Bedrock Newsletter Friday, November 28th 2014

Merry Christmas everybody… Oh wait, it's still November! Who needs the Black Friday shopping bonanza when Christmas has come early for the US economy, industrials and the SUV-driving gas-guzzling public! As OPEC did nothing at the meeting yesterday, effectively refusing to cut Saudi Arabian oil production, the price of WTI Crude (effective US oil price) for immediate delivery sunk by 7% from $73/Bbl, to hit $67.75/Bbl. Leaving crude oil down a whopping 31% year to date… What about the dollar effect, we hear you shouting?!? In EUR terms oil is down 23% and in JPY terms it is down 22%. So regardless of the USD rally, oil in terms of a basket of the global major currencies has dropped to levels that will have real effects on the global economy. To help quantify exactly the impact, we had the Euro CPI today with core CPI measured at +0.7%. As oil accounts for roughly 3% of the European economy through both direct and indirect effects, this would imply that the impact of lower energy prices has reduced the Euro CPI by about 0.7% overall this year…!

Looking back in time, we are now at levels that we have seen in 2008 and again in 2010, these were the price level for pre-crisis oil. In 2008, the World GDP was $57 Trillion, with oil well below $70 per barrel. The World GDP today is $75 Trillion, a 32% increase in world GDP in USD terms, in EUR terms it increased by 39% and in JPY terms by 24%; WTI crude oil is unchanged in JPY terms, +12% in USD terms and +23% in EUR terms. Effectively, we see that by stripping out the currency effects on GDP growth versus the price of oil, World GDP is 20% higher than any effective change in the value of oil… Is this a reasonable level then for oil?

It is not just the US who has taken a frontline view of the oil price movements, our friends in Russia will be only too familiar with the effects that the price tumble has had on their country's equities and currency. Regardless of the economic sanctions imposed by the US, as the oil price has tumbled so too have the RTSI and the Micex index, as well as the Russian Ruble. This week has seen the currency lose over 10% of its value, moving from 44.4 to touch 50.0 this morning. Vladimir Putin is in a quandary… he has to defend his political honour against the Western powers, but does it have to come at the expense of his economy. The exported oil creates less revenue, some companies can no longer trade in USD (maybe this is a blessing in disguise as oil has dropped less in EUR terms, perhaps Obama didn't see that knock-on effect!), the RUB is down 34% year to date and the RTSI has dropped 33%. Regardless of the interest hike by the Russian Central Bank, the free floating currency is getting battered; with such high borrow costs for the domestic economy it is highly likely that Russia will be pushed further and deeper into recession in 2015.

The US on the other hand is currently looking at annual growth of 4%, unemployment at 5.8% (who knows this could drop even further!) and a large "fiscal stimulus" with the fall in oil prices. Could we be seeing the first embers lighting in the fire to raise rates in the US?! Well… we don't think it will happen straight away but when you look at the Core PCE in the US, the FED has managed to steer through this financial quagmire to put the target of 2% squarely in their sights (currently at 1.6%!). It looks like Big Ben and Janet deserve a little pat on the back. As Ella Wheeler Wilcox wrote, "A pat on the back is only a few vertebrae removed from a kick in the pants, but is miles ahead in results." As the FED would appear to be miles ahead in terms of results than the BOJ and ECB, what does that mean the ECB and BOJ are deserving of…?

Japan… oh, Japan… you so *nearly* managed to get it right. With a possible third quarter of continuous recession after the tax hike in April helped push the Japanese economy into its fourth recession since 2008, at least Abe has postponed the increase in sales tax that was planned for next October. With Inflation outpacing the total cash earnings which rose 0.7% in September from a year earlier, wages fell by 3% after being adjusted for price changes. This is the 15th straight monthly decline; however the BOJ gave its first pay rise in 9 years to its Board and executives, will the domestic companies follow suit? We doubt it. As household incomes are being squeezed can the BOJ realistically expect the CPI to rise without further stimulus? Tumbling oil prices are stifling the BOJ's stimulus plans to inflate the economy, Kuroda's statement of "there is no limit to the steps that the BOJ could take to reach its 2% inflation target" may be tougher to support than he believes. The BOJ Board members were divided at last month's meeting, having to backtrack on the prediction that there was no chance that the BOJ's inflation gauge would drop below 1%, as Kuroda is warning that may well be the case. Looks like the land of the rising Sun, could do with a rising consumer base to complement the flag.

As we close out the final day of November and we look to the future we can't help but be reminded of J. Paul Getty's quote, "Formula for success: rise early, work hard, strike oil". ☺ We hope you have a restful 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. Economics are in 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 future earnings and sales.

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 not likely 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 add downward 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 -** October hit many managers hard. November saw the Macro funds rebound, CTA's perform well and Multi-Strat mixed. 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 is now trading at about $1.2470 against the EUR and up to 0.9630 against the Swiss Franc. We maintain our belief in the fundamental strength of the US$ and would not bet against it at this time. The Japanese Yen has stalled a little on its mighty descent, trading at 118.10 vs. the US$. Gold is showing difficulties in holding its value and trades now around $1,190, we note that Oil has slipped yet lower level as OPEC have refused to cut production, WTI trading around $68.60/Bbl, having touched $67.75!

This Week's Highlights:

- EURUSD nudged higher throughout the week, moving from 1.2360 to 1.2550 just before the OPEC announcements. With the USD stronger after the oil move, the pair has dropped a little to 1.2470. The CHF has strengthened as Eurozone worries weighed heavily on the market, trading at 0.9630 now having been as high as 0.9730 on Monday. The JPY tradedbetween 118.60 and 117.30 for the whole week, again the USD taking strength after OPECs lack of action. Cable is almost unchanged on the week at 1.5700. The Real had seen some renewed strength as the pair moved from 2.55 to 2.50 with the news that the Finance Minister would be Joaquim Levy, however the strength of the USD move saw all of the gains wiped out after OPECs comments.
- The US 10Yr Treasuries saw a renewed buying interest causing the yields to slowly move from 2.32% to 2.20% this morning – although we are not sure how much of this price action has to do with the US Thanksgiving illiquidity. The UK's 10Yr Gilt moved in a similar fashion to that of the US 10Yr Treasuries, seeing the yield cross the 2% barrier and touch 1.90% this morning, could we be heading back to the all-time lows around 1.5% on the back of worryingly high property price data? The bunds traded below 0.80% for the whole week, briefly moving to 0.694% today, making this the lowest ever level for the German 10Yr. With Eurozone CPI at +0.7% and German CPI at 0.6%, how sustainable are the Bund levels that we see today?
- Equities had another relatively quiet week in the US as the markets were on holiday yesterday and are taking a half day today. The S&P500 moved higher throughout the week, reaching new highs again, the Nasdaq being the best performer of the week at +2.4%. The core European markets rebounded with more vigour, on average rising by a little over 2%. The periphery nations moving less so, at a shade over 0.25% for the week. 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… Russia's RTS Index on the other hand had a terrible week, dropping 8%.

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

27/11/2014

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	1,744.71	-0.19	0.43	2.14	3.57	0.02	2.26	7.11	5.04	16.43
MSCI WORLD LOCAL	-	1,289.05	-0.03	1.20	2.88	6.13	2.65	6.05	11.09	8.83	-
MSCI AC WORLD	USD	427.32	-0.16	0.47	1.88	3.41	-0.75	1.74	6.33	4.59	15.85
MSCI EM	USD	1,012.62	0.06	0.82	-0.34	2.02	-6.84	-2.47	0.06	0.99	12.21
S&P 500 INDEX	USD	2,072.83	0.30	1.18	2.71	5.67	3.64	8.42	14.70	12.14	17.21
DOW JONES INDUS. AVG	USD	17,827.75	0.11	0.80	2.51	6.00	4.12	6.91	10.75	7.55	15.69
NASDAQ COMPOSITE INDEX	USD	4,787.32	0.67	2.39	3.38	6.72	4.76	12.99	18.36	14.62	19.79
RUSSELL 2000 INDEX	USD	1,190.62	0.38	2.85	1.46	6.55	1.53	4.24	4.32	2.32	19.66
EURO STOXX 50	EUR	3,244.92	0.58	1.35	3.98	6.62	2.30	-0.28	4.68	4.12	14.80
CAC 40 INDEX	EUR	4,382.34	0.20	0.49	3.20	6.22	0.06	-3.60	1.54	1.69	15.18
DAX INDEX	EUR	9,974.87	0.60	2.33	6.78	9.83	5.25	0.21	6.10	4.27	13.92
FTSE 100 INDEX	GBP	6,723.42	-0.07	-0.84	2.25	4.55	-1.65	-2.30	0.59	-0.82	14.09
SWISS MARKET INDEX	CHF	9,129.15	0.78	0.50	3.26	5.74	5.84	4.82	10.51	11.25	17.87
NIKKEI 225	JPY	17,248.50	-0.78	0.92	6.37	13.89	12.94	19.01	11.02	7.17	18.73
HANG SENG INDEX	HKD	24,004.28	-0.45	2.35	-0.04	1.99	-3.05	3.93	0.83	2.92	11.16
SHANGHAI SE COMPOSITE	CNY	2,630.49	1.00	7.88	10.85	14.76	22.18	30.86	20.88	26.79	10.79
S&P BSE SENSEX INDEX	INR	28,438.91	0.19	1.54	3.25	7.04	8.01	17.17	40.11	35.91	18.29
RUSSIAN RTS INDEX $	USD	1,006.43	-2.06	-7.64	-10.40	-6.83	-19.81	-24.80	-30.47	-32.22	4.96
BRAZIL IBOVESPA INDEX	BRL	54,721.32	-0.68	2.47	0.17	4.57	-9.24	3.95	5.54	6.24	12.17
EQUITY MARKET INDICES - BY SECTOR											P/E
MSCI ENERGY	USD	254.17	-1.79	-4.54	-3.97	-2.75	-15.41	-13.68	-5.25	-7.77	13.19
MSCI MATERIALS	USD	232.33	-0.60	-0.48	2.84	2.63	-7.02	-6.05	-0.95	-3.19	16.32
MSCI INDUSTRIALS	USD	203.61	-0.23	0.58	2.49	3.87	0.45	-0.21	3.69	0.82	17.25
MSCI CONS DISCRETIONARY	USD	185.30	-0.11	1.31	4.45	6.03	2.05	3.94	4.01	1.95	17.85
MSCI CONS STAPLES	USD	202.94	0.14	0.37	3.18	4.34	2.86	3.16	7.11	6.55	19.90
MSCI HEALTH CARE	USD	204.38	0.26	1.22	2.63	4.52	5.90	11.71	20.10	18.93	19.02
MSCI FINANCIALS	USD	104.42	-0.01	0.98	1.22	2.66	-0.19	1.46	3.63	2.48	13.87
MSCI INFO TECH	USD	143.11	-0.03	1.53	4.43	6.45	4.83	12.32	21.54	16.20	17.61
MSCI TELECOMS	USD	72.01	-0.10	0.61	2.24	3.40	0.94	-0.57	1.92	0.03	16.45
MSCI UTILITY	USD	122.72	-0.05	0.47	-0.15	1.05	1.51	1.61	11.65	11.69	16.64
MSCI WORLD REAL ESTATE	USD	196.11	-0.16	0.78	0.73	2.57	0.32	4.24	11.31	12.08	24.25
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,227.02	0.02	0.45	0.28	0.83	-1.54	-0.23	1.06	0.12	
HFRX EQUAL WEIGHTED	USD	1,197.40	0.04	0.37	-0.16	0.13	-1.79	-0.83	0.81	0.03	
HFRX GLOBAL EUR	EUR	1,133.19	0.01	0.45	0.26	0.79	-1.69	-0.46	0.68	-0.22	

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27/11/2014

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			PRICE CHANGE IN % (unless indicated)							
FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)										
US 3 MONTH	USD	0.02	0.01	0.01	0.01	0.01	-0.01	-0.02	-0.05	-0.05
US 2 YEAR	USD	0.51	-0.01	0.01	0.02	0.11	0.01	0.14	0.22	0.13
US 10 YEAR	USD	2.21	-0.04	-0.10	-0.13	-0.09	-0.13	-0.24	-0.53	-0.82
FIXED INCOME INDICES - BY TYPE OF ISSUER										
GLOBAL AGG TR HEDGED	USD	472.57	0.10	0.60	0.82	0.79	1.33	3.28	6.34	6.91
US GOVERNMENT TR	USD	2,070.24	0.00	0.55	0.58	0.31	1.28	2.01	3.55	4.57
US CORPORATE TR	USD	2,581.58	0.00	1.13	0.51	0.18	0.49	2.09	6.89	7.22
US HIGH YIELD TR	USD	1,647.71	0.00	0.47	-0.55	-0.47	-1.41	-0.11	4.83	4.14
EU GOVERNMENT TR	EUR	236.45	0.30	0.91	1.19	1.60	1.45	5.48	10.59	11.18
EU CORPORATE TR	USD	244.24	0.04	0.30	0.58	0.77	1.31	3.54	7.43	7.80
EU HIGH YIELD TR	EUR	269.15	0.10	0.52	0.96	1.01	0.36	1.29	6.86	5.98
JACI GLOBAL	USD	251.14	0.18	0.71	0.58	1.27	-2.89	-4.31	0.69	-0.88
GLOBAL EM TR (HEDGED)	USD	327.91	0.01	0.58	-0.32	0.08	-0.46	1.66	7.79	7.49
S&P/LSTA U.S. LEV LOAN	USD	97.22	-0.01	0.04	0.03	0.49	-1.05	-1.42	-0.94	-1.03
COMMODITY INDICES - BY TYPE OF ISSUER										
GSCI INDEX TOTAL RETURN	USD	3,997.79	0.00	-0.29	-4.86	-4.42	-15.09	-21.10	-15.93	-17.22
GSCI ENERGY TR	USD	861.38	0.00	-0.90	-7.48	-7.30	-20.75	-26.23	-21.60	-23.51
GSCI INDUSTRIAL METALS TR	USD	1,360.72	0.00	0.23	-0.37	1.80	-5.24	0.20	3.14	-0.44
GSCI PRECIOUS METALS TR	USD	1,485.38	0.00	0.39	2.21	-2.94	-7.85	-8.38	-5.50	-2.49
GSCI AGRICULTURE TR	USD	547.71	0.00	3.16	1.03	4.10	-1.68	-19.16	-12.27	-9.71
GENERIC 1ST 'CL' FUTURE	USD	73.69	-6.62	-9.28	-14.85	-15.77	-26.68	-29.02	-19.60	-24.74
GOLD SPOT $/OZ	USD	1,191.07	-0.60	-1.46	0.89	-3.63	-8.20	-5.90	-4.84	-1.80
CURRENCIES										
DOLLAR INDEX SPOT	USD	87.61	0.69	-0.11	1.49	3.28	6.95	9.48	9.46	10.21
Euro Spot	EUR	1.25	-0.25	0.36	-0.71	-2.34	-5.66	-8.50	-8.60	-9.51
Japanese Yen Spot	JPY	117.71	-0.41	-0.34	-4.97	-8.49	-12.24	-13.83	-13.42	-10.90
British Pound Spot	GBP	1.57	-0.25	0.26	-1.86	-2.68	-5.36	-6.07	-3.95	-5.19
Brazilian Real Spot	BRL	2.53	-1.17	1.66	-2.11	-0.40	-11.22	-11.59	-7.93	-6.68
China Renminbi Spot	CNY	6.14	-0.10	-0.33	-0.52	-0.50	-0.02	1.80	-0.85	-1.48
Singapore Dollar Spot	SGD	1.30	-0.36	-0.33	-1.42	-2.45	-4.16	-3.67	-3.70	-3.14
Norwegian Krone Spot	NOK	6.93	-0.83	-2.54	-3.35	-5.34	-11.53	-14.46	-12.84	-13.08
VOLATILITY / LIQUIDITY INDICES										
CBOE SPX VOLATILITY INDX	USD	12.07	-1.47	-13.54	-13.97	-24.75	2.46	4.87	-7.01	-12.03
USD SWAP SPREAD SEMI 2YR		19.50	1.95	-8.09	-7.02	-20.67	-7.02	62.42	133.88	89.33
TED SPREAD		22.85	-0.87	-1.89	0.66	0.44	9.17	11.68	29.24	26.80

All data is compiled from Bloomberg

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