

Bedrock Newsletter Friday, December 19th 2014

This is our last Newsletter for 2014! We wish you a wonderful Hanukah, a merry Christmas, happy New Year and a joyous Mawlid an-Nabi!

In today's Newsletter you will find an additional page - Our Crystal Ball based predictions for next year.

We always knew that commodities were a volatile and dangerous bunch! The recent movements in oil prices just reconfirmed this knowledge - Yesterday oil had been up 3.5% before turning (for no apparent reason) to close the day down 3%, only to open on Friday morning up 1.5%. Clearly we are not the only observers who can't figure-out a fair base price for the sticky black essence of modern society.

Equities which have been trading in tandem with the oil movements until a couple of days ago broke the pattern and rose quite dramatically in the past two days. Volatile you say? Yes indeed, but then, what you see and observe isn't always the reality - somehow, despite these huge swings in the stock indices, the VIX as a measure of volatility has fallen from a spike to 23, back down to 16. As says Nassim Taleb (of Black Swan notoriety) - "Never think that lack of variability is stability. Don't confuse lack of volatility with stability, ever..."

At the same time, US Treasuries' prices fell, with 10 year yields rising the most in 17 months, with the entire yield curve edging higher and steepening somewhat after Yellen's conference on Wednesday. Yes, the Fed is set to start raising rates beyond April into Q3 of next year, if conditions warrant...

But then, with consumer prices falling 0.3% and the producer prices sliding by 0.2% in November with most of the oil price decline yet to manifest itself in prices, inflation is clearly way below the Fed's targets. So why would they raise rates? And what if they did raise rates? By how much will they move? 0.25%? 0.50%? How terrible would this be? When corporations have more cash than ever and are not borrowing, will this rise have a detrimental effect? On whom? Homebuyers? Possibly a positive effect on retirees' pensions? So why get so agitated about conjugations of the words "patience" and "considerable time"?

Yes, maybe more investors started to peer beyond these fine details and then treated Yellen's talk as an addition of nitro-glycerine to the markets fuel tank - explosive two trading days followed, and we expect a third one for today! At school we learned that for so long as interest rates are below inflation rates, it fuels the economy.

Well, we do recall that last week we got US consumer confidence data at 93.8, way ahead of expectations... In the background we had the Russian story - with oil prices falling hard, the Russian currency has collapsed into a seemingly bottomless tar-pit. The Russian Central Bank acted with a dramatic increase in interest rates (to 17%) at midnight on Tuesday as the Rouble hit 80 to the US\$. The press was filled with analysis of the true value of their 400Bn or so of reserves. What part is liquid? How much gold might they sell? Clearly, not very much of the latter, as gold prices have been amazingly steady all week. Is Putin really boxed into a corner? As Obama is contemplating signing into law yet heavier sanctions against Russia, the Rouble has edged back to 60. Well, we all know that Obama is a "lame duck" president and those birds have no teeth...

Clearly, oil has been fuelling the markets for the past few days. Only a few months ago (or say \$30/barrel ago), the talk was of how this drop will fuel consumer demand in America and elsewhere being the equivalent of a tax cut... Then some analysts computed that for Americans, this tax-cut would be similar to the tax-increase implicit in the Obama-care program... Some others were reading in their oil-covered tea leaves a global slowdown as the driver of this fall.

Well, we choose to listen to Schwartzman, chairman of Blackstone who said last week, "...going to be a fallout. It's going to be one of the best opportunities we've had in many, many years." This view was supported independently by David Rubenstein, founder of the Carlyle Group saying about oil industry stocks, "This is a great time to buy..." But, not everyone agrees - weak demand and oversupply in oil markets raise the risk of global social instability and the potential for financial defaults, the International Energy Agency (IEA) warned, as it cut its forecasts for global oil demand growth in 2015. "Continued price declines would for some countries and companies make an already difficult situation even worse," We would point out that the energy sector now accounts for 8.05% of the S&P 500 weighting, half that of financials, and down from their 10.24% weight at year-end 2013. Disruptive times... The fall in oil comes at a bad time when governments are finally starting to work on global warming. Alternative and renewable energies are a difficult sell with oil at \$100, hardly easier at \$50. And we must not lose sight of the second disruption happening in parallel - the rise of the all mighty US Dollar. We certainly have much to ponder into next year!

As Hellen Keller said "The only thing worse than being blind is having sight but no vision". We try to bring some of the latter hereunder!

Looking Into Our Crystal Ball – The Year of 2015

With just five trading days before the close of the 2014 season, we powered-up our crystal ball and attempted to read its tea-leaves, to give you a shorthand view of a likely outlook for next year. Here is what we see;

General Overview - The economic and financial world continue their healing process from the 2008 collapse. We believe that this process will proceed at a steady pace in the USA and is likely to show some fruits growing off the ECB-tree in Europe. Japan, under Abe's leadership, may finally have found the proper road to growth and then, the emerging world may best benefit from the drop in energy costs and re-accelerate their growth (except perhaps the more fragile producer countries such as Venezuela and Russia). This said we do not expect an economic implosion in Russia, whilst Venezuela is under threat of severe social unrest and a possible default with some of their debt trading below 40%. Elsewhere, ISIS is unfortunately likely to pursue its fight against all others, Iran will continue to negotiate on a road to nuclear-nowhere and Cuba may leave the "bad boys" club. But we will keep our eyes peeled on the horizon, watching for unexpected black swans... One such possible "swan" in particular merits attention - Cyber hacking for ransom. We do expect more Sony-type attacks where the target might be a government's infrastructure and the demanded ransom may be more significant than the withdrawal of a movie... With these fundamental views we predict the following:

Central Banks and yield:

- The Federal Reserve is likely to hold short term interest rates at or about zero through till mid-year. If indeed the US Economy will show strong growth, we can expect the Fed Funds base rate to rise towards 0.25% and possibly to 0.50% over the last two quarters of 2015. We reiterate our long-standing conviction that inflation, as measured by both CPI and PPI will remain at the lower end of the range between zero and the Fed's targeted 2%. As inflation expectations are the primary driver of the longer-end of the yield curve, with our outlook, it is unlikely that the US Treasury yields will rise significantly. When looking at the benchmark 10 year Treasury Note we are comfortable predicting a yield level of 2.35% to 2.75% (up from today's 2.23%).
- The European Central Bank is faced with a low inflation if not a deflationary outlook. As such, it is more likely to implement its own QE programs and therefore we would expect Euro interest rates to remain at zero and a flat yield curve, likely to trade between 0.50% to 0.75% for the reference ten year German Bund (trading near the current 0.62% yield).
- The Bank of Japan will hold its rates at zero and its entire JGB yield curve will remain within a cat's whisker of this base case scenario.
- High Yield Corporates/Emerging Markets - Yield spreads which opened up towards the close of 2014 are likely to tighten again as economies will be showing strength. We would venture that this sub-category of bonds are likely to perform best for 2015.

Currency Exchange Rates:

We feel confident in predicting a continuation of the Reign of the US Dollar. Interest rate differentials are expected to further favour the Dollar against the Euro (and its twin the Swiss Franc) and the Japanese Yen. Our crystal ball can't predict precise levels but we permit ourselves to extract probable ranges for 2015; US\$/Euro 1.10 to 1.25 (as a reminder, the Euro came into being in 1999 at \$1.17), the US\$/JPY to trade in the range of 119 to 135 and then emerging markets' currencies in general to strengthen from today's depressed levels as their economies regain higher growth rates with generally higher interest rates than on the OECD monies. The "big guy" in the emerging universe is China and we expect the Yuan to pursue its slow appreciation against the US\$ from 6.22 today, towards 6.00 in the future. The Brazilian currency which was hurt this year is likely to pursue a downwards trend in 2015.

Bedrock Newsletter

Commodities:

After a general rout in 2014 for oil in particular and the entire commodity sector in general, given our expectation that world GDP will continue in its growth trend in the range of 3-3.5% throughout 2015, it is likely that we are approaching the lows in most input commodities and for oil in particular. We would expect the WTI Oil to trade in a \$50-\$65 range during the upcoming year.

As we have a view that the Dollar will reign with a firm grip on the markets we therefore think it is hardly likely that Gold will have a large upside bias when priced in USD.

Equities:

After a volatile year with a reasonable return to “normal” valuation matrices, we believe that the normalisation of valuations will continue into 2015. We now peer into our Crystal Ball and concentrate on the part titled “Capital Asset Pricing Model” and attempt to calculate a reasonable value for the S&P 500 index for year-end 2015. We see that the earnings of the S&P for 2014 are expected to be about \$123.04 (Bloomberg) for an estimated trailing P/E of 16.75 with S&P index at 2'061 as of today;

As we expect global GDP to expand at about 3.50% for 2015, and that this growth will express itself in a similar growth for S&P 500 earnings, we see a probable earnings' value for next year at \$127.35. As normalisation sets in and risks are seen to abate, it is likely that we experience a further expansion of the P/E ratio to about 17.50. If indeed both these predictions materialise, then we can comfortably deduce a target for the S&P 500 index at year-end 2015 of 2'229, or a rise of about 8% from Thursday's closing level of 2'061. We have seen other ‘prophecies’ for this particular future valuation ranging from 1'000 to 3'000 and we feel compelled to recite the ancient saying “*making predictions is very hard, especially about the future...*”

If indeed the S&P index will follow our formula and hypotheses, we can expect that other equity markets around the world will share directionality, with each market's own “Beta” or correlation. As we expect continued ECB and BOJ liquidity injections, we may find that the Nikkei and EuroStoxx indices generate yet higher returns in the upcoming future.

Using this same methodology we had predicted a year ago a close of 2014 for the S&P at about 2'100 and we are hopeful that the last few days of trading will bring the S&P yet closer...

This Week's Highlights:

- The Dollar story continued apace this week seeing EURUSD drop back to the lows of 1.2280. The CHF retreated on the strength of the USD and saw the pair hit a new high for the year of 0.9848 as the SNB cut the 3 month Libor target rate to negative 0.25%. The JPY strengthened till Wednesday as the world weighed up the re-election with the super majority of PM Shinzo Abe; however, this was short lived as the USD rally has caused the pair to rally to 119.50 this morning. The Ruble has had a torrid week. The central bank intervened in the market on Tuesday and hiked the interest rate to 17%. The currency collapsed, losing 24% of its value in two trading days. The Ruble fell and the USD soared from 58 RUB/\$ to almost touch 80RUB/\$. As the Central Bank has now started selling its reserves to prop up the currency it has settled back to 60.00 Ruble per US Dollar.
- The US 10Yr Treasury saw yields back up this week as the US jobless report was as expected, the Equities rallied, Yellen gave another dovish speech and the oil movements have taken a short breather (albeit at the lows) as a result the US 10 Yr yield moved from 2.0% to 2.23% this morning. The German 10 Yr Bund is unchanged on the week; however, it did put in a new low in terms of yield on Wednesday at 0.565%!! The periphery in Europe saw their yields fall this week, compressing the spread over the Bund. Italy's 10 Yr fell to 1.95% with Spain falling to 1.74%. Japanese 10Yr yields moved lower and saw them fall to 0.35% hitting new lows again for their 10 year debt – the lowest even through the 20 years of stagflation! The UK topped of the week with the yields rising to 1.90% from 1.70% on the UK BOE statements.
- Equities turned a corner as oil stalled its meteoric price collapse. The S&P500 rallied by nearly 3% this week seeing the Dow Jones following suit with a similar magnitude return. Europe was less positive, but positive nonetheless. The DAX rallied by 1.5%, the CAC40 by 3%, FTSEMIB by 0.6% and the UK FTSE up 3% as well. In Japan the Nikkei rallied 1.5% on the week but the Hang Seng dropped 0.5% in China. In the Emerging Markets, the Bovespa was almost unchanged but the Russian markets took a yet further pummelling, seeing the RTS Index literally collapse in the space of two days from 802 to 578.21 – a 28% drop in the value of its Index in two sessions!! It has since recovered to be trading at about 762... this is terrible in anyone's history books. Let's see if the Central Bank and Tsar Putin can weather the US sanction storm into the next election.

Bedrock Newsletter

Highlighted items are interesting data points for the week

MARKET INDICES PERFORMANCE

18/12/2014

INDEX NAME	CCY	Last Price	PRICE CHANGE IN % (unless indicated)								P/E
			1D	5D	MTD	1M	3M	6M	1Y	YTD	
EQUITY MARKET INDICES - BY REGION											
MSCI WORLD	USD	1,706.33	2.03	1.87	-1.91	-1.07	-1.95	-2.41	5.43	2.72	16.19
MSCI WORLD HEDGED	USD	701.40	2.28	0.66	-1.32	-0.32	0.86	3.39	12.35	9.10	-
MSCI WORLD LOCAL	-	1,269.18	2.28	0.64	-1.39	-0.41	0.51	2.66	10.29	7.15	-
MSCI AC WORLD	USD	415.44	2.01	1.64	-2.44	-1.54	-2.98	-3.34	4.21	1.69	15.60
MSCI EM	USD	935.12	1.85	-0.35	-6.93	-5.53	-11.27	-10.94	-5.61	-6.74	11.75
S&P 500 INDEX	USD	2,061.23	2.42	1.27	-0.31	0.61	2.53	5.19	13.91	11.52	17.16
DOW JONES INDUS. AVG	USD	17,778.15	2.44	1.03	-0.28	0.52	2.88	5.06	9.88	7.25	15.70
NASDAQ COMPOSITE INDEX	USD	4,748.40	2.24	0.85	-0.90	1.55	3.68	8.92	17.01	13.69	19.52
RUSSELL 2000 INDEX	USD	1,192.16	1.48	2.16	1.61	2.98	3.94	0.69	5.93	2.45	19.68
EURO STOXX 50	EUR	3,153.77	3.33	3.42	-2.42	1.57	-3.09	-4.30	4.65	2.03	14.52
CAC 40 INDEX	EUR	4,249.49	3.35	4.14	-2.53	0.30	-4.08	-6.22	2.44	-0.39	14.83
DAX INDEX	EUR	9,811.06	2.79	2.78	-1.20	4.10	0.63	-1.43	5.63	3.23	13.84
FTSE 100 INDEX	GBP	6,466.00	2.05	3.24	-3.24	-2.87	-4.88	-4.46	-1.22	-3.62	13.83
SWISS MARKET INDEX	CHF	9,013.11	2.70	1.56	-1.27	0.56	2.19	4.15	12.53	10.13	17.43
NIKKEI 225	JPY	17,210.05	2.32	1.44	0.93	1.92	7.97	14.71	11.11	8.16	18.77
HANG SENG INDEX	HKD	22,832.21	1.09	-0.57	-3.63	-1.10	-4.89	-0.22	1.00	-0.81	10.90
SHANGHAI SE COMPOSITE	CNY	3,057.52	-0.11	5.80	15.87	26.83	33.45	53.61	46.09	46.91	12.77
S&P BSE SENSEX INDEX	INR	27,126.57	1.56	0.42	-4.28	-2.03	1.38	8.98	32.62	29.73	17.55
RUSSIAN RTS INDEX \$	USD	764.93	6.50	-5.67	-22.62	-26.18	-35.58	-45.04	-47.32	-47.75	4.45
BRAZIL IBOVESPA INDEX	BRL	48,495.70	-0.45	-2.74	-11.38	-9.19	-16.08	-12.15	-6.08	-5.85	11.07
EQUITY MARKET INDICES - BY SECTOR											
MSCI ENERGY	USD	234.54	1.98	6.32	-2.57	-9.58	-18.87	-24.33	-12.52	-14.89	12.57
MSCI MATERIALS	USD	220.56	1.65	1.73	-3.31	-4.04	-9.22	-12.64	-4.87	-8.10	15.78
MSCI INDUSTRIALS	USD	198.15	2.14	2.18	-1.83	-1.17	-2.08	-4.75	0.96	-1.89	16.91
MSCI CONS DISCRETIONARY	USD	183.23	1.60	0.68	-2.12	0.99	1.50	1.04	3.56	0.81	17.66
MSCI CONS STAPLES	USD	199.79	2.00	1.40	-2.39	-1.05	1.48	-0.70	6.99	4.89	19.81
MSCI HEALTH CARE	USD	204.67	2.44	1.69	-0.27	1.34	3.85	9.38	21.39	19.10	19.11
MSCI FINANCIALS	USD	102.07	1.73	0.90	-2.19	-0.89	-2.61	-2.92	2.91	0.18	13.67
MSCI INFO TECH	USD	141.89	2.83	2.43	-1.17	1.60	3.04	8.42	18.86	15.21	17.36
MSCI TELECOMS	USD	68.90	1.46	1.50	-4.94	-3.72	-4.16	-5.72	-2.13	-4.29	15.93
MSCI UTILITY	USD	122.87	1.82	1.71	-0.37	0.51	2.43	-1.62	13.76	11.82	16.65
MSCI WORLD REAL ESTATE	USD	192.69	0.65	-0.10	-1.94	-0.51	2.98	1.33	12.02	10.12	24.12
HEDGE FUND INDICES											
HFRX GLOBAL HEDGE FUND	USD	1,196.75	0.60	-0.83	-2.51	-1.83	-4.01	-3.66	-1.37	-2.35	-
HFRX EQUAL WEIGHTED	USD	1,174.45	0.41	-0.71	-1.94	-1.40	-3.65	-3.41	-1.17	-1.89	-
HFRX GLOBAL EUR	EUR	1,104.43	0.56	-0.86	-2.59	-1.90	-4.20	-3.94	-1.78	-2.76	-

MARKET INDICES PERFORMANCE

18/12/2014

INDEX NAME	CCY	Last Price	PRICE CHANGE IN % (unless indicated)								
			1D	5D	MTD	1M	3M	6M	1Y	YTD	
FIXED INCOME INDICES - YIELD ON US GOVERNMENT BONDS (Change in bps)											
US 3 MONTH	USD	0.04	0.00	0.02	0.03	0.04	0.03	0.03	-0.03	-0.03	-
US 2 YEAR	USD	0.64	0.01	0.10	0.17	0.12	0.07	0.19	0.27	0.26	-
US 10 YEAR	USD	2.23	0.02	0.15	0.06	-0.13	-0.35	-0.39	-0.70	-0.80	-
FIXED INCOME INDICES - BY TYPE OF ISSUER											
GLOBAL AGG TR HEDGED	USD	473.56	-0.10	0.09	0.10	0.86	2.35	3.46	6.84	7.13	-
US GOVERNMENT TR	USD	2,072.15	-0.25	-0.10	-0.10	0.53	2.19	2.48	4.22	4.67	-
US CORPORATE TR	USD	2,573.57	-0.06	-0.23	-0.48	0.58	1.61	1.82	6.78	6.89	-
US HIGH YIELD TR	USD	1,606.59	1.21	0.14	-2.32	-2.27	-3.02	-3.51	1.91	1.54	-
EU GOVERNMENT TR	EUR	237.88	-0.07	0.40	0.52	1.51	2.95	5.66	11.59	11.85	-
EU CORPORATE TR	USD	244.77	0.01	0.15	0.22	0.42	1.59	3.45	7.98	8.04	-
EU HIGH YIELD TR	EUR	268.02	0.30	-0.30	-0.49	-0.09	0.00	-0.03	5.92	5.53	-
JACI GLOBAL	USD	251.85	0.22	-0.42	-0.14	0.78	-2.33	-4.49	1.36	-0.59	-
GLOBAL EM TR (HEDGED)	USD	317.06	1.09	-0.91	-3.36	-2.78	-2.66	-2.17	3.94	3.93	-
S&P/LSTA U.S. LEV LOAN	USD	94.75	0.82	-0.82	-2.52	-2.51	-3.09	-4.14	-3.45	-3.55	-
COMMODITY INDICES - BY TYPE OF ISSUER											
GSCI INDEX TOTAL RETURN	USD	3,348.93	-1.63	-4.63	-10.53	-16.62	-26.29	-34.88	-30.17	-30.66	-
GSCI ENERGY TR	USD	658.20	-3.01	-7.35	-16.10	-24.39	-37.32	-45.32	-40.95	-41.55	-
GSCI INDUSTRIAL METALS TR	USD	1,260.00	-0.63	-2.60	-3.28	-4.95	-6.80	-4.71	-5.56	-6.35	-
GSCI PRECIOUS METALS TR	USD	1,475.80	0.03	-3.00	1.73	-0.42	-4.06	-7.97	-5.78	-3.12	-
GSCI AGRICULTURE TR	USD	569.60	0.93	3.47	4.61	6.08	11.60	-10.56	-6.68	-6.10	-
GENERIC 1ST 'CL' FUTURE	USD	54.11	0.39	-6.04	-17.88	-27.43	-40.77	-46.03	-40.99	-40.59	-
GOLD SPOT \$/OZ	USD	1,198.72	-0.08	-2.03	2.60	1.27	-1.48	-9.29	0.76	-0.66	-
CURRENCIES											
DOLLAR INDEX SPOT	USD	89.24	0.10	1.09	1.10	1.92	5.42	11.22	10.79	11.61	-
Euro Spot	EUR	1.23	-0.09	-1.50	-1.42	-2.22	-4.32	-9.80	-10.15	-10.68	-
Japanese Yen Spot	JPY	118.84	-0.50	-0.58	-0.68	-1.23	-8.71	-14.65	-12.72	-11.83	-
British Pound Spot	GBP	1.57	-0.01	-0.30	0.15	-0.08	-3.80	-8.04	-4.28	-5.36	-
Brazilian Real Spot	BRL	2.66	1.97	-0.39	-3.66	-3.00	-11.19	-16.34	-12.45	-11.29	-
China Renminbi Spot	CNY	6.22	-0.09	-0.53	-1.22	-1.61	-1.29	0.13	-2.41	-2.68	-
Singapore Dollar Spot	SGD	1.31	-0.23	-0.23	-0.95	-0.85	-3.77	-5.10	-3.86	-4.09	-
Norwegian Krone Spot	NOK	7.39	-0.02	-0.54	-4.88	-8.18	-14.04	-17.20	-16.78	-17.86	-
VOLATILITY / LIQUIDITY INDICES											
CBOE SPX VOLATILITY INDEX	USD	16.81	-13.53	-16.28	26.11	20.42	38.81	58.29	18.80	22.52	-
USD SWAP SPREAD SEMI 2YR	USD	22.00	0.59	-6.35	-0.54	5.99	-6.82	42.96	187.78	110.76	-
TED SPREAD	USD	21.16	-6.00	-3.95	-5.32	-4.60	-7.19	-1.95	14.81	17.43	-

All data is compiled from Bloomberg

Bedrock Newsletter

Disclaimer

This document is for information purposes only and has been prepared by Bedrock SA, representing the opinions and investment views of Bedrock SA as applied in its investment advisory and management activities. It is a private publication intended for private circulation only. It does not constitute a company survey, a financial research, an offer, a solicitation or a personal recommendation to buy or sell specific products or securities. Bedrock SA disclaims all liability for any losses or damages of any kind relating to such information, which may be changed at any time without notice. The risks inherent in certain investments, particularly derivative products, may not be suitable for all investors. The contents of this publication may have been used for transactions by Bedrock SA prior to their communication. Distribution or dissemination of this document and/or the sale of certain products mention herein are subject to restrictions. Copyright 2013 All rights reserved. Approved for circulation in the UK to professional clients only by Bedrock Asset Management (UK) Ltd which is authorized and regulated by the Financial Conduct Authority. This presentation is being made to you solely for your information and must not be copied, reproduced, further distributed to any other person or published, in whole or in part for any purpose.

© 2014 Bedrock S.A. 4, ch. Des Vergers, 1208 Geneva, Switzerland, T: +41 (0)22 592 5455 F: +41 (0)22 592 5459, www.bedrockgroup.ch