.49	4.85	25.07	12.73	17.97
MSCI FINANCIALS	USD	105.65	0.07	0.64	0.64	3.86	1.47	3.80	14.50	3.69	13.74
MSCI INFO TECH	USD	136.55	-0.13	-0.42	-0.42	3.56	5.62	8.38	26.89	10.87	17.19
MSCI TELECOMS	USD	71.43	-0.27	-0.22	-0.22	0.11	-1.77	1.67	12.93	-0.78	15.80
MSCI UTILITY	USD	121.72	0.01	0.26	0.26	3.71	-0.44	5.35	17.09	10.78	16.17
MSCI WORLD REAL ESTATE	USD	196.27	-0.34	0.31	0.31	3.19	2.66	9.41	15.96	12.17	23.92
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,251.21	-0.02	0.24	0.13	1.50	1.21	1.01	5.23	2.10	
HFRX EQUAL WEIGHTED	USD	1,221.92	-0.01	0.14	0.07	0.91	0.93	0.81	4.54	2.08	
HFRX GLOBAL EUR	EUR	1,157.08	-0.01	0.22	0.11	1.47	1.12	0.87	4.93	1.88	

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FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.02	0.00	0.00	0.00	0.00	-0.01	-0.03	0.00	-0.05
US 2 YEAR	USD	0.54	2.26	0.06	0.06	0.08	0.16	0.21	0.03	0.16
US 10 YEAR	USD	2.44	-0.22	0.10	0.10	-0.04	-0.14	-0.26	-0.55	-0.58
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	465.19	-0.04	-0.31	-0.32	0.68	1.86	3.21	6.78	5.24
US GOVERNMENT TR	USD	2,040.47	-0.16	-0.46	-0.45	0.23	0.82	1.58	3.67	3.07
US CORPORATE TR	USD	2,560.67	-0.31	-0.79	-0.74	0.48	1.55	3.56	9.01	6.35
US HIGH YIELD TR	USD	1,668.51	-0.14	-0.21	-0.23	1.77	0.80	2.62	10.22	5.46
EU GOVERNMENT TR	EUR	232.38	0.23	-0.22	-0.20	1.45	3.83	6.08	11.52	9.27
EU CORPORATE TR	USD	241.46	0.13	0.12	0.07	1.15	2.51	4.38	8.65	6.58
EU HIGH YIELD TR	EUR	268.06	-0.02	0.00	-0.03	0.97	0.69	2.93	10.72	5.55
JACI GLOBAL	USD	259.14	0.19	-0.22	0.09	0.36	-1.70	-1.33	9.05	2.29
GLOBAL EM TR (HEDGED)	USD	328.96	0.04	-0.17	-0.11	0.99	1.66	5.99	12.04	7.83
S&P/LSTA U.S. LEV LOAN	USD	98.24	-0.05	-0.02	-0.03	0.04	-0.54	-0.09	0.60	0.00
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	4,696.38	-0.67	-0.58	-1.25	-2.64	-5.54	-6.31	-6.22	-2.76
GSCI ENERGY TR	USD	1,083.93	-0.90	-0.57	-1.44	-2.81	-5.48	-5.78	-6.93	-3.75
GSCI INDUSTRIAL METALS TR	USD	1,433.95	0.89	0.78	0.13	0.13	6.64	7.33	6.71	4.91
GSCI PRECIOUS METALS TR	USD	1,588.04	-0.30	-1.92	-1.65	-2.23	1.64	-6.08	-10.42	4.25
GSCI AGRICULTURE TR	USD	538.64	-1.30	-4.27	-3.56	-4.87	-17.49	-20.38	-17.08	-11.20
GENERIC 1ST 'CL' FUTURE	USD	94.45	0.34	0.23	-1.24	0.01	-2.70	-0.61	-8.39	2.87
GOLD SPOT $/OZ	USD	1,261.93	0.19	-1.82	-1.82	-1.90	0.85	-5.43	-7.54	4.87
CURRENCIES										
DOLLAR INDEX SPOT	USD	83.82	-0.02	1.28	1.28	3.04	4.27	4.61	1.42	4.71
Euro Spot	EUR	1.29	0.05	-1.39	-1.39	-3.18	-5.20	-5.70	-1.30	-5.77
Japanese Yen Spot	JPY	105.27	0.03	-1.09	-1.09	-2.51	-2.69	-2.79	-4.87	0.07
British Pound Spot	GBP	1.63	-0.11	-1.72	-1.72	-3.39	-3.01	-2.45	4.64	-1.47
Brazilian Real Spot	BRL	2.24	-0.27	-0.04	-0.31	0.69	1.64	4.52	5.23	5.31
China Renminbi Spot	CNY	6.14	-0.04	0.04	0.04	0.48	1.85	-0.20	-0.37	-1.41
Singapore Dollar Spot	SGD	1.26	0.08	-0.48	-0.48	-0.55	-0.18	1.24	2.10	0.66
Norwegian Krone Spot	NOK	6.26	-0.20	-1.25	-1.25	0.06	-4.63	-4.50	-2.43	-3.26
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	12.64	2.27	7.30	5.51	-25.07	8.22	-9.00	-19.85	-7.87
USD SWAP SPREAD SEMI 2YR		21.06	0.33	-5.59	-5.59	-2.31	50.28	60.93	39.66	101.24
TED SPREAD		-	-	2.64	0.23	-1.38	7.33	12.50	-12.31	-85.41

All data is compiled from Bloomberg

Disclaimer