Bedrock Newsletter Friday, October 24th 2014

For your own safety, please keep your arms, hands and feet inside the vehicle at all times! This is the safety advice given out on Disney's Magic Kingdom website… It also mentions that some guests may be concerned that they do not have the stamina to wait for the rides. Well, we certainly hope that you followed their advice this week, waiting patiently and remaining safely on the "Equity-Market-Rollercoaster" (please note this is not a real Disney rollercoaster).

Well, as another year comes to an end for our friends and readers celebrating Diwali, we wish you all Saal Mubarak and a healthy and prosperous new year. We thought we would use the same symbolic reference of the victory of knowledge over ignorance, good over evil and light over dark by stepping back from the markets of the last two weeks to look at the broader picture; the S&P500 is almost back to where it started October (+5.5% for the year), the DJIA is only 500 points below its recent highs (a matter of a couple of positive trading days!), the VIX is BELOW where it started October and the DXY (US$ index) is roughly unchanged. We have just had the most important week in terms of companies' reporting Q3 earnings, with 35% of the S&P500 reporting so far – 69% beat expectations and 10% matched, leaving 21% who missed. Now… either the Analysts are grossly misinformed, the companies have not been totally open about their earnings (tut tut Tesco!) or the economy really is improving faster than current expectations. Even China's enormously reliable data reported stronger than expected GDP results; the Reserve Bank of Australia minutes noted that there was further room for China to stimulate their economy regardless of the injection of 200Bn CNY (roughly US $32.6Bn) and all this in the face of their real estate investment ONLY rising 12.5% in the first 9 months of the year… we are not convinced that a growth rate of "only" 7.3% will force the administration to push for further easing, regardless of "missing" the 7.5% growth target!

Despite last week's fairly sharp declines we are generally higher than last week's closes; that includes the US Treasury yields. However, Goldman Sachs slashed its year-end 2014 forecast for the US 10 year Treasury yield to 2.5% from 3.0%, stating that the bank doesn't expect the yield to rise to 3% until the end of next year. The 10-year yield is currently hovering around 2.26%. Looking far into the future they only see rates hitting 3.75% by 2017!

Well, all this being said we want to take a moment to think about the Pink Elephant… liquidity. This mythical beast is abundant when you have no need of it and disappears in a puff of smoke in times of stress and necessity. At the moment the most liquid investment outside of the currency markets is the US Treasury market with an average of $505Bn traded per day this year! A huge amount, no doubt, but when the market has tripled in size since last year, where incidentally the daily volumes were nearer $560Bn per day, you have to ask the question… what happens when the Fed stops reinvesting? Well as the majority of the owners of Treasuries are effectively worried about credit worthiness our vison focuses squarely on corporate spreads. In 2013 when Ben Bernanke signalled the start of "Tapering" the liquidity had already started to dry up and with his signal the US bonds collapsed from 1.60% to 2.60% in the matter of a few months. How long will Janet Yellen be able to avoid the inevitable and when that signal comes how will the markets react? We are not convinced that the 2.3% that the US 10 year Treasury currently provides properly compensates the holders for the true risk that they are taking; let alone the rates that corporate America is currently providing to Investors! Liquidity is here… for now. We are not so sure for how long the Pink Elephant will remain. Perhaps it might be prescient to think about Risk again?

Now that we have a caveat in place about risk let's look at the equity market turmoil and the media story around Ebola that is affecting the markets. First of all there have been a total of 8 reported cases of Ebola in the US. One person died whilst all other patients have been treated in specialist units and have survived. Well, every year up to 20% of the US population are infected with a far more virulent virus and it hospitalises 200,000, killing over 14,000; you don't need contact with a person as it is airborne… Yes, Influenza, or more commonly known as the 'Flu. We understand the fear of the unknown with Ebola, but this is a media-built story before the event has even taken place! Looking at the equity markets, it's all together possible the market put in a tradable bottom at last Wednesday's low; it's also probable that the market has much repair work, technically, to do before one can say with any certainty that the correction has come AND gone. From peak-to-trough, the DJIA fell about 7.5%; the S&P 500, 9.9% while the Russell 2000 fell about 12% and the Nasdaq, 10%. Very much a correction; painful and swift. But we have seen strong corporate earnings, adding 5% to the top line on average (!), the small caps leading the charge with the large caps following, the Transports leading the Industrials and markets above their long term moving averages again. We may not be out of the woods in terms of the correction but the landscape it looking favourable for stocks.

We leave you with a thought for the weekend, with 75% of October's trading days complete and 53% of those days being positive, if you had bought one share of the S&P500 on the close every day you would be +1.5% for the month. We go into the last week of the dreaded October feeling positive and looking forward to Christmas (yes we have mentioned it already!). Have great weekend ☺

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 with the significant pullback in equities from September into October having reversed course for the moment. We feel that the equity-markets are at a tipping-point between falling into a recession/deflation mode or setting a base for a big rally based on stabilized economics and growth in earnings to be fuelled by the fall in energy prices and slower Fed interest-rate action. The equity-markets' falls of last week confirmed the bond market view - the bonds having rallied strongly all year long, continuing into the equity rout. For a change, the equities, bonds and commodities behaved in concert; Oil and equities joining the bond market view of deflation risks taking the upper hand over earnings. A tough call as to which way we move forward. It may be the opportunity of a decade or the start of a big problem. We say we hold our positions of both some equities and some bonds and wait for some clarity to emerge, even though it would look like the large outflow has been stemmed for the moment.

We expect the ECB to add fuel to the European economies and act as a back-stop against economic declines, just as the Fed has done over the past several years. And now, the Bank of China is said to join the "party" supporting the rising Japanese support…
As a group, most Central Banks are targeting an elusive 2% inflation rate. 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- looking forward…*
The big unknown is the effects of the huge US$ rally - What dislocations will this cause? Prices of commodities in general (oil in particular) are rising for non-US Dollar economies, whilst falling for the USA. The US consumer sees a drop in import prices and a decline in petrol costs; a significant boost to their purchasing power. It adds downwards pressure on American inflation, whilst boosting inflation elsewhere. This is further confused by the effects of increased oil production in the USA, lowering its dependence on energy imports and an immediate effect on its balance of payments - with a drop in its trade deficit, it may further bolster the US$, but at the same time it reduces the surpluses of oil-producing nations and therefore reducing the latters' appetite for buying US Treasuries. Complicated and difficult algorithm to assess. All this coupled with Geopolitics, there is much fog covering our long-vision. In short we must keep vigilance on the following;

1. **Geopolitics in connection with the Islamic radicalisation in Iraq and Syria, accentuated by the risk of spill-over into Saudi Arabia, in-fighting in Libya, and the ongoing quarrels in the Sea of China.**
2. **Russia-Ukraine conflict - the risk of escalation remains severe despite the talks towards a settlement.**
3. **The health-scare of Ebola spreading beyond West Africa - with risks of quarantines, reduced air-travel and eventual repercussions on economies.**
4. **Continued slide in oil prices and rise of the US Dollar.**

These risks don't produce predictable outcomes or 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 - little upside exists in the sector and expected returns at the 3% level (coupons with eventual capital gains/losses) barely offset the underlying risks. We find that the reward for assuming credit-risk has become too small.

- **Equities -** We feel secure in owning equities. We remain positive in spite of recent large scale volatility and recommend exposures to be maintained or even increased - we say this even in light of the large drop from last week and despite the increased volatility! We suggest using global-diversified equity funds, some niche themes or allocating some fixed income holdings into convertible bonds for bond-oriented investors, especially as we see some pricing opportunities in the convertible space appearing.

- **Alternatives -** With steady economic stability, fundamentals are returning to text-book norms of relative values. We expect allocations to active management to maintain, if not exceed, its relatively low recent results – but this with low correlation to any particular sector and significantly lower volatility than equities. With the first half of October hitting most managers very hard but the CTA's having a strong performance to offset some of the equity managers' low returns. 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 with an uptick in option-volatility continuing. The USD has gained ground versus almost all its major trading counterparts, now trading at about $1.2660 against the EUR and up to 0.9530 against the Swiss Franc. We maintain our belief in the fundamental strength of the US$ and would not bet against it at this time. The Japanese Yen has dropped again, trading at 108.10 vs. the US$, having briefly rallied to 105.20! Gold has dropped some points and trades now around $1,232; we note that Oil has steadied, with WTI trading around $81.30/BBl.

This Week's Highlights:

- US Government bonds held their breath this week, standing pat at around 2.22% all week and only yesterday briefly weakening to 2.30%. The UK Gilt traded steadily throughout the week, moving slowly from 2.18% to 2.22% today. The Bund yields are coming back to where they started the week at around 0.86% after have dropped to as low as 0.83% whilst also touching 0.90% at the close yesterday prior to the new Ebola case in New York. The yields on the French OAT 10 year bonds have been steady at 1.28%.

- The USD regained some ground against the EUR after dropping to 1.2840 on Tuesday; the USD moved up to 1.2650 this morning. Cable moved from 1.6180 to 1.60, JPY moved back to 108.20 after reaching 106.88. As the Dollar rise has been very fast it is only normal that we see it pull back a little to catch its breath, and now starting to climb again. We view these moves as normal and look for the USD to slowly build up momentum again to resume its rise to higher highs.

- After last week's meteoric equity market drops we are back on steady ground for now and have recouped most of last week's declines. The S&P500 having moved from 1,886 last Friday to 1,950 last night. The Dow rallying from 16,380 to 16,677 and the majority of the developed world being up between 2% to 5.6% on the week. Brazil is still facing a torrid time at the moment with the run-off election causing a large drop in their listed equity market. The Bovespa has dropped from a peak of approximately 61,900 to now be trading at about 50,700… or 18% off its recent high in less than two months. Sunday will see the new President elected; we hope for the markets that Neves is elected and that he is able to deliver on their expectations… Perhaps better to hope for the best and plan for the worst!

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

23/10/2014

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	1,659.97	0.79	2.88	-2.26	-3.70	-5.48	-1.26	3.24	-0.07	15.41
MSCI WORLD LOCAL	-	1,211.69	0.91	4.56	-2.27	-2.76	-2.87	1.58	6.97	2.30	-
MSCI AC WORLD	USD	407.38	0.64	2.62	-2.27	-3.86	-5.90	-1.37	2.34	-0.29	14.84
MSCI EM	USD	981.75	-0.54	0.51	-2.35	-5.17	-9.17	-2.26	-4.76	-2.09	11.31
S&P 500 INDEX	USD	1,950.82	1.23	4.73	-1.09	-2.38	-1.87	3.84	11.34	5.54	16.22
DOW JONES INDUS. AVG	USD	16,677.90	1.32	3.48	-2.14	-3.09	-2.38	1.07	7.54	0.61	14.71
NASDAQ COMPOSITE INDEX	USD	4,452.79	1.60	5.58	-0.90	-2.25	-0.43	7.34	13.33	6.61	18.54
RUSSELL 2000 INDEX	USD	1,116.49	1.79	2.82	1.34	-1.05	-3.44	-2.44	-0.21	-4.05	18.51
EURO STOXX 50	EUR	3,044.30	1.19	2.14	-6.21	-6.73	-6.04	-5.15	-0.44	-2.68	13.83
CAC 40 INDEX	EUR	4,157.68	1.28	2.44	-6.45	-6.40	-6.33	-7.77	-3.37	-3.83	14.35
DAX INDEX	EUR	9,047.31	1.20	1.67	-5.03	-6.87	-8.13	-5.77	0.19	-5.80	12.58
FTSE 100 INDEX	GBP	6,419.15	0.42	1.18	-3.59	-4.79	-6.40	-4.74	-4.89	-5.39	13.33
SWISS MARKET INDEX	CHF	8,546.08	0.47	3.27	-3.57	-3.15	-1.36	1.32	3.48	3.86	16.54
NIKKEI 225	JPY	15,138.96	-0.37	5.22	-5.45	-5.42	0.05	6.16	5.56	-6.14	16.59
HANG SENG INDEX	HKD	23,333.18	-0.16	1.02	1.42	-2.78	-3.66	3.08	1.85	-0.21	10.72
SHANGHAI SE COMPOSITE	CNY	2,302.42	-1.04	-1.66	-2.61	-1.76	9.37	11.92	6.37	8.80	9.12
S&P BSE SENSEX INDEX	INR	26,851.05	0.24	3.28	0.83	0.40	2.20	17.37	29.56	26.83	17.29
RUSSIAN RTS INDEX $	USD	1,035.91	-1.10	-4.34	-8.66	-13.69	-18.97	-10.41	-31.29	-28.86	4.60
BRAZIL IBOVESPA INDEX	BRL	50,713.26	-3.24	-6.60	-6.29	-10.75	-12.53	-2.13	-7.59	-1.54	11.03
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	261.53	1.44	2.88	-6.27	-7.88	-15.53	-10.22	-2.45	-5.10	13.31
MSCI MATERIALS	USD	225.75	-0.11	1.81	-3.55	-6.32	-12.18	-8.16	-5.51	-5.93	15.48
MSCI INDUSTRIALS	USD	192.51	1.25	2.94	-2.36	-3.50	-6.15	-4.66	-0.42	-4.68	15.80
MSCI CONS DISCRETIONARY	USD	172.86	0.65	3.21	-1.43	-2.95	-5.25	-2.12	-0.89	-4.90	16.36
MSCI CONS STAPLES	USD	191.28	-0.20	1.44	-1.06	-2.23	-4.08	-1.08	1.72	0.43	18.48
MSCI HEALTH CARE	USD	192.49	1.30	4.44	-1.01	-2.40	1.28	7.53	17.13	12.01	17.82
MSCI FINANCIALS	USD	100.05	0.65	2.57	-1.65	-3.42	-4.69	-1.89	0.14	-1.81	13.17
MSCI INFO TECH	USD	131.69	1.32	3.46	-2.98	-3.92	-2.93	6.40	15.51	6.93	16.12
MSCI TELECOMS	USD	67.66	-0.19	1.96	-3.60	-4.77	-7.01	-3.56	-4.23	-6.01	15.28
MSCI UTILITY	USD	119.22	0.31	2.37	0.68	0.45	-3.02	-0.41	6.20	8.50	16.11
MSCI WORLD REAL ESTATE	USD	189.08	0.42	2.77	3.29	2.38	-2.59	3.89	2.19	8.06	23.53
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,213.27	-0.16	1.28	-2.16	-2.66	-2.52	-1.66	0.07	-1.00	
HFRX EQUAL WEIGHTED	USD	1,192.78	-0.09	1.05	-1.65	-2.12	-2.22	-1.57	0.44	-0.36	
HFRX GLOBAL EUR	EUR	1,120.98	-0.17	1.23	-2.19	-2.73	-2.67	-1.87	-0.27	-1.30	

MARKET INDICES PERFORMANCE

23/10/2014

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			PRICE CHANGE IN % (unless indicated)							
FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.01	0.00	-0.02	-0.01	-0.01	-0.02	0.00	-0.03	-0.06
US 2 YEAR	USD	0.38	-0.01	0.01	-0.19	-0.21	-0.11	-0.06	0.08	0.00
US 10 YEAR	USD	2.26	-0.02	0.06	-0.23	-0.31	-0.25	-0.43	-0.26	-0.77
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	468.44	-0.13	-0.23	0.67	0.80	1.42	3.33	5.30	5.97
US GOVERNMENT TR	USD	2,063.78	-0.22	-0.50	1.21	1.32	1.36	2.53	2.93	4.25
US CORPORATE TR	USD	2,576.91	-0.33	-0.44	1.35	1.13	0.89	2.98	6.48	7.03
US HIGH YIELD TR	USD	1,655.29	0.07	2.03	1.09	0.17	-0.35	1.15	6.14	4.62
EU GOVERNMENT TR	EUR	232.50	-0.09	-0.12	-0.25	0.09	1.76	4.82	9.51	9.32
EU CORPORATE TR	USD	242.02	-0.06	0.08	0.12	0.22	1.58	3.85	7.12	6.82
EU HIGH YIELD TR	EUR	265.62	0.11	1.27	-0.34	-0.88	-0.48	0.74	6.73	4.59
JACI GLOBAL	USD	246.87	0.18	1.52	-1.24	-2.75	-5.46	-6.10	-1.52	-2.56
GLOBAL EM TR (HEDGED)	USD	327.15	-0.04	0.42	0.56	0.09	-0.31	3.38	6.30	7.24
S&P/LSTA U.S. LEV LOAN	USD	96.68	0.15	1.03	-0.29	-0.89	-2.12	-1.40	-1.09	-1.59
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	4,220.03	1.30	0.62	-5.58	-6.23	-14.41	-16.38	-11.83	-12.62
GSCI ENERGY TR	USD	938.45	1.74	0.55	-8.97	-9.93	-18.20	-18.61	-13.86	-16.67
GSCI INDUSTRIAL METALS TR	USD	1,344.42	-0.07	2.67	-0.01	-0.63	-5.52	0.30	-1.38	-1.64
GSCI PRECIOUS METALS TR	USD	1,527.21	-1.22	-1.04	1.35	0.11	-7.51	-5.38	-10.31	0.26
GSCI AGRICULTURE TR	USD	532.17	1.10	0.08	6.85	7.00	-5.90	-24.38	-19.38	-12.27
GENERIC 1ST 'CL' FUTURE	USD	82.09	-0.72	-1.13	-10.28	-11.87	-17.24	-14.91	-10.08	-10.60
GOLD SPOT $/OZ	USD	1,231.87	-0.03	-0.55	1.93	1.18	-4.81	-4.79	-8.56	2.14
CURRENCIES										
DOLLAR INDEX SPOT	USD	85.84	0.03	0.89	-0.08	0.97	6.18	7.60	8.44	7.29
Euro Spot	EUR	1.26	-0.06	-0.96	0.06	-1.11	-6.13	-8.63	-8.43	-8.04
Japanese Yen Spot	JPY	108.27	0.07	-1.21	1.35	0.79	-5.89	-5.43	-10.08	-2.66
British Pound Spot	GBP	1.60	0.02	-0.37	-1.11	-1.88	-5.61	-4.58	-1.04	-3.16
Brazilian Real Spot	BRL	2.50	-0.52	-1.09	-2.12	-3.52	-11.22	-11.12	-12.38	-5.52
China Renminbi Spot	CNY	6.12	0.02	0.11	0.34	0.25	1.24	2.15	-0.61	-1.05
Singapore Dollar Spot	SGD	1.28	0.09	-0.06	-0.01	-0.67	-2.72	-1.40	-3.03	-1.01
Norwegian Krone Spot	NOK	6.58	-0.06	-0.55	-2.36	-2.89	-5.76	-8.82	-10.47	-7.75
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	16.53	-7.50	-34.40	1.35	24.57	39.61	24.10	25.23	20.48
USD SWAP SPREAD SEMI 2YR		25.81	1.24	-0.23	6.39	22.62	30.65	148.86	95.58	148.86
TED SPREAD		-	-	-	-	-	-	-	-	-

All data is compiled from Bloomberg

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