TheFinancialEngineer®

Weekly Observations

November 20, 2016

(1)

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Summary - November 8 to 20

- US Presidential Election November 8, 2016
- Stocks have stormed to record levels
- The rise in rates is very dangerous in equities as whole, not just in some sectors
- Traders interpreted President Elect Trump's spending promises as economic growth and inflation booster, thus bond prices decreased with higher yields
- Janet Yellen's latest speech make certain a rate hike in December, but Trump's fiscal policy created an uncertainty regarding the Fed's monetary policy in 2017
- The BoJ intention to keep interest rates near 0% by rising the gap between long-term and short-term interest rates.
- US core inflation decreased by 0.1% to 2.1%, Fed still waiting for the PCE index at the end of the month. Demand for the housing market increased.

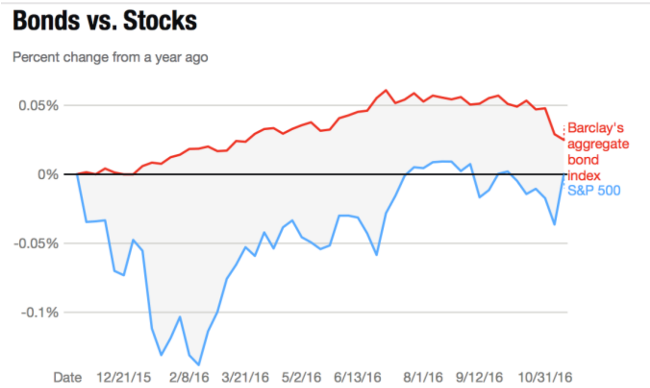
Summary - November 21

- Oil jumps to 3 week high as Putin freeze comments
- Dollar rally shows signs of fatigue
- Global Stocks mostly higher
- Fed rate hike odds approach 100%
- ECB President Draghi speech: Bank solvency improved, the profitability is still challenging for banks. Todays' low interest rate environment is necessary for a return to higher rates in the future. Structural reforms and more growth friendly fiscal policies should be implemented to boost the growth.
- Commodity – A brief story of gold (price) digging – An Elephant with a golden Trump

Bonds and stocks market dynamic

We know that higher inflation cause a decrease in bonds prices, that's because bond investors will receive fixed payments regardless of the level of inflation, this will erode the value of those fixed payments over time. However, equity markets can react and protect the value of stocks by rising prices or paying dividends to respond higher inflation.

This dynamic would only have effect in an inflationary environment, current non-existent inflation can change this dynamic.



Above chart shows that bonds and stocks market were correlated strongly over the past year, but this is changed the last week. Bond investors have been selling US Treasuries and other bonds, result of the new stimulus after Trump's election. Spending at a time of low unemployment and rising wages should cause prices to rise, eroding the value of bonds.

What would be the Fed reaction to Trump Impact?

Fed reaction could effectively be raising interest rates (rate hike in December is a near certainty), which won't be good for the bond market as well as the whole stock market. Stock market is already expensive, in terms of price to earnings ratio, as a result of central banks pushing easy money on markets and the lack of other investment opportunities.

The combination of high spending, high rates, and high unemployment growth combined with Trump's anti-growth measures such as trade barriers could cause to a stagflation. Economists from Goldman Sachs are warned against the risk of stagflation.

In her last speech Yellen confirms last week's bonds yield reaction and she interprets that as an expectation among investors that the federal government's deficit could increase based on Trump's budget and tax plans. And she gave an important signal that moved the probability of a rate hike up to 60 % in December: *"Waiting for further evidence does not reflect a lack of confidence in the economy. Rather, with the unemployment rate remaining steady this year despite above-trend job gains, and with inflation continuing to run below its target, the Committee judged that there was somewhat more room for the labour market to improve on a sustainable basis than the Committee had anticipated at the beginning of the year. Nonetheless, the Committee must remain forward looking in setting monetary policy. Were the FOMC to delay increases in the federal funds rate for too long, it could end*

up having to tighten policy relatively abruptly to keep the economy from significantly overshooting both of the Committee's longer-run policy goals. Moreover, holding the federal funds rate at its current level for too long could also encourage excessive risk-taking and ultimately undermine financial stability."
On the other hand, Yellen continues to worry about low business investment and declining productivity. In her statement, she confirmed that after the election, market's interpretation regarding the next fiscal policy stimulus could increase thus hurt the inflation, by saying that she has already gave a tightening signal to react to Trump's possible fiscal stimulus plan. Relatively, we could say that the impact of a December hike won't be so important, we should wait and see FED's real reaction after the Trump's fiscal policy agenda is clearly defined.

Japan surprises with plan to buy Unlimited JGBs at Fixed Rates

"Interest rates have risen in the US, but that doesn't mean that we have to automatically allow Japanese interest rates to increase in tandem" Mr Kuroda said. Japan took action in September and introduced "yield curve control", an attempt to keep short-term rates low while allowing longer term rates to rise. Thus the central bank of Japan send a signal to counter sharp rises in short (2Y gvt bonds) and midterm yields (5Y gvt bonds). However, there are not any financial firms that offered to sell Japanese government bonds at fixed rates on Thursday as rates were fixed at higher market levels, it's natural that nobody wanted to sell.

As we know banks provide long term financing with short term fund resources. Thus yield curve control of BoJ is aimed to increase the credit appetite by decreasing the worries of the banks' profitability if the gap between short and long term government bond rates rises by an increase of long term rates. However, on the other hand, the intention of raising long-term interest rates is opposed to the principles of an accommodative monetary policy program. The BOJ, this time clarified its intention to keep interest rates near 0%.

US Inflation rised to 2.1 %, Housing market in good shape

US Core CPI YoY decreased to 2.1% (october) by 0.1% and CPI MoM(october) raised to 0.4% from 0.3% in October (The Core consumer Price Index CPI measures the changes in the prices of goods and services, excluding food and energy and CPI is the consumer price index. A measure of the cost of living for the typical person. CPI is more volatile than core CPI and can give a misleading impression of underlying inflationary pressures.) Fed prefered inflation data is the Core personal consumption expenditures price index (less volatile measure of the PCE price index which excludes the more volatile and seasonal food and energy prices), that reading rose 1.2% from a year earlier in september, the Commerce Department will release its october inflation measure at the end of this month. Initial Jobless claims decreased by 19K to 235K, this is the lowest value recorded after 40 years. Building permits recorded 1.229mm, higher that forcast and US Philadelphia Fed Manufacturing Index decreased to 7.6 from 9.7.

21 NOV 2016

EUR/USD _ Less political uncertainty in Europe make euro rose from an 11 month low

French and German elections less uncertain gave some support to the currency. Socially conservative Fillon won the first round ballot with 44 percent of the vote. In Germany, Angela Merkel's annoncement that she would seek a fourth term in office is interprated as a positive signal for the euro. The euro increased to $1.0645 after having hit its weakest level on last friday ($1.05691) since december 2015 ($1.05168).

Global markets closed higher today

As oil prices jumped to their highest level in three weeks on, global markets had a strong uptrend. Major US indices as Dow, S&P500, Nasdaq, Russell 2000 closed at record levels. The reason of that OPEC could finaly reach a deal to cut production. European markets fallowed also this trend. Mario Draghi's confirmation of strong European financial sector and today's break of dollar's strength are other factors appreciated by investors.

SYMBOL	TIME & PRICE		CHG & % CHG		DAY'S LOW & HIGH	
^SPX	04:49pm EST	2,198.18	+16.28	+0.75%	2,186.43	2,198.70
^DJI	04:49pm EST	18,956.69	+88.76	+0.47%	18,883.10	18,960.76
NDAQ	04:00pm EST	65.97	+0.12	+0.18%	65.65	66.26
^FCHI	12:05pm EST	4,529.58	+25.23	+0.56%	4,479.69	4,540.90
^STOXX50E	11:50am EST	3,032.97	+12.14	+0.40%	3,003.82	3,042.27
^GDAXI	11:45am EST	10,685.13	+20.57	+0.19%	10,595.14	10,727.09
^IBEX	11:38am EST	8,614.60	-8.30	-0.10%	8,558.50	8,660.90
^FTSE	11:35am EST	6,777.96	+2.19	+0.03%	6,754.16	6,820.90
^STI	04:10am EST	2,816.67	-21.98	-0.77%	2,816.67	2,839.60
^HSI	03:09am EST	22,357.78	+13.57	+0.06%	22,227.80	22,480.75
000001.SS	02:00am EST	3,218.15	+25.29	+0.79%	3,188.28	3,229.76
^N225	01:00am EST	18,106.02	+138.61	+0.77%	-	-

ASIA _ Yuan depreciated by chinease government

China's central bank on Monday set the yuan lower against the US dollar for a 12th consecutive day in its daily fix, at 6.8985 against the dollar. Onshore, the yuan weakened 0.1% to 6.8945 against the US dollar in trading Monday. Offshore yuan was flat against the US dollar at 6.9118.

Foreign money had poored into China at an average rate of $387 billion a year between 2010-2014, while the developped world had encountered recessions and experienced slow recoveries. However, funds have fled emerging markets and headed to the US and japan since the US election. That drove the dollar higher and put the presure on the yuan as result.

Upward trend in cyclical stokcs is still in good shape

Investors in China bet a weeker yuan will push up inflation and benefit Chinese exports, boosting demand for cyclical shares, thus China stocks climbed to near 11 month high on Monday morning. As we said before, Trump's election could be an accelarating factor for outflows from emerging markets. Infrastructure sector is also joined to the uptrend by 2% increase with the push of a week yuan.

Draghi's speech

18 November 2016, the state and prospects of the euro area recovery

- In 2016, GDP in the euro area has been above its pre-criss level (7.5 years needed to get this level)
- Economy is recovering at a moderate and steady pace.
- Emplayement growth is more that 4 million since 2013.
- Healing in the euro area banking sector made the credit growt positive again and allowed monetary policy transmission strengthen.
- He confirmed to remain committed to preserve an important degree of monetary accommodation, which is necessary to converge inflation close to 2% in the merdium-term.

21 November 2016, Introductory statement to the plenary debate of the European Parliament on the ECB's Annual Report 2015

- "European fiscal sector stronger in terms of capital, leverage, funding and risk taking : Equity Tier 1 ratios improved from 7% for significant banking groups in 2008 to more than 14% today. "

- “The improvements in bank solvency and the related improvement in asset quality are tengible result of our common work to create the Banking Union.”
- Mario Draghi stated also that the profitability of euro area banks remain low. He stipulated factors behind this as fallow :
    - First factor is low growth and low inflation which translate into low interest rates.
    - Secondly, structural factors behind banks’ loww profitability where profitability is being affected by structural issues, such as overcapacity and inefficient cost structures.

A brief story of gold (price) digging

After 40 years of observations (1976 – 2016), the initial idea that gold price is closely correlated to a change in interest rates finally turned out to be a spurious bias.
This wrong correlation comes from an implicit rule which asserts that a rise in interest rates (for instance) is decided because of an upcoming inflation period and therefore a loss in value of the domestic currency.
If people get more money, more easily, they will (in theory) spend more and in fine create a phenomenon of inflation (central banker do you agree?). Among other things, the inflation is supposed to come with depreciation in the national currency and consequently a need for investors to protect/hedge their portfolios with a “safer money”: Gold.
This is the reason why gold has been used as a hedge against inflation and Central Banks have bought extensive amounts of gold over the past decades to cover the risk of inflation and potential currency losses of value.
These past 40 years include 7 periods of rates hike and all of them have shown a different reaction to gold prices: increase, decrease, flat trend... That being said, between 1986 and 2016, the price of gold rose up more than it went down after each announcement of an increase in interest rates showing that investors are still using this precious commodity to face any phenomena of depreciation, inflationary periods and still take it as a safe haven for their investments.
In 2016, the uncertainty in the actual economic system has pushed traders, portfolio managers and private investors to buy gold (physical, paper-gold, ETF...) considering it would still be a safer investment/hedge. The trend was definitely upward especially until after Brexit when gold price reached its record values in two years carried by a feeling of confusion regarding the economic impact of this referendum. After this summer, the US dollar regained ground, little by little, pushed by a stronger thought that the Fed would raise interest rates without affecting US growth leading to a small bearish trend on gold.
It seems like the adversity to riskier assets is slowly leaving investors’ minds, they prefer to take positions on stocks rather than gold or even silver.

An Elephant with a golden Trump

What happened to gold just after the U.S. Presidential elections? The answer isn't “Trump” but “India”!

Ahead of the elections last Tuesday, several investors betting on Trump's victory early started to buy gold assuming his political views would weakened the dollar and the economy as a whole. Immediately followed by many others, after Trump's win, gold buyers continued to lift up gold price until it suddenly crashed to a six-month low. “And why is that?” you would ask!

Firstly because, the markets didn't react as bad as many of us were thinking they would after Trump's nomination. Moreover the Russel 2000 index went up showing that investors believe in a strong U.S. Economy and this is shown in parallel by the rise of the USD. A strong economy and a strong currency can be received as a signal to buy riskier assets like equity or even high yield products (in some ways).

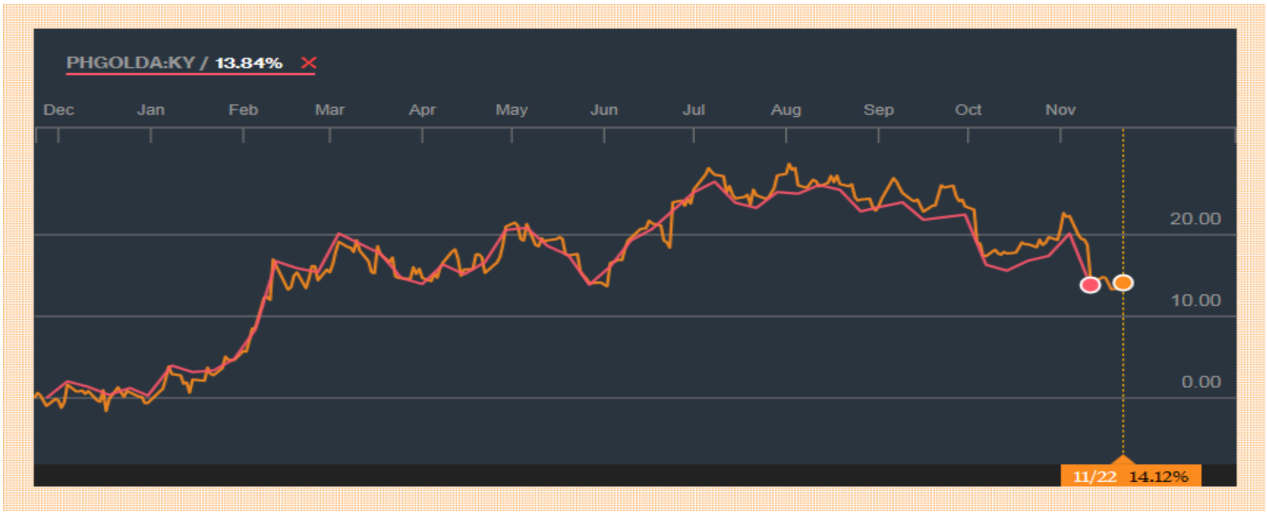
Also, many investors did not see that coming! When everybody was looking at the U.S. Elections' results and effects, many forgot about one of the most important actors in the gold sector: India.

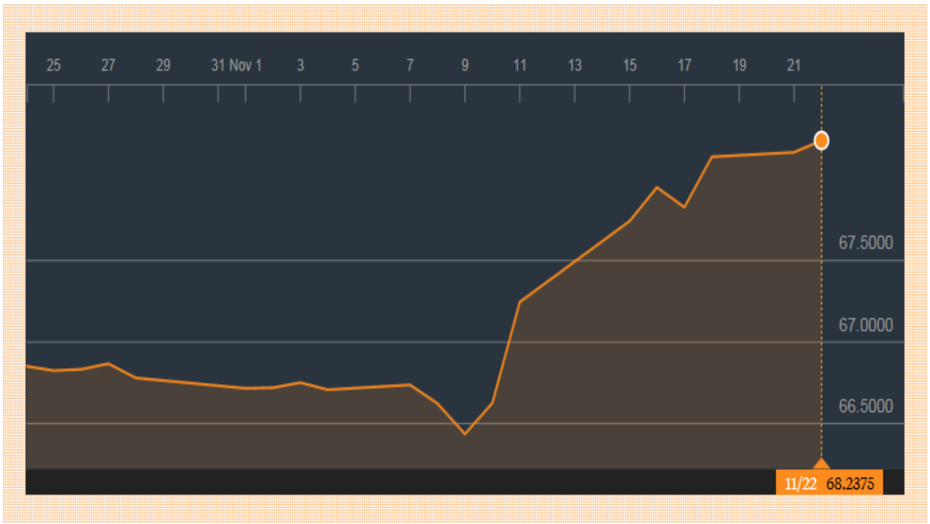
India is a major force affecting gold price. This effect is due to the fact that India is often the biggest buyer of physical gold in the world. Why is that? Because of India's underground economy. India's underground economy represent 25% of its total economy and people participating in these illegal transactions, corruptions, tax dodging, counterfeiting bills, uses mostly large Indian rupee bills (500 – 1000) that they convert to gold as a money-laundering system. This is why India is buying so much gold in general and as a consequence, has a strong influence on its price.

Narendra Modi, India's Prime Minister, in order to thwart and interfere with this growing illegal economy has directed last week, to ban large rupee bills (500 – 1000) which has subsequently led to an important drop of gold price.

Gold price diminished so did the INR (Indian Rupee) as expected. India's economy was quite affected by Modi's intervention but it also could end up being an opportunity for the people of India as illegal cash transactions will minimize, counterfeiting banknotes will considerably reduce and India's rather high inflation might cool down with decreasing goods prices.

2016: Comex Index facing SGOL (ETFS: Physical Swiss Gold)

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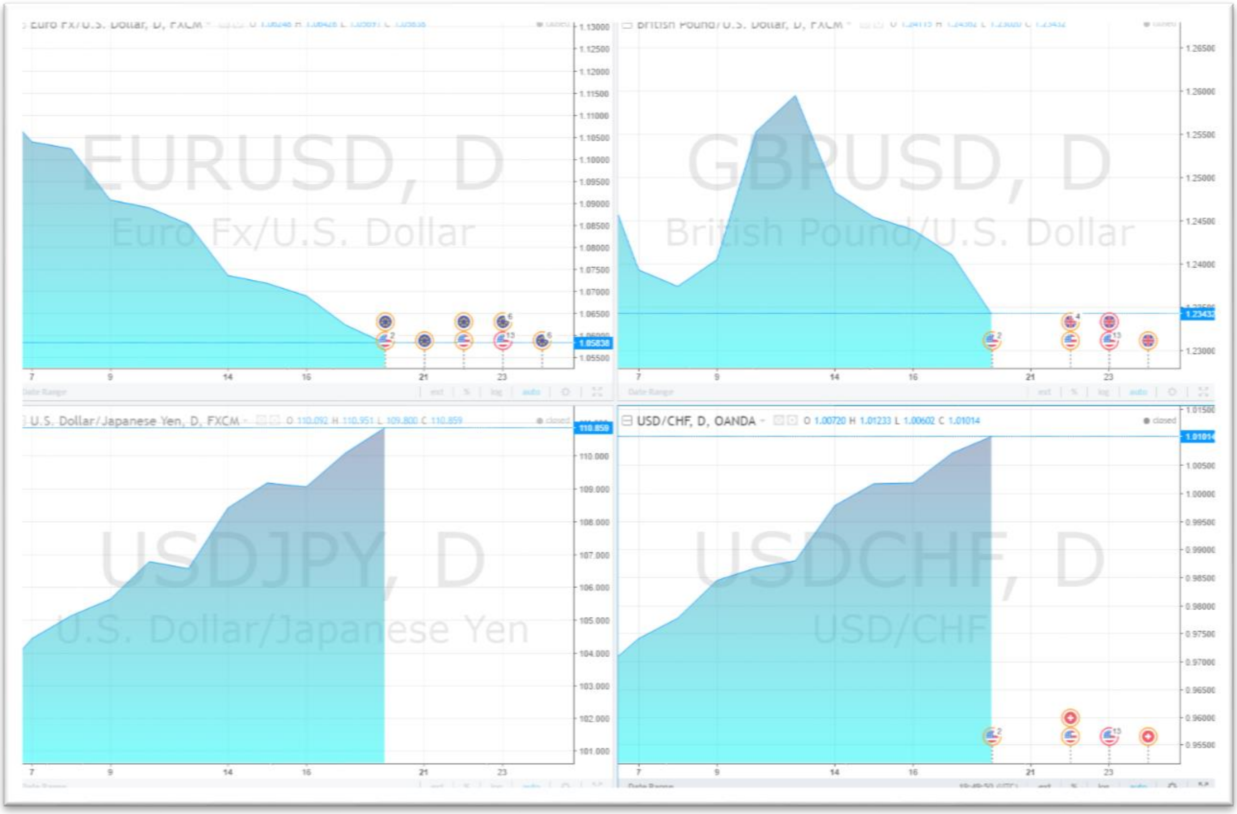
Last week's major currency movements



- Yen Falls Asian stocks rise, BOJ comes up empty in bond-buy operation
- US Dollar may extend rally if Yellen endorses steeper rate hike outlook
- Hawkish remarks from Bank of England BoE Governor Mark Carney failed to prop up the sterling even as the central bank head warned inflation will build towards the end of this year and into 2017 on the marked depreciation in the local currency. In turn, the pound-dollar stands at risk for further losses ahead of th eUK Budget Statement due out on November 23 as the exchange rate breaks down from a near-term range. Hogh uncertainty surrounding the economic outlook for the UK continues to cast a long-term bearish outlook for the sterling, and GBP/USD stands at risk of facing additional losses going into the end of the month.

Last week's most important calendar events

Time	Cur.	Imp.	Event	Actual	Forecast	Previous
			Monday, November 14, 2016			
All Day		Holiday	India - Guru Nanak Jayanti			
10:00	EUR		ECB President Draghi Speaks			
19:30	AUD		RBA Meeting Minutes			
			Tuesday, November 15, 2016			
All Day		Holiday	Brazil - Republic Day			
02:00	EUR		German GDP (QoQ) (Q3) P	0.2%	0.3%	0.4%
04:30	GBP		CPI (YoY) (Oct)	0.9%	1.1%	1.0%
05:00	GBP		Inflation Report Hearings			
05:00	EUR		German ZEW Economic Sentiment (Nov)	13.8	8.1	6.2
08:30	USD		Core Retail Sales (MoM) (Oct)	0.8%	0.5%	0.7%
08:30	USD		Retail Sales (MoM) (Oct)	0.8%	0.6%	1.0%
			Wednesday, November 16, 2016			
04:30	GBP		Average Earnings Index +Bonus (Sep)	2.3%	2.4%	2.3%
04:30	GBP		Claimant Count Change (Oct)	9.8K	2.0K	5.6K
08:30	USD		PPI (MoM) (Oct)	0.0%	0.3%	0.3%
10:30	USD		Crude Oil Inventories	5.274M	1.480M	2.432M
19:30	AUD		Employment Change (Oct)	9.8K	20.0K	-29.0K
			Thursday, November 17, 2016			
04:30	GBP		Retail Sales (MoM) (Oct)	1.9%	0.4%	0.1%
05:00	EUR		CPI (YoY) (Oct)	0.5%	0.5%	0.5%
08:30	USD		Building Permits (Oct)	1.229M	1.198M	1.225M
08:30	USD		Core CPI (MoM) (Oct)	0.1%	0.2%	0.1%
08:30	USD		Philadelphia Fed Manufacturing Index (Nov)	7.6	8.0	9.7
10:00	USD		Fed Chair Yellen Testifies			
			Friday, November 18, 2016			
03:30	EUR		ECB President Draghi Speaks			
08:30	CAD		Core CPI (MoM) (Oct)	0.2%	0.2%	0.2%

Most important investment calendar events of the week ahead

Time	Cur.	Imp.	Event	Actual	Forecast	Previous
			Monday, November 21, 2016			
11:00	EUR		ECB President Draghi Speaks			
			Tuesday, November 22, 2016			
08:30	CAD		Core Retail Sales (MoM) (Sep)		0.5%	0.0%
10:00	USD		Existing Home Sales (Oct)		5.42M	5.47M
			Wednesday, November 23, 2016			
All Day		Holiday	Japan - Labour Thanksgiving Day			
03:30	EUR		German Manufacturing PMI (Nov) P		54.7	55.0
08:30	USD		Core Durable Goods Orders (MoM) (Oct)		0.2%	0.1%
10:00	USD		New Home Sales (Oct)		592K	593K
10:30	USD		Crude Oil Inventories			5.274M
14:00	USD		FOMC Meeting Minutes			
			Thursday, November 24, 2016			
All Day		Holiday	United States - Thanksgiving Day			
02:00	EUR		German GDP (QoQ) (Q3)		0.2%	0.2%
04:00	EUR		German Ifo Business Climate Index (Nov)		110.6	110.5
			Friday, November 25, 2016			
04:30	GBP		GDP (QoQ) (Q3) P		0.5%	0.5%
04:30	GBP		GDP (YoY) (Q3) P		2.3%	2.3%

Legend

Speech
P Preliminary Release
Revised Release
Retrieving Data
Report
Low Volatility Expected
Moderate Volatility Expected
High Volatility Expected

Interesting Topics:

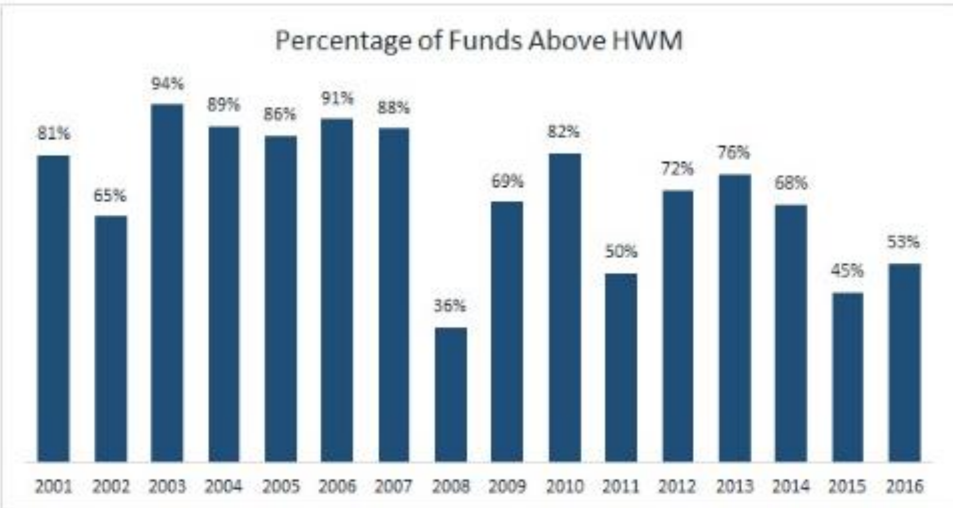
Wounded by 2015 losses, few hedge funds reattain hig-water marks despite widespread gains

by Miles **Kruppa, HEGE FUND INTELLIGENCE**
18 Nov 2016

Slightly more than half of funds stand to receive incentive fees this year.

Despite a surge of positive performance, many hedge funds look unlikely to earn performance fees this year following losses sustained in 2015. While 78% of Americas-based funds reporting to the Hedge Fund Intelligence database have achieved positive performance and a median gain of 3.98% through September, only 53% of managers were above their high-water marks in that period, according to an analysis of funds reporting to the Hedge Fund Intelligence database.

Since 2008, during which only 36% of funds earned performance fees, the percentage of funds attaining their high-water marks has fluctuated from a high of 82% in 2010 to a low of 45% in 2015.



This year's success rate, if it remains stable by year-end, would improve upon a two-year decline in the industry's standard metric for long-term profitability, though fourth-quarter performance could significantly impact the outcome.

Through Q3 of 2015, with a median return of just 0.56%, only 41% of funds in the database stood above their high-watermarks. That figure improved to 45% by year-end following a median gain for all funds of 0.23% in the fourth quarter. This year looks less hopeful. Americas-based funds fell 0.16% in October, according to early estimates, the first monthly decline since a 1.44% drop in January.

Of those funds that missed their high-water marks last year after hitting them in 2014, 55.73% have not made up the difference so far this year. Those underwater funds will need to produce a median return of 7.8% (and an average return of 10.61%) in the fourth quarter to reach their previous peaks. The most embattled fund will need to earn 197.78% to reach dry land.

$1.2 billion Mudrick Capital Management was the closest to reaching its high-water mark of those down last year after a positive 2014. The firm fell 26.30% in 2015 on early bets in the bonds of upstream energy and metal development companies. Those same bets propelled the firm to a 34% return this year through September. The firm has since generated an estimated October gain of 3.20%, putting it on dry land. Only 40.91% of funds in the distressed category, which includes Mudrick, have reached dry land so far.

Founder Jason Mudrick declined to comment on performance.

Bill Ackman's Pershing Square Capital Management may be the highest-profile manager struggling with profitability following a dip in 2015 from 2014 heights. After bets on Valeant and Herbalife soured in the second half of 2015, Pershing Square Holdings was down 21% from its previous year-end high-water mark, according to the firm's reports. As of Nov. 8, the gap had widened to 37%, and the fund will have to gain nearly 59% to re-attain its high-water mark.

Pershing Square will begin offering a new share class next year with a performance fee of 30% that only kicks in over returns of 5%, Reuters reported last month. Existing investors will also have the option of putting in additional money that will not be charged performance fees until the current high-water mark is reached.

Pershing Square representative Fran McGill declined to comment on the drop.

Some managers have endured even longer periods of ill health, with 10.86% of all funds on track to remain underwater for the fourth straight year. The situation for these funds remains dire: to return to profitability they need to generate a median return of 26.15% in the fourth quarter, with the return requirement for individual funds ranging from 1.36% to 1594.60%. (The chart below shows every permutation of performance for funds in the database based on whether the fund was above or below its high-water mark from the end of 2013 through the third quarter of 2016, and the returns necessary for underwater funds to re-attain their high-water marks[*].)

Credit and fixed income were among the best performing strategies so far this year, with 78.43% and 69.05% of funds projected to clear their high-water marks, respectively. This marks the fifth straight year that most credit funds have been expected to reach their previous peaks.

The majority of the funds in the U.S. Equity strategy, the largest in the database, have not reached their benchmarks despite 76.31% of those funds up for the year through September. The 43.68% of funds above water still marked an increase from last year, when just 30% were positioned to charge performance fees.

Managed futures and macro funds also suffered, with 32.46% and 37.29% expected to hit their high-water marks, respectively. The findings marked a drop for the macro strategy, which had 60% of funds above water at this time last year. The chart to the right shows the health of funds in each strategy.

Once again, larger funds were the most likely to clear their benchmarks by the end of the year. Of those managing more than $1 billion, 65.56% were on track.

The smallest funds faced greater difficulties, with 46% of funds managing less than $100 million expected to earn performance fees this year. It was an improvement from this time in 2015, when only 35% were on track.

The median fund above its high-water mark has cleared it by 5.28%. On the flip side, underwater funds need to earn a median return of 8.05% to meet their high-water marks with the least troubled fund needing only a 0.05% performance bump.

The healthiest funds — those meeting their high-water marks in the past three years and on track to hit again this year — totaled 25.68% of the funds counted.

Link :

http://www.hedgefundintelligence.com/article/b10gkr4gkhsc3m/wounded-by-2015-losses-few-hedge-funds-reattain-highwater-marks-despite-widespread-gains