Bedrock Newsletter Friday, November 14th 2014

Surprise! It is Friday again…Week two of November coming to a close and the 'word of the week' is "UP"! New highs in the DJIA and S&P 500 keep ticking-in! Bonds are holding steady as oil and gold pursue their respective declines. Here is a thought about this - Setting aside all the disappointment with gold this year, it is actually doing what it says on the box; Gold has been held historically in a portfolio as a diversifier, which means that when other assets are performing poorly, an investor counts on gold to do better. On the flipside, this implies that when other assets are doing well, gold cannot be expected to yield the same returns as before. This is precisely what is happening right now: gold is down 5% YTD but US equities are performing well (+10%), the dollar is strengthening (DXY Index also up 10%). So from a portfolio diversification perspective, gold is doing what is expected of it. Over the last several years, gold has been simultaneously regarded as a crisis hedge, a currency hedge, an inflation hedge and a deflation hedge. Gold's beauty, it seemed, was in the eye of the holder. But in the absence of a full-scale geopolitical crisis, economic collapse, or other "black swan" event, there is no good reason to hold gold — at least for US investors. Even in its recent rally, gold never took out its 1980 high which adjusted for inflation would equate to $2,300 today. Oil though is an entirely different story - It is both an essential commodity and a powerful political tool. As the US is asserting itself as not only the largest consumer of the black gunk but now, becoming (again) also one of its largest producers; relative powers are shifting. The precipitous drop in oil over the past few months has been heralded by many as the true fuel for the next leg of economic growth. Whilst we support this view, we can point at some interesting bits of data that give us cause for concern - Iran needs oil at $130 to fund its budget, Iraq needs $114 and Russia $110. Saudi Arabia needs the barrel to be at $90. Shale-oil in the US breaks-even at about $60. At the same time as Congress rushes to approve the long-delayed Keystone XL pipeline, it is questionable whether or not the project will make as much of a difference as proponents expect. Since June, crude oil has declined by 28%, pushing the price that oil from new wells in Canada may command below what the expected cost will be to produce it. The so-called "heavy sand oil" extracted from sand in Alberta, which the proposed pipeline would carry to Nebraska, en-route to refineries on the Gulf Coast, will cost between $85 and $110 to produce. Barclays analysts calculated that with a 20% decline in oil prices, capital expenditures for the industry should fall by $40 billion, but savings to consumers could amount to $70 billion. Clearly, at its current levels, oil is at a dangerous level for stability in many areas…

The governance of the US has shifted to the Republicans. Now we see an increased likelihood that the abovementioned Keystone pipeline will be approved, we expect that laws will be amended to permit the US to export oil and gas and that the corporate tax code will come to be reviewed. In response, the still Democrat President is firing ideas in all directions- from pollution agreements with China to an ill-conceived thought of regulating Broadband internet access as a utility. Just uttering this last thought has caused an immediate halt to certain providers' fibre-optic cable laying projects… A concise reminder that the difference between stupidity and genius is that genius has its limits…
With all this going on, it was pleasing to hear yesterday that "It's still too early to raise interest rates given below-target inflation" from New York Federal Reserve President William Dudley, noting there could be a significant benefit from letting the economy run "slightly hot." Maybe our outlook for bonds and yields will hold for yet longer, i.e., no change into quite some time further… Reinforcing our fundamentally bullish outlook for equities… Well, today we got some data from the Chinese - China's slowdown deepened in October as policy makers refrained from economy-wide stimulus, with industrial output and investment trailing estimates. Factory production rose 7.7% from a year earlier, the second weakest pace since 2009. Investment in fixed assets such as machinery expanded the least since 2001 from January through October, and retail sales gains also missed economists' forecasts last month. Well, their overall growth rates are still at the top of the pile, just decelerating. Against this small disappointment, Investors breathed a sigh of relief on Friday, as the euro zone's economy grew more than expected in the third quarter and Germany narrowly avoided falling into recession. Euro zone gross domestic product (GDP) grew by 0.2% on the previous quarter, according to data from the Eurostat, the European Union's statistics service, beating a Reuters forecast of a 0.1% expansion. Greece grew 0.7% in Q3, France by 0.3% and Germany by 0.1%. Although all these figures start with a Zero maybe Europe is becoming interesting?

The biggest disruptor of all remains the US$ whose stellar rally is creating new dislocations in global 'terms of trade'. Looking at the current exchange rates we note a certain stabilization around these levels- The big and quiet gainer is the Yuan, whilst holding steady against the US$, it has risen about 13% against the Euro, which gives Europe a huge economic competitive edge.
We go to our weekend reassured with our long held views. Remember that "The best way to cheer yourself up is to try to cheer somebody else up" (Mark Twain)

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 our "bullish" view on equities as Q3 earnings have come-in generally ahead of expectations and looking forward we believe that lower energy costs are to flow into futures earnings and sales.

Bond markets seem to have shifted away from their deflationary outlook, having dropped somewhat in prices, slightly raising yields across the board. Whilst we do not expect any significant moves here, we find it reassuring that both fixed-income and equity markets views have converged - Growth is back on the agenda. As a group, most Central Banks are targeting an elusive 2% inflation rate. The industrialized economies are running with excess labour (less so in the USA as per Janet) and substantial excess of industrial capacity, the return of inflation appears to be far 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…

Our main concern lies with the effects of the US$ rally - What dislocations is this causing? And then, the ongoing drop in prices of commodities in general and oil in particular. These phenomena's add 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 from a drop in its trade deficit; it may further bolster the US$, but at the same time it reduces the surpluses of other oil-producing nations and therefore reducing the latters' appetite for buying US Treasuries. This re-emergence of the USA as a major energy producer has and will have significant geo-political side-effects, further complicating an already difficult algorithm to assess.
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, especially in light of the Ukrainian vote in favour of steering to the West.**
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- changes in allegiances and alliances might emerge here!**

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 anytime soon. 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 is too small.

- **Equities -** We feel secure in owning equities. We remain positive despite the recent large scale volatility and recommend exposures to be maintained or even increased. 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 some pricing opportunities in the convertible space are appearing.

- **Alternatives -** With October hitting many managers hard, the CTA's having a strong performance to offset some of the equity managers low returns, we maintain 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 USD has gained ground versus almost all its major trading counterparts, now trading at about $1.2450 against the EUR and up to 0.9650 against the Swiss Franc. We maintain our belief in the fundamental strength of the US$ and would not bet against it at this time. The Japanese Yen has dropped further, trading at 115.75 vs. the US$. Gold is showing difficulties in holding its value and trades now around $1,152; we note that Oil has headed yet lower still, WTI trading around $73.50/Bbl.!!

This Week's Highlights:

- With the US Treasuries closed on the 11th for Veteran's Day the 10Yr US Treasuries moved very gently around 2.30%, trading now at the relative highs of the week of 2.34%. The UK 10Yr Gilt is stronger on the week with the yields lower at 2.15% and heading in the opposite direction to the US Treasuries! The bunds are continuing their price march higher, sending the yields lower again, we are at 0.78% now and nearing the lows of 0.715% reached in mid-October. How much price upside is there in the German Bunds left? When do they become the carry trade of choice as the cheapest bond to short?
- EURUSD bobbled around 1.2450 this week, with little news flow or economic data on the headlines the currency pair remained in a trading range of 1.24 to 1.25. The JPY continued its slide against the USD this week, moving from 114.50 to 116.45 as we write! Abenomics and a Central bank who are able to use rhetoric and gigantic levels of stimulus to their advantage, seems to be having the right effect. The CHF traded in a similar fashion to that of EURUSD and moved between 0.9620 and 0.9680, where we stand at the lower end of the range at the moment. Cable dropped like a stone from 1.5950 to 1.5650 on news that the UK inflation outlook would be a little less rosy than originally thought. The BRL dropped against the USD to a fresh low of 2.61 yesterday amid rumours that Henrique Meirelles might not be selected as Finance Minister, with Barbosa looking like the favourite for now. As the Russians are staring down the barrel of further restrictions and sanctions, the RUB has tumbled again from 45.00 on Monday to 47.87 today. And the future looks cold for the Rub as we move into Moscow winter!
- Equities had a relatively quiet week in the US as the S&P500 stood pat at about 2,035 throughout the week, albeit reaching new highs for some indices. The European markets took a little bit of a hit relative to the US, with the DAX dropping from 9,400 to 9,250 as we write. With little real news flows and little talk of Ebola, the Ukraine and Russia or Syrian issues there were very few drivers for the market to change direction. As a result this has been a quiet week for the developed markets… Even Russia with the possibility of new sanctions was practically unchanged on the week, with the RTS Index only down 0.3% on the week.

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

13/11/2014

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	1,716.24	0.09	0.54	0.48	6.55	0.03	1.27	6.41	3.32	16.11
MSCI WORLD LOCAL	-	1,265.35	0.18	0.54	0.99	7.58	3.62	4.88	10.59	6.83	-
MSCI AC WORLD	USD	420.19	0.04	0.54	0.18	5.83	-0.81	0.70	5.71	2.85	15.51
MSCI EM	USD	992.72	-0.34	0.51	-2.30	0.06	-7.43	-3.83	0.10	-0.99	11.78
S&P 500 INDEX	USD	2,039.33	0.06	0.40	1.05	8.61	4.30	7.99	13.89	10.33	16.92
DOW JONES INDUS. AVG	USD	17,652.79	0.23	0.56	1.51	8.20	5.62	6.25	11.19	6.49	15.54
NASDAQ COMPOSITE INDEX	USD	4,680.14	0.11	0.90	1.07	10.72	5.10	14.13	17.81	12.06	19.32
RUSSELL 2000 INDEX	USD	1,175.42	-0.91	0.30	0.16	10.72	2.81	6.55	5.76	1.01	19.44
EURO STOXX 50	EUR	3,056.80	0.31	-0.13	-1.69	2.00	0.09	-4.66	0.23	-1.55	14.03
CAC 40 INDEX	EUR	4,187.95	0.21	0.24	-0.79	2.73	-0.13	-6.69	-1.96	-2.24	14.53
DAX INDEX	EUR	9,248.51	0.41	-0.29	-0.66	4.98	0.43	-5.02	1.26	-3.01	12.96
FTSE 100 INDEX	GBP	6,635.45	0.50	0.92	1.24	3.68	-0.86	-3.65	-0.58	-1.80	13.90
SWISS MARKET INDEX	CHF	8,954.40	0.98	1.25	1.01	7.07	5.90	3.66	7.49	8.83	17.32
NIKKEI 225	JPY	17,392.79	1.14	3.62	6.56	17.10	14.21	21.42	17.57	7.36	18.90
HANG SENG INDEX	HKD	24,019.94	0.34	2.28	0.37	4.51	-2.88	6.66	6.35	3.35	11.17
SHANGHAI SE COMPOSITE	CNY	2,485.61	-0.35	2.51	2.42	5.06	12.34	21.04	18.01	17.15	9.93
S&P BSE SENSEX INDEX	INR	27,940.64	-0.24	0.46	0.47	6.25	7.25	17.56	37.24	32.24	17.72
RUSSIAN RTS INDEX $	USD	1,012.16	-3.15	-1.42	-8.99	-7.63	-19.37	-21.23	-30.75	-31.15	4.85
BRAZIL IBOVESPA INDEX	BRL	51,846.03	-2.14	-1.50	-5.09	-10.63	-7.05	-4.72	-3.00	0.66	11.46
EQUITY MARKET INDICES - BY SECTOR											**P/E**
MSCI ENERGY	USD	256.87	-1.47	-2.54	-2.95	3.63	-12.37	-13.35	-4.62	-6.79	13.22
MSCI MATERIALS	USD	227.93	-0.07	0.51	0.89	3.57	-8.84	-8.78	-3.67	-5.03	15.96
MSCI INDUSTRIALS	USD	200.25	-0.14	0.27	0.80	8.25	0.05	-1.61	3.29	-0.85	16.85
MSCI CONS DISCRETIONARY	USD	179.97	0.57	1.41	1.44	7.90	0.48	2.93	2.69	-0.98	17.32
MSCI CONS STAPLES	USD	200.93	0.59	1.37	2.16	6.01	2.86	2.10	5.71	5.49	19.66
MSCI HEALTH CARE	USD	200.27	0.12	1.29	0.56	8.59	6.59	9.97	20.08	16.54	18.61
MSCI FINANCIALS	USD	102.83	0.07	0.23	-0.32	4.77	-0.02	0.69	3.97	0.92	13.66
MSCI INFO TECH	USD	139.38	0.52	1.22	1.71	9.32	4.12	12.25	19.88	13.17	17.05
MSCI TELECOMS	USD	71.44	0.66	2.45	1.43	6.98	1.42	-1.60	2.10	-0.76	16.30
MSCI UTILITY	USD	120.89	-0.48	-1.48	-1.64	3.03	1.68	0.94	8.54	10.02	16.43
MSCI WORLD REAL ESTATE	USD	194.50	0.36	1.10	-0.09	5.75	0.45	3.69	9.04	11.16	24.15
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,221.89	0.03	0.05	-0.14	0.75	-0.78	-0.61	1.05	-0.29	
HFRX EQUAL WEIGHTED	USD	1,194.18	-0.06	-0.06	-0.43	0.08	-1.32	-1.06	0.69	-0.24	
HFRX GLOBAL EUR	EUR	1,128.50	0.03	0.04	-0.16	0.71	-0.93	-0.83	0.68	-0.64	

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13/11/2014

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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	0.00	0.00	-0.02	-0.02	-0.07	-0.06
US 2 YEAR	USD	0.52	0.00	0.02	0.02	0.15	0.10	0.15	0.23	0.14
US 10 YEAR	USD	2.33	-0.01	0.04	0.00	0.14	-0.07	-0.21	-0.36	-0.69
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	469.15	0.06	0.14	0.09	0.17	1.25	2.92	5.85	6.14
US GOVERNMENT TR	USD	2,058.80	0.07	0.19	0.03	-0.04	0.80	1.82	3.32	4.00
US CORPORATE TR	USD	2,561.87	0.01	0.07	-0.26	-0.59	0.20	1.74	7.09	6.40
US HIGH YIELD TR	USD	1,653.57	-0.08	-0.05	-0.20	1.22	-0.26	0.33	6.06	4.51
EU GOVERNMENT TR	EUR	234.14	0.01	0.23	0.21	0.29	1.86	4.79	9.89	10.10
EU CORPORATE TR	USD	243.87	0.02	0.23	0.43	0.74	1.86	3.55	7.40	7.64
EU HIGH YIELD TR	EUR	268.67	0.00	0.41	0.78	1.29	1.39	1.00	7.22	5.79
JACI GLOBAL	USD	249.31	-0.10	-0.14	-0.15	2.10	-3.05	-5.23	0.61	-1.60
GLOBAL EM TR (HEDGED)	USD	327.22	-0.08	-0.11	-0.52	0.30	0.44	2.19	8.29	7.26
S&P/LSTA U.S. LEV LOAN	USD	97.23	0.01	0.00	0.04	0.79	-0.65	-1.50	-1.04	-1.03
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	3,993.90	-2.65	-3.18	-4.95	-7.47	-16.35	-20.41	-14.82	-17.30
GSCI ENERGY TR	USD	860.87	-4.07	-5.58	-7.54	-11.29	-22.46	-24.66	-19.88	-23.56
GSCI INDUSTRIAL METALS TR	USD	1,353.92	-0.80	-0.49	-0.86	0.49	-3.32	0.28	2.62	-0.94
GSCI PRECIOUS METALS TR	USD	1,437.30	0.18	1.62	-1.10	-6.06	-12.82	-11.61	-10.66	-5.65
GSCI AGRICULTURE TR	USD	546.93	0.74	3.08	0.89	4.22	-1.61	-22.42	-13.07	-9.83
GENERIC 1ST 'CL' FUTURE	USD	74.21	-1.01	-6.60	-8.79	-9.89	-20.14	-23.65	-15.84	-19.42
GOLD SPOT $/OZ	USD	1,162.45	-0.78	-2.09	-1.71	-6.45	-12.19	-11.68	-10.39	-4.33
CURRENCIES										
DOLLAR INDEX SPOT	USD	87.67	0.21	0.25	1.09	2.38	7.69	9.73	8.44	9.78
Euro Spot	EUR	1.25	-0.06	0.12	-0.44	-1.49	-6.70	-9.08	-7.36	-9.26
Japanese Yen Spot	JPY	115.77	-0.42	-1.43	-3.39	-7.92	-11.88	-12.35	-13.98	-9.42
British Pound Spot	GBP	1.57	-0.15	-1.15	-1.93	-1.36	-5.99	-6.44	-2.36	-5.25
Brazilian Real Spot	BRL	2.59	-0.80	-0.73	-4.29	-7.51	-11.87	-14.44	-9.84	-8.76
China Renminbi Spot	CNY	6.13	-0.06	-0.12	-0.28	-0.08	0.38	1.61	-0.61	-1.23
Singapore Dollar Spot	SGD	1.29	-0.39	-0.62	-0.88	-1.60	-3.89	-3.59	-3.81	-2.61
Norwegian Krone Spot	NOK	6.79	0.06	0.46	-0.55	-3.09	-9.26	-12.72	-9.34	-10.56
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	13.79	5.91	-2.68	-1.71	-39.49	11.03	13.31	11.48	0.51
USD SWAP SPREAD SEMI 2YR		21.94	0.27	2.33	2.90	-19.27	-2.78	63.69	109.52	109.52
TED SPREAD		22.70	1.75	7.43	0.00	0.67	11.71	11.49	33.84	25.97

All data is compiled from Bloomberg

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